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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/34

3:00 p.m., February 24, 1986

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
	D. C. Templeman, Temporary
J. de Groote	
M. Finaish	T. Alhaimus
H. Fujino	
G. Grosche	
	Jiang H.
J. E. Ismael	
	J. Hospedales, Temporary
T. P. Lankester	
H. Lundstrom	H. Fugmann
	G. D. Hodgson, Temporary
E. I. M. Mtei	
	C. A. Salinas, Temporary
Y. A. Nimatallah	
P. Pérez	
H. Ploix	S. de Forges
	J. de Beaufort Wijnholds
C. R. Rye	
G. Salehkhou	
	A. Vasudevan, Temporary
	N. Coumbis

L. Van Houtven, Secretary
L. Collier, Assistant

Also Present

African Department: A. D. Ouattara, Director. European Department: P. B. de Fontenay, Deputy Director; Y. Horiguchi, S. Mitra, J. K. Salop, N. Streefkerk, G. S. Tavlas, R. G. Thumann, H. Vittas. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; J. T. Boorman. Fiscal Affairs Department: M. Shadman. IMF Institute: A. B. Milligan, Participant. Legal Department: J. M. Ogoola, J. K. Oh. Middle Eastern Department: P. Chabrier, Deputy Director; S. H. Hitti, S. Kawar, H. E. Jakubiak, S. Thayanithy. Research Department: A. D. Crockett, Deputy Director; J. M. Boughton, F. Larsen, S. Ramachandran. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: A. A. Agah, W.-R. Bengs, M. B. Chatah, L. P. Ebrill, G. Nguyen, G. W. K. Pickering. Assistants to Executive Directors: J. R. N. Almeida, J. de la Herrân, F. Di Mauro, R. Fox, S. Geadah, L. Hubloue, O. Isleifsson, A. R. Ismael, S. King, H. Kobayashi, M. Lundsager, A. Ouanes, W. K. Parmena, J. E. Rodrîguez, H. van der Burg, B. D. White.

1. UNITED KINGDOM - 1985 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/86/33, 2/24/86) their consideration of the staff report for the 1985 Article IV consultation with the United Kingdom (SM/86/15, 1/27/86; and Sup. 1, 2/21/86). They also had before them a report on recent economic developments in the United Kingdom (SM/86/22, 2/10/86; and Sup. 1, 2/11/86).

Mr. Jiang commented that the medium-term financial strategy adopted by the U.K. authorities in 1980 had had some success. The rate of inflation had been brought down from 20 percent in 1980 to 5 percent in 1985. In addition to that significant achievement, the economy had grown at an annual rate of 3 percent, and the current account had recorded a surplus over the past several years. Although those gains were impressive, there remained three areas of concern to the authorities.

The first area was inflation, Mr. Jiang continued. The staff report indicated that the authorities had placed too much emphasis on monetary policy by applying downward pressure on inflation through interest rates; however, a lack of fiscal policy coordination could pose the danger of rekindling inflation. He welcomed the authorities' reaffirmation of their intention to stabilize public expenditures in real terms and to tighten control on outlays. He also welcomed their determination to reduce the public sector borrowing requirement.

Second, the persistently high level of unemployment in the United Kingdom warranted the authorities' attention, Mr. Jiang observed, especially at present in view of the relatively low rate of inflation. The unemployment level was partly due to the tight financial policies pursued by the authorities. He was pleased, however, to learn that the authorities were fully aware of the various causes of the unemployment situation and had taken a series of measures to reduce rigidities in the labor market.

The third area of concern was the current account position. Despite a relatively small share of oil exports in terms of GDP, or of tax revenue--but a rather high share in terms of total exports--a continuing drop in oil prices would have a serious adverse impact on the U.K. current account. The staff had therefore given the authorities sound advice in suggesting that they prepare contingency plans in the event of a sharp decline in oil prices. However, the non-oil trade balance, in order to trade off the weakening of the oil trade balance, would rest to a certain degree on the expansionary effect of the oil price drop on the United Kingdom's trading partners.

He shared the staff view that the United Kingdom should use the available opportunities to press within the European Communities for the rollback of existing barriers to trade in the agricultural and industrial sectors as well as in services, Mr. Jiang concluded. He hoped that the United Kingdom would play a greater role in promoting world trade and official development assistance to the developing countries.

Mr. Orleans-Lindsay commented that the economy of the United Kingdom had continued to perform satisfactorily during 1985. The pace of economic recovery had been sustained for another year, with real GDP growing by about 3 1/2 percent. The public sector borrowing requirement had decreased, although moderately. The profitability of several companies had improved, and the external current account surplus had risen markedly. Those achievements were commendable. However, they should not overshadow some negative developments, as reflected by several economic and financial indicators.

In the real sector, industrial production, on average, had lagged substantially behind that of the other countries of the Group of Five, while lending rates were significantly higher than those prevailing in that group of countries, Mr. Orleans-Lindsay continued. Furthermore, unit labor costs had increased sharply, contributing in part to the persistent high level of unemployment. Chart 5 in the staff report indicated that the downtrend of employment in the manufacturing sector had accelerated recently, with the lowest level recorded in 1985. Table 4 in the staff report also showed that apart from the experience of Canada, the Netherlands, and Norway--major energy producers--the U.K. share of manufacturing output in total GDP had fallen the most rapidly over the period 1960-83. The table had not included the trend in Japan, which was not a major energy producer, and he asked the staff to comment on the Japanese experience. The continuous decline of manufacturing, as a source of both employment and output, should be considered a serious development that needed to be addressed effectively. However, the staff had reported the view of the U.K. authorities that "the deterioration in manufacturing...represented no immediate threat to the external position of the country." While the deterioration in employment, output share, and exports of manufacturing might not pose an immediate threat, it was nevertheless gratifying that the U.K. authorities had shown some concern about that adverse development and, as indicated in Appendix III (SM/86/22, Sup. 1) and Mr. Lankester's statement, had formulated plans to deal with the decline in manufacturing and the intractable problem of unemployment.

He invited the staff or Mr. Lankester to comment on the "unduly generous" wage awards reported by the staff, Mr. Orleans-Lindsay said. Normally, workers' compensation should reflect factors such as large productivity gains and scarcity of skills. It was not clear why workers' remunerations were so high in the United Kingdom relative to other industrial countries, particularly when viewed against comparable productivity levels, skills, inflationary experience, and the unemployment level. He wondered whether the measures being implemented by the U.K. authorities would go very far to make the labor market adjust rapidly to rising real wages.

The current account position and the balance of official financing in 1985 had improved, Mr. Orleans-Lindsay commented. However, gross official reserves had decreased, and sharp movements had occurred in the foreign currency value of the pound sterling. Furthermore, exporters were concerned about the weakening of their competitive position.

Certainly their high production costs, of which wages were undoubtedly an important component, would normally play a role in their competitive position. The current account of the United Kingdom had recorded a surplus in 1985, as in preceding years; however, that evolution masked some serious weaknesses, in particular the large dependence on oil and services as sources of foreign exchange earnings, and the resulting vulnerability of the external sector position to a sudden decrease in those resources. Mr. Lankester had stated that the importance of oil to the U.K. economy should not be overstated. But the recent pressure on the pound sterling stemming from developments in the oil market testified to that vulnerability. Furthermore, the dependence on services would not be worrisome if the continued expansion of activity abroad could be assured. In the event, that would be a daring assumption, especially if heavily indebted countries and small oil exporting countries were among the importers of services from the United Kingdom. A more active participation of the United Kingdom in finding appropriate solutions to the growth prospects of the developing countries would be commendable.

