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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/35

10:00 a.m., March 6, 1985

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

Executive Directors	Alternate Executive Directors
A. Alfidja	
	M. K. Bush
J. de Groote	H. G. Schneider
	X. Blandin
M. Finaish	
H. Fujino	M. Sugita
G. Grosche	
J. E. Ismael	Jaafar A.
	G. W. K. Pickering, Temporary
A. Kafka	H. A. Arias
H. Lundstrom	
	A. Abdallah
	B. Jensen
Y. A. Nimatallah	
P. Pérez	
J. J. Polak	J. de Beaufort Wijnholds
C. R. Rye	A. V. Romuáldez
	R. Msadek, Temporary
	A. S. Jayawardena
N. Wicks	T. A. Clark
S. Zecchini	N. Coumbis
Zhang. Z.	Wang E.

L. Van Houtven, Secretary
R. S. Laurent, Assistant

Also Present

European Department: B. Rose, Deputy Director; P. Dhonte, O. J. Evans, M. T. Hadjimichael, Y. Horiguchi, A. Knobl, S. Mitra, R. H. Nord, J. K. Salop, H. O. Schmitt, S. M. Thakur. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; G. G. Johnson, N. Kirmani, M. Nowak. Fiscal Affairs Department: V. Tanzi, Director; G. M. Bartoli, G. Blöndal. Legal Department: S. A. Silard. Research Department: A. Crockett, Deputy Director; J. Artus, J. M. Boughton, A. K. McGuirk. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: D. Hammann, K. A. Hansen, P. Péterfalvy, M. Z. M. Qureshi, C. Robalino, E. M. Taha, D. C. Templeman, T. Sirivedhin, A. Vasudevan, M. A. Weitz. Assistants to Executive Directors: J. R. N. Almeida, J. de la Herrán, G. Ercel, R. Fox, G. D. Hodgson, Z. b. Ismail, M. Lundsager, J. A. K. Munthali, K. Murakami, J. K. Orleans-Lindsay, W. K. Parmena, M. Rasyid, J. Reddy, D. J. Robinson, A. A. Scholten, Shao Z., Wang C. Y., B. D. White.

1. UNITED KINGDOM - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with the United Kingdom (SM/85/44, 2/6/85; and Sup. 1, 3/5/85). They also had before them a report on recent economic developments in the United Kingdom (SM/85/54, 2/14/85).

Mr. Wicks made the following statement:

The central aim of the Government's economic strategy is to bring down the rate of inflation, through monetary control, in order to sustain the conditions for continuing growth. My authorities' Medium-Term Financial Strategy (MTFS) is based on the view that there is no conflict between lower inflation and higher employment and that securing the first objective will help to attain the second. In parallel with macroeconomic measures, my authorities are also implementing policies to strengthen the supply capacity of the economy by restraining the public sector's absorption of resources, by improving the operation of private markets, and by promoting competition.

My authorities have now applied these policies consistently for nearly six years, with positive results for growth and inflation.

(Percentage changes year on year)

	1980	1981	1982	1983	1984
GDP	-2 1/2	-1 1/2	2 1/2	3	2 1/2 1/
Inflation (RPI)	18	12	8 1/2	4 1/2	5

1/ Projection in November's Autumn Statement.

As the table indicates, GDP has risen steadily since 1981 in what will very shortly be the United Kingdom's longest continuous upturn of the postwar period. Growth should be maintained and, as the strike by some coal miners comes to an end, should accelerate in 1985. The upturn has, moreover, been sustained, while inflation has declined to a rate lower than at any time since the 1960s.

Recent developments

In the past year:

- GDP growth has been close to the European Community average despite the effects of the prolonged coal strike, which is estimated to have reduced GDP by about 1 percent. If the strike is settled soon, GDP is expected to increase by about 3 1/2 percent in 1985.

- Employment has been rising overall, though not fast enough to reverse the rise in unemployment (13 percent in January).

- Manufacturing output rose by 3 1/4 percent, the fastest increase for 11 years, and there are indications that manufacturing employment is now beginning to increase.

- Output per capita in manufacturing in the 11 months to November rose by 4 percent compared with the same period in 1983. And in the 3 months to November, it was 26 percent above the trough in the last quarter of 1980, an average growth of 6 percent each year for four years.

- The real rate of return for enterprises outside the North Sea rose to about 7 percent, the highest level since 1978.

- Total fixed investment was up by 8 percent between the first three quarters of 1983 and 1984 and is forecast to be at the highest level ever for the year as a whole. Manufacturing investment is estimated to have risen by nearly 15 percent in the first three quarters of 1984.

(1) Monetary policy

Since the staff report was written, there has been a sharp increase in interest rates, reflecting pressures in the financial markets. If the Government had sought to resist those pressures, this could have raised doubts about its determination to keep firm control over the monetary aggregates and thus maintain downward pressure on inflation. Short-term interest rates were therefore allowed to rise by 4 1/2 percent from 9 1/2 percent to 14 percent. The latest published figures to mid-January, which did not reflect the effect of recent increases in interest rates, showed that M-0 was below the middle of its target range (4-8 percent) and £M-3, the other target aggregate, was at the top of its range (6-10 percent). Monetary conditions in the United Kingdom are now tight on any measure.

(2) Fiscal policy

As the staff notes, the public sector borrowing requirement (PSBR) is higher than projected in the 1984 budget. For the most part, this can be accounted for by higher public borrowing to finance the temporary costs of the coal strike, although there have also been overruns in local authority capital expenditure. Thus, the estimate for the PSBR in 1984/85 has now been revised upward by £1 1/4 billion to £8 1/2 billion; but at some 2 1/3 percent of GDP, this is still 3/4 of a percentage point less than the PSBR in 1983/84. The continuation of the miners' strike could mean that the revised target is slightly exceeded, though all estimates at this stage are subject to wide margins of error.

My authorities are continuing to take measures to improve public expenditure control. For instance, in the traditionally difficult area of local authority spending, they are limiting the ability of local authorities to finance excessive spending ("rate capping"), are reducing grants to overspending councils, and are in the process of abolishing an unnecessary tier of local government.

(3) External policy

The coal strike has also affected the external sector; extra imports of coal and oil, for example, have reduced the current account balance by about £2 3/4 billion in 1984. Nevertheless, a small current account surplus of £0.2 billion was registered in 1984. It is projected to rise to £2 1/2 billion in 1985, assuming an early end to the strike.

Since the beginning of 1984, the sterling exchange rate has declined by 13.3 percent in effective terms. The decline last year can be attributed to anxieties about the effect of a fall in oil prices on the U.K. economy, anxieties which, given the favorable developments in the remaining 95 percent of the economy, appear to have been considerably exaggerated; to perceptions in the financial markets that the Government's determination to maintain tight financial policies might have weakened, perceptions that have been materially altered by the recent rise in interest rates; and to the extraordinary and excessive strength of the dollar. More recently, the decline in sterling is attributable very largely to the appreciation of the dollar. My authorities view this development with concern because it represents a major instability in the international economy.

As the staff notes, my authorities do not have an exchange rate target, but regard the exchange rate as a supplementary indicator for monetary policy. They do, of course, recognize that the real exchange rate has an influence on the level of activity in the economy, but they do not believe that significant or sustained shifts in the real rate can be achieved by manipulating the nominal rate. Hence my authorities' emphasis on improvements in the supply side of the economy, including realistic pay settlements and an improvement in nonprice competitiveness.

(4) Labor market policy

My authorities agree that the present rate of increase in real wages gives cause for concern. This has benefited those in employment but has reduced the incentives to employers to take on additional employees as output rises. A recent treasury study suggested that if real wages grew 1 percent more slowly, employment would eventually be between 110,000 and 220,000 higher than otherwise. The employed labor force rose by about 340,000 (1 1/2 percent) in the year to the third quarter of 1984. Much of this rise came from increased self-employment, although this estimate is based on a small sample and may be subject to a large margin of error. As the staff notes, the increase in employee numbers has been concentrated among women working part-time. This may well reflect the lower unionization and freer operation of market forces in that segment of the labor force.

The Government has taken a wide range of measures in order to encourage the better operation of the labor market, which by their nature are unlikely to have a quick effect. But the influence of some, such as youth schemes designed to improve skills and encourage more realistic pay levels, is already being felt. There are also a wide range of measures in place to encourage freeing of the labor market more generally. Labor supply should be helped, for example, by policies on pensions and housing to ease mobility, by improved education and training, and by changes in income tax and social security legislation to alter the "replacement ratio" of incomes in and out of work. The previous budget reduced the incentive in the business tax system to substitute low-return capital investment for labor. Trade union legislation--for example, removing legal protection for the closed shop and for industrial action not approved by ballot--should have an important effect in encouraging better operation of the labor market. The Government is weighing carefully evidence and opinion on the future of the wages councils, which set minimum pay rates in certain industries.

(5) Other structural policies

My authorities have continued their program of supply-side measures to improve the efficiency of the economy. For example, they have abolished in the 1984 budget the National Insurance Surcharge, which acted as a payroll tax discouraging employment; planned to reduce the main corporate tax rate from 52 percent to 35 percent by 1986; taken measures to introduce greater competition into the financial services industry, beginning with the securities industry, with the building societies to follow; privatized the state-controlled telecommunications corporation, through the largest single equity issue undertaken anywhere in the world, in which over two million individuals bought shares.

This program will continue in 1985, and will include, among other measures, a rationalization of regional policy and the privatization of British Airways.

Fiscal policy in the medium term

As I have already indicated, the central aim of policy is to secure price stability by a continuation of tight fiscal and monetary policies. A treasury discussion paper last March ("The Next Ten Years: Public Expenditure and Taxation into the 1990s") noted that this will require a further reduction in the PSBR beyond the period at present covered by the MTFS. The MTFS projects a PSBR of 1 3/4 percent of GDP by 1988/89, and the paper was based on a further reduction to 1 percent of GDP by 1993/94, though there is inevitably some uncertainty about the precise PSBR path that would be constant with the Government's aims on inflation. At the same time as reducing the PSBR, my authorities attach great importance to reducing the burden of taxation. This has been reduced slightly since 1981-82--and direct taxation has been reduced considerably--but it remains excessive, with unfortunate effects on incentives to work, particularly among lower-paid workers.

The key to achieving the reduction in the PSBR and in taxation is, of course, the control of public expenditure. The treasury discussion paper gave some indications of the degree of public expenditure restraint needed both to reduce taxes and to reach a PSBR of 1 percent of GDP by 1993/94. In 1983/84, non-North Sea taxation represented about 38 1/2 percent of non-North Sea GDP. By 1988/89, the end of the current MTFS period, this ratio is projected to fall to 35 1/2 percent; and the table below shows projections for 1993/94, on various assumptions for GDP and public expenditure growth. This makes clear that zero real growth in public expenditure is necessary if the tax burden is to be brought much below its 1978/79 level of 34 1/2 percent.

Burden of Non-North Sea Taxation in 1993/94 as a Percentage of Non-North Sea GDP at Market Prices

		Annual Real Public Expenditure Growth after 1988/89:	
		Zero	1 percent
Annual GDP growth after 1988/89	1 1/2 percent	32 1/2	34
	2 percent	31 1/2	33 1/2

Note: The projections take into account the decline in oil revenues over the next ten years.

Conclusion

The key question of this year's consultation is whether financial policies are sufficiently restrained to allow consolidation and then extension of the progress made in reducing inflation. My authorities believe that the current policy stance is fully appropriate to their medium-term policy goals. As my Prime Minister told the House of Commons last Tuesday, the aim remains continued reduction of inflation and sustained economic growth based on sound financial policies. There would also be a continuation of policies designed to achieve better prospects for employment, involving a more flexible and competitive economy encouraging initiative and enterprise.

Mr. Ismael commented that he would have liked to receive a more detailed analysis by the staff of some recent, significant developments in the U.K. economy. For instance, he would have liked to learn about the projected impact of the sharp depreciation of sterling and the increase in interest rates on investment, growth, employment, inflation, and balance of payments for 1985. The projections given in the staff report were based on the assumption that the nominal exchange rate and nominal interest rates would remain where they had been in mid-November 1984, an assumption no longer justified. Could the staff explain whether the outlook for the economy had changed materially since the recent movements in interest rates and the exchange rate?

