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January 27, 1986

To: Members of the Executive Board

From: The Secretary

Subject: United Kingdom - Staff Report for the 1985 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1985 Article IV consultation with the United Kingdom, which has been tentatively scheduled for discussion on Monday, February 24, 1986.

Mr. Horiguchi (ext. 8795) or Ms. Salop (ext. 8793) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

UNITED KINGDOM

Staff Report for the 1985 Article IV Consultation

Prepared by the Staff Representatives for the
1985 Consultation with the United Kingdom

Approved by L. A. Whittome and C. David Finch

January 27, 1986

I. Introduction

A staff team consisting of Messrs. de Fontenay, Horiguchi, Ms. Salop, Mr. Thumann (all EUR), Mr. Streefkerk (EP, EUR), and Miss Whitely (RES), as secretary, held Article IV consultation discussions in London from December 6-16, 1985. The U.K. representatives included officials of the Treasury, the Central Statistical Office, the Departments of Trade and Industry and of Employment, and the Bank of England. The head of mission also met the Chancellor of the Exchequer, Mr. Nigel Lawson, the Permanent Secretary of the Treasury, Sir Peter Middleton, and the Governor and the Deputy Governor of the Bank of England, Mr. R. Leigh-Pemberton and Mr. C. W. McMahon. Mr. T. P. Lankester, Executive Director for the United Kingdom, attended the meetings as an observer.

On the occasion of the Board discussion of the 1984 Article IV consultation with the United Kingdom, Directors expressed concern about recent trends in inflation and in particular about the continued rapid increases in unit labor costs. They observed that the reduction in the public sector borrowing requirement (PSBR) had been largely due to transitory factors and that little progress was being made toward the objective of creating room to reduce the burden of taxation on a permanent basis. Directors welcomed the authorities' intention to return to their earlier commitment to hold public spending in real terms to the 1983/84 level. They thought that the high level of interest rates was warranted and necessary to effect the desired wage and price restraint. Directors regretted that unemployment had continued to rise and feared that the continuing growth of real wages would limit job creation. They commended the authorities for their efforts to improve the efficiency of the economy and hoped that further steps toward remedying the deep-seated distortions in the labor market would be forthcoming.

II. Recent Developments and Policies

During 1985 the recovery of the U.K. economy entered into its fifth consecutive year, although the underlying rate of growth slowed somewhat in the second half of the year following a tightening of financial policies in the first quarter (Chart 1). Inflation, which had reaccelerated at the beginning of the year, fell back as the year wore on. Even so, at year's end it was still above the average recorded in both 1983 and 1984 and above the average of the other main industrial countries. Although unemployment seems to have stabilized after six years of steady increases, sustained reductions are not yet in sight. This remains the most disappointing aspect of the current situation. On the external side, 1985 was marked by a high degree of volatility of the exchange rate associated with changes in domestic and foreign interest rates and in oil prices. The current account of the balance of payments remained in surplus for the sixth straight year, with surpluses on oil trade and invisibles offsetting a large deficit on non-oil trade.

1. Financial policies

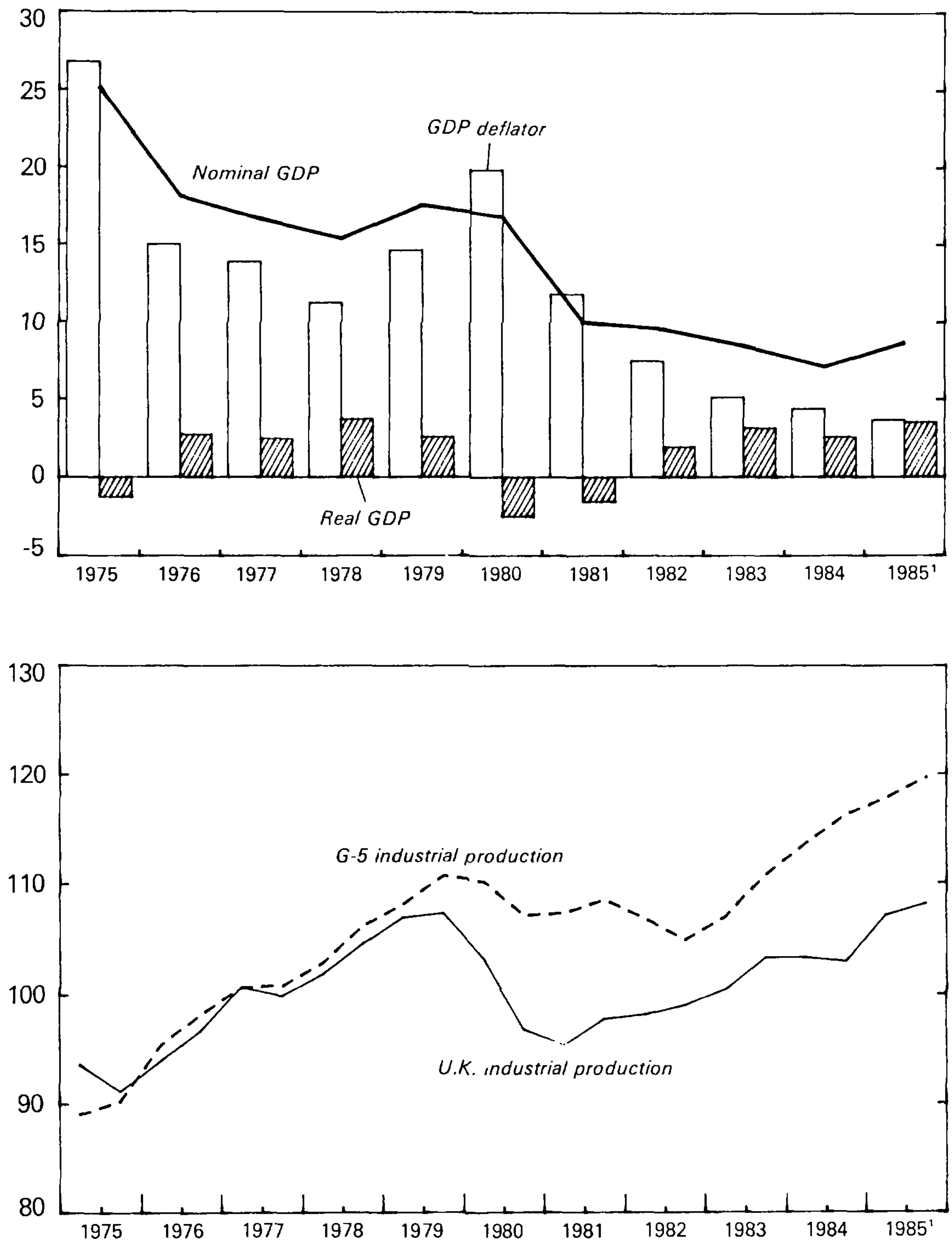
In January 1985, the authorities allowed interest rates to rise sharply. The move was triggered by concern about a quickening of the rate of depreciation of sterling and the associated perception that monetary policy was no longer clearly aimed at reducing inflation. Banks' base lending rates jumped in several steps from 9 1/2 percent to 14 percent in the course of January, and other short-term interest rates quickly followed suit. Although they declined steadily after the publication of the budget in mid-March and were down to 11 1/2 percent by end-July, in real terms they remained well above the average for the main industrial countries (Chart 2). In view of the apparent strength of the economy and amid signs of a reacceleration of earnings growth in manufacturing, the authorities were unwilling to risk a further reduction in interest rates. At the same time, they judged that further tightening was unwarranted despite very rapid growth in £M3 (the targeted broad money aggregate) (Chart 3), given the continued strength of sterling in conjunction with the slow growth of Mo (the targeted narrow money aggregate). In January 1986, however, downward pressure on the pound which had persisted since the OPEC meeting in early December and the continuing buoyancy of bank lending led the authorities to allow base rates to rise to 12 1/2 percent.

The budget presented in March 1985 sought to lower the PSBR from £10.2 billion (3.1 percent of GDP) in 1984/85 to £7 billion (2 percent of GDP) in 1985/86. The outturn for 1984/85 had exceeded substantially the budgeted level (£7 billion), with overruns associated with the coal miners' strike largely responsible for the slippage. The target set for 1985/86 reflected the Government's intention to bring fiscal policy back to the path envisaged in the Medium-Term Financial Strategy (MTFS) presented in the March 1984 budget. In the Autumn Statement of November 1985, the projected PSBR for 1985/86 was revised upward by £1 billion (to £8 billion or 2.2 percent of GDP), in the light of a shortfall in

CHART 1

UNITED KINGDOM

REAL GDP GROWTH AND INDUSTRIAL PRODUCTION



Source: CSO, *Economic Trends;* IMF Data Fund;
[1]Estimate.

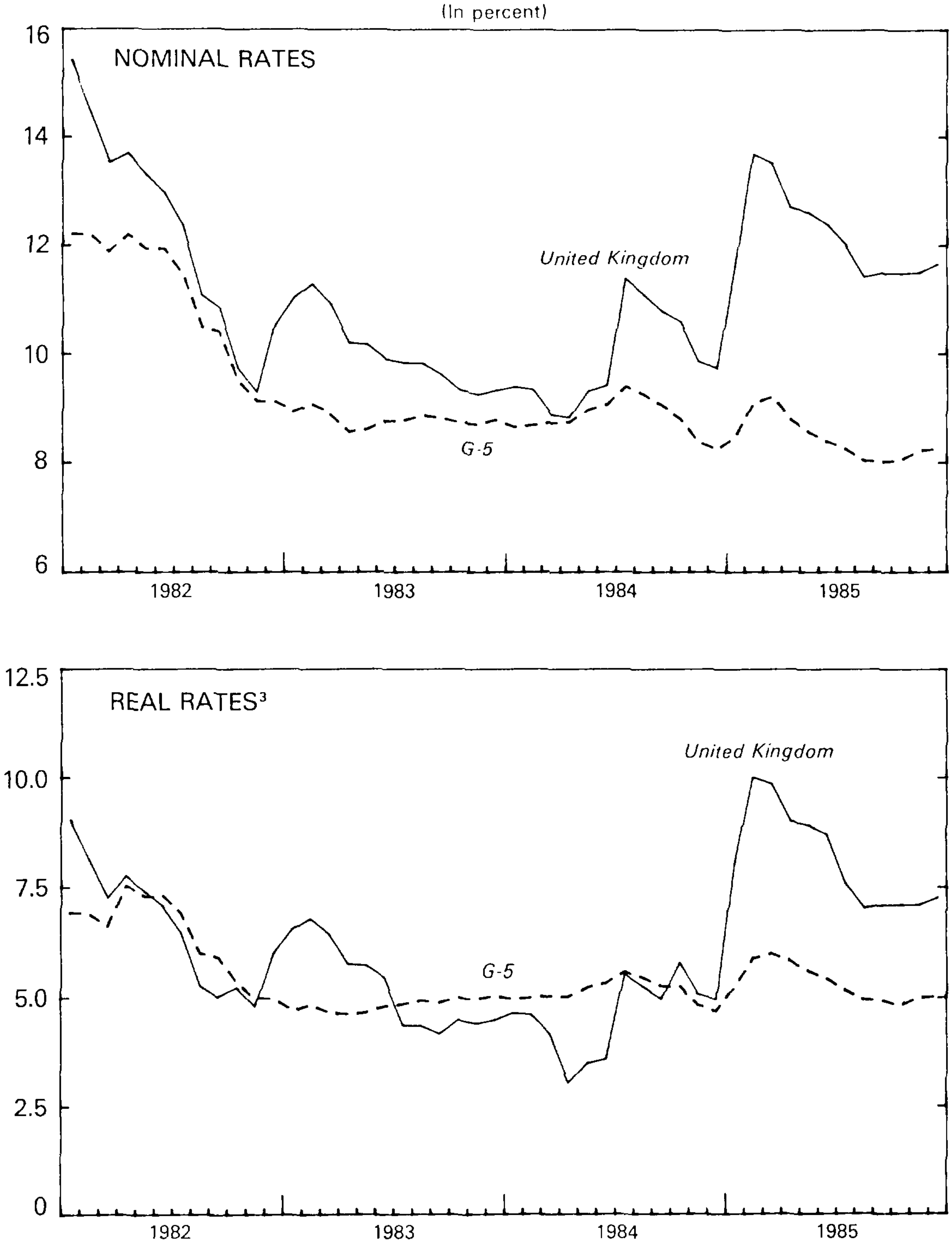
CHART 2

UNITED KINGDOM

SHORT-TERM INTEREST RATES[1]:

UNITED KINGDOM AND AVERAGE OF FIVE MAJOR INDUSTRIAL COUNTRIES[2]

(In percent)



Sources: IMF, Data Fund; and staff calculations.

[1]Monthly averages of daily rates on money market instruments of about 90 days' maturity.

