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Prime Minister

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Mr Finch's statement attached is worth reading - a clear assessment of what we are trying to do and of the problems ahead.

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

cc Mr Wolfson
Mr Hoskyns

10th July 1979

An excellent assessment - would the Chancellor let more colleagues see it? MT.

10/7

Dear Tim,

IMF : 1979 ARTICLE IV CONSULTATION

On 7th June the Chancellor sent a minute to the Prime Minister about the annual Consultation with the United Kingdom on Article IV of the IMF's Articles of Agreement. He thinks the Prime Minister may now be interested to see the "concluding remarks" made by the head of the IMF Mission, Mr Finch, to Treasury officials at the end of the discussion.

The Chancellor saw Mr Finch himself, but only briefly, just before leaving for Tokyo. The Financial Secretary and the Minister of State (Mr Rees) had a rather longer talk with him.

The Chancellor thought that the Prime Minister would be interested in Mr Finch's commendation of the policy underlying the Budget, and his stress on firm monetary policy. It is also useful to have an indication of what most concerned the IMF's representatives - e.g. the possible path of public sector pay and its consequences. It would not have been proper for the IMF to offer prescriptions; but there is perhaps room for doubt whether Mr Finch could in any case have offered serious practical alternatives to the policies the Government have chosen, in the areas where he expressed doubts.

The Chancellor was on the whole pleased with the outcome of the consultation; he understands this statement is one of the more favourable ever made by a representative of the Fund about UK policy.

Yours ever,

M.A. HALL

T Lankester, Esq.

tmw

Econ Pol

16 July 1979

IMF: 1979 Article IV Consultation

The Prime Minister has read your letter of 10 July, and was very glad to see the copy of Mr. Finch's "concluding remarks" which - in her view - provides an excellent assessment of our current situation. She has asked whether the Chancellor might circulate Mr. Finch's statement to Ministerial colleagues.

TPL

KRB

M.A. Hall, Esq.,
H.M. Treasury.

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√MAP

Econ Pol

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

19th July 1979

Dear John,

IMF : 1979 ARTICLE IV CONSULTATION

At the Prime Minister's suggestion, the Chancellor has asked me to circulate for the information of his Cabinet colleagues the concluding remarks of Mr. Finch, head of the IMF Mission which recently came to London for consultations with the Government on Article IV of the IMF's Articles of Agreement. I also enclose a copy of my letter to Tim Lankester of 10th July.

I am copying this letter to the Private Secretaries to other members of the Cabinet, including the Minister of Transport, and to Murdo MacLean and Tim Lankester.

Yours ever,

M A Hall

(M.A. HALL)

J.A. Chilcot, Esq.,
Home Office

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Friday, June 29, 1979

United Kingdom--1979 Article IV Consultation

Concluding Remarks

On previous occasions I have remarked on the difficulty of writing a closing statement. This time, however, my task has been greatly eased. The recent budget speech by the Chancellor has set forth the principles of a new strategy so effectively that there is no need for me to paraphase our understanding of the policies. And your answers to our questions on the main elements of the immediate prospects have been so clear and consistent that we have little need to repeat them. Consequently, these remarks can be brief.

The economic situation faced by the U.K. authorities at present involves much more serious hazards than we had expected when planning for our visit. While the balance of payments situation is manageable, given the strong reserve position, and North Sea oil will insulate you from much of the immediate impact of the energy crisis on the external accounts, the other aspects of the economy are quite unfavorable. The immediate outlook for growth and employment is very depressing, due quite directly to the legacy of the last winter and the top priority which the authorities properly attach to breaking the new momentum given to inflation. The recurrent strong wage pressures have their roots in the low growth of the U.K. economy over past decades and frustration arising from the consequent growing income gap between British and European workers--in other words, in the supply problems of the economy which are so correctly identified in the Chancellor's budget speech.

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We welcome the clear acceptance by the Government of the challenge of redressing these long-standing weaknesses. The intention to achieve more rapid growth in the future by undertaking to apply policies of enhancing incentives and easing supply constraints without being diverted by the short-term costs and strains of these policies is undoubtedly one which we can wholeheartedly support. We are convinced that the persistent losses of market shares of U.K. manufacturers both at home and abroad, and the associated recurring payments difficulties, were mainly the result of the entrenched supply weaknesses in the economy.

Equally, we believe that many of the elements of the new policy are well chosen to achieve the objectives. In particular, the commitment to restraint on public sector expenditures is clearly most important if resources are to be released for private investment and growth--growth which over time will enable public sector services to improve over present levels. The emphasis on tight financial policies is also appropriate in our view. It is now widely understood that fine tuning financial policies to deal with immediate areas of slack in the economy can achieve only short-term gains in output and are incompatible with inflation control and sustained economic expansion. We also accept that in present conditions, after a long period of direct wage restraint, financial policy has to assume primary responsibility for checking cost and price increases at this time.

Our task here is, however, not to catalogue our support for the policies undertaken--the list would be long and would include many that were previously in place. Rather, it is to look as closely as possible into the future to see where the difficulties may arise and to note what might be done to lessen the dangers. Following this plan, we intend to focus our remarks on one difficulty with the design of the strategy which comes largely from inherited commitments, and then to make a few comments on some aspects of implementing the main lines of the fiscal, monetary, and exchange policies.