With regard to the privatization policies pursued by the authorities, Mr. Orleans-Lindsay asked the staff or Mr. Lankester to comment on whether all the public enterprises had been running at a loss before the change of ownership. If those enterprises had been making profits and presumably had not been heavily dependent on government subsidies and loans for their operations, he would be interested to know the criteria for their privatization. If they were making profits at present, he wondered what their financial contribution would be to the budget in terms of profits and other taxes; in sum, whether the financial gain or loss to the Treasury was greater before or after privatization. Mr. Dallara had commented that it was worthwhile to move efficient public enterprises into the private sector so that their performance could be an example to other enterprises. Perhaps public enterprises that were making profits or were efficient should be allowed to remain in the public sector. His comments should not be construed as implying that only financial considerations entered into the decision to privatize public sector enterprises.

Some improvements had occurred in the U.K. economy in 1985, notably in the form of higher economic growth, an increase in the external current account surplus, and a lower public sector borrowing requirement, Mr. Orleans-Lindsay remarked. However, performance in such areas as wages, inflation, and employment had been less than satisfactory. The heavy dependence of the economy on uncertain oil revenues and earnings from the export of services was worrisome. Those problems should be addressed in a pragmatic and nondoctrinaire fashion so as to establish a firmer basis for noninflationary economic expansion and enhanced export competitiveness.

He regretted that U.K. official development assistance had decreased in real terms in 1985 and had represented only 0.33 percent of GDP in 1984/85, far below the UN target of 0.7 percent, Mr. Orleans-Lindsay concluded. Most low-income countries that benefited from official development assistance would appreciate efforts by the U.K. authorities to increase the level of their assistance.

Mr. Finaish remarked that although the U.K. economy had achieved important gains in the past few years, recent trends indicated some growing difficulties, and future prospects were clouded with some uncertainties. The maintenance of uninterrupted growth in the past six years certainly contrasted favorably with the previous record, and the decelerating trend in inflation since 1980 had been an important achievement. On the external side, the current account of the balance of payments had continued to show a surplus since the latter part of 1979.

More recent developments, however, indicated some worrying signs, Mr. Finaish continued. The pace of output growth had clearly slowed in the second half of 1985, and business investment and export activity had weakened. The inflation rate, notwithstanding the deceleration that had been achieved, was still above the average of the other main industrial countries. Furthermore, little progress, if any, had been made in tackling the United Kingdom's most chronic structural problem: a continued high unemployment rate coupled with relatively high costs. As the staff indicated, both consumer prices and unit labor costs were currently rising faster than in the other main industrial countries.

Economic policies had attempted to address the various problems facing the economy, including the structural rigidities, and perhaps further steps could be expected from the budget statement of March 1986, Mr. Finaish said. But the authorities' task might be made more difficult as a result of the most recent sharp fall in oil prices and the uncertainties surrounding the future of the oil market structure. If that situation persisted, pressure might be felt on the external current account balance, and fiscal revenues and policy options might consequently narrow in some areas. A sharp fall in the current account surplus had already been projected for 1986, even assuming a modest oil price fall.

The current dramatic developments in the oil market served to draw attention to the role of oil in the U.K. economy and its impact on future prospects, Mr. Finaish observed. For example, Mr. Lankester had stated that the importance of oil to the U.K. economy "should not be overstated" as it accounted for 5-6 percent of GDP and 8 percent of tax revenue. But looking at the economic scene as described in the staff report and elsewhere, it seemed that policy implications of developments in that sector, however small it might appear in terms of those aforementioned ratios, could be significant.

Possible ramifications of oil market developments could be felt in several areas, Mr. Finaish continued. The oil price impact on the pound sterling exchange rate and its implications for interest rates had again been demonstrated by the recent oil market developments. Persistence of the present volatile conditions in the oil market could be expected to be an important factor in future exchange rate fluctuations.

The fiscal impact could be felt in more than one aspect of the budget, Mr. Finaish stated. On revenues, it might no longer be useful, given actual price developments, to examine the impact of, for example, a

$5 oil price fall and determine that the impact would be rather limited. The calculations presented in the British press showed that whereas the previous budget had projected revenues of £11.5 billion, the subsequent fall in the price of oil would reduce prospective revenues to £6.5 billion. Currently it was expected that the Government's objective of reducing taxes by £3.5 billion in 1986/87 would not be possible, even with a $20 oil price. On the other hand, it was being argued that a cut in oil prices was similar to a tax cut for businesses and consumers. He agreed that an oil price fall was akin to a fall in indirect taxes; the question was whether it was similar to the tax cut originally intended, especially a lowering of income taxes. He invited the staff to comment on that point.

The contribution of oil proceeds to the current account balance had also been significant, Mr. Finaish commented. For the past several years, the widening of the non-oil trade deficit had been increasingly compensated by a surplus in the oil trade, thus considerably limiting the visible trade deficit. It was thus expected that the oil market conditions would contribute to a widening of the visible trade deficit in 1986. The implications of that trend in the medium term could not be understated. The staff had reported that a "vigorous debate" was taking place in the United Kingdom on the implications for economic policy of the declining importance of the manufacturing sector and the emergence of a deficit on foreign trade in manufactures "especially over the medium term when oil production tapers off." The staff had summed up the possible future impact of oil fairly well when it had stated that "one major uncertainty in the U.K. economic outlook relates to the evolution of international oil prices." The staff added that "the decline in oil prices in 1986 assumed both by the authorities and 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 account."

In Supplement 1 to SM/86/15 the staff had attempted to assess the impact of a large oil price fall on the U.K. economy, Mr. Finaish noted. Important sectoral effects were expected in such a case, but the staff considered that, on balance, the effect would be small. No indication had been given, however, of the precise assumptions underlying that assessment. A reference to a 10 percent fall in oil prices suggested that that assumption had been used by the staff. Such a magnitude could not be regarded as large in light of prevailing prices; it would have been interesting if the implications of some other assumptions had also been analyzed and if an assessment had been made of whether the overall impact of a larger drop in oil prices would be, on balance, favorable or unfavorable to the U.K. economy. In that context, it might be useful to point out that the OECD had noted in its recent Economic Outlook report that the strong contribution to growth which had come from the oil sector in the past would now ease.

Given such significant and wide-ranging implications, the staff could usefully have included a more comprehensive description of the oil sector and some analysis of oil policies in the staff report and the report on recent economic developments, which would have facilitated better understanding of the issues involved, Mr. Finaish concluded. In particular, a discussion of the implications for the U.K. economy of the country's present oil production policy would have been of interest. Account could also have been taken of the implications of that policy, which had come under debate in the United Kingdom, for the rate of depletion of oil reserves.

The Deputy Director of the European Department commented that for the United Kingdom the decline in oil prices represented a loss of welfare which could be estimated by the change in the terms of trade; based on net exports of oil amounting to £8.5 billion, a decline in oil prices of about 45 percent would result in a loss in the terms of trade equivalent to 1 percent of GDP. Other effects would depend on exchange rate policy. If a 10 percent fall in the price of oil was accompanied by a 3 percent effective depreciation of the exchange rate, the effect on prices would be nil. Assuming a 40 percent decline in the price of oil, calculations indicated that a 12 percent effective depreciation would keep the price level unchanged.

With respect to the current account of the balance of payments, the Deputy Director continued, if the exchange rate were allowed to depreciate by 3 percent for every 10 percent fall in the price of oil, the effect on the trade balance would be about nil, at least over a period of three to five years. In effect, the decline in oil exports would be offset by an improvement in the non-oil trade balance. A problem of timing could arise, however. When the price of oil was falling rapidly, as it was currently, an unfavorable effect on total exports in the first or second year would be made up only later by the effect of depreciation on the non-oil trade balance.