[2]*United States, Japan, France, Germany, and the United Kingdom.*

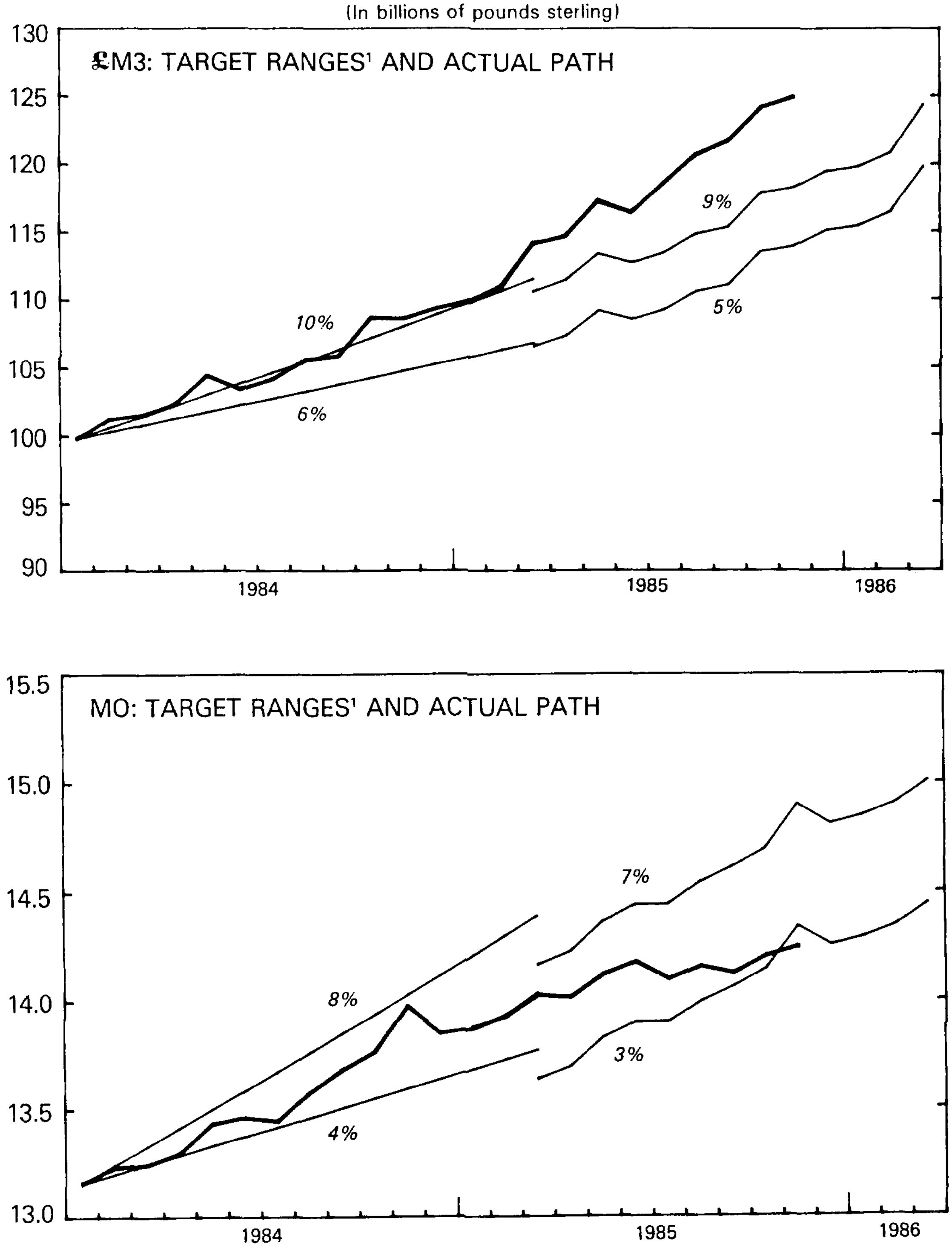
[3]Nominal rates deflated as indicated by a weighted average of the increase in the private final domestic demand deflator in the current and the following two quarters; for the most recent periods, staff projections of the deflator are used.

CHART 3

UNITED KINGDOM

TARGETED MONETARY AGGREGATES

(In billions of pounds sterling)



Source: Bank of England data.

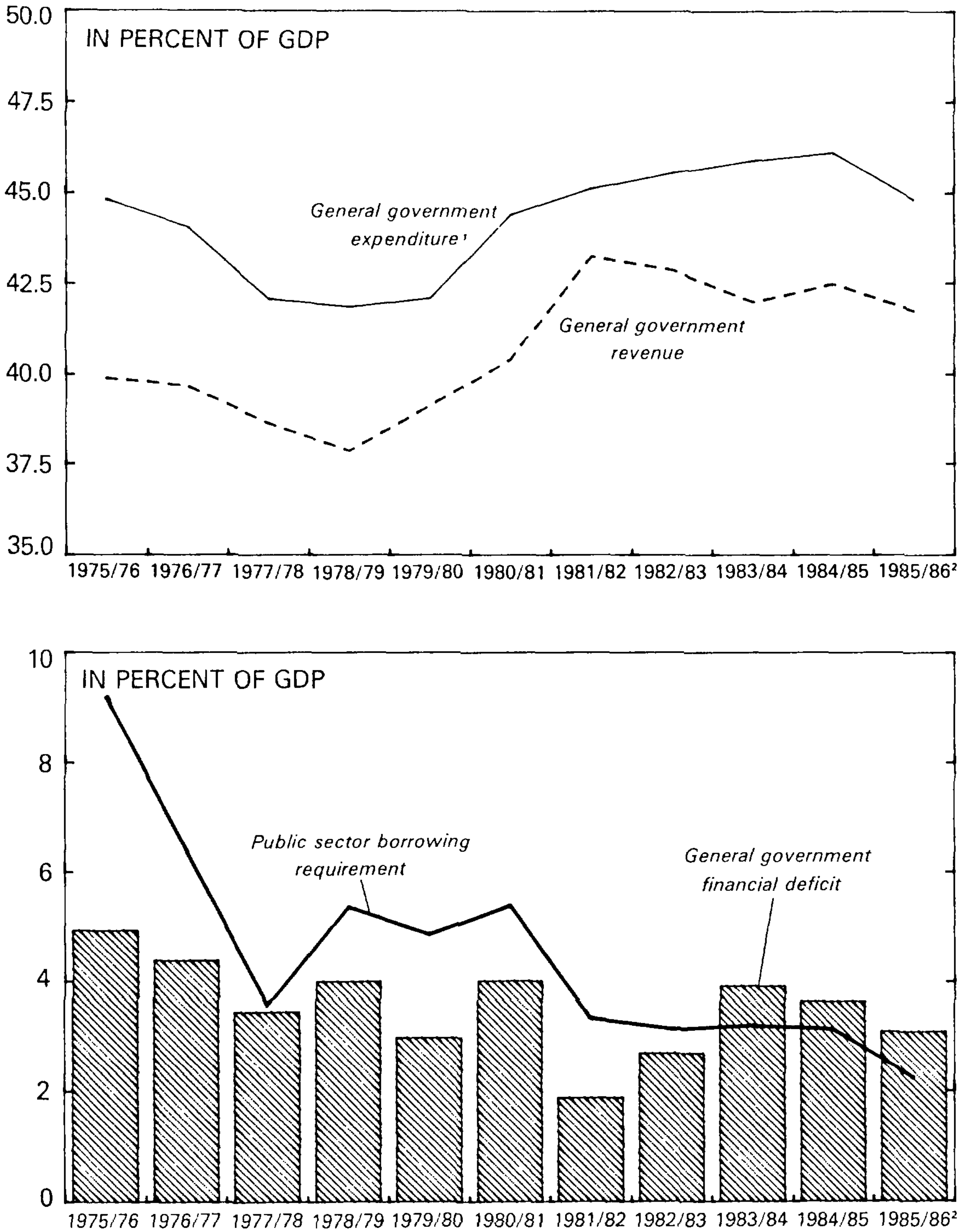
[1]Since April 1985, the performance of the targeted aggregates has been evaluated by the authorities in terms of rolling 12-month growth rates rather than annualized rates of growth from the start of the target period.

CHART 4

UNITED KINGDOM

FISCAL TRENDS

(Fiscal year; April-March)



Sources CSO, *Financial Statistics;* HMSO, *Financial Statement and Budget Report 1985–86*, and *Autumn Statement,* November 1985.
[1]Excludes net lending.
[2]Based on *Autumn Statement*, November 1985.

North Sea oil revenue (related to lower-than-expected oil prices in sterling terms) which was not fully offset by increases in other revenue. As a percentage of GDP, the forecast PSBR would still represent a marked decline from previous years (Chart 4), and general government expenditure would decline by 1 percentage point.

Staff calculations suggest that the budget outturns in the three fiscal years 1982/83 to 1984/85 provided a cumulative stimulus to economic activity of about 2 percent of GDP, following a cumulative withdrawal of stimulus in excess of 5 percent of GDP in the two years 1980/81 and 1981/82. In its original version the 1985/86 budget was to withdraw stimulus equivalent to some 1/2 percent of GDP, but based on current prospects the stance of fiscal policy appears broadly neutral.

2. Recent developments

The economy was buoyant in the first half of 1985. Strong export performance, combined with stepped-up investment expenditures and the recovery from the coal miners' strike, boosted real GDP growth to an annual rate of 4 percent. But the pace of economic expansion slowed in the second half of the year as the effects of the tighter financial policies began to be felt. Although private consumption benefited from an increase in real disposable personal income associated with the ending of the coal miners' strike and the receding of inflation, business investment and export activity became more subdued. For the year as a whole, real GDP (average measure) is estimated to have grown by about 3 1/2 percent compared with 2 1/2 percent in 1984 (Table 1). Adjusting for the effects of the coal miners' strike, the corresponding growth rates were 3 percent and 3 1/2 percent, respectively.

The strength of business fixed investment in 1984 and in the early part of 1985 was partly due to the phasing down of capital allowances announced in the March 1984 budget, which encouraged firms to bring forward their investment outlays. However, it also benefited from considerable buoyancy in business profitability, the stock market, and company liquidity. Gross profits of industrial and commercial companies (excluding North Sea oil companies) have shown large gains since 1981, albeit from very low levels. In 1984 they are estimated to have risen by about 20 percent, and in the first half of 1985 they were about 25 percent higher than a year earlier. In contrast to the strength of business fixed investment, public and residential investment declined in 1985; however, there seems to have been some pickup in housing starts following the decline in mortgage rates.

Table 1. United Kingdom: GDP and Main Components

(Percentage changes)

	1982	1983	1984	1985	1986 Official	1986 Staff
GDP (average measure) at market prices	1.9	3.2	2.6	3.4	3.0	2.5
Consumers' expenditure	0.7	4.0	1.7	2.5	4.2	3.8
Government current expenditure	0.9	1.9	1.0	0.2	0.4	0.3
Gross fixed investment	6.4	4.6	8.2	4.1	3.7	2.3
Stockbuilding 1/	0.7	0.8	-0.3	0.1	0.2	0.4
Total domestic demand	2.5	4.4	2.4	2.5	3.6	3.2

Sources: CSO, Economic Trends; data provided by the authorities; and staff estimates.

1/ Contribution to GDP growth.

Employment has been increasing since mid-1983, although it is still well below the peak reached in 1979 (Chart 5). In the two years to mid-1985, it is estimated to have risen by more than 650,000, mostly on account of self-employment and part-time jobs for women in the services sector. However, over the same period, the labor force expanded even faster, so that the unemployment rate rose by a percentage point to 13.1 percent. More than 50 percent of the increase in the labor force was due to a rise in participation rates, especially for women. Since April 1985, unemployment appears to have leveled off, partly in response to special employment and training measures enacted by the authorities.

