CONFIDENTIAL

Prime Minister
A clean bill of health from the IMF.
AT 14/12

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

14 December 1983

Andrew Turnbull Esq
10 Downing Street

Dear Andrew,

IMF 1983 ARTICLE IV CONSULTATIONS

The IMF concluded earlier this week their annual review of the UK economy - the so-called Article IV Consultations. You may like to see the attached transcript of the closing remarks delivered by Patrick de Fontenay (Head of the Fund team) at the final plenary session on 12 December.

As you know, 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 assessment is thus provisional at this stage. But as they stand the Chancellor regards the Fund's conclusions, and the supporting analysis, as broadly satisfactory.

On this occasion the Fund seem to have had two main objectives. First, while impressed with the performance of the economy in terms of prices, competitiveness and output - the increasingly favourable split in nominal GDP between growth in output and inflation is one way they put it - they wanted to be satisfied they could track these developments back to the underlying policy stance. Secondly, they decided this year to give their analysis a medium term perspective, and in particular to test the objectives for public expenditure, tax reform and labour legislation against that time frame. On both counts, they appear to have come away broadly content with what they learnt.

/Although

CONFIDENTIAL

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 de Fontenay that in the event of any erroneous press speculation, or disclosure in Washington, it would be reasonable for us to confirm informally that the Fund staff endorsed the general stance of Government economic policy.

Yours ever,

John Kerr.

J O KERR
Principal Private Secretary

December 12, 1983

INTERNATIONAL MONETARY FUND

United Kingdom - 1983 Article IV Consultation

Preliminary Conclusions of the Mission

Our preliminary conclusions will not come as a surprise to you. As you noted at our first meeting, previous Fund missions have endorsed the general thrust of the Government's economic policies and the improved performance of the economy, in terms of prices, output and employment, appears to have vindicated those policies. We had to satisfy ourselves, however, that the current recovery in economic activity actually resulted from the policies which the Fund had supported in the past and not from a change in the policy stance. On this point we are now generally reassured.

Some slippage from fiscal and monetary objectives did occur toward the end of last year and earlier this year but corrective action has been taken. By the next fiscal year, both the PSBR and public expenditure should be back in line with the MTFS guidelines. Monetary aggregates are back around the top of the target range. We note that if greater weight were to be given now to the behavior of Mo it would signal a somewhat easier policy stance than the other indicators but we have not yet been able to form a judgment as to the significance and interpretation of that particular aggregate. Most countries have found it necessary to widen the array of intermediate targets and supplementary indicators used to monitor monetary policy. This leaves a greater role for judgment in interpreting often conflicting evidence, and therefore increases the margin for error. Perhaps this is inevitable given the pace of financial innovation and the changes in savings patterns. But too much agnosticism can carry risks as well. For this country, the steadily declining growth rate of nominal GDP in recent years, with an increasingly favorable split between growth in output and inflation, suggests that both judgments and policies have been broadly appropriate. Nevertheless, current monetary developments need to be watched in order to ensure that the deceleration in monetary expansion implied by the targets for next year takes place smoothly.

Exchange rate policy has remained flexible. While we recognize that exchange rate developments can prove a useful supplementary indicator of monetary conditions, they should not lead to policy reactions in all circumstances: this has not been the case. Changes in the nominal exchange rate have contributed, together with a better relative cost performance, to an improvement in competitiveness in 1981 and 1982. The deceleration in production costs, like the improvement in profitability, is not as broadly based as one would wish, however, as it applies to a smaller number of firms. Further progress in restraining domestic costs remains desirable. Otherwise the current recovery could be in jeopardy as there are clearly limits to the extent the exchange rate can compensate for a deterioration in the external current balance without resulting in unacceptable inflationary pressures.

We have tried on this occasion to look beyond 1984, a year for which prospects remain favorable, to see what further actions seem called for to leave the economy in a stronger position for the time when it will face a decline in oil production and exports. Another reason for adopting a somewhat longer time horizon, is our conviction that appropriate macroeconomic policies are not enough to ensure a better performance of the British economy. Actions are needed to enhance its competitiveness, efficiency, and flexibility. The type of measures needed take time to design and implement, and their effects are likely to come through only with a lag. The earlier the reform process can be started, the better. There is of course a very wide range of measures which appear useful and desirable, some of which, like privatization, have already been set in motion. We shall focus here on three areas only: public expenditure, tax reform, and the labor market.

