March 2005
IMF Country Report No. 05/80

United Kingdom: 2004 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 2004 Article IV consultation with the United Kingdom, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on December 20, 2004, 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 8, 2005. 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 March 2, 2005 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its March 2, 2005 discussion of the staff report that concluded the Article IV consultation.

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

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

Selected Issues Paper

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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INTERNATIONAL MONETARY FUND

UNITED KINGDOM

Staff Report for the 2004 Article IV Consultation

Prepared by the Staff Representatives for the 2004 Consultation with the United Kingdom

Approved by Michael Deppler and Juha Kähkönen

February 8, 2005

- Article IV consultation discussions were held during December 8–20, 2004. The staff team, which comprised Ms. Schadler (head), Mr. Morsink, Mr. Hunt, Ms. Honjo, Mr. Schule, and Ms. Koeva (all EUR), 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 government officials, as well as representatives from financial institutions, research institutes, and labor and business organizations. Mr. Scholar and Mr. Gregory (OED) attended most meetings.

- The Labour Government enjoys a large majority in Parliament. General elections are expected this spring.

- In concluding the last Article IV consultation on March 3, 2004, Directors commended the strong performance of the U.K. economy, agreed that monetary policy should continue to tighten to facilitate a soft landing scenario, and concurred that the fiscal deficit needs to be reduced, with many Directors recommending that new fiscal measures be adopted. For further details, see http://www.imf.org/external/np/sec/pn/2004/pn0415.htm.

- The United Kingdom has accepted the obligations of Article VIII, Sections 2, 3, and 4. The exchange system is free of restrictions on payments and transfers for current international transactions (Appendix II). The United Kingdom has subscribed to the Special Data Dissemination Standard, and data provision is adequate for surveillance (Appendix III).

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

Contents Page

Executive Summary

Background

Macroeconomic performance over the past decade has been strong and steady, owing much to structural reforms and improvements in policies and policy frameworks. Over the past year, growth moderated, reflecting in part the tightening of monetary policy, and appears to be settling at potential. Wage growth stabilized and inflation remained subdued. The fiscal deficit, which deteriorated sharply between 2000 and 2003, stayed at about 3 percent of GDP. House price appreciation slowed, but house prices are widely seen as overvalued.

Key policy issues

Outlook: Most interlocutors agreed that the economy was operating in the vicinity of full capacity and that growth would remain at about 2½ percent. However, the Treasury saw a still-sizable output gap and expected quarterly growth to increase, supported by stronger external demand and government spending. Views differed on the economic impact of a possible decline in house prices. Another risk was a disorderly resolution of global imbalances. The widening trade deficit and higher oil prices were not seen as major concerns.

Monetary policy: The BOE and staff thought that monetary policy had been appropriate over the past several years. With the policy interest rate now in the neighborhood of the neutral rate and given the important uncertainties to the outlook, the next move in interest rates could be up or down. Monetary policy was well-positioned to respond to shocks. Staff welcomed the increased emphasis on inflation projections based on market expectations of future interest rates and the extension of the projection horizon from two to three years. Staff suggested that the BOE publish numerical projections for a broader range of key variables.