In 1984, the performance of the U.K. economy could best be described as mixed, Mr. Ismael considered. Although a number of positive developments had taken place, there continued to be several areas of concern. Among the positive developments had been increased productivity, improved profitability, and an upturn in business investment. Real GDP had grown by about 2 percent, in spite of the adverse impact of the coal miners' strike. After sharply decelerating in 1983, inflation had remained relatively low at some 5 percent. Among the less favorable developments had been a high rate of growth in unit labor costs, a rise in the unemployment rate, and a deterioriation in the performance of the external sector. Perhaps the single most pressing challenge to the authorities was how to reduce the rise in real wages in order to bring down unemployment, while avoiding any buildup of inflationary pressures.

The authorities' fiscal objectives within the medium-term financial strategy (MTFS)--a reduction in the role of government in the economy and, consequently, a reduction in the ratio of government expenditure to GDP and a fall in the public sector borrowing requirement (PSBR)--were appropriate, Mr. Ismael remarked, as was the objective of reducing tax rates. However, actual developments indicated that little progress was being made in achieving the stated fiscal objectives. For instance, the rise in the ratio of government expenditure to GDP from 44 percent in 1980/81 to 46 percent in both 1983/84 and 1984/85, together with overspending in excess of the original 1984 budget, ran counter to the authorities' stated fiscal objectives and made the prospects for any tax reduction quite remote. He would urge the authorities to translate their intention to strengthen expenditure control into action. The present did not appear to be the right time to implement the authorities' proposal for tax relief. Although in general a tax reduction could have a positive supply-side impact, at present such a move could worsen public finances, increase the rate of inflation, and diminish the foreign exchange value of sterling. Any tax reduction should be accompanied by significant progress in expenditure control. Could the staff say whether it supported or opposed the proposal for granting general tax relief?

The authorities had reduced the public sector borrowing requirement from 5.3 percent of GDP in 1980/81 to 3.2 percent of GDP in 1983/84, Mr. Ismael recalled. As the staff had pointed out in SM/85/44, the improvement had come about not as a result of reduced expenditures or better revenue performance, but rather through sales of public assets and from petroleum reserves, a policy that seemed to provide only a temporary solution to the fiscal problem. As indicated in Appendix I to SM/85/54, the United Kingdom's reserves of petroleum were limited, and production was expected to decline significantly by 1988. Public assets that could be sold to cover the fiscal gap were also limited. When adjustments were made for those factors, as had been done in Table 2 of SM/85/44, the PSBR--equivalent to 6.2 percent of GDP--could be considered rather high. Thus, it would only be prudent and logical to emphasize once again the importance of reducing public expenditure as a means of curtailing the PSBR on a more sustainable basis, rather than reduce the PSBR using temporary stop-gap measures.

A relative laxness of monetary policy in the United Kingdom had partly accounted for the depreciation of the exchange value of sterling and for the lack of progress in reducing inflation further during 1984, Mr. Ismael considered. The staff indicated that monetary targets were too generous and that monetary aggregates had tended to overshoot the target range. Indeed, there had been rapid growth in bank credit to the private sector, and the £M-3 target had been achieved only after large sales of government debt to the public. Supplementary nontargeted monetary indicators, such as M-2 and PSL-2, also indicated excessive monetary growth. Therefore, monetary conditions had been somewhat too lax in 1984 to achieve a reduction in the rate of inflation. More recently, the substantial rise in short-term interest rates should no doubt bring about a reduction in the rate of domestic credit creation by the banking system and, at the same time, help to diminish the slide in sterling on foreign exchange markets. On the basis of the latest interest rate developments and possible revisions in the real GDP forecast for 1985 following the end of the coal miners' strike, could the staff assess the appropriateness of monetary policy for the coming year?

The U.K. approach to monetary management was somewhat different from that of some other industrial countries for which the Executive Board had held Article IV consultations during the past month, Mr. Ismael stated. For example, the interpretation of monetary aggregates in Australia and

Canada had been complicated by innovations in the financial markets, so that the national authorities had felt that the targeted monetary aggregates should be judged in the light of developments in certain supplementary nontargeted monetary aggregates. A majority of Executive Directors had endorsed that approach. In the United Kingdom, the behavior of monetary aggregates had also been complicated by financial innovations in the marketplace, yet the U.K. authorities continued to insist that only the targeted monetary aggregates were relevant in judging monetary conditions and that supplementary indicators, including nontargeted monetary aggregates, were irrelevant. Noting that the staff's approach to that question was consistent with that taken for Australia and Canada, he strongly supported the view that supplementary indicators should be used to guide policy formulation in all cases where the interpretation of targeted monetary aggregates was complicated by innovations in the financial markets, or for other reasons.

The current account surplus of the United Kingdom had declined markedly, primarily owing to additional imports of coal and petroleum necessitated by the coal miners' strike, Mr. Ismael recalled. With the end of the strike and the sharp depreciation in the real effective exchange rate of sterling, a substantial improvement in the balance of payments outlook for 1985 could be expected. It was encouraging that exports had performed strongly in the three months ended January 1985; if the trend continued, a significant surplus on current account could be expected for the year as a whole. He endorsed the authorities' view that improvements in the supply side, including further wage moderation, could play an important role in improving export performance.

On labor market policy, the staff and the authorities agreed that the rate of increase in real wages had been too large, Mr. Ismael said. One of the central issues facing the authorities was how to bring about a level of real wages that would lead to a sharp reduction in the rate of unemployment. Some evidence did indicate an improvement in the operation of the labor market; declining salaries for working youths had led to an increase in youth employment, and part-time employment of women had also increased. Nonetheless, those developments had had limited success so far; he hoped that they would lead to lower real wages in the future. The staff report made it clear that inflationary expectations had not yet been removed from the economy, expectations that could be an important factor in determining wage rates. In his view, inflationary expectations could not be removed as long as loose monetary and fiscal policies persisted. Therefore, he hoped that the authorities would pursue tighter fiscal and monetary policies to remove entrenched inflationary expectations as a means of ensuring more realistic, sustainable wage levels consistent with low unemployment.

In response to the high rate of unemployment, protectionist pressures had intensified in the United Kingdom, Mr. Ismael concluded. The staff had noted that the incidence of nontariff barriers had increased and that the authorities were implementing more aggressive incentives to exports. In addition, voluntary measures for import restraint were increasingly being adopted. As those restrictive policies had negative implications both for world trade and for resource allocation within the United Kingdom, he would urge the authorities to roll back existing trade barriers and avoid new restrictive measures. Although he welcomed the recent tariff cuts by the authorities on a number of exports from developing countries, he would like to emphasize that the beneficial impact of tariff cuts could easily be eroded by an intensification of nontariff barriers. Therefore, he urged the authorities to push back all protectionist barriers against exports from developing countries.

Mr. Alfidja said that he commended the U.K. authorities for having maintained the thrust of their policy within the framework of the medium-term financial strategy. During the past five years, the authorities had brought monetary growth under control, while the rate of inflation as measured by the retail price index had declined from 18 percent in 1980 to 5 percent in 1983 and 1984. As the rate of growth of GDP had averaged 3 percent in the same two years, the authorities appeared to have achieved their major objectives of maintaining growth and keeping down inflation. The recovery that had begun in 1981, although sustained in 1984, did not appear to have been strong enough to reverse the rise in unemployment, which remained a worrisome feature of the U.K. economy.

The authorities had adopted a mix of monetary and fiscal policies designed to keep inflation in check, Mr. Alfidja noted. As to the important objective of higher employment, he welcomed the implementation of policies that would strengthen the supply capacity of the economy, as stated by Mr. Wicks.

It had proved difficult to reduce the public sector borrowing requirement as a share of GDP from 3.2 percent in 1983/84 to 2.2 percent in 1984/85 not only because of the coal miners' strike but also because of overruns in current and capital expenditure by local authorities and higher than expected pay settlements in the public sector, Mr. Alfidja observed. While unavoidable, those developments were nonetheless regrettable. He had therefore been pleased to hear from Mr. Wicks that the U.K. authorities were continuing to take measures to improve controls over public expenditure, particularly by local authorities. It was also encouraging that the timetable for achieving a reduction in the public sector borrowing requirement and a further easing in the burden of taxation had been placed in a longer-term perspective, 1988/89 and 1993/94, with an assumption of zero real growth in public expenditure and a sustainable rate of overall economic growth.

The rising rate of unemployment, at 13 percent, called for urgent corrective measures, Mr. Alfidja said. Noting the wide range of measures already taken to promote proper functioning of the labor market, he would encourage the authorities to persevere in their efforts to bring down the rate of unemployment.

It was disappointing that official development assistance provided by the United Kingdom had been declining as a percentage of GDP, Mr. Alfidja concluded. He encouraged the authorities to review their position, with the aim of meeting as soon as possible the goal of 0.7 percent of GDP set by the United Nations.

Ms. Bush remarked that the United Kingdom had been a pioneer in a basic economic strategy that had become the norm in many member countries of the Fund. The strategy focused on bringing down the rate of inflation as a precondition for restoring sustainable economic growth through the use of restrained monetary and fiscal policies over a sustained period, at the same time as the authorities addressed structural problems to enhance the supply response of the economy in order to improve market incentives. In the past few years, the U.K. authorities had had some success in bringing down the rate of growth of monetary aggregates and in reducing the public sector borrowing requirement. For example, the annualized increase in £M-3, after reaching nearly 20 percent in 1980/81 and nearly 13 percent in 1981/82, had declined to 9.5 percent in 1983/84. Similarly, the public sector borrowing requirement had been cut from more than 5 percent of GDP in 1980/81 to an expected 2.6 percent for 1984/85. Those more restrained fiscal and monetary policies had had a more favorable impact on inflation, on the pace of economic growth, and on the composition of economic growth, i.e., the breakdown between the real output and inflation components of GDP. Economic recovery had arrived rather early in the United Kingdom, as both exports and business investment had turned up, Ms. Bush noted. The rise in the real rate of return on capital and the increase in business investment in manufacturing had been particularly positive signs, following a considerable shakeout in that sector. Moreover, the rate of inflation had fallen from 18 percent in 1980 to about 5 percent at present. The recent growth in total employment after steady declines for at least four years, in combination with structural changes emerging in the labor markets, offered promise over the medium term.

Despite the progress achieved, there were strong pressures on the authorities to relax financial policies in the face of high unemployment, Ms. Bush went on. In fact, there was some evidence of a slowdown in adjustment performance in both the fiscal and the monetary areas, and significant rigidities remained in the labor market. Experience showed that a reversal of hard-won progress could occur quickly if determination waned. For example, there had been some slippage in tax receipts from the original budget target; declining fiscal deficits during the past few years had largely reflected certain one-time or transitory factors, such as asset sales and exceptional oil revenue. Thus, the present status of the fiscal accounts was less favorable than it might appear on the surface.

The authorities' record in reducing the ratio of public spending to GDP had been somewhat disappointing, Ms. Bush considered. The ratio of general government expenditures to GDP seemed to have become stuck at nearly 46 percent, although the share of spending by the entire public sector seemed to have been declining somewhat in 1984/85. One major problem had been overspending by local authorities; in addition, overall grants and subsidies had been rising as a proportion of government spending. How effective were the new measures to cap rate increases and cut grants to local governments likely to be?

Over the medium term, the authorities were contemplating further cuts in the public sector borrowing requirement, Ms. Bush noted. Under the financial strategy presented with the 1984/85 budget, they projected that in subsequent years such cuts would make room for tax cuts designed to create a simpler, more efficient tax system. She wondered whether the slippage in the 1984/85 fiscal outturn, or the effects of the recent increase in interest rates on interest payments on public debt, would worsen the chances for eventually reducing the tax burden, as important a task as that was.

Continued growth of £M-3 at a 10 percent annual rate seemed inconsistent with keeping pressure on to reduce the rate of inflation below 5 percent, the rate at which it seemed to have leveled off since 1983, Ms. Bush observed. She sympathized with the authorities' reluctance to try to fine-tune monetary policy in response to short-term events. However, periodic overshooting of targets and overrapid monetary growth rates in 1984 raised doubts about the authorities' determination to stick with a strong anti-inflationary policy and also contributed to the weakening in the foreign exchange value of sterling. The decline in the exchange rate had eventually led to a large, abrupt rise in interest rates in January, leaving the impression that the authorities might begin to rely too much on interest rates to affect exchange rates. Although interest rate differentials did have some effect on a country's exchange rate, a number of other factors, including domestic economic factors, also came into play. In sum, she hoped that the authorities would continue carefully to set target ranges for monetary growth and carefully monitor compliance within those targets.

