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February 2003
IMF Country Report No. 03/48

United Kingdom: 2002 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the United Kingdom

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the Article IV consultation with the United Kingdom, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **December 7, 2002,** with the officials of the United Kingdom on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on February 5, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **February 26, 2003** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its February 26, 2003 discussion** of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for the United Kingdom.

The document(s) listed below have been or will be separately released.

Selected Issues Paper
Financial System Stability Assessment

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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UNITED KINGDOM

Staff Report for the 2002 Article IV Consultation

Prepared by the Staff Representatives for the 2002 Consultation with the United Kingdom

Approved by Michael Deppler and Leslie Lipschitz

February 5, 2003

- Article IV Consultation discussions were held in London during November 21-December 7, 2002. The mission comprised Mr. Cottarelli (Head), Ms. Coorey, Mr. Escolano, Ms. Koeva, and Ms. Vladkova-Hollar (all EU1). Mr. Zelmer (MAE) joined the mission to conclude FSAP discussions. Mr. Scholar, Executive Director for the United Kingdom, and Mr. Kelmanson (OED) attended the meetings. Staff met with the Chancellor of the Exchequer, the Governor of the Bank of England (BoE), the Chairman of the Financial Services Authority (FSA), and other senior officials, including members of the Monetary Policy Committee (MPC). Staff also met representatives of the employers' and employees' organizations, financial institutions, and members of the academic community.

- At the conclusion of the last consultation in March 2002, Directors commended the authorities for the impressive performance of the U.K. economy. Directors, however, stressed that the overall structural fiscal deficit should not be raised beyond the path envisaged in the November 2001 pre-budget report. They noted that any additional spending should be undertaken only if based on a clear-cut economic justification and if risks of spending efficiencies were adequately addressed.

- The authorities have generally responded appropriately to policy challenges identified in previous Article IV consultations. In particular, the reforms of the macroeconomic policy framework introduced during the 1990s and the cautious macroeconomic policy management followed in recent years have been in line with international best practices and Fund advice. However, as discussed in this report, the recent weakening in the medium-term fiscal deficit outlook, reflecting decisions taken during the last year, goes beyond the Fund's recommendations during the 2001 Article IV consultation.

- The United Kingdom has accepted the obligations of Article VIII, Sections 2,3, and 4. The exchange system is free of restrictions on the making of payments and transfers for current international transactions (Appendix II).

- The United Kingdom has subscribed to the Special Data Dissemination Standard, and its data provision is adequate for conducting surveillance (Appendix III).

- The authorities released the mission's concluding statement and have agreed to the publication of the staff report.

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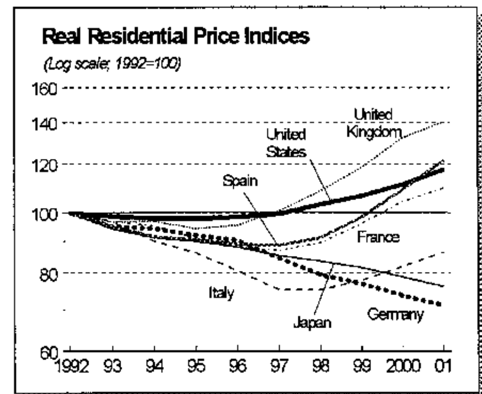
I. KEY ISSUES

1. **The U.K. economy has performed well since last year's Article IV consultation.** Output decelerated in 2001–02 less than in the other G7 countries (except Canada), closing a decade of sustained growth that saw real GDP rising at an average annual rate of 2¾ percent. During the slow down, unemployment rose only slightly from a trough of below 5 percent in April 2001. Inflation has been low and stable. In spite of sterling's continued strength, the current account deficit has remained below 2 percent of GDP.

2. **These achievements are due in significant measure to sound economic policies within a strong policy framework.** Growth during the 1990s was facilitated by structural reforms in the 1980s, particularly in labor markets; and by the strengthening of the monetary and fiscal policy framework and implementation in the 1990s, with an emphasis on division of responsibilities, accountability, and transparency. Financial supervision has been effectively consolidated under the FSA. More recently, the independence of the BoE in pursuing the 2½ percent symmetric inflation target has allowed it to respond swiftly to the deflationary effects of the global slowdown with the support of fiscal policy, which was relaxed from a strong underlying position

3. **Nevertheless, key issues remain.**



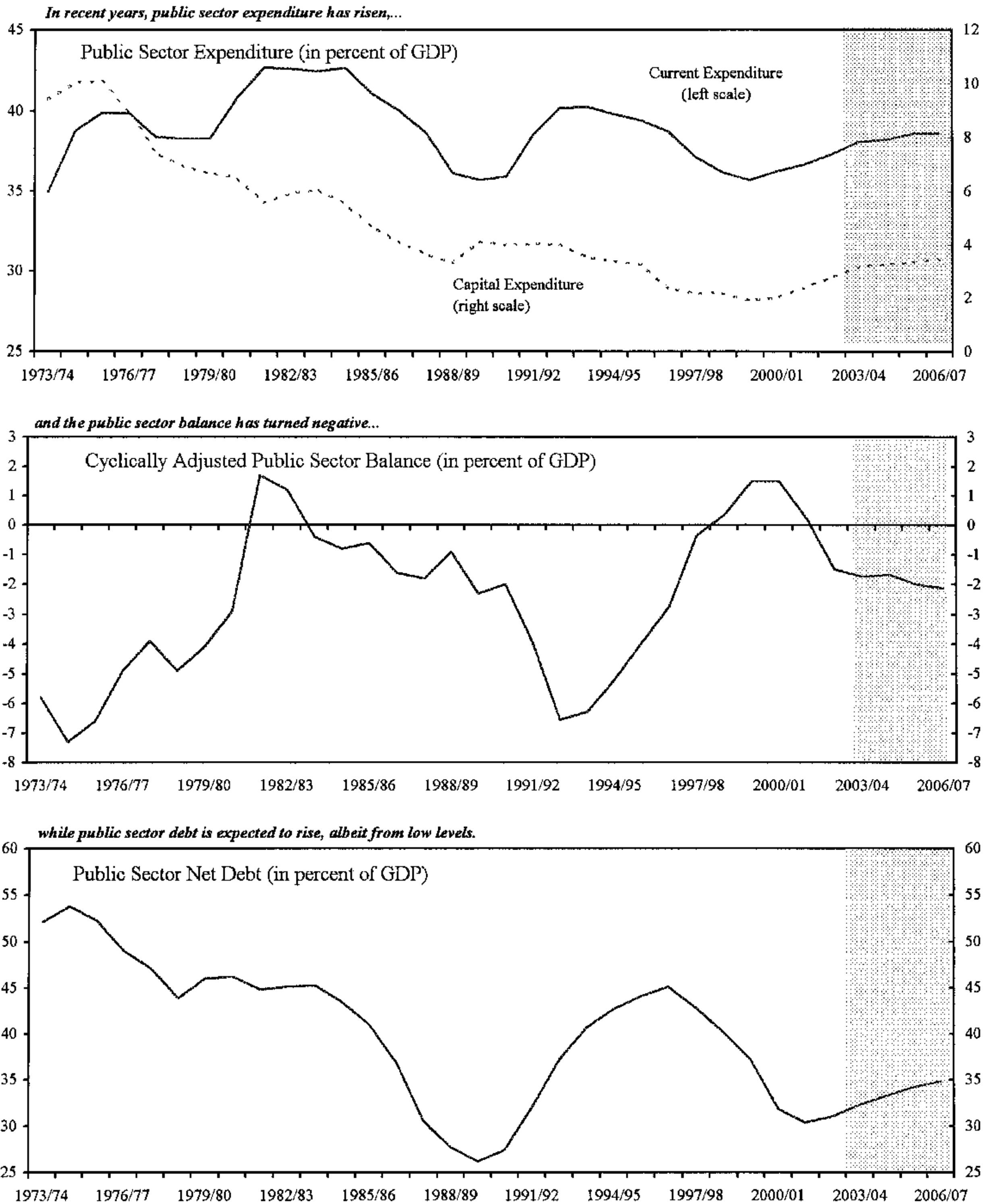
- With the global slowdown, growth has increasingly relied on buoyant consumption demand, associated with a sharp rise in households' debt and a house price boom stronger than in other large economies (text figure). **Can strong macroeconomic performance and financial stability be maintained, if these developments unwind—perhaps abruptly?**

- Domestic demand has also been sustained recently by fiscal expansion. Public spending has been raised sharply, shifting the structural fiscal balances from surplus in 1999–2000 to deficit in 2001–02 and over the medium-term (Figure 1). There is also considerable downside risk to revenue projections. **What are the macroeconomic implications of this turn in the fiscal stance? Moreover, have proper safeguards been put in place to guarantee that public money is spent efficiently, notwithstanding the acceleration in the pace of spending?**

- Despite the pick up in growth over the 1990s, the United Kingdom ranked only 19th among OECD countries in terms of per capita income in 2001. **This reflects low labor productivity (Figure 2): are the government's policies adequate to raise it rapidly?**

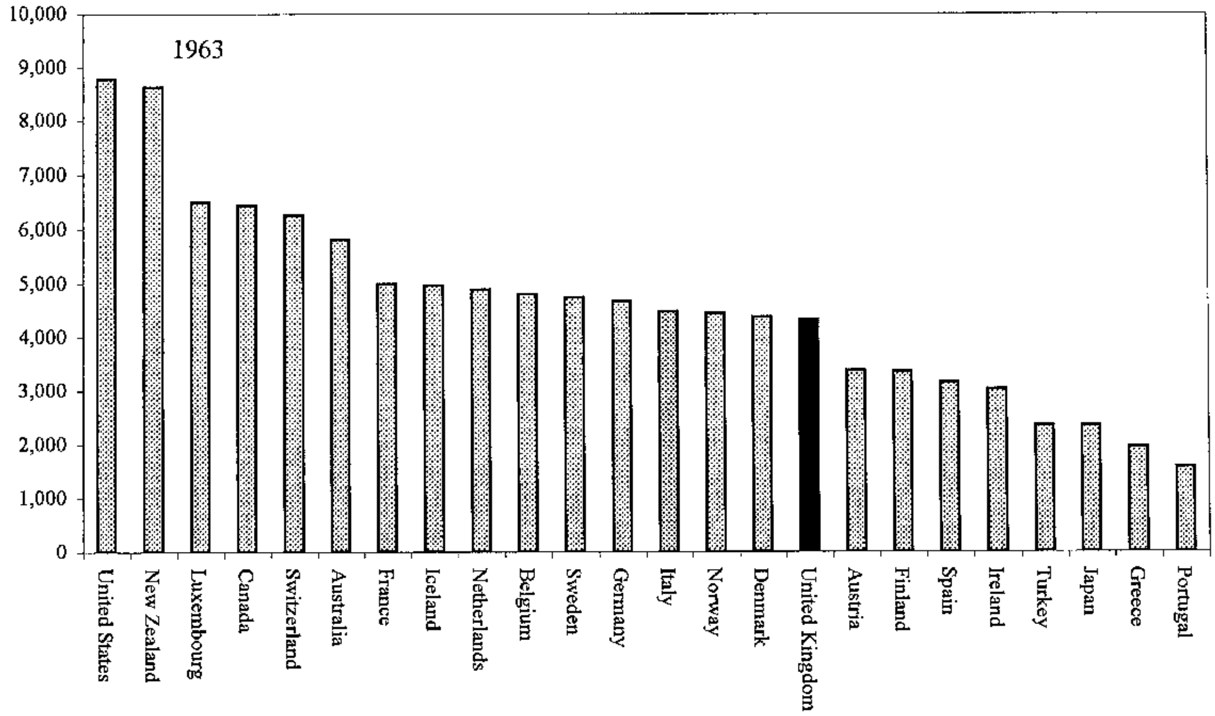
4. **Discussions focused on these and other issues that are important for growth prospects,** including the stability of the financial system—a Financial Sector Assessment Program (FSAP) was conducted in 2002—and the work that the authorities are undertaking to assess the case for entering EMU.

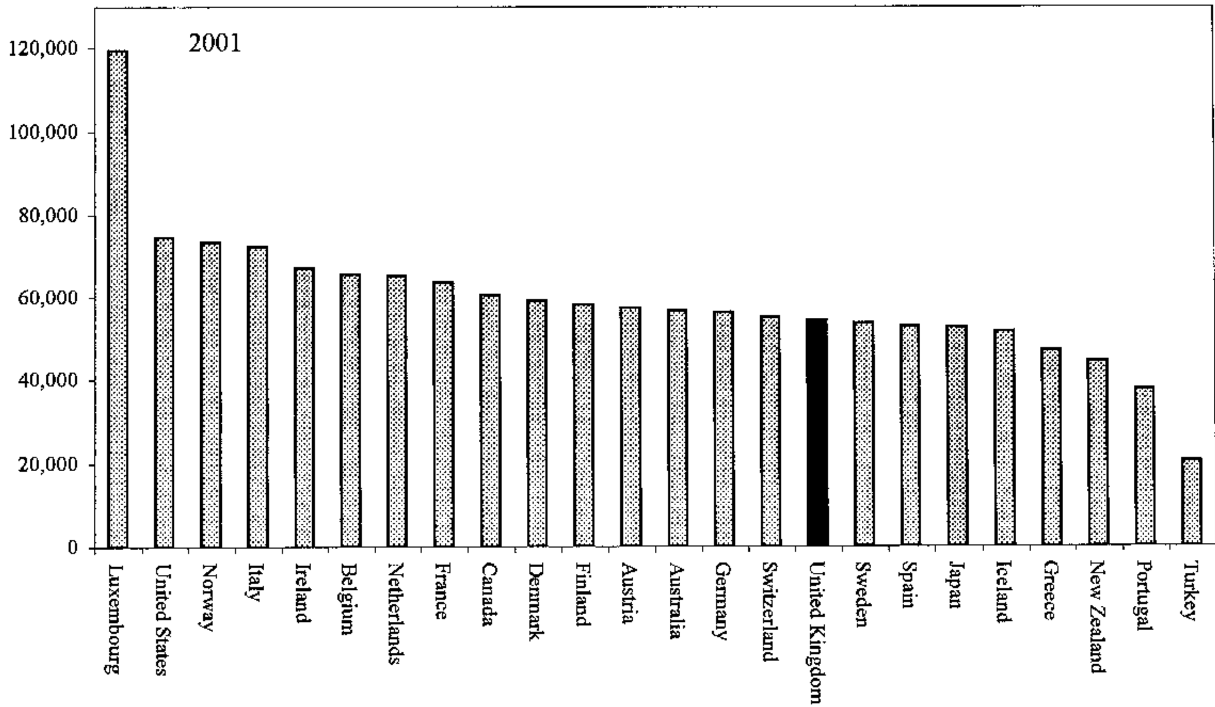
Figure 1. United Kingdom: Fiscal Indicators



Sources: HM Treasury; and IMF staff projections.

Figure 2. United Kingdom: Output per Employee in Selected OECD Countries and Years
(PPP US$, current prices)





Sources: OECD; AMECO database.

II. REPORT ON THE DISCUSSIONS

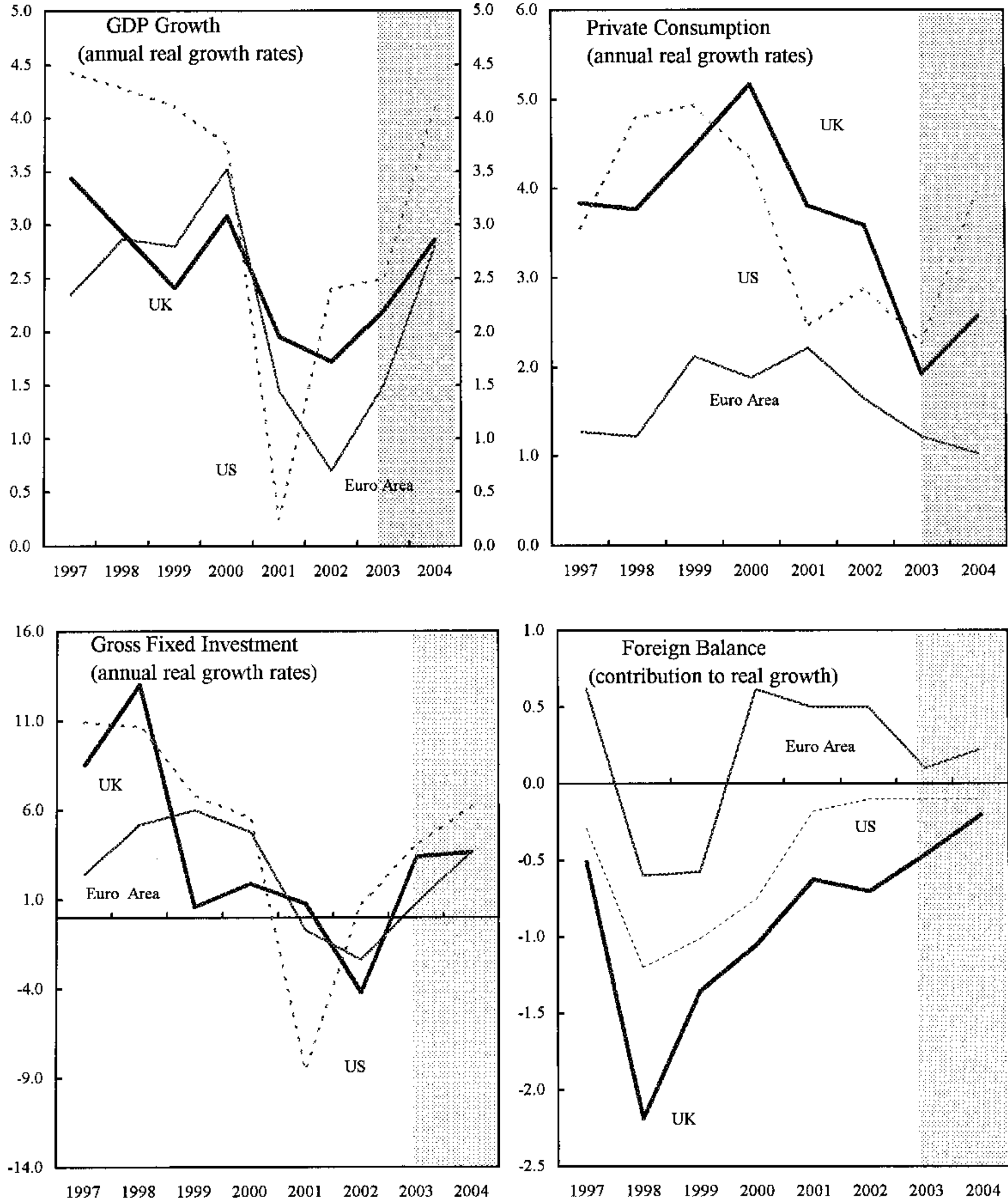
A. An Uncertain Outlook

5. **The U.K. economy weathered the global slowdown well.** Following a pause in late 2001 and partly 2002, real GDP growth recovered to its trend rate of 2½ percent (annualized) in the second and third quarters, and is projected at 1¾ percent for the year, twice the euro area average (Table 1 and Figure 3). This reflected mainly the strength of private consumption and public spending. Business investment, while still high by historical standards, continued to decline (Figure 4). Exports have suffered from weak demand in Europe, in the context of broadly stable market shares (Figure 5). On the supply side, growth in services more than offset a contraction in manufacturing (which now accounts for just one-fifth of GDP).

6. **Authorities and staff were in broad agreement on the short-term outlook, although staff's projected GDP growth was somewhat below that of the authorities.** Premised on a gradual acceleration in world demand, staff projected GDP growth to rise to 2¼ percent in 2003 and 2¾ percent in 2004 (Tables 2 and 3). The output gap, estimated at about 1 percent in 2002, would gradually close (Figure 6). Consumer spending was expected to soften in late 2002—recent retail sales data did suggest a deceleration (Figure 7)—and in the first half of 2003 owing to the waning effects of the 2001 monetary easing, high household indebtedness, and the decline in equity wealth. However, activity would be sustained by public spending—planned to continue to rise strongly—and, later in 2003, exports, in line with the expected global recovery. The current account deficit was projected to remain around 2 percent of GDP (Table 4). The authorities projected GDP to grow by 2½–3 percent in 2003, and 3–3½ percent in 2004, with the differences from staff's projection mainly reflecting a sharper rebound in private investment. They noted that, in contrast to households, the corporate sector had been repairing its balance sheet after the 1990s borrowing surge (Figure 4). Income-gearing ratios had been rising as profitability declined, but remained well below early-1990s levels. Private investment could be expected to rebound sharply in 2003 because of high rates of depreciation in ICT equipment and continued domestic demand growth. While agreeing these factors would support investment, staff felt the recovery would be gradual, given uncertain global growth prospects, low corporate profitability, and the fact that investment was still at historically high levels.