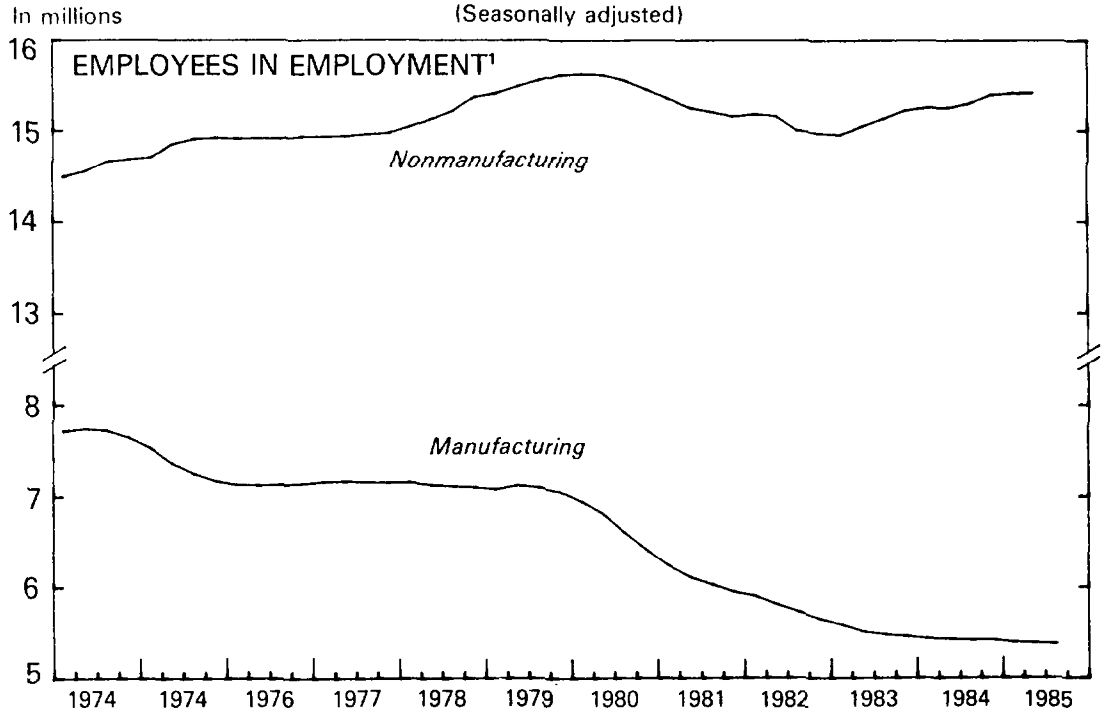
After reaching a low of 4.1 percent in the first quarter of 1984, inflation, as measured by the rate of increase in the GDP deflator, drifted slowly upward to 5.1 percent in mid-1985 before coming down a little in the third quarter. The rate of increase in the retail price index (RPI) has been more volatile under the impact of changes in mortgage rates (which have a large weight in the index), the exchange rate, and commodity prices. It reached a low of 3.8 percent in the second quarter of 1983, but edged up somewhat in 1984 before climbing to 7 percent in the second quarter of 1985. It fell subsequently and was down to 5.5 percent by the fourth quarter of 1985. The 12-month rate of increase in producers' input prices rose to almost 10 percent in the early months of 1985, but it fell sharply in the wake of the appreciation of sterling. In November, producer input prices were about 5 percent below the level a year earlier.

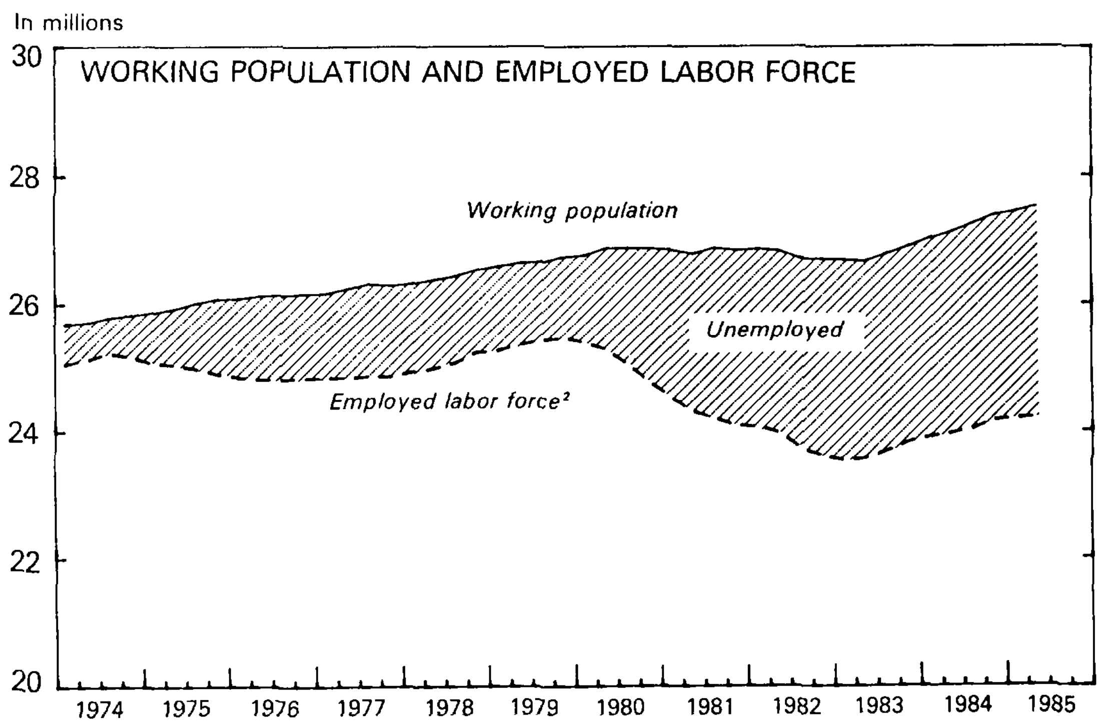
CHART 5

UNITED KINGDOM

EMPLOYMENT, 1974-85

(Seasonally adjusted)





Sources; U.K. Department of Employment; *Employment Gazette.*

[1]Data are for Great Britain.

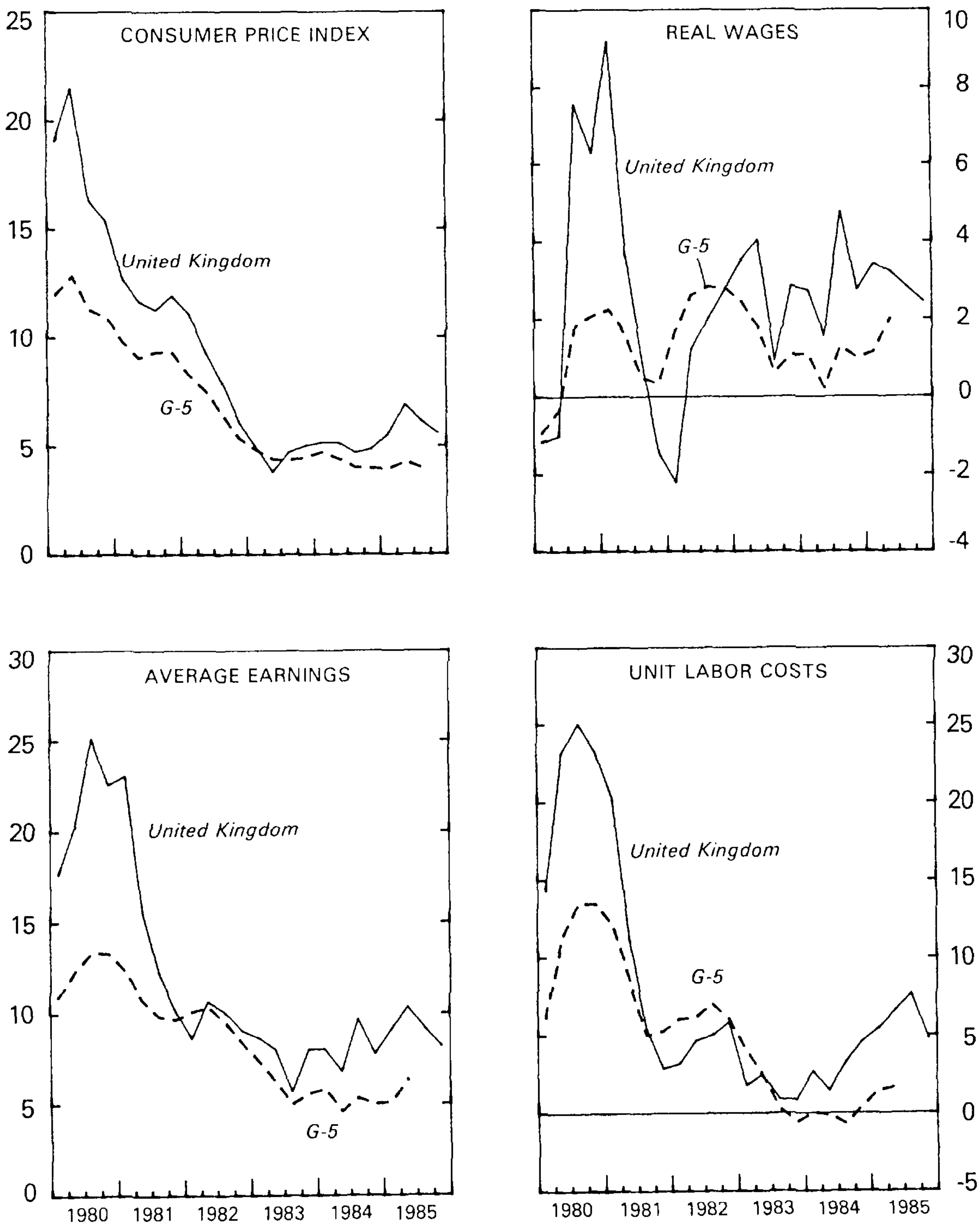
[2]Includes employees in employment plus employers, self-employed, and H.M. Forces.

CHART 6

UNITED KINGDOM

INTERNATIONAL COMPARISON OF REAL WAGES AND UNIT LABOR COSTS IN MANUFACTURING

(Year-over-year percentage changes)



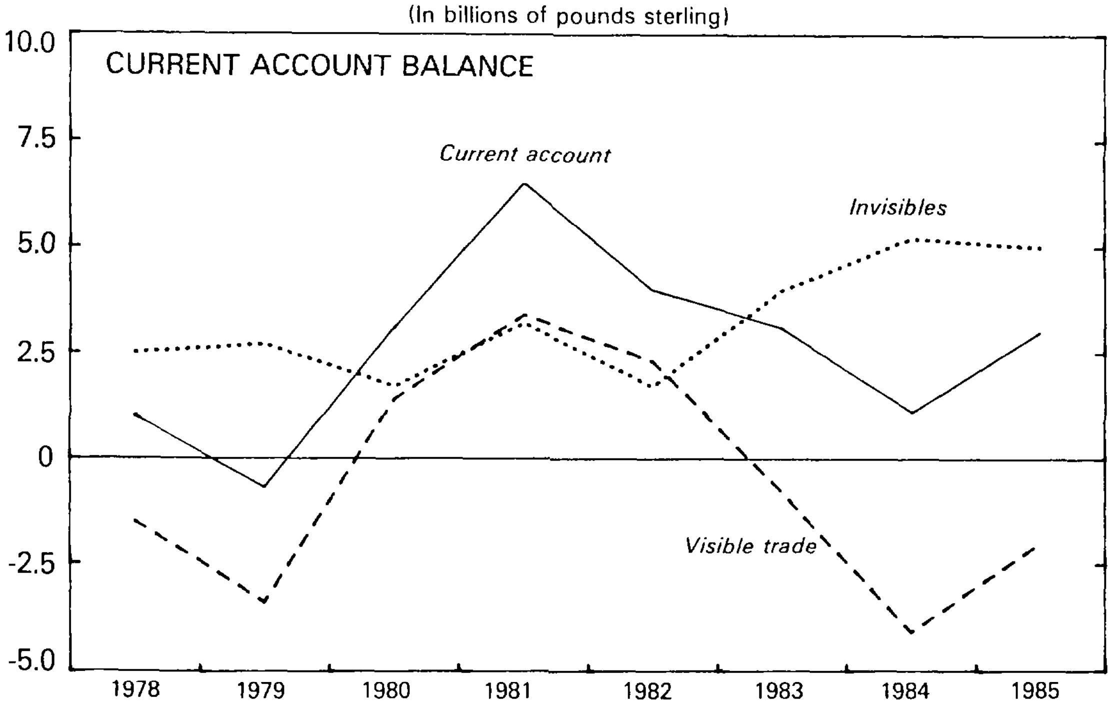
Sources: IMF, Data Fund; and staff calculation.