Despite progress in reducing the rate of nominal wage increases from nearly 21 percent for the economy as a whole in 1980, and in halting the decline in overall employment levels, some serious problems remained, Ms. Bush continued. For example, real wage increases in manufacturing continued to outpace those in the economy as a whole, while employment in manufacturing continued to fall, albeit at a slower rate in 1984.

The inauguration of a strong anti-inflationary policy had almost inevitably been destined to cause some initial loss of output and employment, Ms. Bush said. However, the size of those losses depended upon how quickly the rate of price increases responded to the less inflationary environment; labor market rigidities had continued to impede a rise in employment. The expected rate of inflation appeared to have exceeded the actual rate of inflation. Rapid increases in nominal wages suggested either that labor unions had willingly allowed rising unemployment as a trade-off for continued high real wages, or that their failure to believe that inflation would be reduced had resulted in an overshooting of their wage targets. How did Mr. Wicks view that thesis? How did he and the staff evaluate current inflationary expectations and their potential effects on wage bargaining? Moreover, what effect might the end of the coal strike have on wages and the labor market generally?

One of the major problems in achieving a better record of job creation had been the persistence of labor market rigidities, Ms. Bush considered. Besides high real wages and nonwage costs, generous unemployment compensation, rent control, and illegal strikes alarmed workers and weakened incentives for them to seek new job opportunities. The authorities had made some changes in unemployment compensation, and Mr. Wicks had referred to an alteration in the replacement of workers' incomes, in and out of work. Had there been a significant reduction in the replacement ratio?

Although some of the structural measures in the labor market might take time to produce an effect, favorable initial signs of change had emerged, Ms. Bush pointed out. The decline in wage rates for youths relative to opportunities and the greater flexibility in the labor market for part-time workers in the services sector had contributed to higher employment of youths and women. That response might be indicative of what could be accomplished if labor markets more generally became less rigid and if wage increases reflected more closely the rate of sustainable growth in productivity.

Arguments were often heard that movements in a country's exchange rate were outside the control of national monetary authorities, Ms. Bush said. Certainly, external factors did play a role in the evolution of exchange rates for all currencies, including the dollar. Internal factors were important as well, both the quality of management of traditional monetary and fiscal policies, and the degree of success achieved in effecting reforms aimed at reducing economic inefficiencies and market rigidities. The present real exchange rate for sterling was inconsistent with external equilibrium at full employment. In fact, the United Kingdom's current account surplus had virtually disappeared in 1984; the balance on non-oil trade steadily worsened from a surplus of about £500 million in 1981 to a deficit of £11.4 billion in 1984; the country had been losing market shares steadily, although the weakening of competitiveness appeared to have decelerated recently as a result of the rise in productivity owing to labor shedding. Although relative normalized unit labor costs had shown a gain in competitiveness since early 1981, the country's competitiveness at present was still substantially less favorable than in the late 1970s. She would welcome comments on the adequacy of Britain's current international competitive position, taking into account uncertainties in the world oil markets.

Like many Fund members, the United Kingdom had been facing rising protectionist pressures, to which it had succumbed to some extent: nontariff barriers to imports had increased, export incentives had become more aggressive, and voluntary export restraints had been extended in some areas, Ms. Bush noted. Such restrictions in one country tended to aggregate protectionist pressures in other countries. The U.K. authorities also appeared to be somewhat reluctant with regard to inaugurating a new round of multilateral trade negotiations. She hoped that, as a result of the recent meeting in Kyoto, the U.K. authorities would take a more positive position within the EC council in favor of a new round beginning in 1986.

In conclusion, the U.K authorities deserved commendation for the success that they had had in following more prudent fiscal and monetary policies and in embarking on the difficult business of structural reform of labor markets in particular, Ms. Bush remarked. Success in some areas might have resulted in uncovering some underlying problems that needed attention. It was important for the U.K. authorities to succeed in their adjustment efforts, both for the sake of their country and for the good of the world economy. Although she would not place too much stress on the demonstration effect as a motive for persevering with adjustment efforts, she did believe that the pursuit of consistent anti-inflationary policies by each of the major industrial countries could make the efforts of each of them more effective.

Mr. Zhang observed that on the basis of its analysis of the United Kingdom, the staff had concluded that further progress in reducing the rate of inflation must be the overriding objective. In support of that view, the staff had pointed out on page 16 of SM/85/44 that there was "a broad consensus among the major countries that the control of inflation would contribute to sustained economic growth in the medium term." That consensus had undoubtedly been strengthened by the recent resumption of economic growth in the industrial countries, led by the United States. However, recovery in the United States had been associated with a highly expansionary fiscal policy. Recent experience did not provide evidence to support any conclusion concerning the probable course of events if all industrial countries were to pursue fiscal and monetary restraint simultaneously. Available evidence did suggest, however, that in most industrial countries unemployment would tend to rise so long as a determined effort was being made to bring down the rate of inflation by restrictive monetary and fiscal policies alone. Despite the "broad consensus," could it be known from experience that, if price inflation were eliminated in industrial countries, a steady high rate of private investment would ensue and heavy unemployment would not be prolonged?

The most important element of the staff's advice to the U.K. authorities related to the monetary targets, Mr. Zhang commented. Although they had approximately met the targets the authorities should tighten monetary policy and reduce the public sector borrowing requirement. The staff judged monetary policies to have been insufficiently tight, because the target ranges had been consistent with the marked 10 percent depreciation of the exchange rate during 1984. The staff was implying that, if countries with a more balanced mix of fiscal and monetary restraint should experience a weakening exchange rate when interest rates were forced up by an unbalanced policy mix applying elsewhere, those countries were considered to have an unduly easy monetary policy. Nevertheless, when interest rates in a country were effectively determined abroad, a rising public sector deficit might help to offset the effects on the exchange rate of mounting public sector deficits in other countries.

At one point, the staff had conceded that the urgency of reducing the public sector deficit might have lessened, Mr. Zhang observed, yet the staff urged the authorities to strive for a reduction in the PSBR for the public good. On page 17 of SM/85/44, the staff had made that recommendation in order to avoid the danger of "the demonstration effect on other countries which, like the United Kingdom, may not individually have a significant effect on world interest rates but, collectively, certainly do." However, the present difficulty seemed to be that one country did have a significant effect in holding up world interest rates under the prevailing pattern of policy mixes. Would the "demonstration effect" of the U.K. authorities' not allowing their public sector borrowing requirement to rise offset the influence of a widening in the U.S. budget deficit?

The case for tightening monetary policy and reducing the public sector borrowing requirement essentially rested on the great emphasis that had been placed upon the need to avoid rekindling inflationary expectations, Mr. Zhang noted. First, a key element was said to be the failure to achieve a deceleration in nominal wage increases matching the reduction in price inflation, with increases in both real wages and unemployment as the consequence of a delayed adjustment of price expectations. The staff postulated on page 17 of SM/85/44 that "wage contracts apparently set nominal wages that, given price expectations, should produce a real wage that will maintain employment." If the actual rate of inflation then turned out to be lower than expected, real wages would be higher than expected, so that unemployment would drop as more firms shed labor in response. Table 3 and Chart 8 purported to show that the size of nominal wage increases could be explained by price expectations, which the staff assumed were indicated by the yield differential between nonindexed and indexed government securities. However, it was likely in the United Kingdom that the premium that investors in government securities were prepared to pay for protection against inflation was influenced by their knowledge of the current rate of wage increases. If so, the direction of causation was the opposite of what the staff assumed. Even if the yield differential were indicative of investors' price expectations, there would be no reason to suppose that their expectations related to the expected rate of inflation over the period relevant to current wage settlements.

Second, it was unreasonable to assume that the rate of nominal wage increases was predominantly conditioned by forward-looking expectations rather than by explicit or de facto indexation and other influences extending from previous price increases to current wage settlements, such as higher realized profits by enterprises and stronger pressures for wage increases when retail prices had been rapidly rising, Mr. Zhang said. If for some reason the rate of wage increase were largely a lagging function of the rate of price increase in monetary expansion, and if the staff had mistakenly chosen a price-expectation variable that actually reflected the change in wages, it would have set up a model demonstrating incorrectly that "lagging price expectations" were the cause for increases in real wages and unemployment when the rates of monetary expansion and price inflation were being brought down.

Third, the change in average earnings--the variable shown in Table 3--was not equivalent to the change in wages set by labor contracts, Mr. Zhang noted. Did the data on earnings refer to all employees and wages plus overtime? In short, did the series provide an indication of the change attributable to wage settlements? Even if he could accept Table 3 on its own premises, he would still have to explain why the increase in nominal wages should have been substantially lower than "expected inflation" in 1984, but not in 1981, 1982, or 1983. In fact, the markedly smaller rise in nominal wages in the entire economy in 1984 could be explained by the sharp drop in the actual rate of price inflation in 1983, assuming that the average increase in earnings was influenced by the prior rate of inflation. Table 3 also suggested that the rate of increases in earnings in the open, manufacturing sector responded quickly to a depreciation of the exchange rate.

Efforts to bring down the rate of nominal wage increases by restrictive monetary and fiscal policies were likely to be associated with further rises in unemployment, Mr. Zhang continued, unless the authorities supplemented financial policies with deliberate efforts to secure a future deceleration of nominal increases by instituting an incomes policy, by taking labor market measures to influence wage bargaining, and by opening employment opportunities. In other words, the objective of attaining uninterrupted progress in reducing inflation could not be secured by the authorities' strategy of relying on firm monetary and fiscal restraint, while leaving the market to determine the split in nominal income between prices and output as well as consequent developments in employment. Could the staff give its views on that point?

He was in broad agreement with the staff's forecast that the recovery was likely to continue in 1985, Mr. Zhang said. However, if the authorities were to implement a more stringent monetary and fiscal policy, the likely outcome would be a considerable further rise in unemployment and an acceleration of wage and price increases. As it was, the average rate of wage increases was likely to accelerate under the influence of the price effects of the 1984 depreciation of sterling and in acceleration of wage increases in the open sector.

He accepted in general the staff's appraisal of page 16 of SM/85/44 that "the authorities have had considerable success with their financial strategy, but this success has not been achieved without stress," Mr. Zhang concluded. Indeed, the main challenges for government policies in the medium term would remain those of finding solutions for the problems relating to high and rising unemployment and the drastic shrinkage of the country's industrial sector and export potential.

Mr. Fujino observed that the U.K. authorities had implemented a medium-term financial strategy consistently over the past several years as their first-priority policy in macroeconomic management. They had targeted monetary growth to decelerate and the public sector borrowing requirement to decline progressively in order to achieve their primary objective of reducing inflation. The United Kingdom was a pioneer in the pursuit of that policy mix, which had become a well-established consensus in the international community. The authorities' success would encourage those of other countries who followed the same course. Under that strategy, growth in real GDP had recovered steadily from a negative rate to a positive 2.4 percent in 1984, in spite of the coal miners' strike, and the rate of inflation had declined to about 5 percent in both 1983 and 1984.

That favorable outturn had produced a marked improvement in the financial position of private enterprise and in the real rate of return on capital, an essential condition for active business investment, Mr. Fujino noted. Indeed, private business investment had expanded by over 10 percent in the first three quarters of 1984; if sustained, the expansion would provide a promising basis for continued future growth of the economy. By contrast, the authorities had not yet succeeded in removing various rigidities, particularly in the labor market, where real wages had continued to rise rapidly in spite of the Government's efforts. As a result, the unemployment rate had risen to 13 percent by the end of 1984, and the number of the unemployed had more than doubled in five years.

The staff considered that part of the increases in real wages reflected a delayed downward adjustment of high inflationary expectations or the forecast rate of inflation at the time of wage negotiations compared with the actual decline in inflation, Mr. Fujino continued. Such a lag might be inevitable at a time when inflation was slowing rapidly. However, there seemed to have occurred an accumulation of similar lags; in spite of recent increases in productivity, there was a clear tendency toward an increase in unit labor costs in local currency terms, as shown in Chart 4 of the staff report. With increased price stability, those lags in wage determination would disappear, and a more normal relation among wage increases, the rate of inflation, and increases in productivity would emerge. Decreased rigidity in the labor market would certainly facilitate that process of normalization, and he welcomed the authorities' efforts to lessen labor market rigidity by such means as reducing disincentives to work.