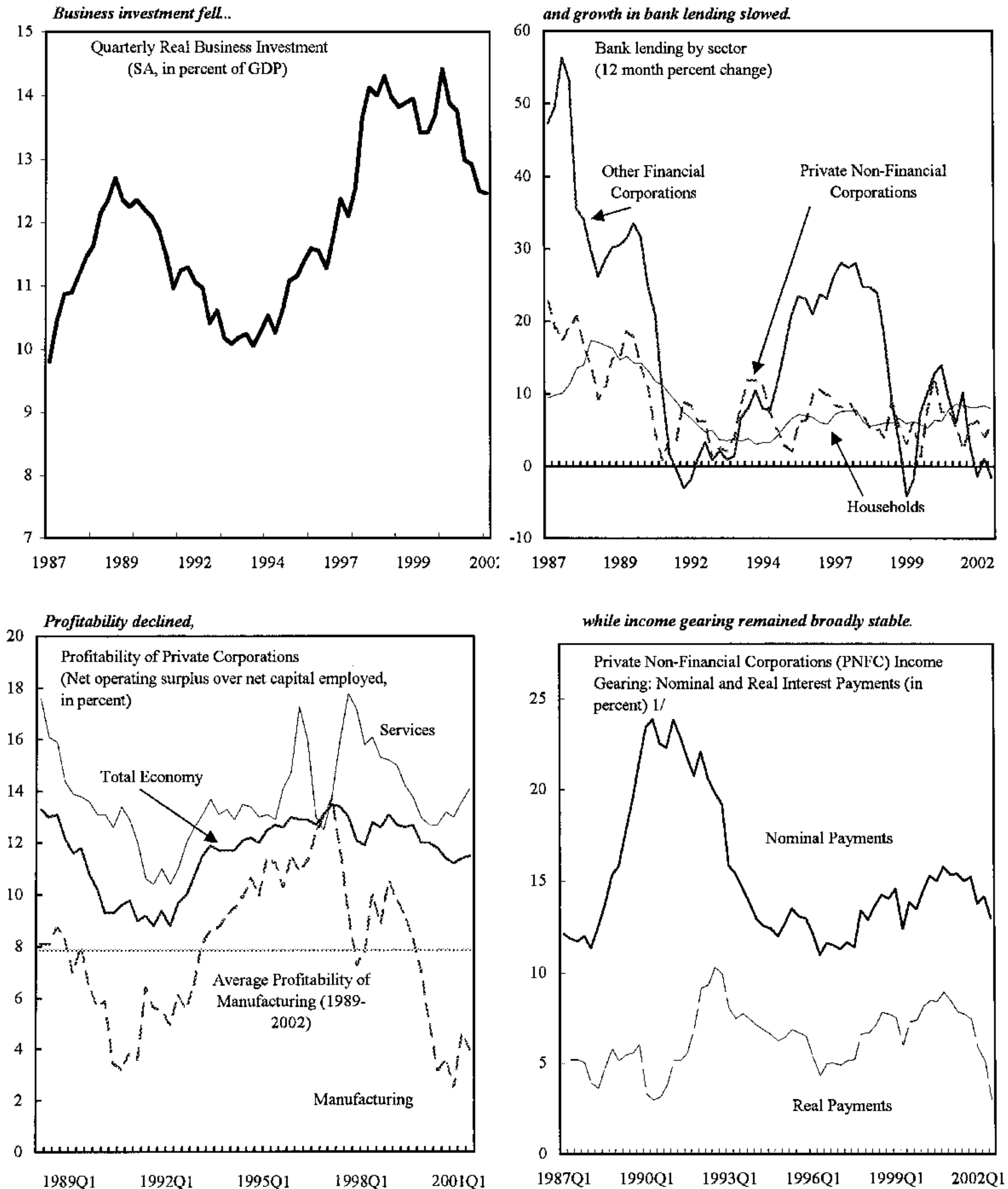
7. **There were significant downside risks to this outlook, arising not only from the uncertain external outlook (Box 1), but also from the vulnerability of private consumption to unemployment and house price shocks:**

Figure 3. United Kingdom: International Comparison of Trends and Forecasts.



Sources: WEO; and IMF staff estimates.

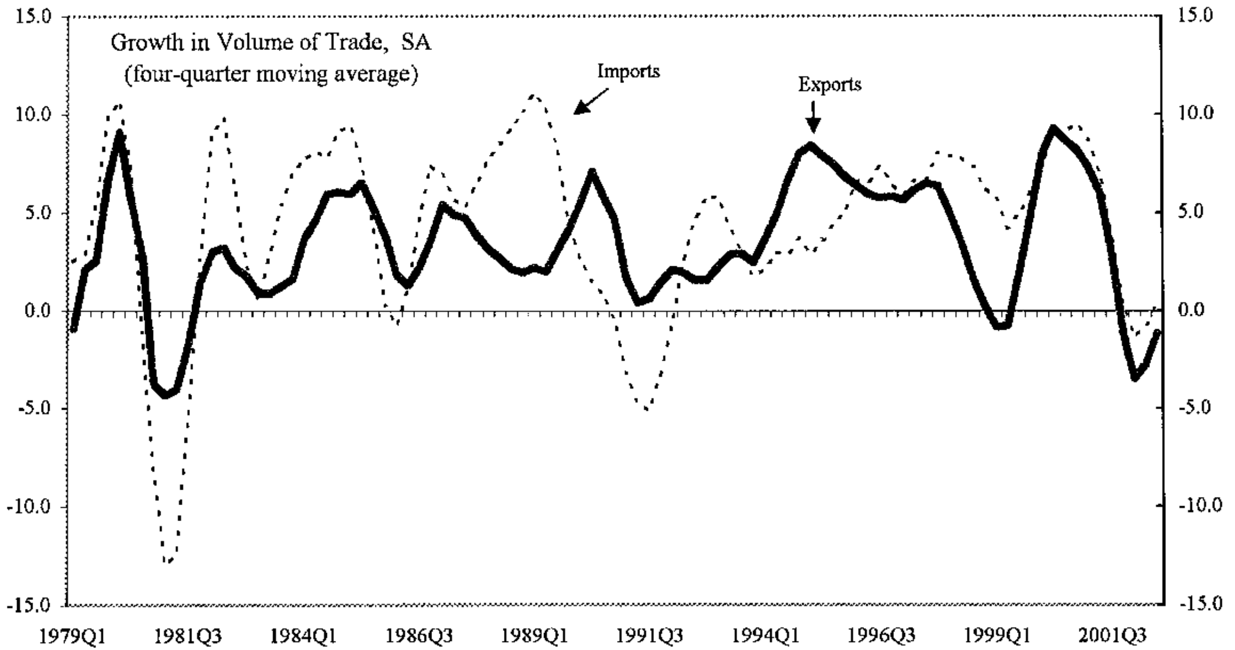
Figure 4. United Kingdom: Corporate Sector Developments

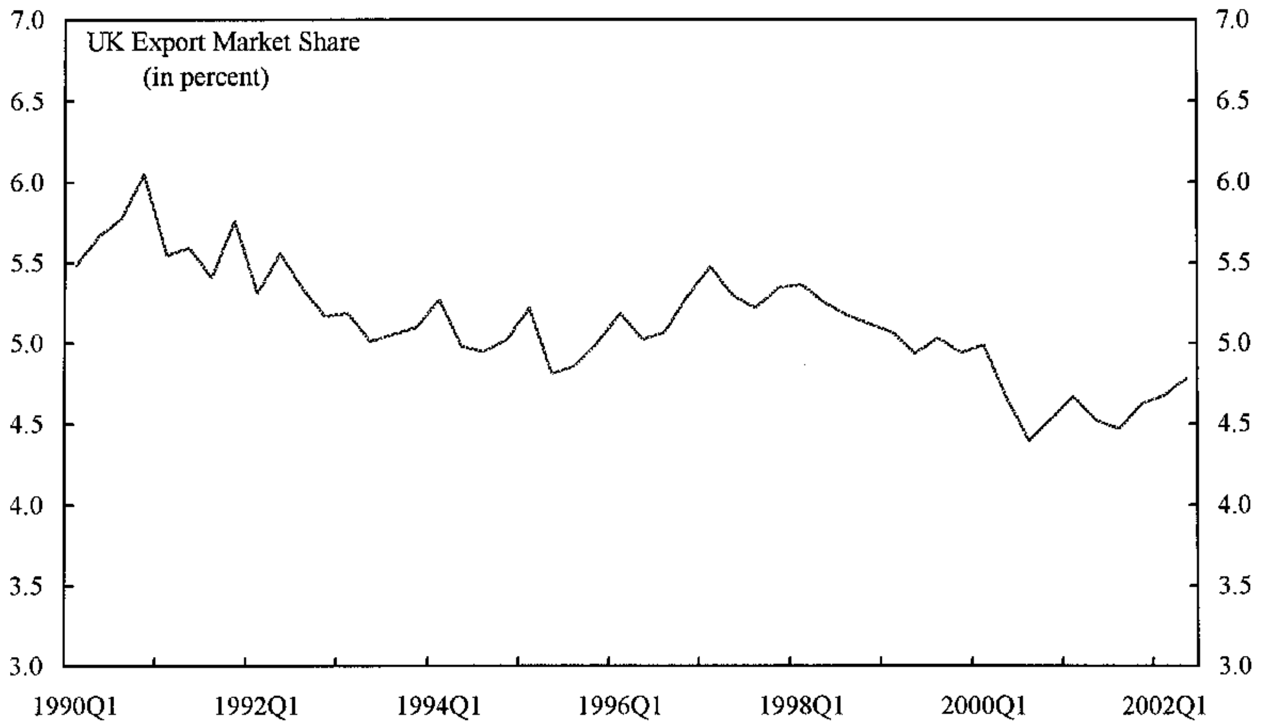


Source: Office of National Statistics (ONS).

1/ Defined as total interest payments (nominal or adjusted) over gross primary income. Real payments were derived from nominal payments after subtracting the quarter-on-quarter growth inflation rate (smoothed by HP filter) multiplied by the stock of outstanding debt.

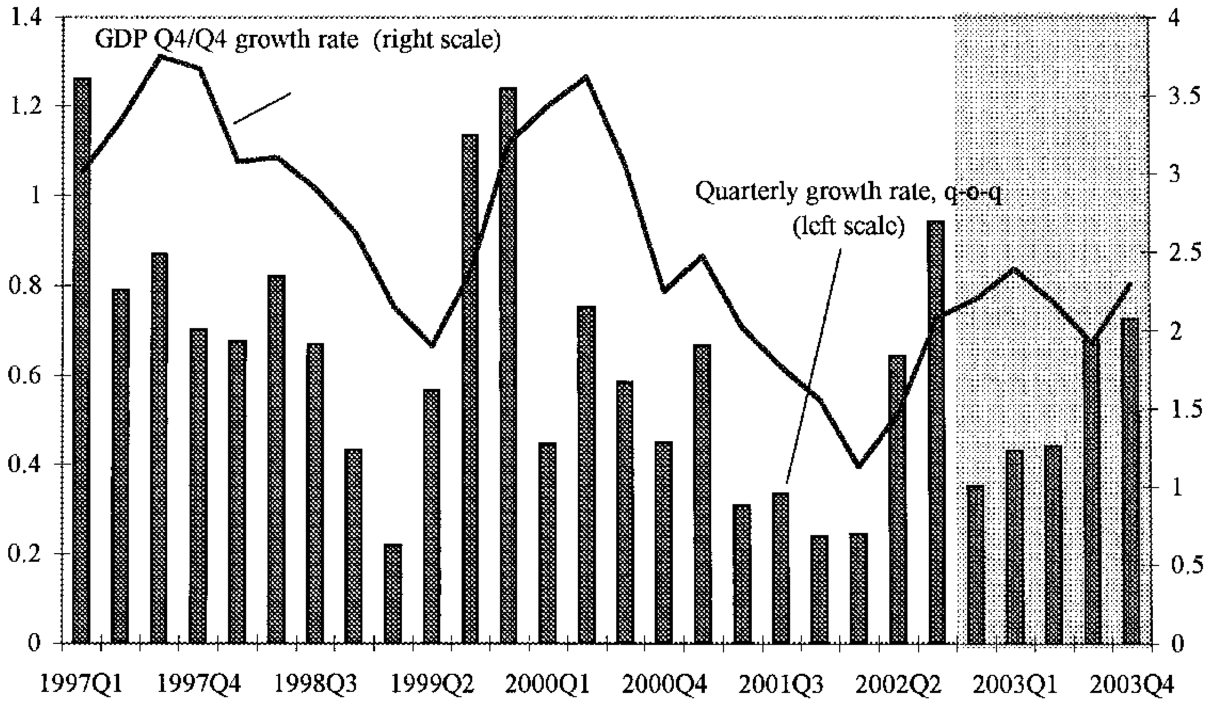
Figure 5. United Kingdom: External Trade

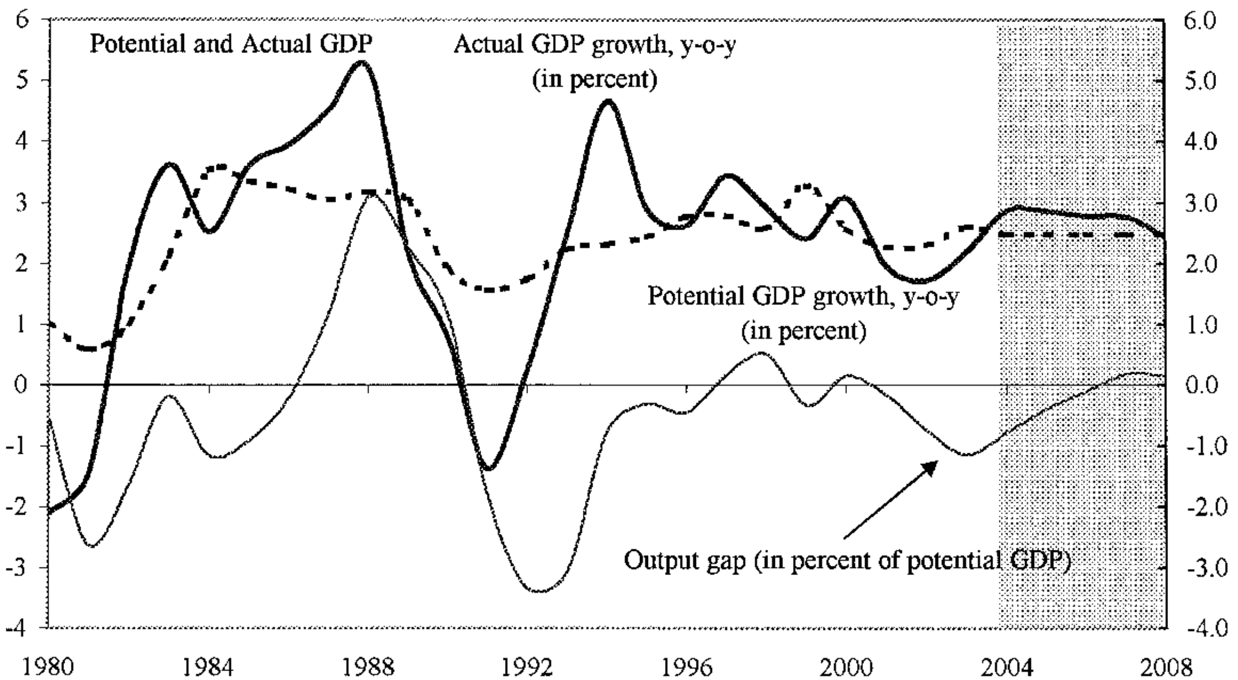




Sources: IMF, *Direction of Trade*; Office of National Statistics (ONS).

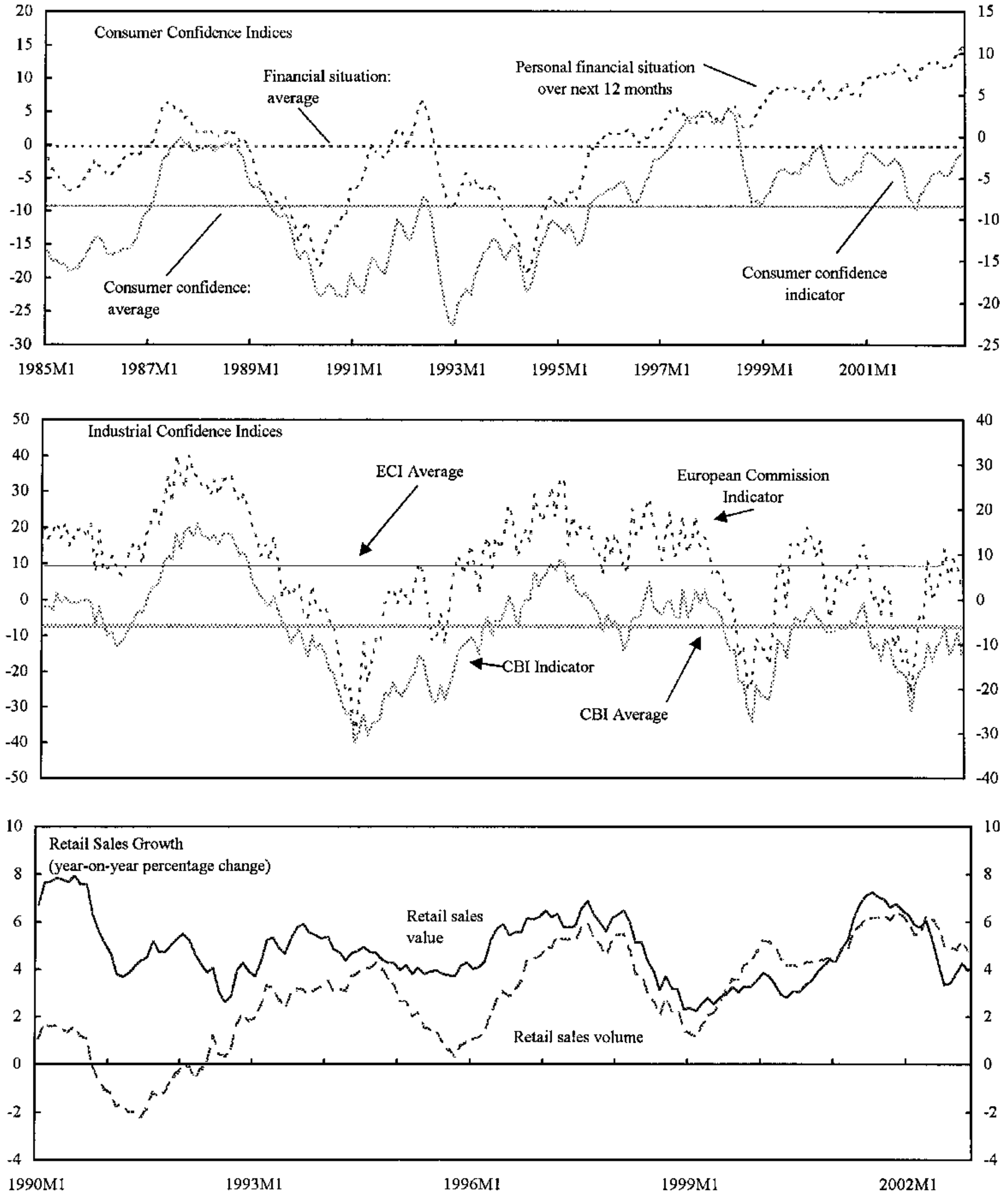
Figure 6. United Kingdom: GDP Growth and the Output Gap





Sources: Office of National Statistics (ONS); and IMF staff projections.

Figure 7. United Kingdom: Leading Economic Indicators 1/



Sources: WEFA; and Office of National Statistics (ONS).
1/ 3-month moving averages.

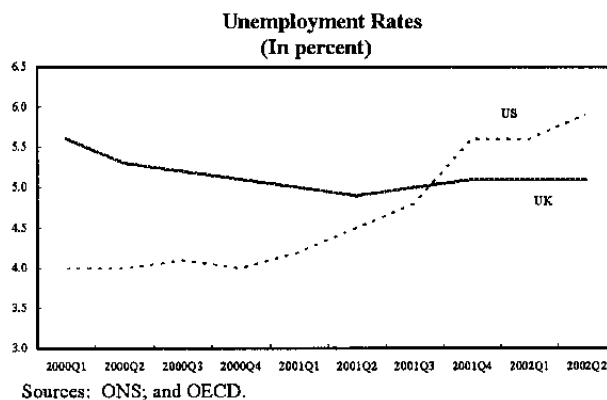
Box 1. Global Economic Uncertainties

The risks to the United Kingdom's outlook from external shocks remain significant, and could interact with, and amplify, the domestic risks outlined in paragraph 7. The main risk arises from a slower-than-anticipated recovery in world demand. The projected continuation of the U.K. recovery depends importantly on the assumption that global demand will gather steam later in 2003, offsetting the weakening trend in private consumption. If the recovery, particularly in euro area, were delayed—possibly reflecting uncertainties in developments in the Gulf—U.K. growth in 2003–04 would suffer not only because of lower exports and investment, but also because of weakening consumer confidence, particularly if unemployment were to rise.

