

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 89/26

10:00 a.m., March 3, 1989

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors

F. Cassell
Dai Q.

E. V. Feldman

G. Grosche
J. E. Ismael
B. Jalan
A. Kafka

Mawakani Samba
Y. A. Nimatallah
J. Ovi
H. Ploix
G. A. Posthumus
C. R. Rye
K. Yamazaki

Alternate Executive Directors

C. Enoch

C. S. Warner
J. Prader
S. M. Hassan, Temporary

M. A. Fernández Ordóñez
N. Kyriazidis
A. M. Othman
O. Kabbaj

E. Kiriwat
L. E. N. Fernando

D. McCormack

M. Fogelholm

S. Yoshikuni

L. Van Houtven, Secretary and Counsellor
C. E. Wahlstrom, Assistant

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|----|---|---------|
| 1. | Contacts with Media | Page 3 |
| 2. | United Kingdom - 1988 Article IV Consultation | Page 3 |
| 3. | Venezuela - Technical Assistance | Page 52 |
| 4. | Approval of Minutes | Page 52 |
| 5. | Executive Board Travel | Page 52 |

Also Present

Asian Department: R. J. Corker. European Department: M. Russo, Director; P. B. de Fontenay, Deputy Director; M. Guitián, Deputy Director; D. J. Archer, K. B. Bercuson, K.-W. Riechel, J. Saito, B. J. Smith, S. M. Thakur, J. R. Wein. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; P. A. Acquah, M. R. Kelly. Fiscal Affairs Department: V. Tanzi, Director; A. L. Bovenberg. Legal Department: J. V. Surr. Research Department: J. A. Frenkel, Economic Counsellor and Director; G. Hacche, Y. Harada, E. Hernández-Catá, F. Larsen, P. R. Masson. Secretary's Department: C. Brachet, Deputy Secretary. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: P. O. Montórfano, G. Pineau, S. P. Shrestha, A. Vasudevan. Assistants to Executive Directors: J. R. N. Almeida, H. S. Binay, R. Comotto, E. C. Demaestri, A. Y. El Mahdi, B. R. Fuleihan, J. Gold, M. Hepp, J. Heywood, A. Iljas, C. J. Jarvis, K.-H. Kleine, V. K. Malhotra, T. Morita, N. Morshed, D. Saha, C. Schioppa, J.-P. Schoder, M. J. Shaffrey, Shao Z., C. C. A. van den Berg.

1. CONTACTS WITH MEDIA

The Managing Director indicated that, following attempts by the press to contact individual staff members, he would shortly be circulating a note to remind staff of procedures relating to contacts with the media.

2. UNITED KINGDOM - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with the United Kingdom (SM/89/29, 2/6/89; and Sup. 1, 2/28/89). They also had before them a background paper on recent economic developments in the United Kingdom (SM/89/38, 2/17/89; and Sup. 1, 2/22/89).

Mr. Cassell made the following statement:

My authorities always value the opportunity to exchange views with the staff on the United Kingdom's economy. The staff report illuminates many of the uncertainties and questions facing the economy at the current time. My authorities have little difficulty with the basic approach of the staff appraisal; in particular, they agree that "the task now is to rein in demand and inflationary pressures." However, they believe that the staff has underestimated the speed with which the effect of the restraining measures taken last year will come through, and hence that the policy recommendations in the report are based on a more buoyant view of the economy in 1989 than seems likely to be justified.

As the staff makes clear, 1988 was another year of strong growth for the U.K. economy, the seventh successive year of relatively high output growth, combined with inflation of low levels, compared with the record of the 1970s. This strong performance was underpinned by continuing high productivity growth--particularly in manufacturing--which was reflected in a further sharp fall in the rate of unemployment, to below the European average. Moreover, the year witnessed a large rise in private investment, which should increase the sustainable growth rate of the economy over the medium term.

Nevertheless, during the course of 1988 it became increasingly evident that domestic demand was growing more rapidly than had been expected in the aftermath of the worldwide stock market falls in October 1987. There was a significant deterioration in the current account deficit, an increase in wage pressure and over the year as a whole, an upward drift in the underlying rate of inflation. In the face of the emerging evidence of unsustainable demand growth, my authorities moved promptly to reaffirm their overriding commitment to reducing the rate of inflation. As Directors are aware, the strength of sterling in

the early months of 1988 posed serious dilemmas for the operation of monetary policy, which initially led to a reduction in short-term interest rates. However, since May 1988, short-term interest rates have been increased by 5.5 percentage points, to 13 percent, and there has clearly been a marked tightening of monetary conditions. In contrast, long-term interest rates have remained remarkably steady, partly reflecting the financial market's confidence in the Government's anti-inflationary commitment.

Although monetary policy is the essential tool for macro-economic management in the United Kingdom, the fiscal stance has played an important supporting role. The budget surplus in the current financial year is expected to be over 2.5 percent of GDP--more than three times the surplus recorded in 1987/88. In addition, the appreciation of the real exchange rate over the last two years has acted as a restraint on inflation.

Given this background, the staff mission rightly focused on the question of whether the measures taken to dampen demand would be sufficient to engineer a soft landing for the U.K. economy in 1989, or whether further restraining measures would be needed. The staff report acknowledges that there were honest differences of views on this matter. We all recognize that economic forecasting is a hazardous art that requires a large measure of judgment and a drop or two of common sense; this is particularly true when the recent data are imperfect and subject to considerable revision, and when agents' responses to policy shifts are sensitive to their perception of the steadfastness of policymakers and the credibility of their strategies. In addition, I think we all recognize that to forecast, with precision, the time and extent of an economic turning point is extremely difficult.

Thus, the differences between my authorities' forecast for 1989/90 and the staff's forecast are perhaps not too surprising. As the staff says, there is a broad agreement on the magnitude of the response of domestic demand to the recent monetary tightening. The main difference relates to the rapidity with which the dampening effects of recent measures are projected to come through. The staff report is based on the view that domestic demand will continue to grow strongly through the early part of 1989. In contrast, the U.K. Treasury's November 1988 forecast envisaged that a slowdown in domestic demand would take place in the latter part of 1988, which would allow a greater easing of capacity constraints during 1989, in turn leading to some improvement in the external deficit.

Since the staff mission in November/December 1988, the data have, on balance, lent support to the view that the sharp tightening of policy in 1988 would begin to affect domestic

demand earlier than the staff had projected. As to consumer demand, growth in retail sales slowed significantly in the last quarter of 1988, and the volume of retail sales actually fell in January. In addition, separate surveys of consumer and retailer/wholesaler confidence--which in the past have tracked consumer spending reasonably closely--have revealed a sharp fall in confidence about the outlook for 1989.

There is clear evidence also that the housing market has begun to slow down after a very buoyant period. House price inflation has begun to abate, mortgage lending for house purchase has slowed since mid-1988, and private housing completions fell in the fourth quarter of 1988. As the staff suggests, the previous strength of the housing market and of mortgage demand--although partly caused by temporary tax-related factors in the early summer--may have been an important underpinning for rising consumer demand in the first half of 1988.

New car registrations fell in 1988 (fourth quarter), and there was virtually no growth in registrations between 1987 (fourth quarter) and 1988 (fourth quarter). Despite a rebound in January 1989, the growth in car registrations in the last three months, compared with the same period in 1988, points to a significant slowdown.

The growth in the targeted narrow monetary aggregate (M0) has slowed significantly in recent months.

In contrast, the latest survey of investment intentions points to continuing strong growth in industrial investment in 1989--perhaps at a rate above the Treasury's forecast in November 1988. In addition, the measured inflation rate has continued to edge up in recent months--partly driven by the impact of higher mortgage rates on the retail price index.

My authorities fully recognize that it is still too early to form a definitive judgment on whether the slowdown in domestic demand growth seen over recent months is consistent with their own projections. Nevertheless, their tentative conclusion is that the latest evidence points that way. I am glad to see that the staff, in its revised forecast, is moving in the same direction.

The overriding objective of the United Kingdom's macro-economic policy is, and will continue to be, to reduce and, eventually, eliminate inflation. My authorities are fully apprised of the downside risks associated with allowing inflationary pressures to become entrenched. Should the need for a further tightening of policy arise, they will not hesitate to take the necessary steps to reinforce the credibility of their anti-inflationary stance. The inflation outlook will, of

course, be a central consideration in the formulation of the budget for 1989/90, which will be unveiled on March 14.

The medium-term scenarios developed by the staff highlight the question of the appropriate medium-term fiscal norm for the United Kingdom. The staff suggests that a sustained tightening of fiscal policy, of 1 percent of GDP over the medium term, could forestall the risk of a hard landing for the economy. Moreover, it concludes that certain medium-term considerations "would argue for setting a more ambitious medium-term fiscal norm than the balanced budget specified in the medium-term fiscal strategy at present." In this context, there are two distinct issues: first, should fiscal policy be used in the short term in an attempt to engineer a soft landing for the economy; and, second, what is the appropriate medium-term fiscal policy objective?

The staff's analysis is driven partly by its judgment that the measures taken during the course of 1988 will not have much effect on the growth of domestic demand until the latter part of 1989. It is also based on the view that fiscal policy may be a useful tool of demand management with the potential to "moderate demand pressures directly and relatively quickly." My authorities take a different view on both the points. Given the extent of the slowdown in domestic demand that is already evident in recent indicators, they do not agree with the staff's assessment of the balance of risks. They believe that the measures already taken will be sufficient to reduce significantly the growth of domestic demand in the first half of 1989. Nor do they not regard fiscal policy as an effective or reliable instrument for fine-tuning the economy; their firm view is that it is important to set fiscal policy in a medium-term context.

The staff recognizes that stability in the tax structure is a legitimate objective; however, by implication it places less weight on the stability of public expenditure policies. In contrast, my authorities see no case for altering tax rates or changing public expenditure plans in order to influence demand conditions in the short term. Nevertheless, they have made it clear that the public sector debt repayment (PSDR) may be greater or smaller in individual years than the zero implied by a balanced budget.

On the appropriate norm for fiscal policy over the medium term, it is clear that to some extent this is a matter of judgment. The staff posits various arguments to support the view that it might be appropriate for the United Kingdom to provide for a fiscal surplus over the medium term. For example, it is suggested that financial deregulation may have resulted in a permanent reduction in the household financial balance and, in such circumstances, large public savings might help to

alleviate external deficits over the medium term. My authorities are not convinced that a simple rule that aims for a balanced budget over the medium term is inappropriate. It has the merits of being clear and comprehensible, and, if broadly followed for some years, would attain a useful credibility. Moreover, they are not persuaded that the process of financial liberalization and deregulation in itself might lead to a permanent shift in the private sector's desired financial balance.

My authorities note that, as is brought out clearly in Appendix IV (SM/89/38, Sup. 1, 2/28/89), a large part of the recent change in the private sector's financial balance has resulted not from lower private savings, but from higher private investment which is cyclical in nature and which will, in any event tend to increase the economy's potential growth rate in the future. My authorities would also argue that the emergence of a private sector financial deficit, as well as an external deficit, reflect private decisions taken by economic agents and should therefore, over time, be self-correcting. Furthermore, they would point out that given the current serious weaknesses in the national accounts statistics and, particularly, the large residual item in the private sector accounts, it is very difficult to estimate with any precision the size of the private sector financial balance.

Since neither the size nor the likely duration of the current private sector financial deficit can be identified with any confidence, my authorities do not believe that fiscal policy could sensibly be framed to offset it. This conclusion leaves aside the more fundamental question of whether higher public net savings can, indeed, offset lower private net savings over the medium term.

The staff rightly devotes considerable attention to the issue of tax reform. My authorities have placed strong emphasis over recent years on the role that tax reform can play in improving the supply performance of the economy--by sharpening work incentives, removing distortions, and reducing the scope and incentive for evasion. Significant achievements in this area have already been recorded. The United Kingdom now has one of the simplest income tax structures in the world, with a top marginal rate of only 40 percent. In addition, many personal tax breaks have been eliminated or substantially reduced through, for example, sharp increases in the taxation of company cars, the abolition of tax relief for new life insurance contracts, and restrictions on the tax deductibility of mortgage interest. The corporate tax system has also been radically reformed. The main corporation tax rate was reduced to 35 percent in 1984--one of the lowest corporate tax rates in the world. At the same time, the tax base was considerably

broadened by replacing large first-year investment allowances, with depreciation allowances. In aggregate terms, one impact of these changes has been that the burden of taxation at the margin has moved from incomes to expenditure. For both companies and individuals, the tax base has been substantially widened and marginal rates sharply reduced.

