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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/32

3:00 p.m., February 24, 1987

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	E. T. El Kogali
	P. E. Archibong, Temporary
	Jiang H.
	M. K. Bush
J. de Groote	
A. Donoso	
	S. K. Fayyad, Temporary
G. Grosche	
	A. Iljas, Temporary
	L. M. Piantini, Temporary
T. P. Lankester	
H. Lundstrom	
	D. McCormack
	J.-C. Obame, Temporary
	A. R. Al-Abdullatif, Temporary
	J. de la Herrán, Temporary
	G. Pineau, Temporary
G. A. Posthumus	
	I. Sliper, Temporary
	H. Alaoui-Abdallaoui, Temporary
	A. Vasudevan, Temporary
	T. Morita, Temporary
	F. Di Mauro, Temporary

L. Van Houtven, Secretary
S. L. Yeager, Assistant

Also Present

European Department: P. de Fontenay, Deputy Director; J.-P. Cotis, M. T. Hadjimichael, G. T. Saxerud, E. Spitaeller, H. Vittas. Exchange and Trade Relations Department: J. T. Boorman. Fiscal Affairs Department: A. A. Tait, Deputy Director; G. M. Bartoli. Legal Department: A. O. Liuksila. Middle Eastern Department: S. M. Thakur. Research Department: W. M. Corden, F. Larsen. Advisor to Executive Director: G. D. Hodgson. Assistants to Executive Directors: R. Fox, M. Hepp, O. Isleifsson, S. King, K.-H. Kleine, M. Lundsager, V. K. Malhotra, J. A. K. Munthali, G. Schurr, G. Seyler.

1. UNITED KINGDOM - 1986 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/87/31, 2/24/87) their consideration of the staff report for the 1986 Article IV consultation with the United Kingdom (SM/87/25, 1/28/87; and Sup. 1, 2/20/87). They also had before them a background paper on recent economic developments in the United Kingdom (SM/87/32, 2/10/87; and Sup. 1, 2/12/87).

Mr. Donoso made the following statement:

We are pleased to note the progress made by the U.K. economy, which in 1986 entered its sixth year of growth in an environment of increasing price stability. Underlying this progress is the strong commitment of the authorities to create appropriate conditions for growth and, certainly, good management of the available policy instruments.

The United Kingdom faced difficulties in the external environment in 1986, especially because of the decline in the price of oil. The deterioration in the terms of trade resulting from lower oil prices implied a loss of income equivalent to 1 percent of GDP. However, policies were oriented to meet this situation, and thanks in part to a depreciation of the exchange rate, the economy was able to grow at a rate of 2 1/2 percent, while the inflation rate was lower than in 1985, and the external current account was in equilibrium. These welcome developments are commendable. Several difficulties that remain, however, deserve analysis and specific actions to assure a good economic performance in the period ahead.

Traditionally, the United Kingdom has been a supplier of financial resources in international markets. The forecasts for 1987, however, show a worsening of the current account balance. In view of the importance of assuring a positive current account position in the longer run, ways should be found to increase the competitiveness of the economy and improve the non-oil trade accounts.

In addition to appropriate pricing policies, tight fiscal policy can play an important role in assuring a good external position. Efforts to lower public expenditures can directly affect the external balance and can also free resources to speed up investment in the non-oil exporting sector. In that regard, the impact of lower oil prices on government revenues and the authorities' privatization policies had a significant effect on the financial position of the public sector in 1986. In view of this and the recently announced increases in some government expenditures, it is important to have a more detailed projection of the components of the public sector borrowing requirement (PSBR) for the coming years.

Table 6 of the staff report shows a declining trend in the PSBR as a percentage of GDP over the next few years according to the projections for the authorities' medium-term strategy. The concept of the PSBR used in these projections, however, includes North Sea oil revenues, which are subject to a high degree of uncertainty over the medium term owing to fluctuations in international oil prices, as well as the proceeds of asset sales resulting from privatization efforts, which is a temporary financing item. For an overview of the medium or long term, a disaggregation of the PSBR would be more useful. Like several other Directors, we would be interested to see the expected evolution of different determinants of the PSBR so as to better evaluate the authorities' projections and facilitate the analysis of policies.

In general, we agree with the staff that at present fiscal policy has an important role to play in the economy and that the effort to lower the public sector deficit would reassure financial markets, relieve pressures on interest rates, and help sustain investment activity. At a time when it is important to strengthen the non-oil exporting sector, and when there are persistent unemployment problems, a tighter fiscal policy can enhance the flexibility of the economy to respond to those challenges.