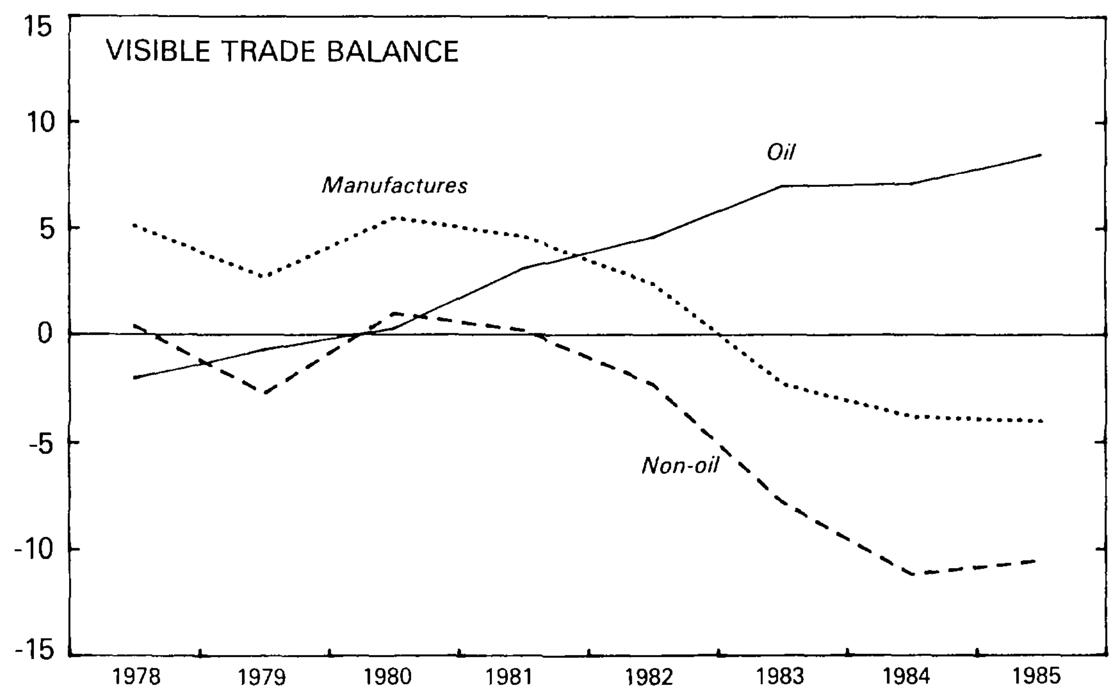
CHART 7

UNITED KINGDOM

CURRENT ACCOUNT DEVELOPMENTS

(In billions of pounds sterling)





Sources: CSO, *Economic Trends;* and *United Kingdom Balance of Payments (The CSO Pink Book), 1985 Edition.*

Following a marked decline in 1981-83, the underlying growth of earnings in the whole economy (i.e., adjusted for timing of settlements, back pay, and strikes) has changed little and remains at about 7 1/2 percent. In manufacturing, wage settlements have shown a tendency to drift upward, and the underlying growth of average earnings showed signs of reaccelerating in the first three quarters of 1985. As productivity growth slowed (though remaining well above the average rate recorded in the 1970s), the rate of increase in unit labor costs in manufacturing has risen since end-1983 and the gap between the United Kingdom and the other G-5 countries has widened (Chart 6). Real wages have continued to grow despite the very high levels of unemployment. In the first three quarters of 1985 average earnings deflated by the retail price index increased by 2.3 percent, following an increase of 0.7 percent in the same period of 1984.

3. The external sector

The surplus on the current account of the balance of payments is estimated to have been about £3 billion in 1985 (0.9 percent of GDP) compared with £1 billion in 1984 (Table 2 and Chart 7). In both years the surpluses are estimated to have been reduced by the effects of the coal miners' strike (by about £1 billion in 1985 and £2 3/4 billion in 1984). On trade account, net oil exports have been growing rapidly, reaching £8 1/2 billion in 1985, but the surplus has not been large enough to offset the deficit in non-oil merchandise trade. The deficit on trade in manufactures, which emerged in 1983 for the first time since WWII, was about £4 billion in both 1984 and 1985. The surplus on invisibles has increased since the early 1980s largely owing to rising receipts on interest, profits, and dividends (IPD) associated with higher levels of net overseas assets. (These are estimated to have reached £73 1/2 billion at the end of 1985, compared with £12 1/4 billion at the end of 1979.) In 1985, the effect of larger net overseas assets on IPD was somewhat tempered by the rise in U.K. interest rates relative to those abroad.

The balance on identified capital transactions has been in deficit since the abolition of exchange controls in late 1979. In the first three quarters of 1985 the deficit was at an annual rate of £4 billion (1 1/4 percent of GDP), somewhat below the level registered a year earlier. Total official international reserves declined from a peak of US$27 1/2 billion at the end of 1980 to about US$15 1/2 billion at the end of 1984; part of this decline reflected the effect of valuation changes and repayment of foreign currency debt of the public sector. They declined further in the first three quarters of 1985 before being replenished in October by a US$2 1/2 billion Euroborrowing. At the end of 1985, total reserves stood again at US$15 1/2 billion.

Table 2. United Kingdom: Summary Balance of Payments

	1982	1983	1984	1985	1986	
					Official	Staff
Visible trade balance	2.3	-0.8	-4.1	-2.0	-2	-4
Oil	4.6	7.0	7.1	8 1/2	8	7 3/4
Non-oil	-2.3	-7.8	-11.2	-10 1/2	-10	-11 3/4
Invisibles balance	1.7	4.0	5.2	5.0	6	6
Of which: IPD	1.1	2.4	3.3	3 1/4	--	--
Current balance	4.0	3.1	1.1	3.0	4	2
Identified capital transactions	-3.3	-4.8	-5.7	-4.1 1/	--	--
Official financing 2/	1.3	8.2	1.3	-0.2 1/	--	--
Balancing item	-2.0	0.9	3.2	2.1 1/	--	--

Sources: CSO; Autumn Statement 1985; and staff estimates.

1/ First three quarters, not seasonally adjusted, annual rate.
2/ Surplus (-); deficit (+).

The exchange rate fluctuated widely in 1984 and 1985 (Chart 8). In nominal effective terms, it declined by 13 percent between January 1984 and a low point in February 1985, but by July the decline had been fully reversed. To some extent these fluctuations mirrored movements in the U.S. dollar, but sterling followed broadly the same path against other currencies as well. The effective exchange value of the pound has come down considerably from a peak in July 1985, with downward pressure intensifying since the OPEC meeting in early December. In the first half of January 1986, the pound's effective exchange rate averaged some 6 percent below the July 1985 level. Vis-à-vis the U.S. dollar, the pound was only 6 percent higher in the first half of January 1986 than in the period immediately preceding the G-5 meeting in September 1985, while the yen and the deutsche mark were, respectively, 18 percent and 14 percent higher.

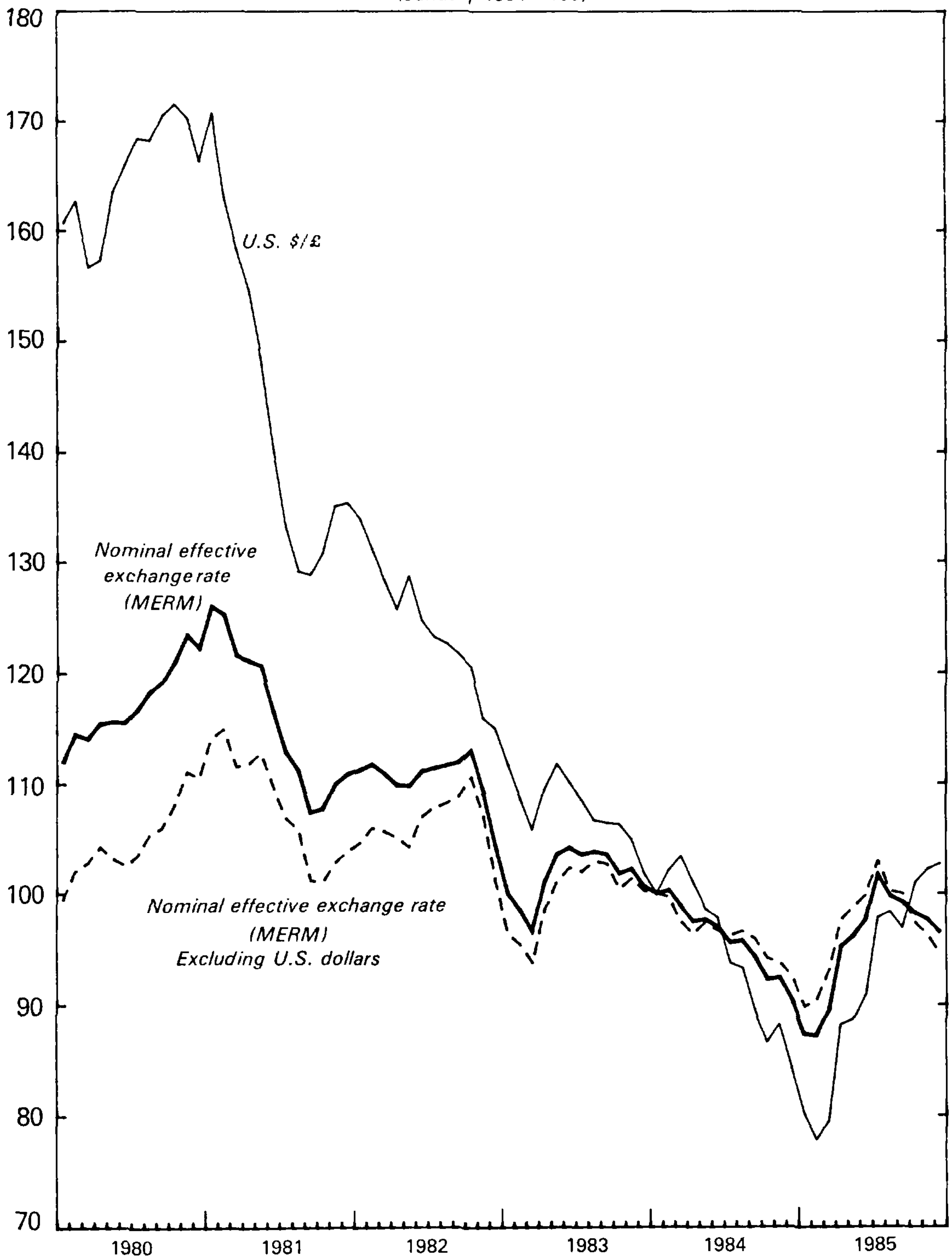
Export competitiveness has improved since 1981 (Chart 9), as the nominal effective depreciation of the pound since that time has outweighed by a large margin the intervening deterioration in the relative domestic cost position. Over the year to the first quarter of 1985, the real effective exchange rate (measured by relative unit labor costs in manufacturing) depreciated by 7 percent. Although that depreciation was subsequently reversed by mid-1985, the real effective exchange rate in the third quarter of the year was still some 20 percent below the peak reached

CHART 8

UNITED KINGDOM

STERLING EXCHANGE RATE INDICES

(January 1984 = 100)

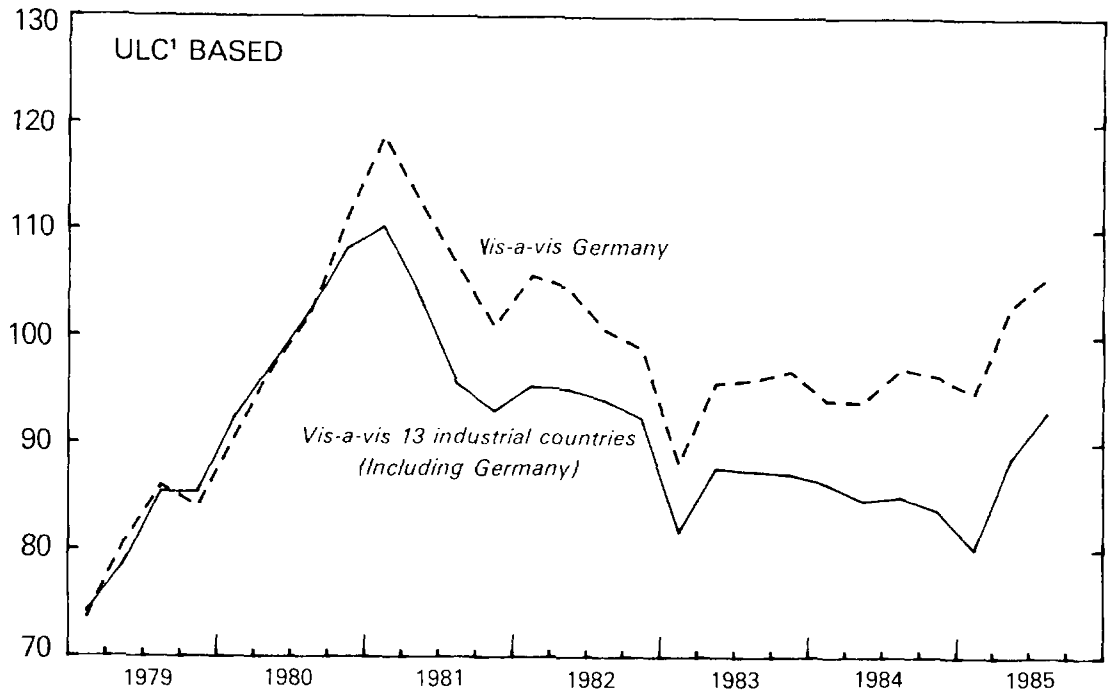


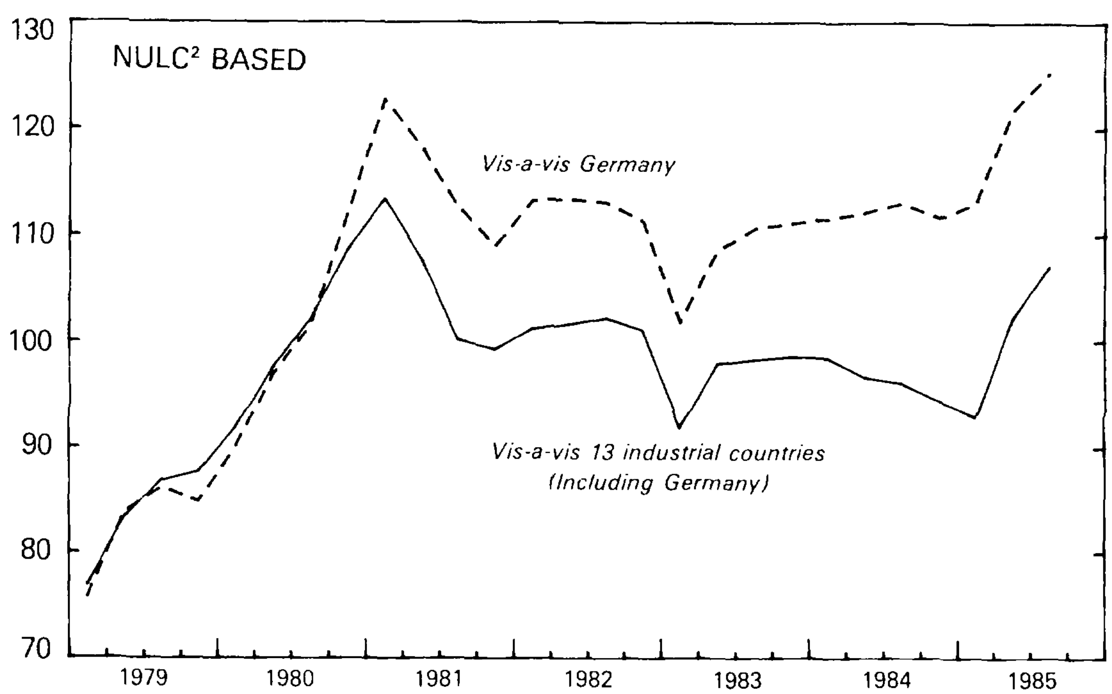
Sources: IMF, Data Fund; and staff calculations.