The main impact of the fall in oil prices would be on the government sector, amounting to a decline in revenue of about £4-5 billion, the Deputy Director stated. An amount of that magnitude raised a number of questions for the next budget and for the appropriate stance of fiscal policy. One option for the next budget would be to allow the deficit to expand; another would be to keep the original target for the deficit because an expansionary fiscal policy would produce a mix of policies that was not appropriate for the country's circumstances and the achievement of its medium-term objectives. The current account gave cause for concern as the staff forecast a current account deficit as early as 1987. The level of productivity in the United Kingdom was still too low compared with the other major European countries, which suggested a need for a higher level of capital formation. Unemployment was also a problem that called for the stimulation of investment in order to generate employment; the high level of unemployment was partly related to the shortage of capital stock.

For those reasons, a policy mix consisting of a tight monetary policy and an expansionary fiscal policy would be disadvantageous, the Deputy Director explained. It would push up interest rates, maintain the exchange rate at a level preventing an expansion of exports, and place too much of a burden on monetary policy to fight inflation. Although it had been suggested that it might have been preferable to schedule the Article IV consultation with the U.K. authorities after the budget statement, the present timing had allowed the staff to be associated with the debate on the appropriate stance of U.K. policy and on decisions affecting taxes, expenditures, and the size of the deficit.

The staff was somewhat less optimistic than the U.K. authorities about prospects for prices in 1986, although in the past the forecasts by the U.K. Treasury for inflation had proved to be extremely accurate, the Deputy Director noted. The final outcome would depend largely on exchange rate policy.

It had been asked whether the reduction in oil prices, if considered equivalent to a reduction in direct taxes, was in line with the general intentions of the Government regarding tax reductions, the Deputy Director recalled. In fact, the reduction was not in line, in the sense that the Government was emphasizing the need for a reduction in direct taxes in order to provide greater incentives to work and to acquire skills. At the same time, one option available to the authorities was a restructuring of taxes, with an increase in some types of indirect taxes compensated by a reduction in direct taxes. Unfortunately the scope for such a restructuring was fairly limited, as mentioned in the staff report.

The public sector borrowing requirement was a flawed indicator of fiscal policy because it included asset sales, which to a large extent should be regarded as a financing item, the Deputy Director remarked. It did not take into account the effects of change in the cyclical position of the economy, and there was undoubtedly a need to look at indicators other than the public sector borrowing requirement. The staff had measured the government deficit excluding asset sales and North Sea oil revenue, as well as the structural budget using the methodology of the World Economic Outlook. The staff did not have figures for a full employment budget, largely because it was difficult to estimate full employment in the United Kingdom. It was generally believed that a reduction in the rate of unemployment of about 1 percent would result in an improvement in the budget position of about 1/2 percent of GDP, which was a sizable impact.

The staff's position on monetary policy was based on a number of indicators, the Deputy Director said. At the beginning of 1985, there had been a marked tightening of monetary policy, reflected in a sharp rise in interest rates. Since then, even though interest rates had come down slowly, they were still, in both nominal and real terms, well above the corresponding rates in the other main industrial countries. The exchange rate, as a result of that tightening, had appreciated strongly during 1985 until the end of the year when, as a result of the slide in oil prices, it had started to depreciate. Some aggregates, like the more narrow M0, had increased slowly. Another indicator--asset prices, in particular for houses--did not reflect an acceleration of inflation. The staff therefore believed that monetary policy had not been excessively loose in 1985. An extreme view was that it should have been tight enough to prevent any depreciation of the exchange rate; it was difficult to accept that view in light of the 45 percent decline in the price of oil and its effect on the U.K. economy.

With regard to the relation of the broad aggregates to nominal GDP, velocity for £M3 had been volatile so that there had not been a close relationship between the evolutions of £M3 and nominal GDP, the Deputy Director continued. Meanwhile, the U.K. authorities had been successful in achieving their goal for nominal GDP--a steady deceleration in nominal GDP with only a slight rise in 1985, owing in part to the end of the coal miners' strike--which was the ultimate target of their monetary policy. The authorities believed that it was inappropriate to use monetary policy as a countercyclical policy instrument and that it should be geared toward the medium term with no fine-tuning based on cyclical developments. The authorities intended to continue to target M0--the narrow monetary aggregate--but in addition to target a broad aggregate, which could again be sterling M3 but, as suggested by the staff, could also be a broader aggregate like PSL2A, which covers both banks and building societies and would avoid some of the problems of shifts of deposits between the two types of institutions.

The authorities would have preferred to achieve a real depreciation of the exchange rate through a reduction of domestic costs and prices relative to other countries, the Deputy Director stated. That position had been taken when it had been expected that any decline in the price of oil would be slow and spread over a number of years. Subsequently, the authorities had shown that they would allow a nominal exchange rate depreciation, which, accompanied by a decline in the price of oil, did not have an effect on prices and therefore did not risk a reacceleration of inflation. The authorities believed that a depreciation of the nominal exchange rate tended to be reflected quickly in wage rates; but, in fact, the United Kingdom had succeeded between 1982 and 1984 in achieving a substantial effective depreciation at a time of falling inflation. Therefore the relationship between the exchange rate and inflation was complicated; the change in the rate--rather than the actual rate--of depreciation affected the rate of inflation. The staff believed that the weakening of exports in the second half of 1985 had been due to the appreciation of the exchange rate in the first half of the year.

Several Directors had commented that there might be room for a new approach to the problem of unemployment, the Deputy Director noted. At present, the authorities preferred to rely on market forces in order to achieve a deceleration of wages. It was possible to perceive a sense of fatigue on the part of the authorities with respect to measures to improve the functioning of the labor market. The authorities considered that they had done as much as possible, and they tended to blame the employers for the wage awards, which, although perhaps justified by productivity gains, were considered excessive in that they were too high to improve employment prospects for the large number of workers who would be prepared to work at a somewhat lower wage.

An Executive Director had questioned whether the staff had endorsed the subsidization of labor, the Deputy Director said. The staff believed that some of the schemes used by the authorities were cost effective and had improved the functioning of the labor market. The most recent measure was a form of subsidization to workers who accepted low-paying jobs; it improved the labor market by avoiding the minimum wage legislation, which the authorities had not been able to change, and it encouraged workers and employers to create employment at the lower end of the wage scale. Because of the segmentation of the labor market in the United Kingdom, some of those schemes might be usefully directed toward those groups, such as the long-term unemployed, for whom other measures had had little impact. Some alternative policies would be more detrimental in the long term than the specific schemes aimed at additional training or special measures for the unemployed. The recent increase in employment had been concentrated in the areas of self-employment and the services sector. Although a job in the services sector was as good as one in manufacturing, the staff had underlined the difference between the two because an increase in employment in the services sector, particularly when, as in the United Kingdom, it took the form of part-time employment, usually tended to be associated not with a reduction of unemployment but with an increase in the participation rate.

The staff's presentation of trade measures and restrictions described measures that had been in place for a number of years, the Deputy Director explained. Table 50 in the report on recent economic developments should not be interpreted as indicating an increase in protectionism in the United Kingdom; there had been no such increase during the past year and in fact no change in trade policy since the previous consultation. In the penultimate paragraph of the staff appraisal, the staff had wished to indicate that trade policy for the United Kingdom was at present conducted within the European Communities; it was therefore appropriate to state that the desirability of reducing protection did not apply to the United Kingdom alone because such a policy could only be implemented within the context of the European Communities.

Although the staff did not have definitive figures on the share of manufacturing in Japan, the share had been much more stable than that in the energy producers listed in the staff report, the Deputy Director considered.

The main consideration behind the privatization program had been efficiency rather than finances, the Deputy Director of the European Department stated. The authorities believed that public enterprises--even those that had been profitable before privatization--would operate more efficiently if they were completely in the private sector. In an environment with a risk of bankruptcy and with pressures from other companies, there would be a greater likelihood that those firms would become more efficient. One firm in particular had incurred large losses before privatization, after which it had made profits for its new shareholders. With regard to the long-term effects on the budget, to the extent that those companies became more efficient and therefore became profit making, there would be an impact on the public sector; it would collect corporate taxes whereas previously it had had normally to make up losses out of the budget. A financial gain would thereby accrue to the Treasury over time.

