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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/36

3:00 p.m., March 6, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
	M. K. Bush
	D. C. Templeman, Temporary
J. de Groote	
	G. E. L. Nguyen, Temporary
M. Finaish	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	
J. E. Ismael	Jaafar A.
	G. W. K. Pickering, Temporary
	J. R. N. Almeida, Temporary
H. Lundstrom	
	A. Abdallah
	B. Jensen
Y. A. Nimatallah	J. E. Suraisry
	J. de la Herrán, Temporary
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
R. S. Franklin, Assistant

Also Present

European Department: P. Dhonte, Y. Horiguchi, A. Knöbl, 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, S. Kanesa-Thasan, N. Kirmani. Fiscal Affairs Department: V. Tanzi, Director; G. M. Bartoli, G. Blöndal. Legal Department: J. K. Oh, S. A. Silard. Middle Eastern Department: P. Chabrier, Deputy Director; J. G. Borpujari, F. Drees, H. E. Jakubiak, M. Schulze-Ghattas. Research Department: A. D. Crockett, Deputy Director; J. Artus, J. M. Boughton. Western Hemisphere Department: E. Wiesner, 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, E. M. Taha, A. Vasudevan, M. A. Weitz. Assistants to Executive Directors: I. Angeloni, G. Ercel, R. Fox, G. D. Hodgson, Z. b. Ismail, J. A. K. Munthali, K. Murakami, 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 resumed from the previous meeting (EBM/85/35, 3/6/85) their consideration of 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 the report on recent economic developments in the United Kingdom (SM/85/54, 2/14/85).

Mr. Finaish commented that he would have appreciated more discussion in SM/85/44 of whether the authorities could consider some fiscal expansion at the present stage as a means of boosting growth to a rate that could have an impact on the high and still-rising rate of unemployment. The point had often been made that in view of the present rate of unemployment--well above the natural rate--and the rapid, considerable reduction in inflation already achieved, a moderate fiscal stimulus might not be inflationary, while it would help in speeding up the growth of output and employment.

The staff position, set out on pages 16-18 of SM/85/44, appeared to be that any tilt toward fiscal expansion would be inadvisable, even if it took place within the scope of a broadly unchanged medium-term strategy, Mr. Finaish remarked. The question could be raised whether such a position might be based on excessive caution. If a moderate shift toward fiscal expansion were made within the broad framework of the medium-term financial strategy (MTFS), and were perceived accordingly, there might be no adverse effect on expectations, and the credibility of the authorities' medium-term anti-inflationary, nonaccommodating policies might not be undermined. If moderate fiscal expansion were successful in raising output sufficiently to begin to bring down unemployment without triggering a significant rise in the rate of inflation, the effect on expectations would be favorable: it would demonstrate that the progress achieved against inflation was not temporary, bought at the expense of the large increase in unemployment, but was more durable and consistent with falling unemployment. Indeed, one factor that might have contributed to keeping inflationary expectations high relative to actual inflation had been market perceptions that the decline in inflation might be unsustainable because of the accompanying high rate of unemployment.

The staff noted that the impact of a moderate dose of fiscal expansion on interest rates would probably be limited, given the linkage between domestic rates and those abroad and assuming an appropriately matched monetary stance, Mr. Finaish observed. The same factors could serve to cushion the impact on the exchange rate as well.

As a large part of the present unemployment seemed to result less from a lack of demand than from relatively high wages and low profitability, it followed that the solution to such unemployment lay basically in continued moderation of wage demands and improvements in productivity, Mr. Finaish pointed out. In that connection, the discussion presented in Appendix VI in SM/85/54 was useful. However, several analyses of unemployment in the United Kingdom had come to the conclusion that a significant share of unemployment was demand related; the authorities might be able to reduce that share by ensuring adequate growth in demand. As Mr. Zecchini had said, elements of both Keynesian unemployment and classical unemployment were present in the United Kingdom, and a policy package should accordingly include both financial policies to maintain adequate growth in demand as well as measures to bring about greater flexibility in real wages.

Reducing the fiscal deficit and the public sector borrowing requirement (PSBR) had been an important and necessary part of the authorities' strategy, Mr. Finaish stated. An adjustment of the fiscal stance toward expansion, which might be considered in present circumstances, should be within the broad framework of the medium-term strategy and should not compromise, or be seen as compromising, the authorities' medium-term fiscal objectives. Thus, the question was not one of abandoning the medium-term fiscal objectives currently envisaged, but one of making some modification in the time path for moving toward the attainment of those objectives. After all, despite a severe recession, a sizable improvement in the fiscal position had already been achieved: in cyclically adjusted terms, the overall fiscal deficit had been reduced by 6-8 percentage points of GDP, according to different estimates, between 1979 and 1983, resulting in a structural surplus. The tightening of fiscal policy in the United Kingdom had been much more pronounced than the average tightening that had taken place in other major industrial countries, indicating that the effect of fiscal policy during that period had been highly contractionary in the United Kingdom, much more so than in other major industrial countries, even though the recession had perhaps been the severest in the United Kingdom. According to some analysts, the greater depth of the recession in the United Kingdom could be explained partly by the authorities' fiscal stance.

Against that background, the slight relaxation in the fiscal stance that had occurred since 1983 might not be a source of much concern and might indeed be regarded as a corrective to the previous, extremely contractionary impact of fiscal policy, Mr. Finaish said. The expansionary impulse imparted by fiscal policies in 1982/83 and 1983/84 was estimated to have been in excess of 1 percent of GDP each year and to have been a significant factor in strengthening the recovery during both years. It appeared to have had no significant adverse inflationary impact, as the rate of inflation had fallen further during that period.

It would be useful to have an elaboration of the staff's position on the recent and current stance of fiscal policy, Mr. Finaish suggested. He was not necessarily advocating a change toward fiscal stimulus but rather was raising certain questions that were relevant to the stance of fiscal policy.

It was usual for staff reports for consultations with major donor countries to contain a brief section on developments in aid flows and policy, Mr. Finaish concluded. A small section on aid had been included in the present set of papers, but only in the report on recent economic developments. It had been a useful practice to include some mention of developments with respect to aid in the staff report as well, and that practice should be continued.

The staff representative from the European Department explained that the staff found it difficult to judge the short-term outlook for the U.K. economy by striking a balance among such events as the depreciation of the pound, the rise in interest rates, and the end of the coal miners' strike. The staff had not attempted to quantify the different effects, but some of them tended to operate in opposite directions. Certainly, the depreciation of sterling--which had partly reversed itself since January 1985--would, by itself, have certainly produced upward pressure on prices; indeed, the corrective action taken by the authorities had in part been motivated by a wish to avoid such pressures. Even then, the present exchange rate still differed from that assumed in the Exchequer's forecast of no change in inflation between 1984 and 1985, so that the exchange rate might be exerting some residual upward pressure. However, the end of the coal miners' strike could improve the atmosphere in the labor market, so that upward cost pressures from that quarter would turn out to be less than expected. In addition, rising interest rates would presumably tend to discourage investment. Nevertheless, the ending of the coal miners' strike and possible repercussions in the labor market might keep profit expectations more buoyant than they would otherwise have been.

