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HER MAJESTY'S TREASURY

IMF: UNITED KINGDOM CONSULTATIONS 1984

Attached is a copy of the concluding remarks delivered by Mr Schmitt, Head of the IMF team, at the closing session of the Article IV consultations on Monday 10 December.

H M TREASURY

December 10, 1984

Concluding Remarks

1. The United Kingdom has been an early pioneer in the pursuit of policies that have become an international norm. It is now part of a broad consensus among the major countries that the control of inflation is a necessary condition for sustained economic growth. It is also generally accepted that this objective is to be achieved by monetary and fiscal restraint. The experience with such policies in the United Kingdom is therefore of keen interest to the international community which we represent.

2. The success you have had with your financial strategy has been considerable, but it has not been without stress. The growth in nominal GDP has been lowered progressively from over 15 percent in 1979-80 to less than 7 percent by the first half of 1984, and the split between price inflation and output gains has become more favorable. Price inflation has been brought down below 5 percent--but wage inflation remains at nearly 8 percent. Output growth reached 3 1/2 percent in 1983 and on a strike-adjusted basis in 1984 as well--but not without putting pressure on the external position. And unemployment has contined to increase and now stands at 13 percent of the labor force.

3. With inflation down to a much lower level, increasing concern is being expressed about unemployment. There are two views on the mix of factors that have brought it to its present level, and on the most effective

ways of ameliorating it. According to one view, a large part is attributable to a persistent deficiency in aggregate demand stemming from overly restrictive financial policies. According to the other view, the bulk of it is attributable to excessively high and rising real wage levels. We see greater risks in tilting towards expansion than in maintaining restraint.

4. We appreciate that it would be less difficult for you to sustain downward pressure on prices if unemployment had come down as you expected it to do a year ago. We also understand that any tilting is taking place within the scope of a broadly unchanged medium-term strategy. You continue to target a zero inflation rate, at least by 1993; by that time you expect the PSBR to have come down to 1 percent of GDP, a rate that would allow the public debt to rise in tandem with nominal GDP. We are nevertheless concerned about a policy stance this year and next that promises no better than to leave price inflation unchanged at just under 5 percent.

5. The expansion of your main monetary aggregates has thus far remained within the target ranges set for them at the beginning of the financial year. However, these target ranges have proved consistent with developments in domestic interest rates relative to those abroad that have depressed the exchange rate by as much as 10 percent in the twelve months to October 1984. There has been need on occasion, particularly in July, to adjust interest rates upward to minimize the inflationary threat from this quarter. There clearly is a limit to the extent to which the U.K. can decouple its real interest rates from those in the U.S. in current conditions of fairly mobile capital. To the extent it cannot, monetary expansion will only depress the exchange rate and drive up prices.

6. Though the main monetary targets may still be met this year, the PSBR is all but certain to exceed the level specified in the budget. The whole of the excess is due to spending overruns inasmuch as revenues are also higher than anticipated. However, any adverse effects on domestic interest rates from the higher borrowing requirement is likely to be small, linked as domestic rates are to those abroad, and the net stimulus to activity is therefore likely to have been appreciable. Within a given monetary environment, furthermore, the higher level of activity is likely to have held exchange rates up and prices down compared to where they would otherwise have been.

7. A progressive lowering of the PSBR was originally intended to minimize the effect of the anti-inflationary strategy on interest rates. Now that this effect appears to be much smaller than once thought, the urgency of reducing the borrowing requirement looks to be rather less strong than before. To bring it down this year and next increased reliance is therefore being placed on oil revenue and on asset sales neither of which have a major impact on demand or on monetary conditions. Making the necessary adjustments shows the PSBR rising in relation to GDP not only above the level budgeted for this year, but above the level registered the year before (see Table).