My authorities remain committed to the process of tax reform and have noted with interest the staff's suggestions. However, the staff argues that "a smoothing of marginal rates of social security contributions at the lower earning limits might be considered." To some extent, this approach was already taken in 1985 with the introduction of lower rates for low-paid employees. It would not be possible to reduce these lower rates much further without endangering the contributory principle. Moreover, if the present "step-system" were converted into a threshold structure--with contribution rates applying only above a certain threshold--millions of employees, including most of the lower paid, would have to pay higher marginal rates, if the budgetary costs were to be kept within reasonable bounds.

While the staff notes that tax distortions affecting the allocation of savings and investment remain, I want to stress that there is no evidence to suggest that the tax system is having any significant net effect on the aggregate level of savings. The existing tax incentives for particular forms of savings and investment transparently reflect the Government's priorities: the commitment to spread home ownership and wider share ownership, the desire to give a kick-start to the provision of rented accommodation to improve regional job mobility, and the need to promote pay flexibility and private pension provision. Moreover, as the staff acknowledges, the sharp reduction in income tax rates over the past few years has reduced both the cost and the impact of the remaining tax reliefs within the system.

While the United Kingdom's aid budget is programmed to increase by 18 percent in cash terms over the next three years, as noted by the staff, my authorities' main focus has been on the quality and the effectiveness of the program. They have, especially, sought to concentrate on the problems facing the low-income countries. In line with this strategy, the United Kingdom has provided the largest single contribution to the subsidy account of the enhanced structural adjustment facility, reflecting the importance it attaches to the availability of financing on concessional terms to the world's poorest countries.

The U.K. official development assistance ratio is certainly low by international standards. But this measure of official aid is only a partial indicator of the assistance provided to

developing countries; it does not include amounts rescheduled through the Paris Club, or the United Kingdom's private direct investment in developing countries. Over the period 1982-86, the U.K. private sector invested on average \$1.7 billion a year in developing countries--a level second only to that of the United States. In 1987, the latest year for which figures are available, private direct investment from the United Kingdom rose further to \$1.9 billion.

In conclusion, considerable uncertainties surround the prospects for the United Kingdom's economy over the coming year. Reflecting these uncertainties, significant differences remain between the forecast produced by my authorities and the revised projections circulated by the staff. These differences, in turn, lead to somewhat differing emphases on the appropriate policy prescription. In the end, time will tell which view of 1989 proves the more accurate.

Mr. Warner made the following statement:

At the outset, I would like to express our continuing admiration for the major economic advances that have been made in the United Kingdom in recent years. Most notable have been the strength and duration of economic recovery; the rapid growth of productivity, especially in manufacturing; the modest rate of growth of unit labor costs; the restoration of profitability; the surge of business investment; and the recent impressive pattern of job creation and rapidly falling rate of unemployment. Structural reforms in the tax system and labor markets have had very positive effects on the supply side, although there remains room for further progress in these areas.

Nevertheless, at the Board's discussion of the 1987 Article IV consultation with the United Kingdom, some concern was expressed about growing demand pressures, rapid growth of wages, less than expected progress in reaching the inflation target, a weakening current account balance in the balance of payments, and need for monetary and fiscal constraint. The strength of domestic demand--both consumption and investment--and the size of its impact on inflation and the balance of payments has been surprising. Clearly, the rising rate of inflation and the growing external deficit are the most urgent problems currently facing the United Kingdom. Accordingly, we are pleased to note the staff's emphasis on these matters.

The greatest danger to the U.K. economy is that domestic demand growth may not decelerate quickly enough, allowing inflation to become entrenched and slowing the convergence of import and export growth rates. While good progress was made in the early 1980s in bringing the United Kingdom's inflation rate

more in line with those of other major industrial countries, the goal of a further decline toward a zero rate of inflation has proved illusory. Therefore, there is both an immediate motivation for promptly and strongly addressing this problem, as well as a longer-term goal yet to be achieved. While the containment of current excess demand by prudent financial policies is clearly critical, we would also place strong emphasis on supply-side policies, for example, with regard to further tax and labor market reforms.

As suggested by staff, the United Kingdom's labor market is in a period of transition; greater competition has forced management to resist excessive upward pressures on labor costs and, to some extent, work practices have been liberalized. Nevertheless, real wages have risen substantially owing to the growth of productivity. Accordingly, more emphasis should be placed on labor market reform. The combination of the relatively high, though decreasing, unemployment rate and the large number of job vacancies shows that the market remains constricted by structural rigidities. There is an interesting discussion of these issues in Appendix III of the background paper (SM/89/38, 2/17/89). To reduce the very high effective marginal tax for low-income workers, dismantle rent controls, introduce tax reforms related to housing, and improve the job training programs might help to create greater incentives to work, as well as increase labor mobility regionally and sectorally.

Major structural shifts are also taking place in the savings and investment pattern in the United Kingdom, including a rise in private business investment, growing public savings, and important changes in the composition of private savings. The staff's discussion of the recent decline in personal savings in Appendix IV of the background paper was particularly interesting. There are some similarities, but also some differences, between the developments in savings in the United States and the United Kingdom. One similarity between the two countries has been the more or less concurrent strengthening of public savings, while the dependence on foreign savings has remained high or even increased. This development shows that reductions in budget deficits, however necessary, do not alone assure that the current account deficits will contract. In addition, attention needs to be paid to the fostering of private savings, which in both countries are being affected by such structural changes as developments in the social security system, as well as wealth effects from rising values in the securities markets and financial innovations that make it easier to borrow for consumption purposes on the basis of growing asset values.

Clearly, more progress has been made in the United Kingdom than in the United States in bringing down the fiscal deficit;

in fact, a small surplus has been achieved, while the high marginal personal income tax rates have also been reduced. We agree with the authorities and the staff that fiscal policy should continue to be set in a medium-term framework. However, the staff is arguing strongly for tighter fiscal policy over the medium term, aiming at a fiscal surplus rather than a balanced budget as the medium-term norm. With the benefit of hindsight, we agree that the 1988/89 budget may have been too expansionary, but the microeconomic benefits of the lower marginal tax rates introduced at that time are important. Moreover, it is important, to the achievement of these benefits, that the market has confidence in the continuity of the tax reform. Nevertheless, it would not be appropriate to include substantial tax reductions or expenditure increases in the 1989/90 budget. However, we have some doubts about whether fiscal tightening would be as powerful as the staff claims it to be in addressing the savings/investment imbalance, and in sustaining confidence in the anti-inflation effort.

Too frequent adjustment of fiscal policy could do more harm than good, but a continuing effort at tax reform seems necessary over the longer run. The staff discussed some adjustment possibilities in the staff report and background paper, but it should be aware that the remaining tax distortions, in relation to savings and investment, may be increasingly difficult--politically--to change.

The recent dilemma of trying to use interest rate policy to fight inflation and stabilize the exchange rate is amply described in the staff report. At present, it seems clear that the monetary authorities should err on the side of resisting inflation, but we are uncertain how restrictive the monetary policy really is. While short-term interest rates are high, and have been rising, growth of the monetary aggregates also seems to be high. In the United States, longer-term interest rates, which may have more influence over spending decisions, have not risen correspondingly. Ironically, this situation may reflect the anti-inflation credibility of the monetary authorities in both countries, although it does tend to reduce the effectiveness of interest rate policy.

The rapid rise in the current account deficit needs to be closely monitored. However, we recognize that a substantial deficit has only recently emerged, and we have some sympathy with the authorities' view that this development is the product of private decisions relating to savings and investment; it appears that financing of the deficit should pose no significant problem. Eventually, it will be interesting to find out where the counterpart to the United Kingdom's deficit is showing up in other countries, and what it means for world payment adjustments.

We commend the authorities for their strong support of open trading policies in the GATT negotiations, as well as in the European Communities (EC) preparations for the single market in 1992. We understand that the United Kingdom opposes current reciprocity proposals in financial services, but we have the impression that the authorities are willing to use reciprocity as a tool to open up third country markets. In the recent Board discussion of the European Monetary System (EBM/89/10; 2/1/89), and at the 1988 Article IV consultations with the Kingdom of the Netherlands (EBM/89/16, 2/15/89), we argued strongly for a national treatment approach to liberalization of markets, and we urge the U.K. authorities to continue to work toward this objective within the EC.

Finally, the serious problems that have emerged with U.K. national income statistics warrant timely remedies. Important analytical assessments and policy decisions depend on reliable data. Accordingly, we wonder when the results of current studies on this matter can be expected.

Mr. Grosche made the following statement:

It is a pleasure to speak on the United Kingdom's economy not only because of the tremendous success of its economic policies in the 1980s, but also because we are close neighbors working together with other countries toward a single European market in 1992.

The sharp tightening of policy during 1989 will begin to affect domestic demand earlier than the staff has projected, according to Mr. Cassell; in the staff's revised forecast, consideration has been given to the recent indications to that effect. We are pleased with these developments, since the continued strong buoyancy of demand in excess of potential output is already producing negative side effects typical of an overheated economy.

As illustrated in Chart 1 of the staff report, and as confirmed by more recent price data, inflationary pressures are strong. Fortunately, the exchange rate appreciation and impressive productivity gains helped to cushion cost pressures during 1988. However, it is worrisome that wages are responding quickly to the buoyant demand and falling rate of unemployment, particularly as capacity utilization appears to have reached levels close to those of earlier cyclical peaks.

With the benefit of hindsight, it appears obvious that monetary policy during the first half of 1988 was not sufficiently tight. While I understand why this was the case, it reminds me of a very basic principle: in the long term, a

general rise in prices is not possible without a disproportionate expansion in money supply. An excessive increase in money supply is not necessarily the primary cause of a rise in prices. However, monetary policy, in determining the "monetary cloak" for the economy, ultimately sets the limits to increases in the price level. I fully endorse the authorities' open commitment to a further tightening of monetary conditions, if demand remains too strong. Interest rate policy can send the most visible signals to the markets, indicating that the authorities are not willing to tolerate any further entrenchment of inflation.

Obviously, the high demand pressure is not the result of weaknesses in the fiscal area. On the contrary, by international standards, the United Kingdom has achieved an enviable fiscal position. We fully endorse the medium-term orientation of the fiscal strategy and share the U.K. authorities' rejection of fine-tuning. Nevertheless, we would endorse the staff's advice to forgo substantial tax cuts at this point in time--desirable as they may be to further improve incentives--and, thus, to increase the public sector's contribution to domestic savings. After all, the trend in household savings behavior is more likely to continue its downward path.

The sharp deterioration in the external current account, as illustrated in Chart 6 of the staff report, was quite surprising--perhaps even for the authorities. Despite improvements on the supply side, and their favorable impact on trade performance, the staff's revised forecast did not affect the outlook for another year in deficit. It seems that even higher than projected deficits could be financed easily, given the attractiveness of high interest rates and the United Kingdom's high stock of net foreign assets. However, international capital flows can be highly volatile, and financial market sentiment might change abruptly. A further widening in the current account deficit, or renewed fears of overheating, could translate into capital outflows and downward pressure on the exchange rate.

Over the last decade, most EC countries have experienced the beneficial results of full participation in the exchange rate mechanism of the European Monetary System. We do respect the United Kingdom's position on this issue but would, nevertheless, wish to repeat what we have said on previous occasions: the medium-term benefits for the United Kingdom and Europe of having the United Kingdom participating in the exchange rate mechanism would clearly outweigh the disadvantages. However, I would agree that the episode of closely shadowing the deutsche mark in 1987/88 needs a careful study, as one wants to prevent too sharp a conflict between external and domestic stability.

According to the staff report, the "expansionary surge was unexpected and...it has been overwhelmingly of domestic origin." I hope that the U.K. authorities are right in believing that the staff has underestimated the speed with which the effects of the restraining measures taken in 1988 will come through. If, however, demand growth proves to be stronger than the authorities project, I trust that they will act promptly to forestall inflation from becoming entrenched again, as was the case in the 1970s.

Mr. Ismael made the following statement:

The performance of the U.K. economy in 1988 was highly commendable. The structural reforms and the medium-term financial strategy implemented by the authorities have continued to produce positive results: the growth rate has been impressive; productivity in manufacturing has continued to rise strongly; unemployment has fallen steeply; and profitability and business investment have increased substantially. Given these developments, the U.K. economy has expanded at a rate well above the average rate of the G-7 and EC economies in many areas. However, the continuation in 1988 of earlier observed adverse trends is a matter of concern. It seems that the overexpansion of economic activities, leading to acceleration of domestic demand, threatens the U.K. economy with serious inflationary pressures.

I welcome the intention of the authorities to contain the increasing rate of inflation to a desirable level. However, the desire to choke off inflationary pressures in full will also inhibit the speed of any relaxation in the high interest rate policy; a too rapid fall in rates might lead to imported inflationary pressures owing to the weakness of sterling, as well as a rise in unit labor costs owing to a too high rate of nominal wage increases. While I believe that, in the context of the U.K. economy, the role of fiscal policy in contributing to a reduction in the external deficit is limited, budgetary policy in 1989/90 should be aimed at supporting monetary restraint by achieving a somewhat larger surplus than in 1988/89.