One reason why the increase in investment had had little effect on unemployment so far might be that the stimulus to such investment could come from higher profit margins, which in turn had come from labor shedding, itself attributable to upward pressure on wages, the staff representative observed. Naturally, the investment stimulated by higher profits might have been gone in the direction of labor saving. In addition, the same labor-saving motivation would presumably affect the technology chosen by enterprises when they installed capital equipment.

On balance, investment had flowed out of the United Kingdom rather than into it, the staff representative conceded. Until recently, the country had, after all, registered current account surpluses. More specifically, in 1979, the authorities' decision to dismantle exchange controls had stimulated capital outflows. At the same time, capital inflows related to the oil sector had tended to level off and then fall. Nonetheless, at present, the sum of inflows and outflows should be approximately zero.

Monetary policy had recently been tightened, the staff representative observed. Whether it was tight enough was a question on which judgment should be suspended until the staff could examine the impact of interest rate changes on the growth of monetary aggregates. Although those aggregates were probably within the target ranges, caution would be advised as the possibility of errors was greater on the up side than on the down side.

At present, U.K. interest rates were probably too high, simply because of the overshoot necessary to calm market expectations, the staff representative said. Thus, it might well be consistent with the necessary slowdown in monetary aggregates for interest rates to be somewhat lower. Certainly, the stance of monetary policy had tightened, a development reflected in the appreciation of the exchange rate for the pound since January. As to the relationship between monetary policy and the exchange rate, an easing of monetary policy would not at once necessarily cause a depreciation of the exchange rate. It might take some time for the market to perceive the shift accurately, as in July 1984, when pressure on the pound had developed suddenly, in response to what had been perceived as an easing of monetary policy for some time previously. Similarly, in November and December 1984, it had seemed to the staff that monetary policy had already become too easy to maintain the stability of the exchange rate, but the markets had responded with a delay, and had then perhaps overresponded.

The staff and the U.K. authorities both believed that £M-3 had obtained such a venerable position that it would be quite difficult to eliminate it as an indicator of monetary conditions, the staff representative continued. The markets observed £M-3 very closely. However, the U.K. authorities were sufficiently cognizant of the possible weaknesses of that variable and were examining other measures: in particular, during the past year, they had introduced the monetary base as another indicator. At present, the authorities were considering an expansion in the definition of £M-3 to include deposits in building societies, which had been rising rapidly. The difficulty was that money in the theoretically pure sense was an elusive concept that was not easy to keep track of in the market.

The budget would soon be published, the staff representative noted. The authorities' position was that if the sum of the targeted PSBR and projected tax receipts exceeded government spending, there would be some room for tax relief. On the face of it, that attitude appeared defensible: if the authorities could maintain the trend of the PSBR as a proportion of GDP in a downward direction and, nevertheless, give some tax relief, then the medium-term objective of reducing the burden of taxation and thereby improving the supply side would be legitimate. On the other hand, the recent reduction in the PSBR had relied largely on temporary, transitory factors like asset sales and oil revenues; perhaps the authorities should not rush into giving tax relief too quickly.

The revenue deriving from sales of assets and petroleum had a relatively lower impact on national income, monetary aggregates, and liquidity than other types of revenue or expenditure cuts would have, the staff representative pointed out. The U.K. authorities concurred with the staff in that judgment; asset sales reshuffled the stock of assets in the economy but did not affect the flow of spending in any other way. Although that reshuffling no doubt had some effect on the spending propensities of the public and perhaps also of the Government, it would be much less than a general wage cut in the public sector. Similarly, it was quite likely that the shift in the value of oil companies' tax obligations in sterling would stimulate them to switch into sterling out of foreign currency earnings, thus offsetting some of the liquidity-restricting effects of taxation that would otherwise take place.

The U.K. authorities also had another consideration in mind--namely, that it might prove easier to accomplish needed changes in the tax structure by reducing the total burden of taxation, the staff representative remarked. Indeed, the fact that the authorities could rely on asset sales and oil revenues at the moment created a period of opportunity during which they could introduce needed tax changes while reducing the overall tax burden.

As noted by Mr. Lundstrom, the Fund staff differed with other institutions on the appropriate stance of monetary and fiscal policy in the United Kingdom, the staff representative went on. Perhaps, after the events of January in the foreign exchange markets, the other institutions would also revise their notions about how much slack had previously existed in the U.K. economy that the authorities could take up in a noninflationary way. Even with the relatively modest relaxation of fiscal and monetary policy that had occurred, there had been two occasions--in July 1984 and January 1985--when the pressure of demand, or at least of liquidity, had spilled over directly into the foreign exchange markets and had threatened the anti-inflationary objectives of the authorities. Thus, the staff's judgment, formulated in December 1984, seemed to have been validated by subsequent events.

The staff had also discussed with the authorities whether, within the context of a tight monetary policy, there might be room for some fiscal relaxation that would stimulate real demand, thus reducing unemployment; at the same time, such an increase in demand under a tight monetary policy would create upward pressure on the exchange rate and downward pressure on prices, so that there would be higher demand and lower inflation, the staff representative recalled. To some in the United Kingdom, the option was quite attractive. Nevertheless, the staff had concluded that, although such an experiment would doubtless have those specified effects in the short term, it would soon produce deleterious secondary effects.

One point made by the staff, which had been challenged by some Executive Directors, was that if the Fund were to endorse such fiscal easing within monetary constraints in one country, it would have to endorse such a combination in all countries; if the Fund did so, there would be upward pressure on real interest rates, which already seemed excessive in the world at large, the staff representative indicated. After all, the staff had often maintained that the large U.S. budget deficit was exerting upward pressure on world interest rates--the United States accounting for about 40 percent of the fiscal deficits of industrial countries--so that the increase in interest rates around the world would doubtless be quite strong if the Fund told other countries that they could relax fiscal policies to stimulate economic activity. As with protectionism, the short-run interests of any particular country might well run counter to the joint interests of all countries. Moreover, in any one country, strong upward pressure on the exchange rate that depressed prices at a time of fiscal expansion would in due course cause the external accounts to worsen, something that would offset the fiscal stimulus by a negative stimulus that would tend to dampen activity in a way analogous to the increase in interest rates that would otherwise have been occurring.