CHART 9

UNITED KINGDOM

REAL EFFECTIVE EXCHANGE RATES





Source: IMF, Data Fund.
[1]Unit labor cost.
[2]Normalized unit labor cost.

in the first quarter of 1981. Nevertheless, the proportion of firms responding to business surveys citing price competitiveness as a factor likely to limit exports rose sharply during 1985 and by November was higher than at any time since January 1982.

III. Financial and Exchange Rate Policies

Financial policies in the United Kingdom continue to be set in the context of a medium-term financial strategy, designed to achieve a fall in inflation through a progressive lowering of the rate of growth of nominal GDP. While the ultimate goal of the MTFS has remained unchanged since its introduction in the 1980 budget, the outturns for the targeted monetary aggregates and the PSBR have often exceeded the official projections. Still, the authorities believe that the MTFS has proved valuable in influencing expectations and in imposing discipline on the Government and that it has contributed substantially to the deceleration of inflation.

In 1985, there was some shift in the role of interest rates within the MTFS. Previously, reductions in the PSBR were viewed as necessary to permit interest rates to fall in nominal and real terms despite declining rates of monetary growth. The 1985 budget, however, stressed the need to maintain short-term interest rates at whatever level was necessary to lower inflation and nominal GDP growth. In this context, a question about the authorities' continued commitment to the original fiscal goals of the MTFS naturally arose, and the issue of the appropriate mix of policy at this stage of the recovery was part of the discussions of fiscal, monetary, and exchange rate policies. The U.K. representatives argued that despite the high level of interest rates at present, there had not been a change in the mix of fiscal and monetary policies, but they reminded the staff that in last year's budget speech the Chancellor of the Exchequer had indicated that he was prepared in principle to contemplate changes.

a. Fiscal policy

The U.K. representatives said that the authorities were disappointed at having fallen short of their goal of rolling back public spending, which was a precondition for achieving both a reduction of the PSBR and a lower burden of taxation. Over the past six years, general government expenditure had increased on average by 2 percent per annum in real terms and, in relation to GDP, it remained above the level prevailing when the present Government took office. The upsurge in spending had been due in part to the large increases in unemployment and interest rates in the intervening years, to exceptional expenditures associated with defense and the coal strike, and to difficulties encountered in controlling spending by local authorities. The U.K. representatives emphasized, however, that the ratio of spending to GDP had now begun to fall, enabling the PSBR to come down in 1985/86 to the lowest level in relation to GDP since 1979/80, even in the face of a decline in the ratio of revenue to GDP. They added that the PSBR projected for 1985-86, at about 2 1/4 percent of GDP, was below the level required to keep the ratio of public debt to GDP constant. The

U.K. representatives attached importance to the debt/GDP ratio because long-term sustainability was in their view a key consideration in assessing the size of a budget deficit.

The staff noted that the interpretation of the PSBR as an indicator of the stance of fiscal policy had become more difficult in recent years because of the growing importance of receipts from North Sea oil and from asset sales (Chart 10). Both items were largely transitory and had a weaker impact on domestic demand than other revenues. Indeed, asset sales (which are treated in the U.K. budget presentation as a negative expenditure item) were probably more akin to financing items. The U.K. representatives responded that these considerations were taken into account in assessing the appropriate level of the PSBR, but that there was a sizable permanent element in oil revenue and that the time horizon for both oil and asset sales was a long one. In their analysis, the sale of assets differed from borrowing to the extent that the purchasers did not regard these assets as substitutes for gilts and other government debt instruments in their portfolios. While no particular assumption about the degree of relative substitutability was made, the U.K. representatives acknowledged that it was unlikely that the difference between given amounts of asset sales and gilt sales in terms of their impact on interest rates would be large.

For FY 1986/87, the Autumn Statement provided updated expenditure projections but did not include projections for revenue. The target for the PSBR in 1986/87 is to be announced in the next budget (to be presented on March 18); in the MTFS projections included in the March 1985 budget, it was set at £7 1/2 billion (2 percent of the then estimated 1986/87 GDP), but at that stage this was merely indicative. The expenditure figures remain the same as in the March 1985 Budget, but projected asset sales have been increased by £2.5 billion and the reserve reduced by £1.5 billion. The Autumn Statement's projections imply that general government expenditure in real terms would decline by about 0.5 percent. Excluding asset sales, it would rise by about 0.5 percent but still decline in relation to GDP by about 1 percentage point.

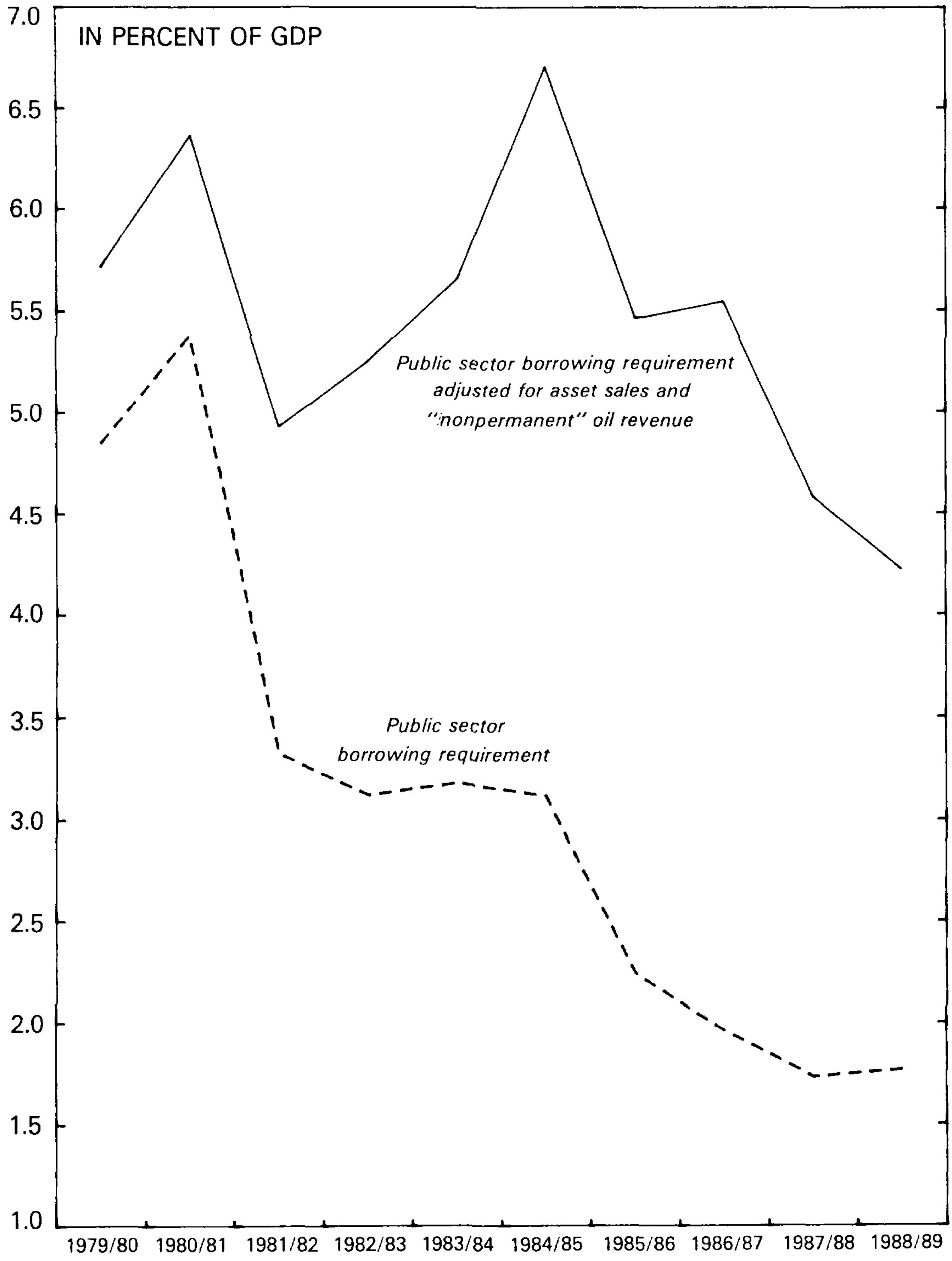
At the time of the March 1985 Budget, the levels tentatively set for the PSBR and expenditure for 1986/87, in conjunction with revenue projected for that financial year under the assumption of unchanged tax policy, implied room for a reduction in taxes of £3.5 billion. These projections have now been thrown off course by the fall in oil prices (a 1 percent change in the price of oil in sterling tends to alter government revenue by slightly more than £100 million at current production levels, with 90 percent of the effect occurring in the first year). Unless the PSBR is raised for the next fiscal year, the room for tax reductions may turn out to be small. The U.K. representatives noted that a case could be made for allowing the PSBR to be higher in the face of a decline in oil revenue to the extent that increases in oil revenue in previous years had been used to reduce the PSBR. They drew attention to the contrast between their experience, of a decline in the net public debt/GDP ratio over the past ten years, and that of most other major industrial countries, whose debt/GDP

CHART 10

UNITED KINGDOM

ACTUAL AND ADJUSTED PSBR

(Fiscal years; April-March)



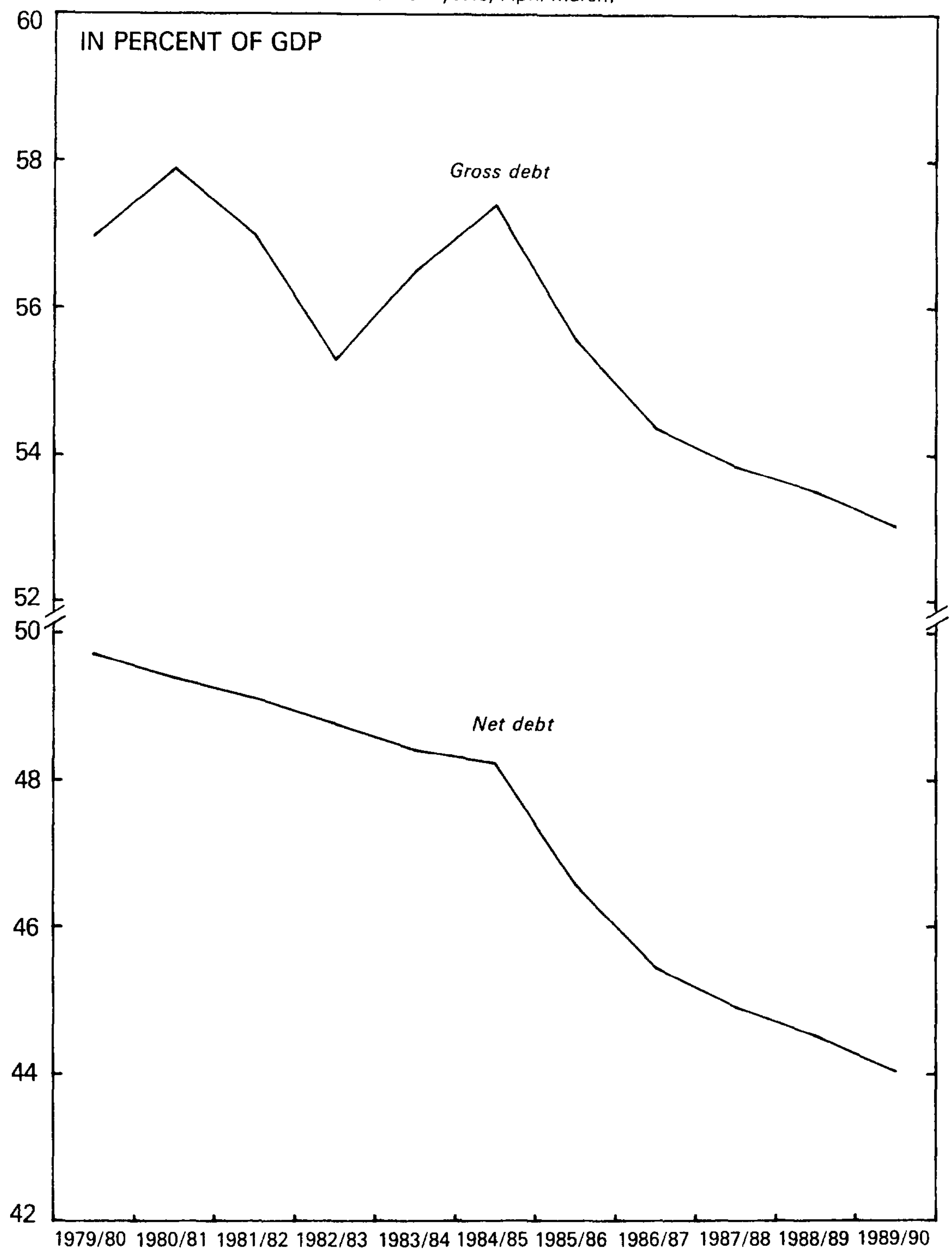
Sources: CSO, *Financial Statistics;* HMSO, *Financial Statement and Budget Report,* 1985/86; and staff estimates.