The most serious problems remain in the labor sector. With average earnings and labor costs growing at about 7 percent a year, and the unemployment rate peaking at about 11 percent of the labor force during 1986, the situation is difficult to understand. Some good explanations for this situation are given in the staff papers, which present the dual character of the labor market, separate short- and long-term unemployment, and emphasize the increase in those unemployed for more than a year during this decade. The presentation of the "hysteresis" theory to explain unemployment in the United Kingdom is also interesting.

We commend the authorities' efforts to improve flexibility in the labor market. The staff analysis explains the attractiveness of the specific employment schemes and measures being applied, including the Community Program, hiring the long-term unemployed in projects to benefit the community, the Youth Training Scheme, and the Restart Program. Even so, some room still remains for new approaches to the problem of unemployment, for example, by complementing the present policies with schemes like profit sharing as a means of improving the functioning of the labor market.

On financial and monetary policies, considerable progress has been made as a result of the adoption of measures aimed at improving the deregulation of financial markets. We note with interest the so-called Big Bang exchange reform aimed at facilitating the United Kingdom's role as a major net exporter of financial services, by increasing international competition in financial markets and modernizing trading methods.

Monetary aggregates have become difficult to interpret, and monetary policy has remained difficult. The velocity of M3 has been volatile. But even though there has not been a close relationship between M3 and nominal GDP, the target for nominal GDP has been achieved. Some reasons that probably explain the M3 performance--as in other countries where the same phenomena is present--are the ongoing financial innovations and the increasing activity of nonbank financial intermediaries, which present a rising demand for financial assets. Taking into account the difficulties mentioned, we share the staff's view that the overall direction of monetary policy has been broadly appropriate.

Finally, I want to join the staff in urging the U.K. authorities to continue pressing within the European Community for a rollback of trade barriers and of subsidies to production and exports of farm products. The present trade situation is very damaging for the United Kingdom and for many developing countries who are relatively more efficient in agricultural production.

Mr. Archibong made the following statement:

I would like to commend the U.K. authorities for the continued expansion of their economy. It is encouraging to note that the growth in domestic economic activity in 1986 markedly reversed the slow growth trend that had developed in the second half of 1985 and thus re-established a strong growth path with prospects for further expansion in 1987. This favorable economic performance at a time when developments in international oil markets were unfavorable indicates the effectiveness of economic management. The fundamental transformation of the economy that has been under way for several years appears at last to be generating sustainable growth, which will have a positive impact on world trade.

There remain, however, many areas of concern that require continuing attention by the authorities. First and foremost is the behavior and performance of the labor market. Two main problems persist: the relatively high level of unemployment--which has characterized the U.K. economy over the years--and the apparently paradoxical situation of rapidly rising real wages in the face of growing unemployment. I note Mr. Lankester's interesting explanations for the existence of this puzzling situation. However, labor market rigidities lie at the heart of these problems. Inflexibilities are so prominent in the labor market that policy efforts should continue to devise ways and means of improving the functioning of the market. The various measures already taken by the authorities to promote flexibility are in the right direction. So far, these measures have borne some fruit, as reflected in productivity growth and in the slight but noticeable decline in the rate of growth of unemployment toward the end of 1986.

Nevertheless, wages continue to rise faster than productivity, resulting in high labor unit costs. The authorities are fully aware of the risks inherent in this unsustainable situation and have shown considerable courage and innovation in confronting it. One constructive proposal under consideration is the extension of profit sharing so that an employee's remuneration would depend partly or directly on a company's profitability. This new approach to labor compensation has already been tried in some companies in the United States with astounding results, and definitely has the potential of minimizing the rigidity of the fixed wage system.

The fiscal performance of the economy generally reflects prudence. In terms of the authorities' medium-term financial strategy, it is encouraging to note that the public sector borrowing requirement target for the current fiscal year has been kept, notwithstanding a significant decline in oil revenues. However, unless the existing buoyancy of the non-oil sector is strengthened, it is doubtful that the target could be maintained. In view of the authorities' intention to scale down the PSBR over time, I wonder how the Government intends to hold spending constant in real terms, unless there is a contingency reserve to support that policy stance.