Beyond that, the decline in the exchange rate for sterling in January 1985 indicated that expectations of a continued tight monetary policy became quite precarious once the authorities widened the fiscal deficit, the staff representative said. In other words, the authorities apparently premised their actions on the supposition that monetary policy would stay tight despite the expansion of the fiscal stimulus, but few outside the Government believed that monetary policy would in fact hold steady at a time of an increased fiscal deficit. That increase in inflationary expectations would have damaging effects, not least in the labor market. For those reasons, it would be ill-advised for the authorities to relax their determination to bring down the PSBR as a proportion of GDP.

The problem to which the authorities medium-term financial strategy had been addressed had been that of stagflation, a condition where an expansion of monetary demand had been associated with such a rapid increase in prices that the real content of the monetary expansion had turned out to be quite low, and perhaps even negative, producing stagnation in growth together with inflation in prices, the staff representative went on. In other words, the excess of monetary demand had had an effect contrary to that intended: it had produced inflation rather than an expansion of economic activity. As Mr. Wicks' statement showed, under the current strategy, inflation had been declining while output had been rising.

It was undeniable that in the short run, a fiscal stimulus within the tight monetary policy could heighten economic recovery, the staff representative remarked. However, to the extent that such a fiscal stimulus raised interest rates sharply, the sustainability of such a recovery would be in doubt. If, in addition, a fiscal stimulus increased inflationary expectations, particularly through the expectation that the authorities would have to abandon the tight monetary stance eventually, such a policy would maintain inflationary expectations rather higher than they should be and, in the end, would probably produce the inflation that the policy makers had originally intended to eliminate. Therefore, the danger of such a policy would be a return to economic stagnation, where high monetary demand coexisted with high inflation and perhaps with a negative real stimulus to demand.

The economic strategy being pursued in the United Kingdom was intended to put growth on a sustainable basis, the staff representative suggested. Presumably, then, short-run measures should be shunned. The authorities should combine monetary restraint with fiscal restraint to create the room for a durable recovery of the private sector.

Rigidities in the labor market were the fundamental reasons for stubbornly high unemployment in the United Kingdom, the staff representative continued. The lack of any role for the unemployed in wage bargaining was probably the major barrier to their re-employment. That factor, by itself, did not explain why real wages had continued to rise to the point where more and more people were becoming unemployed. Some mechanisms produced real wages that were higher than was consistent with the market-clearing real wage. Apparently, when wage bargains were struck, inflationary expectations were above the realized rate of inflation. The staff needed to explain not only why the unemployed did not become re-employed but also why the employed continued to lose jobs. The discrepancy between expected and realized inflation seemed to have produced a straightforward explanation.

The first question about price expectations was whether in fact the measure used by the staff had been the appropriate one, the staff representative said. Although not ideal, it was the best one available to illustrate developments in the United Kingdom. To be sure, differences did exist in the tax treatment given to capital gains and interest earnings. However, nonindexed bonds tended to be held by institutions that were tax exempt, so that the difference in tax rates did not make for as big a difference in tax collections as might be expected. There were doubtless other imperfections in the measure of price expectations, not the least of which was, as Mr. Zhang had noted, that the expectations in the labor market and the financial market were quite different. Nonetheless, the downward adjustment in inflationary expectations in the labor market was probably even slower than in the financial market. Thus, if a pure measure of expectations in the financial market were available, it would understate inflationary expectations in the labor market. For that reason, despite its imperfections, the measure of price expectations used by the staff was at least a fair approximation, if a rough one. As to the direction of causation, perhaps inflationary expectations were remaining higher than they otherwise would, precisely because nominal wages were continuing to increase.

Another point had been made that factors other than fiscal policy or the size of the PSBR also affected inflationary expectations, the staff representative recalled. He would, on the contrary, be prepared to argue that the record of the Government in sticking to its anti-inflationary policies had to be one of the most important single explanations for the lowering of price expectations in the economy as a whole, and might indeed be the most important one.

Of course, real wages might rise for other reasons, the staff representative conceded. For example, the increased profit margins resulting from the shakeout of labor might have disposed enterprises to be more generous in awarding higher wages to employees still on the job.

Expectations about the future course of inflation had played a role, however, and the firmness of the Government's pursuit of its policies had been one of the major causes of the decline of inflationary expectations, the staff representative remarked. Not only market participants but every academic forecaster, too, had persistently overestimated the rate of inflation.

Many Executive Directors had wondered whether the statistics in Table 3 of SM/85/44 had covered more workers than had participated in trade union wage bargaining, the staff representative continued. Actually, real wages in manufacturing had been more buoyant than in the economy as a whole. However, not all those working outside of manufacturing were nonunionized; a large number of unionized nonmanufacturing labor consisted of public sector employees. Perhaps part of the reason why their real wages did not increase as fast as those in manufacturing had been because of delays in implementing new wage contracts. They might soon catch up.

It had been argued that a cut in real wages would not necessarily expand employment because it would reduce consumption and therefore presumably aggregate demand also, the staff representative said. Within the framework of the MTFS, a slowdown in nominal wage increases would trigger at least a potential upward adjustment in real demand as well; with money wages lower than they otherwise would be, the same monetary targets would accommodate higher real demand. Consequently, greater real demand within the same monetary target would ensure that some of the cut in real wages would be translated into higher employment. In fact, the Exchequer had calculated that there would be a 0.75 percent increase in employment for every 1 percent reduction in real wages.

There had been some reduction in the replacement ratio because of the abolition of the earnings-related supplement and because of the taxation of unemployment compensation, the staff representative noted. The authorities would nonetheless agree that a great deal more needed to be done.

On the question of public sector wages versus private sector wages, the U.K. authorities had been challenged to apply wage restraint in the public sector, the staff representative observed. There had been some such restraint, but there could be more; the actual wage contracts had exceeded by a small margin the intended increases.

The argument had been made by Mr. Pérez that perhaps the authorities could cause real wages to increase less rapidly by reaching a social consensus, perhaps in the form of a social contract, the staff representative stated. Recent events in the U.K. labor market would cast doubt on whether any such agreement could take place soon. On the other hand, the statutory incomes policy would probably affect inflationary expectations adversely because it might be interpreted as meaning that the authorities were not going to pursue the medium-term financial strategy with the same rigor as previously and that they were resorting to an incomes policy as an alternative measure to keep real wages down.

As to the adequacy of the exchange rate after it had declined somewhat in real terms, the staff representative from the European Department commented, an attempt to absorb the currently unemployed by raising demand would still lead to a sharp deterioration in the external accounts and strong inflationary pressures. Thus, the competitiveness of the U.K. economy still required further improvement, but continued reductions in the nominal exchange rate for sterling would turn out to be only a short-run solution. He agreed with those Directors who had said, in agreement with the U.K. authorities, that the feasibility of reducing the real exchange rate through nominal exchange rate changes was probably limited because of the consequent inflationary effects of such a move.

