Econ Pol.

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Prime Minister (2)

Worth reading through, for an independent assessment of our monetary stance and for the general reassurance it conveys. MCS 16/12

Treasury Chambers, Parliament Street, SW1P 3AG
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15 December 1982

Michael Scholar Esq
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Dear Michael,

As you may know, the IMF team were here earlier this month to conduct their annual review of the economy - the so-called Article IV Consultations, a regular event for all Fund members. You may like to see the attached transcript of the concluding remarks delivered by Mr Schmitt (Head of the Fund team) at the final plenary session on 13 December. The tone is rather bland, but the substance amounts to a clear endorsement of our current economic strategy.

After the visit a report is prepared by the staff (but not published) and the consultation process is completed by a discussion in the Fund's Executive Board. The team's findings on their visit are thus provisional at this stage, but on the assumption that the same approach informs the assessment put to the IMF Executive Board, the Chancellor sees nothing here which need cause us concern. While some of the language about productivity is perhaps a little negative - and we may be able to secure some improvements - the Fund have resisted the temptation to suggest that exchange rate depreciation provides any sort of panacea.

Although the press are told of these annual IMF visits, we do not normally say anything publicly after them. The Chancellor thinks it right to preserve this tradition. We have, however, established with Mr Schmitt that in the event of any erroneous press speculation, or disclosure in Washington, it would be reasonable for us to confirm informally that our impression was that the Fund staff endorsed the general stance of Government economic policy.

Yours ever,

John Kerr.

J O KERR

December 13, 1982

Concluding Remarks

1. At the conclusion of this year's Article IV consultation discussions we would like again to leave with you the customary record of our preliminary conclusions. They are preliminary, as you know, and subject to further thought and discussion with our colleagues in Washington before they go into our report to the Executive Board. Your own reactions will, we hope, strengthen our confidence that we have got the issues about right.

2. In the year since our last visit, the control of inflation has remained the pre-eminent objective of financial policy in the United Kingdom, in the expectation that it will establish a firm basis for sustained growth in the medium term. A medium-term financial strategy has been adhered to with admirable consistency and its credibility is now firmly established. As a result some of the returns to it have begun to come through much as one would have expected. Of course, some costly imbalances remain. But first we note the achievements.

3. The rate of inflation has fallen dramatically. From a peak of 21 per cent in mid-1980 the twelve month rate of increase in retail prices has come down to below 7 per cent, and is forecast to approach 5 per cent early next year. During 1982 the abatement of inflation has been rapid, and it has been associated with a very steep fall in short-term as well as long-term interest rates. Wage inflation is also coming down though regrettably not as fast as retail price inflation.

4. Much of the deceleration of price inflation can be traced to monetary restraint. To be sure the initial quantitative money growth targets had to be adjusted as experience was gained with the operation of the financial strategy. Nevertheless downward pressure has been maintained and monetary expansion has abated. The wider aggregate (£M3) expanded by 10 per cent in the year to November 1982 compared with 14 1/2 per cent the year before. The narrow aggregate (M1) expanded by 10 1/2 per cent in both periods despite the decline in interest rates.

5. The decline in interest rates has also been rapid--the three-month inter-bank rate fell to about 10 per cent in November 1982, compared with 15 per cent at the beginning of the year. Setting indicative targets for the public sector borrowing requirement (PSBR), consistent with the monetary targets, played a large role in making this progress possible. Here, too, modifications were required as circumstances changed, but even so, the PSBR in relation to GDP has been brought down from nearly 6 per cent in 1980/81 to just over 3 per cent in 1982/83.

6. The rapid fall in the inflation rate, set against the narrow monetary aggregates in particular, is beginning to yield a marked growth in the real money stock that is expected to continue next year. This should provide the room--as well as part of the stimulus--for the sustained recovery of economic activity that has been the objective of the counter-inflationary strategy. Domestic demand in real terms has resumed growth at a rate of about 3 per cent per year. Unfortunately, poor levels of profitability and competitiveness seem likely to restrict the share of demand met by domestic producers.

7. The lag in the deceleration of earnings is regrettable mainly for this reason. To be sure, the increase in productivity, though mainly the consequence of a large-scale shedding of labor, has also been impressive. Even so, however, the deceleration in the growth of wage costs has not been sufficient to improve the competitiveness of British products either at home or abroad. Measured in local currency, there has been little change in relative unit labor costs between the United Kingdom and its major trading partners. Much of the increase in demand therefore spills out into imports while export shares continue to decline in a depressed world market. As a result, the growth in real GDP next year is not expected to exceed 1 1/2 per cent, and the rise in unemployment is unlikely to be checked.

8. The external balance on current account, though already weaker in 1982 than the year before, is still expected to register a substantial surplus in 1982 equivalent to 1 1/2 per cent of GDP. It is, however, likely to disappear altogether in 1983. That prospect undoubtedly contributed to the recent weakening of the pound in the exchange markets, and the associated increase in interest rates. At the time of writing, sterling appears to have stabilized after about a 6 per cent depreciation in effective terms. While this development will ease the competitive constraint on economic expansion somewhat, it may have done so at the cost of moderating the decline in inflation.

9. As long as exchange rate adjustments are consistent with a steady downward trend in the rate of inflation, monetary policy can be regarded as broadly on track. It seems to us important to ensure that this is the case. A downward trend in the rate of price inflation is still necessary to secure the wage restraint without which depreciation of the currency would in any case have little effect on competitiveness. Further moderation in the growth of earnings remains a crucial element both in the control of inflation, and in the improvement of competitiveness on which its reward depends.

10. With monetary policy broadly on track there should be no need to change its stance in either direction. Even a steady stance may require occasional adjustments in the quantitative targets set for the main monetary aggregates. Nominal GDP is expected to rise by 8 per cent next year. With indicative limits of 7-11 per cent your forecasts show a 13 per cent rise in M1, but a rise in £M3 and PSL2 of just over 8 per cent, reflecting a switch back to transactions balances as inflation and interest rates come down. A separate limit for M1 is therefore being considered. Alternatively, the discrepancy could be left to stand as an indicator of concern, as it was in similar circumstances for £M3.

11. Restraints on the public sector borrowing requirement continue to be required to ensure that its financing will not place undue upward pressure on interest rates. Though still relatively high in real terms, interest rates seem pitched about right on external grounds. We are therefore inclined to accept the present PSBR projection of 2 3/4 per cent of GDP as about right for 1983. If you should find room within

this limit for a small fiscal adjustment at budget time, we would urge you to use it in a way that will enhance the competitiveness of industry.

12. As long as poor export performance and high import penetration continue, pressures for protection are likely to increase. We are concerned by the strength they have already acquired particularly where other countries seem slow to open their markets to your own exports. In the common interest we urge you not to respond in kind. Similarly, we hope that you will resist any pressures that may develop for scaling down official development assistance, though you justly take pride also in the private flows to developing countries.

13. In conclusion, I should like to express our appreciation to you and your colleagues who have spent much time in answering our numerous written and oral questions. We hope that you find the result rewarding to yourselves also, despite the inevitable differences of perception and emphasis that must doubtless remain here and there. We certainly are much in debt. Thank you.

Econ Pol, June 79, IMF