A large part of the increase in unemployment in the past five years had come from decreased employment in manufacturing, Mr. Fujino remarked. Adaptation to rapidly changing domestic and international economic conditions was quite important, and he understood that a structural change was taking place in the U.K. economy. However, the experience of his country showed that a shift to higher-technology industries did not necessarily entail a sharp reduction in employment: in the United Kingdom, part of the reduction might be due to forced labor shedding by enterprises in the face of a substantial increase in real wages. Removal of labor market rigidities would help to create greater opportunities for employment and to maintain competitiveness among industries.

A more positive approach could be seen in the increase in business investment and the facilitation of a shift in the industrial structure, Mr. Fujino went on. He welcomed the recent strengthening in business investment and, as Mr. Wicks had stated, the reduction in the corporate tax rate in 1986, together with higher competition in financial services. Developments in coal mining provided one indication of the difficulties encountered in promoting a basic shift in a country's economic structure. There might be a greater role for the Government to play in promoting a smooth withdrawal from less competitive industries, so that resources could be directed toward more efficient sectors to apply the initiative. In his view, such a policy would be quite different from discretionary government policies intended to pick up winners. Could the staff or Mr. Wicks comment?

A stimulative policy would involve greater risks in the absence of solutions to inflation and employment, Mr. Fujino observed. He was encouraged that the authorities were continuing to carry out measures to improve public expenditure control and that they remained firmly committed to persevering with tight fiscal and monetary policies as a medium-term strategy for containing inflation. He broadly supported the staff appraisal.

Although the ratio of the public sector borrowing requirement to GDP had been steadily brought down, Mr. Fujino recalled, there had been consecutive spending overruns in recent years, mainly owing to excess expenditure by local authorities. He welcomed the U.K. authorities' continued efforts to improve control over public expenditure, particularly by local authorities, which Mr. Wicks had described as "the traditional difficult area." Looking ahead, he found it fortunate that the total of revenue and the targeted PSBR were both expected to exceed spending beginning in 1985/86, when the projected course of policy would actually materialize. As Mr. Wicks had suggested, the authorities could take advantage of the discretionary margin and afford tax relief to lower-paid workers to heighten their incentives to work.

In 1984, although the expansion of the targeted monetary aggregate £M-3 had been close to the target range, it had sometimes overshot, and other monetary aggregates had expanded more rapidly, Mr. Fujino noted. For most of 1984, interest rates on sterling-denominated deposits had been lower than on comparable dollar-denominated assets. It could be argued that, in an attempt to decouple domestic interest rates from those abroad, the authorities had been generally reluctant to see interest rates rise, despite a significant decline in the exchange rate of sterling. To the extent that domestic interest rates could not be uncoupled from those abroad, stronger pressure toward depreciating the currency could develop. He would appreciate further comment by the staff or Mr. Wicks about the effect of monetary policy on the exchange rate. Although the currency depreciation had prevented the United Kingdom's cost-competitiveness from deteriorating, despite the rapid rise in real wages in 1984, it could certainly exert an inflationary impact on the economy; he was concerned about the possibility because the inflation rate was estimated to remain at just under 5 percent in 1985.

He was disappointed that protectionist pressures had recently intensified in the United Kingdom, Mr. Fujino concluded. He shared the expectation of the staff and others that the United Kingdom would continue to play a leading part in rolling back protectionism.

Mr. Pickering observed that the substantial progress achieved by the U.K. authorities during the past few years had, in no small part, given credibility to the view that sustainable economic growth and progress in reducing inflation were consistent goals and, indeed, closely interlinked ones. Inflationary pressures had fallen dramatically, while economic growth had compared favorably with that of other European countries, particularly those which had delayed tackling inflation. An encouraging rate of growth was likely in 1985, and the recent end of the coal miners' strike would improve the situation further.

Despite the progress achieved, improvements were needed in many areas, Mr. Pickering went on. The trend in unemployment and wages during the past few years had been disappointing. The deceleration in the rate of price increases had slowed considerably, an unfortunate development, given that inflation remained somewhat high compared to many of the country's competitors in the industrial world. There was also a risk that the depreciation of the pound, if it were to continue, could raise inflation in 1985 above the rate currently projected. Although the competitiveness of non-oil industries had improved in recent years, it had still not regained all the losses incurred during the late 1970s. Moreover, the favorable trend in competitiveness seemed to have stalled with the substantial depreciation in the effective exchange rate for sterling and had been largely offset by rising unit labor costs. The emergence of a large trade deficit in 1983 on manufactured goods, and its continuation in 1984, were matters for concern, particularly in view of the uncertain future for oil exports. Unless the competitiveness of manufacturing were strengthened, declining oil exports in coming years would put increasing strains on the current account position.

His authorities were in broad agreement with the staff analysis, Mr. Pickering said. In view of the length of time required for structural adjustment to bear fruit, and given that inflationary expectations might be reacting relatively slowly to the anti-inflation effort, it remained important for the authorities to maintain a restrictive demand management stance. He therefore welcomed the unambiguous reaffirmation by Mr. Wicks that his authorities remained committed to their medium-term goals. Frankly, his authorities had had some concerns that the momentum behind the medium-term policy might be easing.

In view of the medium-term framework of economic policy in the United Kingdom, it would be undesirable to attach too much importance to short-term developments, Mr. Pickering pointed out. Nevertheless, the authorities should remain concerned about divergences in the stance of demand management from the medium-term path: unless corrective measures were taken, they would find it increasingly difficult to ensure that the medium-term goals were met. Consequently, they would be well advised not to understate the strong stimulative impact of fiscal policy during the past two years or certain doubts surrounding the degree of restraint indicated for 1984/85. His concern was heightened by the staff's questions about the quality of the recent declines in the public sector borrowing requirement. As other Executive Directors had noted, those declines had become increasingly dependent on revenues from the sale of assets and on the effect of the pound's depreciation on the price of oil. Those factors had only an indirect effect on domestic demand and would have no lasting effect on the public sector borrowing requirement.

A key factor in the United Kingdom's medium-term program had been a reduction in the Government's role in the economy, as well as the creation of conditions conducive to a more vigorous private sector, Mr. Pickering noted. Tax relief, within an overall stance of fiscal restraint, was important in strengthening incentives to business, and he welcomed the major tax reforms introduced in the 1984/85 budget. If tax revenue and the targeted PSBR should exceed government spending in the next few fiscal years, some room would exist for tax cuts, but only in combination with strong expenditure restraint.

In assessing monetary and exchange rate policy, the staff had emphasized that the significant effective depreciation of sterling during the past year might signal a policy stance easier than that which was appropriate, given developments on the price and wage fronts, Mr. Pickering observed. The target for reducing inflation was unambitious. As Mr. Ismael had noted, in other countries--including Canada--financial innovation had had distorting effects on monetary aggregates and had limited their usefulness as targets. Perhaps the U.K. authorities should place greater weight on other financial indicators, including the exchange rate. He also had some concern about whether, even assuming that the policy was broadly appropriate, currently targeted monetary aggregates were transmitting the correct signals of the degree of tightness of policy. In particular, under the present policy of having both broad and narrow money as targets, might there not have been some playing off between those two targets? The growth of £M-3 near the top of the target range seemed to have been tolerated as long as growth in M-0 had remained well within the range. Furthermore, he had some questions about the authorities' attempt to keep the growth of £M-3 within the target range by "overfunding," and he wondered whether such a practice might not lead to some discrediting of the targets.

Encouraging progress had been made in reducing structural rigidities in the labor market, Mr. Pickering considered, but additional efforts were still required if unemployment were to be reduced to a more acceptable rate. Against a background of high unemployment and declining growth in productivity, the sharp increase in average wages and the resulting high increase in unit labor costs were unsustainable. There was a need for continued moderation in labor costs. Evidence suggested that the real price of labor was being maintained at a level where unemployed workers had little chance of finding alternative employment. The only area in which employment had been growing in recent years had been part-time work, where wage costs had not been inflated. However, a substantial reduction in unemployment would depend upon more than encouraging wage restraint: further progress was also required in reducing segmentation in the labor market and encouraging the emergence of new industries.

Although the high rate of unemployment understandably resulted in increased pressure on the Government to attempt a quick fix, the authorities must resist such a course of action, Mr. Pickering concluded. A revitalized economy and, ultimately, lower unemployment would depend on their determination to maintain their stated policy course over the coming years.

Mr. Grosche expressed broad agreement with the staff's analysis and support for the staff appraisal. In some respects, the previous year had been successful for the authorities: real GDP had grown substantially, despite the coal strike; despite some overruns, the PSBR had been further reduced; the growth of monetary aggregates had been kept close to target. Unemployment, however, had risen further to uncomfortable levels, with the growth of the labor supply outpacing the growth of labor demand. Despite the depreciation of the pound, the competitiveness of the non-oil manufacturing sector in international markets had not increased. The current account had balanced only because of net oil exports, which had reached 2 1/4 percent of GDP.

It was his impression that in 1984, although conditions had been broadly favorable, the achievements had fallen short of what might have been possible, Mr. Grosche commented. At least partly, that shortfall might be explained by the coal miners' strike, which again showed clearly how difficult industrial relations could be in the United Kingdom and how they influenced the overall performance of the economy. Continuing labor market rigidities might be an important reason why the Government had displayed a certain weakness in implementing its economic strategy.

Although most monetary targets had been met, the target range for £M-3, the main indicator, had been quite generous from the outset, Mr. Grosche noted, but it had been met only because the authorities had stepped up sales of government debt to the public. Moreover, £M-3 did not include certain important deposits. In view of the conceptual problems with that aggregate, he wondered whether it might be advisable for the authorities to rely on other indicators, a point on which he would appreciate additional comments by the staff or Mr. Wicks. It seemed that, in general, the growth of monetary aggregates had been too high. The inflation rate stubbornly remained above a level that might be described as price stability. In addition, the steep decline in the exchange rate of the pound, steeper than the declines experienced by other European currencies, might provide further evidence of a slightly overexpansionary course of monetary policy. Therefore, he welcomed the recent exchange-rate-oriented rise in interest rates, even though it might be incompatible with domestic requirements. He agreed with Mr. Wicks that the authorities could not achieve a sustained strengthening of the exchange rate by manipulating the nominal rate, but that they could do so only by improving the supply side of the economy, including higher productivity.

It was sobering that the public sector borrowing requirement had fallen only because of extraordinary revenues stemming from sales of oil and the privatization of public enterprises, Mr. Grosche remarked. As Mr. Ismael and others had pointed out, in the absence of those nonrecurring factors, the PSBR would have risen from 4.75 percent of GDP in 1981/82 to an estimated 6.25 percent in 1984/85. He was concerned that the authori-ties ities had again failed to reduce the Government's share in general economic activity; government expenditure had risen from 42 percent of GDP in 1979/80 to 46 percent in 1984/85. Although the rise had been attributable partly to special factors beyond the authorities' control, such as the strike and capital expenditure by local governments, increases in wages had also played an important role.

According to Mr. Wicks, the U.K. authorities were well aware of the challenges that they faced in controlling public expenditure in order to achieve their medium-term goals, Mr. Grosche said. Bold, timely action was required. It might be difficult to reverse expenditure trends at present, yet it would become no easier in the future, once revenue from petroleum began to decline. Only expenditure restraint could provide room for achieving a reduction in the PSBR and also in taxation. He welcomed the authorities' intention to move toward a simpler, more efficient tax system within the framework of general tax relief. Nonetheless, simple arithmetic considerations showed that if growth were only moderate, general tax relief and a reduction in the PSBR would become feasible solely through decisive action to reduce expenditure.

He shared Mr. Wicks's view that there were no quick and easy solutions to difficulties in the labor market, Mr. Grosche stated. He welcomed all the measures taken by the authorities to encourage its smoother operation, particularly measures designed to improve the skills of unemployed youths. As employers and employees should be more mindful of the unemployed, trade union legislation aimed at removing legal protections for the closed shop seemed well taken.