Mr. Wicks recalled that Mr. Zecchini had wondered, perhaps rhetorically, whether a statement made in the staff report--that the U.K. authorities had no intention of changing their economic strategy--meant that they took no notice of what happened in the Executive Board or of the Fund's responsibility for surveillance. The economic strategy in the United Kingdom had had the general support of the Board for some years; the authorities were trying, with certain difficulties, to continue to follow what the Board had endorsed in previous years.

After the coal miners' strike had been settled, interest rates and the exchange rate had changed substantially, Mr. Wicks noted. In ten days' time, he would be able to circulate the official budget forecast to his colleagues. However, the authorities' determination in implementing the strategy had been shown in the increase in interest rates by 4.5 percent in January. The authorities could have tried to avoid that increase by performing some monetary manipulations and injecting some short-term credit into the market. As it had turned out, they had acquiesced in the interest rate rise because it lay at the heart of their strategy of controlling inflation. A second piece of evidence of the authorities' determination had been their handling of the coal miners' strike, which had been a searing experience; in such situations, if national authorities lacked the requisite determination, they could opt for a face-saving compromise. Although not seeking confrontation, the U.K. authorities had been determined in their resolve to close down uneconomic pits.

The U.K. authorities' policy had been one of taking advantage of the window of opportunity, Mr. Wicks continued, and they had laid the basis for sounder growth with low inflation. The prospects were good that growth would continue in the years ahead, although not uninterruptedly because of the business cycle. If the authorities could maintain public expenditure broadly constant in real terms, the situation adumbrated for the PSBR in 1993/94--which a colleague had termed idyllic--ought to come about. The strategy was feasible and realistic.

He would accept that overfunding could be regarded as a form of disintermediation, Mr. Wicks continued. However, overfunding did affect liquidity in the economy and, to that extent, affected nominal spending and fulfilled a function in monetary policy.

The monetary authorities kept close track of supplementary indicators such as PSL-2 and the exchange rate, Mr. Wicks remarked. It was only fair to point out that PSL-2, a broad measure, was currently subject to some distortion: like most countries, the United Kingdom was experiencing financial innovations that tended to distort PSL-2 upward; the composition of building societies' liabilities to the public was changing and appearing in PSL-2 for the first time. The shift represented an accounting change and meant little in terms of monetary demand or policy, but it did inflate PSL-2 somewhat. The main monetary aggregates tracked by the authorities--£M-3 and M-0--were used because evidence showed that they were the best indicators of fundamental monetary conditions.

Short-term interest rates had risen substantially in recent months, while long-term interest rates had by no means gone up so far, Mr. Wicks observed. That smaller increase in long-term rates should reassure Executive Directors who had expressed concern about the effects of higher interest rates on investment and growth as well as those who had wondered about the effect of higher interest rates on the fiscal deficit. Obviously, higher interest rates would mean that the authorities would have to pay more in servicing the public debt. However, since the public debt was of a fair maturity, the increase would be smaller than it might at first appear.

He agreed with Executive Directors who had doubted whether the divergence between the yield on indexed gilts really served as a good indicator of inflationary expectations, Mr. Wicks went on. At present, his authorities appeared to place little stock on that divergence. In addition, the narrowness of the market for indexed gilts tended to depress the yield, as did the insurance against possible inflation inherent in indexed gilts. All those factors seemed to exaggerate the divergence between the yields on the two types of gilts, thus leading to a slightly exaggerated view of inflationary expectations as set out in Table 3 of SM/85/44.

The authorities had not taken the decision never to join the European Monetary System (EMS), Mr. Wicks said. Rather, they were keeping the matter under review. In the U.K. press, the impression might have been given that if the United Kingdom had joined the EMS, some of the problems with interest rates and the exchange rate recently experienced might not have occurred. Personally, he considered that joining the EMS would not have substituted for internal financial discipline.

During a recent visit to Washington, the Prime Minister had announced that she supported President Reagan's call for a new GATT round, Mr. Wicks recalled. In addition, his authorities would pursue their efforts to reform the Common Agricultural Policy of the European Community and expected to be fully involved in initiatives for liberalizing trade both inside and outside the European Community in goods as well as services.

The ODA provided by the United Kingdom had a grant element as high as 98 percent, well above the DAC average, Mr. Wicks noted. Moreover, the authorities sent two thirds of that ODA to the poorest countries. In

1984/85, the aid provided had amounted to £1.09 billion; in 1985/86, it would rise to £1.13 billion, then to £1.17 billion in 1986/87. For 1987/88, the authorities were planning for about £1.22 billion, so that in cash terms there would be a small rise from year to year.

He agreed with the staff and Executive Directors that rising real wages were at the heart of the United Kingdom's economic difficulties, Mr. Wicks said. The staff was correct in ascribing to labor market rigidities the rising level of real wages at a time of high unemployment. Although he did not believe that trade union leaders adopted the cynical attitude of preferring higher pay for their members while being less concerned about unemployment, the United Kingdom had a history of strong pressure for higher pay that was taking a long time to fade. The best way would be to alter labor market mechanisms so that market forces could have a greater scope to operate. In an economy that had not been performing adequately over a long period, where attitudes and practices had become well entrenched, time was required to promote structural adjustment. His authorities were going to continue to push for reform and to restructure the economy so that it could become a good deal more competitive and could play a larger part in world economic affairs than it had done during the past few years.

Mr. Finaish recalled that the staff representative from the European Department had said that if the Fund endorsed a certain fiscal stance for the United Kingdom, it would have to do so for other countries as well. Surely the need for a certain adjustment in the United Kingdom or any other country would be related to the specifics of the case. There should be no presumption that the Fund had a uniform set of policies for all countries, although it should treat all countries equally.

The staff representative from the European Department expressed agreement with Mr. Finaish's clarification. Nevertheless, there were other countries in circumstances similar to those of the United Kingdom that might also wish to increase their fiscal deficits.