The strategy adopted to reduce inflation--namely, to restrain demand so that prices and costs fall into line with the Government's objectives--is critically dependent on wage determination being responsive to these forces. Unfortunately, in the area of public service pay the determination of wage levels is shielded from such forces by the decision, largely taken by the previous Government, to determine pay levels on the basis of comparability exercises. It is our understanding that largely for this reason wage rates for the public sector encompassing over 20 per cent of the work force may rise almost 40 per cent in the two-year period ending in December 1980. Such increases, even with efforts on a heroic scale to reduce public expenditure programs, would make it very difficult to contain adequately the borrowing needs of the public sector, while implementing the intended further reduction of the tax burden on individuals. Moreover, they inevitably create further pressure for high pay settlements in the private sector, adding to the cost of breaking the inflationary spiral and increasing the delay before the needed recovery in investment and growth. We would therefore hope that every possible effort will be made to moderate the pay awards in the public sector in the immediate future. Of course, fair relativities must eventually be met, but it is most important that they occur when growth in the economy's available resources provides the needed margin.

There are various ways to feature the strain created by wage developments currently in prospect but attention might focus on its consequences on monetary policy. The rise in the general price level now projected for the two-year period is estimated to be of the order of 34 per cent; with such a rise in prices, the desire to hold money balances can only be held down to the planned growth of about 23 per cent by maintaining interest rates throughout the period at uncomfortably high levels. Such abnormal interest rates necessarily dampen the level of investment--the projected reduction of 15 per cent in manufacturing investment by the end of 1980 from the levels of 1978 seems to us realistic but also most unfortunate. The abnormal level of interest rates also strengthens the exchange market, both directly through capital flows and indirectly through lower domestic demand; the resultant further weakening of competitiveness of U.K. industry will severely limit export growth and encourage import penetration. Due to the lagged reactions, the resulting pressure will increase over the next several years--well into the period when it is hoped that incentives will be promoting a recovery in production. We therefore believe that every effort needs to be made to achieve the turnaround in inflation more promptly than is now expected.

In reacting to your plans for reducing growth in the short term to conquer inflation, we have been aware of the background of depressed world conditions consequent on the energy crisis. We regret that your struggle is concurrent with that situation but we accept without reservation the priority you must give to domestic stabilization. However, from all points of view, we hope for early success so that your contribution to world growth can soon be resumed.

Turning now to more specific points related to the implementation of policies, we would first reiterate our support for the planned release of resources by public expenditure cuts. We concur equally in the importance you attach to firm adherence to appropriate cash limits to ensure that those increases in real levels of pay that cannot be avoided are compensated substantially by reductions in the level of employment and economies in the volume of other expenditures. We feel that there will also be advantage if actions are taken to show that public enterprises are under the same discipline as the private sector. Thus, the individual elements of the nationalized industries may need to be made more subject to the danger of closure arising for private sector firms when they fail the standard of market viability.

As regards monetary policy, we welcome the willingness shown at the time of the budget to raise interest rates to ensure that the monetary targets are met. This demonstration of your understanding that firm monetary policies are synonymous with interest rates fully responsive to emerging market pressure was absolutely essential. Unfortunately, the continuing rapid growth in bank lending to the private sector and the immediate large needs of the public sector may well require ? further demonstration in the near future of your commitment to this principle. As the experience of recent years clearly demonstrates, reluctance to allow such flexibility quickly undermines the credibility of the authorities' willingness to accept the unpleasant short-term consequences of their monetary objectives. On a related matter, while we understand the reasons for the maintenance of the corset at the present time, we welcome the assurance that it is not a permanent instrument of control as it seriously X distorts the financial system and over time makes the stability of M3 irrelevant to judging the attainment of monetary policy objectives. For a strategy so strongly based on limiting growth in the volume of money to predetermined target zones, this distortion must be unacceptable in the medium term.

X i.e. people avoid the banks by, for example, placing their money in local authority debt and by dealing in "acceptances". The Treasury, who will cover this at the seminar, claim to monitor it. R

On the exchange rate, the stress on flexibility and the desire to avoid weakening other policy objectives by support of rate levels either against appreciation or depreciation seems entirely appropriate in present conditions. We note the recognition that the rate is unduly appreciated at present but we accept that there is little that can be done to return it immediately to a level more consistent with the growth objectives. We support the policy of reducing exchange controls on capital outflows and believe that the conditions are now appropriate for terminating the investment currency market. On a smaller issue, we note that the previous way of acquiring the foreign exchange needed for debt amortization--namely, through resisting from time to time pressure for appreciation--is largely precluded with the new emphasis on exchange rate flexibility and would suggest that consideration be given to acquiring the desired exchange steadily quarter by quarter, so giving the market a stable basis for its judgments.

We welcome the clear stand against import controls which might create some temporary increase in employment but by a method diametrically opposed to the new policy strategy with its emphasis on medium-term supply improvement guided by the market. The pleas that some will raise for exceptions as declining competitiveness and growing unemployment cause special industry difficulties must be resolutely opposed. With the enhanced emphasis on market guidance, we hope that the United Kingdom will do all in its power to encourage EC action to reduce common restrictions on trade, notably on textiles and agricultural products. Progress toward greater integration of the world economy to enhance the ability of developing countries to emerge from poverty can be critically aided by the trade policies of this single most important community of nations in its period of economic ascendency.

Many of our members will regret the reduction of aid programs made in the budget, even though the reduced plans still allow for some increase in the share of resources devoted to development assistance. The United Kingdom has an important role to play, together with other industrial countries, and as the recipients are currently entering a period of severe strain arising from the repercussions of the energy crisis, their needs are very great.

In closing, I would return to our main theme. The courageous decision of the Government to act to improve productivity performance of the U.K. economy, whatever the short-term cost, is an essential step toward avoiding the recurrent payments difficulties of the past. The task undertaken is tremendously difficult because fundamentally its success will depend on winning the support of the mass of the population for new attitudes toward productivity. But it is a struggle which can be won if the right policies are pursued with persistance and consistency.