He had been glad to learn from Mr. Wicks that the Government was firmly resolved to pursue a strategy of bringing down the rate of inflation through monetary control, Mr. Grosche went on. Perseverance would be important in correcting the labor unions' overpessimistic assumptions about the inflation rate and to bring about nominal wage increases more in line with the country's competitive position. It was worrisome that for some time real wages had grown faster than productivity, leading to increased labor unit costs, reduced profit margins, and impaired international competitiveness, as shown by the negative outturn in the United Kingdom's balance of trade in manufactures. Like Ms. Bush, he would welcome any comments that Mr. Wicks or the staff might have on that issue.

To prevent a further loss of shares in the domestic market, as well as the international market, the authorities would have to devalue the real effective exchange rate further or reduce the costs of production, Mr. Grosche observed. He shared the view that cost reductions were preferable; they required a reduction, or at least a stagnation, of real wages simultaneous with further gains in productivity. He urged the authorities to redouble their efforts at implementing financial policies conducive to achieving the goals set out in their overall strategy.

Mr. Blandin commented that the economic strategy adopted in 1979 by the U.K. authorities had since been regarded as an exemplary one and followed by many other countries, being judged as a sort of textbook case. One of the main features of that strategy had been its medium-term perspective. Contrary to a "stop-and-go" policy, the authorities' aim had been to provide the economy with a stabilizing environment on a durable basis. A lowering of the rate of inflation through monetary control and fiscal discipline was to have been paralleled by some structural measures, the entire strategy directed at restoring steady, noninflationary growth. Five years after the medium-term strategy had begun the staff report called for more modesty and also for more patience.

The overall macroeconomic results appeared extremely delicate, Mr. Blandin continued. As Mr. Wicks had mentioned, the result achieved for growth and inflation had been quite positive, but the macroeconomic results appeared contrasting, sometimes even contradictory. The first contrast was between the growth in GDP--almost 3 percent in both 1983 and 1984--and the unprecedented rise in unemployment. Why had the remarkable upturn in business investment, especially in manufacturing investment--15 percent in the first three quarters of 1984--had no positive effect on the labor market? As the problem was widespread, particularly in Europe, he would appreciate hearing the staff's views on that point. Another worrying contrast was that between the rise in unemployment and the decline of inflation, on the one hand, and real wage earnings, on the other. He was concerned that, despite continuously rising unemployment, actual real wage increases in manufacturing had accelerated from 1.4 percent in 1981 to 3.8 percent in 1984. Such developments appeared to contradict the traditional Phillips curve, but raised more fundamental, structural questions about the very nature of adjustment in the United Kingdom and about the flexibility of the labor market. Another contrast was that between the generally favorable evolution of economic activity and the recent weakness of sterling. As Mr. Wicks had stated, the weakness could be attributed to a fall in international oil prices and to the extraordinary strength of the dollar. It might also reflect a recent deterioration in financial results. Indeed, the upward revision in the PSBR for 1984/85, as well as the persistent expansion of £M-3 at the top of its target range--or even above--might have played a negative role in undermining confidence in the strategy pursued so far.

It was too early to make a global assessment of structural aspects of the medium-term strategy, Mr. Blandin considered. Some results were indeed very encouraging; for instance, the recovery, entering its fourth year, appeared to be better balanced and less dependent on an expansionary fiscal policy and the oil sector than in the past. Relatively good performance had been maintained in 1984, despite the prolonged coal miners' strike. A sharp rise in manufacturing investment, as well as an increase in the real rate of return for enterprises were positive structural achievements and boded well for the future of the U.K. economy. However, the country's non-oil trade deficit was still increasing; real interest rates were still quite high; while unemployment had not only increased but also become structural, meaning that the average duration of employment had increased. The lack of flexibility in the labor market had probably prevented the recovery from spreading to the entire economy. Moreover, competitiveness in the manufacturing sector appeared to be threatened by the high rise in the unit wage costs, and it had been maintained in 1984 only through a deterioration in the exchange rate.

In sum, he wondered whether the structural adjustment of the U.K. economy had had positive but limited effects so far, Mr. Blandin continued. Indeed, to what extent might the results already achieved have occurred, at least partly, at the price of a shrinkage of the productive sector as a whole?

Another structural weakness was the apparent lack of confidence that the British seemed to have in their own economy, Mr. Blandin said. For instance, on page 21 of SM/85/44, it seemed as if they were convinced that the rate of inflation could not decline durably below 7-8 percent per annum; the remaining gap between actual and expected inflation was striking in a country that had been successful in its fight against inflation. Moreover, he noted from Table 39 of SM/85/54 that U.K. investment abroad had been steady since 1981 and had probably increased in 1984. In the meantime, the structural gap between overseas investment in the United Kingdom and U.K. private investment overseas had also widened. He would appreciate hearing from Mr. Wicks or the staff the reasons for that development.

The current picture called more for continued effort than for radical changes either in macroeconomic policy or in the structural strategy, Mr. Blandin considered. In the first area, the authorities must avoid any overreaction, which might have counterproductive effects. On the one hand, an overhasty relaxation of monetary or fiscal policy would rekindle inflationary pressures, either through wage settlements or indirectly through a further depreciation of the exchange rate. On the other hand, the authorities should also avoid overreacting--particularly through excessive increases in interest rates--to the depreciation of sterling, which might also have some positive effects on the external accounts. Monetary policy should become a bit more ambitious in the control of monetary aggregates. In addition, any tax reductions, which were certainly needed to improve the supply side, should be cautiously balanced with adequate restraint on expenditure.

The crucial element on the structural side would be a reduction in the rigidities prevailing in the labor market, and he welcomed the measures announced by Mr. Wicks, Mr. Blandin went on. A better functioning of the labor market would undoubtedly help to reduce wage costs, enhance British competitiveness, and strengthen the non-oil trade balance, the other important structural weakness remaining in the United Kingdom.

It was important that the authorities' strategy should succeed, not only because it served as a textbook case but also because the well-being of the U.K. economy was important for the world economy as a whole, and for European partners of the United Kingdom in particular, Mr. Blandin concluded. In 1984, the difficulties and fragilities of such a strategy had been clearly outlined. He was confident that the authorities would take the present opportunity to pursue and complete their efforts where needed.

Mr. Nimatallah observed that the medium-term financial strategy continued to provide generally favorable results, as indicated in the table provided by Mr. Wicks. He agreed that the outlook for 1985 should be even more favorable, particularly now that the miners' strike had ended. The authorities should continue to address four major policy issues, so that the economy could be placed on a course of sustained growth with price stability in the medium term.

The authorities should maintain firm control over inflation, Mr. Nimatallah said, thus reducing pressures for higher wages, and even reducing real wages, besides improving the prospects for bringing unemployment down. Success in controlling inflation would also strengthen the country's competitive position. The authorities could keep inflation under control by maintaining the medium-term financial strategy, which combined fiscal discipline with monetary control, and, if necessary, by strengthening their strategy further.

The authorities needed to continue their efforts to reduce the role of government in the economy and promote private sector activity, Mr. Nimatallah noted, in order to improve resource allocation and enhance efficiency in both the public and the private sectors. They could achieve that purpose by gradually reducing the fiscal deficit through firm control of expenditure, particularly current expenditure. They could do so by selling industries that should be in the private sector. At the same time, they should take every opportunity to provide the private sector with appropriate tax incentives in various forms, without undermining the fiscal strength of the economy.

The authorities needed to emphasize measures that enhanced the supply side or, as Mr. Wicks had called it, the supply capacity of the economy, Mr. Nimatallah remarked, to remove bottlenecks and make more resources available for sustained growth. Comprehensive supply-side measures would avoid the need for quick short-term policy fixes in the future. Among other things, the authorities could encourage greater savings by fiscal reform and the introduction of attractive financial instruments and also by what Mr. Wicks had called continued higher expenditure on fixed investment, a policy that would boost badly needed capital formation. They could also promote labor retraining and other policies to encourage labor mobility.

It was important to ascertain the direction of structural changes in the United Kingdom, Mr. Nimatallah said. There was a need to move away from declining industries into areas of comparative advantage. For example, as the United Kingdom could compete in both manufacturing and services, further investment should be encouraged in those sectors as well as other competitive ones. He fully supported the authorities' continuing attempts to remove artificial supports and promote greater competition in the economy.

In sum, the United Kingdom could benefit from a long-term economic strategy to complement the medium-term financial strategy, Mr. Nimatallah suggested. The authorities had created a credible financial course for stable growth, and they needed to combine that with well-designed structural changes designed to strengthen the economy further.

Mr. Zecchini observed that, over the past few years, the international community had regarded with interest, and often with sympathy, the medium-term stabilization effort implemented by the United Kingdom, often referred to as the "British experiment." Both the recent report on the United Kingdom by the OECD and the general tone of the staff papers for the Article IV consultation suggested the time might be ripe for a comprehensive assessment of that experiment, not only because six years had elapsed since the experiment had begun in 1979 but particularly because the performance of the U.K. economy could be examined at present under external conditions that were particularly favorable in many respects. It would be more difficult to review the package of measures, either if too short a time had passed for them to produce results, or if their effectiveness had been hampered by a hostile external environment.

By consistently pursuing financial restraint within a medium-term framework, the authorities had achieved their goals for inflation and largely for public finance, although the costs of the adjustment had been higher than many of its original proponents would have expected, Mr. Zecchini remarked. Indeed, some courageous modifications were called for to redress the precarious situation of the real economy; those modifications would not require a retreat from the gains achieved on the price front, a point on which he was in agreement with the U.K. authorities and with Mr. Wicks. He was less in agreement with the view that the stimulus could be given by pursuing current policies without modification; it should be given through macroeconomic demand policies, which, under certain conditions, could be consistent with price stability. Once again, he dissented from the view that the combination of a number of demand-restrictive policy measures, whatever their supply-side effects, could amount to an overall stimulative policy stance. Recent experience in major industrial countries, beginning with the United States, supported the view that economic recovery required the combined effect of both demand and supply factors.

On page 4 of SM/85/44, the staff had written "that the authorities have stated repeatedly that they have no intention of changing their economic strategy," Mr. Zecchini went on. Of course, national governments had complete authority to implement economic policies according to their own preferences, and the Executive Board had repeatedly discussed difficulties in effectively implementing Fund surveillance in relation to creditors, particularly large industrial countries. However, it was unfortunate that the staff had begun its report on the policy discussions by saying that current policies would all be left unchanged, presumably regardless of the views expressed by Executive Directors; the statement led him to question whether the consultation was worth the effort. Perhaps Mr. Wicks could assure Directors that the authorities' attitude on Fund surveillance was not as negative as it appeared from that sentence.

He agreed with the staff that the problem of employment in the United Kingdom deserved center stage, Mr. Zecchini said. Unfortunately, the response by the non-oil manufacturing sector to stimuli originating abroad had been weak and that the United Kingdom had steadily been losing market shares in its non-oil exports, no matter how foreign competitiveness as shown in relative unit labor costs had evolved, according to Table 33 of SM/85/54. In focusing on unemployment, the authorities should examine its nature and causes, as different types of unemployment required different policies. Two views could be taken. At one extreme, primary responsibility for the excess supply of labor could be attributed to the downward rigidity of real wages, so that no significant constraint existed on the side of aggregate demand in the goods market. Such a situation should presumably be characterized by a fair amount of upward pressure on prices, the main obstacle to an expansion of output consisting of constraints on the supply of goods. Business cycle studies had usually referred to such a situation as "classical unemployment." At the other extreme, low employment would be due to a constraint on aggregate demand for goods, so that the demand for employment by firms ceased to respond positively to decreases in real wages, simply because producers saw no possibility of selling additional products. In such a case, a fall in real wages would at best leave the level of employment unchanged; normally, it would decrease the demand for goods, inducing some slack in the markets for output as well as downward pressure on prices, leading eventually to a further fall in employment. Whether appropriately or not, such a case was usually referred to as "Keynesian unemployment," for which the cure would normally be a policy-induced stimulus to aggregate demand. In fact, "classical" and "Keynesian" unemployment were not so incompatible with each other as they might appear at first sight. Indeed, both elements could well be present in the United Kingdom; therefore, policy prescriptions applicable to both cases might be called for.