With the United Kingdom being a small net oil exporter, a rise in oil prices would have, instead, limited effects. The output effect of an oil price increase is likely to be negative, but small: (i) on the supply side, the adverse impact on domestic non-oil producers is likely to outweigh the positive impact on oil producers; (ii) on the demand side, the contractionary effect on oil consumers is likely to be larger than any positive impact from higher incomes of oil producers and the government (through taxation). The effect on inflation is damped by the fact that a large part of U.K. oil taxation is levied at specific rates (i.e., not as a percentage of the base price). Staff's simulations suggest that a US$5 per barrel increase in oil prices would, in the first two years, cumulatively lower GDP by about 0.2–0.4 percent and raise RPIX inflation by 0.3–0.6 percent.

- United Kingdom's employment and wage growth had recently been puzzlingly strong, compared for instance, with the United States. Unemployment had edged up only slightly (Figure 8) as output growth decelerated, and unit labor cost growth had remained comparatively high (see text figure). Firms had reacted by cutting working hours and increasing the share of part-time work. But—staff noted—if the prospects for a global recovery dim, unemployment would eventually rise, jeopardizing consumption growth, particularly given households' high debt ratios.[1] The authorities acknowledged these risks, which were, however, partly mitigated by two considerations. First, the output deceleration had been more limited than in other countries. Second, manufacturing—the sector more affected by the slowdown—had already shed labor (with employment rising in the public, distributive, and construction sectors; see text figure).

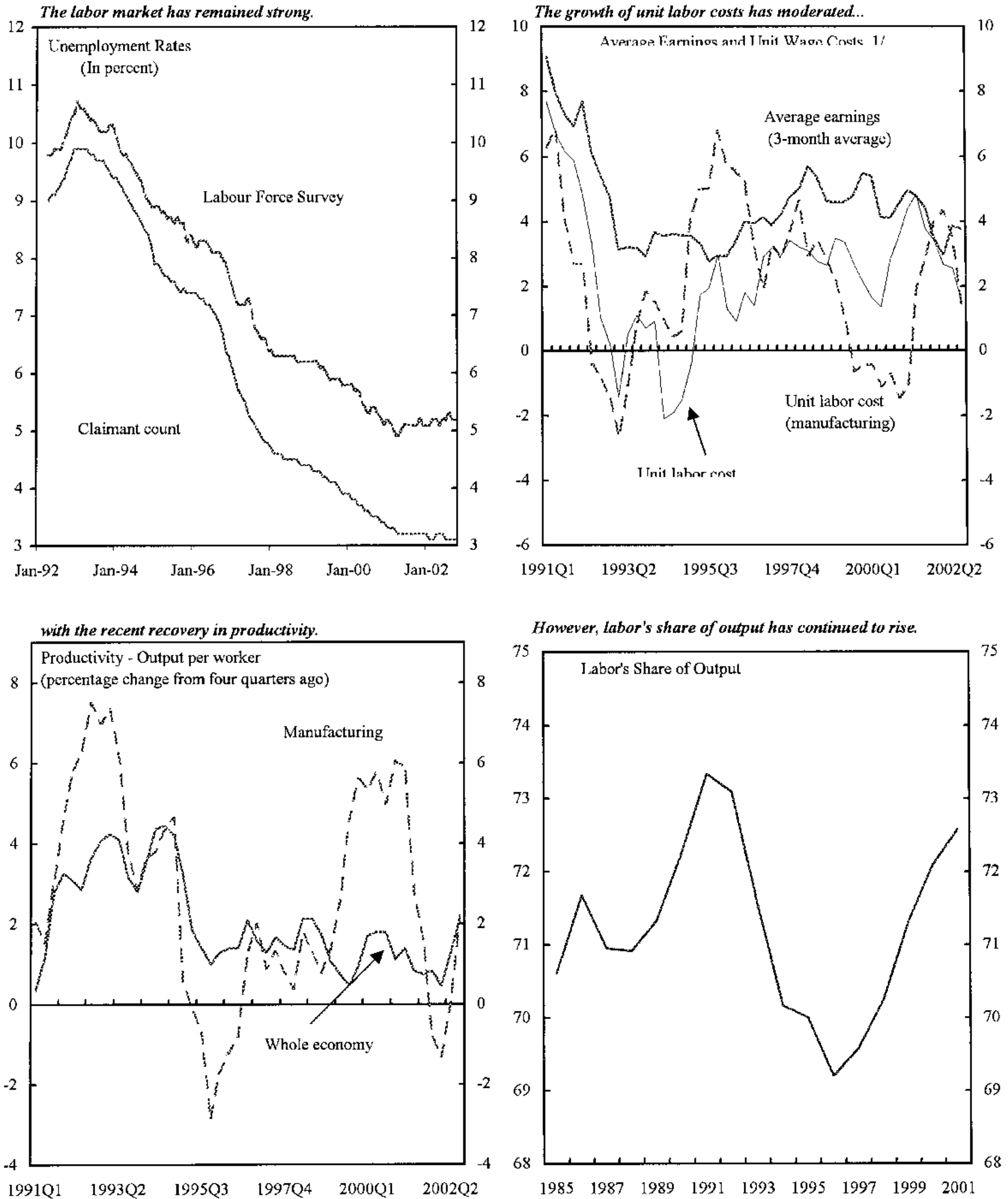
Unemployment Rates
(In percent)



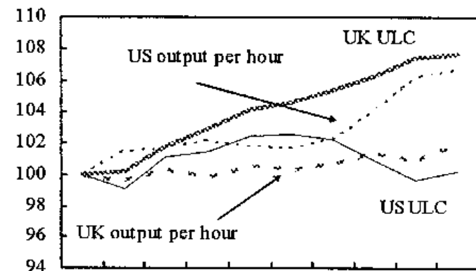
Sources: ONS; and OECD.

[1] As in other countries, consumption in the United Kingdom is quite sensitive to developments in unemployment. See "Why Has U.K. Household Consumption been so Strong?" (IMF Country Report No. 02/46).

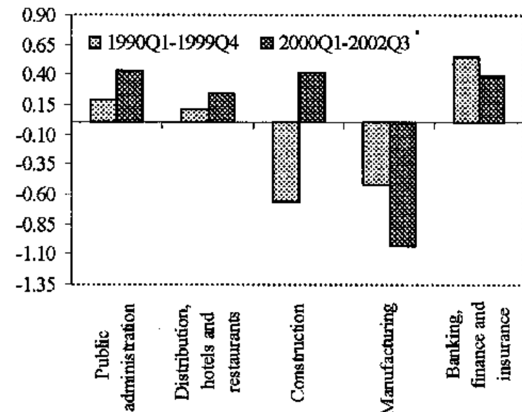
Figure 8. United Kingdom: Labor Market Developments



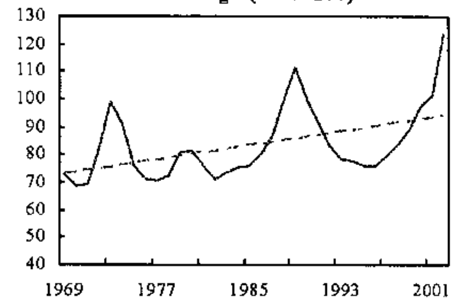
Source: Office of National Statistics.



Sources: ONS; and BLS.
1/ UK data for whole economy; US data for non-farm businesses.



Source: ONS; and staff calculations.



Source: Mix-adjusted housing index, ODPM.

- House prices, following years of sizeable growth, had surged by some 25 percent in 2002, rising above historical trends also when scaled by households' earnings. The strength of house prices, and of consumption, had partly reflected better credit conditions stemming from increased competition in retail banking. In turn, however, higher house prices had raised the value of households' collateral with feedback effects for borrowing opportunities. As a result, household debt, both secured and unsecured, had risen sharply, reaching the peak preceding the early-1990s fall in house prices (Figure 9). Although the rise in house prices was partly structural, staff analysis and the views of many analysts suggested that increases over the past year or so were difficult to justify in terms of fundamentals and might reflect a bubble.[2] A fall in house prices would slow consumption growth, as it would reduce households' wealth and capacity to borrow.[3] This effect would be amplified if the fall were accompanied by rising unemployment, because job losses would reduce households' ability to service their debt, thereby weakening the financial sector and slowing credit growth further (although financial stability was not likely to be jeopardized; see below). The authorities noted, moreover, that microeconomic aspects of the debt data underscored the vulnerabilities (Box 2). Monetary policy would, of course, support economic activity, should shocks to consumption push inflation below target. But— staff noted and the authorities agreed—a slower-than-anticipated pace of growth might be inevitable in such a scenario. Discussions also explored the scope for removing any distortion that may have underpinned the exuberance of house prices (and, in general, their volatility). While the recent boom was not fueled by tax distortions (mortgage interest is not tax deductible), there was agreement that planning restrictions placed a considerable constraint on housing supply and could be usefully reviewed.

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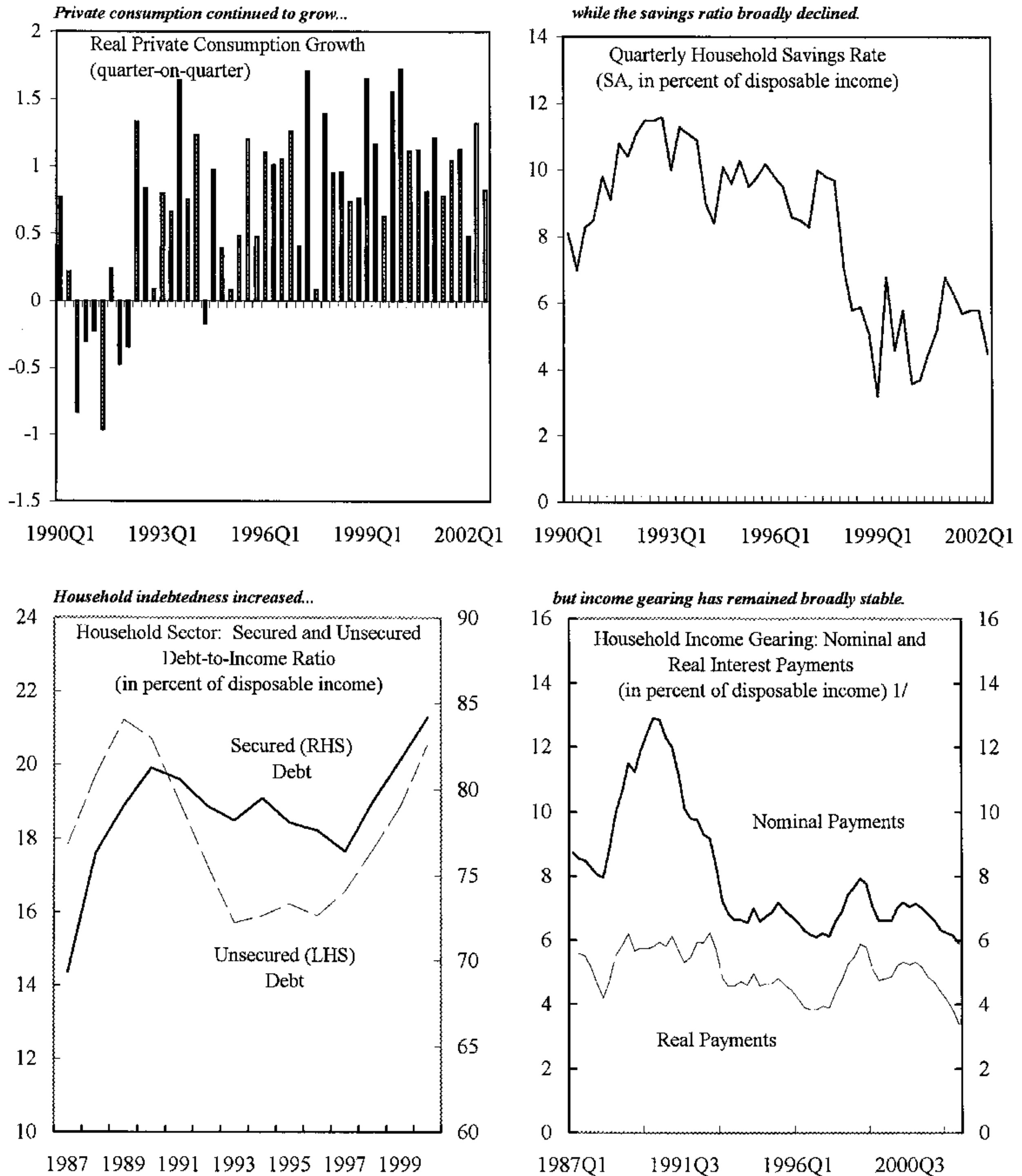
[2] See accompanying *Selected Issues* paper, "An Analysis of House Prices in the United Kingdom."

[3] Staff analysis suggests a sizeable short-run sensitivity of consumption to net housing wealth that is much larger than the sensitivity to net financial wealth (IMF Country Report No. 02/46).

Figure 9. United Kingdom: Private Consumption Developments



Sources: Bank of England; and Office of National Statistics (ONS).

1/ Real payments were derived from total payments after subtracting the quarter-on-quarter inflation rate (smoothed by HP filter) multiplied by the stock of outstanding debt.

Box 2. Household Debt: Survey Evidence

Aggregate data suggest that the sustainable debt of households may have risen due to the drop in interest rates since the early 1990s. Indeed, interest payments in relation to income have fallen sharply (although less markedly if adjusted for inflation; Figure 9). However, microdata from the British Household Panel Survey indicate that the household sector is somewhat more vulnerable to adverse shocks than aggregate data suggest:

(i) While accounting for only a small share of household debt, lower income (and youngest) households have the highest levels, and the largest increase, in debt-income ratios—both secured and unsecured—which underscores their vulnerability to unemployment shocks. During 1995–2000, these households' unsecured debt more than doubled in relation to income.

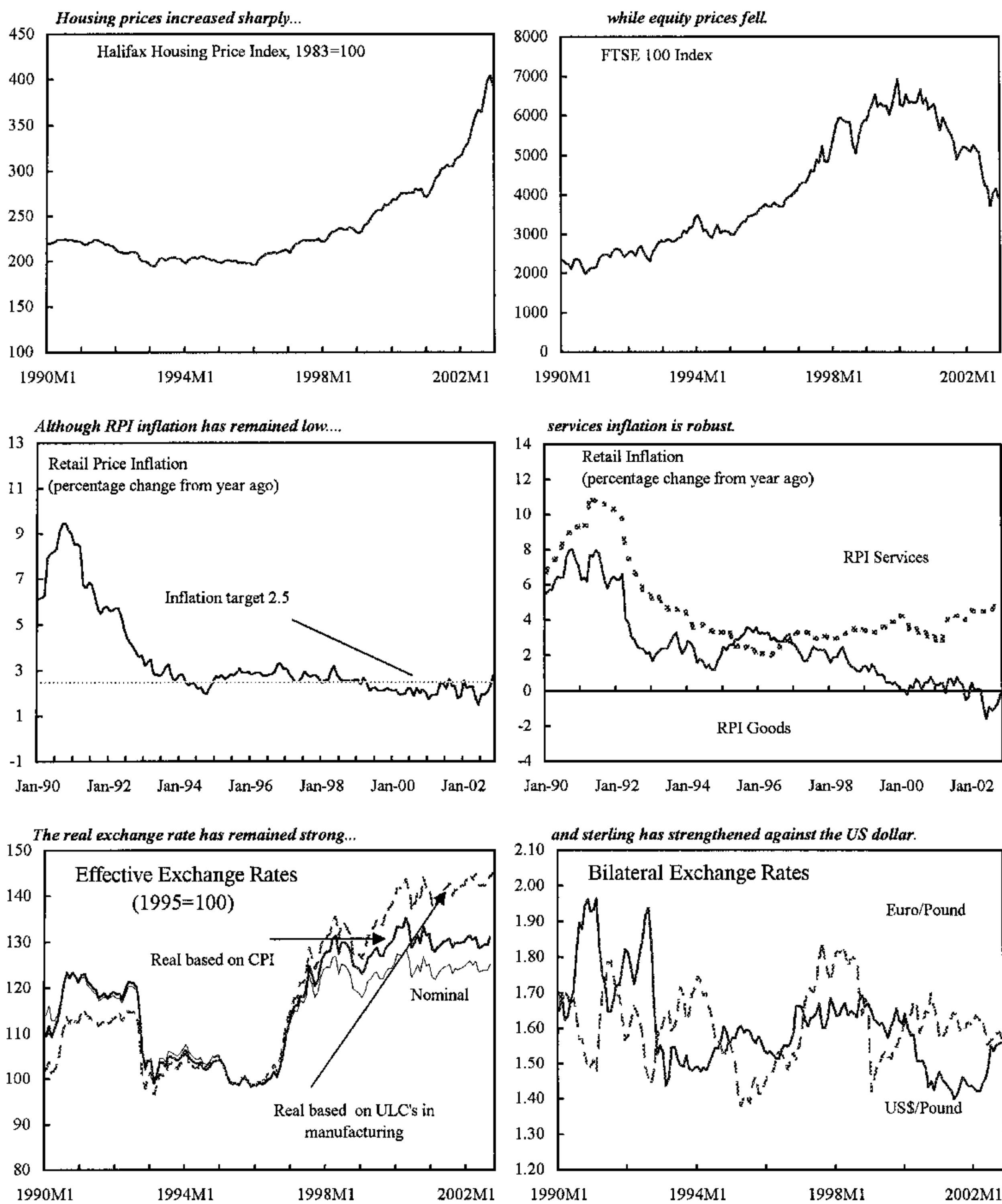
(ii) More indebted households do not, overall, have substantially greater liquid assets than other households, leaving them potentially more exposed to an adverse shock.

8. **There were also some upside risks, mostly related to the possible weakening of sterling**. Following its sharp appreciation since the mid-1990s (Figure 10), the issue of sterling overvaluation had attracted much attention and was discussed in detail during the last Article IV consultation. On that occasion, staff had concluded that sterling seemed to be somewhat overvalued, although not as much as a cursory look at the data would suggest.[4] This view had been shared by the authorities. With the real exchange rate and the current account remaining broadly stable in 2001–02, staff and the authorities remained of this view. A weakening of sterling would facilitate the recovery of manufacturing , with little risk of adverse balance sheet developments, which market analysts and authorities—and also the FSAP assessment—regarded as minimal. Such weakening would put upward pressure on inflation, but, with the real exchange rate moving closer to its long run equilibrium, a moderate depreciation was not expected to be eroded by full pass-through to domestic prices.

9. **Discussions also covered the authorities' plans on possible EMU entry, which would have important implications for the medium- and long-term outlook.** The government's policy remained, as set out in 1997, that: (i) the determining factor underpinning the decision to join would be the national economic interest; (ii) the economic case for joining

[4] IMF Country Report No. 02/39 and "The Rise of the Sterling Real Exchange Rate" (IMF Country Report No. 02/46). This conclusion is also consistent with the assessment under the Fund's "macroeconomic balances" approach (see Isard and others, *Methodology for Current Account and Exchange Rate Assessment*, IMF Occasional Paper 209, 2001). Staff analysis also does not suggest significant sustainability issues (Appendix IV).

Figure 10. United Kingdom: Asset Prices, Retail Inflation, and Exchange Rates



Sources: Bloomberg; IFS; Office of National Statistics (ONS).

had to be clear and unambiguous, based on five economic tests;[5] and (iii) the tests would be assessed by June 2003. A number of supporting studies—to be published concurrently with the assessment—were being prepared relating to specific aspects of each test. The preliminary and technical work was under way and a paper describing the nature of this work had been submitted to Parliament. If the assessment were positive, following cabinet approval, the decision on joining would be put to a vote in Parliament and, subsequently, to a national referendum. The authorities were continuing to make preparations for entry should a decision to join be made.

B. Monetary Policy Dilemmas

10. **The monetary policy discussions focused on how the BoE should respond to the continued rise in house prices and credit to households**. The inflation-targeting framework followed by the Bank implied that it should respond to such developments in so far as they affected the inflation outlook. In this respect, the MPC has stressed that an asset price bubble that eventually burst would have deflationary effects, leading to the undershooting of the inflation target. This might justify a monetary tightening to fend off the development (or excessive growth) of a bubble. However, such an approach involved difficult trade-offs and judgments:

- A monetary tightening is, in itself, deflationary. This, as stressed by MPC members, gave rise to a trade off between undershooting the inflation target now (as a result of the monetary tightening) or undershooting it later (as a result of the bubble bursting).[6]

- Would a monetary tightening have a predictable effect on asset prices? Members agreed that it was difficult to assess the effects of a rate change on asset prices. Some noted that the marginal changes under consideration were unlikely to lead to abrupt changes in asset prices, but could have an effect on inflation via the usual transmission channels.