One of the reasons for the acceleration of U.K. economic growth is the move toward supply-side policies. In this connection, I believe that further efforts are needed to improve the prospects of noninflationary growth in the U.K. economy. Although the rate of unemployment declined to 7.4 percent at the end of 1988, it is still high in some specific regional areas. If the present momentum of growth is to be sustained without causing a higher rate of inflation, it is important that the rigidities in the labor market, as well as the impediments to occupational and regional mobility, are reduced. I welcome the

authorities' initiatives to make additional legislative changes, including the rationalization of the employment training scheme.

The authorities' achievements in strengthening the fiscal position over recent years have been impressive. Given the advantage of the current situation, I welcome the intention of the authorities to reduce the basic tax rate to 20 percent over the medium term. In addition, I welcome the authorities' intention to provide tax incentives for selective social objectives.

While I agree that an increase in interest rates is an effective tool to counter inflationary pressures and maintain a stable exchange rate, it might also slow down the economy as domestic demand reacts to interest rate rises. In the absence of a recession, these measures will not result in much immediate improvement in the balance of payments position, because the high interest rates and the overvalued exchange rate will curb export growth. In turn, slow progress in improving the balance of payments will inhibit significant interest rate declines owing to fears of precipitating major sterling weakness.

Finally, I commend the U.K. authorities for their commitment to a liberal trading system and their intention to increase the official development assistance by 1-2 percent a year in real terms, in the next three years. I would also like to take this opportunity to express my appreciation for the United Kingdom's leading role in alleviating the difficulties faced by low-income developing countries, including its large contribution to the Subsidy Account of the enhanced structural adjustment facility, and the extension of interest rate reduction by the Paris Club.

Mr. Prader made the following statement:

The medium-term economic policy pursued by the U.K. Government in the 1980s turned out to be very successful in many respects. The past six to seven years' rapid economic growth, which was rather high by international and historical standards, was one of the most important achievements. As a consequence, the rate of unemployment was reduced, despite a considerable increase at the beginning of this decade. In addition, as a result of the new supply-side policies, both profitability and productivity rose significantly. Above all, the authorities' economic policy seems to have restored the economic agents' confidence, which, in turn, established the psychological basis for the impressive recovery of the economy.

However, the high confidence in the U.K. economy may also have contributed to the greatest shortcoming of the present upswing--the fact that growth has almost entirely been fueled by

domestic demand. The personal savings ratio declined further to a record low, and real consumer expenditure rose--owing to the favorable economic situation--by about 6 percent in 1988. Stimulated by high capacity utilization and a surge in profits, private investment exhibited particularly strong growth and made the largest contribution to GDP growth in the present business cycle. The excess in domestic demand is responsible for the United Kingdom's problems of a high and rising rate of inflation and huge current account deficit. Given that these two drawbacks are likely to persist, or even get worse in the near future, I would like to concentrate my further remarks on these two problems.

The U.K. authorities argue that a deteriorating external balance is no longer a cause for concern, because the foreign assets that resulted from oil exports in the early 1980s now give room for maneuver. However, as has been the experience in some other countries, if enough attention is not paid to the development of the current account, net foreign assets can run down quickly and turn to net foreign liabilities. Moreover, the U.K. authorities hope that private decisions will bring about a self-correction of the imbalances, since the emergence of the external deficit was also a reflection of private decisions relating to savings and investment. In their opinion, the worsening of the external balance should not be considered dangerous, as long as it is not caused by a high budget deficit. However, I am uncertain whether or not foreign exchange markets analyze accurately the reasons for unexpected high trade and current account deficits; it appears that they generally only refer to the changes compared with the previous published figures.

If the deficits were to reach new records, the financial markets' confidence in economic management would inevitably decline sooner or later--no matter how the deficits were created. To counter a weakening of the pound in such a situation, a further rise in interest rates would be necessary, which, in turn, would increase the risk of a hard landing for the economy. The possibility of a continued high and growing current account deficit cannot be excluded--not even in the case of a slowdown in domestic demand growth. A decline in international competitiveness might also cause a continuation of the high deficits. Furthermore, changes in the exchange rate tend to produce quantitative reactions after a lag of one to two years; accordingly, the past two years' real effective appreciation of the pound is expected to have a negative influence on the current account balance in the near future.

Despite the fact that the authorities' monetary policy goal in the 1980s has been to eliminate inflation, no progress has been made in this area since 1983. The rate of inflation is

rising again, and moreover without taking into account the effect on the retail price index of rising mortgage interest rates. Incidentally, the exclusion of mortgage interest rates from the retail price index is not acceptable, because it is used as an intention to justify wage demands. In addition, foreign financial markets express concern about the rate of inflation as measured by the official price index, but express, at the same time, very little understanding for the distorting effects on the retail price index of mortgage interest rates.

At the present juncture, the outlook for inflation does not seem very encouraging; as a result of the tightening labor market, wage growth--above the OECD average for many years--cannot be expected to decelerate. The unusually high rise in productivity in recent years did not cause a similar increase in unit labor costs. However, given the already high level of capacity utilization, a substantial growth in productivity, which would raise both unit labor cost and the rate of inflation, can no longer be expected.

A potential danger for price stability emanates from the external side. In the case of a depreciation of the pound, owing to a loss of confidence in international financial markets, prices of imported goods would rise correspondingly and add to domestic inflation. The United Kingdom's only positive response to inflation, so far, has been to tighten monetary policy. In spite of the considerable rise in interest rates by 5.5 percentage points, it appears that domestic demand growth has not been affected significantly. Undoubtedly, one reason for this development may be that private consumption depends primarily on the level of income, wealth, and consumer confidence, and less on interest rates. Despite the sharp rise in interest rates, the continuation of the investment boom may be the outcome of the extremely favorable financial position of industry, owing to low capacity reserves and a bright economic outlook. The considerable surge in profitability not only provides the financial means needed for real investment, but also enables the yields on real assets to rise above those of financial assets. If a company does not need credit for financing its investment and expects to earn more by investing in real, as opposed to financial, assets, rising interest rates would not show the desired effect.

In this context, a more restrictive monetary policy by means of higher interest rates may not succeed in dampening domestic demand, but might, instead, only contribute to a tightening of the international interest rate spiral. In the light of these developments, interest rates will increase at the international level without changing the existing current account imbalances. Against this background, and given the weak impact of interest rate changes in the present economic climate,

an additional tightening of fiscal policy may be the only way to reduce domestic demand pressure and avoid a hard landing, not only for the U.K. economy; but, given the importance of the U.K. economy, also for the world economy as a whole.

Mr. Kafka made the following statement:

There is no question that the U.K. economy continued to perform satisfactorily in 1988 in terms of output growth, unemployment, and productivity trends. However, there continues to be a deterioration in the current account deficit, as well as a rise in wage pressure and the underlying rate of inflation. There is also no question on the present need for demand restraint or, indeed, on the fact that considerable measures of demand restraint already have been adopted. There seems to be no difference of opinion between the staff and the U.K. authorities with respect to the experiment of addressing to monetary policy to the goal of exchange rate stability until early 1988.

However, there is a difference of opinion between the staff report and Mr. Cassell's opening statement about how quickly monetary policy can be expected to affect demand. The facts quoted by Mr. Cassell give reasonable support to his thesis that monetary policy can act with dispatch. Certainly, it seems that short-term rates have risen considerably compared to their level before, and not only during, the deutsche mark peg. Under the circumstances, I do not think that the staff or Executive Directors should emphasize the need for immediate tightening of monetary policy as distinct from other forms of domestic tightening, as growth is also an important objective. Must not the United Kingdom continue to regain what it lost in the pre-Thatcher period with respect to growth?

As to the instruments of macroeconomic policy, I think that the staff has a valid point in its emphasis on greater fiscal restraint in the short run. In fact, the United Kingdom's deutsche mark peg that ended in early 1988 would--or at least might--have been quite appropriate if fiscal policy had been tighter. Parenthetically, I wonder whether the tightening of fiscal policy can be measured by the public sector borrowing requirement in relation to export GDP. Policy is, after all, by nature a prospective concept. To return to the role of fiscal policy in the genuinely short term, it seems that the staff asks legitimate theoretical questions. However, the staff is not, as I have indicated, necessarily correct to question why fiscal policy should not be used for demand restraint in the short term. I have the impression that this attitude reflects a change in the staff's approach, but we all know that consistency is for small minds. If fiscal policy can be made flexible on the revenue side, as well as on the expenditure side, why not

make it flexible? Could we not have a short note from the staff on why the so-called regulator was abandoned? I believe that if fiscal policy was made flexible both on the revenue and expenditure sides, we would have an additional and very helpful instrument. As regards the appropriate stance of fiscal policy over the medium term, it would be unjustified, at this time, to load the dice in favor of demand restraint; hence, I think that Mr. Cassell is right on this point.

Finally, we welcome the United Kingdom's large contribution to the enhanced structural adjustment facility and the interest rate reduction initiatives within the Paris Club. We also welcome the authorities' strong commitment to improving the international trading environment, particularly in the Uruguay Round. However, the United Kingdom could do more to increase its official development assistance.

Mr. Nimatallah made the following statement:

In the past few years, the economic turnaround in the United Kingdom has been both impressive and commendable. I am convinced that these achievements are consequences of the authorities' correct medium-term policy assignment; macro-economic policy has been directed primarily at monetary stability, while structural policy has been targeted at growth and employment. However, strains on economic resources have emerged, as the robust investment performance has been coupled with a declining savings rate. The resulting distortion in the savings/investment balance and the substantial escalation of private consumption, has accelerated aggregate demand, fueled inflation, and aggravated the current account deficit.

The authorities are concerned about the inflationary buildup, but regard the external deficit as a reflection of private decisions that are self-correcting. While the authorities might be right, private decisions are normally influenced, *inter alia*, by public financial behavior. Therefore, private expenditures may be altered if the Government announces that expenditures in certain areas are to slow down. Furthermore, the problem is not only that aggregate demand is outstripping aggregate real output, but also that the domestic savings rate is insufficient.

It is quite obvious that domestic demand will have to be constrained, but the crucial question is how. The authorities believe that fiscal policy is effective in a medium-term framework, but is inappropriate to counter short-term demand shifts; thus, monetary policy should be used to contain aggregate demand. However, an insufficient savings rate is not purely a short-term phenomenon, but should be solved within a medium-term

context. I question the ability of monetary policy, on its own, to solve both the demand problem behind the surge in the rate of inflation and the weakening of the external account. Indeed, owing to the structural shifts in personal savings and consumption brought about by improved confidence and greater access to financial markets, interest rate increases may not be as effective as one would otherwise expect. Restrictive monetary policy would affect the investment component of aggregate demand, thereby containing both GDP growth and the desirable capacity expansion. Increased interest rates over a prolonged period of time will lead to higher input prices, including wages, thereby inducing cost-push inflation that increases the probability of a hard landing for the economy. It is usually much more difficult to control cost-push inflation than demand-pull inflation.

An appropriate mix of monetary and fiscal policy is needed to support investment and savings, and to avoid cost-push inflation. While I agree with the authorities that the uncertainties regarding tax and benefit rates must be minimized, there is scope for some selective expenditure reduction with a view to increasing the fiscal surplus; this would have the dual outcome of reducing aggregate domestic demand and enhancing domestic savings. In this context, while Ricardian equivalence may have contributed to the reduction in personal savings, it is not obvious that marginal changes in the fiscal surplus would cause offsetting effects in personal savings behavior. Therefore, I am inclined to believe that higher public savings over the medium term could largely compensate for lower private net savings. Consequently, I see no problem with incurring fiscal surpluses over a few years.

The fiscal surplus is important to relieve the demand pressure until the authorities' supply-side policies meet their objectives to enhance capacity and increase domestic savings. In this regard, it would be helpful to implement a more neutral tax treatment of private savings and investment, as that would not only increase savings, reduce consumption, and improve the external position, but also increase the effectiveness of monetary policy and reduce the need for continued surpluses in the future.

Finally, we must not lose sight of the fact that high interest rates for a prolonged period of time could seriously aggravate the debt problem.

Extending his remarks, Mr. Nimatallah said that a very good question had been asked by Mr. Kafka concerning fiscal policy versus monetary policy in the short run. From time to time in certain countries, on certain occasions, the effects of monetary policy tended to be delayed, while fiscal policy could act more effectively and sooner.

The performance of the authorities and of the U.K. economy had both been very impressive in the past year, Mr. Nimatallah said. However, he wondered why the high rate of inflation had not been detected earlier; especially since the Chancellor of the Exchequer had been very keen on finding ways and means to detect inflation at an early stage. Currently, it would be a lot more difficult to control the rate of inflation, which was worrisome in view of the U.K. economy's impact on other economies. Its high interest rates could hurt indebted countries in particular; in fact, current high interest rates could impose an additional burden of about \$6 billion on the indebted countries. Accordingly, more attention had to be paid to the high rate of inflation in the United Kingdom.