Mr. de Groote observed that if the problem were a shortage of capital, a reduction of taxation in favor of profitable investment was a way to correct the situation. The staff had implied that either an increase in the deficit or an increase in interest rates had to take place. But there would also be some scope for reduction in many areas of expenditure, especially social transfers as advocated by the United Kingdom for many years. He had not considered a fiscal expansion unaccompanied by a corresponding reduction in expenditure but rather a moderate fiscal expansion with a transfer of resources from households to enterprises as a result of a combination of tax and expenditure reductions.

Interest rates were increasingly determined by the foreign exchange market, and therefore a shift in the composition of expenditure did not necessarily entail a major effect on interest rates, Mr. de Groote continued. A reduction in the oil price did not seem to call for a more rigid and more stringent monetary policy but rather an opposite reaction.

On another occasion, Mr. de Groote recalled, when income from oil had increased significantly, a few Executive Directors had said that it would have been better not to allow for increases in the exchange rate at that time but to channel the additional receipts from oil exports to foreign or offshore accounts. The exchange rate would not have increased to the point where it penalized those enterprises that needed to improve their situation and maintain their export markets. If, instead of letting the exchange rate increase, the United Kingdom had allowed for some stability in the exchange rate at that time and had increased reserves in the form of assets in offshore accounts while allowing the enterprises to maintain a better competitive position on the export market and continue their structural improvement, then the United Kingdom would currently have at its disposal large foreign exchange assets that would have helped it to offset the effects of a loss from the declining oil prices by maintaining the stability of the exchange rate.

The Deputy Director of the European Department agreed that another option for the budget was the reduction of expenditures to make room for tax cuts. But the budget process in the United Kingdom was such that expenditure plans had already been announced at the time of the autumn statement. The size of the deficit and the amount, if any, of tax cuts remained to be announced at the time of the budget. According to that process, there was no longer an option for change in expenditure, but that option could be considered the following year.

If monetary policy were unchanged, an increase in the deficit would put pressure on interest rates, which could offset any advantage received from a reduction in corporate taxes, the Deputy Director explained.

If the United Kingdom had pursued a different policy concerning receipts from oil exports, it would have different options at present, the Deputy Director said. Nevertheless, some of the gains from oil were still present in the balance of payments in the form of higher receipts from the assets invested abroad. Investments through the private sector in the form of capital outflows were the counterpart of the current account surplus generated by oil exports over the past four to five years. At present, that surplus had accumulated, and there was a sizable reflow of dividends and interest payments, which provided some support to the balance of payments; otherwise, the situation would be more critical. The measures described by Mr. de Groote would weigh more heavily on fiscal policy, if monetary policy could remain geared to a certain level of nominal income or inflation. In effect, the measures would mean sterilizing a large part of the oil revenue, preventing it from entering the domestic flow of spending. They also implied a different budget position; there would have to be a much tighter policy with respect to expenditure in order to maintain the same level of deficit.

Mr. de Groote noted that there were countries that had a surplus on current account and lived under a system of stable exchange rates; one country had such surpluses deriving from energy. Some members implied that they were in a unique situation that called for a system of fluctuating rates because of energy surpluses. Within the European Monetary System there were two countries in surplus--one for energy reasons--that maintained a stable exchange rate. The policy was to accumulate reserves and to use them when the position became negative; that measure was one of the attributes of a system of stable exchange rates.

Mr. Fujino commented that it was difficult to judge whether the weight of the manufacturing sector in Japan was increasing or not. There had been a drastic change in relative prices among the sectors. In nominal terms, the manufacturing sector had perhaps declined, while in real terms it seemed not to have done so.

Mr. Lankester explained that the United Kingdom had actually had significant current account surpluses over the past five to six years, amounting to about £20 billion, which had been reflected in private investment flows overseas and a consequent return in dividends. Investment had been profitable because stock markets worldwide had done very well over the past five years, and the buildup of assets was in excess of £70 billion. When the exchange rate for sterling had risen, the United Kingdom had been under intense inflationary pressures. Domestic arguments had arisen for tightening policy, and had the authorities tried to keep the exchange rate down, interest rates would also have had to be kept low. While a lower exchange rate could have been achieved by the authorities, it was unlikely that they could have created the disinflation of 1980 which, while painful, had been necessary.

His authorities had appreciated the staff's emphasis on microeconomic issues in its reports, and while there were no areas of major disagreement, there were some differences of emphasis between the authorities and the staff, Mr. Lankester observed. In a number of areas, the performance of the United Kingdom had been good. Growth had amounted to 3 percent a year in 1981-84 and to 3 1/2 percent in 1985. The inflation rate had stabilized at about 5 percent over the past three years. Current account surpluses had continued, amounting to £3.5 billion in 1985--higher than the staff forecast. Export performance in the non-oil sector had been excellent in the past year. Productivity and manufacturing had grown at 3 1/2 percent a year, which was the highest rate in the major industrial countries except Japan. Employment had grown; despite a too high unemployment rate, 200,000 jobs had been added over the past year, and about 600,000 jobs--more than the aggregate amount added in the EC--had been created since mid-1983. Nevertheless, unemployment remained high as a result of demographic factors and increased participation rates. The real rate of return of industrial and commercial companies had risen to a record 11 1/2 percent in 1984, and business start-ups in 1985 had hit a record level. The privatization program had been successful: companies that had been operating at a loss had become profitable, and those that had been profitable were making greater profits.

Nevertheless, there were no grounds for complacency, Mr. Lankester continued. Serious problems remained, notably the high level of unemployment and the labor market rigidities associated with that unemployment. Although fiscal policy had perhaps been too loose in 1979 and 1980, real progress had been made since then. The public sector borrowing requirement for 1985/86 in the previous budget had been forecast at £7 billion; that forecast had been increased to £8 billion in November 1985. Since then the figures had been favorable. During the first ten months of the current year, the public sector borrowing requirement had been only £3.2 billion compared with £7.8 billion over the ten months of the previous year. That development suggested that the £8 billion forecast discussed with the staff in November might be high; furthermore, even that figure, at 2 1/4 percent of GDP, would be the lowest since 1971/72. Excluding asset sales, the ratio became 3 percent. The trend of fiscal policy had without doubt tightened during the current year. If the public sector borrowing requirement were adjusted for asset sales on a 100 percent basis, and if the nonpermanent element of oil revenues were eliminated, the ratio was higher, amounting to 5 1/2 percent for 1985/86. But there were a number of ways of adjusting the public sector borrowing requirement, and perhaps not all country deficits were adjusted for the nonpermanent element of oil revenues. Although asset sales were largely akin to financing items, they were not precise substitutes for government bonds or gilts. Asset sales tapped a different market; therefore, they did not result in the same one-for-one effect on interest rates as a sale of gilt. Nor had the asset sales of the past year crowded out other equity issues, which had reached an all-time high over the past 12 months.

Other adjustments could possibly be made, Mr. Lankester remarked. For example, the unemployment level in the United Kingdom was extremely high by any standard; at 13.2 percent it was not the natural rate. Assuming that the equilibrium rate of unemployment were several percentage points lower than 13.2 percent, an adjustment could be made to the public sector borrowing requirement for the unemployment benefits paid by the Government. In other words, the structural deficit was not as bad as the figures presented in the staff report would indicate.

With regard to the fiscal deficit, the U.K. accounts covered all aspects of the public sector, Mr. Lankester explained. There were no off-balance sheet items in the public accounts, and the totality of public transactions was presented. Although overspending had occurred during recent years despite the authorities' plans, spending was under better control at present. For 1985/86, no increase in real terms, after correcting for asset sales and the effects of the coal strike, was expected. The Government intended to hold spending constant in real terms over the next few years, and a substantial contingency reserve would facilitate that stance. The authorities were improving control over local authorities' expenditure, which had been a major problem in recent years. Neither expenditure on unemployment benefits nor defense spending was expected to continue to increase as previously. Therefore the prospects for public spending were improved.