CHART 11

UNITED KINGDOM

OUTSTANDING DEBT OF PUBLIC SECTOR

(Fiscal years; April-March)



Sources: CSO, *Financial Statistics*, and *Economic Trends;* staff estimates (1985/86–1989/90).

ratio had risen during that period (Table 3 and Chart 11). The staff team noted, however, that, by comparison with the authorities' long-term goal of reducing the PSBR to 1 percent of GDP, the level of the PSBR in the current fiscal year, adjusted for transitory items, viz., asset sales and the nonpermanent component of oil revenue, amounted to 5 1/2 percent of GDP, implying that a considerable effort would have to be made in the years ahead. The staff also noted that, while it had declined considerably, the ratio of net debt to GDP in the United Kingdom remained above that of all the other G-5 countries. The U.K. representatives added that a separate consideration in support of tax cuts, even if they were to compromise the PSBR target to some extent in the short run, would be their supply-side effects; this consideration assumed greater validity if the fact that their effects took time to work through the economy was clearly recognized. They acknowledged, however, that the drop in oil prices would itself be equivalent to a tax cut.

Table 3. United Kingdom: Medium-Term Public Sector Debt Projections

(In billions of pounds sterling)

	1979/80	1984/85	1985/86	1986/87	1987/88	1988/89	1989/90
Gross public sector debt outstanding	117.6	188.4	198.4	207.9	217.4	226.9	236.4
Net public sector debt outstanding	102.6	158.3	166.3	173.8	181.3	188.8	196.3
Gross public sector debt as a ratio to GDP (in percent)	56.9	57.4	55.6	54.4	53.9	53.5	53.0
Net public sector debt as a ratio to GDP (in percent)	49.7	48.2	46.6	45.4	44.9	44.5	44.0

Sources: CSO, Financial Statistics and Economic Trends; and staff estimates.

The Autumn Statement provided for the first time detailed expenditure plans for the next three years. According to these projections, expenditure will remain broadly unchanged in real terms and decline as a percentage of GDP. Excluding asset sales, general government expenditure as a ratio to GDP would be down to 42 percent by 1988/89, compared with a peak of 47 percent in 1982/83 (and 43 percent in 1978/79). The U.K. representatives explained that there were a number of favorable factors which made them confident that, barring exceptional developments, the planned expenditure restraint could be achieved. First, unemployment had stabilized enabling the rise in social transfers to be lower than in recent years; second, the period of rapid growth of defense spending was over; third, interest rates were unlikely to rise further; and finally, expenditure control had improved, particularly vis-à-vis the local authorities, who were now subject to downward adjustments of grants received from the Central Government when their current expenditures exceed a norm and, for some of them, to "rate capping" (i.e., ceilings on local tax rates). Improved prospects for the coal industry, resulting from planned pit closures, were also expected to reduce the financing requirements of the nationalized industries, which were included in public sector expenditure.

The 1984 budget provided for a phased replacement of the generous capital allowances then in place by reductions in the corporate income tax rate. The reform is expected, when the transition is complete, to improve the efficiency of investment and (together with the abolition of the National Insurance surcharge on payrolls) to reduce the bias against the use of labor in the production process. It is also expected to yield a net reduction in the burden of corporate taxation. As to personal income taxation, the authorities would like to reduce tax rates and raise tax thresholds in order to improve incentives to work and acquire higher skills. It remains the authorities' goal to shift the burden of taxation from income to expenditures, but the U.K. representatives saw limited prospects for such a shift in the short term because increasing indirect taxes would have an adverse impact on the price level and in some instances would be at variance with commitments undertaken within the EC.

b. Monetary policy

In a recent speech, the Chancellor of the Exchequer announced changes in the operation of monetary policy. He stated that with hindsight the target range set for £M3 in 1985/86 appeared too tight, and that the continued downward trend in velocity associated with financial deregulation and positive real interest rates had not been sufficiently allowed for. He also announced the abandonment of overfunding as an instrument of monetary control. In future, the level of official funding through the gilt-edged market would reflect the Government's borrowing needs rather than efforts to contain the recorded growth of broad money. The aim of monetary policy would be to maintain short-term interest rates at levels needed to keep inflation and money GDP growth on a declining path. To this end, Mo (mainly currency) and the exchange rate had assumed increased importance as early warning signals of possible spillovers of broad liquidity into expenditure.

At the time of the discussions, the U.K. representatives thought that monetary conditions were broadly in line with the targeted path for nominal income growth. To be sure, some developments were worrying, but at that time there was not felt to be sufficient cause for raising interest rates. Mo was tending toward the lower end of its 3-7 percent target range, while £M3 had grown by 14 1/2 percent in the 12 months through November. Although it had been targeted to increase by 5-9 percent this year, it was thought that an upward shift in money demand had made it inappropriate to try to bring £M3 within the target range. To some extent the large difference between the growth rates of Mo, on the one hand, and £M3 and the other broad aggregates, on the other, was attributable to the high level of nominal interest rates which may have prompted economizing on cash balances. But for the most part, the strong growth of the broad aggregates was thought to reflect the effects of innovations stemming from the deregulation of the financial system, which had caused a considerable scaling up of both the financial assets and liabilities of the personal sector. This also explained the buoyancy of bank credit. As to the other indicators of monetary conditions, the exchange rate continued to be strong relative to the early part of the year, although it had eased in the wake of the December OPEC meeting, while prices of agricultural land and of houses showed few signs of acceleration. Still, the high degree of liquidity was cause for concern, as was the acceleration in unit wage cost increases.

Sterling M3's changed role in 1985/86 notwithstanding, a new target is to be set for it in 1986/87; however, at the time of the discussions detailed work on the monetary framework for the new financial year was still in an early stage. In view of the increasing competition between the banks and the building societies, there was some discussion of the merits of replacing the target on £M3 (which excludes liabilities of the building societies) with a target on a broader liquidity aggregate. On narrow money, the U.K. representatives said that Mo was likely to be targeted again in 1986/87. While it was generally thought that an appropriate target range for the growth of Mo could influence inflationary expectations, the U.K. representatives acknowledged that financial innovations relevant to cash management had probably been partly responsible for the slow growth of Mo in recent months and that, as a general proposition, such changes were often difficult to distinguish from those associated with variations in activity levels.

As regards overfunding, the U.K. representatives agreed that while its abandonment was needed to reduce distortions in financial markets and in the interest rate structure, it also had made control over the broad aggregates more complicated. The only remaining instrument of monetary control was short-term interest rates which, however, appeared to affect the magnitude of bank lending and holdings of broad money only with considerable and variable time lags. This suggested that the broad money aggregate to be targeted next year could not be construed as a target to be met on a month-to-month basis. However, even though higher interest rates, for example, might take a long time to restrain the growth of the broad aggregates, they could still in the meantime exert a restraining influence on spending and the evolution of nominal income. The U.K. representatives noted that, ceteris paribus, short-term interest rates would tend to be higher, and longer-term rates lower, without overfunding.

c. Exchange rate policy

The U.K. representatives stressed that, while the authorities were paying close attention to movements in the exchange rate as an indicator of monetary conditions, they did not have an exchange rate target. Hence, when the exchange rate moved in response to identifiable nonmonetary factors--such as changes in oil prices--it was less likely to trigger a policy reaction. Causes of exchange rate movements, however, were not always easy to identify and large downward movements in the exchange rate, whatever their cause, could not be ignored because of their potential effects on expectations and the price level. On this point the U.K. representatives distinguished between a fall in the exchange rate associated with an oil price decline and one in which the driving force was a drop in market expectations concerning oil prices at some future date. In the former the price effects of the exchange rate depreciation would be offset by the actual decline in oil prices. Indeed, simulations with various models suggested that a 10 percent drop in the oil price in U.S. dollars accompanied by a 3 percent drop in the sterling effective exchange rate would tend to leave the overall price level little different at the end of a five-year period. However, if the exchange rate were to fall by a proportionately greater amount, the authorities would have to judge how far monetary conditions should be allowed to tighten. In deciding how to respond, the authorities would be influenced by the need to maintain market confidence.

The U.K. representatives were more optimistic than most forecasters (and the staff) about the evolution of the current account position in the rest of the 1980s. They thought it likely that it would remain in surplus, with a strengthening of the invisibles balance offsetting the deterioration of the trade balance. If, however, the decline in net oil exports called for a real depreciation of sterling, they would prefer to achieve it through an adjustment of domestic costs and prices. Although such adjustments had been slow in the past, the Government's present policy was to pressure employers to reduce their costs and not in effect to bail them out through a currency depreciation, especially when their financial difficulties were their own doing, viz., by the granting of excessive wage increases. The United Kingdom's experience had been that a nominal depreciation seldom resulted in a real depreciation as wages adjusted rapidly to changes in the cost of living.

Concern about the volatility of the exchange rate, the increasing difficulties of interpreting monetary aggregates, and the priority given to reducing inflation have generated wide support for the United Kingdom's participation in the exchange rate mechanism of the EMS. The Government's position, however, is that, while it remains committed to such action in the future, the time has not come yet. The Treasury Select Committee of the House of Commons has also recommended the maintenance of the status quo in the short to medium term based on "the difficulties of securing an appropriate valuation for sterling and the need to keep options open to pursue domestic policies in the national interest."

The role of intervention continues to be essentially to smooth out excessive fluctuations in the exchange rate. The United Kingdom has also acted in concert with other countries to encourage markets to move toward a valuation of the dollar judged better to reflect economic fundamentals, e.g., at the beginning of 1985 and again after the September 22, G-5 agreement, and it has played its part in the implementation of the latter agreement. Intervention is sterilized quasi-automatically in terms of base money as the Bank of England takes it into account in assessing the amount of assistance it provides to the money market.

The United Kingdom's official reserves are not high, even after the recent US$2 1/2 billion official Eurodollar borrowing, especially if account is taken of the level of official financing liabilities in foreign currency. The level of reserves has come down progressively since 1981 as a result not only of intervention but also of the Government's policy of repaying foreign debts in full when they come due and of the Government's foreign exchange requirements for its normal activities such as defense procurement. These requirements have amounted to about US$300 million per month.

IV. The Labor Market

The U.K. representatives recognized that the stubbornly high--and until recently rising--rate of unemployment and the associated failure of real wages to adjust downward constitute the most disappointing aspects of the United Kingdom's economic performance. A number of structural factors have contributed over many years to raising unemployment, including increased skill and geographical mismatches between vacancies and job seekers, distortions in relative factor prices, and disincentives for the unemployed to seek employment. In addition, the recession in 1979-80, which was particularly severe, pushed unemployment sharply higher, and during the ensuing recovery the acceleration of productivity growth prevented the absorption of the rapidly growing labor force in the absence of substantial adjustments in real wages. Over the period 1979-85, during which the unemployment rate rose by some 8 percentage points, real wages increased (cumulatively) by more than 10 percent. Employment has been increasing since mid-1983 but, as noted earlier, the increase has been concentrated in self-employment and in part-time jobs for women in the services sector. Regardless of whether the faster growth of productivity in recent years was a response to the rise in labor costs or to autonomous factors, the lack of response of real wages remains puzzling.