There were three main problems facing the U.K. economy at present: cost-push inflation, the external deficit, and the declining domestic savings rate, Mr. Nimatallah remarked. Given that there were three problems, it would be difficult to tackle them with only one or two policy tools--interest rate and monetary policy. Accordingly, additional instruments were needed. In addition, he, as well as the Governor of the Central Bank of Saudi Arabia, had doubts about the effectiveness of using interest rates as the main policy tool in certain circumstances. Fiscal policy would be needed in addition to monetary policy to avoid cost-push inflation. However, at the present stage, it would be best not to change tax rates.

It appeared that Mr. Cassell believed that the declining domestic savings ratio was a temporary phenomenon, Mr. Nimatallah stated. The fact was that the domestic savings rate--the private savings rate in particular--had been declining ever since 1980. Accordingly, the declining domestic savings rate was not a short-term phenomenon, which made it even more certain that expenditure cuts with a view to increasing the fiscal surplus could help in enhancing domestic savings. Furthermore, he believed that high interest rates for a prolonged period of time would, in addition to increasing the prices of inputs, lead to cost-push inflation, which was much more difficult to control than demand-pull inflation.

In sum, he agreed with Mr. Warner on the need to put emphasis on structural adjustment to reduce rigidities in certain areas, such as the labor market, Mr. Nimatallah said. In addition, it was also important to put more emphasis on fiscal surplus by reducing public expenditures.

Mr. Fernández Ordóñez made the following statement:

At the outset, I want to commend the U.K. authorities on the economic policy they have followed since 1979. The economic results have been excellent, even though there have been some negative developments recently. Furthermore, I recognize the efforts the authorities have made to implement new policies, as the externalities they create should always be taken into account. We can all profit from the experience of countries like the United Kingdom, which have been experimenting with certain policies.

I endorse the staff appraisal and most of the views expressed in the staff papers. According to the supplement to the staff report (SM/89/29, Sup. 1, 2/28/89) as well as Mr. Cassell's opening statement, the authorities' official forecast was more accurate than the staff's forecast in predicting a slowdown in economic activity. However, the staff was on target in predicting the high rate of inflation, which the U.K. Government was not. Recent data indicate that the authorities will need to slow down domestic demand even further to achieve the desired results with respect to inflation.

As to the different methods of slowing down domestic demand, I agree with the staff that a more restrictive budgetary policy seems to be the most appropriate one. A reduction in domestic demand of a developed country is never good news for a developing country. However, if a reduction is necessary in light of the high inflation rate and current account deficit--which clearly is the case in the United Kingdom--it is always better for indebted countries if budgetary policy is used, as it does not have negative effects on interest rates.

With respect to domestic savings, I am not very pleased with the appendix supplied by the staff, as it supports the authorities' opinion that the declining personal savings rate is due to the authorities' actions to improve confidence, reduce the rate of inflation, deregulate the financial markets, and reduce taxation. I agree that some of these factors might have had a certain impact on personal savings, but, as I mentioned during the Board's discussion of the 1988 Article IV consultation with Canada, we need to study further the issue of declining domestic savings.

The positive outcome of the worsening of the balance between savings and investment is, of course, the favorable development with respect to investment. As the staff highlights, the case of the United Kingdom is very different from that of other countries, especially owing to the surge in private investment. Therefore, could we not use some kind of indicator to differentiate the case of the United Kingdom and similar cases from others? We could, for example, calculate the ratio between the current account deficit and investment, not only by using the ratio between the current account deficit and GDP, but also by looking at the evolution of the ratio between the current account deficit and investment. That study could give us a better idea of how external resources have been spent in the economy.

The staff report provides a good review of tax policy in the United Kingdom. The success of the Government in reducing taxes might encourage other countries to follow in its footsteps, which could prove to be dangerous. It is true that the

Government recently reduced taxes and, at the same time, was successful in cutting expenditures; however, that is not the complete picture. The Thatcher Government increased tax revenue by more than 4 percentage points of GDP in its first two years in office, as Table 2 of the staff report shows. The table points out that tax revenue in the United Kingdom was below the OECD average in 1979, but above it in 1986. One might think that developments in the United States had affected these comparisons; however, the result is the same when the United Kingdom is compared with the EC average.

Among the positive developments in the U.K. economy, I want to highlight the fall in the rate of unemployment to below the European average, which is indicated in Chart 1 of the staff report. Nevertheless, the current unemployment rate is above the rate in 1979, when the Government first took office, and there might be statistical changes and demographic reasons that could explain the recent fall. With respect to the presentation in the staff papers of the unemployment situation, I would have been interested also in knowing what effects the changes in social security contributions, which were adopted in 1985/86, have had on young and nonskilled workers.

Finally, I want to stress the importance of an active U.K. contribution to the development of the European Monetary System and, in general, monetary cooperation in Europe. In April the Delors Committee on economic and monetary union will circulate a report, and I think it is extremely important that the United Kingdom play an active role in this area--especially because its pragmatic approach has been a necessary and helpful ingredient in building European institutions ever since its entrance into the EC 15 years ago.

Mr. Rye made the following statement:

The discussion of the United Kingdom is of particular interest to us, as the United Kingdom faces an economic situation remarkably similar in a number of respects to that in Australia: a strong economic performance giving way to increasing inflationary pressures, a low level of personal savings, high private capital investment, incipient personal tax cuts, and a fiscal balance that has moved into what is apparently a very satisfactory position.

Since mid-1988, monetary policy in the United Kingdom has been playing its part in the attempt to restrain domestic demand and reduce inflationary pressures. With the benefit of hindsight, it is easy to criticize the relaxation in monetary policy following the stock market decline in October 1987; however, in that respect, few of us are in a position to cast

the first stone. Moreover, the problems in the United Kingdom do seem to have been compounded by the efforts to maintain a stable exchange rate in early 1988. At present, the key difference of opinion between the staff and the authorities concerns whether or not further monetary tightening is necessary to restrain demand pressures. The recent economic indicators show somewhat mixed signals, although a number suggest that a slowdown in domestic demand is taking hold. Obviously, the situation will be looked at very closely in the coming months.

An issue not raised explicitly by the staff, and one bearing on the fiscal versus monetary policy debate, is whether, and under what circumstances, it is appropriate to make gradual upward adjustments in interest rates, as opposed to tightening monetary policy. The shock effect of a sudden large change in monetary policy may have both larger and earlier consequences for activity than under a gradual approach. The staff points to the need for the right mix of policies in order to avoid a hard landing for the economy--something overreliance on monetary policy might bring about--and suggests a greater role for fiscal policy. It is not irrelevant that the contractionary effect of fiscal policy on demand in 1988/89 may turn out to be somewhat greater than that envisaged at the time when the staff report was prepared. However, I am not sure if the authorities would agree that such an outcome should lessen the burden on monetary policy.

We are, of course, looking ahead to the presentation of the 1989/90 budget. I agree entirely with the authorities' view that fiscal policy is not "an effective or reliable instrument for fine-tuning the economy," as Mr. Cassell put it in his opening statement. However, I do not think that the situation calls for a choice between one policy or the other; the U.K. position is not necessarily inconsistent with the staff appraisal, which states that further tax cuts could exacerbate demand pressures. It would surely be possible to adopt a more cautious approach to the proposed tax cuts, without abandoning, or even putting at risk, the medium-term framework of fiscal policy. That approach would take some of the pressure off interest rates and provide a signal to the market that the Government is committed to its anti-inflationary stance. We are also inclined to support the staff's view that a more ambitious medium-term fiscal stance is necessary in light of developments such as the sustained recovery in private investment; nevertheless, I agree with Mr. Cassell that this a matter of judgment.

The low level of private savings in the United Kingdom is closely linked to the current account problem, which the staff attributes to the strengthening of confidence associated with the falling unemployment level, the strengthening of public finances, and the lowering of tax rates, as well as the rise in

household wealth and new borrowing resulting from financial liberalization. We note with interest also the staff's view that financial liberalization has weakened the effect of fiscal policy on improving the savings ratio. However, I think, like Mr. Fernández Ordóñez, that the staff's view hardly provides a fully coherent picture, and we would therefore be most interested in the staff's or Mr. Cassell's opinions about the reasons for the United Kingdom's low savings rate and what can be done to improve it.

I share the staff's concern that wage increases may begin to outstrip productivity growth when domestic demand slows down. Wages are beginning to accelerate, and some moderation would be desirable to avoid adding to inflationary growth and reducing competitiveness further. It is not clear whether the relationship in which wages and productivity have been closely matched will last--particularly if high inflationary expectations are rekindled. In that context, the credibility of the medium-term inflation target is clearly at risk. We would agree that sound fiscal and monetary policies, as well as policies to improve flexibility in the labor market, should be the main elements in a convincing anti-inflation strategy for the United Kingdom.

We agree also with the staff that there are several areas where tax distortions could be tackled, in particular the deductibility of mortgage interest and the narrow coverage of the value-added tax. While we recognize the constraints imposed by political commitments, the real gains--both in providing room for further income tax cuts and on efficiency grounds--from pursuing reform in these areas are undeniable.

As to the external sector, the authorities appear to believe that the forces that brought about the large external deficit will be self-correcting. Given that exchange rate policy is dedicated to a maximum degree of stability consistent with the major objective of reducing the rate of inflation, I tend to agree with the staff that the external deficit may remain for quite some time. The possibility of a hard landing for the economy cannot be dismissed; a cautious approach to policy across the board seems to be the right stance to adopt.

Finally, the commitment of the U.K. authorities to a liberal trading system is very much appreciated by my constituency.

Mrs. Ploix made the following statement:

Last year was another successful year for the U.K. economy. Indeed, economic growth was very strong, above the average of

other G-7 countries; private investment rose sharply; profitability improved further; productivity increased significantly; and the unemployment rate fell steadily. One cannot but be impressed by this outcome that must be attributed to permanent and skillful implementation of sound macroeconomic policies and far-reaching structural reforms.

However, it is evident that the increase in demand and activity in the economy has become excessive. Domestic demand has accelerated significantly, outstripping GDP growth, and the rate of inflation has further increased to an average well above that of other G-7 countries. Moreover, conditions in the labor market have contributed to upward pressures on wages, and the external current account has deteriorated sharply, the deficit in 1988 having been the highest since 1973. However, recent economic developments suggest that there has been some deceleration in domestic demand. Nevertheless, we should not draw too definite conclusions, especially since there are considerable uncertainties surrounding the official statistics. I note the current debate in the United Kingdom on how to improve the quality of economic data, and I would be interested in Mr. Cassell's comments on this point.

Managing monetary policy in 1988 was not an easy task for the U.K. authorities, because of the increasing difficulty in reconciling the objective of maintaining a stable exchange rate with that of containing inflationary pressures. The implementation of monetary policy was complicated by the difficulties encountered in adhering to a broad monetary aggregate. In this context, the use of interest rates played an overwhelming role in the management of economic policy. Undoubtedly, the significant interest rate increases have been fully warranted during the recent months. However, even though the considerable tightening of monetary policy may have begun to produce the intended effects, the large interest rate increases required to achieve the desired outcome have not yet been consolidated. Furthermore, a tightening of monetary policy may prove costly. To boost interest rates may lead to an inadequate short-term appreciation of the pound at a time when the current account is deteriorating rapidly, and it could also have an unfavorable impact on costs and create a vicious circle. At the same time, there is a risk that demand conditions will remain buoyant for a longer time than was projected, thus increasing the risk of a too slow adjustment and, ultimately, a sharp deceleration in activity. One may wonder whether it would be advisable to support the monetary policy restraint by setting more ambitious fiscal objectives.

It has been clearly stated in the medium-term financial strategy that the role of fiscal policy is to help achieve the deceleration in monetary growth without "excessive reliance on

interest rates." However, the U.K. authorities stress that the current strength of domestic demand reflects private decisions on savings and investment, and that the role of fiscal policy is limited. I understand the rationale behind this argument, but I believe that the present circumstances warrant some flexibility without losing sight of the medium-term fiscal objective. I agree with the staff that in light of the uncertainties with respect to monetary policy, and the important structural shifts in private savings and investment patterns, fiscal policy should be aimed at countering imbalances in the private savings and investment sectors.

It may also be appropriate to reconsider the medium-term target of fiscal policy at this time. A more ambitious target would probably help to reduce the interest rates and have a favorable impact on national wealth accumulation. Furthermore, the fiscal target could be set taking into account the temporary character of oil revenues and the prospective net worth of the public sector; such an approach would be fully consistent with the aim to establish a framework of stable tax benefits over the long term. The sharp decrease in public investment is one of the main reasons for the budget surplus, which is not necessarily warranted since public projects may also have high returns, in particular in the form of external effects. One may consider also that a decrease in public investment can affect the public sector's net worth.