Specifically, the U.K. economy was demonstrating one of its lowest employment levels of the past decade, while most of its demand components were growing sluggishly, and no significant upward pressure on inflation seemed to be present: all those ingredients characterized Keynesian unemployment, Mr. Zecchini commented. At the same time, two elements of classifical unemployment were present: real wages tended to be on the high side--mostly, but not entirely, because nominal wage adjustments were lagging behind price changes, as shown in Chart 3 of SM/85/44--and wages tended to withstand downward pressures aimed at bringing them into line with levels compatible with greater use of potential resources. At present, a decrease in real wages, assuming it to be feasible, could well be counterproductive, since wage resistance in the face of excess labor supply had helped to maintain the growth of consumption so far, thereby supporting the pattern of aggregate demand. Conversely, stimulative macroeconomic policies without downward wage flexibility would probably stimulate inflation rather than output, if high real wages constrained growth in output from the supply side. A combination of both expansionary demand policies and flexibility in real wages could permit a rise in output and employment while limiting or even avoiding any increase in the rate of inflation.

Clearly, a policy involving reductions in real wages was unlikely to be easily acceptable socially or politically, Mr. Zecchini went on. However, the very precarious situation in the labor market, particularly in view of the continuing expansion in the rate of labor force participation, as depicted in Chart 6 of SM/85/54, indicated that the benefits were likely to outweigh the costs and that a gradual macroeconomic stimulus would provide inadequate compensation for wage flexibility. In turn, wage flexibility would require not only that the adjustment of wage rates to price inflation should be less than complete, at least temporarily, but also that the price indicators used for that purpose should be appropriate.

In Table 3 of SM/85/44, the staff had used the yield differentials between nonindexed and indexed government securities as a means of assessing inflationary expectations, Mr. Zecchini noted. Aside from problems of allowing for an appropriate consistency in the time framework of inflationary expectations with the maturity of financial institutions, the differential was likely to embody an additional risk premium related to the uncertainty of future inflation rates for the holder of "conventional" bonds. Wage behavior based on such an indicator would therefore tend to be inflationary. Could the staff explain whether that differential actually did have any influence on wage demands by trade unions in the United Kingdom?

So far, the medium-term financial strategy had performed an important stabilizing function, and the authorities should be commended for their persistence, Mr. Zecchini concluded. Nonetheless, without abandoning any of their original objectives, they should introduce some modifications. Neither a traditional, expansionary macroeconomic policy nor a reduction in real wages, if implemented alone, could ensure stronger, noninflationary growth. The most effective way out of the United Kingdom's present difficulties appeared to require, as its essential components, both rigorous economic policies typical of the current Government since 1979 and some important ideas that had originated in the United Kingdom and of which the world would soon celebrate the 50th anniversary.

Mr. Polak expressed particular interest in the status of the medium-term financial strategy as a whole, but on that subject he found the evidence provided by the staff worrisome. In many respects, the strategy was not coming up to the authorities' earlier expectations. The authorities had not achieved their original aim of reducing public spending as a proportion of GDP; the ratio was about 4 percentage points higher than in 1979, and hopes of bringing it down seemed to have vanished. In addition, the reduction in the ratio of the PSBR to GNP had been wholly due to transitory factors such as the sale of government assets and oil revenue; when adjustments were made for those factors, the PSBR would be between 5 1/2 percent and 6 percent of GNP. Furthermore, although the rate of inflation had declined sharply, it had been edging up again to about 5 percent per annum for the foreseeable future. Real wages had risen persistently, while unemployment had also continued to rise. Monetary expansion had been on the generous side, and the foreign exchange value of the pound had shifted from a position where it had subjected the economy to the rigors of a hard-currency approach to the opposite position, where it was feeding inflationary pressures.

In those circumstances, he found it difficult to be impressed by the idyllic scenarios for 1993/94, when the PSBR would supposedly equal 1 percent of GNP, the rate of inflation would have declined to zero, and real growth would progress at 2 percent per annum, Mr. Polak went on. Moreover, he was not surprised that the staff had reported a perception that the priority might have changed from lowering the rate of inflation to lowering the rate of unemployment. He did, however, agree with the authorities that any attempt to turn their strategy in that direction would be misguided.

Whether intended or not, the easing of both fiscal and monetary pressures during the past year had not achieved, and was unlikely to achieve, solidly based growth, a lower rate of unemployment, and a strong balance of payments, Mr. Polak observed. He had been glad to note, at the conclusion of Mr. Wicks's statement, that the Prime Minister also held that view. As Mr. Wicks had said, the authorities' decision to allow interest rates to rise from 9.5 percent to 14 percent over a brief period had been fully in line with that determined policy view. He hoped that next year's Article IV consultation would provide convincing evidence that those policies did indeed constitute the heart of the authorities' financial strategy.

He had some reservations about the theory developed by the staff that recent increases in real wages were to be attributed to the persistence of inflationary expectations at a higher level than the actual rate of inflation, Mr. Polak commented. Specifically, he was not convinced that a general belief that the rate of inflation would remain at, say, 5 percent, would stabilize real wages; he would place great weight on existing rigidities in the labor market. The authorities did not control wage rates generally, but they might set a better example by not overshooting the wage targets set for the public sector, as had happened during the past two years, and by striving to diminish restrictions in the labor markets.

He had the impression that the authorities had not taken sufficient account of Goodhart's Law that monetary aggregates chosen as policy targets tended by that very fact to lose their economic significance, Mr. Polak stated. The increasingly monetary character of deposits of building societies, reflected in the rise of PSL-2, was being ignored because the authorities were concentrating on M-0 and £M-3. Moreover, containment of the latter variable just within the target range was being achieved only by the technique of overfunding. The effect of that technique was that the Government raised more expensive long-term funds to allow the private sector more flexible and cheaper bank credit; the steepening of the yield curve that resulted might further encourage demand for bank credit. Although the authorities maintained that private demand for bank credit was insufficiently elastic to allow use of the interest rate instrument, the private sector's ability to pay increasing real wages might indicate that higher interest rates could be restored, a development that might prove beneficial. Surely the authorities would expect that credit demand would react to the recent increase in interest rates.

He did not believe the authorities' argument that the decline in the exchange rate for the pound--which, in earlier years, would have been seen as a signal that monetary policy needed tightening--was mostly a dollar problem, Mr. Polak said. The Bank of England's indices showed that some 60 percent of the effective depreciation of sterling in 1984 had been due to a decline against currencies other than the dollar.

On page 7 of SM/85/44, the staff had cited as a major argument made by the authorities against participating in the European Monetary System "the potential incompatibility of exchange rate targeting with the policy of targeting the monetary aggregates, with which the authorities had been broadly satisfied," Mr. Polak concluded. Of course, such an incompatibility did exist. As a consultation mission to the United Kingdom had told the authorities some 20 years earlier, it was targeting of domestic credit expansion rather than of any money supply variant that was compatible with exchange rate targeting. Incidentally, were the U.K. authorities still satisfied with the targeting of monetary aggregates, at a 14 percent interest rate? More fundamentally, the authorities seemed to imply a permanent rejection of participation in the EMS, the essence of which that each member was prepared in the short run to adjust domestic financial conditions to ensure exchange rate stability. If the authorities considered that there was no prospect under any circumstances for sterling to join the EMS, they could hardly hold out hope for a systematic attack on the broader question of excessive exchange rate fluctuations in general.

Mr. Pérez joined Executive Directors who had welcomed the steady path followed by the U.K. authorities, as well as their success in bringing down the rate of inflation from 18 percent in 1980 to 5 percent in 1984. He agreed with the staff about the need to lower prices as a first step toward reducing the imbalances of an inflationary economy. Forceful, decisive implementation of tight policies had proved the only solution to control economies with high costs and prices.

The authorities' achievement of a low rate of inflation had not been accompanied by similar improvements in other areas, Mr. Pérez continued. If the target of last resort was to make price stability compatible with steady increases in growth and employment, the U.K. authorities still had to accomplish the second part of their task. In that respect, he could not agree with the staff that the authorities were displaying a lack of ambition in their intention to leave the rate of inflation unchanged at 5 percent. At the present stage, the key question was that posed by Mr. Wicks: was it was possible to consolidate recent achievements and undertake further steps within the framework of the current medium-term financial strategy? The priorities were clear, lowering the rate of inflation remaining the prime target, but the authorities should also give sufficient attention to the social problem of unemployment.

Although the PSBR was not high in relation to GDP compared with other industrialized countries, Mr. Pérez noted, there were some underlying structural problems that could jeopardize the medium-term projections. The increase in expenditures due to local authorities' unrestricted policies was of great concern; he welcomed the recent measures limiting such expenditures by bringing local authorities within the same framework of public expenditure control as central government departments. In addition, as Mr. Ismael and others had pointed out, oil revenues and asset sales--which had helped to reduce the PSBR recently--were not to be regarded as permanent factors making for a further decrease in the financial resources absorbed by the public sector. Furthermore, although recognizing that fiscal adjustment should be based on tighter expenditure control, the authorities had also shifted their attention to the possibility of reducing taxes. Such a policy should be managed carefully. A tax reform could have beneficial effects by encouraging entrepreneurs to hire more labor and could also have some positive results in promoting income redistribution. Nevertheless, those outcomes could be offset if, as a result of tax cuts, the PSBR should begin to rise and start to crowd out private investment.

During the past few years, monetary policy had been an essential tool within the framework of economic policy in the United Kingdom, Mr. Pérez said, but some doubts could arise about its effects on the real side of the economy. In the staff report and Mr. Wicks's statement, great stress had been placed on the control of monetary aggregates; in fact, £M-3 had been evolving at the top edge of the target range in recent months. In addition, financial innovations had provoked not a few difficulties in the management of those aggregates, weakening the causality relationship between real variables and monetary variables. Moreover, the recent exchange rate fluctuations could not be regarded as temporary and could thus create some distortions in monetary control. Although such factors could give the impression that targeting monetary aggregates was advisable within the schedule of the medium-term financial strategy, the effective role of such monetary techniques could be questionable in the short run. The U.K. authorities did not share the staff's opinion about the need to tighten monetary policy to control the inflation rate. Could Mr. Wicks or the staff comment on the role being played by monetary policy in the short run?

In conclusion, probably the greatest threat to economic stability in the United Kingdom was the rate of unemployment, Mr. Pérez remarked. The main cause of the imbalance was located on the supply side, specifically in the behavior of wage demands and the downward rigidity of real wages. Given the poor results already obtained in promoting wage flexibility, he wondered what efforts could be made to reach a social consensus between representatives of labor and the Government. Perhaps a policy introducing ceilings on nominal wage increases could provide better expectations for investment, and trade unions could apply the principle of job creation as their main target in all bargaining. That combination could not only produce further results in the fight against inflation, but also reduce rigidities in the labor market, which would contribute to stabilizing expectations for the economy.

Mr. Lundstrom noted that the economic strategy pursued by the United Kingdom since 1979 had been likened by some, including the Chancellor of the Exchequer, to an experiment, because the authorities had departed from traditional demand management policies and were relying on macroeconomic policy to reduce inflation and check the expansion of nominal income. At the same time, they were gearing microeconomic policy to promoting growth and improving the working of markets for goods, labor, and capital through a series of supply-side measures, including reductions in government intervention and ownership. Although the strategy had had considerable success in slowing the rise in nominal incomes and the rate of inflation, that success had been achieved at great costs.

The Fund's appraisal of economic policy in the United Kingdom differed markedly from that of other organizations, Mr. Lundstrom observed. In assessing the British economy, both the OECD and the National Institute of Economic and Social Research had rejected a further tightening of economic policy, suggesting that other measures should be applied to improve the functioning of the labor market. The EC had recently pointed out that the United Kingdom was one of the few OECD countries with sufficient room at present to adjust its policy in that direction.

To maintain credibility in the Fund's assessments, much should be required of the analysis underlying its conclusions, Mr. Lundstrom said. In particular, the staff's analysis was based on the idea that an "expectation gap" existed in the U.K. economy. According to the staff, the gap could be defined as the difference between the observed rate of inflation and the discrepancy between yields on indexed and nonindexed bonds. His authorities were hesitant to accept that explanation. Actually, the tax system was not consistent with respect to indexation allowances and interest rates; expectations had different timeframes on the labor and financial markets. Moreover, he found it difficult to believe that inflationary expectations were a function solely of the Government's efforts to fulfill its objectives for monetary growth and the budget deficit. To the extent that high unemployment per se reduced confidence in economic policy, inflationary expectations might well increase with unemployment.