Regarding the concept of the PSBR used as an indicator of fiscal policy, the point made by the staff is relevant: because asset sales are transitory in nature and have no restraining effect on aggregate demand or monetary conditions, their inclusion in the PSBR tends to render it a somewhat unreliable indicator of fiscal policy. I agree with the staff that an assessment of the impact of fiscal policy on economic activity or as a measurement of the government deficit the PSBR should exclude asset sales. However, the authorities appear to have taken account of the special nature of the proceeds from privatization in setting the PSBR. Perhaps Mr. Lankester or the staff could shed some further light on this matter.

Judged in terms of its main objective of reducing inflation, the authorities' eclectic approach to monetary policy is broadly appropriate, as the rate of inflation has decelerated substantially from 13 percent to 3 1/2 percent over the past six years. However, the continuing price and cost increases, particularly the upward pressures on real wage rates and unit labor costs, underscore the need to maintain a restrictive monetary policy. Furthermore, monetary policy is relying heavily on interest rates, which could undermine growth. Given the relatively high rates of interest in the United Kingdom and the large spread of rates in other markets, it appears that too much of the anti-inflation burden is being borne by monetary policy when compared with fiscal operations. Although Mr. Lankester has provided a justification for the high nominal and real interest rates, their potential adverse impact on growth remains. The authorities should, therefore, adopt an appropriate mix of fiscal and monetary policies in their pursuit of an anti-inflation policy.

Finally, I commend the United Kingdom for its continued commitment to an open international trading system and for its support of recent initiatives in the GATT. Like the staff, I urge the authorities to press for a rollback of protectionism within the European Community in order to ensure an open market to exports from developing countries. I would also urge them to increase their net disbursements of official development assistance, which, at 0.34 percent of GNP, are currently below the existing Development Assistance Committee average of 0.35 percent and still very much below the UN target of 0.7 percent of GNP.

The Deputy Director of the European Department, commenting on several technical questions, noted that the difference between the projection for potential output, which was estimated to grow by about 2 percent in 1987, and the 3 percent average rate of growth since 1981 arose because the average rate of growth reflected the recovery from a strong recession. Subsequently, the gap between potential output and actual output had closed; thus a 3 percent average growth rate was consistent with an estimated 2 percent growth in potential output. As for the behavior of the curves in Chart 7 of the staff report, one curve showed the number of unemployed and the other showed the unemployment rate in percentage terms; because the former was based on three-month moving averages, the two curves behaved differently. In addition, the behavior of the growth of the labor force was not taken into account in the part of the chart that was based on actual numbers only.

A Director had asked whether there was a reliable index of competitiveness that took into account the underlying rate of inflation, the Deputy Director continued. In that regard, it should be noted that the index of unit labor costs was subject to wide periodic variations; for instance, between the second and the third quarters of 1986 the rate of growth of unit labor costs on a 12-month basis had fallen from 6 1/2 percent to 3 percent. That variability suggested that "normalizing" unit labor costs, which smoothed out the changes in productivity, would produce a better index. The procedure for normalization was, however, a somewhat controversial subject, especially between the staff and the U.K. authorities. In the staff's view, perhaps the best measure of competitiveness would be the GDP deflator, which was less affected by short-term movements in productivity or the terms of trade.

A few Directors had suggested that the discussion of the Article IV consultation with the United Kingdom should take place after the announcement of the budget for the coming fiscal year, the Deputy Director noted. That was certainly possible, if the U.K. authorities agreed to do so. The staff mission should, however, be conducted at about the same time as in the past because--both from the point of view of the authorities and of the staff--it was useful to hold discussions when the budget was under preparation. As requested, the staff would circulate a note to Executive Directors on the 1987 budget in the near future. 1/

It had been noted that the unemployment statistics had been affected by changes in reporting rules, the Deputy Director commented. It was true that under the international standardized definitions of unemployment established by the International Labour Organisation, the U.K. unemployment rate in the first quarter of 1986 was 13.1 percent, whereas the rate reported by the U.K. authorities was 11.5 percent. Thus, there was a significant difference between the two reporting standards.

As to the effects of the Restart Program on reducing unemployment, all long-term unemployed had to be interviewed, and those who did not respond to the invitation for interviews were removed from the unemployment register, the Deputy Director explained. So far, between 10 percent and 20 percent of the long-term unemployed had not responded, for one reason or another, and as a result they were progressively being removed from the unemployment rolls. Some of the recent decline in recorded unemployment was therefore due to that program, but that was not the only factor. Since mid-1986 there had also been a recovery of economic activity, which was accompanied by some increase in employment.