In the present circumstances, we wonder whether more emphasis should not be put on controlling wage developments, especially since productivity is expected to slow down, putting further pressures on labor costs. I understand the great reluctance of the U.K. authorities to intervene directly in the wage bargaining process. However, we believe that they could provide guidance through their wage policy in the public sector.

As to the external sector, I understand that the U.K. authorities are not too concerned about the deterioration of the external current account, since they consider that a strong net external asset position should help to sustain confidence. However, I agree with the staff that one cannot preclude the risk of disruptive market reactions that could increase with the size and duration of the deficits. Furthermore, I note that, aside from the strong growth in imports related to strong domestic demand, export volume in 1988 was 2.5 percent lower than in 1987. I would be interested in the staff's opinion on whether this decline suggests a deterioration in competitiveness. One may fear that the current external position, without further adjustment--can make it difficult to maintain exchange rate stability.

The U.K. authorities have made remarkable achievements in tax reform and in the labor market; there have been significant improvements in efficiency of the tax system over the past ten years. However, distortions remain, in particular, with respect to the treatment of corporate investment taxes and taxation of savings. In this context, I note the very favorable tax treatment of owner-occupied housing, and its significant drawbacks. Therefore, we urge the U.K. authorities to take further steps in the area of tax reform.

I am impressed by the steady decrease in the unemployment rate over the past two years. It seems to be attributable not only to the buoyancy of the economy, but also to the improvement in efficiency of the labor market; for instance, the lower than expected salary increases may suggest changes in the wage formation pattern. In the absence of income policy, it is of the utmost importance to improve the flexibility of wages in order to moderate increases in labor costs. Significant labor market rigidities persist, as evidenced by the wide dispersion in regional unemployment rates. These disparities may stem from a possible widening in regional performance, but are also due to other impediments such as housing policy.

Finally, I would like to mention also that we are very pleased with the progress in the construction of the "channel" between France and the United Kingdom.

Mr. Feldman made the following statement:

The economic performance of the United Kingdom during 1988 was impressive. It was the seventh consecutive year of sustained growth, and substantial progress was made in reducing the unemployment rate--traditionally one of the most difficult problems in the U.K. economy. In addition, there was strong growth in productivity and profitability, resulting in a substantial increase in private investment.

However, a further deterioration was observed in the external current account, which, given the excellent performance of the public sector, had as a counterpart the weakening of the savings/investment ratio of the private sector. Furthermore, the acceleration in domestic demand was accompanied by increased inflationary pressures. In this context, we welcome the recent data, indicating that a slowdown in domestic demand is occurring, and that the pace of adjustment is quicker than previously envisaged.

Given the difference of opinion between the U.K. authorities and the staff, we believe that the discussion should focus on what the most appropriate economic policy mix is--both

in the short and the medium term--under the present conditions. The starting point in the assessment of short- and medium-term policies is the acknowledgment that the reduction in the rate of inflation has continuously been the central objective in the design of the medium-term fiscal strategy. In this connection, the results obtained during the first half of the 1980s have been impressive. However, inflationary pressures are currently gathering momentum, and the authorities intend to act firmly to reinforce the credibility of their commitment and implement the set of policies described in the staff papers. In this respect, to peg the pound to the deutsche mark has been a key decision, as the achievement of a maximum degree of exchange rate stability was considered to be the best way of bringing down the rate of inflation and inflationary expectations. The U.K. authorities have shown a clear determination to tighten monetary policy to counter possible weakness in the exchange rate or threats to exchange rate stability. However, this approach, which entails an excessive reliance on monetary policy, presents a major difficulty, as a large and widening current account deficit has been building up, particularly the past two years.

Neither the staff nor the authorities seem very concerned about the development in the current account position. The authorities believe that the emergence of the external deficit mainly reflects private decisions relating to savings and investment that are self-correcting. I am not fully convinced by that explanation, as it basically implies that the external imbalance can be reversed, and confidence can be sustained, on the basis of the strong net external asset position of the United Kingdom. I agree with the staff that sudden and unexpected shifts in private portfolios may be highly disruptive, and could embody unpredictable risks associated with the size and duration of the deficits. To rely even more on interest rate corrections would increase the risk of a sharp deceleration in activity, which would cause a hard landing for the economy, as explained by the staff in the context of the medium-term scenarios.

Moreover, the appreciation of the pound since end-1987 has had a greater role in the worsening of the trade account than indicated either by the staff or the authorities. Furthermore, the appreciation does not seem to have contributed to alleviate the inflationary pressures that are building up in the U.K. economy. We note also that the trade account has been showing a persistent deterioration since the beginning of the decade, but the situation has intensified in the past two years. In fact, two thirds of the deterioration in the current account is due to the increasing U.K. trade deficit with Japan and West Germany. In these circumstances, I believe that the deterioration in the current account calls for a different policy mix; the recent appreciation of the pound needs to be reversed, and the deutsche

mark/pound relationship has to be brought back to a level similar to that which prevailed in 1987. This new parity would strengthen the United Kingdom's competitiveness and help redress external and internal imbalances, as the contribution of net exports to total demand will increase. In light of the scenario under which the exchange rate has been corrected, and given that domestic demand is already expanding at an unsustainable rate, we agree with the staff that a tightening of fiscal policy is a necessary element.

I understand the authorities' position with respect to the inconvenience of altering a medium-term fiscal norm to correct a short-run macroeconomic imbalance. I agree with them that fiscal policy should not, in general, be used in the short term in an attempt to prevent a hard landing for the economy. I agree also that too frequent revisions of the medium-term fiscal objectives may potentially entail a loss of credibility in policies. Fiscal policies--tax reform, in particular--should be considered within the framework of structural policies. However, under the present circumstances, a correction of the pound/deutsche mark parity is called for to help redress the current account deficit, and a withdrawal of fiscal stimulus should also be considered. To withdraw fiscal stimulus would help to cool down domestic demand pressures and contribute to the consistency of lower interest rates with a new set of relative prices; the balance between interest rate and exchange rate policies would become more realistic. I believe that it might be dangerous to rely too heavily on interest rate policy at certain times. In fact, too high interest rates in the United Kingdom may have induced capital inflows beyond the amount necessary to finance the current account deficit. Accordingly, the strong accumulation of reserves observed since 1987 might have been a major source of monetary expansion, which might have adversely affected inflationary expectations and domestic demand. However, these comments do not imply that the United Kingdom should underestimate the importance of the Louvre Accord or the commitment to policy coordination. My point is just the opposite: the United Kingdom will be in a better position to stick to its economic strategy, and to continue benefiting from the pegging to the deutsche mark, if a more realistic exchange rate parity is attained. Once they achieve that position, I would fully agree with the economic policy mix designed by the authorities.

The decline in personal savings is a very disturbing feature that has been detected in several industrial nations--especially in those embarking on strong programs of financial liberalization. This problem was brought up by Mr. Fernández Ordóñez at the discussion of the 1988 Article IV consultation with Canada (EBM/89/20, 2/22/89). In this connection, the equation presented in Appendix IV of the background

paper is not completely satisfactory. First, the real value of equities (EP) and the real value of housing (HP) are variables that may show high colinearity, which could explain the lack of statistical significance of the latter. Second, I would appreciate some clarification on the construction and measurement of the financial liberalization variable. Third, though statistically significant, the variable reflecting changes in the unemployment rate is not very convincing. Was the variable included to capture the precautionary motive? Would an income variable not have been more suitable? Fourth, I would also like to know why the real cyclically adjusted fiscal balance may have a stronger explanatory power than an interest rate variable.

Finally, I welcome the authorities' commitment to a liberal trade policy, which has been demonstrated by the United Kingdom in the context of the Uruguay Round. In this regard, the United Kingdom's efforts in the EC to reduce existing trade barriers--which clearly are affecting the development of new markets for low- and middle-income countries' exports--are very welcome.

We note the decline in U.K. official development assistance. Despite the efforts made recently for higher quality and effectiveness of assistance, we would encourage the authorities to increase their assistance in real terms in the forthcoming years, in particular given the country's much stronger fiscal position. We appreciate the United Kingdom's support to low-income countries through its generous contribution to the enhanced structural adjustment facility. We very much hope that soon the middle-income countries' debt problem will also be high up on the authorities' list of priorities.

Mr. Ovi made the following statement:

Despite some indications to the contrary, the U.K. economy appeared to be moving too fast. Although declining, demand pressures are strong, the rate of inflation is on an upward trend, and the current account position has not improved. A slowdown in domestic demand is expected, but the crucial question is when. Currently, there is an active debate about what the policy mix should be to avoid a hard landing for the economy.

In his statement, Mr. Cassell conveyed the views of his authorities with respect to the role and appropriateness of using fiscal policy to engineer a soft landing for the economy; he said, basically, that fiscal policy should not be utilized to influence demand conditions in the short term. That point is valid provided that the economy is in a situation of no major disturbances or imbalances. However, the staff argues quite

convincingly that important underlying changes have taken place in the U.K. economy, suggesting the need for a more ambitious fiscal policy.

Certainly, in the Nordic countries, a combination of wealth effects and financial deregulation has had a fairly dramatic impact on personal savings. Ideally, this should be taken care of by working directly on the incentive structure. However, the Nordic authorities have had to use fiscal policy to counteract the impact on the overall economy. In addition, I would have thought that it was generally accepted that the impact of monetary policy on demand usually occurred after a considerable, and rather unpredictable, time lag. In the meantime, there are often substantial and unwarranted side effects on the foreign exchange rate. In contrast, the impact of fiscal policy on demand is generally more direct and predictable. Given the present economic situation, one would therefore expect the U.K. authorities, whose overriding policy objective is to lower the rate of inflation, not to exclude the utilization of fiscal policy. Furthermore, the staff's medium-term scenario and policy simulations suggest that tight monetary policy, combined with active fiscal tightening, would help to achieve both the domestic objectives and the external targets.

Considering the uncertainties with respect to the inflation rate, the authorities should not take any risks on the demand side. Both domestic and external objectives suggest that fiscal policy be tightened, which, of course, means that there is little room for tax cuts at present. However, I am not implying that the tax reform process would need to come to a halt. According to recent press reports on the U.K. economy, there is considerable scope for attacking loopholes in the present tax system; for instance, homogenous tax treatment could be given to all personal savings. Other tax measures to be contemplated would be a tax on imputed rent and a capital gains tax, or, alternatively, a removal of the present deductibility of home mortgage interest payments. It seems necessary for the Government, at least in the short run, to continue to support gross savings through public sector finances, thus compensating for the substantial fall in the personal savings ratio.

Labor market rigidities have been markedly reduced in recent years, but it remains to be seen whether the U.K. economy not only will be able to return to its earlier and fairly constant levels of wage and price increases, but also achieve a deceleration beyond those levels. Despite the Government's strong emphasis on reducing, and eventually eliminating, the rate of inflation, the U.K. performance continues to lag behind that of its major European competitors.

The demand for skilled workers has been reflected in recent wage settlements, and indicates a high increase in labor costs also in 1989. Thanks to rapid productivity growth, the rise in unit labor costs in the manufacturing sector has been minimal so far. However, the cyclical downturn may affect adversely both the profitability of firms and their relative competitiveness when productivity growth returns to a more normal level. Thus, more active efforts--such as education and training--should be encouraged in order to eliminate rigidities and moderate wage demands; the favorable fiscal position, no doubt, provides opportunities for such efforts. In the medium term, these measures, together with continued brisk investment activity, could provide a more sustainable solution to the rather high long-term unemployment level, and the disparities in the unemployment levels between various regions in the United Kingdom.

We appreciate the authorities' efforts to attain a more open world trade system both within the EC and in the context of the Uruguay Round. The authorities should be commended also for their initiatives to alleviate the debt-servicing difficulties of low-income countries, and for raising their official development assistance (ODA). However, in light of the still relatively low level of ODA, we hope that the favorable developments in the United Kingdom's fiscal position will be reflected, in part, in a greater effort to increase ODA resources beyond what has been indicated in the most recent projections. In this context, I want to emphasize that the Nordic countries do not wish to tie ODA to the budgetary situation in a member country. However, in the case of the United Kingdom, earlier cuts in ODA were strongly motivated by the need for budgetary restraint.

Finally, Mr. Cassell ends his statement by noting that with regard to the policy prescription, time will tell whether the staff's or the authorities' view of 1989 proves to be the more accurate one. Looking back on the discussion of the 1987 Article IV consultation with the United Kingdom and developments since then, we hope that the authorities will be more responsive to warnings from the outside.

Having said this, I should finally like to commend the authorities for the major achievements in the U.K. economy in recent years.