Mr. Zecchini noted that Mr. Wicks had confirmed both that the U.K. authorities attached importance to the role of Fund surveillance and that they assumed beforehand that a Fund consensus existed on the appropriateness of their policies. He had reservations about some of the views expressed by the staff. It seemed that the staff had been making a case wherein the policies pursued in the United Kingdom involved costs in the short run that should be assessed in the light of the larger benefits that would accrue in the longer run. Yet did the five-year period of the U.K. economic experiment to the present still fall within the domain of the short run and its related costs, or should it be regarded more appropriately as part of the longer run, involving prolonged costs? In addition, the staff representative had not dealt adequately with the nature of the unemployment problem and the policy response that should be given. In the United Kingdom, there were clear advantages in pursuing a trade-off between real wage flexibility and an aggregate demand stimulus. Attention should be paid to the fact that the cyclical adjusted fiscal position showed a significant surplus. Perhaps some of the answers given to explain the links between exchange rate depreciation and the stance of monetary and fiscal policy on the basis of common sense could be challenged on theoretical and analytical grounds.

The staff representative from the European Department responded that he looked forward to participating in a discussion with Mr. Zecchini on the points that he had raised.

The Chairman gave the following summing up:

Directors commended the U.K. authorities for the role that their policies had played in improving the performance of the economy. They noted that the recovery had continued in 1984 despite the coal miners' strike; manufacturing had posted its largest gains since 1973, and fixed investment was showing a healthy increase. In view of the ending of the strike, prospects seemed favorable for further output growth this year. Directors expressed concern, however, about recent trends in inflation. They observed that the previous deceleration had stopped, and that the rate of price increases continued to exceed that of some of the main trading partners. Directors stressed their particular concern about the continued rapid increases in unit labor costs in the United Kingdom. Real wages in the economy as a whole continued to rise--in the manufacturing sector the increases had actually accelerated in recent years--while at the same time unemployment continued to increase to a very worrisome 13 percent of the labor force.

Directors noted the sharp depreciation of sterling in the past year; in real effective terms, the depreciation had exceeded 10 percent between the previous Article IV consultation and January 1985. While these exchange rate movements appeared broadly appropriate in view of the need to improve the competitiveness of the non-oil sector, several Directors feared the inflationary consequences of such movements. Noting that the depreciation in large part reflected the market's perception of some relaxation of financial policies, a number of Directors questioned whether financial policies had been sufficiently tight to consolidate the progress made against inflation.

Directors noted that the public sector borrowing requirement (PSBR) for 1984/85 had been revised upward. While some Directors saw a role for a more relaxed fiscal policy to help take up the apparent slack in the economy, most Directors expressed regret at the slippage from the 1984/85 budget's spending targets, granting that in large part this had been due to the coal miners' strike. More fundamentally, a number of Directors felt that the implementation of the Government's medium-term fiscal strategy appeared to have lost some of its initial vigor. While the

Government wished to reduce the size of the public sector, in fact, since 1979 public spending had increased by some 4 percentage points to about 46 percent of GDP. In the same period, Directors observed that the reduction in the PSBR had been largely due to transitory factors. Thus, little progress was being made toward the objective of creating room to reduce the burden of taxation on a permanent basis. Directors welcomed the authorities' intention to return to their earlier commitment to holding public spending in real terms to the 1983/84 level. They encouraged the authorities to improve controls over public expenditures, especially those of the local authorities.

Many Directors expressed concern about the stance of monetary policy. They worried about the continued rapid expansion of some financial aggregates in the 1984/85 target period, in particular the rapid growth in M-2 and PSL-2. While acknowledging that special factors could explain these growth rates, Directors thought that the evidence suggested that monetary policy had been too lax prior to January. Noting that the effect on £M-3 of the very rapid growth in bank credit had been offset by overfunding the PSBR through higher sales of government securities, some Directors wondered whether the inflationary impact of credit increases could be fully neutralized by such action. On the whole, Directors thought that the bold increase in interest rates in January had been warranted to slow the decline in the exchange rate for sterling and to provide the basis for the tighter monetary conditions necessary to effect the desired wage and price restraint.

Directors regretted that unemployment had continued to rise and feared that the continuing growth of real wages would limit job creation and contribute to a further rise in unemployment over the near term. While some Directors believed that greater priority should be attached to reducing unemployment by some relaxation of fiscal policies, most Directors cautioned the authorities against taking chances with financial policies that could be construed as a weakening of the resolve to eliminate inflation. In this connection, the latter Directors stressed the importance of maintaining the downward momentum of inflationary expectations and noted the possibility that an attempt at expansion could backfire by reigniting inflationary expectations and widening the gap between actual and expected inflation. On the other hand, Directors found it encouraging that employment had continued to increase. Some thought that the large increases in part-time jobs for women testified to the strength of market mechanisms in the economy and suggested that there was scope for further reductions in distortions introduced by government regulations.

Directors commended the authorities for their program to improve the efficiency of the economy. In addition to the reforms in financial markets, they noted the reform of corporate taxation designed to end distortions created by favorable tax treatment of investment in fixed and working capital. Directors hoped that steps toward remedying the deep-seated distortions in the labor market would also be forthcoming.

Mindful of the strengthening of protectionist pressures in the United Kingdom, a number of Directors stressed the importance of trade policy liberalization in industrial countries as a requirement for continued recovery in the world economy as a whole, and hoped that the United Kingdom would continue to play a leading role within the EC in rolling back formal and informal barriers affecting imports of manufactures. Directors noted with approval the sizable private financial flows to developing countries, and also urged the authorities to increase the amount of their official development assistance.

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

2. BAHRAIN - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Bahrain (SM/85/45, 2/7/85). They also had before them a report on recent economic developments in Bahrain (SM/85/57, 2/19/85).

Mr. Finaish made the following statement:

The diversification of activity in the non-oil sector is a central element of the economic strategy that has been followed in Bahrain for the attainment of sustained growth with financial stability. The Bahraini authorities, aware of the depletability of crude oil resources, have endeavored consistently, and with a good measure of success, to develop new activities in manufacturing and services. The process of expanding the non-oil sector has progressed at a steady pace and the share of crude oil production in GDP now stands at about 20 percent. Developments in the past few years have demonstrated the significant contribution of diversification policies to the country's ability to withstand the impact of adverse conditions in the international oil market. The economy grew by 8 percent in 1983 and the estimated growth rate for 1984 is about 5-6 percent, with a similar rate projected for 1985. Nevertheless, Bahrain's export receipts and budget revenues still depend considerably on general oil market conditions, including the demand for various hydrocarbon-based products. The persisting weakness in the global oil market has therefore induced policy adjustments in several areas.

Having made important strides in new areas of activity, Bahrain's diversification effort is now reaching a stage of consolidation as well as adaptation to the changing environment. The oil industry has moved from an almost total dependence on crude petroleum to the establishment of a large refining industry utilizing mainly imported crude and catering for the export market. Action has been directed in the recent period to reversing the present trend of depletion of onshore oil fields as well as exploring methods to enhance the utilization of the existing refining capacity. An extensive exploration program for oil and gas has been in place. Efforts have also been made in the refining industry to introduce processes to improve profitability by increasing the output of more profitable products and by reducing costs, and some encouraging results have already been realized. Furthermore, the authorities have been exploring the possibilities of processing crude oil imports on a fee basis. On the other hand, unfavorable market prospects have not made it possible to proceed with a major regional joint venture for heavy oil conversion.