Although some speakers had suggested that monetary policy had been too loose, others had implied that it might be too tight and that there was scope for a reduction in interest rates, Mr. Lankester recalled. Perhaps the answer was that the United Kingdom had maintained an appropriate stance. The country could not afford to reignite inflation, and there had been a bad experience in early 1985 when the exchange rate had fallen dramatically and the interest rates had been increased by 4 1/2 percentage points. As a result, the mortgage rate had increased, and that development, combined with the depreciation of the pound sterling earlier in the year, had led to an increase in inflation to about 7 percent in mid-1985. Since then inflation had been reduced to 5 1/2 percent, and the authorities were committed to ensuring that inflation was not refueled.

Most speakers had commented that the authorities had been correct in ignoring the substantial overshooting of £M3, Mr. Lankester noted. Appendix VI to Supplement 1 of the report on recent economic developments had described some of the problems experienced by the authorities in interpreting £M3. For example, there had been a shift in deposits from building societies to banks, and whereas bank deposits were included in that monetary aggregate, building society deposits were not. High interest rates had probably induced a buildup of financial assets as opposed to other assets. The deregulation started in 1979 had resulted in a buildup of both assets and liabilities. Because that aggregate had been difficult to interpret, the authorities had tended to downplay it. They had considered monetary policy tight because, inter alia, real interest rates were extremely high; with clearing bank base rates at 12 1/2 percent and the rate of inflation at 5 1/2 percent, the implication was that real interest rates amounted to about 7 percent. The five-year gilt index was showing a 4 percent real return, which by financial standards was high. MO had been running toward the bottom of its range, and various other indicators suggested that a further tightening of policy would not be appropriate at the present time. As to whether £M3 should be used as a target, the Chancellor of the Exchequer would be making that decision in his budget. A problem of market perception must be kept in mind when moving from one aggregate to another, especially as £M3 was the oldest aggregate used by the authorities for targeting.

The authorities were taking a closer look at the exchange rate in the conduct of monetary policy, Mr. Lankester remarked, although the United Kingdom was not yet ready to join the exchange rate mechanism of the European Monetary System (EMS). It was not clear that membership in the EMS could have prevented the volatility experienced over the past year, given the size of the various shocks encountered, although the United Kingdom would continue to keep the possibility of membership under close review. As North Sea oil exports decline in the coming years, there would be a need for a real depreciation of the exchange rate, although it would be preferable to achieve that depreciation through a slower rise in costs in the United Kingdom than in competitor countries. The real depreciation experienced over the past two months had been most appropriate, with a nominal depreciation resulting in a real depreciation without the inflationary consequences of a nominal rate because of the associated reduction in oil prices. In other words, the reduction in oil prices had more or less canceled out the effect of the depreciation.

The impact on activity in the U.K. economy of lower oil prices was ambiguous, but on balance he believed it was favorable, Mr. Lankester said. The United Kingdom would benefit from both the higher activity and lower inflation worldwide that should arise from lower oil prices. Direct benefits would include the lower exchange rate, which would provide additional stimulus to the tradable goods sector. Furthermore, the profitability of the non-oil sector of the United Kingdom would benefit, which should improve the long-term supply potential of the economy. On the other hand, the effect on the fiscal situation was adverse, commensurate with exchange rate assumptions. The Chancellor of the Exchequer would decide in the next week or two on his response and on the public sector borrowing requirement figure for 1986/87. The oil price reduction did not mean that there would be absolutely no scope for tax reductions. The Medium-Term Financial Strategy included projections for the public sector borrowing requirement of £7.5 billion, or 2 percent of GDP, on the assumption of a fiscal adjustment including tax cuts of £3.5 billion in addition to indexation, thereby allowing some room for maneuver. Although oil revenues were expected to be lower than earlier projections, the total revenue picture must be considered. The staff forecast a visible trade deficit of about £2 billion in 1986, although he was unsure of the oil price assumptions. His authorities tended to be more optimistic regarding the current account; although the effect of the oil price decrease on the balance of payments would be adverse, it did not follow that the current account would be in deficit in 1986.

The continuing rise in real wages at a time when unemployment was high was a cause of concern to his authorities, Mr. Lankester continued. It was disappointing that after the efforts of recent years the labor market had not responded better. There had been a number of positive aspects: real wages had not risen uniformly across sectors--sectors with particularly high levels of unemployment had experienced lower real wage increases than other sectors. Public sector wages had been held down, and the authorities had taken a tough position on public sector pay; the civil service in 1985/86 was being offered 4.9 percent of the total pay bill, which was considerably lower than the earnings figures for the private sector. Trade unions were agreeing to more flexibility at the individual plant level; demarcation barriers were being broken down; and the number of grades and job titles in some businesses was being cut back. Plant level, as opposed to national level, pay bargaining was becoming more important. Furthermore, there had been a large rise in self-employment, which argued well for greater flexibility in future. But certainly a great deal more needed to be done, both in making the market more flexible and, in particular, in trying to ensure that real wages did not continue to rise as they had in recent years. Although the authorities were perhaps disappointed in the results of their policies, they were nevertheless determined to continue to attack the problem of unemployment.

The authorities had introduced a number of measures over the past year to fight unemployment, Mr. Lankester added, but the area of labor legislation was politically difficult. In the early 1970s, the Conservative Government had tried to reform trade union legislation and had failed for a number of reasons. Currently, the authorities had introduced important reforms of trade union immunities and officials' accountability, despite a considerable risk that they would not be acceptable to the trade unions. While it could be said that more should have been done, it was important to bear in mind the potential problems of having those changes accepted; nevertheless, the authorities would continue their efforts.

The United Kingdom had not increased trade protection over the past year, Mr. Lankester said. Official development assistance had been increased in the latest public expenditure White Paper, although admittedly not by a large amount; nevertheless, compared with previous plans, the aid budget had been increased by £20 million in 1986/87 and £30 million in 1987/88.

The Chairman made the following summing up:

> Executive Directors commended the U.K. authorities for the uninterrupted expansion of the economy since mid-1981, which had made a positive and outstanding contribution to world economic growth, and they spoke favorably of the fundamental transformation that had been under way in the U.K. economy since the present Government took office in 1979. However, Directors also emphasized their serious concern regarding the very high level of unemployment in the United Kingdom and about the high and still rising level of unit labor costs.

Directors welcomed the U.K. authorities' continued commitment to the achievement of price stability through continued adherence to the medium-term financial strategy. They emphasized that cautious financial policies were essential to dispel any doubt about the authorities' commitment to fight inflation, and they added that a sustained reduction in inflation could not be secured without a slowdown in the growth of labor costs. On this score, Directors expressed disappointment that, despite the higher rate of unemployment, unit labor costs were rising faster than in the other main industrial countries and had even shown some tendency to accelerate. Underlying increases in wages and earnings in the United Kingdom remained disturbingly high, and productivity growth was now slower than in the early phase of the recovery, albeit significantly faster than in the 1970s.

The lack of downward adjustment of real wages and the inflexibility in the functioning of the labor market that lay behind it seemed to be at the heart of the unemployment problem, Directors observed. While commending the authorities on the various measures adopted to deal with labor market rigidities, they stressed the need for further action. In the Directors' view, attempts at reducing unemployment through easier financial policies would run the risk of rekindling inflationary expectations, which remained sensitive to financial developments. Directors were generally supportive of the direct measures to reduce unemployment that the U.K. authorities had introduced. Most of them did not disagree with the staff's view that those measures could be extended if their cost effectiveness and contribution to greater wage flexibility could be ascertained with a reasonable degree of confidence.