Mr. McCormack made the following statement:

We agree with the staff that economic developments in the United Kingdom in recent years have, in the main, been impressive in comparison with those in other major industrial countries, as well as compared with the United Kingdom's own past. The economy has expanded strongly in the past six years, the

unemployment level has fallen steeply since the mid-1986, productivity in the manufacturing sector has been rising at a substantially faster pace than the average for the other G-7 countries, profitability of industry has grown strongly, and business investment has surged. At the same time, there has been a major adjustment on the fiscal side, from a public sector borrowing requirement in excess of 5 percent of GDP at the beginning of the 1980s, to a public sector debt repayment that is estimated to reach 2.5 percent of GDP in 1988/89. Significant progress has also been made in strengthening the supply side of the economy.

Nevertheless, in the past year, a number of serious problems have emerged. In particular, the rate of inflation has accelerated and the current account deficit has widened sharply. With the benefit of hindsight, we can see that an undue relaxation of monetary policy through the first half of 1988 underlay this development. It became obvious that the underlying strength of the economy following the stock market fall in October 1987 had been underestimated, and so had the authorities' efforts to maintain a stable pound/deutsche mark cross rate, as a means of controlling inflation in the medium term.

To the authorities' credit, once it became clear around mid-1988 that domestic demand was growing too rapidly, they moved quickly to raise interest rates and accepted an appreciation of the pound vis-à-vis the deutsche mark. We find the resultant tightening of monetary conditions since then, and the authorities' commitment to raise interest rates further if the growth of demand fails to decelerate as expected, entirely appropriate and reassuring.

It appears that the tightening of monetary policy since mid-1988 is beginning to show the intended results: the narrow monetary aggregate, M0, and bank lending growth have decelerated, retail sales have slowed, and house prices have come down. Additional information, released after the staff report was circulated, suggests a deceleration in industrial activity and overall economic production, with the output measure of GDP rising by only 3.4 percent a year in the fourth quarter of 1988, following a downward revised growth of 4.3 percent in the third quarter. However, this slowing in activity has not yet been reflected in either labor market or price and cost developments; recent statistics are still showing considerable pressure in these areas.

In addition to the continued risk of running up against capacity constraints, inflationary risks are increased by uncertainties as to whether high rates of productivity growth will continue to offset increases in wages. Despite rapid growth in

average earnings of 8.7 percent in 1988, large gains in productivity served to hold increases in unit labor costs in manufacturing to less than 2 percent. Structural reforms introduced since 1979 could have been expected to result in an improvement in trend rates of productivity growth, compared with the depressed rates of 1973-79. However, the staff appears to be somewhat skeptical about the impact of the structural reforms, and gives a larger weight to the cyclical component of productivity gains. Assessments by the Bank of England in February 1989 conclude that the underlying trend of labor and total factor productivity has improved noticeably since 1980. In this context, I would appreciate the staff's comments.

With regard to alternative anti-inflationary strategies, my authorities question advocacy of any quick return to using the exchange rate as an anchor for monetary policy. The increased role given to the exchange rate was an important factor in contributing to the overly expansionary monetary policies in the first half of 1988; this comment--essentially a judgment about the short term--is without prejudice to the question of ultimate participation in the exchange rate mechanism of the European Monetary System, as recommended by Mr. Grosche. Moreover, in light of the unsatisfactory experience associated with shadowing the deutsche mark in the spring of 1988, and the effective severing of that link in mid-1988, we are not certain how to interpret the statement on page 11 of the staff report (SM/89/29, 2/6/89) that "the unchanged objective of policy is to achieve the maximum degree of exchange rate stability consistent with the overriding goal of bringing down inflation." Since no specific time frame for reducing the rate of inflation is mentioned, this statement might suggest that the achievement of price stability could be pushed further aside in response to each episode of exchange rate strength. This apparent lack of clarity in describing policy objectives could be harmful to the authorities' credibility among financial market participants.

The sustainability of large current account deficits over the medium term is another uncertainty. We agree with the staff that the current account deficit is likely to remain substantial, reflecting the large initial imbalance and the deterioration in competitiveness. However, we expect that a number of factors will help to maintain the confidence necessary to the financing of current account deficits, including a strong net external asset position, the surplus position of the public sector borrowing requirement, and the expected buoyant investment in line with tax reforms and improvements to the supply side. Nevertheless, the possibility of disruptive market reactions cannot be excluded, particularly if the assumed rebound in the savings rate from historically depressed levels fails to materialize and increases the projected current account deficit.

We agree that the authorities should remain vigilant until there is firmer evidence that the desired slowdown in demand is under way and inflationary pressures are abating. However, despite the risks already mentioned, my authorities are somewhat more optimistic than the staff, and are more in line with the views expressed by Mr. Cassell in his opening statement with respect to the adequacy of measures taken so far; in part, this reflects the additional statistical evidence of recent weeks. In light of the investment boom of recent years, and the possibility that such expenditures may be considerably greater than reported, the potential output growth of the economy in the near term may be higher than the 2.7 percent of GDP assumed by the staff, which would reinforce the disinflationary effects of any restraining action taken so far.

In the event that some further restrictive measures were needed, we would share the authorities' views that the burden in the short term should be placed mainly on monetary policy, and that fiscal policy should remain geared primarily to medium-term objectives. In this regard, the staff has suggested that the authorities might want to consider revising their current medium-term balanced budget norm to provide for a structural surplus, especially in view of the need to raise national savings and alleviate the external deficit problem. As discussed in Appendix IV of the background paper (SM/89/38, Sup. 1, 2/22/89), it is likely that the magnitude of the decline in personal savings, and the extent of the deterioration of the external accounts, have been overstated as a result of measurement problems. Furthermore, the decline in aggregate private savings has also been overestimated, reflecting offsetting increases in savings of the industrial and commercial sectors and, to a lesser extent, the financial sector. It is sensible that, within the confines of a revenue-neutral tax reform, the authorities undertake action to reduce distortions that act to reduce savings; however, to invert the problem and look at the outcome, and then try to solve the problem, is probably not an appropriate strategy for macroeconomic policy. In addition, as the authorities have pointed out, an increase in the fiscal surplus may not be effective with respect to savings, as private agents in the United Kingdom may see less of a need to save to offset future taxes when the Government reduces its borrowing requirements.

There is no pressing and clear-cut need at this stage for the authorities to rethink fundamentally their medium-term strategy. However, we note that the authorities have publicly stated that there may be little room in 1990 for further tax cuts toward achieving their medium-term aims. We view this increased flexibility within the overall medium-term orientation of fiscal policy as encouraging. Mr. Cassell appears to be of the same view; he states that the public sector borrowing

requirement may be greater or smaller in individual years than the zero implied by a balanced budget. In addition, particularly if the projected rebound in private savings fails to materialize, we would favor an even more cautious policy stance. In a longer-term context, however, the United Kingdom clearly has made substantial progress in removing fiscal imbalances. The United Kingdom is the only G-7 country forecast to be in budgetary surplus, in terms of central government financial balances, in 1989/90; on a general government basis, only the United Kingdom and Japan are projected to be in surplus. Furthermore, government expenditure as a ratio to GDP has fallen--from about 46 percent in 1980/81 to about 38-39 percent in 1988/89--since the introduction of the medium-term financial strategy. That strategy has served the authorities well, and we would be reluctant to suggest changing it against the judgment of the authorities.

In conclusion, we believe that economic policies are broadly on the right track. The cautious stance of fiscal and monetary policy appears to be having an effect in slowing down economic activity. Nonetheless, there clearly has been some divergence from the authorities' medium-term financial strategy, and continued uncertainties regarding inflation, the external account, and private savings behavior suggest that a cautious policy stance may have to be pursued for some time.

Mr. Jalan noted that there were differences of opinion between the U.K. authorities and the staff on almost all major issues, including the outlook for 1989, the medium-term fiscal targets, and the use of fiscal versus monetary policy. Mr. Cassell had rightly pointed out that those differences were legitimate, given the current uncertainties and possible errors with respect to forecasting.

There seemed to be a link between the public sector fiscal surplus in the U.K. economy and the private sector fiscal deficit; since mid-1986, the household financial balance had declined sharply, while the government financial balance had increased, Mr. Jalan remarked. It appeared that the private sector deficit was, to a certain extent, the counterpart of the public sector surplus. What effects would a large private sector deficit, a large public sector surplus, and a high interest rate scenario have on the financial markets? He believed that there were some inherent dangers in such a situation, especially in the case of the United Kingdom, which played an important role in determining the nature of the world's financial markets. What would be the permanent effects on the household and corporate financial balances if the private sector deficit increased further? Interestingly, the opposite situation was true in many developing countries, where a private sector surplus was combined with a public sector deficit. The situation in the United Kingdom was, of course, very different, but the question that arose in both circumstances was the

relation between the fiscal surplus of the Government and the private sector deficit, and its impact on the financial markets.

The United Kingdom was a very dynamic provider of development assistance, Mr. Jalan observed. The quality and effectiveness of U.K. aid was probably the best in the world, as it was very responsive to the requirements of low-income countries. However, after a period of budgetary stringency and cutbacks, it was time for the United Kingdom to consider an increase in the volume of its official development assistance.

Mr. Hassan made the following statement:

I commend the U.K. authorities for their remarkable performance over the past year. The U.K. economy continued its impressive upswing, recording another year of substantial expansion in output and employment, characterized by a strong rise in productivity in the manufacturing sector and a surge in business investment. However, the robustness in domestic demand, which led to intensification of inflationary pressures and further weakening of the external current account position, emerged as a clear sign of a possible overheating of the economy. I note the staff's view that the relative relaxation in monetary policy in late 1987 and early 1988, and the unduly low interest rates, have contributed to the surge in domestic demand. Moreover, the staff believes that the contractionary effect of budgetary policy was not sufficient to neutralize the stimulus to domestic demand from monetary policy.

The authorities and the staff agree that the immediate objectives of financial policies should be to contain growth in domestic demand and ease inflationary pressures. According to the authorities' forecast, the monetary tightening in the second half of 1988 should lead to a quick and substantial slowdown in domestic demand. Indeed, Mr. Cassell's opening statement, as well as the supplement to the staff report (SM/89/29, Sup. 1, 2/22/89), indicate that the authorities might be correct. However, the staff believes that considerable uncertainty remains regarding the pace of deceleration in domestic demand, which implies that the economy may have to cope with stronger inflationary pressures and a further widening in the current account deficit for some time. The authorities' commitment to raise interest rates further and strengthen the exchange rate of the pound, in order to ensure the envisaged deceleration in demand, is a clear indication of their determination to address the problem.

The staff raised an interesting question regarding the role of fiscal policy in reducing the risk of a hard landing for the economy in view of the considerable time lag involved before monetary tightening would have a significant impact on domestic

demand. The role that fiscal policy can play under the prevailing circumstances in the U.K. economy is not clear, because the weakening in the external current account position appears to be a reflection of a deterioration in the private sector savings and investment balance, rather than of a worsening in the public sector fiscal position. I can understand the authorities' reluctance to use fiscal policy to counter short-term shifts in demand, as well as their reliance on monetary policy as the main instrument to curb the current surge in domestic demand. Nonetheless, I found the staff's argument concerning the hard landing scenario appealing. I believe that consideration should be given to the use of budgetary policy in 1989/90 to support monetary restraint by aiming at a larger surplus; it seems that the staff has the same view even after new information has been released about an early deceleration of demand.

The staff raised a question with respect to the compatibility of an exchange rate policy based on using the deutsche mark as an exchange rate anchor, and policies required to achieve the medium-term target for inflation, as specified in the medium-term financial strategy. Although the inflation rate has been reduced substantially compared with the high levels of the early 1980s, the authorities have not been able to achieve the inflation target of the medium-term financial strategy, and there are indications that the rate of inflation may be on the rise again. Therefore, the overriding objective has to be the achievement of domestic stability. However, firm monetary policy aimed at achieving this objective may not be consistent with the interest rate level needed to maintain the desired exchange rate for the pound. Under such circumstances, to give priority to the restoration of domestic stability, and to concentrate the alleviation of inflationary pressures, may be the appropriate course of action for the authorities to follow.

Finally, I note that the United Kingdom's official development assistance has declined considerably in recent years, having reached the low level of 0.28 percent of GDP. Therefore, I welcome the planned increase in official development assistance over the coming three years to reverse this trend, as well as the large grant element--particularly to low-income countries. The United Kingdom's leading role in providing resources to the subsidy account of the enhanced structural adjustment facility is also most appreciated.