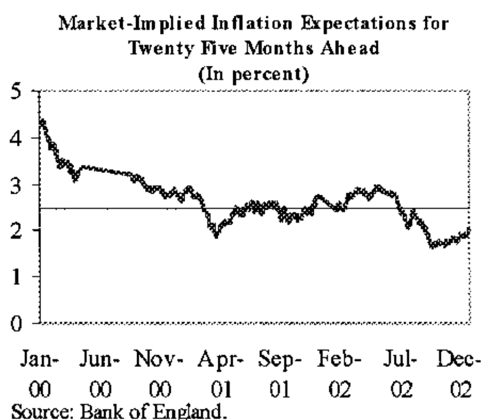
- Could the policy maker know whether the asset price increase reflects a bubble rather than fundamentals? The academic literature has expressed different views on this subject. MPC members also differed on the extent to which they considered house prices to be overshooting equilibrium values (and, correspondingly, whether households were borrowing excessively in relation to permanent income). However, as both house prices and households'

[5] Staff's assessment of the costs and benefits of the United Kingdom joining EMU were discussed in IMF Country Report No. 00/106.

[6] See, for example, Charles Bean, *The MPC and the UK Economy: Should We Fear the D-words?*, speech given at the Emmanuel Society, London November 25, 2002. The intertemporal aspect of the trade-off, however, is not critical. The real choice is between missing the inflation target as a result of the tightening, or missing it as a result of the bubble bursting.

debt continued to grow last year, the likelihood that an imbalance was developing appeared higher than in 2001—a possible reason why these factors seem to have weighed on monetary policy decisions more strongly during the past several months.

11. **The continued rise in house prices and households' debt has indeed been cited in the MPC minutes as a factor that weighed on the decision not to lower interest rates during 2002, in spite of weaker-than-expected external demand**. The repo rate had been kept at 4 percent since November 2001, a historically low level, but still higher—including in real terms—than corresponding rates in the United States and the euro area (Figure 11). In this context, RPIX inflation had remained below target for most of the year. It rose above target recently, mainly due to higher imputed housing costs reflecting the rise in house prices.[7] Inflation, on a HICP basis, has remained at about 1½ percent.

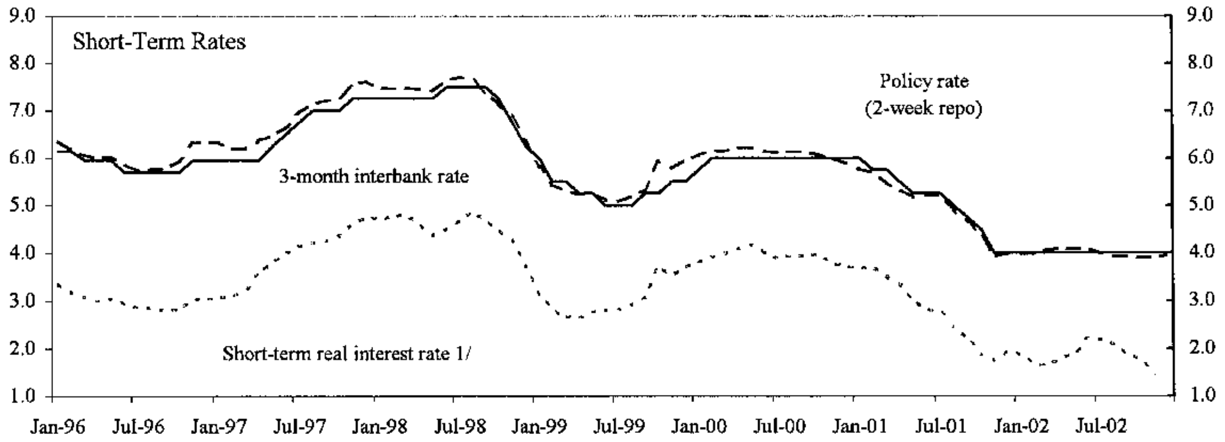


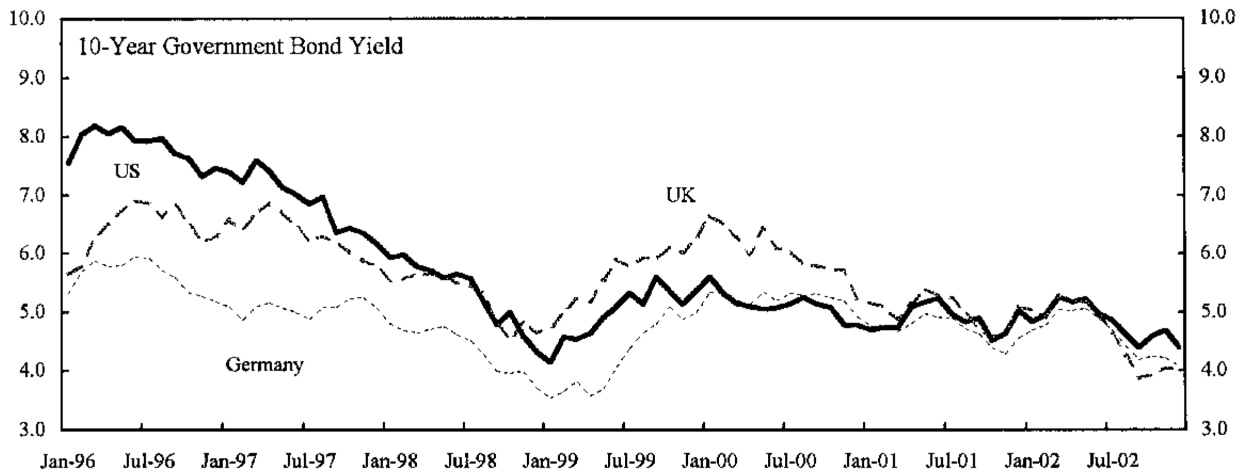
Source: Bank of England.

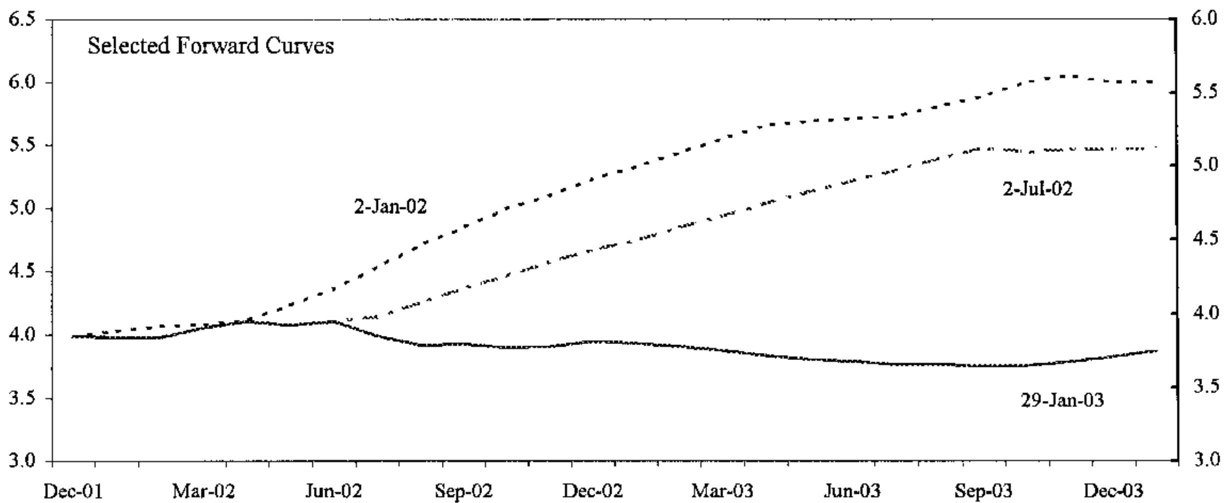
12. **Looking ahead, the MPC did not see immediate reasons to change interest rates**. At current rates, inflation was projected to remain somewhat above target in the near term (mainly due to the April 2003 increase in national insurance contributions, the lagged technical impact of house price inflation, and oil prices), before gradually declining to target two years hence. This projected stability of underlying inflation was underpinned by low inflation expectations (indeed, below the inflation target and at all-time lows); prospects for GDP that were in broad balance with supply capacity; and the view that consumption would decelerate as employment growth and house price inflation slowed. Risks to inflation were broadly balanced, although for most members, the short-term risks had shifted modestly to the upside due to the impact on consumption of continued strong household borrowing and house price inflation. In addition, the continued tightness of the labor market—as reflected in the low unemployment rate, relatively sustained unit labor costs growth, and the rising labor share in output (Figure 8)—also suggested some upside risks in the upcoming settlement round. However, a few members considered there was a case for a small rate cut due to a weaker outlook for global growth and domestic investment. They also felt that the housing market was slowing and that household debt accumulation was a rational response to lower interest rates and a robust labor market. Staff agreed that the present monetary policy stance was broadly appropriate, noting in particular, the downside risks from a slower-than-anticipated global recovery and the upside risk that public spending could lead to public sector—as well as generalized pay—pressures in

[7] In the United Kingdom a rise in house prices thus also has a direct effect on inflation.

Figure 11. United Kingdom: Interest Rates.







Sources: Bank of England; Bloomberg; IFS; Office of National Statistics (ONS).
1/ The short term real interest rate is $\{[(1+i)/(1+\pi)-1]*100\}$, using three month treasury rate and RPIX inflation rate.

a tight labor market.[8] Of course, the authorities should stand ready to respond swiftly to the changing balance of risks, taking into account the significant loosening of fiscal policy, whose effects will take some time to materialize fully.

C. Fiscal Policy Challenges

Policy Implementation

13. **The November 2002 Pre-Budget Report (PBR) envisaged a larger widening of the fiscal deficit, in both the short and the medium term, than the 2001 PBR.** Leaving aside cyclical factors, the 2 percentage points of GDP weakening in the deficit in FY 2002–03 with respect to the previous year reflected not only increased spending—which the authorities were raising from levels they regarded as structurally too low—but also an unexpectedly large loss of profit taxes paid by financial corporations. This loss, however, was projected to be temporary (as financial company profits were expected to recover) and partly offset by stronger tax compliance, reflecting recent (or forthcoming) anti-evasion measures. Indeed, the larger medium-term deficit (1½ percent of GDP against 1 percent in the 2001 PBR) was mostly due to the further increase in public spending envisaged in the April 2002 budget, which had been only partly offset by a hike in social security contribution rates.

Fiscal Balances and Public Debt 1/ 2/
(In percent of GDP)

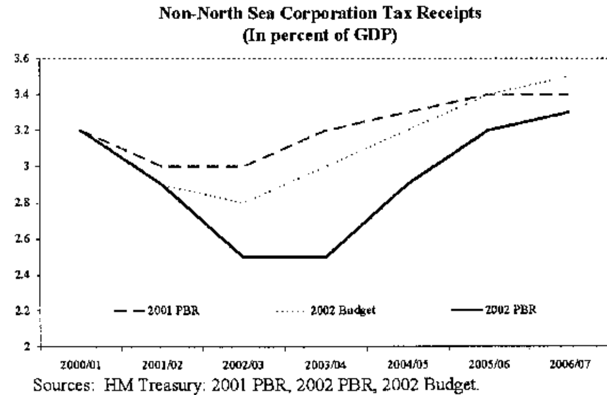
	2001/02	2002/03	2003/04	...	2005/06	2006/07
Overall balance	Outturn		Projections			
Nov 2001 PBR	-0.3	-1.1	-1.4		-1.1	-1.1
Nov 2002 PBR	-0.1	-1.9	-2.2		-1.6	-1.5
Staff	0.1	-2.1	-2.5		-2.3	-2.2
Cyclically-adjusted Overall balance						
Nov 2002 PBR	-0.2	-1.2	-1.5		-1.5	-1.5
Staff	0.2	-1.5	-1.7		-2.0	-2.1
Net public debt						
Nov 2002 PBR	30.4	31.0	32.1		32.6	32.7
Staff	30.3	31.0	32.3		34.2	34.8

Sources: 2001 PBR, 2002 PBR and staff projections.
1/ Official projections based on official GDP, and staff projections based on staff's GDP.
2/ In fiscal years, which run from April through March.

14. **Staff did not regard the short-run widening of the deficit as a cause for concern, but saw the need for corrective measures over the medium term to move the cyclically-adjusted deficit gradually back to about 1 percent of GDP.** The fiscal expansion had supported economic activity in 2002, thus contributing to the comparatively favorable output performance and, in the context of a low debt ratio, had been financed without an increase in long-term interest rates. But, over the medium term, additional measures would be needed for two reasons:

- On current trends, the deficit would likely exceed the authorities' projections. It was, in particular, doubtful whether tax payments from financial corporations might recover their

[8] Views differed on this issue, with many commentators noting that there was little evidence of public sector wages leading private wages. Others, however, agreed that the labor market had not been so tight for many years and, hence, spillover to the private sector might be greater than in the past.

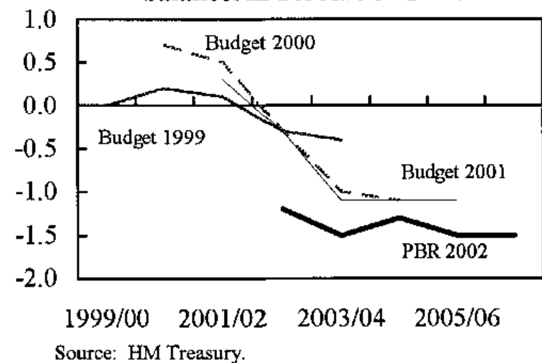


Sources: HM Treasury: 2001 PBR, 2002 PBR, 2002 Budget.

late-1990s level—a period of financial market boom; more generally, the reasons for tax buoyancy in that period were not fully understood, which called for caution.[9] Altogether, the medium term deficit could be 2–2¼ percent of GDP (Table 5).[10]

- Staff saw no strong reason for revising the medium-term deficit target from 1 percent of GDP to 2–2¼ percent of GDP (or to 1½ percent of GDP). The increase had reflected the authorities' decision to raise spending further, even though the 2001 PBR already envisaged quite a rapid growth in spending. Larger medium-term deficits involved, ceteris paribus, more crowding out and would reduce the scope for counter-cyclical action: starting from a strong initial position, the last two years' fiscal expansion had played a useful counter-cyclical role, but expanding from a starting deficit of over 2 percent of GDP might elicit a negative market response.[11] Moreover, a new downward revision of the medium-term fiscal outlook, after already large revisions in previous years (text figure), might be interpreted as a sign of reduced commitment to fiscal prudence. Finally, even though the projected effect of population aging on the public finances appeared more moderate than in continental Europe, there were significant

Development of Budget Forecasts (Cyclically-adjusted public sector budget balance, in percent of GDP)



Source: HM Treasury.

[9] Eschenback and Schuknecht (*The Fiscal Costs of Financial Instability Revisited*, ECB Working Paper 191, 2002) provide evidence (including a case study of the United Kingdom in the early 1990s) that the end of asset price booms are followed by persistent declines in tax revenues.

[10] Another source of uncertainty was the effect on revenues of improved tax administration. The 2002 PBR also raised the trend GDP growth used to project revenues. The revised growth rate (2½ percent) was in line with staff's estimate but, in staff's view, no longer included a margin for uncertainty.

[11] Moreover, European Commission estimates suggest that a structural deficit larger that 1¼ percent of GDP would place the United Kingdom at risk of breaching the SGP's 3 percent deficit limit during economic downturns.

uncertainties over the size of pension liabilities that argued for a more conservative medium-term fiscal deficit target (Box 3).[12]

Box 3. Pension Obligations and Long-Term Fiscal Trends

The United Kingdom's long-term public finances appear to be in a better position than those of many other advanced economies. Fiscal sustainability has been underpinned by low public debt, less unfavorable demographics, and most importantly, limited future public pension obligations.[1] These limited obligations reflect a largely privately-funded pension system, whose adequacy depends on individuals saving sufficiently for retirement. Retirement saving was encouraged through a variety of tax-supported pension and saving schemes, while budgetary support was increasingly focused on providing a safety net for pensioners through the Minimum Income Guarantee, combined with a graduated Pension Credit.[2]

Staff supported this approach, but noted that there were some risks. The projection of low pension liabilities for the state hinged on the assumptions that the private sector would save enough and that the yield on private savings would be sufficiently high. Should these assumptions prove wrong, public sector spending through the Minimum Income Guarantee, which was indexed to earnings,[3] would be larger. Recent official publications have noted that a significant number of individuals are not saving adequately for retirement.[4] To encourage retirement saving, staff suggested simplifying the existing array of tax-supported saving vehicles, which seemed excessively complex. A subsequent government consultation paper, indeed, proposed some simplification. Staff also supported improving the transparency of various pension saving instruments, particularly by establishing standardized, regulated life-insurance products, as recommended by the Government-commissioned Sandler Review.

[1] The authorities' baseline projection is that public pension expenditure will remain broadly constant at 5 percent of GDP over the next thirty years.
[2] *Simplicity, Security and Choice:* Working and Saving for Retirement, Department for Work and Pensions, 2002.
[3] The current policy is to index to earnings through the life of this Parliament.
[4] *Financial Risk Outlook*, 2003, FSA.

15. **The authorities maintained that, as in the past, their revenue projections remained cautious and that, with the two fiscal rules met under their projections, fiscal credibility was not at stake.**[13] In particular, the VAT projections were conservative, and may overperform.[14] As to credibility, the critical test was whether their budget outlook was meeting the two fiscal rules that were a key pillar of the fiscal framework. These rules were indeed met (and with a margin) under their projection. Moreover, they did not rule out the possibility that the medium-term deficit would be lowered after the period covered by the present forecast. Staff noted that, while the two rules were important, due to past

[12] See Appendix IV for a further discussion of fiscal sustainability scenarios.

[13] The two rules are: the *golden rule* requiring current spending to be covered by current revenue over the cycle; and the *sustainable investment rule* requiring debt to be held at a stable and prudent level, currently interpreted at 40 percent of GDP, also over the cycle.

[14] Budget projections assume that the ratio of underlying VAT to consumption falls by 0.05 percentage points a year.

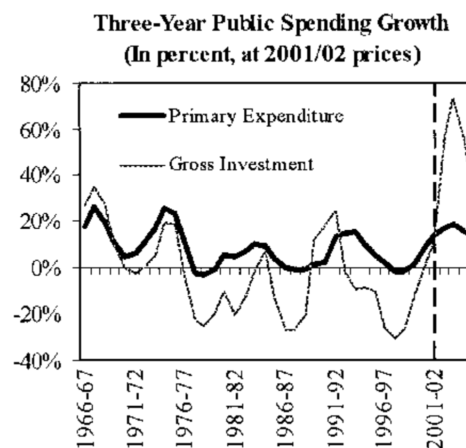
overperformance, the rules now left much leeway for actual fiscal policy, and could be met by policies with very different effects on the economy (see below).

Expenditure Increases Under Department Expenditure Limits (DELS)
(Real growth rates)

	2002/03	2003/04	2004/05	Cumulative increase
Education	20.7	7.4	5.9	37.2
Health	9.6	9.1	6.6	27.4
Transport	18.5	24.3	1.2	48.9

Source: U.K. authorities.

16. **Staff also questioned whether it would be possible to raise public spending as rapidly as currently envisaged without risking inefficiencies.** Staff acknowledged the need to respond to the demand for better public services (Box 4). Some spending increases were likely needed in areas such as health and transport, where spending was low relative to historical and EU averages. However, the need for higher spending was less obvious in other areas, such as education, where spending was already comparable to international levels. Moreover, as noted in last year's discussions, the sheer speed at which spending was being increased risked inefficiencies that a more gradual approach might have avoided.



Sources: Staff calculations based on 2002 PBR and ONS data.

17. **The authorities stressed that reforms to the public expenditure management framework, which was under continuous improvement, reduced the risk of spending inefficiencies.** Reforms to enhance the efficiency of public spending comprised three aspects:

- **Setting clear and monitorable targets in terms of delivery of services** (the so-called Public Service Agreements, or PSAs, that each department had to publish). Based on these targets, spending plans were set on a three-year horizon, so as to allow departments more effective planning. Departments were also given greater freedom on how to achieve the targets, including through greater delegation to local units responsible for delivering services.

- **Enhancing monitoring and transparency.** Departments were increasingly being required to publish their investment strategies and assessments of progress against PSAs. Public reporting on the performance of local authorities, schools, hospitals and police forces was also being expanded.

- **Enhancing accountability and incentives.** Independent audit and inspection units were being strengthened. The authorities had also recently undertaken a review of public sector pay. The review noted the need to give managers greater freedom to make personnel management choices, to consider pay systems linking pay to performance, skills, and merit; and to allow greater local-level pay variation, particularly in the London area, to respond to local skill needs and recruitment difficulties.

Box 4. Why More Public Services Now?