For some years, the United Kingdom had maintained a stable growth rate, a relatively high one by European standards, while economic policy had caused a marked decrease in price inflation, Mr. Lundstrom recalled. Nevertheless, unemployment had increased at an alarming rate, and industrial production had fallen by about 10 percent during the past five years. In view of those developments, he questioned the apparently categorical belief that inflation and employment objectives did not conflict in certain circumstances.

During the recent period of growth, economic developments had been affected by relatively strong domestic demand, Mr. Lundstrom went on. It was encouraging that economic policy had been less contractive than originally planned, owing to special circumstances such as sales of public sector assets and higher than expected revenue from petroleum exports following the depreciation of sterling. Given the high and rising rate of unemployment, there should be no tightening of fiscal policy, even if those temporary revenues were to decrease.

The problems in the labor market were of paramount importance, Mr. Lundstrom considered. The authorities' financial strategy would not be sufficient in the medium term to solve the structural problems contributing to labor market rigidity. Therefore, distortions resulting from combinations of different taxes, fees, and allowances should be further reduced to stimulate demand for labor. However, there was a risk that the announced tax reforms would not be implemented as planned. In addition, capital formation should be initiated in communications as well as research and development, in order to strengthen overall output, competitiveness, and domestic demand, hence, improving opportunities for employment.

The competitive position of industry in the United Kingdom had been considerably strengthened by the depreciation of the pound in recent years, Mr. Lundstrom remarked. However, against the background of a simultaneous upsurge in wages, there were substantial risks in allowing wages to advance at a faster pace than that warranted by underlying developments in productivity, a problem accentuated because the course of productivity had been largely influenced by substantial labor shedding and dismantling of unprofitable activities. Thus, to maintain international competitiveness, such productivity gains must not be allowed to lead to income increases for those already employed. However, the marked increase in real wages in the United Kingdom in recent years, in contrast to many other European countries, had become a serious problem for British industry, as the staff pointed out. Considering the balance of payments position, a more restrained evolution of wages would seem to be a better solution to the problem of competitiveness than a depreciation of the pound, particularly as the recurrent increases in interest rates might tend to discourage investment in manufacturing.

The staff had noted that pressures for protectionism had intensified in the United Kingdom, as in many other countries, Mr. Lundstrom said. His constituency was concerned by the authorities' attitude toward protecting certain domestic industries. State support to certain lines of business had become more or less permanent and was contributing to the delay in structural adjustment within traditional export industries, where more rapid adaptation should be encouraged. However, he noted the positive steps taken so far to abolish trade barriers and hoped that the United Kingdom, as a traditional supporter of free trade, would play a central role in that endeavor and would intensify its efforts, together with other members of the EC. In conclusion, his authorities noted with regret that, in spite of its developed economy, the United Kingdom was reducing its development aid, which had fallen below the GNP-related average approved by the DAC.

Mr. Rye indicated that he expressed broad agreement with the staff appraisal. As the staff had said at the beginning of SM/85/44, the U.K. authorities had had considerable success in implementing their medium-term financial strategy in recent years. Although sharing many of the concerns raised by the staff about more recent developments, he believed that the staff was judging current developments in the United Kingdom more against the progress made in recent years than against the international economic situation. Perhaps such an approach was proper only in cases where the staff detected a change for the worse in policies or conditions, even though such changes in the United Kingdom, so far at least, appeared relatively minor by most standards. The Fund had a duty to ring warning bells loud enough for the message to be clearly understood, however, and he regarded the staff report as a constructive document in that respect.

He found the techniques of monetary control employed by the U.K. authorities to be puzzling, Mr. Rye said, particularly the practice of overfunding the PSBR as a means of controlling £M-3, but then supplying funding through Bank of England activities in the bill market. Did containing the growth of £M-3 in that way really ensure the maintenance of monetary control in any fundamental sense? In Appendix IV on page 103 of SM/85/54, the staff had suggested that overfunding "could be interpreted as having the function of reconciling strong growth in credit demand with slower monetary growth," because the Bank of England rather than commercial banks intermediated between private savers through gilt sales and corporate borrowers through purchases of commercial bills. If accurate, that interpretation suggested a procedure akin to disintermediation, in the sense that financial flows were being redirected outside the £M-3 statistical framework. Mr. Polak had already drawn attention to the possible relevance of Goodhart's Law, a point on which he would welcome the views of the staff and Mr. Wicks.

He had been intrigued by the references made by Mr. Wicks to the recent sharp rises in interest rates, which Mr. Wicks had attributed to "pressures in the financial markets," Mr. Rye remarked. He wondered whether that episode had been an instance of the policy attributed to the U.K. authorities on page 7 of the staff report:

> Of course, it would be very difficult for the authorities to stand aside when exchange markets were disorderly because of

doubts about the soundness of monetary policy. In such instances, the authorities might choose to take steps, as they did in July 1984, to tighten monetary conditions beyond what might be called for by underlying developments, as a means to reassure the markets.

He had also noted, Mr. Rye went on, what seemed to be a quite sweeping statement made by Mr. Wicks that "monetary conditions in the U.K. are now tight on any measure." While noting that there were few measures available relevant to the here and now, he wondered whether the staff agreed with that view.

He had been particularly interested in the staff's analysis of the fiscal balance in relation to its permanent and temporary components, Mr. Rye commented. Although he would not wish to make too much of the issue--after all, the oil revenue had actually been available--the U.K. authorities would continue to face considerable challenges in fiscal policy in the years ahead. Against that background, the recent surprisingly stimulatory stance of fiscal policy, and the possible further slippage referred to in SM/85/44, Supplement 1, might be a cause for concern. Doubtless, the Chancellor of the Exchequer would be seeking to give a clear signal to the markets in his next budget that the Government's resolve to adhere to the MTFS had not waned in any way. Indeed, the projections in the January white paper on public expenditure, providing for overspending during 1984/85 to be recouped mostly in 1985/86, might have already contributed to that objective. Incidentally, he did not understand why revenues from oil and asset sales were not supposed to have "a major restraining impact on domestic demand or on monetary conditions," as the staff had said on page 9 of SM/85/44. Did not such revenues result in a withdrawal of funds from private financial markets in the same way as any other government revenue-raising activity? Perhaps the staff could clarify that point.

In the labor market, rising wages were a serious problem, Mr. Rye considered. Although the staff's explanation for that phenomenon in terms of a slow downward adjustment to inflationary expectations was interesting--and that adjustment might indeed be one influence--he nonetheless believed that, if the wage determination process actually worked as the model underlying the explanation would have it, wage earners in subsequent wage rounds could be expected to make some allowance for their previous "mistakes," as manifested in layoffs of fellow workers. There seemed few signs of such a development in the United Kingdom. It was easier to believe that the core of the problem was that the unemployed had no say in setting wages. Therefore, he endorsed the staff's comment that the functioning of labor markets had to be improved to allow the unemployed to become a factor in wage bargaining. However, it was easier to advance such a general prescription than to identify specifics or to carry them out. Nevertheless, he agreed with the staff that a reflation of demand through easier monetary or fiscal policies was hardly likely to assist in reducing unemployment. A more probable outcome would be further exchange rate depreciation and increased inflation; before long, unemployment would rise even higher.

The measures taken by the Government to improve the functioning of the labor market, in relation to tax thresholds, unemployment benefits, labor law, youth unemployment, and, more recently, national insurance and investment tax allowances had clearly gone the right direction, Mr. Rye said. Nonetheless, public sector pay settlements in 1983/84 had been unexpectedly high. How did public sector wages stand in relation to private sector wages? Had such public sector pay settlements made it more difficult to achieve the desired wage restraint in the private sector?

Demand management during the past year, especially through monetary policy, might have been less firm than in earlier periods, Mr. Rye suggested. Indeed, in the authorities' views as conveyed by the staff, he detected a strong hint of interest rate targeting, as the authorities had attempted to "decouple" U.K. interest rates from international interest rates, and the staff had stated that the authorities sought to keep interest rates as low as possible within the constraint imposed by their monetary targets. Taken too far, such attitudes would be incompatible with monetary targeting. It should also be borne in mind that the exchange rate for sterling had depreciated substantially, there were misgivings about the reliability of £M-3 as the sole indicator of the stance of monetary policy, and there had been rapid growth in other monetary aggregates, particularly PSL-2. All in all, he hoped that recent measures indicated that the U.K. authorities in future would place less emphasis on holding down interest rates and would allow a greater share of the burden of monetary restraint to fall on private sector borrowing. Such an approach seemed necessary to bolster the credibility of the MTFS, which lay at the heart of the U.K. approach to keeping inflation under control. However, it must have come under some strain recently, especially given the comparative weakness of sterling.

Finally, Mr. Rye commended the U.K. authorities for the extent to which they had resisted pressures for increased protection, although, as earlier speakers had noted, they had succumbed in one or two areas. In addition, he was particularly grateful to them for their endeavors to reform the Common Agricultural Policy of the European Community.

Mr. Abdallah welcomed the opportunity to review economic developments in the United Kingdom, as they had important implications for all the countries that he represented. He agreed with the staff analysis and appraisal of recent economic performance in the United Kingdom. In 1984, recovery had continued for the third year in a row. Despite a long coal miners' strike, with all its ramifications for the economy, real GDP had grown by an estimated 2.5 percent in 1984, only marginally below the 2.8 percent projected in the 1984/85 budget, while the rate of inflation had been kept at about 5 percent and the rate of monetary expansion had slowed considerably. Those achievements reflected the appropriateness of the policies pursued by the authorities, who deserved commendation.

Some problem areas remained, Mr. Abdallah went on. First, the rate of unemployment had risen to 13 percent of the labor force by January 1985; persistent increases in real wages had been the major factor. The authorities had taken measures to improve the situation, including amendments to the labor law, abolition of the national insurance surcharge, phasing out of the initial capital allowance to reduce the bias against labor in investment decisions, and the introduction of special schemes to improve youth employment. The authorities were also making efforts to facilitate a proper functioning of the labor market, with the ultimate objective of reducing real wages to the level warranted by productivity. Such measures would, no doubt, take time to produce the desired effect. In the meantime, perhaps the authorities could consider some easing in monetary and fiscal policies to create more jobs without putting at risk the major objective of promoting noninflationary growth.

Unemployment of the size currently confronting the U.K. authorities deserved special, prompt attention, not only because of the loss in output but also because of its social aspects, Mr. Abdallah noted. After all, the ultimate objective of economic management must be to promote the welfare of the people. High unemployment was coupled with rising industrial unrest, which, in the first 11 months of 1984, had resulted in a considerable loss of working days: excluding the miners' strike, the loss had been about 32 percent higher than in the corresponding period of 1983. Perhaps such unrest transmitted as a clear signal that the machinery for resolving industrial disputes was not working as it should and therefore needed to be streamlined.

The medium-term financial strategy of the United Kingdom had two principal objectives, Mr. Abdallah considered: a progressive deceleration of monetary expansion designed to keep inflation down, and the substantial scaling down over time in the public sector borrowing requirement to ensure that the planned monetary deceleration did not generate excessively high interest rates. By and large, the authorities had attained both objectives. In particular, the ratio of the PSBR to GDP had been brought down from a 1980/81 peak of 5 1/4 percent to about 2 1/2 percent, although actual progress had been less than it might appear at first sight. As Mr. Ismael and others had pointed out, the decline in the ratio had been due to two special factors: continuing sales of assets and higher oil revenues arising from the strong dollar. Nevertheless, despite the scaling down of the PSBR, in late 1984 the authorities had had to curtail the steady decline in interest rates, which had begun in 1983, because of unacceptable pressures on the exchange rate for sterling. He agreed that the authorities could have done little to prevent an upward rise in interest rates, given the volatility of financial markets and what Mr. Wicks had described as the "extraordinary and excessive strength of the dollar." That development, like many others, pointed to the need for closer economic coordination among large industrial countries. The adverse impact of high real interest rates on government finances, investment decisions, and the creation of employment opportunities in rich industrial countries was considerable, while the repercussions of such high interest rates on developing countries should not be overlooked.