The strategy regarding manufacturing industries has also been to diversify into lines of production that are considered feasible. Since the early 1970s Bahrain has been engaged in a major effort--with active regional cooperation, currently within the framework of the Gulf Cooperation Council--to exploit the plentiful natural gas resources in developing new industries, particularly aluminum, iron and steel, and petrochemicals. This strategy has already shown its value in offsetting some of the adverse effects of the present weak oil market. This was evident in 1983 when the real value added in the non-oil manufacturing industries increased by over 25 percent, thus serving to compensate for the decline in oil refinery output. The change in the prospects for oil receipts has contributed to a shift in industrial policy from promoting large-scale industrial projects with direct government participation toward private sector projects in light manufacturing industries. This policy shift does not only reflect the move toward overall fiscal restraint but also an attempt to consolidate the gains made thus far in the industrial field by deepening and spreading the impact of the established large industries and thereby helping to foster a more integrated industrial structure.

Pressures on the fiscal balance were expected to emerge as oil revenues normally account for over two thirds of budgetary receipts. A deficit appeared in 1982 in the overall government finances and, in 1983, also in the budget. This situation is estimated to have persisted in 1984 and is expected to continue in 1985. In the past two years, the authorities have responded in a number of ways to contain expenditures and improve revenue performance. The most significant step taken in early 1983 was to stretch the large Economic and Social Investment Program from four to six years, and the total budgeted outlays of the program were also reduced somewhat. As the impact of this curtailment was not expected to be felt in 1983, the rate of growth of current expenditure was cut from 23 percent to 6 percent to ensure a more immediate adjustment of outlays. The measures taken in the past two years included cuts in subsidies for utilities and fuel as well as a wage freeze in the public sector. Revenue measures included increases in rates of customs duties on some commodities, an increase in registration fees for banks, a charge on the gas input of Bahrain's National Gas Company, a charge on the electricity department for the gas used in generators, and a change in the method of billing municipal rates designed to raise revenue and reduce the cost of subsidy. Further measures are being contemplated to raise domestic non-oil revenues and contain the growth of expenditures in the period 1985-91. Specific limits have been suggested on the growth of current spending and the provision of services, and re-evaluations of capital projects have been proposed to ensure viability and conformity with needs. A set of revenue measures previously submitted by a Fund mission is under consideration, including a tax on the wages of expatriate labor and various fees and rates on services and utilities.

Monetary policy in recent years has sought to ensure stable domestic conditions conducive both to growth of the economy and the maintenance of Bahrain as an international financial center. In 1983 liquidity growth decelerated markedly, and the rate of inflation fell sharply following the acceleration of the preceding years. Although domestic liquidity increased at a faster rate in 1984, it partly reflected certain nonrecurring factors and is expected to moderate in 1985. The credit and interest rate policies remain directed at ensuring adequate growth of domestic investment within the context of financial stability. The authorities are prepared to adopt a more active interest rate policy if capital flows necessitate a move in that direction. The prudence exercised in its policies by the Bahrain Monetary Agency continues to provide an assurance of a stable and healthy functioning of the offshore financial market, which now ranks as a major international financial center. In the past several years, offshore banking experienced rapid growth in assets and income and its contribution to the local economy reached a share in GDP of 12 percent in 1983. More recently, however, growth in the offshore market has slowed, reflecting, as expected, declining oil receipts in the region and the uncertainties prevailing in capital markets. To ensure stability in the offshore market, the monetary authorities continue to exercise an appropriate supervisory role. To this end, the format of monthly balance sheet returns submitted by offshore units has been improved and a prudential information return for both domestic and offshore banks has been introduced. The latter is designed to help supervisors to diagnose problems before they assume serious proportions.

The external balance has come under pressure in the past two years mainly as a result of the weakening oil trade balance. Uncertainties about the likely course of the external sector in 1985 make firm projections difficult. Some major elements of the external balance remain beyond the policy control of the authorities. The authorities, however, have sought over the years to effect a gradual structural change in the external balance through greater diversity in exports and service receipts. This policy has shown results in mitigating somewhat the impact of the recent adverse shift in oil trade. Particularly significant in this regard was the increase in aluminum exports and service receipts from the offshore units in 1982 and 1983. With respect to the exchange rate, a more active policy at present is not expected to have any meaningful impact on the main components of the external balance and the staff has noted that it does not seem that Bahrain's non-oil exports or service receipts have so far been hampered by the appreciation of the effective exchange rate. The authorities consider the prevailing rate appropriate in the circumstances and feel that any depreciation would exert an upward pressure on prices and could encourage speculation. The situation, however, is being carefully monitored and the authorities maintain an open mind on exchange rate flexibility in case the need arose.

Looking at the medium-term prospects, the external environment will continue to exercise an important influence on future developments in the economy. This notwithstanding, a major positive development with potentially wide-ranging effects will be the completion later this year of a causeway linking Bahrain to Saudi Arabia. The authorities are in the process of assessing the opportunities for trade in goods and services that it is expected to open for private sector activity. The search for wider horizons has even led to exploring the feasibility of a large land reclamation scheme to ease the pressure on land. This search for new opportunities is typical of Bahrain's determined approach to meeting new challenges that it, as a small open economy, faces along its path of development.

Mr. Suraisry observed that in 1983 and 1984, the economy of Bahrain had enjoyed strong growth, escaping the recessionary impact of recent developments in the oil market. It was encouraging that the growth had been noninflationary and had not jeopardized the gradual adjustment efforts begun in 1983. The authorities were to be commended for the steps they had taken to increase revenue and contain the growth of expenditure. In particular, as both Mr. Finaish and the staff had stated, the Economic and Social Investment Program had been stretched from four to six years, and growth of current expenditure had been substantially reduced. Nonetheless, further efforts were called for to reduce the overall fiscal deficit; and he saw merit in the staff's recommendation to integrate the extrabudgetary accounts into the budget, which should help the authorities to strengthen the public finances.

The projected increase in the growth of current expenditure in the 1985 budget should not be cause for concern, Mr. Suraisry continued. It represented a once-for-all increase following a freeze in 1984; and, as could be seen from the technical reports before the Council of Ministers, the authorities were determined to continue their policy of restraining the growth in current expenditure and were considering a package of revenue raising measures. Aside from helping the fiscal stance, the measures he had mentioned should be adequate to reduce the growth in domestic credit. Assuming they were implemented soon, he saw no need for increasing interest rates as the staff had argued. Interest rates had not been changed since January 1983, but that did not appear to have had an adverse impact on the economy. He was not convinced that interest rates should be revised at a time when international interest rates were generally declining; it was far more important to strengthen the public finances.