Following the decline in public investment since the mid-1970s, current public spending was cut sharply in relation to GDP from the mid-1980s until 1990, seemingly with popular support. Attitudes to public spending seem now to have shifted markedly—demand for better public services in health, education and transport was a central issue in the 2001 election, backed by an apparent greater willingness to pay higher taxes, if needed. Why have attitudes changed? Discussions with academics, analysts, and policy makers suggested the following factors:

- Voter attitudes favoring public provision of health, education, and infrastructure have not fundamentally changed. Rather, by the early 1980s, voters were disillusioned with government's capacity to deliver, partly because of spending in other areas such as support for failing industries and welfare benefits. Following privatization, and the government's economic track record since 1997, voters may be more inclined to believe that taxes will be well-spent.
- Health and education have remained largely publicly provided. As spending was tightened, the effects of underfunding these services have become evident over time.
- Expectations regarding the quality of public services have increased with rising incomes and growing awareness of standards in continental Europe.
- Although the tax revenue-to-GDP ratio has increased in recent years, there have been few rate hikes, so voters have not yet perceived the cost of higher spending. Hence actual willingness to pay higher taxes cannot be gauged as yet.
- With the fiscal expansion coinciding with a cyclical downturn, the crowding out of the private sector has been limited. Hence, the cost in terms of competition for resources has not been felt.

Preferred Balance between Tax and Spending

Date	Prefer both tax and spending cuts (1)	Keep current tax and spend levels (2)	Prefer both tax and spending increases (3)	Majority for spending increases (3)-(2)-(1)
		(In percent of total responses)		
Jan. 1959	13	9	78	+56
May 1960	28	5	67	+34
Oct. 1978	29	26	45	-10
May 1979	37	26	37	-26
July 1993	8	15	75	+52
Feb. 1995	8	16	69	+45

Source: Clark, Tom, 2001, "The Limits of Social Democracy? Tax and Spend under Labour, 1974–79" Institute of Fiscal Studies Working Paper No. 01/04; based on Gallup Political Index (various editions).

18. **Staff supported the thrust of these reforms, but noted that their effectiveness in improving public service delivery, particularly at higher levels of spending, will not be known for some time**. While clear progress had been made in setting targets for service delivery, some of the reforms to enhance monitoring and, especially, improve incentives were relatively new; being revised based on experience; or still being defined. Staff encouraged the authorities to act swiftly on these issues, particularly in the difficult area of public sector pay

policy. There was also greater scope for the private provision of public services in order to improve delivery and increase competitive pressures. The authorities noted that they were encouraging private sector participation through Public Private Partnerships (PPPs), which provided additional resources for investment—especially in hospitals, schools, and transportation—and helped ensure more efficient management of these investments. Private investment through PPPs represented about 10 percent of total public investment each year.

19. **Public spending—staff added—could also be made more efficient through the broader application of user fees, to rationalize demand and avoid subsidizing middle-to-upper-income users**. Larger income transfers—or, where applicable, means-tested user fees—could offset the negative impact on low-income groups. The authorities observed that user charges were applied in some areas such as transportation and drug prescriptions, but noted that market failures—for instance due to information asymmetries between providers and users—militated against their use in areas such as health.

20. **The authorities have met part of their increased spending commitments with tax increases.** Most significantly, the 2002 budget raised national insurance contributions for both employees and employers by 1 percentage point starting April 2003. Staff reiterated that broadening the tax base, particularly of indirect taxes, would have been preferable as it would have improved the neutrality of the tax system (see IMF Country Report No. 02/39). As with user fees, targeted transfers could have offset the adverse effects of base broadening on the poor. On other aspects of tax policy, staff welcomed the authorities' proposals to reform the corporate tax regime with a view to simplifying it and bringing it closer to business accounting practices. Staff also suggested moving similarly in other areas to streamline the special favorable tax treatments and deductions introduced in recent years.

Fiscal Framework

21. **Staff welcomed the high standards of transparency in fiscal policy.** In particular, budget documentation provided a clear and comprehensive view of performance relative to past budgets and policy intentions moving forward. The new report on long-term public finances was also useful, and staff encouraged further improvements, for instance, by publishing more detailed assumptions and sensitivity analyses, particularly regarding the expected performance of private pensions (which had important implications for future claims on means-tested public pension benefits).

Meeting the Fiscal Rules: An Illustrative Example 1/
(In percent of GDP)

	Average Current Balance	Maximum Average Overall Balance
Actual, FY00/01-FY02/03	2.5	-0.1
Feasible, FY03/04-FY06/07, if:		
1. golden rule is met	-2.5	...
2. sustainable investment rule is met at all times 2/	...	-3.8
3. sustainable investment rule is met over the cycle 3/	...	-8.7

Source: Staff calculations.
1/ Assuming the duration of the current economic cycle is from FY00l to FY06/07.
2/ With net debt reaching 40 percent of GDP by FY06/07.
3/ With the net debt to GDP ratio averaging 40 percent during FY00/01–FY06/07.

22. **The two fiscal rules—the "golden" rule and the sustainable investment rule—are a keystone of the authorities' fiscal policy**

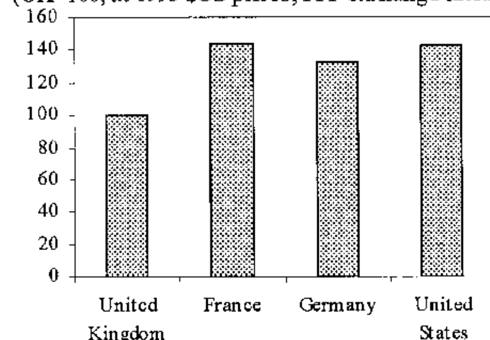
framework. Staff noted, however, that given past surpluses, the rules—particularly the sustainable investment rule—were no longer as constraining as when they were introduced. Moreover, it was not clear whether the sustainable investment rule should be interpreted as setting a public debt ceiling holding at all times or only on average over the cycle. In the latter case the current leeway would, indeed, be very large (see text table). The mission suggested that it would be timely—almost five years after their introduction—to undertake a study of the fiscal rules, with a view to assessing whether they could be calibrated so that margins from past overperformance did not allow excessive leeway in the future. The authorities maintained that the rules provided an adequate guide to policies that was well understood by the private sector, but agreed that a clarification of the sustainable investment rule was needed: while the 40 percent ceiling was meant to hold at all times, the wording of the rule was not clear in this respect.

D. Boosting Long-Term Growth

23. **Raising labor productivity remains a policy challenge.** The United Kingdom lost most of the ground on productivity vis-à-vis continental Europe during the 1960s and the period of macroeconomic instability in the 1970s. Although the relative productivity decline was arrested in the early 1980's, and some gains made in the 1990s, a sizeable productivity gap remains. Recent evidence shows that this gap is associated with both a low capital-labor ratio and low efficiency in the use of capital and labor (total factor productivity or TFP).[15] Indeed, with the decline in U.K. public investment since the mid-1970s, public capital remains low compared with other countries. Against this background, the government's strategy to raise productivity includes, in addition to increased public investment, maintaining the macroeconomic conditions for strong private investment and a multipronged approach to boost TFP.

GDP per Hour Worked: Average 1991-2000

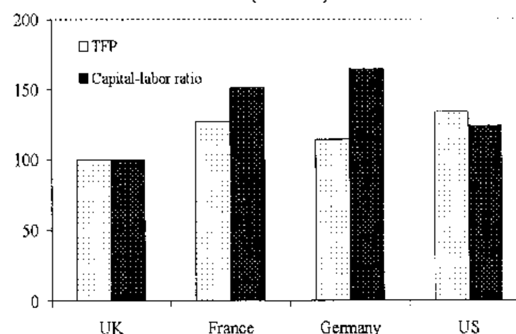
(UK=100, at 1995 $US prices, PPP exchange rates)



Sources: AMECO; and staff calculations.

Labor Productivity Components: Averages 1991–2000

(UK = 100)



Sources: AMECO; and staff estimates.

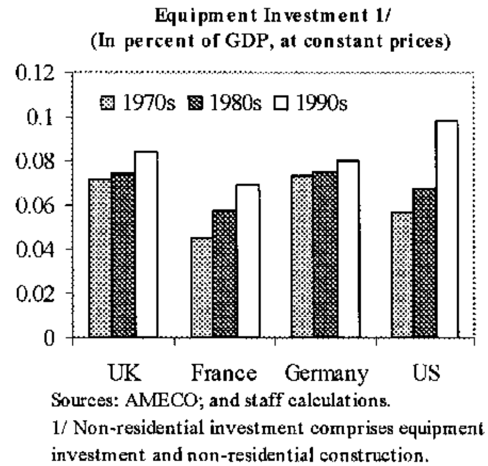
24. **Staff agreed with the strategy favoring increased investment, albeit with some reservations.** It concurred that maintaining a stable macroeconomic environment and financial system was key to boosting private investment. The

[15] See *Selected Issues* paper, "Cross-country Overview of Growth Patterns, 1970–2000."

historically high investment rates during the late 1990s—and indeed even currently—could be considered a measure of success in this regard. At the same time, staff noted the need to qualify the importance attributed to the capital shortfall in holding back productivity. First, much of the capital shortfall was related to a lower stock of non-residential structures, rather than of machinery and equipment, which might be expected to be more closely related to productivity differentials.[16] Second, the gap in the capital-labor ratio vis-à-vis countries such as the United States and Canada was narrower than that vis-à-vis continental European economies. In fact, in some of the latter countries, the rise in capital-labor ratios might partly reflect labor market distortions and high labor costs.[17] Third, while the United Kingdom's public capital stock was, indeed, lower than that of other industrialized countries, it did not necessarily follow that increases in public capital would lead to productivity increases—although they might address the pent-up demand for public services. The empirical evidence was ambivalent on the extent of spillovers from public investment to higher private sector productivity.[18] Authorities and staff agreed that the quality and cost-effectiveness of public investment was thus critically important to any expected productivity gains.

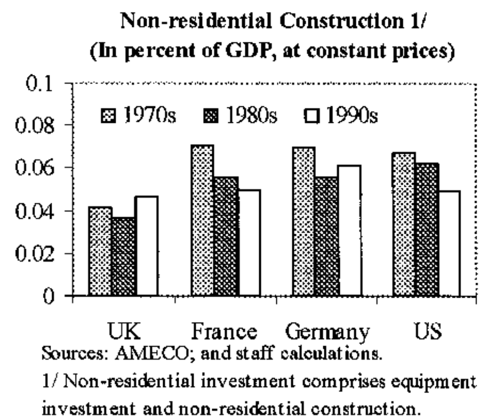
25. **The key to long-term economic prosperity is to raise TFP, as this would allow resources to be diverted from investment to consumption without sacrificing growth.** The factors that contribute to higher TFP are uncertain and the ability of policies to raise TFP is frequently

Equipment Investment 1/
(In percent of GDP, at constant prices)



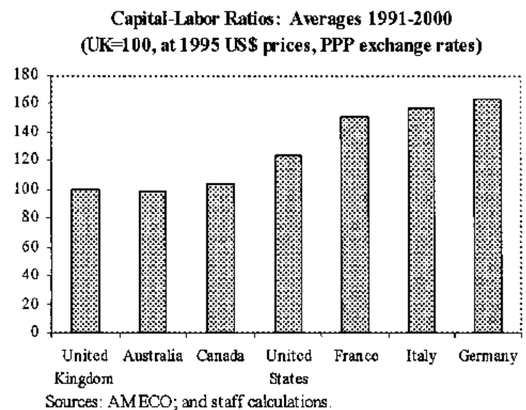
Sources: AMECO; and staff calculations.
1/ Non-residential investment comprises equipment investment and non-residential construction.

Non-residential Construction 1/
(In percent of GDP, at constant prices)



Sources: AMECO; and staff calculations.
1/ Non-residential investment comprises equipment investment and non-residential construction.

Capital-Labor Ratios: Averages 1991-2000
(UK=100, at 1995 US$ prices, PPP exchange rates)



Sources: AMECO; and staff calculations.

[16] See *Selected Issues* paper, "United Kingdom Investment: Is There a Puzzle?"

[17] Blanchard (1997): "The Medium Run," *Brookings Papers on Economic Activity.*

[18] Sturm and Haan (1995): "Is Public Expenditure Really Productive?" *Economic Modeling.* Indeed, public investment was high by international comparison in the 1960s and 1970s when the U.K. productivity fell behind, The present low public capital stock reflects the sharp cutback in public investment since the mid-1970s.

questioned. Nevertheless, the evidence suggests the importance of three factors central to the authorities' strategy.[19]

- **Competition Policy.** Increased competition—starting with the 1980's reforms furthering privatization and deregulation—has had a strong positive impact on U.K. TFP growth through: (i) the entry and exit of firms; (ii) more productive firms gaining market share; and (iii) "preemptive innovation" by incumbent firms to defend market share. Scope remains for intensifying competition. The authorities are now strengthening the competition framework through the Competition Act that came into force in 2000, the proposed Enterprise Act, and the enhanced powers of the Office of Fair Trade and the Competition Commission. Staff supported these reforms and encouraged efforts to liberalize planning restrictions, which have been shown to hamper competition in important sectors (including wholesale and retail distribution and housing).

- **Skills.** Changes in the skill composition of the labor force have been estimated to explain about one fourth of labor productivity growth and almost half of TFP growth in the United Kingdom during 1995–2000. Still, skill differences are estimated to account for most of the TFP differential with countries such as France and Germany. As the United Kingdom's education spending-to-GDP ratio is comparable to ratios in these countries, staff stressed that the focus should be on targeting and improving delivery, particularly in secondary school education and vocational training to develop intermediate skills—areas where the United Kingdom lags other countries. The authorities intended to publish a strategy on higher education by early-2003. The staff welcomed the decision to reconsider the balance between government and private contributions to tuition costs and, given the considerable private returns to higher education, suggested greater application of user fees to rationalize demand, combined, as appropriate, with means-tested financial assistance.

- **Research and Development (R&D).** The United Kingdom's low level of R&D is estimated to account for a large part of the TFP gap with respect to the United States. The authorities expect that the recently-introduced tax credit should boost R&D spending. They had also commissioned an independent review on how business could better draw on university services.

26. **As part of the growth strategy, the government is also encouraging further increases in the employment ratio, from levels that are already high by international standards.** Labor market reforms date back to the 1980s. More recently, further welfare reforms and active labor market policies have aimed to lower unemployment and poverty among specific groups and raise female labor force participation. Notably, the New Deal for Young People appears to have been successful in cost-effectively reducing unemployment among its target group (18–24 year-olds). New Deals programs have been rolled out to other

[19] The academic literature supporting the points below is discussed in the accompanying *Selected Issues* paper on cross-country growth patterns.

socio-economic groups—the unemployed aged 25 and over, lone parents, and the disabled—but these programs have yet to prove their effectiveness and may need to incorporate stronger job-seeking incentives.

E. Providing for Financial System Stability

27. **As discussed in more detail in the accompanying Financial System Stability Assessment (FSSA), the FSAP found U.K. banks well placed to manage domestic and foreign risks.** The authorities agreed that a slower-than-anticipated global recovery or further declines in global equity prices were sources of risk, as some 40 percent of U.K.-incorporated banks' claims were against foreign counterparts.[20] Regarding domestic claims, they concurred that risks to the financial system could arise if unemployment increased or interest rates rose sharply, especially if property prices declined significantly as well. In addition, bank profit margins had narrowed due in part to competitive pressures, regulatory moves to limit fees, and loan loss provisions. Nevertheless, the FSAP supported the authorities' and market participants' view that, overall, U.K. banks remained sufficiently profitable and capitalized to be able to absorb the effects of the more likely macroeconomic shocks without systemic distress. This reflected the healthy profits and capital accumulated during the past decade, the broad range of the banks' activities, and improved risk management practices.

28. **The insurance industry is under considerable stress,** reflecting depressed investment returns, declining profitability in basic life insurance products, and, more recently, increasing regulatory compliance costs as the FSA introduces more stringent prudential supervision. General (property and casualty) insurance companies are also experiencing rising uncertainty from potential claims associated with low probability catastrophic events. The FSAP concluded that the life insurance industry appears headed for large-scale consolidation in coming years, while the general insurance sector appears to have coped remarkably well, benefiting from higher premia following September 11. The authorities agreed with the FSAP finding that the difficulties in the insurance sector do not appear to constitute a systemic vulnerability for the financial system, since most of the weakness is concentrated in small-to-medium sized insurers and the industry's links to the banking system are less important than in other countries.[21] Since insurance companies hold around a fifth of total U.K.-quoted equities, the sector constitutes a potential source of market risk. Indeed, in September 2001, the FSA temporarily suspended—and subsequently amended—part of the resilience test for insurance companies to forestall a potentially destabilizing sale of equities. Given these risks, the FSAP emphasized the need for close monitoring and supervision (see below).

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[20] The FSSA reports the results of stress tests and includes a detailed table of financial soundness indicators.

[21] As noted in the FSSA, financial conglomerates offering both banking and insurance are a relative rarity in the United Kingdom and bank loans to insurers, a traditional channel of contagion, represent only a small fraction of U.K.-owned banks' claims.

29. **U.K. financial markets and infrastructure function well.** Moreover, the authorities agreed with the FSAP's finding that the global financial market activity that takes place in London does not, in itself, appear to pose significant risks to the stability of U.K. financial markets. Although some U.K.-owned institutions are significant players in these markets, London's trading activity mainly involves wholesale market transactions between branches of foreign institutions that have little connection to the domestic financial system. However, the authorities acknowledged the need to continue intensifying surveillance of banks' exposures in the unsecured inter-bank segment of the money market since they could potentially act as a contagion channel in the unlikely event a major bank suffered financial distress (Box 5).

30. **The FSAP found that the supervision framework, which is under continual improvement, shows a high degree of observance of international standards and codes.** The authorities agreed that insurance supervision was the area in most need of reform. They were thus introducing a risk-based insurance supervision framework similar to the one

Box 5. Summary of FSAP Recommendations

While the United Kingdom benefits from a strong financial stability policy framework, the FSAP offered some recommendations to improve the framework further. The main recommendations were:

- Continue to rectify the shortcomings in the current insurance supervision framework and implement the recommendations of the Tiner Report so that supervision is fully consistent with the importance of the U.K. insurance sector.
- Actively pursue the remaining steps needed to strengthen the payments and securities settlement infrastructure.
- Continue to strengthen the monitoring of inter-bank linkages, particularly via unsecured money markets, that could be important channels for contagion.
- Continue efforts to promote market discipline through improved disclosure and governance in financial institutions.
- Pursue technical improvements within the supervisory framework in general to strengthen further the baseline monitoring of key risks.
- In the area of AML/CFT, pursue a range of technical improvements to enhance the regime's strength and effectiveness, following the new Proceeds from Crime Act.

adopted for banking supervision, in order to bring insurance supervision up to the standards applicable to a major international center. The FSAP found the safety net, systemic liquidity, public debt management, and system-level surveillance and insolvency arrangements to function well and the accounting and disclosure regime to be of a high quality.

31. **The United Kingdom's legal, institutional, and supervisory regime for AML/CFT is broadly in line with the criteria set forth in the IMF/World Bank AML/CFT Methodology.** The FSAP found the system to have been strengthened over the last few years, with the adoption of key measures on terrorist financing and non-bank financial institutions, and by issuance of the FSA's Money Laundering Sourcebook. The authorities expected further improvements with the implementation of the Proceeds of Crime Act and new provisions that mandate the inclusion of originator information on fund transfers originating in the United Kingdom.

F. Other Issues

32. **The authorities have strengthened anti-bribery legislation and consider the United Kingdom to be now fully compliant with OECD requirements.** New provisions—that came into force in February 2002—clarify both the criminal offense status of acts of bribery of foreign officials and the jurisdiction of U.K. courts over corruption offenses committed abroad by U.K. nationals or bodies incorporated under U.K. law.

33. **The United Kingdom strongly advocates a trade liberalization agenda, within the framework of EU membership.** On EU agricultural trade policies, the authorities are committed to increasing market access, cutting export subsidies and trade-distorting domestic support, and eliminating barriers to imports. They were promoting reform of the Common Agricultural Policy by seeking the gradual replacement of production-linked direct payments by environmental and rural development measures, and pursuing cuts in price supports and abolition of associated supply controls. The authorities expressed concern over the proliferation of trade remedy measures and emphasized their support for tightening rules to prevent abuse of anti-dumping and countervailing measures.

34. **The government is committed to increasing ODA.** ODA is expected to be 0.32 percent of GNP in FY2002/03, rising to 0.33 percent of GNP in FY2003/04, and 0.40 percent of GNP in FY2005/06.

III. STAFF APPRAISAL

35. **U.K. economic performance has remained enviable.** Following almost a decade of sustained output growth, achieved with a low inflation rate, the economy appears to have weathered the global slowdown relatively well. The current account deficit has held steady, despite the continued strength of sterling. The mildness of the United Kingdom's current slowdown can partly be attributed to the timely easing of monetary and fiscal policies, in the context of a credible inflation-targeting framework and a fiscal policy framework oriented to medium-term objectives.