Mr. Posthumus said that economic developments in the United Kingdom over the past six years had been remarkable, thanks to a well-designed and well-implemented policy package. However, monetary developments had been less successful. He hoped that the present overheating of the economy would not do damage to the economy or the economic policy package itself. It was sobering that despite all the Fund's and the authorities' knowledge

and experience of the workings of economies, the recent economic upsurge had been unexpected. In the case of the United Kingdom, external factors could not be blamed for the recent developments. At the discussion of the staff report for the 1987 Article IV consultation with the United Kingdom, Directors had recognized that only modest progress had been made in reducing the rate of inflation and inflationary expectations in the past four years. In addition, monetary indicators had shown substantial growth in 1986 and 1987. Indeed, there had been signals of an economic upsurge, and Directors had recognized those signals, but--with the benefit of hindsight--had not drawn the right conclusions, or had been, perhaps, too diplomatic and cautious.

He supported the staff appraisal, but had some particular observations to make with respect to fiscal policy and exchange rate policy, Mr. Posthumus remarked. Fiscal policy, as carried out in the United Kingdom, had been exemplary; the United Kingdom's medium-term fiscal strategy appeared to be very sustainable--also in a political sense. The U.K. fiscal policy did not allow for anticyclical policies to work, but for automatic stabilizers to operate. The resulting fiscal surplus should be accepted and showed that fiscal policy was working in the desired direction. The authorities seemed to be prepared to take certain anticyclical fiscal measures at the time of the introduction of 1989/90 budget, as well as to postpone further tax cuts in the new budget, and, in that respect, he agreed with their approach. The staff had suggested also to change the course of fiscal policy, but that might, however, undermine the approach of medium-term fiscal discipline and a balanced budget norm. While such a change of course might be acceptable at present, it might turn out to be unacceptable at a later stage; the result of fiscal stimulation might be a fiscal deficit. In addition, it would take time before the fiscal measures would bear fruit. The staff should take all those considerations into account when calling for a revision of the medium-term fiscal norm.

At present, an exchange rate stabilization effort would hamper rather than support internal stability, Mr. Posthumus commented. The authorities' decision--which had been supported by Directors--to give greater weight to the stability of the exchange rate, had proved to be wrong, because monetary growth had been too strong already. Exchange rate stability could be supportive of a low-inflation strategy, but in an already highly inflationary situation the introduction of a stable exchange rate policy was not possible. In sum, the authorities would have to choose between controlling the rate of inflation or stabilizing the exchange rate; he believed that the authorities' choice to give top priority to controlling the rate of inflation was correct, as well as their choice to postpone the United Kingdom's participation in the exchange mechanism of the European Monetary System.

The authorities believed that the fact that long-term interest rates had edged up only slightly showed that the markets were confident that the authorities' fight against inflation would be successful, Mr. Posthumus noted. However, he wondered whether it was not rather the

fact that the markets could expect budget surpluses and that the Government would not intervene in the capital markets that had contributed to lower longer-term rates, thus netting out the upward pressure caused by inflationary expectations.

Finally, Mr. Cassell had remarked in his opening statement that official development assistance was only a partial indicator of the assistance the United Kingdom provided, and that private direct investment had not been taken into account, Mr. Posthumus observed. He was surprised by that comment, as it indicated that the United Kingdom, the largest foreign investor in the United States, was also the largest aid donor to the United States, which, in turn, meant that the Kingdom of the Netherlands was the second largest aid donor to the United States. Interestingly, many of the multinational companies that made private investments in the United States were owned jointly by the United Kingdom and the Kingdom of the Netherlands.

Mr. Kyriazidis made the following statement:

A number of important goals were achieved by the U.K. authorities during 1988: a high rate of growth, a steep decline in the unemployment level, improvements in productivity, and a noticeable rise in business investment. Furthermore, the process of fiscal consolidation proceeded smoothly in the past year. However, a rising rate of inflation, combined with an increasing current account deficit and difficulties in the conduct of monetary policy, suggests that the authorities will face new challenges in 1989. In addition, the unemployment level is still high in many areas of the country; accordingly, renewed action will be required in the field of regional and structural policies.

In many respects, the weaknesses in the U.K. economy are by-products of developments in the rate of growth in domestic demand for both consumption and investment--inevitably reflected in a high current account deficit. However, the difficulties encountered by the U.K. economy also reflect past developments and the fact that the restructuring process, undertaken in the early 1980s, is still under way. In this regard, it is important to remember that labor shedding in manufacturing is continuing, and that while most enterprises are facing capacity constraints of various kinds, the level of manufacturing output only recently exceeded that of 1974. Furthermore, the share of nonresidential gross fixed investment in GDP has increased considerably during the 1980s, but investment in plant and machinery has been much lower.

Therefore, the discussion on the possible future course of economic policy should take into account not only that capacity constraints have already been reached in many sectors, but also that limitations to potential growth are not likely to be

removed in the near future. As a consequence, demand will have to be kept under very strict control in 1989 through an appropriate mix of fiscal and monetary policy. While both the authorities and the staff seem to agree on the need for demand restraint, there is less than full consensus on ways and means to achieve that objective.

According to the staff, a more stringent fiscal policy is necessary given the trends with respect to domestic demand, private sector savings, and the deteriorating current account position. Fiscal policy should be implemented by adopting a fiscal norm that prescribes the achievement of fiscal surpluses in the medium term, and should be coupled either with a tighter monetary policy--if the authorities choose to peg the pound to the deutsche mark--or with a stable monetary stance--if the pound is allowed to float more freely.

The U.K. authorities consider that the present stance of fiscal policy is appropriate on the grounds that a change in the fiscal norm might undermine policy credibility, and that an increase in public savings might not necessarily result in higher global savings. The authorities also believe that inflationary pressures in the United Kingdom can be kept under control by means of a vigilant monetary policy.

I agree to a certain extent with the authorities' point of view with respect to fiscal policy. First, a more restrictive fiscal policy might prove unfeasible, owing to the lack of sufficient social support. One should remember that various categories of social and investment expenditures have already been drastically reduced, and that further reductions might prove counterproductive in the longer term. Second, it is difficult to envisage the final results of increased public savings. It might well be that such an increase will be offset by further decreases in household savings. A new fiscal policy should be based on a set of behavioral relationships, based on past experience, rather than on a set of accounting identities that are, at best, able to describe the past. The recommendation to increase public sector savings, in order to compensate for lower private savings and improve the current account position, seems to be based on an accounting identity. In this connection, I believe that further study is necessary, given the practical difficulties involved in estimating private savings and financial accounts, as pointed out by Mr. Cassell.

However, under the present circumstances, fiscal policy can not be used for the short-term management of the economy, which raises the question of whether monetary policy is capable of assuring, on its own, internal balance--especially if the authorities wish to peg the pound to the deutsche mark. The

authorities have confidence in monetary policy, and the indicators mentioned by Mr. Cassell appear to lend support to this conclusion, but the situation is not at all clear.

The difficulties encountered by monetary policy during 1988 seem to have been caused, in large part, by the authorities' attempt to peg the pound to the deutsche mark, which compounded the effects of monetary relaxation that followed the stock market fall in October 1987. Monetary expansion, which was the authorities' response to the stock market fall, fueled domestic demand more than envisaged. At the outbreak of the crisis, and with the acute weakness of the deutsche mark, further monetary relaxation, including a steep cut in short-term interest rates, was required to prevent the pound sterling from appreciating. It is unlikely that such an unfortunate coincidence of events will occur again; therefore, the task of monetary policy will become easier facilitated, even if the authorities revert to the policy of pegging the exchange rate. The rapidity of the economy's response to monetary stimulus lends additional support to the optimism of the authorities with respect to the speed of adjustment of domestic demand to the tight monetary conditions that have been maintained since mid-1988.

Debt reduction policy, which the authorities envisage as a result of the fiscal surpluses, has recently become the object of discussion in the United Kingdom, and sounds like an embarrassment of riches. I would appreciate some comments from Mr. Cassell or the staff on this point. In particular, various commentators have pointed out that debt reduction should be viewed in light of its effects on the balance sheet of the public sector, and the changes it implies in the public sector's net worth.

I am concerned about the monetary effects of debt reduction--another manifestation of the embarrassment of riches--as the reduction of publicly held debt appears to offset the liquidity effects of the fiscal surplus. Indeed, during an informal Board meeting, Mr. Cassell indicated that the inverted yield curve is at least in part due to operation of debt redemption operations. That would seem to indicate that the pressure to be applied in the short end of the market is much greater if stable monetary conditions are to be maintained. Some further comments on that issue would be welcome.

On structural policies, the staff supports a reduction in the marginal rates of social security contributions as a means of increasing work incentives. That approach seems appropriate, given that the U.K. tax system is characterized by a very low degree of progressiveness. We believe also that taxing the income from owner-occupied housing might moderate increases in house prices in the most dynamic areas of the country, and

contribute to a more active rental housing market. Moreover, increased labor mobility might derive from adopting that tax.

However, the regional disparities in the level of unemployment are too wide to be corrected only by supply-side measures. In this respect, we wonder whether regional policy might not have a major role to play in the United Kingdom. In fact, most of the high employment areas are showing signs of urban congestion, and bottlenecks in the provision of public services seem to be common in fast growing regions. There will be an even stronger need to balance the regional growth rates in 1992, as a single European market would tend to shift the axis of the country southward.

Mr. Yamazaki made the following statement:

The U.K. economy, in its sixth year of expansion, continued to show strong growth centered around domestic demand. Furthermore, the rapid rise in manufacturing productivity, and the sharp decline in the unemployment rate since 1985, are the salient features that reflect the authorities' long-standing efforts aimed at improving the supply-side performance of the economy. However, growing inflationary pressure, associated with strong domestic demand, clearly points to the danger of overheating the economy. Moreover, the sharp deterioration in the external current account occurred, unlike the case of the United States, simultaneously with the improvement in the fiscal balance. Accordingly, the U.K. economy seems to be on the verge of classical demand-pull inflation. Traditional aggregate demand policy, based on monetary and fiscal restraint, is essential to restore price stability and rectify the external imbalance. In this connection, I welcome the strong restrictive measures taken by the Government and the Bank of England since mid-1988, although, as the staff rightly notes, the timing of the change in aggregate demand policy was somewhat late due to the emphasis placed on exchange rate stability. It is of paramount importance to continue the efforts toward more fiscal and monetary restraint.

On fiscal policy, I strongly welcome the fact that, while the other G-7 countries are still faced with large fiscal imbalances, the United Kingdom has succeeded in completely eliminating the budget deficit. Nonetheless, and not to mention the caveat by Dr. Milton Friedman about the lack of incentive to make ends meet, the balanced budget entails a risk of increasing public expenditure. In this connection, it should be emphasized that, as evidenced by Chart 10 of the background paper, the balanced budget was brought about primarily through restraint in expenditures and was, therefore, accompanied by a reduction in the size of the public sector. In addition, the medium-term

financial strategy should play an important role in underpinning the political will to maintain efforts toward a small public sector.

In view of the short-term need for demand restraint, the contractionary effect of fiscal policy should be carefully reviewed. As the staff rightly notes, the recent decline in the public sector borrowing requirement is at least partly due to the cyclical factor reflecting fiscal drag, or the built-in stabilizer effect of higher nominal growth. Also, the large-scale sales of public assets, as a result of privatization, contributed to increases on the revenue side. If we exclude these temporary factors and measure the stance of fiscal policy, a case could be made for further fiscal restraint. The staff could, perhaps, elaborate further on this point.

I broadly support the present stance of monetary policy based on the authorities' overriding commitment to contain inflationary pressure. Such phenomena as the slowdown in consumption and growth in the narrow monetary aggregate M0 endorse the authorities' view that the monetary tightening has begun to exert favorable effects on the economy. Furthermore, the inverted yield curve with relatively stable long-term rates may reflect the fact that they have succeeded in forestalling the resurgence of inflationary expectations. So far, the staff's revised forecast for 1989 provides for a more balanced course for the economy, but there are still some divergences between the U.K. authorities and the staff with respect to the expected increase in domestic demand. According to the staff's forecast, there is still a risk of insufficient restraint. In this connection, the exchange rate policy should be considered carefully. While a further appreciation of the pound would have a negative impact on the current account, insufficient demand restraint would have a greater impact on the external balance. A depreciation of the pound no doubt would exacerbate domestic inflation, but it would not significantly improve the external balance, in view of the already high level of resource utilization.

On the structural side, I appreciate the staff's analysis with respect to the regional aspects of economic performance. However, according to the analysis on the recent decline in personal savings, the increase in the current account deficit is mainly due to increased private investment. This development suggests that the present external imbalance is not so much a structural problem stemming from the savings/investment balance, as a cyclical phenomenon reflecting the relationship between supply and demand. The need to contain domestic demand in the context of the traditional absorption theory should be underscored.

Finally, I welcome the recent achievements by the U.K. authorities in the area of tax reform. The U.K. tax system has already become simple and efficient relative to that of other industrial countries, and I note with great pleasure Mr. Cassell's strong commitment to the process of tax reform.