8. While such developments may not appear overly disquieting in the immediate present, they do store up dangers for the future. The danger of particular concern to us internationally is the demonstration effect on other countries which, like the U.K., may not individually have a signi- cant effect on world interest rates but collectively certainly do. Even

individually, acquiescence would have to delay the time when the growth of public debt in the U.K. can be scaled down to leave room for private debt to expand in a framework of non-inflationary growth. Any short-term gain will therefore come at a considerable long-term loss.

9. With a continued tight fiscal policy a degree of monetary ease might still be defensible if downward pressure on the exchange rate were to succeed in improving competitiveness. Improvements in competitiveness did occur after 1981 because extensive labor shedding raised productivity fast enough to absorb wage increases. These productivity increases dropped sharply in 1984, and as wages continued to rise, unit labor costs jumped by 6 1/2 percent, a rate well above the current rate of price inflation. As long as wages continue to rise more rapidly than prices, it will be difficult to improve competitiveness by exchange depreciation. Monetary ease will then be largely spent on rising prices rather than on increased output and employment.

10. It seems to us that the troublesome increases in real wages may in large part reflect a lag in the downward adjustment of inflationary expectations behind the fall in actual inflation. Wage contracts set nominal wages that, given price expectations, should produce a real wage that will clear the market. If actual prices turn out to be higher, real wages will be lower and employment temporarily higher than the equilibrium level; if actual prices are lower, real wages will rise and employment be reduced. A policy of continued financial restraint may well be best suited to narrowing the distance between them and to bringing unemployment down.

11. Seeking to correct a deficiency of aggregate demand may thus be counter-productive. A direct attack on real wages would seem to carry more promise. One feature in the functioning of labor markets deserves particular attention in this regard. In finding the market clearing wage, the effective supply seems often to be limited to those workers still employed. In such cases there is little scope for the real wage once set to be reduced, and no direct way therefore to re-employ those once out. There is need to reduce the barriers to entry not only for new entrants into the labor market, but for anyone seeking a job.

12. The functioning of labor markets has already improved in a number of ways in recent years. Thus the pay of young workers, relative to that of adults, seems to have been falling for some time now, suggesting that their share in total employment may now begin to increase. Similarly, the growth in employment in recent years seems to be accounted for entirely by women in part-time work where wage costs are not inflated by government or trade union policy. Much more needs to be done before such impediments to employment are reduced for adult full-time workers as well. There is no doubt, however, that supply-side measures will need to concentrate in this area before the benefits of an anti-inflationary policy can be fully realized.

13. We would also like to note the contribution to a more competitive economy that can be made by a continued liberalization of trade. Similarly, we hope that you will resist pressures that may develop to limit official development assistance unduly.

14. Because the U.K. was one of the first countries to initiate a coherent anti-inflationary policy, its problems as well as its successes are of keen interest to the world at large. You are clearly a vital component in the application of that policy on a global scale. We are gratified by the resolve you have shown in persevering with it even in difficult times. Any slippage from it could adversely affect expectations well beyond your own borders. We therefore continue to wish you well.

PSBR Actual and Adjusted

	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86
1. in billions of pounds sterling							
PSBR, actual	10.0	12.6	8.6	8.9	9.7	8.4	7.0
plus oil revenues	+ 2.4	+ 3.8	+ 6.4	+ 7.8	+ 8.9	+ 12.0	+ 12.0
less permanent income from oil	- 1.6	- 1.9	- 2.1	- 2.2	- 2.3	- 2.4	- 2.5
plus special asset sales 1/	+ 1.0	+ 0.4	- 0.1	+ 0.5	+ 1.1	+ 2.3	+ 2.5
PSBR, adjusted	11.8	14.9	12.8	15.0	17.4	20.3	19.0
2. in percent of GDP							
PSBR, actual	4.8	5.3	3.3	3.1	3.2	2.6	2.0
PSBR, adjusted	5.7	6.3	4.9	5.3	5.7	6.2	5.4

Source: H.M. Treasury

1/ Excluding sales of Council Houses