36. **The cyclical recovery in output is expected to continue, but there are appreciable risks to the outlook.** Based on a gradual recovery in world demand—the prospects for which remain uncertain—output growth is expected to pick up in 2003, with modest inflationary pressures. But the increasing reliance on domestic demand has been associated with high levels of household debt and rising house prices that have increased vulnerability to adverse shocks—particularly a sharp rise in unemployment, including as a result of external shocks. The effect of these shocks could be alleviated by a prompt monetary response, but a period of slower-than-anticipated growth may be inevitable as consumers retrench from high debt levels.

37. **The decision whether to join EMU remains a key strategic issue with substantial long-term ramifications.** The government's five tests for assessing the case for entry are broadly appropriate and the announcement of the results of the assessment by June this year,

and subsequent cabinet decision, if any, should clarify the government's intention regarding this issue.

38. **Monetary policy has struck an appropriate balance between competing inflation pressures.** The inflation-targeting framework has performed impressively, as attested by low inflation expectations over the past five years. If the outlook for economic activity weakens, a rate cut may be needed, but would have to be weighed against the risk of fuelling a further rise in household debt and house prices; potential wage pressures; and the fact that fiscal policy has been eased significantly. Wage moderation in public sector settlements can contribute to keeping inflation low.

39. **While the U.K. public finances are among the strongest in the G-7, a cyclically-adjusted medium-term fiscal deficit target of about 1 percent of GDP remains appropriate for the United Kingdom.** Given the current cyclical conjuncture, the short-term widening of the deficit above this level is not a concern. But, there are good reasons for moving the cyclically-adjusted deficit gradually back towards 1 percent of GDP: avoiding crowding out; allowing more room for fiscal policy to play a countercyclical role; preventing the risk that repeated upward revisions to the deficit outlook may weaken fiscal credibility; and maintaining a larger buffer against risks related to population aging. This would require adjustment measures of some 1–1¼ percent of GDP over the medium term. The automatic stabilizers should be allowed to operate freely around a path of cyclically-adjusted deficit targets in line with this recommendation.

40. **Slowing the rise in spending would reduce the risk of significant spending inefficiencies and could help contain medium-term deficits.** The need to respond to the demand for better public services is understandable. But, quite apart from the question of the appropriate spending levels—spending is being raised also in areas where spending ratios are comparable to those of other EU countries—the rapid speed at which spending is being increased raises the risk of inefficiencies. The thrust of the ongoing reforms of the public expenditure management framework is appropriate. However, their effectiveness in improving public service delivery—especially in the presence of a sizeable acceleration in spending—is uncertain. Channeling resources more gradually to strategies that prove effective over time, would allow time for these reforms to be completed and fine tuned. Moreover, the authorities should move expeditiously on reforms to enhance incentives in the public sector, including through greater pay variation at the local level and linking pay to performance, skills, and merit. There is also greater scope for private provision of public services to improve efficiency and delivery. A broader application of user fees—accompanied by higher income transfers or, where relevant, means-tested user fees—would help rationalize demand and reduce subsidies to middle-to-upper income users.

41. **Regarding taxes, broadening the tax base would have been a more efficient way of financing the spending increases than raising tax rates.** Looking ahead, the authorities' proposals to improve the corporate tax regime are welcome and similar efforts could be extended to other areas to streamline the special tax treatments introduced in recent years.

42. **Limited future public pension obligations are key to keeping the United Kingdom's long-term fiscal position strong.** The thrust of the recent pension reforms, shifting emphasis from universal pension provision to providing a safety net for pensioners, has been appropriate. Given the importance of adequate individual retirement saving, the recent proposals to simplify its tax treatment are welcome. Scope remains for further enhancing the transparency of various pension and saving instruments.

43. **The United Kingdom's fiscal transparency meets a high standard and the policy framework has provided an appropriate medium-term orientation to fiscal policy.** Given past surpluses, the fiscal rules—particularly the sustainable investment rule—have become less constraining on future policy. In this light, a review of the working of the rules may be useful, also with a view to clarifying their interpretation.

44. **Raising productivity remains a key challenge.** The authorities' approach to addressing the shortfall in the capital stock is broadly appropriate, but policies to raise TFP are even more important. In this respect, the authorities' have rightly focused on measures to boost competition, skills, and R&D. The recent strengthening of the competition framework is welcome and further efforts to liberalize planning restrictions would be useful. On skills, the focus should be on improving delivery, particularly with regard to strengthening secondary education and developing intermediate skills. As trend output growth can also be boosted through higher employment, the government's efforts to increase labor force participation and further reduce unemployment are welcome.

45. **Overall, U.K. banks appear sufficiently profitable and well-capitalized to be able to absorb the effects of likely macroeconomic shocks without systemic distress. The insurance industry, on the other hand, is under considerable stress.** Although the latter is not likely to pose a systemic vulnerability for the financial system, close monitoring will clearly be required. U.K. financial markets and infrastructure function well. Surveillance of banks' exposures to the unsecured money market should continue to be intensified. The supervision framework, shows a high degree of observance of international standards and codes. The ongoing reforms to the insurance supervision framework should help bring insurance supervision up to the standards applicable to a major international center.

46. **The strengthening of the AML/CFT regime and of the anti-bribery legislation is welcome.**

47. **The United Kingdom's stance on trade liberalization is commendable,** particularly with regard to barriers against exports from developing countries. **Staff welcomes the government's commitment to raising ODA** and the support given to the HIPC program, and encourages the establishment of a time path to accelerate progress towards achieving the U.N. target of 0.7 percent of GNP.

48. It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

Table 1. United Kingdom: Selected Economic Indicators

	1998	1999	2000	2001	2002 1/ Est.	2003 Proj.
Real Economy (change in percent)						
Real GDP	2.9	2.4	3.1	2.0	1.7	2.2
Domestic demand	5.0	3.6	3.9	2.4	2.4	2.4
CPI (excluding mortgage interest; RPIX)	2.7	2.3	2.1	2.1	2.2	2.6
Unemployment rate (in percent) 2/	6.3	6.0	5.5	5.1	5.2	5.4
Gross national saving (percent of GDP)	17.6	15.5	15.3	15.0	13.8	13.6
Gross domestic investment (percent of GDP)	18.1	17.7	17.3	16.7	15.6	15.7
Public Finance (fiscal years) 3/						
General government balance	0.5	1.7	4.0 /4	0.0	-1.9	-2.5
Public sector balance	0.5	1.7	4.0 /4	0.1	-2.1	-2.5
Public sector cyclically-adjusted balance	0.2	1.4	1.2	0.2	-1.5	-1.7
Public sector net debt	39.2	36.2	31.2	30.3	31.0	32.3
Money and Credit (end-year, percent change)						
M0	5.5	11.6	4.3	8.3	5.1	...
M4	8.4	4.3	8.3	6.6	7.0	...
Consumer Credit	16.5	14.5	12.2	14.1	15.1	...
Interest rates (year average)						
Three-month interbank rate	7.3	5.4	6.1	5.0	4.0	...
Ten-year Government bond yield	4.3	5.4	4.8	5.0	4.4	...
Balance of Payments						
Trade balance (in percent of GDP)	-1.1	-1.7	-1.9	-2.3	-1.7	-2.0
Current account balance (in percent of GDP)	-0.6	-2.2	-2.0	-1.7	-1.8	-2.2
Reserves (national valuation of gold, end of period, in billions of SDRs)	26.5	30.5	37.0	32.2	31.5	...
Fund Position (As of December 31, 2002)						
Holdings of currency (in percent of quota)					57.5	
Holdings of SDRs (in percent of allocation)					14.0	
Quota (in millions of SDRs)					10,738.5	
Exchange Rate						
Exchange rate regime					Floating	
Present rate (February 3, 2003)					US$ = £0.6101	
Nominal effective rate (1995=100) 5/	123.4	122.4	125.5	123.8	125.0 /7	...
Real effective rate (1995=100) 5/ 6/	131.3	133.6	141.0	140.6	143.8	...

Sources: National Statistics; HM Treasury; Bank of England; International Financial Statistics; INS; and IMF staff estimates.

1/ Staff estimates, except otherwise indicated.

2/ ILO unemployment; based on Labor Force Survey data.

3/ For example, fiscal balance data for 2002 refers to FY2002/03. The fiscal year begins in April. Debt stock data refers to the end of the fiscal year.

4/ Includes 2.4 percentage points of GDP in 2000/01 corresponding to the auction proceeds of spectrum licenses.

5/ An increase denotes an appreciation.

6/ Based on relative normalized unit labot costs in manufacturing.

7/ Data as of November 2002.

Table 2. United Kingdom: Quarterly Growth Rates and Contribution to Growth

	2001					2002					2003
	Q1	Q2	Q3	Q4	Q4/Q4	Q1	Q2	Q3	Q4 Est.	Q4/Q4 Est.	Q4/Q4 Prj.
	Quarter-on-quarter growth rate, except where indicated (in percent)										
Real GDP	0.7	0.3	0.3	0.2	1.6	0.2	0.6	0.9	0.4	2.2	2.3
Domestic demand	0.2	0.5	0.4	0.9	2.1	0.7	0.0	1.1	0.3	2.2	2.7
Private consumption	0.9	0.7	1.1	1.3	4.1	0.4	1.2	0.8	0.4	2.9	1.7
Government consumption	0.7	-0.4	2.0	2.7	5.1	1.2	0.7	0.8	-0.3	2.4	5.2
Gross fixed investment	-2.3	-0.2	-1.6	-1.6	-5.5	-2.5	0.5	-0.9	1.3	-1.6	4.2
Public investment	-8.6	8.0	-5.3	-1.3	-7.7	22.8	-9.0	5.8	24.0	46.7	20.2
Residential investment	-1.9	-4.9	5.2	-0.4	-2.2	6.0	4.0	-0.1	0.5	10.6	4.2
Business investment	-1.8	-0.7	-1.8	-2.5	-6.6	-5.4	0.5	-1.9	-1.5	-9.0	1.6
Foreign Balance	0.4	-0.2	-0.1	-0.7	-0.7	-0.4	0.7	-0.2	-0.2	-0.1	-0.6
Exports of goods and services	1.5	-2.3	-2.9	-1.6	-5.2	0.3	3.8	-1.2	0.4	3.3	3.9
Imports of goods and services	0.4	-1.4	-2.2	0.5	-2.8	1.4	1.3	-0.5	0.8	3.0	4.8
	Q1	Q2	Q3	Q4	Annual	Q1	Q2	Q3	Q4 Est.	Annual Est.	Annual Prj.
	Contribution to growth (in percentage points of GDP)										
Real GDP	0.7	0.3	0.3	0.2	2.0	0.2	0.6	0.9	0.4	1.7	2.2
Domestic demand	0.2	0.5	0.5	1.0	2.6	0.8	0.0	1.2	0.4	2.4	2.7
Private consumption	0.6	0.5	0.8	0.9	2.6	0.3	0.8	0.6	0.3	2.5	1.4
Private investment	-0.3	-0.2	-0.2	-0.3	0.1	-0.8	0.2	-0.2	-0.2	-1.1	-0.1
Public expenditure	0.0	0.0	0.3	0.5	0.4	0.6	0.0	0.2	0.4	1.2	1.3
Stockbuilding	-0.1	0.1	-0.4	-0.1	-0.7	0.7	-1.0	0.4	0.0	0.0	0.0
Foreign balance	0.4	-0.2	-0.1	-0.7	-0.6	-0.4	0.7	-0.2	-0.2	-0.7	-0.5
Imports of goods and services	0.2	-0.6	-0.9	0.2	0.9	0.5	0.5	-0.2	0.3	0.5	1.4
Exports of goods and services	0.5	-0.8	-1.0	-0.5	0.3	0.1	1.2	-0.4	0.1	-0.2	1.0

Sources: Office for National Statistics (ONS); and staff projections.

Table 3. United Kingdom: Medium-Term Scenario
(Percentage change, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Real GDP	3.1	2.0	1.7	2.2	2.9	2.9	2.8	2.8	2.5
Real domestic demand	3.9	2.4	2.4	2.4	2.9	2.6	2.7	2.7	2.3
Private consumption	5.2	3.8	3.6	1.9	2.6	2.4	2.6	2.8	2.6
Government consumption	2.1	2.3	5.0	3.6	3.2	3.0	2.6	2.4	1.7
Fixed investment	1.9	0.8	-4.2	3.4	3.7	2.8	2.8	2.6	1.9
Public	5.3	3.0	22.6	35.1	8.5	7.5	6.6	3.9	2.0
Residential	1.5	-6.1	10.3	4.4	2.1	2.3	3.0	2.7	2.2
Business	1.3	1.8	-9.0	-1.3	3.1	2.0	2.0	2.2	1.8
Stocks 1/	0.0	-0.7	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
External balance 1/	-1.1	-0.6	-0.7	-0.5	-0.2	0.1	-0.1	-0.1	0.0
Exports	10.1	0.9	-0.7	2.9	5.8	6.4	6.1	6.0	6.0
Imports	11.7	2.3	1.2	3.6	5.3	5.1	5.2	5.4	5.2
Current account 2/	-2.0	-1.7	-1.8	-2.2	-2.3	-2.2	-2.1	-2.0	-2.0
Inflation									
RPI (excluding mortgage interest)	2.1	2.1	2.2	2.6	2.5	2.5	2.5	2.5	2.5
Employment and productivity									
Employment	1.4	0.7	0.1	0.2	0.6	0.5	0.5	0.5	0.5
Average unemployment rate 3/	5.5	5.1	5.2	5.4	5.3	5.3	5.3	5.3	5.3
Productivity 4/	1.6	1.0	1.6	2.0	2.3	2.3	2.3	2.3	2.0

Sources: Office for National Statistics; and IMF staff projections.
1/ Contribution to the growth of GDP.
2/ In percent of GDP.
3/ In percent; ILO definition.
4/ Whole economy.

Table 4. United Kingdom: Balance of Payments

	1999	2000	2001	2002 Est.	2003 Proj.	2004 Proj.	2005 Proj.	2006 Proj.	2007 Proj.	2008 Proj.
					(In billions of pounds)					
Current account	-20	-19	-16	-18	-23	-27	-26	-26	-27	-27
Trade balance	-16	-18	-22	-18	-22	-25	-24	-24	-25	-25
Trade in goods	-27	-30	-34	-31	-37	-41	-42	-45	-48	-50
Imports	194	218	224	221	234	255	275	297	322	348
Exports	166	188	190	190	197	214	233	253	274	298
Trade in services	12	12	11	14	15	16	18	21	23	25
Imports	59	65	66	66	67	73	79	86	93	101
Exports	70	77	78	80	82	89	98	106	116	126
Income balance	3	9	13	9	10	9	9	10	10	11
Compensation of employe	0	0	0	...	...	...	...	...	...	0
Investment income	2	9	13	...	...	...	...	...	...	0
Current transfers	-7	-10	-7	-10	-11	-11	-12	-12	-13	-14
Central government	-4	-6	-3	-6	-7	-7	-7	-8	-8	-9
Other sectors	-3	-4	-4	-4	-4	-4	-4	-5	-5	-5
Capital account	1	2	2	...	...	...	...	...	...	...
Financial account	20	14	13	...	...	...	...	...	...	...
Direct investment	-70	-89	-1	...	...	...	...	...	...	...
Portfolio investment	95	99	-49	...	...	...	...	...	...	...
Financial deriviatives	3	2	8	...	...	...	...	...	...	...
Other investment	-9	7	52	...	...	...	...	...	...	...
Reserve assets	1	-4	3	...	...	...	...	...	...	...
Net errors and omissions	-1	3	2	...	...	...	...	...	...	...
					(In percent of GDP)					
Current account	-2.2	-2.0	-1.7	-1.8	-2.2	-2.3	-2.2	-2.1	-2.0	-2.0
Trade balance	-1.7	-1.9	-2.3	-1.7	-2.0	-2.1	-2.0	-1.9	-1.9	-1.8
Income balance	0.3	1.0	1.3	0.9	0.9	0.8	0.8	0.8	0.8	0.8
Current transfers	-0.7	-1.1	-0.7	-0.9	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Capital and financial accou	2.3	1.7	1.5	...	...	...	...	...	...	...
Direct investment	-7.7	-9.4	-0.1	...	...	...	...	...	...	...
Portfolio investment	10.5	10.4	-5.0	...	...	...	...	...	...	...
Other investment	-0.9	0.7	5.2	...	...	...	...	...	...	...

Sources: Office of National Statistics (ONS) and staff projections.

Table 5. United Kingdom: Public Sector Budgetary Projections
(Percent of GDP and percent of potential GDP)

	2001/02	2002/03		2003/04		2004/05		2005/06		2006/07	
	Outcome	PBR 2002 Prj 1/	Staff Prj 2/	PBR 2002 Prj 1/	Staff Prj 2/	PBR 2002 Prj 1/	Staff Prj 2/	PBR 2002 Prj 1/	Staff Prj 2/	PBR 2002 Prj 1/	Staff Prj 2/
Non-cyclically adjusted											
Total revenue	39.1	38.3	38.0	39.3	38.7	40.0	39.2	40.4	39.6	40.7	39.8
Current revenue	39.0	38.3	38.0	39.3	38.7	39.9	39.1	40.4	39.5	40.6	39.8
Tax revenue	36.5	35.9	35.6	36.9	36.3	37.6	36.7	38.0	37.2	38.5	37.6
Non-tax revenue	2.0	2.0	2.0	2.0	2.0	2.0	1.9	1.9	1.9	1.8	1.7
Capital revenue	0.1	0.1	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Total expenditure	39.0	40.3	40.1	41.5	41.3	41.6	41.5	42.0	41.9	42.2	42.0
Current expenditure	36.7	37.5	37.3	38.4	38.1	38.4	38.2	38.6	38.6	38.7	38.6
Capital expenditure 3/	2.4	2.8	2.8	3.2	3.2	3.3	3.3	3.4	3.3	3.5	3.5
Current balance 4/	1.0	-0.5	-0.7	-0.4	-0.8	0.2	-0.4	0.4	-0.4	0.6	0.0
Overall balance	0.1	-1.9	-2.1	-2.2	-2.5	-1.6	-2.3	-1.6	-2.3	-1.5	-2.2
Public sector net debt 5/	30.3	31.0	31.0	32.1	32.3	32.4	33.3	32.6	34.2	32.7	34.8
Cyclically adjusted 6/											
Current balance 4/	1.1	0.2	-0.1	0.3	0.0	0.6	0.2	0.5	-0.0	0.6	0.0
Overall balance	0.2	-1.2	-1.5	-1.5	-1.7	-1.3	-1.7	-1.5	-2.0	-1.5	-2.1
Real growth	1.6	1.9	2.0	2.7	2.3	3.1	2.9	2.7	2.9	2.5	2.8
Output gap	-0.4	-1.3	-0.8	-1.0	-1.1	-0.3	-0.7	0.0	-0.3	0.0	-0.0

Sources: National Statistics; HM Treasury; and staff projections.

1/ Official estimates reflected in the November 2002 Pre-Budget Report based on official GDP data and projections.

2/ Staff estimates are based on staff's GDP projection.

3/ Capital expenditure data reported here differ from official publications since the latter focus on capital expenditure net of capital receipts and depreciation.

4/ Including depreciation.

5/ Stock of net debt at the end of the fiscal year as a proportion of fiscal year GDP.

6/ Official estimates are based on official projections of potential output, and staff estimates are based on staff's projections of potential output.

United Kingdom: Basic Data

Demographic and other data:

Area	94,247 square miles (244,100 sq. km.)
Population (mid-2001)	60.2 million
Infant mortality (per 1,000 live births)	6.1
Doctors per 1,000 inhabitants	0.5
GDP per capita (2002)	SDR 19,927

Composition of GDP in 2001, at current prices	In billions of Pounds	Distribution in Percent
Private consumption	586.8	59.2
Public consumption	153.9	15.5
Total investment (including stockbuilding)	163.0	16.4
Total domestic demand	896.7	90.5
Exports of goods and services	287.7	29.0
Imports of goods and services	339.1	34.2
GDP at market prices	990.9	100

Selected economic data	2000	2001	2002 Est.	2003 Proj.
	(Annual percentage change)			
Output and unemployment:				
Real GDP (at market prices, average estimate)	3.1	2.0	1.7	2.2
Manufacturing production	2.0	-2.4	0.9 /1	...
Unemployment (in percent of labor force)	5.5	5.1	5.2	5.4
Earnings and prices:				
Average earnings in manufacturing	4.6	4.3	3.5	4.1
Retail price index, excluding mortgage interest	2.1	2.1	2.2	2.6
Money and interest rates:				
M0 (end of period)	4.3	8.3	5.1	...
M4 (end of period)	8.3	6.6	7.0	...
3-month Interbank rate	6.1	5.0	4.0	...
10-year government bond yield	4.8	5.0	4.4	...
Fiscal accounts (In percent of GDP): 2/				
General government balance	4.0 3/	0.0	-1.9	-2.5
Public sector balance	4.0 3/	0.1	-2.1	-2.5
Public sector net debt	31.2	30.3	31.0	32.3
	(In billions of pounds sterling)			
Balance of payments:				
Current account balance	-19.2	-16.4	-18.0	23.0
(In percent of GDP)	-2.0	-1.7	-1.8	-2.2
Trade balance	-18.5	-22.3	-17.8	-22.2
Exports	265	268	269	279
Imports	284	290	287	301
Direct investment (net)	-89.4	-1.0	-21.9 4/	...
Portfolio investment (net)	99.0	-49.0	45.0 4/	...
Reserve assets (US$ billion,eop)	48.2	40.4	42.8	...