A Director had rightly observed that the labor market might be tighter than it appeared, especially if the shortages of skilled labor and the increase in the number of vacancies were considered, the Deputy Director added. However, the latest business survey indicated that firms reporting shortages of skilled labor had declined from 12 percent to 9 percent, and a rate of 9 percent was well below previous peaks.

It had been suggested that perhaps monetary policy had been too expansionary in the recent period, the Deputy Director remarked. The evidence in that regard was conflicting. On the one hand, monetary aggregates were increasing rapidly, the exchange rate either was depreciating or had not responded to the recent oil price increase, and, as some Directors had noted, the price of housing had increased extremely rapidly in past years. Those factors suggested some easy monetary conditions. On the other hand, interest rates were high, both in nominal and real terms; they had been high since the beginning of 1985, and there was some tightening of rates in October 1986. The yield curve was fairly flat, which suggested that a tightening of the interest rate structure, rather than inflationary expectations, was pushing up interest rates.

A number of factors explained the rapid increase in the monetary aggregates--deregulation, financial innovation, and lower inflation, the Deputy Director continued. But, for the United Kingdom, there were also some special factors involved, for instance, heavy borrowing on the

1/ A staff paper on the 1987 budget was circulated to Executive Directors as SM/87/85 on April 6, 1987.

part of security firms before the "Big Bang." The privatization program had also been accompanied by an increase in demand for credit on the part of individuals or institutions who wanted to buy shares in the privatized companies. In addition, the latest figures for January 1987 suggested that monetary expansion was slowing down. M3 was down to 17 1/2 percent. The rate of expansion of MO for the 12 months to January had fallen to 4 percent, which suggested that the tightening of interest rates in October 1986 had already affected the rate of increase of that aggregate.

Investment was relatively weak, and consumption was providing the main stimulus to economic activity, which suggested that a tightening of monetary policy would not be desirable at the present stage, the Deputy Director commented. In addition, consumer credit had not been very responsive to higher interest rates. If domestic demand was too buoyant, the staff considered that the best way of dampening the present consumption boom would be through greater reliance on fiscal policy rather than monetary policy.

The special factors he had mentioned could not justify indefinitely the rate of monetary expansion in 1986, which was on the order of 20 percent for the broader aggregates, the Deputy Director added. There must be a fairly rapid deceleration of those aggregates, and the January figures indicated that it was already under way.

It had been suggested that perhaps the authorities should target MO exclusively since that aggregate had behaved better than the others, the Deputy Director recalled. The staff's examination of that suggestion had revealed several difficulties. The aggregate was not highly esteemed in the financial community, largely because it was a very narrow one, representing mainly currency in circulation. In addition, there was a risk that targeting that aggregate exclusively might create an impression that the authorities were no longer paying attention to the growth of the main aggregates, and that might have unfavorable effects on expectations. Finally, the well-known Goodhart Law suggested that when an aggregate was targeted, it tended to misbehave, so that exclusive reliance on one aggregate could be dangerous. The staff had therefore supported a more eclectic approach for assessing the various aggregates and the factors that might affect them.

A number of Directors had supported the staff suggestion that a somewhat more ambitious fiscal target seemed appropriate, the Deputy Director noted. For the current fiscal year the fall in oil revenue was equivalent to about 2 percent of GDP, while the deficit--excluding privatization receipts--had increased only by 1 percent of GDP. Although there had been an implicit tightening of fiscal policy, the tightening was largely due to the buoyancy of non-oil revenue, which was largely cyclical; as a result, the structural deficit had not been reduced. The deficit in the coming fiscal year would not be affected by a decline in oil revenue, but would benefit from the continued cyclical growth of non-oil revenue. However, the authorities' plans in the last budget with respect to the PSBR implied a sizable increase in the structural deficit.

Such an increase would not, in the staff's view, be appropriate at a time when private demand was extremely buoyant. Another reason for supporting a tighter fiscal policy was the significant depreciation of the exchange rate over the past year: for the economy to benefit from that depreciation, fiscal policy had to help make room for an increase in net exports.

A number of Directors had referred to the desirability of tax cuts, the Deputy Director recalled. In that regard, a distinction had to be made between tax cuts and tax reform. Tax cuts in themselves were not desirable in current circumstances because they would increase the buoyancy of private domestic demand. Tax reform, however, was very much needed for supply-side reasons--some of which had been indicated in the staff report--particularly, the high marginal rates of taxation on lower incomes.