The balance of payments had been weakened by exogenous factors such as the oil market and the state of the world economy, Mr. Suraisry observed. It was estimated that an overall balance of payments deficit might emerge in 1985; however, the adjustment measures that the authorities were undertaking should strengthen the balance of payments position. The authorities had been successful in diversifying the economy and, as a result of an export-oriented strategy and the establishment of a major international financial center, about 80 percent of GDP was at present created in the non-oil sector, which had moderated the negative impact of the weak oil market on the Bahraini economy and had provided a major role for the private sector in the development process. The authorities should be commended for their diversification achievements.

The successful diversification strategy and the emphasis on the private sector had put Bahrain in a position to take full advantage of the new opportunities created by the Gulf Cooperation Council (GCC), Mr. Suraisry commented. The private sector in Bahrain had gained the necessary knowledge and experience to become fully involved in economic activity, although it had been constrained somewhat by limited market outlets and investment opportunities. The far-reaching measures that GCC members had taken to coordinate their economic and financial policies had unified all the GCC markets for goods and services produced in member countries. Those measures had also made the factors of production readily available for entrepreneurs in member countries. The private sector in Bahrain at present had a larger market and new opportunities, not only in Bahrain but also in other GCC members, a situation that should be mutally beneficial to all.

The causeway between Saudi Arabia and Bahrain, which was expected to be completed in 1985, provided yet another important dimension to the outlook for the Bahraini economy, Mr. Suraisry remarked. Once opened, the causeway should facilitate the movement of goods and services, reduce transportation costs and strengthen ties between the two economies, which would assist diversification in Bahrain while benefiting the Saudi economy as well. He would be interested in seeing a detailed analysis of those factors, and their implications for Bahrain, in the next Article IV consultation report. In sum, the economic prospects for Bahrain had been greatly enhanced by the GCC; if the international economic environment improved further, those prospects would be even brighter.

Mr. Msadek remarked that the economy of Bahrain was characteristic of those of the Persian Gulf State members of the Gulf Cooperation Council (GCC) that had experienced or were experiencing a major shift in approach following a decade of heavy dependence on oil revenues. Broadly speaking, the decline in oil revenues coincided with the end of the first phase of industrialization and was forcing the majority of the Persian Gulf States to limit the providential nature of the State, encourage the private sector, and rationalize consumption. Since 1981, oil revenues had been cut in half.

The financial crisis affecting Bahrain had slowed that country's economic activity and rate of growth and had reduced its liquidity, Mr. Msadek continued. The crisis had also coincided with the completion of modern infrastructures, which had required large investments and had not been implemented without costly errors. It had also led to the emergence of a strong private sector endowed with important resources. In pursuit of its new development strategy, Bahrain had adopted several measures aimed at modifying the economic model in place during the phase of expansion and directing it toward a phase of consolidation. After having reduced public expenditures by 20 percent over the past two years, the authorities had cut subsidies and had undertaken to reduce the consumption of energy, which, if left unchecked, could surpass the export level by 1990. Petroleum products were at present taxed and, as their prices had increased by 70 percent, receipts from tax recovery had doubled. Furthermore, Bahrain was encouraging the private sector to replace the State in many activities. The role of the private sector in GDP had grown to 40 percent and was expected to reach 55 percent in 1985; at the same time, State companies--such as the airline--were being privatized. Finally, the reduction in oil revenues was leading to a rapid decline in the number of foreign workers, which currently represented 70 percent of the labor force.

Despite the apparently gloomy appraisal of the Bahraini economy, it was clear that the authorities had taken a number of positive steps on the road toward economic diversification; and the results of their efforts since the previous Article IV consultation discussion were generally favorable, Mr. Msadek commented. The success of the authorities could best be illustrated by the fact that the non-oil sector had accounted for approximately 80 percent of total GDP in 1984. A diversification effort--particularly in the aluminum sector--had required strong government incentives to the private sector as well as the development of a dynamic international financial sector. While the rate of growth had declined from 8 percent in 1983 to 5.6 percent in 1984, it appeared that the latter level would be maintained in the coming year.

The reduction in subsidies in electricity and water, together with the taxes on non-essential products should limit the budget deficit to 5 percent of GDP, particularly since major capital expenditures were projected to decline with the completion of some major projects and the stretching out of others, Mr. Msadek noted. Externally, the sharp decline in oil prices in 1983-84 had strongly affected the trade balance, while non-oil imports had grown as a result of the growth in GDP. In the circumstances, the overall balance of payments was projected to register a deficit in 1984 and 1985 of approximately $30 million and $80 million, respectively, as against a surplus in 1983 of $130 million. However, because of the concessionary nature of the loans contracted by Bahrain, debt service payments would be less than 1 percent of export earnings while the total external public debt would equal only about 5 percent of GDP, a small amount by international standards. That did not mean, of course, that Bahrain should not monitor its external position carefully; on the contrary, and in view of the continuing reduction in oil reserves, a tight watch on the balance of payments should be maintained and reinforced with measures that would check the outflows of savings deposits abroad by providing profitable investment opportunities at home and by reorienting valuable resources to more productive ends.

Bahrain should not, in his view, entertain great hopes from the causeway, since the economies of the region were competitive rather than complementary, Mr. Msadek said. Moreover, in the absence of substantiating evidence from the staff, he was uncertain about the extent of trade, if any, that would result from the new road. Finally, he saw no indication that the momentum of economic growth after 1985 would be sustained, especially given the gloomy picture for world oil prices and the limitation on further resource diversification in Bahrain.

Mr. Templeman commended the Bahrain authorities for their prudent and early response to changes in the international oil market during 1983 and 1984. The policies pursued, particularly in the non-oil sectors of the economy, had placed Bahrain in a comparatively better position at present to withstand the effects of the oil price decline. In response to strains in the fiscal sector--created mainly by decreases in oil revenues--the authorities had succeeded in implementing a cutback in the growth of current expenditures while extending the Economic and Social Investment Program and introducing revenue-enhancing measures.