With regard to monetary policy, many Directors expressed concern about the continued buoyancy of the broad monetary aggregates and the attendant buildup of liquidity in the economy, and some Directors were not convinced that monetary policy had been tight enough. While welcoming the authorities' decision to abandon overfunding, some Directors wondered whether present techniques of monetary control were adequate to the task of meeting a broad money target on a reasonable time frame. While concerned about the high level of nominal and real interest rates, most Directors took the view that a lowering of rates, unless associated with fiscal tightening, would tend to risk an excessive exchange rate depreciation with attendant inflationary repercussions.

Directors remarked that the monetary aggregates had become difficult to interpret because of ongoing financial innovations, and they agreed that the exchange rate could provide useful signals on monetary conditions--although, admittedly, it was not always possible to identify causes of exchange rate movements. Directors did not disagree with the authorities' basic preference to see a real depreciation of the exchange rate achieved through containment of costs and prices, rather than through nominal depreciation. However, Directors generally advised the U.K. authorities to maintain exchange rate flexibility whenever pressure on the pound sterling was judged to stem from factors such as a decline in oil prices which affect permanently the external position of the United Kingdom. It was observed that in the latest episode of downward pressure on the pound, which seemed related to the evolution of international oil prices, the U.K. authorities had allowed the exchange rate to depreciate while, at the same time, endorsing some rise in short-term interest rates from already high levels to dispel any doubt about their commitment to fight inflation.

Directors were unanimous in urging the authorities to aim at a policy mix that was consistent with long-term objectives. In this respect, Directors expressed concern about the tendency for improvements in the fiscal position to proceed less rapidly than envisaged in the medium-term strategy, thereby tilting the mix of financial policies away from one conducive to strong investment and exports, the prerequisites for the achievement of long-term objectives. In this connection, Directors observed that, adjusted for the effects of transitory factors such as special asset sales and the nonpermanent component of North Sea oil revenue, the ratio of the public sector borrowing requirement to GDP had hardly declined. Directors stressed that the budget to be presented shortly should be sufficiently restrained to maintain confidence in financial markets and, if possible, permit a reduction of interest rates. Given the expected large drop in oil revenue, they recognized that the adoption of a restrained budget would probably preclude tax cuts of any significant size. They pointed out, however, that the reduction in oil prices was akin to tax cuts in many respects and that, in any event, a permanent reduction in tax burdens could not be secured without a permanent containment of public expenditure. Directors strongly endorsed the authorities' determination to keep public expenditure constant in real terms over the medium run.

The structural changes that had been taking place in the U.K. economy were commended by Directors. In this context, they observed that the role of the public sector in commercial activities had been reduced through the privatization of public enterprises. They also welcomed the creation of a large number of small and medium-sized enterprises, and praised the steps taken to free markets and increase competition.

Directors welcomed the U.K. authorities' reaffirmation of their commitment to an open trade system and their support for a new GATT round. Directors encouraged the U.K authorities to use available opportunities to press within the European

Communities for a rollback of existing barriers to trade in agricultural and industrial products, as well as in services. Several Directors stated their concern at the incidence of non-tariff barriers. While expressing appreciation for the authorities' determined efforts to contain public spending, Directors urged them not to scale down official development assistance.

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

2. SYRIAN ARAB REPUBLIC - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with the Syrian Arab Republic (SM/86/18, 1/30/86). They also had before them a report on recent economic developments in the Syrian Arab Republic (SM/86/21, 2/6/86).

The Deputy Managing Director took the chair.

Mr. Finaish made the following statement:

After a decade of rapid economic growth and largely stable financial conditions, the Syrian economy has come, since 1982, under considerable strains. The coincidence of adverse weather conditions during 1982-84 with unfavorable developments in the international oil market resulted in a sharp slowdown in growth and increased financial imbalances, both domestic and external. The weather-related decline in agricultural output had a direct negative effect on the growth rate, as well as an indirect effect through industries which depend on agricultural raw materials. The manufacturing sector in general was also adversely affected by the reduced availability of foreign exchange resulting mainly from the slowdown in economic activity in the neighboring oil exporting countries. This slowdown reduced workers' remittances and financial assistance from some of those countries.

The financial situation in 1984 reflected to a large degree the developments mentioned above. In spite of an increase in tax revenue resulting from improved collections, total budget revenue actually fell by 4 percent as a result of a decline in imports--and thus in receipts from customs duties--and in the transfers of surpluses from state enterprises, particularly in the oil sector. Although budget expenditures rose only modestly in 1984, primarily on defense, the fiscal deficit, excluding grants, registered a significant increase over 1983. The shortfall in external grants led to a further increase in the public sector financing requirement, and thus in monetary expansion.

In the external sector, the decline in external aid and workers' remittances, the lower international prices of oil and phosphate exports, and the substantial imports of food grains to supplement poor crops were among the factors affecting the balance of payments negatively. As a result, the overall external deficit was significantly higher than in 1983.

In order to help contain the pressures on the country's finances while at the same time revive growth, some wide-ranging measures were taken in 1985, particularly in the area of pricing. Although the positive effects of some of these measures may not be reflected in the 1985 outcome, the estimates for the year, though tentative, do point to some improvement in economic performance.

In the area of budget revenues, the efforts to improve the collection of the business profits tax and tax arrears were stepped up, which is estimated to have resulted in a 20 percent increase in tax revenue. Nontax revenue, on the contrary, is estimated to have increased by 12 percent, mainly owing to the authorities' efforts in expediting the transfer of surpluses from public enterprises. The policy of expenditure containment continued in 1985, with capital expenditure being maintained at roughly its 1984 level. While the policy of expenditure restraint was also applied to current outlays, the fact that most of these outlays were for defense, wages, and subsidies on some basic items limited the scope available for significant cuts. This was especially so in light of the general wage increase--the first since 1980--which was granted to public sector employees. Nevertheless, the efforts to compress current expenditures were further intensified in midyear in order to ensure that the public sector borrowing requirement did not exceed that registered in 1984.

In the area of pricing policy, significant measures were taken in September 1985. The prices of 65 consumer goods, including a number of socially sensitive items, were raised to reflect increases in production costs. Among these were petroleum products whose prices were raised by substantial amounts ranging from 27.3 percent for high octane gasoline to 70 percent for natural gas. The official retail prices of a large number of agricultural products were also raised, although government subsidies on a number of essential agricultural commodities were continued.

In response to the difficulties faced by the manufacturing sector and in order to improve productivity and cost efficiency, the authorities intensified their efforts toward increased rationalization of the use of domestic and external resources by public enterprises. Steps were also taken to improve the managerial training and to accelerate the completion of ongoing projects. At the same time, a decision was taken to promote joint ventures with the private sector in new investment activities in agriculture and industry. Similar projects are already under way in the tourist and transportation sectors.

In addition to a 1984 decision authorizing private sector importers to obtain foreign exchange from alternative sources, the Syrian authorities initiated, in mid-1985, a number of important measures to simplify and improve the functioning of the exchange and trade system. These measures included the following: (1) The discontinuation of exchange rate mixing for the surrender of exports proceeds. Aside from petroleum, phosphate and few agricultural products, all exports receipts are now exchanged at the parallel rate. (2) The simplification of the system of advance deposits required for private imports by using a uniform ratio of 50 percent. (3) The introduction of a new depreciated exchange rate for certain expenditures abroad. Although an additional exchange rate may appear to be inconsistent with the goal of eventual unification of the exchange rate, it should be noted that the depreciated level of the new rate implies an effective depreciation of the Syrian pound on a weighted average basis.

The measures to improve the functioning of the exchange rate system should be looked at within the framework of the gradualist approach, which the authorities consider more appropriate in moving toward full unification. In their view, a one-step approach would have detrimental effects on prices as well as on the surpluses transferred to the budget from public enterprises. Moreover, changes in the exchange system need to be coordinated with other policies within the context of the institutional structure of the Syrian economy. It should also be noted that recent increases in import prices reflect a more depreciated exchange rate and can thus be considered as part of the gradual reform of the system.