On exchange rate policy, the staff considered that a flexible exchange rate policy had been appropriate both to offset the real appreciation of the pound in the late 1970s and early 1980s, and, more recently, to take account of the fall in oil prices, the Deputy Director remarked. At present, the question remained whether the real depreciation had been sufficient to ensure the viability of the current account position over the medium term. The staff had discussed that question with the authorities, who agreed that it would be highly desirable to maintain the present level of competitiveness, ideally, through restraint on wages and costs. The staff also considered that a net appreciation of the exchange rate should be avoided.

There was perhaps some disagreement between the authorities and the staff on the appropriate response if the authorities' efforts to restrain wages and costs were not successful, the Deputy Director of the European Department continued. At the same time, the staff recognized that, while the authorities were strongly committed to a nonaccommodating exchange rate policy, they had in practice demonstrated since 1981 that they were prepared to be flexible when circumstances warranted.

Mr. Lankester noted that Directors had broadly endorsed the strategy and policies of his authorities.

Several speakers had commented that growth in 1986 had not been broadly based, but was instead too much based on domestic consumption, Mr. Lankester continued. It was true that domestic demand was the main stimulus to growth in 1986. In fact, the latest estimate showed that output growth in 1986 was 2.6 percent, and that growth had picked up in the second half of the year. In 1987 growth was expected to be more broadly based. The latest surveys suggested that investment would pick up after stagnating somewhat in 1986. Moreover, manufacturing should pick up in 1987, partly owing to the improvement in competitiveness that had been achieved through the 15 percent depreciation of the effective exchange rate over the past 12 months or so. There was already some evidence of a pickup in manufacturing in the second half of 1986.

On balance of payments prospects, the staff had indicated that a modest current account deficit was likely in 1987, Mr. Lankester recalled. His authorities were perhaps slightly more optimistic in that regard than the staff. In their view, exports should do slightly better than estimated by the staff. In fact, exports had picked up strongly in the second half of 1986. In any event, the deficit was unlikely to be on a sufficient scale to cause significant concern. The United Kingdom had built up overseas assets on a major scale in the early 1980s, so that its net overseas assets were second only to Japan's. According to the latest data, net overseas assets totalled £80 billion, which would cushion any immediate balance of payments problem.

His authorities believed that a further depreciation of the exchange rate would be premature, Mr. Lankester continued. The exchange rate had fallen considerably in 1986, and that depreciation was appropriate in the light of the oil price collapse. At the present stage, a period of stability was needed.

In that context, his authorities welcomed the agreement that had been reached by the Group of Six in Paris, Mr. Lankester commented. They were pleased with the commitment that that agreement indicated and the intensification of mutually supporting policies. The period of exchange rate stability that the agreement was intended to produce should be helpful to achieving the U.K. objective of exchange stability, at least in the period ahead.

The issue of U.K. membership of the exchange rate mechanism of the EMS at the present stage continued to be under review, Mr. Lankester noted. However, the arguments, many of which had been reiterated at the present meeting, had shifted opinions somewhat; while the United Kingdom was still not ready to join the EMS, the arguments against membership were certainly not as strong as they had been in the past.

On monetary policy, the authorities were not about to abandon monetary targeting despite the difficulties they had had with the formerly favored aggregate, M3, Mr. Lankester observed. The narrow aggregates, particularly MO, had been providing a good indication of monetary conditions. Efforts had been made to educate the market regarding the useful properties of MO. The reimposition of credit ceilings was unlikely, in view of the policy of deregulation that had been undertaken over recent years. Deregulation had contributed importantly to improving the efficiency of the financial system. Finally, he agreed with the staff that the U.K. monetary policy stance had been appropriate. He recognized, however, that there would be less concern about monetary policy among his colleagues if U.K. fiscal policy was somewhat tighter.

The PSBR had been running well below the budget estimates for the first ten months of 1986 and would almost certainly be within the estimate at the end of the year, Mr. Lankester observed. The revenue prospects looked fairly good for the coming year, and the Chancellor of the Exchequer was considering whether the additional revenue should be used to lower tax rates or to reduce further the PSBR. Any decision on that matter would certainly take into account the considerations mentioned by the staff as well as by a number of Directors.