It has always been the stated intention of this Government to reduce the relative size of the public sector. Considerations of efficiency and of the magnitude of the tax burden have been prominent. We believe there are others which can best be discussed in the framework of the MTFS. We were pleased to read that the Chancellor had said that the MTFS was alive and well. Indeed, we hope that its horizon can be extended and an LTFS might even be envisaged.

In that framework, reducing the size of the public sector should mean reducing public expenditure in order to reduce both taxes and borrowing. Tax reductions are desirable in the context of the tax reform we discuss next and because of the need to stimulate saving formation and avoid a possible tax-push to incomes and prices. In other words, reducing the PSBR by raising taxes is not an attractive option in the medium-term. In this context, the current proposals on "rate-capping" for local authorities are an important and commendable initiative. At the same time, the goal of reducing the PSBR, particularly now when the economy is on a cyclical upswing, seems equally desirable in order to avoid upward pressure on interest and exchange rates. For the recovery to be sustainable investment must not be crowded out and competitiveness must be enhanced. From a longer term perspective, if this country is to make up for its lagging growth performance relative to other industrial countries, it must devote a larger share of resources to investment and a smaller share to both public and private consumption.

We believe that these are some of the considerations which should guide public expenditure plans. The goal of keeping public expenditure constant in real terms over the next three years is no doubt not an easy one to achieve. If adhered to, it should allow some reduction in both taxes and public borrowing, though perhaps more modest than one would wish. It may also be possible, in public discussions of these issues, to move away from the notion that asset sales are an offset to public expenditure.

We would hope that early action can be initiated on some of the reforms of the demand determined programs, such as turning to the private sector for the provision of certain supplementary health and pension benefits, so as to ensure that the present spending targets are not exceeded and that they can be extended in a more ambitious direction in the subsequent period. Although the margin of uncertainty as regards long-term capital requirements is considerable, it seems clear that they are higher than the present investment ratio can provide and that a shift of resources out of the public sector is required to stimulate private savings and investment. We do not see foreign borrowing as an attractive option given the prospect that the current account position will soon begin to be adversely affected by the progressive reduction of North Sea oil production.

Turning to tax reform, we would include under that heading both the desirability of cutting certain taxes and tax reform proper. Reductions in payroll taxes and higher tax threshholds which would encourage employment and reduce the "poverty trap" should, in our view, be high on a list of priorities. We also very much support the ongoing reassessment of the various forms of investment allowances and other financial incentives to enterprises, which produce distortions between sectors and tend to encourage firms to substitute capital for labor, and hope that this reassessment will lead to a simpler and more neutral system of corporate taxation.

As regards labor markets, we can also be brief. Generally, we endorse the conclusions of the Chancellor's recent memorandum to the National Economic Development Council on "Changing Employment Patterns". The Government can provide opportunities for training and encourage labor mobility, but beyond that we would agree that it cannot determine where and when new jobs occur. The scope to influence the choice between the level of earnings and the level of employment is also limited. Nevertheless, tax and employment protection legislation which discourages hiring could be changed. Labor legislation can also provide an environment in which labor markets respond more readily to supply and demand changes in the whole economy and to the special circumstances of individual companies and plants. Important changes have already been made in that area. Anything that can be done to reverse the continued upward trend of real wage costs should over time contribute to a better labor market situation and reduce the social and financial costs of unemployment.

Finally, we have for the first time examined in some detail the U.K.'s trade and trade adjustment policies. Like most other countries, the U.K. has not been able to resist all the pressures for protection resulting from loss of competitiveness and the recession, as well as actions taken by some trading partners. It would seem in accordance with the general principles of the Government's economic policies to aim at greater transparency in that area and at progressive trade liberalization. The gains to be reaped from freer trade in terms of lower inflation and greater efficiency would argue strongly for the dismantling of trade barriers and the phasing out of assistance to uncompetitive sectors.