The Government's position has been that unemployment is not a problem of insufficient aggregate demand but rather one of labor market rigidity. It has taken a number of measures (see RED) to improve the functioning of the labor market, including changes in labor legislation. The aim has been to increase both the demand for labor (by, e.g., reducing employers' contributions to social insurance and the previous subsidization of investment) and the incentives to seek work (by raising income tax thresholds and lowering tax rates and the "replacement ratio" of unemployment benefits to income from work). Specific measures have also been taken to curb union power and to encourage a more democratic management of trade unions and to limit the role of Wages Councils in setting minimum wages. The U.K. representatives expected these measures to affect the evolution of wages slowly over time. For the present, they saw no compelling need for additional changes in labor legislation and noted that in the first nine months of 1985 work stoppages were at their lowest level in 50 years.

In the consultation discussions of the past two years, lagging adjustment of inflationary expectations to actual declines in inflation were said to have contributed to the continued momentum of real wage increases. During this year's discussions, however, the U.K. representatives tended to emphasize more the responsibility of employers in granting unduly generous wage awards. Employers seemed to prefer securing changes in work practices that would raise productivity in exchange for protecting their workers' earnings from market pressures. In this regard, the U.K. representatives believed that greater competition among firms was needed to stimulate cost cutting. In the public sector, where in recent years wage increases had lagged behind those in the private sector, efforts to keep wage increases in line with the pay assumptions underlying the budget had not been successful.

In view of the disappointingly slow improvement in the functioning of the labor market and some evidence that the number of long-term unemployed has little impact in reducing wage demands, the authorities have adopted measures to reduce unemployment directly, especially for young people and the long-term unemployed. Employment and training measures are estimated to have reduced the number of unemployed at the end of October 1985 by almost one half million, and the measures announced in 1985 (see RED) are expected to reduce the unemployment count in 1986 by some 200,000. Some of these measures have provided incentives to employers to hire workers at the low end of the pay scale (by restructuring the national insurance contributions to favor that type of employment) and to the long-term unemployed to take low paid jobs (by supplementing their earnings).

V. Structural Changes

Over the past ten years, the U.K. economy has undergone considerable structural change. In particular the manufacturing sector has declined in importance, with the decline more pronounced than in most other industrial countries. This change, along with the emergence of a deficit on foreign trade in manufactured products, has prompted a vigorous debate in the United Kingdom on the implications for economic policy, especially over the medium term when oil production tapers off. The Government has rejected the view expressed in a recent report of the House of Lords Select Committee on Foreign Trade that these developments represent a "great threat to the standard of living and to the economic and political stability of the nation and that increased Government assistance to manufacturing is needed." It noted that the U.K. experience had been similar to that of the other industrial countries which are major energy producers (Table 4), that the decline of manufacturing had started before this decade, and that within manufacturing, some industries, e.g., electrical and instrument engineering, had grown faster than GDP (see RED, Table 9). Furthermore, there was nothing intrinsically more worthwhile in exports of goods compared with exports of services, and the deterioration in manufacturing trade represented no immediate threat to the external position of the country. For the future, if the manufacturing sector and the economy were sufficiently flexible, the expected decline in oil production and attendant downward pressure on the real exchange rate would stimulate net exports in nonenergy tradable goods and services. During the discussions, the U.K. representatives noted that, while the U.K. economy had often lacked adaptability, there were signs of improvement in part due to the Government's policies of disinflation, deregulation, and increased competition. They also stressed that the exhaustion of North Sea oil and the adjustment of the economy to it would be spread over a long period of time. Specific assistance to the manufacturing sector, as suggested by the House of Lords Select Committee, could not be justified on economic grounds. The Government's industrial policy consisted in creating the conditions conducive to industrial growth and competitiveness, and in providing financial support for research and development, training, export promotion, and infrastructure.

Table 4. United Kingdom: Share of Manufacturing in GDP

(In percent)

	1960	1970	1980	1983
France, Germany, Italy	33.7	33.0	30.1	28.5
United States	28.6	25.7	22.5	21.1
United Kingdom	32.1	28.1	23.1	21.0
Canada, Netherlands, Norway	26.6	23.3	18.1	16.0

Source: H. M. Treasury.

The other major change in the economy since 1979 has been the reduction in the role of the public sector in commercial activities through the privatization of public enterprises. So far 12 major companies, which in 1979 had represented over 20 percent of the public sector in industry and employed about 400,000 workers, have been sold, and the results have been in line with the main aims of the program, viz., to improve the efficiency of the economy and to encourage wider share ownership both among employees and the general public. Most of the privatized companies have increased their profits and the number of individual shareholders has roughly doubled since 1979 (to about £2.8 million). The Government intends to step up the program, and net proceeds from privatization are expected to be £4 3/4 billion in each of the next three fiscal years compared with an average of about £2 1/4 billion in 1984/85-1985/86 and an average of about £0.5 billion per year in the preceding three years. In the case of companies that operated as monopolies, the approach has been generally to combine deregulation and privatization. For those public enterprises which cannot reasonably be expected to survive as privately run corporations, some components of the companies may be sold and some of the activities taken over by private contractors.

Another important change in the economy has been the creation of new small- and medium-sized enterprises. The number of business start-ups (net) was 140,000 in 1980-84, and the expected trend in 1985 was likely to set a new record. Some of these businesses had been created under the Enterprise Allowance Scheme which has helped nearly 110,000 unemployed to start their own businesses. There has also been a rapid increase in the supply of venture capital and in the number of venture capital funds. The U.K. authorities are placing much emphasis on the role of these new enterprises in bringing about desired changes in work practices and in the structure of production.

Finally, other steps have been taken to free markets and to increase competition, especially in transportation and the financial sector. Many controls on financial markets have been lifted, and profound changes are currently under way in the securities industry, designed to stimulate competition and ensure that London remains an important international financial center. At the same time, the Government has emphasized the need for adequate regulation of the securities industry and supervision of banks (see RED). In the domestic market, the removal of the "corset" in 1980 led to increased competition between the banks and the building societies; the basis of that competition is being further enhanced by recent changes in the legislation governing the activities of building societies (see RED).

VI. Trade and Aid Policies

In line with its overall economic strategy, the Government supports an open trade policy and has welcomed the early launching of a new round of multilateral trade negotiations under GATT. It has taken the view that no item should be excluded from consideration at this stage of the negotiations. On the Multi-Fibre Agreement, the Government's position has been that it should be replaced by a more liberal arrangement. There are currently discussions within the EC of the U.K. proposal for giving favorable treatment under a new MFA to the poorest LDCs and to those whose own trade barriers are low. The Government believes that the longer-term future of the MFA should be decided in the context of the proposed new GATT round.

As part of the European Communities' commercial policy, imports of agricultural products continue to be subject to variable levies, and imports of steel, textiles, and electronic products to quota limitations. At the national level, imports of a few products are constrained by industry-to-industry agreements. On the export side, the voluntary export restraint on exports of certain steel products from the European Communities and the United States was extended in 1985 until 1989, and the coverage was broadened.

Net official development assistance (ODA) in 1984 was the same as in 1983 in local currency terms. Net ODA disbursements were 0.33 percent of GNP in 1984 compared with 0.35 percent in 1983. In the March 1985 Budget, net ODA in 1985/86 is projected to be £1.130 billion, a little more than the £1.099 billion in 1984/85.

VII. Economic Outlook

The official forecast for 1986 contained in the Autumn Statement 1985 assumes that macroeconomic policies will be in line with the MTFS set out in the 1985/86 budget, which aims at maintaining downward pressure on the growth of money GDP and inflation. It also assumes that the effective exchange rate for sterling will not change much from its average level between March and November and that the exchange rate in terms of U.S. dollars will remain at the level prevailing at the end of October. North Sea oil prices are assumed to decline by nearly 10 percent in 1986 from the 1985 average level of US$27 1/2. The projections made by the staff, in the context of the current WEO exercise, are based on similar assumptions though with a slightly appreciated exchange rate. Oil prices are assumed to be a little lower in the staff forecast, reflecting developments in world oil markets since the publication of the official forecast. On the whole, the staff projections are not materially different from the official forecast.

On the official forecast, output growth is projected to be close to the 3 percent annual average experienced since the beginning of the recovery in 1981 and down somewhat from the 3 1/2 percent growth registered in 1985. Adjusted for the effect of the coal miners' strike, output growth in 1986 would be 2 1/2 percent. The composition of growth is expected to shift further from that experienced in 1984 and in the first half of 1985, with growth in personal sector spending becoming more prominent while growth in exports and business investment slows down. The staff envisages a similar pattern of demand but expects overall GDP growth to be about 1/2 of a percentage point below that projected by the authorities.

Following a 2 1/2 percent rise in 1985, private consumption is expected by the authorities to rise by 4 percent in 1986, thus accounting for nearly all the projected growth in output. This would reflect a rapid growth of real personal disposable income, which in turn would result from a continuation of recent trends in nominal earnings in the face of the substantial fall in inflation forecast for next year. The fall in inflation is also expected to lead to a lower personal savings ratio.

The growth of gross fixed investment is forecast to slow from the rapid pace experienced in 1984 and 1985. There would be a slower growth of private business fixed investment--despite the strength of corporate profits and liquidity and the buoyancy of the stock market--reflecting the bringing forward of projects that appears to have occurred in 1985. Public investment is expected to grow only slightly in 1986, after falling sharply in 1985. On the basis of developments in private housing starts over the last two quarters, the authorities are looking for buoyancy in residential construction.

The U.K. authorities thus foresee an acceleration in the growth of final domestic demand and, with the pace of stockbuilding expected to quicken somewhat, total domestic demand is projected to grow by 3 1/2 percent in 1986, up from 2 1/2 percent in 1985. The foreign balance, however, is expected to deteriorate substantially in 1986, reducing GDP growth by 1/2 percentage point, after having contributed to growth in 1985 by 1 percentage point.

The outlook for inflation in 1986 is sensitive to developments in world prices and the exchange rate. On the official forecast, inflation, measured in terms of the retail price index (RPI), is to fall from 5 1/2 percent in the fourth quarter of 1985 to 3 3/4 percent in the fourth quarter of 1986. For the most part the forecast decline results from the weakness in world commodity prices and the strength of sterling, but the decrease in mortgage rates (which figure prominently in the housing component of the RPI) in the course of 1985 has significant carry-over effects.

In the labor market, with average earnings in manufacturing still increasing at a rate of nearly 9 percent, unit wage costs will probably continue to rise strongly. Even with the projected 3 percent growth for real GDP, the staff foresees a slowdown in employment growth from the pace of 1984-85, with the increase continuing to be concentrated in self-employment and part-time jobs for women in the services sector. Nevertheless, there is likely to be a slight decline in the unemployment rate in 1986 as a result of a projected slowdown in the growth of the labor force and the various direct measures being put into place by the authorities.

On the external accounts, the official forecast envisages a widening of the current surplus from £3 billion in 1985 to £4 billion in 1986, on the basis of a further rise in the surplus on invisibles. The visible trade deficit is expected to remain in the vicinity of £2 billion, with a small decline in the oil surplus offset by a reduction in the non-oil deficit. Net oil export volumes are expected to rise in 1986 but, with declining sterling oil prices, the value of the surplus on oil is expected to fall. The projected reduction in the non-oil deficit is predicated on a sharp improvement in the terms of trade. In volume terms, non-oil trade performance would deteriorate substantially, owing to increased import penetration in the U.K. market and a slowdown in the expansion in world trade. According to the staff forecast, the current account surplus would decline to £2 billion in 1986.

One major uncertainty in the U.K. economic outlook relates to the evolution of international oil prices. The decline in oil prices in 1986 assumed both by the authorities and by the staff appears rather modest in the light of the latest developments. A decline substantially larger than assumed would undoubtedly affect the evolution of public finances, interest rates, output, inflation, and the external current account. However, the size, timing, and even in some cases the direction of the effects, are uncertain, depending, inter alia, on the size and the timing of the exchange rate adjustment, the response of the monetary and fiscal authorities, and the way the world economy at large reacts to the fall in energy prices.

VIII. Staff Appraisal

The U.K. economy is entering its sixth year of uninterrupted growth. Even including the severe downturn in 1979-81, the average growth rate over the past seven years has been about the same as that of France and Germany while it had been significantly lower in the preceding 20 years. Productivity gains have accelerated, and the profitability of the enterprise sector has improved considerably. The current account of the balance of payments has continued to register surpluses reflecting increased receipts from oil and invisibles. The economy has also undergone rather fundamental transformations: deregulation, privatization, tax reform, and the creation of numerous small- and medium-sized firms will over time improve the efficiency and flexibility of the whole economy.