Some of the commentary on the United Kingdom's fiscal efforts over the past few years was somewhat unfair, Mr. Lankester considered. The PSBR, both on an unadjusted and on an adjusted basis, had fallen significantly as a proportion of GDP, and a further reduction was expected in the coming year. The Chancellor had made it clear that the PSBR in the coming year would not exceed the previous year's figure; the question was whether and to what extent the PSBR was reduced.

A number of Directors had questioned whether expenditure was under control, Mr. Lankester noted. Of course, his authorities would have liked to control expenditure better, and performance had improved in recent years. General government expenditure, which excluded receipts from privatization, had grown at an average rate of 1 3/4 percent in real terms over the past four years, compared with more than 3 percent in the 1970s; over the coming two to three years, a real increase of about 1 percent was expected. A substantial contingency reserve had been set aside for unforeseen expenditures, and the authorities believed that the new plans announced in November were more realistic.

Public sector pay had grown by 10 percentage points less than private sector pay over the period 1980/81 to 1985/86, Mr. Lankester remarked. Although from time to time there had been some large settlements--most recently for teachers--public sector pay as a whole had certainly not been leading the private sector.

Unemployment continued to be a major concern, Mr. Lankester commented. At least the trend was downward at present, even though the fall in absolute terms was not large. To some extent, high unemployment was a counterpart of the substantial productivity increases achieved over the past five to six years. Productivity, which had slowed in 1985 and early 1986, had picked up again in the second half of 1986, so that in the 12 months from late 1985 to late 1986, manufacturing productivity was 4 1/2 percentage points higher.

Employment had actually increased rapidly over the past few years, Mr. Lankester continued. Over a million additional jobs had been created since 1983. Nonetheless, unemployment was high and had been rising until recently due in part to significant increases in the labor force. It was disappointing that the measures taken on the structural side had not yet had a major impact on unemployment. His authorities would persevere in their efforts, and, in that regard, the latest proposals for profit sharing had elicited a good response from employers and from employees. It was too early to report on the progress of proposals for regional wage settlements; it would, however, be worthwhile if regional settlements could be achieved because of the extent of differentiation in the U.K. labor market.

The Government had given a great deal of consideration over the years to reforming the housing market, Mr. Lankester remarked. Housing reform raised a number of political difficulties, but policy options were under review.

The staff representative had indicated that 20 percent of those appearing for interviews under the Restart Program had been struck off the unemployment register, Mr. Lankester recalled. In fact, 20 percent of those invited had not turned up for interviews, but many of those had had good reasons. Only those who did not have good reasons--about 1 percent--had been removed from the lists.

It had been suggested that the authorities should consider adopting an incomes policy once again, Mr. Lankester noted. He did not think the Government would move in that direction, because of the experience of the 1960s and 1970s. Although in the past an incomes policy might have achieved a leveling off of wages in the short run, it had broken down rapidly and had led to distortions in the labor market.

His authorities would continue to support the open trading system and try to resist protectionist pressures, Mr. Lankester remarked. They would also continue to work for reform of the Common Agricultural Policy.

As to whether the discussion of the Article IV consultation should take place after the announcement of the budget, he wished to point out that his authorities attached some importance to having discussions with the staff prior to the presentation of the budget, Mr. Lankester commented. If the staff mission could continue to be conducted at about the same time as at present, his authorities might agree to schedule the matter for Board discussion sometime after the budget announcement. He would consult with his authorities on that possibility.

Mr. Posthumus remarked that, on monetary policy, he understood that most Executive Directors had indicated that the monetary situation was cause for concern, but they had not advocated a change in policy. Regarding the staff conclusion that "there was not much scope for a relaxation of domestic monetary conditions," in the circumstances he would have expected instead a conclusion such as "the staff does not see sufficient reason for more restrictive monetary conditions at this moment." That, in fact, was what the staff representative had said, and he agreed with that appraisal.

The Acting Chairman then made the following summing up:

> Executive Directors commended the U.K. authorities for achieving over a period of years a marked reduction of inflation and a prolonged economic recovery. They reiterated their support for the medium-term financial strategy (MTFS), which had helped secure a deceleration in nominal GDP growth, and welcomed the improvements in efficiency and productivity in the economy as a whole. Directors noted that prospects were favorable for an

extension of the economic recovery, that corporate profits continued to improve, and that private investment was forecast to become more buoyant as capacity utilization increases. Some Directors saw emerging capacity constraints, and all speakers expressed concern over the prospects for inflation, pointing to the recent widening of the inflation differential vis-à-vis the main partner countries against the background of rapid expansion in the monetary and credit aggregates, strong growth in domestic demand, and sustained rates of increase in real wages in excess of those abroad and unwarranted by productivity gains. Directors urged the authorities to give high priority to their commitment to a further deceleration of inflation.