Sources: National Statistics; HM Treasury; IFS; and IMF staff estimates.

1/ Year-on-year change as of Noverber 2003.

2/ For example, fiscal balance data for 2002 refers to FY2002/03. The fiscal year begins in April. Debt stock data refers to the end of the fiscal year.

3/ Includes 2.4 percentage points of GDP in 2000/01 corresponding to the auction proceeds of spectrum licenses.

4/ Up to third quarter of 2002.

UNITED KINGDOM: Fund Relations
(As of December 31, 2002)

I. **Membership Status**: Joined 12/27/1945; Article VIII

II. **General Resources Account**:	**SDR Million**	**% Quota**
Quota	10,738.50	100.00
Fund holdings of currency	6,173.10	57.49
Reserve position in Fund	4,565.40	42.51
Financial Transaction Plan transfers (net)	81.00	

III. **SDR Department**:	**SDR Million**	**% Allocation**
Net cumulative allocation	1,913.07	100.0
Holdings	267.29	13.97
Designation Plan	0.00	

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund**:

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2003	2004	2005	2006	2007
Principal					
Charges/Interest	31.81	31.66	31.64	31.65	31.65
Total	31.81	31.66	31.64	31.65	31.65

VII. **Exchange Rate Arrangement**:

On September 16, 1992, the U.K. authorities withdrew the pound sterling from the exchange rate mechanism of the European Monetary System and have since maintained a floating regime. As of February 3, 2003 the exchange rate for sterling was $1.64. In accordance with UN and/or EU resolutions, the United Kingdom applies exchange restrictions vis-à-vis Iraq, the Taliban, and individuals, groups, and organizations associated with terrorism; and on specific assets of certain persons related to important government functions in Myanmar, certain persons associated with the former government of the Republic of Yugoslavia, and certain members of the government of Zimbabwe. These restrictions have been notified to the Fund under Decision 144-(52/51).

VIII. **Article IV Consultation**:

Discussions for the 2001 Article IV consultation were conducted in London during November 28-December 10, 2001. The Staff Report (SM/02/45) was considered by the Executive Board and the consultation was concluded on March 4, 2002 (EBM/02/22).

IX. **FSAP**

The FSAP has been undertaken in conjunction the 2002 Article IV Consultation. Preliminary technical discussions were conducted in November 2001. The FSAP work was spread over three missions, which took place in February, May, and July of 2002.

X. **Technical Assistance**: None

XI. **Resident Representative**: None

United Kingdom—Statistical Information

The United Kingdom maintains high standards of economic data provision which are adequate for Fund surveillance. The authorities publish a full range of economic and financial data that is available electronically and have subscribed to the Special Data Dissemination Standard (SDDS). The UK shifted to ESA95 in September 1997. While most of the changes related to the introduction of ESA95 have been implemented, the timetable for the implementation of the reminder of ESA95 extends to 2005. In recent years, the authorities implemented a number of important methodological changes to the national accounts dataset, most of which were related to the adoption of ESA95. As a consequence of these revisions, many of the national accounts time series have been revised back to the start of the dataset, with the level of GDP being revised upwards for all years back to 1987.

United Kingdom: Core Statistical Indicators
(as of February 3, 2003)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Govern-ment Balance	GDP/ GNP	External Debt/ Debt Service
Date of Latest Observation	2/3/2003	December 2002	December 2002	December 2002	December 2002	2/3/2003	December 2002	November 2002	2002 Q3	December 2002	2002 Q4	2001
Date Received	2/3/2003	January 2003	January 2003	January 2003	January 2003	2/3/2003	January 2003	January 2003	January 2003	January 2003	January 2003	December 2002
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly	Annual
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly	Annual
Source of Update	Bloomberg	BOE TRE	BOE Press Rel.	BOE Press Rel.	BOE Press Rel.	RES Reuters Bloomberg	ONS Press Rel.	ONS Press Rel.	ONS Press Rel.	ONS Press Rel.	ONS Press Rel.	ONS
Mode of Reporting	Electronic	Electronic	Publica./ Electronic	Publica./ Electronic	Publica./ Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic
Confidentiality	Published	Published	Published	Published	Published	Published	Published	Published	Published	Published	Published	Published
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly	Annual

United Kingdom: Sustainability Exercise

Fiscal sustainability

The sustainability of the United Kingdom's fiscal position was assessed, analyzing the evolution of net public sector debt under several alternative scenarios which deviate from the baseline projections (Table A1). In the baseline, with the primary balance showing a deficit of over ½ percent of GDP according to staff projections (used in Table A1), the public debt-to-GDP ratio would tend to grow over time (under the reasonable assumption that the average interest rate on government debt exceeds the growth rate of the economy).[1] Such an increase would, however, be quite slow and from a level that is one of the lowest in the OECD. Eventually, the primary surplus would have to be raised to stabilize the public debt ratio. But, a temporary rise in the public debt ratio, by itself, is unlikely to create problems. Indeed, further considerations were used in the text of the staff report to call for a somewhat stronger fiscal stance over the medium-term

Table A1 also presents the results of some sensitivity analysis of public debt dynamics under scenarios that are more pessimistic than the baseline. These scenarios follow a cross-country standard design and many of the assumed shocks are more severe than what most observers would consider likely.[2] The main findings are:

- Given the low initial level of public debt, real interest rates and growth shock would not have severe effects on the public debt ratio (scenarios 2 and 3).
- A real depreciation scenario would not have material effects (scenario 6).
- The public accounts could also stand relatively well a 10 percent shock in the initial debt stock (scenario 7). The public debt would in this scenario jump initially, but would remain still relatively low and would afterwards rise only slightly faster than in the baseline.
- The scenario that involves a stronger deviation from the baseline (in terms of growth of public debt following the shock) is, quite obviously, one in which the primary balance weakens further, as in this case, the debt ratio would start rising more rapidly (scenario 4).

External sustainability

With a net investment position (including direct investment) in the range of a negative 4-6 percent of GDP in 2000-2002 (Table A2), external debt sustainability does not seem to be an

[1] The debt-to-GDP ratio would also grow over time under the authorities' projection of a primary balance close to zero.

[2] See Public Information Notice No. 02/69 and "Assessing Sustainability," IMF, 5/28/2002.

issue. Gross external debt is, of course, much higher, but this reflects the role of London as an international financial center (Table A3). It is useful to note, in this connection, the recent FSAP finding that the international financial operations associated with the role of London as international financial center do not pose a systemic risk to the domestic financial system. (Table A3 also provides a summary set of external and financial vulnerability indicators).

Table A1. United Kingdom: Public Sector Debt Sustainability Framework, 1997–2007 1/
(In percent of GDP, unless otherwise indicated)

	Actual	Projections					
	2001	2002	2003	2004	2005	2006	2007
		I. Baseline Medium-Term Projections					
Public sector net debt 2/	32.1	**31.0**	**32.1**	**33.2**	**34.2**	**34.9**	**35.4**
Change in public sector debt	-1.2	-1.1	1.1	1.1	1.0	0.7	0.5
Identified debt-creating flows (4+7+12)	-2.3	0.1	1.0	0.7	0.7	0.6	0.5
Primary deficit	-2.8	-0.1	0.8	0.7	0.7	0.6	0.6
Primary revenue and grants 3/	39.1	37.8	38.2	38.6	39.0	39.4	39.4
Primary (noninterest) expenditure	36.3	37.7	39.0	39.3	39.7	40.0	40.0
Automatic debt dynamics 4/	0.5	0.3	0.2	0.0	0.0	-0.1	-0.1
Contribution from interest rate/growth differential 5/	0.5	0.3	0.2	0.0	0.0	-0.1	-0.1
Of which contribution from real interest rate	1.1	0.8	0.8	0.9	0.9	0.9	0.8
Of which contribution from real GDP growth	-0.6	-0.5	-0.6	-0.9	-0.9	-0.9	-0.9
Contribution from exchange rate depreciation 6/	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Denominator = 1+g+π+gπ	1.0	1.0	1.1	1.1	1.1	1.1	1.1
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes (2-3)	1.1	-1.2	0.1	0.4	0.3	0.1	0.0
Public sector debt-to-revenue ratio 2/	82.1	82.0	84.1	86.0	87.6	88.6	89.8
Key Macroeconomic and Fiscal Assumptions							
Nominal GDP (local currency)	990891.0	1036599.8	1088866.1	1150513.8	1211503.6	1273750.9	1342743.5
Real GDP growth (in percent)	2.0	1.6	2.1	2.9	2.9	2.8	2.8
Average nominal interest rate on public debt (in percent) 7/	5.8	5.4	5.6	5.6	5.3	5.0	5.0
Average nominal interest rate on forex debt (in percent) 7/	5.8	0.0	5.6	5.6	5.3	5.0	5.0
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	3.5	0.0	2.7	2.9	2.9	2.7	2.5
Exchange rate (£ per US dollar)	0.7	0.6	0.6	0.6	0.7	0.7	0.7
Nominal depreciation of local currency (LC per dollar)	2.9	-10.0	2.8	1.3	4.2	0.0	0.0
Exchange rate (US dollar per £)	1.5	1.6	1.6	1.5	1.5	1.5	1.5
Nominal appreciation (increase in US dollar value of local currency, in percent)	-2.8	11.1	-2.7	-1.3	-4.1	0.0	0.0
Inflation rate (GDP deflator, in percent)	2.3	2.9	2.8	2.7	2.3	2.3	2.5
Growth of real primary spending (deflated by GDP deflator, in percent)	5.0	5.6	5.6	3.7	3.9	3.6	2.8
		II. Stress Tests for Public Debt Ratio					
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-2007		**31.0**	**31.9**	**33.0**	**34.1**	**35.1**	**36.0**
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004		**31.0**	**33.2**	**35.4**	**36.4**	**37.2**	**37.6**
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004		**31.0**	**32.7**	**34.6**	**35.6**	**36.3**	**36.8**
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004		**31.0**	**38.7**	**46.5**	**47.5**	**48.2**	**48.7**
5. Combination of 2-4 using one standard deviation shocks		**31.0**	**36.2**	**41.7**	**42.7**	**43.5**	**43.9**
6. One time 30 percent real depreciation in 2003 8/		**31.0**	**32.1**	**33.2**	**34.2**	**34.9**	**35.4**
7. 10 percent of GDP increase in other debt-creating flows in 2003		**31.0**	**42.1**	**43.2**	**44.1**	**44.8**	**45.3**

Historical Statistics for Key Variables (past 10 years)	Historical Average	Historical Standard Deviation	Average 2002-07
Primary deficit	0.3	3.6	0.6
Real GDP growth (in percent)	2.7	1.1	2.5
Nominal interest rate (in percent) 7/	7.1	1.0	5.3
Real interest rate (in percent)	4.4	1.1	2.3
Inflation rate (GDP deflator, in percent)	2.7	0.7	2.6
Primary revenue to GDP ratio	37.4	1.3	38.7

Sources: ONS; Bank of England; and IMF staff estimates.

1/ Based on staff projections.

2/ Net debt is defined as gross debt minus liquid assets.

3/ Revenue and grants before interest receipts.

4/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

5/ The real interest rate contribution is $r - \pi(1+g)$ and the real growth contribution as -g.

6/ The exchange rate contribution is $\alpha\varepsilon(1+r)$.

7/ Derived as nominal interest expenditure divided by previous period debt stock.

8/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table A2. United Kingdom: Net Investment Position 1/
(Percent of GDP)

	1996	1997	1998	1999	2000	2001	2002Q3
Assets	214	242	248	267	314	321	305
Direct investment abroad	26	28	35	47	64	63	64
Portfolio investment abroad	72	80	82	91	95	92	81
Other investment abroad	112	132	128	126	152	164	159
Reserve assets	4	3	3	2	3	3	3
Liabilities	223	251	264	276	318	328	309
Direct investment to UK	20	21	25	28	32	38	38
Portfolio investment to UK	63	72	81	92	105	97	86
Other investment to UK	140	158	158	157	180	192	184
Net investment position	-9	-9	-16	-9	-4	-6	-4
Direct investment	6	6	10	20	32	25	25
Portfolio investment	9	8	1	-1	-11	-5	-6
Other investment	-28	-27	-30	-30	-28	-29	-26
Reserve assets	4	3	3	2	3	3	3
Net investment position, excluding direct investment	-16	-15	-26	-29	-36	-31	-29

Source: Office of National Statistics.
1/ Data correspond to the end of the indicated period. They are expressed as percent of the cumulated GDP of the four quarters ending on that date.

Table A3. United Kingdom: Indicators of External and Financial Vulnerability
(In percent of GDP, unless otherwise indicated)

	1997	1998	1999	2000	2001	2002 1/	as of:
External indicators							
Exports (annual percentage change, in U.S. dollars)	8.9	-1.2	4.6	9.5	-5.4	-5.3	2002Q3
Imports (annual percentage change, in U.S. dollars)	6.8	2.8	7.2	9.9	-4.2	-6.4	2002Q3
Terms of trade (annual percentage change)	1.4	0.8	0.4	-0.4	0.5	1.3	2002Q3
Current account balance	-0.2	-0.6	-2.2	-2.0	-1.7	-1.8	
Capital and financial account balance	-0.5	0.1	2.3	1.7	1.5	2.0	2002Q3
Of which: Foreign direct investment (net)	-1.9	-3.3	-7.7	-9.4	-0.1	-1.8	2002Q3
Portfolio investment (net)	-3.1	-1.3	10.5	10.4	-5.0	4.7	2002Q3
Other investment (net)	4.0	4.9	-0.9	0.7	5.2	-1.8	2002Q3
Net errors and omissions	0.7	0.5	-0.1	0.4	0.2	-0.6	2002Q3
Official reserves (in billions of U.S. dollars, end of period) 2/	37.1	37.3	41.8	48.2	40.4	45.1	Nov-02
Central bank net foreign assets (in billions of U.S. dollars)	-1.1	7.0	-2.7	-2.9	2.1	1.1	Oct-02
Foreign assets of banking institutions (in billions of U.S. dollars)	1693	1895	1835	2150	2201	2424	Oct-02
Foreign liabilities of banking institutions (in billions of U.S. dollars)	1721	1857	1826	2140	2230	2482	Oct-02
Exchange rate against U.S. dollar (period average)	1.64	1.66	1.62	1.52	1.44	1.56	
Financial markets indicators							
3-month T-bill yield	6.5	6.8	5.0	5.8	4.8	3.9	
3-month T-bill yield (real) 3/	4.5	5.4	4.7	5.3	1.9	1.7	
Change in stock market index (percent, end of period)	13.2	17.3	11.9	6.0	-24.0	-24.4	
Spread of 3-month T-bill vs. the U.S. (percentage points, end of period)	1.4	2.0	0.4	0.0	1.3	2.6	
Credit indicators 4/							
M4 lending	7.5	7.0	8.5	11.3	7.3	9.1	
M4 lending to individuals							
Secured on dwellings	5.1	5.8	7.2	7.3	7.4	8.0	
Consumer credit	14.4	13.1	12.9	13.9	14.3	10.0	
Credit card	17.5	22.4	15.6	16.9	10.6	7.5	
M4 lending to private non financial corporations	10.1	9.5	4.4	12.2	8.0	2.5	Sept 2002
Lending to construction sector	-3.8	10.9	7.1	29.3	16.0	10.0	Sept 2002
Lending to real estate sector	-3.8	14.7	15.6	22.2	25.9	21.2	Sept 2002
Interest rate on personal loans 5/	18.1	18.0	14.9	15.7	16.0	9.6	
Interest rate on fixed rate mortgages 5/	7.6	6.5	7.1	6.5	5.6	5.4	
Interest rate on time deposits 5/	5.8	5.1	4.2	5.3	3.8	3.7	
Financial sector risk indicators 6/							
Total loans to assets (percent)	83.9	82.4	82.5	82.0	82.1	82.8	Sept 2002
Total loans to deposits (percent)	94.5	93.1	93.5	92.9	92.2	93.0	Sept 2002
Foreign exchange loans (in US$bn)	1431.0	1515.7	1443.5	1698.5	1789,1	1944.6	Sept 2002
Share of foreign exchange loans in total lending (percent)	42.2	41.1	39.2	41.4	41.8	40.8	Sept 2002
Deposits in foreign exchange (in US$bn)	1651.1	1768.6	1698.7	1995.0	2,157.4	2362.5	Sept 2002
Share of foreign deposits in total deposits (percent)	55.7	55.5	54.9	57.3	57.8	56.4	Sept 2002
Share of foreign denominated liabilities in total liabilities (percent)	50.9	50.7	48.5	51.5	52.5	52.2	Sept 2002
Share of real estate sector in private credit (percent) 7/	47.3	48.2	48.6	46.9	47.5	47.8	Sept 2002
Share of real estate sector in loans to non financial private corporations (percent) 7/	30.2	33.6	35.8	34.9	41.3	41.4	Sept 2002
Share of non-performing loans in total loans (percent) 7/ 8/	3.7	3.2	3.0	2.5	2.6	2.6	Jun 2002
Regulatory capital to risk-weighted assets 8/	14.9	13.2	14.0	13.0	13.2	13.4	Jun 2002
Return on Assets (before taxes) 8/	0.9	0.8	1.0	0.9	0.5	0.3	Jun 2002

Sources: National Statistics; Bank of England; and IMF, International Financial Statistics.
1/ For 2002 annual data, unless otherwise noted.
2/ Including gold, national valuation.
3/ Calculated as 3-month T-bill over actual 12-month RPI inflation in Dec of relevant year.
4/ Twelve-month growth rates.
5/ Weigthed averages for banks and building societies.
6/ Building societies and insurance companies are excluded from this sample. 'Deposits' includes currency, deposits and money market instruments.
7/ The figures for non-performing loans represent the gross value of loans against which specific provisions have been made.
8/ Includes mortgage banks.

Statement by the IMF Staff Representative on the United Kingdom
February 26, 2003

The following statement updates the staff report for the 2002 Article IV consultation on the United Kingdom. This information does not change the thrust of the staff appraisal.

1. Recent indicators of **real economic activity** suggest a weakening of industrial output, and possibly consumer demand, but labor market indicators remain strong.

- In the fourth quarter of 2002, **industrial production** fell by 0.7 percent (quarter-on-quarter, seasonally adjusted) or 1.2 percent over the fourth quarter of 2001. The decline reflected mainly manufacturing output.

- The latest CBI industrial trends survey indicated a deterioration in **new orders** in January.

- The volume of **retail sales** fell by 1 percent (month-on-month, seasonally adjusted) in January, partly offsetting the strong rise in the index during the December holiday period.

- Following a sharp decline in December, the **consumer confidence** (GfK) index remained low in January relative to levels during most of 2002. The measure relating to consumers' spending intentions over the next 12 months fell in January to its lowest level since December 1998.

- The **unemployment rate** (ILO basis) edged down to 5.1 percent in the fourth quarter of 2002, while the employment rate rose by 0.3 percentage points (quarter-on-quarter, seasonally adjusted) to 74.6 percent. On a claimant count basis, unemployment remained unchanged in January. Labor shedding in manufacturing continued, with **manufacturing productivity** rising by 3.5 percent in the fourth quarter compared with the same period the previous year.

2. **Inflation** (RPIX) remained at 2.7 percent in January, but declined on an HICP basis to 1.4 percent from 1.7 percent in December. Growth in **average earnings** edged down to 3.7 percent in December reflecting a pick up in **public sector earnings** growth to 4.6 percent (up 0.3 percentage points from November), which was offset by an easing of **private sector earnings** growth to 3.5 percent (down 0.2 percentage points from November).

3. **House prices** increased further in January by 1.5–1.7 percent over December. The February 2003 *Inflation Report*, however, noted some early signs that housing demand may be easing. **Equity prices** continued to decline, with the FTSE all share index falling by some 5½ percent from end-2002 to February 21, 2003.

4. The overall **fiscal deficit**, measured by public sector net borrowing, reached a cumulative £16.7 billion during April 2002-January 2003, some £18.3 billion higher than the

deficit during the same period the year before. This outcome is in line with staff's projection of a deficit of £21.5 billion for FY2003/03, which closes at end-March.

5. Preliminary trade data indicate the **trade deficit** (goods and services) reached 2 percent of GDP in 2002, narrowing somewhat from the deficit of 2.3 percent of GDP in 2001. The volume of merchandise exports fell by 2.3 percent while the volume of merchandise imports increased by 0.9 percent over the same period.