Costs and prices decelerated rapidly between 1980 and 1983, but there has been little progress since then. Wages and earnings even showed signs of edging higher in 1985, especially in manufacturing. Both consumer prices and unit labor costs are now rising in the United Kingdom faster than in the other main industrial countries. This is especially disappointing considering that the rate of unemployment is also well above that of the other countries. Although unemployment appears to have stabilized since the summer of 1985, its resistance to decline represents a major challenge for the Government.

The U.K. authorities' overall economic strategy rests on a medium-term framework for financial policies aimed at setting the growth in nominal GDP on a slowly decelerating path, and they have broadly succeeded in meeting that goal (Chart 1). The improvement in the split between price and output and between employment and unemployment is essentially left to supply-side measures, and in particular to those designed to improve the functioning of the labor market. The staff continues to support this strategy. Attempts at pushing up the rate of growth through easier financial policies would run the risk of rekindling inflationary expectations, which as the experience of 1985 demonstrates, remain sensitive to financial developments, and of jeopardizing external equilibrium. If such attempts involved a change in the policy mix based on fiscal expansion, they would result in a disadvantageous shift in the composition of demand.

The emphasis placed by the authorities on the need to reduce labor market rigidities has led to the adoption of a number of measures designed to curb union power, to eliminate some of the disincentives to employment, to reduce distortions in the tax system affecting the relative cost of labor and capital, and to improve training and increase labor mobility. These measures have not, however, prevented a continuous rise in real wages which, in turn, has impeded a permanent reduction in unemployment. The U.K. authorities have rightly argued that the measures they have introduced will take time for their full effect to be felt, but the staff would also stress the need for further action. There are still a number of obstacles to labor mobility--related in part to housing policies--and disincentives both to firms to increase employment, such as the high costs of separation, and to the unemployed to take low-paying jobs, which could be reduced by Government action. The persistence of high unemployment has led the U.K. authorities to take direct measures to reduce it in the form of work and training schemes and financial incentives for employers to create--and the unemployed to accept--jobs at the low end of the pay scale. The staff supports these measures and their possible extension, inasmuch as they appear to be cost effective and contribute to greater wage flexibility.

In formulating financial policies, the U.K. authorities should aim at a policy mix which is consistent with long-term objectives. These objectives, as the staff sees them, should be to close the gap between the level of productivity in the United Kingdom and the other main industrial countries, to secure price stability, to create the conditions for sustained employment growth, and to prepare for a decline in foreign exchange receipts from North Sea oil. With respect to the last objective, the staff is less optimistic than the U.K. authorities about prospects for the balance of payments and foresees a current account deficit emerging as early as 1987, even with relatively subdued growth of domestic demand. The staff favors therefore a mix of financial policies that encourages investment, a major determinant of productivity gains and employment creation, and exports.

It is the staff's view that a sufficiently tight fiscal policy would shore up confidence in financial markets and permit a reduction of interest rates at a time when the complete phasing out of tax allowances is likely to be accompanied by a marked weakening of investment activity. Excluding transitory receipts from North Sea oil and asset sales, the PSBR is well above the medium-term target of 1 percent of GDP and the United Kingdom's net public debt as a percentage of GDP, despite its recent decline, remains above that of the other G-5 countries. The staff hopes, therefore, that the decline of the PSBR for the next fiscal year as projected in the last Budget will be achieved and that allowance will be made for the planned increase in asset sales. This will probably leave little room for tax cuts, given the expected shortfall in receipts from oil production, but the reduction in energy prices may be viewed as the equivalent of a tax cut. Some restructuring of taxes may also be possible--even in the absence of a tax cut--to implement the authorities' intended shift from taxation of income to taxation of expenditure. The staff supports the U.K. authorities' emphasis on the need for tax cuts from a supply-side perspective and agrees that the level of tax rates and thresholds acts as a disincentive to work and acquire greater skills. It believes, however, that tax cuts should be predicated on a permanent containment of expenditure. In this respect the staff welcomes the authorities' reaffirmation of their intention to stabilize public expenditure in real terms and to tighten control on outlays. The recently announced reform of the social security system could also contribute in a more distant time horizon to a deceleration of public spending.

Turning to monetary policy, the staff agrees that, notwithstanding the rapid expansion of the broad monetary aggregates, the weight of the evidence suggests that monetary policy has not been too loose. At the same time, the high level of liquidity in the economy is cause for caution. Given the additional uncertainties associated with the stance of fiscal policy under the next budget and with developments in the oil market, it would be premature to lower interest rates significantly at present, even though they remain well above those in the main industrial countries. The interpretation of the monetary aggregates remains difficult and, in pursuing their nominal income target, the monetary authorities will need to pay attention to the full range of indicators of monetary conditions and be prepared to react promptly if they perceive that nominal GDP may be moving off its targeted path.

The staff agrees that the exchange rate can provide useful signals on monetary conditions, and that, in view of the fragility of the recent subsidence of inflationary expectations, the authorities cannot be complacent as to the size and speed of a depreciation. However, it believes that some exchange rate flexibility should continue to be allowed in response to developments at home or abroad which affect permanently the external position of the United Kingdom. The authorities do not disagree that the real effective exchange rate of sterling will need to depreciate over time as export receipts from oil decline, a development which may occur rather sooner than expected if the recent sharp fall in oil prices is not reversed. Their preference is to see such a real depreciation achieved through a larger decline in domestic costs and prices than in the main trading partner countries rather than through a nominal depreciation, and they view a firm nominal exchange rate as an effective instrument to keep pressure on enterprises to resist excessive wage claims. Nevertheless, the authorities have been prepared to allow the rate to depreciate when this could be done without undermining progress against inflation or the confidence of financial markets. The staff agrees that a depreciation of the nominal effective exchange rate must not be perceived as an automatic response to a loss of competitiveness resulting from enterprises' inappropriate wage and price decisions, but welcomes the recognition by the U.K. authorities that in certain circumstances, such as a pronounced fall in oil prices, it may be necessary to accept an adjustment of the exchange rate. Financial policies should, however, remain firm enough to dispel any doubt about the authorities' commitment to fight inflation.

The staff welcomes the U.K. authorities' reaffirmation of their commitment to an open trade system and their support for a new GATT round, and a liberalization of the Multi-Fibre Arrangement. It encourages the United Kingdom to use available opportunities to press within the European Communities for the rollback of existing barriers to trade in agricultural and industrial products, as well as in services.

It is recommended that the next Article IV consultation with the United Kingdom be held according to the standard 12-month cycle.

United Kingdom - Basic Data

Area and population	
Area	94,247 square miles (244,100 square kilometers)
Population (mid-1984)	56.5 million
GDP per capita (1984)	£5,653

Composition of GDP in 1984, at current prices	In billions of pounds	Distribution in per cent
Private consumption	194.7	61.0
Public consumption	69.7	21.8
Total investment (including stockbuilding)	55.1	17.3
Total domestic demand	319.5	100.1
Exports of goods and services	91.7	28.7
Imports of goods and services	91.8	28.8
GDP at market prices (expenditure estimate)	319.4	100.0

Selected economic data, annual percentage change (period average)	1983	1984	1985
Real GDP (at market prices, average estimate)	3.2	2.6	3.5 1/
Manufacturing production	2.9	3.8	2.7 2/
Average earnings 3/	9.0	8.8	8.7 2/
Unit wage costs 3/	1.3	3.4	6.2 2/
Retail price index	4.6	5.0	6.1
Rate of unemployment (in percent)	12.3	12.7	13.1
Mo 4/	6.4	6.6	2.2
£M3 4/	10.5	9.5	15.0

Public sector accounts, in billions of pounds	1983/84 Outturn	1984/85 Outturn	1985/86 Estimate 5/
General government receipts	128.4	139.4	149.0
General government expenditure 6/	140.4	157.3	160.5
Financial balance	-12.0	-11.9	-11.5
(In percent of GDP)	(-3.9)	(-3.6)	(-3.2)
Public sector borrowing requirement	9.7	10.2	8.0
(In percent of GDP)	(3.2)	(3.1)	(2.2)

Balance of payments, in billions of pounds	1983	1984	1985 7/
Exports	60.8	70.4	78.7
Imports	61.6	74.5	81.4
Trade balance	-0.8	-4.1	-2.7
Net invisibles	4.0	5.2	5.6
Current account balance	3.1	1.1	2.9
Investment and other long-term capital	-6.5	-12.0	-14.2
External sterling liabilities	4.2	6.4	7.5
Trade credits and other short-term capital 8/	-1.6	3.2	4.8
Balance for official financing	-0.8	-1.3	0.2
Gross reserves, official basis (billions of SDRs) 9/	17.0	16.0	14.2
Gross reserves, IFS basis (billions of SDRs) 9/	11.5	10.3	12.6 10/
Average effective exchange rate index (1980 = 100) 11/	86.7	81.9	81.5

1/ First half of 1985 over the corresponding period of 1984.
2/ First three quarters of 1985 over the corresponding period of 1984.
3/ Manufacturing sector.
4/ End period; for 1985, mid-December over mid-December.
5/ Revised estimate based on the Autumn Statement, 1985.
6/ Excluding net lending.
7/ First three quarters at annual rate; current transactions are seasonally adjusted while capital transactions are not.
8/ Including balancing item and allocation of SDRs.
9/ As of the end of December, unless indicated otherwise.
10/ November 1985.
11/ Annual average.

United Kingdom - Fund Relations

(As of December 31, 1985)

I. Membership Status

(a) Date of membership:	December 27, 1945
(b) Status:	Article VIII

(A) Financial Relations

II. General Department

(a) Quota:	SDR 6,194 million
(b) Fund holdings of pound sterling:	SDR 4,384 million (70.8 percent of quota)
(c) Fund credit:	None
(d) Reserve tranche position:	SDR 1,810 million
(e) Current operational budget:	The pound sterling is included in the current operational budget for maximum sales of SDR 34.0 million and maximum receipts of SDR 94.5 million.

	Limits	Outstanding	Uncalled
(f) Lending to the Fund: GAB	1,700.0	--	1,700.0

III. Current Stand-By — Not relevant

IV. SDR Department

(a) Net cumulative allocation:	SDR 1,913.1 million
(b) Holdings:	SDR 1,029.8 million, 53.8 percent of net cumulative allocation
(c) Current designation plan:	Maximum amount of designation is SDR 213.6 million, of which SDR 70 million has been designated so far.

V. Administered Accounts — Not applicable

(B) Nonfinancial Relations

VIII. Exchange Rate Arrangements — The U.K. authorities do not maintain margins in respect of exchange transactions, and exchange rates are determined largely on the basis of demand and supply conditions in the exchange markets. The exchange rate of sterling was £1 = US$1.39 on January 22, 1986.

IX. Last Article IV Consultation — Discussions for the 1984 Article IV consultation were held in London from November 30 to December 10, 1984. The staff report for the 1984 Article IV consultation (SM/85/44, 2/6/85) was considered by the Executive Board on March 6, 1985 (EBM/85/35). The United Kingdom is on the 12-month consultation cycle.

United Kingdom - Statistical Issues

1. Outstanding Statistical Issues

a. Money and banking

Balance sheet data in IFS for the monetary authorities and the deposit money banks are reported on a quarterly rather than a monthly frequency. There is no coverage of other financial institutions. It is expected that, in the near future, data for the monetary authorities' accounts will be published in IFS on a more current basis, with a separate section to be introduced for other financial institutions as well as a Financial Survey. At a later date, it is hoped that monthly data will be published in IFS as a result of a change in the presentation of banking data by the central bank, and a planned shift in the reporting date for deposit banks' data from mid-month to end-month.

b. Government finance

The 1985 Government Finance Statistics Yearbook includes data in the statistical tables for the consolidated central government, local government and supranational authorities through 1984. However, the information for consolidated central government for 1984 is rather incomplete. Also, there are gaps in the United Kingdom's presentation for central government in the Yearbook. No data are available on the functional classification of expenditure and on lending minus repayments for the years 1980 through 1984; nor are data available for any year on capital expenditure by function.

2. Coverage, Currentness, and Reporting of Data in IFS

The table below shows the currentness and coverage of data published in the country page for the United Kingdom in the January 1986 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Bank of England which, during the past year, have been provided on a timely basis.

Status of IFS Data

		Latest Data in January 1986 IFS
Real Sector	- National Accounts	Q2 1985
	- Prices: Manufacturing output	September 1985
	CPI	October 1985
	- Production: Industrial	August 1985
	Crude petroleum	June 1985
	- Employment	Q2 1985
	- Earnings: Average monthly (all industry)	August 1985

Government Finance	- Deficit/Surplus	Q2 1985
	- Financing	Q2 1985
	- Debt	n.a.
Monetary Accounts	- Central Bank	Q2 1985 (partial)
	- Deposit Money Banks	Q2 1985
	- Other Financial Institutions	n.a.
External Sector	- Merchandise Trade: Values	September 1985 1/
	Prices	September 1985
	- Balance of Payments	Q2 1985
	- International Reserves	November 1985
	- Exchange Rates	November 1985

1/ Data on imports of petroleum and crude petroleum are available through Q4 1984.