There had been a significant fall in the United Kingdom's share of non-oil exports, despite the considerable depreciation of the exchange rate, Mr. Abdallah recalled. As the staff had pointed out, the weakness was largely attributable to a serious erosion in the international competitiveness of the manufacturing sector. However, with the recent and continued improvement in cost and price competitiveness, the U.K. manufacturing sector, in due course, would pick up its lost shares of export markets. The authorities could promote that process by continuing not to support lame-duck enterprises, however unpopular the policy might be. Manufacturing should concentrate on high-technology fields like computers and electronics, where the United Kingdom was well equipped to compete, rather than in such fields as textiles, where the country enjoyed no comparative advantage.

The intensification of protectionist pressures in the United Kingdom was quite understandable at a time of widespread unemployment, a loss of international competitiveness, the prevalence of structural rigidities, and rising protectionism abroad, Mr. Abdallah said. However, he urged the authorities not to give in to those pressures. Despite some apparent temporary benefits, protectionism bred itself and might lead to further losses in competitiveness, inefficient allocation of scarce resources, and a premature termination of the ongoing economic recovery. Furthermore, to developing countries struggling under a heavy debt burden, the loss of markets due to protectionism might prove fatal. Thus, he was pleased to note the U.K. authorities' efforts to bring about a reform in the Common Agricultural Policy of the European Community and their desire to accelerate tariff reductions scheduled for 1986 under the Tokyo Round in the hope that other major countries outside the Community, like the United States, would do so as well. He was also pleased with the authorities' commitment to addressing the deficiencies in the international trading system in a multilateral framework. He hoped that when negotiations to that end took place, the United Kingdom and other industrial countries would not be demanding complete reciprocity from the developing countries.

Financial assistance from rich industrial countries, including the United Kingdom, played an important role in maintaining economic momentum in developing countries, Mr. Abdallah concluded. Therefore, he regretted the continuing decline in official development assistance (ODA) provided by the country from an average of 0.43 percent of GDP in 1979-81 to 0.37 percent in 1982, and 0.35 percent in 1983. Every effort needed to be made by the authorities to reverse that trend. Perhaps Mr. Wicks could explain what had happened in 1984 and could project future ODA trends.

Mr. de Groote observed that the United Kingdom had set an example for many other industrial countries facing similar difficulties by implementing, since 1979, a long-term strategy for acting on the fundamental causes of inflation and for diminishing the role of the public sector in favor of private initiative. The United Kingdom could be regarded as a model, not only because the type of structural adjustment policy generally accepted at present in industrial countries had been launched there, but also because that policy had been presented in a systematic framework, with strong analytic overtones. The authorities had needed political courage to pursue a policy whose favorable results had taken time to materialize; the confirmation of the policy given by the British electorate, in spite of the immediate restrictive effects, had provided an incentive to all governments faced with the same problems to secure their future with reform instead of rosy promises. In Belgium, especially, the example of the United Kingdom had been an important part of the background of policies implemented since the beginning of 1981. Indeed, the U.K. and Belgian economies exhibited many similarities resulting from aging industries, an overgenerous welfare system, and rigidities in income determination, all of which had led to an unsustainable public sector deficit in both countries.

Through control of the monetary aggregates, the authorities had tried to reduce inflation and exert continuous downward pressure on inflationary expectations, Mr. de Groote said. The danger of such a policy was that it could have caused a rise in interest rates incompatible with the recovery of output, so that a limitation of the PSBR in relation to GDP had been an essential component of the strategy. The results obtained had been encouraging: consumer prices had increased by only 5 percent in 1984, while the PSBR had fallen to 3 percent of GDP. However, the most recent figures on consumer prices cast some doubt on the durability of the favorable results in inflation, while the reduction in the PSBR/GDP ratio could be ascribed to temporary factors, such as the sale of public assets to the private sector and to local authorities, which had a one-time effect, and to the increase in oil revenue resulting in the appreciation of the dollar. According to staff calculations, if the PSBR were adjusted for asset sales and higher oil revenue, it would have increased instead of decreasing during the past three years, a development partly explaining the growth of output. Thus, the authorities still had to make a substantial adjustment in order to reach the targets set in the medium-term financial strategy for the period up to 1993/94.

The authorities had reacted quickly and with determination to the less favorable than expected outcome by adjusting, in autumn 1983 and in January 1985, their expenditure targets for the next three budgets, Mr. de Groote remarked. The freeze on real public expenditure had been a most welcome decision, for which the authorities were to be commended. Indeed, there was a serious risk that underachievement of the targets for reductions in the PSBR would make it impossible to attain the fundamental objective of reducing the tax burden and reallocating resources in favor of the private sector. Furthermore, if the PSBR should exceed the targets, it would place upward pressure on interest rates, thereby threatening the recovery of GDP, which in turn depended on a long-term easing of interest rates. The staff had correctly stressed the unfavorable demonstration effects that such a course of events would entail in other countries pursuing similar objectives.

From the outset of the recovery program, Mr. de Groote recalled, the authorities had admitted that for the favorable effects of the monetary and budgetary measures to prove durable, progressive action on supply-side and structural changes set simultaneously into operation would be required. In the recent past, investment in the industrial sector had reacted favorably to a reform of the tax system aimed at reducing the overall tax burden of enterprises and dismantling discrimination among categories of investment and sources of financing. In recent months, the rate of return on capital had substantially increased; investments were beginning to play a determining role in the growth of the economy, as expected in a supply-oriented strategy. The U.K. authorities must, however, remain vigilant against the possibility that their choice of policy instruments would impede or prevent a further growth in investment. The exchange rate, fully determined by the market, was not a policy instrument but served merely as an indicator of the stance of monetary policy.

Therefore, Mr. de Groote said, interest rates must carry the burden of compensating for developments in the exchange rate that could result in renewed inflationary risks, as was occurring at present under the pressure of forces outside the authorities' control. Indeed, the objective of promoting continuous growth in investment might be frustrated by the reaction of interest rates to the inflationary effects of a depreciation of sterling. It was not impossible that the recent sharp rise in interest rates, by which the monetary authorities had attempted to offset the depreciation of the currency, would express itself in lower than expected investment for the remainder of 1985 and for 1986, thereby rendering unrealistic the targets for 1993. Therefore, the authorities were faced with difficult choices between their longer-term objectives of providing conditions for sustainable growth and their immediate objective of containing the inflationary risks stemming from the exchange market. Their choices were further complicated by the increase in real wages, appreciably larger than for the United Kingdom's competitors. If the price targets were strictly maintained, those contradictions between the effects of different policy instruments might impose a downward revision in the objectives for growth.

That crucial issue had a direct relationship with the policies adopted for the exchange rate since the beginning of the medium-term financial strategy, Mr. de Groote concluded. At previous Article IV consultations with the United Kingdom, he had stressed the unfavorable effects of the sharply increasing exchange rate for the pound on the country's competitiveness and therefore on the long-term restoration of its productive capacity. The idea had been advanced, by several Executive Directors, that the United Kingdom could have offset the exchange rate consequences of oil price increases by requiring the transfer of exchange proceeds from oil to offshore accounts. To some extent, the dilemmas of the present resulted from past choices concerning exchange rate flexibility and from the need to absorb, through revised investment objectives, major reversals of trends in the exchange markets. In EC circles it had often been said that, by adopting a policy of more stable exchange rates, the United Kingdom might have avoided the ups and downs to which its internal policy targets continued to be subject.

Mr. Jayawardena recalled that, for several decades, the United Kingdom had adopted temporary stop-go policies of alternating stimulation and contraction, while structural problems had become deeply rooted. Discoveries of oil in the North Sea had thus served as a cushion permitting the authorities to take some effective action to tackle some embedded structural rigidities. For that reason, he had supported the medium-term and the longer-term policy strategy as appropriate, although he continued to be concerned at the pace of progress, no doubt owing to both internal and external circumstances. He fully endorsed the points made earlier by Mr. Pickering, and would limit himself to emphasizing structural adjustment, which, in any economy, especially in the major economies, was a difficult and long drawn-out process. Success depended not only on perseverance by the authorities but also on a hospitable international environment. As the latter was difficult to obtain, national authorities had had to depend on their own perseverance.

He broadly agreed with the authorities' approach to tackling structural rigidities, Mr. Jayawardena continued. It was appropriate that the starting point would be the containment of inflation and inflationary expectations by prudent short-term demand management. The authorities' success had been mixed, although they had tried their utmost, despite high social costs. The second aspect was the implementation of supply-side measures that would liberate the economy from the shackles that had multiplied over the years. The authorities' achievements in that area had been mixed: the public sector continued to be large, rigidity persisted in wage determination, and competitiveness had been restored only in some sectors, by apparently transitory methods. In addition, public expenditure showed little sign of declining as a proportion of GDP. However, he was encouraged by the expectation held out by Mr. Wicks of a tax cut, which was to be matched by firm expenditure restraint and further measures to encourage a more competitive economy.

Conflicting signals were being transmitted, Mr. Jayawardena noted with concern. On the one hand, the U.K. authorities' determination was intended to rectify structural rigidities and to shield competitiveness to markets, diminishing the role of the Government accordingly. On the other hand, protectionist pressures were mounting to shield senescent economic activities from market forces, and the authorities were encountering structural difficulties in phasing out the substantial public sector. Such pressures appeared to be a temporary reaction to growing unemployment, which had proved stubborn. Otherwise, persistent high unemployment and the persistent structural rigidities might prove to be the Achilles' heel of the authorities' economic strategy, and there might be a reversion to the old counterproductive stop-go policies. He urged the authorities to persevere in reducing the public sector overhang and in furthering market liberalization.

Restoration of the once-formidable productivity and competitiveness of the United Kingdom was the key to the economy's future success, Mr. Jayawardena remarked, but it could be achieved only in a truly competitive environment. Apparently, a social contract or a social consensus was lacking. Given the country's long history of social welfare, there was no way in which such a consensus could be willed into existence other than through the active promotion of an open and competitive economy, which would heighten citizens' awareness of economic realities. The role of the public sector could be scaled down to furthering the evolution of such a competitive environment under a social consensus and possibly to rectifying the emergence of strong inequality in income distribution.

Although concerned at the decline in ODA as a proportion of GDP in the United Kingdom, he credited the authorities for keeping ODA at a high level, compared with other countries in similar economic circumstances, Mr. Jayawardena concluded. After all, the decline had been from a relatively high figure to a somewhat lower figure. Once the current economic difficulties had been overcome, he hoped that the United Kingdom would resume shouldering its international obligations vigorously, as it had admirably done in the past.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/34 (3/4/85) and EBM/85/35 (3/6/85).

2. ADMINISTRATIVE BUDGET FOR FY 1985 - SUPPLEMENTARY APPROPRIATIONS FOR MAINFRAME COMPUTING SERVICES

1. Management is authorized to increase the administrative budget for FY 1985 for data processing expenditures by $6,072,000 to provide for the purchase cost of an IBM-compatible computer and its peripherals, systems software, and initial expenses.

2. Management is authorized to increase the administrative budget for FY 1985 for data processing expenditures by $200,000 in order to proceed with preliminary research on a site selection and with a detailed cost estimate for the construction of a building designed to house the main computers of the Fund and, possibly, those of the World Bank. It is understood that the findings of the site survey, the preliminary architectural design, and the cost estimate will be submitted to the Executive Board for final approval.

3. Management is authorized to engage in a contract, to be effective not later than April 1, 1985, with a commercial establishment to provide a location and the operational support for Fund-owned computer equipment. It is understood that this would be a temporary arrangement pending completion of the new facility referred to in paragraph 2 and that no additional budgetary appropriations would be required in FY 1985.

4. The total staff ceiling of 1,647 as approved in EBAP/84/64 (amended in EBAP/84/230, 10/29/84) is increased to 1,650, effective February 1, 1985, by the addition of three new positions in the Bureau of Computing Services, one at Division Chief level and two at F-I level. (EBAP/84/276, 2/13/84; and Sup. 1, 2/19/85)

Adopted March 5, 1985

3. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 84/103 and 84/104 are approved. (EBD/85/58, 2/27/85)

Adopted March 5, 1985

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/51 (3/1/85) and EBAP/85/53 (3/4/85), and by an Advisor to an Executive Director as set forth in EBAP/85/51 (3/1/85) is approved.

APPROVED: December 13, 1985

LEO VAN HOUTVEN
Secretary