Many of the measures taken in 1985 were not expected to exercise their full effect on economic performance during the same year. Nevertheless, the tentative estimates available suggest that the decline in real output in 1983 and 1984 was halted in 1985 and that the current, as well as overall payments deficit, may have declined significantly from their 1984 levels. An improvement in weather conditions has also contributed to the generally better performance in 1985.

The prospects for 1986 are clearly sensitive to a number of exogenous variables, such as oil market developments and weather conditions. It is expected, however, that the efforts to stimulate output, including significant upward adjustments in agricultural producer prices and measures to promote private sector activity, will contribute positively to growth in 1986.

The 1986 budget should also benefit from the full-year impact of the wide-ranging adjustments in consumer prices of last September.

With respect to new measures to improve the fiscal performance in 1986, consideration is being given to an upward adjustment in the real estate tax as well as to further improvements in tax collection. The authorities also intend to limit the increase in current expenditures to about 6 percent over the 1985 level and to limit capital expenditure to the completion of ongoing projects. On the monetary side, and in order to absorb excess liquidity, bank credit will be strictly controlled, with the exception of credit to the private sector, which is being encouraged to participate in joint ventures with the public sector as mentioned earlier.

Although quantitative projections are not available, the authorities expect the overall external deficit to decline further in 1986. They recognize, however, that without an increase in external assistance, the country's financial situation will continue to be difficult.

The Syrian authorities recognize that the likely increase in oil exports in the period ahead will not obviate the need for corrective policies. The medium-term agenda for economic policy will be set within the framework of the Sixth Development Plan which is under preparation. The objectives and implementation of the plan and the medium-term outlook in general will depend importantly on the prospective availability of foreign exchange resources, as well as on the regional security situation. The outlook of the international oil market is clearly a major variable in determining the magnitude of foreign exchange inflows, not only in the form of external aid and remittances but also foreign exchange receipts that could be expected from the significant oil discovery in Deir Al Zor in 1984. Moreover, as long as the regional security situation remains precarious and a part of the country remains occupied, defense expenditures will inevitably continue to receive priority and thereby make economic adjustment more difficult and also divert resources from alternative uses. These constraints notwithstanding, the Sixth Development Plan is expected to put emphasis on agriculture and industry and on restoring financial stability. The external financing required for the plan's implementation is expected to come mostly from Arab financial institutions and international organizations.

Finally, the authorities are aware of the need to improve the quality and currentness of economic data. Toward that end, a complete overhaul of the statistical operations at the Central Bank is being prepared, and it is hoped that significant improvements will be in place in early 1986. The authorities intend to develop more comprehensive balance of payments statistics, and to complete the work already initiated for a more representative index of consumer prices. Syria also received Fund technical assistance in the area of government finance statistics in early 1985.

Mr. Nimatallah commented that the Syrian economy continued to face difficulties, some of which were beyond the control of the authorities. Drought conditions had suppressed agricultural output and, therefore, had reduced the flow of raw materials to the industrial sector. The decline in oil prices, workers' remittances, and foreign grants had all contributed to the difficulties of the industrial sector in importing needed raw materials. It was hoped that in 1986 a return to normal weather conditions would revive agricultural production, but it was not clear how the lack of foreign exchange would be alleviated.

The authorities had been implementing a number of measures to improve the availability and quality of factors of production to raise output in the agricultural and industrial sectors, Mr. Nimatallah continued. Prices had been adjusted to reflect costs; for example, the retail prices of oil products had been increased in September in line with international prices. He commended the authorities on those efforts; however, they had not been reinforced by an appropriate exchange system. The multiplicity of exchange markets had not only complicated domestic pricing but had also reduced private sector incentives. That development was a result of the large difference between the low exchange rate at which the private sector had to exchange its export proceeds and the higher rate at which it procured its imports.

The multiplicity and overvaluation of official exchange rates, combined with domestic price controls, as in some other countries, had been important factors in the growth of the underground economy, and thus could deprive the Government of a good source of revenue, Mr. Nimatallah observed. To the extent that price indices accurately reflected domestic price developments, the recent noninflationary growth in liquidity could perhaps be explained by activity in the underground economy. The authorities realized that there was a need to reform the exchange system, but they intended to move cautiously. While he recognized their concerns, he hoped that they would move vigorously toward a unified exchange system.

The restoration of domestic financial balance also depended on improvements in the fiscal position, Mr. Nimatallah remarked. The fiscal deficit had widened to 22 percent of GDP in 1984, and, despite efforts to increase revenues and control expenditures, no significant improvement was in sight. While measures to enhance revenues were needed, it was important not to lose track of the possible negative effects of such measures on private sector activity. The better route for the authorities, therefore, was to continue to restrain mainly current expenditures and to improve the operation of public enterprises. The Syrian Arab

Republic had always had an active and capable entrepreneurial class. Investment by the private sector, as well as foreign investment, could be encouraged by introducing further profit incentives and by reforming the exchange system. More fundamentally, significant efforts were still needed to ease the current imbalances to help the economy reach a path of sustainable growth.

In sum, he agreed with the thrust of the staff analysis and conclusions that domestic balance would not be restored without reducing the fiscal deficit drastically and that the difficult external payments position would not be alleviated easily without reforms in the exchange system, Mr. Nimatallah concluded. For the medium term, the resumption of sustainable growth in the economy was important, and for that purpose the authorities might find it more helpful to reallocate resources in favor of productive investment and to encourage the private sector and foreign investment. Finally, he supported the proposed decision.

Mr. Salehkhou commented that economic performance in the Syrian Arab Republic during 1985 had continued to be handicapped by the lasting effects of a prolonged drought and a shortage of foreign earnings necessary for productive investments. The fifth plan, 1981-85, which called for the doubling of investment over the previous five years, had been fulfilled only to the level of 60 percent, owing to substantial domestic and external financial constraints. Furthermore, the development of the petroleum sector through the promising discovery of new oil fields might have only limited effects on the improvement of the balance of payments, given recent developments in the oil market. In addition, increased outlays for security had been necessary because of regional disturbances.

Those exogenous factors had combined to slow down economic growth and had prompted the authorities to take a number of measures aimed at arresting the erosion of the external position and effectively reducing the fiscal imbalance, Mr. Salehkhou observed. The slowdown in economic growth had been led by manufacturing activity, which continued to be affected by foreign exchange constraints. Agricultural production had shown a slight improvement in 1985 over 1984, particularly in cereals, as producer prices had been set at remunerative levels; prices for the 1986 crop were raised by 22 percent. Domestic production of sugar beet and cotton had not provided sufficient raw materials for the local manufacturing industries, which had been further handicapped by shortages of imported inputs. The authorities had responded to the needs of the private sector by encouraging joint ventures with the state in manufacturing and agriculture, similar to successful enterprises operating in the tourist industry and transportation.

Another positive element was the discovery of a new oil field estimated to yield up to 300,000 barrels a day, Mr. Salehkhou added. Production would thus be boosted to 500,000 barrels a day, a substantial improvement over previous years. Moreover, the country's reserves of natural and associated gas would be used for domestic energy consumption, freeing a larger quantity of oil for export. Currently, the World Bank was assisting in evaluating the energy potential of the Syrian Arab Republic and developing a suitable energy policy.

The need for conservation had led the authorities to follow a market-oriented pricing policy for energy, which had been further extended to cover a wide range of domestic and imported consumer products, Mr. Salehkhou remarked. That policy tended to reflect real production costs and a more realistic evaluation of foreign exchange used for the acquisition of products. The adjustment policy on prices had already yielded the equivalent of 3 percent of GDP in 1985. However, the fiscal deficit was still high, as it had been for the past five years; in 1984, it had stood at 22 percent of GDP because of lower earnings from the petroleum company and a 35 percent drop in foreign grants. As a consequence, borrowing from the banking system, including public sector debt, had risen substantially in 1984. A slight improvement was expected in 1985, as tax collection should net a 20 percent increase over the previous year.