6. **On February 6, 2003, the Bank of England lowered its policy rate by 25 basis points to 3¾ percent**. Forward rates suggest the market now expects a further 25 basis point cut by end-2003, with rates rising back to about 4 percent by end-2004. Following the cut in interest rates, **sterling** weakened by about 3½ percent against the euro and the U.S. dollar. In the staff's view, the rate cut was appropriate, given the weakening of the global growth outlook and a possibly sharper slowing of U.K. consumer demand than previously expected—as suggested by January retail sales, the recent declines in consumer confidence, and the fall in equity prices since mid-January. Staff remains of the view that, in the period ahead, risks are broadly balanced and that monetary policy should continue to react promptly to changes in domestic and external prospects, including in domestic credit markets. In this respect, the February *Inflation Report* noted that secured borrowing has continued to rise, but that the growth in unsecured debt has moderated somewhat.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 03/22
FOR IMMEDIATE RELEASE
March 3, 2003

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2002 Article IV Consultation with the United Kingdom

On February 26, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the United Kingdom.[1]

Background

Over the past decade, the U.K. economy has enjoyed a sustained expansion of output and employment, coupled with low and stable inflation. Real GDP increased at an average rate of some 2.8 percent, and the unemployment rate halved to below 5 percent by April 2001. Inflation, which has been low since the mid-1990s, was—on a harmonized basis—about 1.5 percent, below the EU average. The current account deficit has averaged 1.8 percent of GDP in 2000-02.

Real output growth decelerated in 2002, but remained above that of other large European countries. Notwithstanding the global slowdown, the U.K. economy grew by 1.7 percent owing mainly to buoyant private consumption—which was supported by a robust labor market, low interest rates, and rising housing wealth—as well as increased public spending. By contrast, private investment continued to decline and net exports made a negative contribution to growth, with export volumes also declining. Unemployment edged down to 5.1 percent by end-year.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

Consumer spending, however, has been fuelled partly by a rapid increase in household debt and a housing market boom. Secured and unsecured household debt stands at levels in relation to income that are comparable to previous peaks. However, debt service ratios are much lower than in the late 1980s and early 1990s, reflecting the substantial decline in nominal and real interest rates. Following years of robust growth, house prices surged by about 25 percent in 2002, rising above trend as a ratio to household earnings.

Notwithstanding its strong growth performance over the past decade, the United Kingdom ranked only 19th in 2001 among OECD countries in terms of per capita income. Labor productivity per hour worked also remains lower than in other advanced countries, reflecting both a low capital-labor ratio and low efficiency in the use of capital and labor inputs (total factor productivity). Following a continuous decline in U.K. public investment since the mid-1970s, public capital is low compared with major economies, especially in continental Europe.

Raising income and labor productivity to the levels of partner countries has been a key focus of structural reform efforts. Public investment is being increased rapidly and private investment is expected to continue to benefit from a stable macroeconomic and financial sector environment. The authorities have also adopted a multipronged approach to boost total factor productivity. Recent reforms have focused on three areas—competition policy, skills, and research and development—that have been identified as key elements in explaining the productivity differential vis-à-vis other countries. In addition, the government has in recent years pursued welfare reforms and active labor market policies to increase employment and reduce poverty.

The fiscal position has recently weakened, reflecting both cyclical and noncyclical factors. The November 2002 pre-budget report (PBR) envisaged the overall fiscal deficit to increase by nearly 2 percentage points of GDP in FY2002/03 from a broad balance in the previous fiscal year. In cyclically-adjusted terms, the overall fiscal deficit is projected to increase to 1.2 percent of GDP in FY2002/03 from 0.2 percent of GDP in FY2001/02, due to an increase in spending (mostly on education, health, and public infrastructure) and an unexpectedly large loss of profit taxes paid by financial corporations. The authorities expect this revenue shortfall to be temporary and the PBR projects an overall deficit of 1.5 percent GDP in the medium term.

The Bank of England has operated in recent years within an inflation-targeting framework, which has emphasized transparency and the pursuit of a clear objective—a symmetric inflation target of 2.5 percent. This framework has allowed the Bank to respond swiftly to cyclical fluctuations and to anchor inflation expectations. On February 6, 2003, the Bank lowered its policy rate by 25 basis points to 3.75 percent—the first rate change since November 2001—noting weaker-than-anticipated prospects for global and domestic demand.

Executive Board Assessment

Directors commended the U.K. authorities for the pursuit of prudent and credible economic policies in the context of a sound medium-term policy framework. This has resulted in a strong performance of the U.K. economy, as evidenced by a decade of sustained output

and employment growth and low inflation. While growth decelerated in 2002, the economy has so far weathered the global slowdown relatively well, in part because of the timely easing of monetary and fiscal policies in the context of a well-functioning inflation-targeting framework and a low public debt to GDP ratio.

Looking ahead, Directors noted the prospects for continued economic recovery, but they saw appreciable risks to this outlook stemming from both external and domestic uncertainties. In particular, domestic demand is being sustained by high and increasing levels of household debt, fuelled by house price inflation and low interest rates, which increases vulnerability to potential adverse shocks. Directors therefore called for heightened vigilance to these risks by the authorities, especially regarding the possible existence of a housing price bubble with its potential deflationary consequences.

Directors agreed that EMU membership remains a key decision for the United Kingdom with substantial long-term ramifications. They observed that the five economic tests announced in 1997 remain appropriate for evaluating the economic considerations relevant to this decision. Directors welcomed the authorities' intention to publish their assessment, as well as the associated background studies, by June 2003. They also supported the authorities' approach of continuing to make preparations for entry, should a decision to join be made.

Directors commended the impressive performance of monetary policy, as attested by low long-term interest rates and inflation expectations that have been firmly anchored around the inflation target over the past five years. They agreed that monetary policy has the difficult task of striking an appropriate balance between supporting demand during the current slowdown and minimizing the risks associated with the continued rise in house prices and household credit. In this context, most Directors supported the central bank's recent interest rate cut, given the weakening of the global growth outlook and indications of weakening domestic activity. It was agreed that, going forward, the authorities should stand ready to respond swiftly to the changing balance of risks.

Directors noted the underlying strength of the public finances, as evidenced by the low levels of net public debt and of future public pension liabilities. In this light, and given the cyclical position of the economy, most Directors considered that the current widening of the fiscal deficit does not give cause for concern. Directors had a wide-ranging discussion on the revision of the authorities' medium-term fiscal projections from a deficit of 1 percent of GDP to 1½ percent of GDP. Noting the staff's projection of a cyclically adjusted medium-term fiscal deficit of 2-2¼ percent of GDP, most Directors agreed that risks on the revenue side make an overshooting of the authorities' projected fiscal deficits likely, since growth assumptions appear optimistic in light of recent developments and there are uncertainties about future tax revenue from the financial sector. They encouraged the authorities to take action over the medium term to boost revenue and slow expenditure in order to move the cyclically-adjusted medium-term fiscal deficit gradually back toward one percent of GDP, with automatic stabilizers allowed to operate freely around this path; and a few of these Directors urged an even more ambitious consolidation. Such a lowering of the medium-term

cyclically-adjusted deficit would increase room for future countercyclical fiscal policy; build a buffer against long-term public liabilities related to population aging; reduce crowding out of private sector activity; and prevent any weakening of fiscal credibility. Some Directors, however, did not believe that the widening medium-term fiscal deficits would damage fiscal credibility, since the fiscal rules will continue to be applied and the fiscal position will remain sustainable.

With regard to taxes, Directors felt that it would be more efficient to raise revenue by broadening the base of existing taxes than by raising tax or social security contribution rates. In this regard, Directors welcomed the authorities' intention to streamline corporate taxation and suggested that other areas of the tax system could also benefit from a simplification of special tax treatments introduced in recent years.

On public spending policies, Directors recognized the need to respond to the demand for better public services. However, they expressed concern about the size of the increases in spending, and considered that more moderate increases would help contain medium-term fiscal deficits. Directors stressed that the speed at which expenditure is being increased also raises the risk of spending inefficiencies. They welcomed the ongoing reforms to the public expenditure management framework, which will help minimize these risks, but some cautioned that the effectiveness of these reforms in increasing efficiency is not yet known. Some Directors considered that scope exists for greater private, or user-fee financed, provision of public services, although it was noted that this should not be promoted at the expense of equity or efficiency, particularly where there are market failures.

Directors observed that the strength of the United Kingdom's underlying fiscal position depends importantly on containing future public pension obligations, which in turn depends on adequate individual retirement saving. They agreed that the recent proposals to simplify the tax treatment of retirement saving would facilitate such saving, and encouraged the authorities to consider further measures to enhance the transparency of various pension and saving instruments.

Directors considered the fiscal framework to be transparent, comprehensive, and forward-looking. A number of Directors observed that past budgetary over-performance has resulted in the sustainable investment rule not being as helpful as in the past in guiding future fiscal policies. These Directors, while noting that the sustainable investment rule is intended to apply at all times, saw merit in the authorities reviewing the fiscal rules, with a view to clarifying their interpretation and tightening their role in anchoring fiscal policy. In this context, a few Directors noted the relevance of the Stability and Growth Pact in determining and assessing fiscal policy. Other Directors noted that stability in the rules framework promotes clarity and predictability and enhances the credibility of fiscal policy, and saw the benefits of retaining a framework that is well understood by market participants as the guiding principles for fiscal policy.

Directors supported the authorities' strategy to foster medium-term productivity growth. In this connection, Directors endorsed the authorities' focus on promoting competition, labor force skills, and research and development activity. They commended the recent strengthening of the competition framework—particularly boosting the powers of the competition authorities—and encouraged liberalization of land use and planning restrictions. Regarding skills, Directors noted that the United Kingdom's education spending levels are similar to those of comparable economies, and that the emphasis should therefore be on improving delivery.

Directors noted that the United Kingdom's employment rates are among the highest in industrialized economies. They commended the authorities for the success of active labor market programs in reducing joblessness among the young and encouraged tightening job-seeking incentives in similar programs aimed at other socio-economic groups.

Directors welcomed the findings of the Financial Sector Assessment Program (FSAP) conducted last year. They agreed with the FSAP conclusions that, overall, U.K. banks are sufficiently profitable and well capitalized to absorb the effects of likely macroeconomic shocks without systemic distress. Directors noted the significant difficulties of the insurance industry, and agreed that these do not appear to constitute a systemic vulnerability for the financial system. Nevertheless, they emphasized the need for close monitoring and supervision, and welcomed the authorities' prompt actions to strengthen the insurance regulatory framework. Directors supported the FSAP conclusion that the U.K. financial markets and infrastructure function well, and noted the need to continue intensifying surveillance of interinstitutional exposures, such as in the unsecured inter-bank segment of the money market. On supervision, they commended the authorities' high degree of observance of international standards and codes and the authorities' continual improvements to the framework. Directors welcomed the strengthening in recent years of the regime to counter money laundering, the financing of terrorism, and bribery.

Directors welcomed the United Kingdom's strong stance within the European Union in promoting trade liberalization, including with regard to removing barriers to imports from developing countries. Directors welcomed the authorities' support for the HIPC program and their commitment to increasing the budgetary allocation for official Development Assistance (ODA). They encouraged the establishment of a time path to accelerate progress towards the U.N. target for ODA of 0.7 percent of GNP.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

United Kingdom: Selected Economic Indicators

	1998	1999	2000	2001	2002 1/ Est.	2003 Proj.
Real Economy (change in percent)						
Real GDP	2.9	2.4	3.1	2.0	1.7	2.2
Domestic demand	5.0	3.6	3.9	2.4	2.4	2.4
CPI (excluding mortgage interest; RPIX)	2.7	2.3	2.1	2.1	2.2	2.6
Unemployment rate (in percent) 2/	6.3	6.0	5.5	5.1	5.1	5.4
Gross national saving (percent of GDP)	17.6	15.5	15.3	15.0	13.8	13.6
Gross domestic investment (percent of GDP)	18.1	17.7	17.3	16.7	15.6	15.7
Public Finance (fiscal years) 3/						
General government balance	0.5	1.7	4.0 /4	0.0	-1.9	-2.5
Public sector balance	0.5	1.7	4.0 /4	0.1	-2.1	-2.5
Public sector cyclically-adjusted balance	0.2	1.4	1.2	0.2	-1.5	-1.7
Public sector net debt	39.2	36.2	31.2	30.3	31.0	32.3
Money and Credit (end-year, percent change)						
M0	5.5	11.6	4.3	8.3	5.1	...
M4	8.4	4.3	8.3	6.6	7.0	...
Consumer Credit	16.5	14.5	12.2	14.1	15.1	...
Interest rates (year average)						
Three-month interbank rate	7.3	5.4	6.1	5.0	4.0	...
Ten-year Government bond yield	4.3	5.4	4.8	5.0	4.4	...
Balance of Payments						
Trade balance (in percent of GDP)	-1.1	-1.7	-1.9	-2.3	-2.0	-2.0
Current account balance (in percent of GDP)	-0.6	-2.2	-2.0	-1.7	-1.8	-2.2
Reserves (national valuation of gold, end of period, in billions of SDRs)	26.5	30.5	37.0	32.2	31.5	...
Fund Position (As of December 31, 2002)						
Holdings of currency (in percent of quota)					57.5	
Holdings of SDRs (in percent of allocation)					14.0	
Quota (in millions of SDRs)					10,738.5	
Exchange Rate						
Exchange rate regime					Floating	
Present rate (February 3, 2003)					US$ = £0.6101	
Nominal effective rate (1995=100) 5/	123.4	122.4	125.5	123.8	125.0 /7	...
Real effective rate (1995=100) 5/ 6/	131.3	133.6	141.0	140.6	143.8	...

Sources: National Statistics; HM Treasury; Bank of England; International Financial Statistics; INS; and IMF staff estimate

1/ Staff estimates, except otherwise indicated.

2/ ILO unemployment; based on Labor Force Survey data.

3/ For example, fiscal balance data for 2002 refers to FY2002/03. The fiscal year begins in April. Debt stock data refers to the end of the fiscal year.

4/ Includes 2.4 percentage points of GDP in 2000/01 corresponding to the auction proceeds of spectrum licenses.

5/ An increase denotes an appreciation.

6/ Based on relative normalized unit labot costs in manufacturing.

7/ Data as of November 2002.

Statement by Tom Scholar, Executive Director for the United Kingdom
February 26, 2003

Let me begin by expressing my authorities' appreciation for the work of staff over the past year. As always, the Article IV team has produced an interesting and high quality set of papers, and my authorities will take careful note of their comments. And the FSAP has been a valuable exercise, providing helpful insights.

Economic Prospects

2. Growth was below trend in 2002 at 1.7% reflecting weakness in the world economy. Nevertheless, the UK was among the fastest growing of G7 and large EU economies and continues to experience the longest period of unbroken economic expansion on record. The economic fundamentals remain sound: RPIX inflation at 2.7% (1.4% HICP), interest rates at 3.75%, and employment at record levels of over 74%. With a global recovery and supportive monetary and fiscal policy, growth is forecast (in the 2002 Pre-Budget Report) to be 2½ to 3% in 2003, and 3 to 3½% in 2004. Inflation is expected to remain at, or close to, target over the next two years.

3. As the staff report notes, however, there are risks - for example, the strength of the global economy, and the possibility of a rapid unwinding of buoyant consumer demand or house prices. My authorities remain vigilant to these. They also note that output is below trend and household finances remain strong with debt-servicing costs at 20 year lows.

Policy Framework

4. My authorities believe that the strong policy framework, and the consistent and credible implementation of macroeconomic policy, have improved the resilience of the UK economy to periods of global uncertainty. So they will continue to set policy on the basis of the policy framework established in 1997, and based on the principles of transparency, responsibility and accountability:

- Fiscal policy set according to two fiscal rules:
  - the Golden Rule – over the cycle, the Government will borrow only to invest;
  - the Sustainable Investment Rule – over the cycle, public sector net debt will be held at a stable and prudent level, defined as 40% or less;

- Monetary policy set by the Bank of England's Monetary Policy Committee (MPC), to meet a symmetric inflation target, set at 2½%, with an 'open letter' system should inflation move more than 1% from target either way.

5. The symmetric inflation target allows the MPC to act to support growth when inflationary pressures are weak: interest rates were lowered by 25 basis points in February 2003 in response to a weakening global outlook, and the MPC will remain vigilant and forward-looking to ensure that inflation remains at or near target.

6. My authorities have noted staff's comments on the Sustainable Investment Rule (paragraph 22). They are happy to confirm that the 40% ceiling is meant to hold at all times. They also note that the fiscal rules are widely understood by markets and others as the guiding principles of fiscal policy, and have proved very successful in anchoring expectations. They believe that stability in the framework over time promotes clarity and predictability and enhances the credibility of fiscal policy. They therefore do not favour changing the rule.

Fiscal Policy

7. My authorities agree with staff that the automatic stabilisers should be allowed to operate fully in the short term. Over the medium term, policy will remain prudent and cautious, guided by the fiscal rules. Public sector net debt has fallen from 44% in 1996/97 to around 30% in 2001/02, and is projected to stabilise at around 33% by 2007/08, as the Government borrows modestly to fund increased investment in public services. The fiscal projections show cyclically-adjusted net borrowing of around 1½% over the medium term.

8. My authorities have noted staff's comments in paragraphs 13 and 14. However, they believe that the revenue projections are prudent and consistent with the fiscal rules. They also note the important elements of caution built into the fiscal projections:

- key budget assumptions are set at deliberately cautious levels and independently audited by the National Audit Office;
- the fiscal projections assume growth at the lower end of the forecast range;
- trend growth is assumed to be 2½%, ¼ percentage point below the neutral view;
- finally, the projections are 'stress-tested', by assuming (as a cautious case) trend output to be 1 percentage point lower in relation to actual output than in the central case.

9. Taken together, these give considerable protection against the inevitable risks of forecast error and unexpected shocks. And even on these assumptions (and in the cautious case) the UK meets its fiscal rules over the cycle.

Medium Term Issues

10. My authorities agree with staff on the central importance of raising productivity, and welcome the Selected Issues Paper. They have set out a comprehensive programme of microeconomic reform to remove the barriers that prevent markets from functioning efficiently. In the past year my authorities have introduced new measures, including:

- a reduction in the starting rate of corporation tax from 10 per cent to zero;
- reforms to reduce the burden of VAT and payroll administration, to simplify the tax system and reduce compliance costs for small businesses;
- a volume-based research and development tax credit for large companies;
- 2,000 Enterprise Areas in deprived areas to help businesses start up and grow;

11. In the last Article IV report staff rightly noted the legacy of under-investment in public services. Public sector net investment fell by 15% annually in real terms between 1991/92 and 1996/97 leaving the UK with the lowest level of public investment of any large EU country. To address this my authorities aim to raise public sector net investment to 2.25% of GDP by 2007/08.

12. The key issue, however, is not the level of spending but the quality of the public services delivered. My authorities agree with staff on the need to improve efficiency and effectiveness, and have set out a broad agenda for reform, based on four principles:

- clear, measurable, long-term goals, that focus service providers on the outcomes the authorities seek to achieve;
- independent audit and inspection (separating responsibility for setting and monitoring targets);
- maximum local flexibility and discretion to innovate (with additional freedoms and flexibilities as performance improves);
- transparency (through monitoring and reporting publicly against targets, including local and national comparisons).

With reforms based on these principles, and extra resources being channeled to the best performers, my authorities are determined to ensure value for money in public services.

13. Staff see greater scope for private provision of public services. My authorities see Public Private Partnerships as a key element in their strategy for high quality public services, bringing additional investment, innovation and efficiency. Staff also recommend a broader application of user fees, beyond their existing use. My authorities believe that where there is a commitment (eg. in the health service) to public services free at the point of use and available to all on the basis of need (rather than ability to pay), choice should not be promoted at the expense of equity or efficiency, particularly where there are market failures or capacity constraints. They have rejected user charges for medical or hospital care.

14. My authorities' policy on the single European currency remains unchanged. In principle they are in favour of UK membership; in practice, the economic tests must be met. They will make an assessment of the five economic tests for membership by June of this year. The assessment will be rigorous and comprehensive, and will be published. My authorities have set out details of the preliminary and technical work which is underway, and which will be published in 18 accompanying papers. On the basis of the assessment my authorities will decide whether to recommend membership to the UK Parliament, and then to the British people in a referendum.

Financial Sector

15. My authorities welcome staff's assessment of the UK's financial system. The FSAP was a valuable exercise, and produced a number of helpful suggestions for further

improvements which they will consider carefully.

16. They agree with staff that the financial sector is fundamentally sound and that the policy framework is strong, with a high degree of observance of standards and codes. However, they believe there is no room for complacency and are constantly seeking to develop the risk-based regulatory system to meet new challenges arising within the financial sector. On insurance, the FSA is developing proposals to strengthen supervision, to raise standards from the regular IAIS core principles (which the UK already meets) to the enhanced standards applicable to a major international centre. On anti-money laundering, a number of further improvements are being introduced through the Proceeds of Crime Act.