Mr. Mawakani made the following statement:

The past year was again a good one for the U.K. economy, as evidenced by the many positive indicators recorded: real economic growth continued for the seventh consecutive year, the unemployment rate was further reduced, productivity--particularly in manufacturing--and profitability remained strong, and business investment increased substantially. However, some other indicators gave cause for concern, notably the emergence of inflationary pressures and the widening of the external current account deficit, reflecting the rapid expansion of domestic demand.

I agree with the thrust of the staff appraisal, and will comment only on a few issues of particular importance. Inflationary pressures have emerged in the economy, reflecting strong real domestic demand underpinned by increases in private consumption, expansion of credit, pickup in business investment, and capacity constraints. This development constitutes a potential threat to the continued expansion of the economy.

I welcome the authorities' strong determination to reduce and, eventually, eliminate inflation, as indicated by Mr. Cassell in his opening statement. Despite the problem caused by the strengthening of the pound sterling, it has become clear that further tightening of monetary policy is warranted to help reduce the rate of inflation. In addition, the effects of the ensuing exchange rate appreciation is to be weighed against the hard landing scenario referred to by the staff.

The strength of the present fiscal position is impressive, but fiscal policy could help reduce further the pressures on resources, as illustrated by the two scenarios on page 16 of the staff report. Therefore, I am pleased that Mr. Cassell stated that a central consideration in the formulation of the 1989/90 budget will be to reduce the rate of inflation.

Wage policy would certainly contribute to reduce pressures on resource allocation in the economy. In view of the high unemployment rate, the continued increases in earnings, particularly in the public sector, can be explained only by structural rigidities in the labor market. In this connection, I welcome the steps taken by the authorities to provide tax incentives in order to encourage mobility of the labor force.

It is important to recognize the important role that the United Kingdom's economic policies play in the international policy coordination process. It appears that domestic pressures lead to more frequent changes in domestic policies, thereby giving less room for a broad policy formulation at the international level. We wonder how these two positions could be reconciled. In addition, the maintenance of voluntary export restraint arrangements, together with those operated under the EC framework, hamper seriously the attainment of the broad objectives of international policy coordination, which is a cause for concern. We welcome the steps taken recently by the authorities to reduce voluntary export restraints, and we support their efforts with respect to trade liberalization within the EC and the Uruguay Round.

Finally, we welcome also the U.K. assistance to low-income countries, but we are concerned about the decline in official development assistance to 0.28 percent of GDP in 1987--down from 0.50 percent of GDP in 1979. In view of the strength of the United Kingdom's fiscal position, we would encourage the authorities to increase substantially the official development assistance.

In sum, the U.K. authorities should be commended for the seventh year of strong economic expansion, but lasting gains, they should reinforce their policies aimed at containing inflationary pressures and reducing excess demand and external current account imbalances.

Mr. Kabbaj made the following statement:

We are in broad agreement with the thrust of the staff appraisal. As indicated in Mr. Cassell's opening statement, the United Kingdom's economy continued its steady growth in 1988. The further rise in productivity in manufacturing, the impressive improvement in the domestic fiscal position, as well as the steep fall in the rate of unemployment, are all indications of a remarkable economic performance.

Despite these achievements, the economy has been entangled with imbalances due to overheating demand pressure, a rising rate of inflation, and widening imbalances in the external current account. The external position deteriorated sharply during the second half of 1987--mainly owing to a sharp increase in demand for imports--and intensified further during the third quarter of 1988. The external current account deficit initially emerged in the first half of 1987 in the amount of £3 billion and widened to £15 billion in the third quarter of 1988. Indeed, such an external imbalance has been unprecedented in the U.K. economy--at least in the present decade.

According to unofficial figures published recently, an increase in prices at a rate of 7.5 percent a year is expected during the next few months. These indicators clearly demonstrate the gravity of growing demand pressure. Fortunately, the authorities are well aware of these structural problems, and are determined to make the policy efforts needed to reduce demand pressure. In this regard, it is comforting to note that, according to the supplement to the staff report and Mr. Cassell's statement, the slowdown in demand will take place somewhat earlier than envisaged in earlier staff forecasts.

It hardly needs emphasis that a delay in implementing the needed policies would have a negative impact on inflation, the external deficit, and market confidence in the pound. In such a situation, any attempt to restore the stability of the pound by further increasing interest rates would eventually lead to undue deceleration of general economic activities.

Evidently, it is not an easy task to deal with growing demand pressure in a dynamic economy, such as that of the United Kingdom. There are numerous factors underlying the demand pressure: rising private consumption, the unprecedented fall in private and personal savings, expansion in consumer credits, government expenditure on social welfare schemes, and diminishing confidence in the household sector. We agree with the staff that misconceptions of the potential strength of demand pressure led to undue relaxation of monetary measures in late 1987 and during the first half of 1988.

The staff report for the 1987 Article IV consultation (SM/88/28, 1/26/88) contained an informative account of the potential growing demand, which was also indicated by the upward movement in the monetary base. At the Board discussion of that report (EBM/88/27, 2/29/88), concern was expressed about the intensified pressure on resources in the U.K. economy. The authorities' reliance on maintaining stability of the pound vis-à-vis the deutsche mark, as the main instrument of controlling inflation, was neither sufficient, nor desirable. In principle, the exchange rate, as a tool of monetary policy, is not alone a sufficiently effective instrument to fight growing demand-pull inflation pressures, particularly in light of the rigidities in the labor market.

As to the sharp and unprecedented fall in private savings, we agree with the staff on the factors that have contributed to this development, as well as the predicted persistence of these elements. Interestingly, the fall in private savings during the past six months has been accompanied by a relatively sharp rise in interest rates. As the experience of the U.K. economy demonstrates, private savings are not sufficiently interest rate elastic to cope with inflationary pressure. We continue to

believe that high interest rates are not the only effective way to curb inflation; a package of other monetary policy tools, combined with appropriate fiscal measures, could certainly cope with inflation more effectively.

On the fiscal side, remarkable achievements have been made in generating a substantial surplus. The large fiscal surplus can play a most effective role in addressing imbalances by reinforcing a tighter monetary policy. It was interesting to learn from Mr. Cassell's statement that the authorities' overriding objective will be to reduce the rate of inflation. With an estimated £15 billion government surplus in 1989, the budgetary position will be sufficiently strong to relieve the burden on monetary measures. Indeed, the authorities could rely on the effectiveness of such a restrictive budget in reducing pressure on resources. A fiscal surplus of a higher magnitude would allow further income tax cuts and improvements in the income position of low-paid labor. Given the authorities' recent decision to retain the limits agreed earlier on expenditures in 1989/90, as well as the projected large government surplus, we believe that a further reduction in personal income tax should not be constrained by a need to restrain demand pressure in the short term, in view of the favorable effects of such structural reforms in the medium term. However, we agree with the staff that it would be desirable to broaden the income tax base, as it would have an impact on the efficiency of the system.

The United Kingdom has made remarkable progress in reducing unemployment. All regions of the country have shared in this development, and it seems that the fall in the level of unemployment has been faster than that in other major industrial countries. However, there is a growing concern about rising manufacturing labor costs that, combined with the sharp fall in the rate of unemployment and shortages in skilled labor, could add to inflationary pressure. This development could lead to higher wage settlements, which is not currently a concern due to the stability of earnings, but what indeed could be a concern is the rigidities in the labor market that have pushed up wages over the past years.

The staff report for the 1987 Article IV consultation with the United Kingdom revealed that the authorities had been taking steps to reduce tightness of the labor market; several schemes, such as the so-called restart scheme, had been carried out. It is encouraging to note that further steps were taken in this area in 1987.

Finally, it is unfortunate that the United Kingdom's official development assistance declined in real terms in 1987. We hope that in addition to the positive elements mentioned in

Mr. Cassell's statement, the authorities will take the necessary steps to increase their assistance to the international agreed level.

Mr. Dai commended the U.K. authorities on their remarkable economic achievements. Over the past few years, the British economy had experienced strong and sustained growth. During the two previous years, the manufacturing sector had played a significant role in contributing to the impressive expansionary growth of the economy. As domestic demand had surged, the unemployment level had fallen significantly and business profitability had increased further, as a result of a strong rise in productivity. The remarkable economic performance reflected the authorities' macroeconomic policy management, particularly in the fiscal and monetary fields. In pursuing the medium-term fiscal strategy and the objective of reducing the rate of inflation, the fiscal position, in conjunction with monetary policy, had been strengthened in recent years. In the 1988/89 budget, the authorities had balanced their commitment to cut personal income tax rates with the need to avoid excess demand pressures. It appeared that monetary policy had been pursued flexibly in order to deal with economic issues on both the internal and external sides, and flexible interest rates had been adopted to handle the cumulative negative effects of the stock market fall in October 1987, the upward pressures on the pound sterling, and the excess of domestic demand.

The performance of the U.K. economy had been satisfactory, but economic strains remained: excessive domestic demand, rapid growth in wages, inflationary pressures, and a widening of the external current account deficit, Mr. Dai noted. The most important economic issue confronting the authorities was how to ease excessive domestic demand to contain the rate of inflation. He observed that several macroeconomic policies had been adopted by the authorities to help alleviate the problem of excessive domestic demand, thereby reducing the prospect of inflationary pressures. Those economic strains were interrelated and had to be dealt with firmly and consistently to ensure sustained noninflationary economic growth.

In conclusion, he welcomed the United Kingdom's efforts in the Uruguay Round and its important role in international trade liberalization, Mr. Dai remarked. Moreover, he commended the authorities' initiatives in assisting low-income debtor countries through a generous contribution to the Subsidy Account of the enhanced structural adjustment facility, as well as interest rate reductions within the Paris Club. However, he noted also that the U.K. contribution to official development assistance had reached the low level of 0.28 percent of GNP, and hoped that the authorities would increase their contribution in the near future--especially in view of the country's strengthened fiscal position.

Mr. Othman said that he agreed with the thrust of the staff appraisal. He welcomed the continued economic expansion in the United Kingdom, as well as the sustained and impressive improvements in such key

areas as employment profitability and productivity--especially in manufacturing. However, in that respect, the United Kingdom still lagged behind other major industrial countries, such as Japan, the United States, and the Federal Republic of Germany. While contributing to a further reduction in the level of unemployment in 1988, the buoyancy of domestic activity--which was more than accounted for by the expansionary surge in private demand--was of such magnitude relative to GDP growth that it brought about a sharp widening in the external current account deficit and an acceleration in the rate of inflation.

The authorities and the staff seemed to agree that the major objectives of the authorities should be to slow down domestic demand and reduce the rate of inflation, Mr. Othman noted. The key concern in pursuing those objectives would be the estimated speed with which domestic demand would respond to the measures of restraint taken during 1988. The downside risks associated with overestimating the speed of response were quite obvious, and those associated with underestimating the speed could also be quite significant. It was, perhaps, too soon to tell whether the recent slowdown in domestic demand would translate into the kind of slowdown in domestic demand that was consistent with the authorities' medium-term objectives. He was assured by the authorities' commitment to reduce the rate of inflation, and their readiness to take whatever steps necessary to reinforce the credibility of their anti-inflationary stance.

In conclusion, he agreed with the staff that the United Kingdom could play an important role in international trade liberalization, Mr. Othman commented. In that regard, he welcomed the authorities' position that the 1992 single European market process should help to reduce trade barriers. In addition, the authorities' intention to raise their official development assistance in the coming years was welcome, and so were their efforts in assisting low-income debtor countries--especially through the generous contribution to the subsidy account of the enhanced structural adjustment facility and interest rate reductions within the Paris Club.

Finally, the U.K. authorities had pursued actively a privatization program that had been a source of inspiration to other nations. He wondered whether there were any further plans for privatization, and whether any evaluation had taken place on the postprivatization performance of enterprises.

Mr. Nimatallah said that he questioned the validity of Mr. Cassell's point that the emergence of a private sector financial deficit--and its counterpart, the external deficit--reflected private decisions taken by economic agents and would therefore be self-correcting over time. International experience had been that private market decisions were in need of guidance from time to time, and were influenced by the Government's behavior. Accordingly, it was not evident that the private sector's decisions would be self-correcting over time. Certainly, it was correct that the private sector took its own decisions, but it was not valid that it should be left to correct the deficits by itself. The external

deficit, for example, involved decisions taken by both the private and the public sectors--especially with respect to the declining rate of private savings.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/89/25 (3/1/89) and EBM/89/26 (3/3/89).

3. VENEZUELA - TECHNICAL ASSISTANCE

In response to a request from the Venezuelan authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/89/62 (2/27/89).

Adopted March 2, 1989

4. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 88/104 are approved.
(EBD/89/59, 2/24/89)

Adopted March 2, 1989

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by an Advisor to Executive Director as set forth in EBAP/89/56 (3/1/89) and by an Assistant to Executive Director as set forth in EBAP/89/54 (2/27/89) is approved.

APPROVED: September 7, 1989

JOSEPH W. LANG, JR.
Acting Secretary