Given defense requirements, little compression could be expected on the expenditure side, Mr. Salehkhou noted. As a consequence, the budget deficit, taking grants into account, was estimated to remain at about 12 percent of GDP, indicating that bank borrowing would remain at a high level. The authorities were conscious of the need to restrain the budget deficit, and to that end they had taken supplementary measures in September 1985, the impact of which would be felt in 1986. Such measures included, in particular, a comprehensive tax reform proposal, an increase in foreign exchange receipts through increased exports, and an improvement in the profit picture of public enterprises through higher sales prices and increased management efficiency. Finally, current expenditure control would be strictly adhered to, and a rationalization of investment projects would be carried out. Although the staff considered that further measures were needed to reduce the budget deficit in 1986, because of the special circumstances of the Syrian economy and the prolonged effect of the recession induced by the recurrent drought, only a gradual reduction of the deficit could be achieved, as a large part of the budget was spent on salaries, maintenance, and national security matters.

The external position of the Syrian Arab Republic was also in need of alignment, as recurrent balance of payments deficits were causing payments arrears at the commercial bank level, Mr. Salehkhou observed. External indebtedness had already increased considerably in 1984. But most of the debt was on a concessional basis. Furthermore, the weakness in the balance of payments was in part attributable to the oil market situation and to lower workers' remittances. Furthermore, the prolonged drought had caused higher food imports than expected.

The estimates for 1985 showed a lower balance of payments deficit, mainly owing to higher exports and lower imports, Mr. Salehkhou commented. The improvement in agricultural production and the start of oil exports from the new field cast an optimistic note on balance of payments prospects for 1986, while the measures taken in September 1985 should strengthen the budgetary situation.

Positive steps had been taken by the Syrian authorities to simplify the exchange system, as export proceeds were no longer requested to be surrendered at different rates, Mr. Salehkhou said. Other improvements covered a 50 percent across-the-board import deposit requirement that reduced the number of exchange rates on the import side. Those steps toward the unification of the exchange system were to be strengthened by further measures, but caution had to be taken to avoid any undue financial strain on the public sector by an abrupt movement toward a uniform rate at a higher level. To do otherwise would cause an unsustainable increase in the cost of imports. The adjustment in consumer prices taken after the September 1985 government decision was intended to move the price level upward in order to compensate for the differential in the exchange rate. An abrupt unification of the exchange rate system would curtail the ability of the authorities to ensure higher employment levels.

The economy of the Syrian Arab Republic had been subject to severe exogenous factors, which had greatly slowed down its growth, Mr. Salehkhou remarked. However, with current favorable weather and rising prospects for oil exports--barring further deterioration--and some improvement in the market, the authorities were encouraged to take further adjustment measures in order to align the price system with the economic realities of the country. The provisions contained in the September 1985 program under the new Administration were a clear indication that the authorities were geared toward re-establishing internal and external balances and a unification of the exchange system. He commended the authorities on the progress achieved and supported the proposed decision.

Mr. Finaish explained that the Syrian Arab Republic was, on a net basis, a small importer of oil, and therefore the net impact of the recent change in the oil market would be limited in the short run. But the indirect impact on remittances--amounting to about 25 percent of export proceeds--and external aid might be substantial; there had been a decline in both items in recent years. However, the important discovery at Deir Al Zor of oil of high quality--with production expected to reach 50,000 barrels a day at the end of 1986 and 280,000-300,000 barrels a day after 1987--would more than double production. The balance of payments would be helped in the medium term, and the impact of the changes in oil prices would be mitigated. But the outlook was not clear. It was important to consider other factors, such as the marketing of oil in a glutted market and the fact that at present the country received oil from Iran at concessional prices and was a recepient of aid from oil exporting countries in the region. There was a possibility that if the Syrian Arab Republic were to be perceived as an important oil producer in the future, aid flows would be affected. On the other hand, other factors, including political considerations, could be taken into account by aid donors.

Although the new oil was important for the medium term and longer term, the Syrian authorities recognized that it could not be a substitute for policy action, particularly in the short or medium term.

The Syrian economy in the past two-three years had been affected to a significant extent by exogenous factors, such as the drought, the oil situation, the political environment, and defense spending. Because of the nature of the Syrian economy and of those exogenous developments, it was unrealistic to expect the financial impact to be absorbed fully, at least in the short run. But the authorities recognized that more needed to be done, particularly on the fiscal side, to restore domestic and external balances. Meanwhile, the measures taken by the new Government to restore balance and resume growth should not be underestimated, in particular those in the pricing-structural area taken in September 1985. One recent measure aimed at encouraging private sector participation with the public sector in joint ventures in industry and agriculture, in addition to those in transportation and tourism which had started in 1984.

The exchange rate system was complex, Mr. Finaish continued. Within the gradualist approach to reform, which the authorities considered more feasible, significant measures had been adopted during the past year. Elimination of exchange rate mixing with regard to exports and the standardization of the advance deposit requirement would reduce the multiplicity of effective rates; recently the authorities had indicated their intention to take more steps in that direction. They recognized that the objective was unification of the exchange rates at a realistic level.

The Acting Chairman made the following summing up:

Executive Directors were in agreement with the main points of the staff appraisal in the report on the 1985 Article IV consultation with the Syrian Arab Republic. Concern was expressed that the Syrian economy has continued to experience financial difficulties and a slowdown of real growth. It was recognized that there were a number of contributing factors beyond the control of the authorities, including the drought in 1982-84, declining international oil prices, and falling workers' remittances and official external aid flows. The authorities' wide-ranging domestic price adjustments--including increases in prices for oil products--and their efforts to simplify the exchange system were commended. While these steps were seen as helpful, more was needed and the Syrian authorities were urged to implement a comprehensive set of adjustment measures to tackle the country's economic and financial problems.

In the domestic financial area, the public sector deficit and the associated reliance on bank financing have risen to unsustainable levels. In this context, Directors recommended more rapid action to curtail outlays such as budgetary subsidies and other current expenditures and to enhance the revenue effort. They also pointed to the need to improve the performance of state enterprises in order to strengthen their financial position.

In the external sector, it was noted that the exchange system has remained complex with large spreads between the different official rates while the unofficial market rate has continued to depreciate. The system complicated the price-setting mechanism within the Syrian Arab Republic and served as a disincentive for export growth and for private foreign investment. The authorities' actions during 1985 in simplifying the exchange arrangements were welcomed, but Directors believed that these steps should be considered only the beginning of a more substantive reform of the exchange and trade systems. The authorities were urged to move at a faster pace toward the unification of the various exchange rates at a realistic level.

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

The Executive Board then took the following decision:

1. The Fund takes this decision relating to the Syrian Arab Republic's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1985 Article XIV consultation with the Syrian Arab Republic, in the light of the 1985 Article IV consultation with the Syrian Arab Republic conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Syrian Arab Republic's present exchange regime involves multiple currency practices and exchange restrictions subject to Article VIII, as described in SM/86/21. The Fund notes the simplifications that have been made in the Syrian Arab Republic's exchange arrangements. The exchange system in the Syrian Arab Republic, however, remains complex and the Fund hopes that in the near future the authorities will take steps toward the establishment of a unified exchange system and the liberalization of exchange restrictions. The Fund notes that

the Syrian Arab Republic maintains three bilateral payments agreements with Fund members and hopes that these agreements will be terminated as soon as possible.

Decision No. 8207-(86/34), adopted
February 24, 1986

APPROVED: October 24, 1986

LEO VAN HOUTVEN
Secretary