The extrabudgetary situation had also improved somewhat during 1983 and 1984, although overall net extrabudgetary expenditures were estimated to have been BD 52 million--or approximately half the overall fiscal deficit--in each of the two years, Mr. Templeman continued. Hence, he could support the staff's call for integration of the extrabudgetary accounts on both the expenditure and revenue sides into the budget accounts in order to strengthen the authorities' control over expenditure. Such control was particularly important in light of the projected overall budget deficit of BD 95 million in 1985--equivalent to approximately 4.5 percent of GDP--which was only marginally lower than the estimated overall budget deficit of BD 100 million registered in 1984. Noting that the authorities were considering new measures to address the deficit, he expressed an interest in knowing more precisely what areas were targeted for further reduction in current expenditures, particularly those proposals for eliminating certain subsidies. From Mr. Finaish's statement, it appeared that additional measures might include increases in rates on services and utilities. While still on the budget, he observed that Bahrain had experienced a substantial decline in grants from neighboring countries in 1983 and 1984, and he wondered about the cause of the decline and whether it had any implications for future revenue needs.

To shield the economy from the impact of oil market changes, the authorities in Bahrain had taken steps to diversify the economy, often through joint ventures with neighboring countries, Mr. Templeman said. While industrial development in the past had been financed primarily by the Government, the plan for the future was to encourage private sector initiatives through various incentives in the light manufacturing industries. Growth in other areas of Bahrain's private sector was also needed; in that respect, the causeway linking Bahrain to Saudi Arabia should have a positive impact on growth in the private services sector. He would be interested in hearing how the Bahraini authorities planned to take advantage of the opportunities presented by the causeway. Also, the offshore banking sector had played an important role in the development of Bahrain's economy. He supported the efforts of the offshore banking units to diversify in order to remain viable in a competitive international financial market.

Some restraints on domestic credit were needed to improve Bahrain's external position, Mr. Templeman continued. Such restraint could be accomplished partly through a more active interest rate policy. The relatively low levels of interest rates in Bahrain by comparison with those in the international markets might have added to the demand for credit for arbitrage purposes, reducing private capital available for domestic investment. He understood the Bahrain Monetary Agency's need to be concerned about the effect of domestic interest rates on investments, and it was his understanding that the Bahrain Monetary Agency did not directly set interest rates. Yet it did recommend rates that were generally accepted and could help initiate interest rate behavior that would be more responsive to interest rate developments worldwide. Finally, the recent weakening in the balance of payments--due mainly to the decline in oil prices--and the possibility that an overall deficit might emerge in future were deserving of attention. The staff and the authorities did not seem concerned about the appreciation of the dinar in terms of its possible effect on non-oil exports and services, despite the worsening trade and balance of payments position. However, given the desire of the authorities to diversify the economy and increase private sector exports, he wondered whether continued appreciation of the rate could safely be ignored.

The staff representative from the Middle Eastern Department, responding to questions, observed that the authorities were reviewing some recommendations--made in the context of a technical assistance mission from the Fund--for expenditure cuts. Among those recommendations were reductions in energy and food subsidies. In addition, the authorities had not indicated to the staff mission the factors underlying the decline in grant levels in the budget. Finally, with respect to the appreciation of the dinar, the staff had cautioned the authorities that the movement of the real value of the dinar should be kept under review, particularly as it affected the export-oriented industries and the profitability of the import-substituting industries in Bahrain. As requested, the staff would seek to examine in the next consultation report the implications of the causeway for the Bahraini economy.

Mr. Finaish observed that as reflected in Bahrain's balance of payments and in the budget, the oil situation generally had adversely affected the Bahrain economy; while perhaps somewhat less important than in other countries in the region, oil nonetheless represented four fifths of exports and two thirds of the budget. Indeed, the impact of the oil situation might well provide some answer to Mr. Templeman's question about the decline in grants from other countries in the area, many of which had also been affected by the decline in oil prices.

The authorities in Bahrain had been reasonably successful in their efforts to diversify the economy, Mr. Finaish continued. Offshore banking, for example, had been highly successful. The banks concerned had assets of some BD 60 billion and were contributing significantly to employment, GDP, and the balance of payments. Of course, the growth of offshore banking could not be expected to continue at the high rates registered in 1979-82, especially given changes in the oil situation and in revenues in the area. Still, the authorities were counting on an increased contribution to the economy in future, particularly in the area of investment banking.

The causeway, a 25-kilometer bridge road between the eastern part of Saudi Arabia and Bahrain, should be completed before the end of 1985, Mr. Finaish commented. Bahrain had established a Ministerial Committee to study the economic and social impact of the causeway, and more information on it would be available when the study had been completed. It was already clear that the causeway would facilitate the movement of people and goods between the two countries; what was left to determine was how best to benefit from that movement.

As he had noted in his opening statement, the authorities considered the present level of interest rates to be appropriate, Mr. Finaish remarked. Of course, they must balance domestic considerations--including the availability of credit at a reasonable cost for economic development--with balance of payments considerations. Because there was always a risk of excessive outflow of capital, the authorities would keep a close eye on the interest rate level. As for the exchange rate, it should be noted that, during the consultation discussions, neither the staff nor the authorities had felt there was any need at present for a review.

Mr. Suraisry considered that the reduction in foreign grants to Bahrain should not be cause for concern. Members of the Gulf Cooperation Council (GCC) met regularly to assess their economic policies and to discuss what they had achieved or wanted to achieve in various areas, including those areas affected by the provision of grants. He was certain that, if the need for more grants should arise, the members of the GCC would stand ready to meet that need.

The Chairman made the following summing up:

Executive Directors commended the Bahrain authorities for the success achieved in recent years in diversifying the economy in order to reduce dependence on the petroleum sector. Export-oriented industry has been established, and Bahrain has become a major international financial center. Partly as a result of those developments, the non-oil sector at present accounts for about 80 percent of GDP. More generally, the growth of the economy has been brisk and increases in prices have been moderate. Bahrain's membership in the GCC and the soon-to-be-completed causeway between Bahrain and Saudi Arabia were seen by several Directors as likely to have a positive influence on future developments in the economy.

Directors observed that the changed conditions in the international petroleum market had been reflected in a weakening of Bahrain's fiscal and external positions and that, in response, the authorities had begun to introduce measures to adjust to the changed circumstances; for example, action had been taken to curtail expenditure growth. With regard to the future, Directors agreed that the package of further fiscal measures currently under consideration by the authorities represented a commendable effort, and they advised that the package be implemented forthwith. More particularly, Directors stated that early action on the diversification of revenue sources was needed, and they recommended the integration of the extrabudgetary accounts into the budget. Furthermore, they said, some degree of monetary restraint would support the policy of fiscal restraint in helping the balance of payments.

Directors observed that there had been a steady erosion in the overall external surplus in recent years and that a deficit might emerge in 1985. They also noted the strong appreciation of the dinar in real effective terms in recent years and that the authorities were keeping an open mind on the matter of exchange rate flexibility in case the need arose.

It is expected that the next Article IV consultation with Bahrain will be held on an 18-month cycle.

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LEO VAN HOUTVEN
Secretary