Continued high rates of unemployment were also seen as a difficult problem facing the authorities. While recognizing the efforts made to date, Directors encouraged the authorities to intensify their search for solutions. They agreed with the staff that these efforts should continue to focus on improving the functioning of the labor market, and that stimulating demand through financial policies would be inappropriate. In current conditions such stimulus was likely to be dissipated into inflation and a worsening of competitiveness, instead of securing lasting output and employment gains. Directors supported the emphasis on profit-sharing arrangements, greater regional differentiation of wages, training programs, and measures to improve labor mobility. Directors also urged the authorities to exercise their moderating influence in the negotiation of wage contracts in the public sector.

Directors commented at length on the stance of fiscal and monetary policy. With respect to fiscal policy, Directors commended the authorities for maintaining their target for the public sector borrowing requirement (PSBR) in the current fiscal year, despite the loss of oil revenue, but they strongly argued that the buoyancy of non-oil revenue and the need to shift resources into net exports called for a greater reduction in the PSBR in relation to GDP for the next fiscal year than foreseen in the MTFS. Several Directors observed that a tighter fiscal policy in 1987/88 would strengthen confidence in the financial markets and would help to reduce interest rates and to revive private investment. Speakers generally urged the authorities to cut the share of government spending in the economy as a whole and thereby to create room for income tax reductions. Otherwise, income tax reform should be largely revenue neutral in the current circumstances of the U.K. economy. With respect to tax reform, some Directors encouraged the authorities to reduce high marginal tax rates, including those rates affecting low incomes.

On monetary policy, Directors appreciated the difficulties in assessing velocity behavior and hence in setting targets for monetary aggregates. Some of them expressed the view that despite these difficulties, the policy of announcing targets for monetary aggregates should not be abandoned. Reliance on narrow money as an indicator of the appropriateness of policy stance was not sufficient, many Directors commented; they considered that developments in broad money and credit also had to be closely monitored. In this respect, speakers generally expressed concern over the current rapid buildup of liquidity and the high rates of real credit expansion; a number of Directors argued for a tightening of monetary policy, and others stressed that there was certainly no room for relaxation of policy. Directors agreed that, given the widening inflation differential vis-à-vis other industrial countries, prospects for lower interest rates were dependent on progress on price and cost inflation, and on greater fiscal restraint.

Directors recognized that in the face of the fall in oil prices, the decline in the effective exchange rate of the pound sterling over the past year had been appropriate. They agreed with the staff that it was important to consolidate the resulting improvement in competitiveness in order to broaden the base of output growth, enhance employment prospects over the medium term, and check the recent deterioration in the external current account position. They stressed in this respect the need for lowering markedly the rate of growth in unit labor costs so that it does not exceed the rate prevailing in the main trading partner countries. In this regard, some Directors asked if full membership of the European Monetary System (EMS) might not facilitate monetary policy and reinforce the authorities' efforts to limit inflation. At the same time, it was recognized that participation in the exchange rate mechanism of the EMS would be more demanding with respect to underlying conditions. In addition, some Directors wondered whether full membership of the EMS might be seen as a way of reinforcing broader cooperative efforts to strengthen the stability of exchange rates, in line with the statement of Ministers of Finance and Central Bank Governors of six major industrial countries made in Paris on February 22, 1987.

Directors welcomed the continued liberalization of financial markets and supported the authorities in their efforts to ensure effective market supervision. More broadly, Directors commended the authorities' intention to persevere with a range of measures to improve efficiency in labor and product markets generally. They commended the authorities for their support for foreign trade liberalization, and urged them to step up the implementation of initiatives, both on their own behalf and within the European Communities, to achieve that goal. On official development assistance (ODA), and while recognizing the highly concessional character of ODA and its focus on poorer countries, Directors expressed the hope that the decline in the ODA/GNP ratio which was foreseen on current plans for the period ahead could be reversed.

It is expected that the next Article IV consultation with the United Kingdom will be held on the standard 12-month cycle.