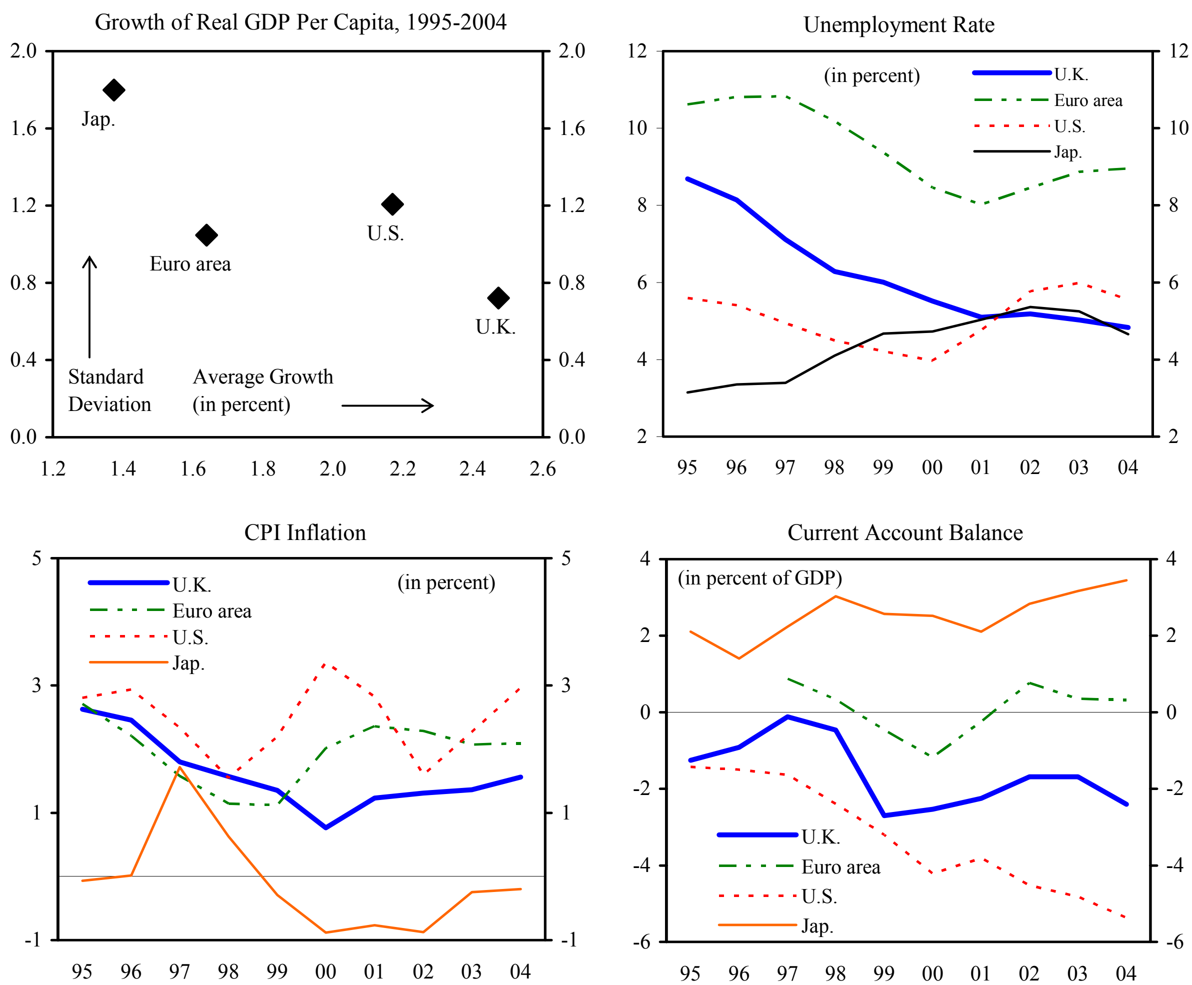
Fiscal policy: The Treasury expected that slower spending growth and a rebound in revenues would reverse the past fiscal deterioration and ensure that the fiscal rules were respected. While accepting the direction of future changes in spending and revenue growth, staff were less sanguine about the strength of structural revenues and the buoyancy of financial sector taxes over the medium term. Therefore, staff called for an early start to smooth fiscal adjustment, amounting to about 1 percent of GDP over the next five years. Staff also recommended further enhancing the transparency and credibility of the fiscal projections.

Structural issues: The Interim Report of the Pensions Commission found that many people were not saving enough for retirement. While there was agreement on some aspects of the solution to this problem, views differed widely on the appropriate role of government in ensuring adequate private saving. Staff welcomed the narrowing of the U.K.'s productivity gap and encouraged the systematic evaluation of government initiatives to boost productivity. Staff urged the implementation of recommendations to reduce house price volatility.

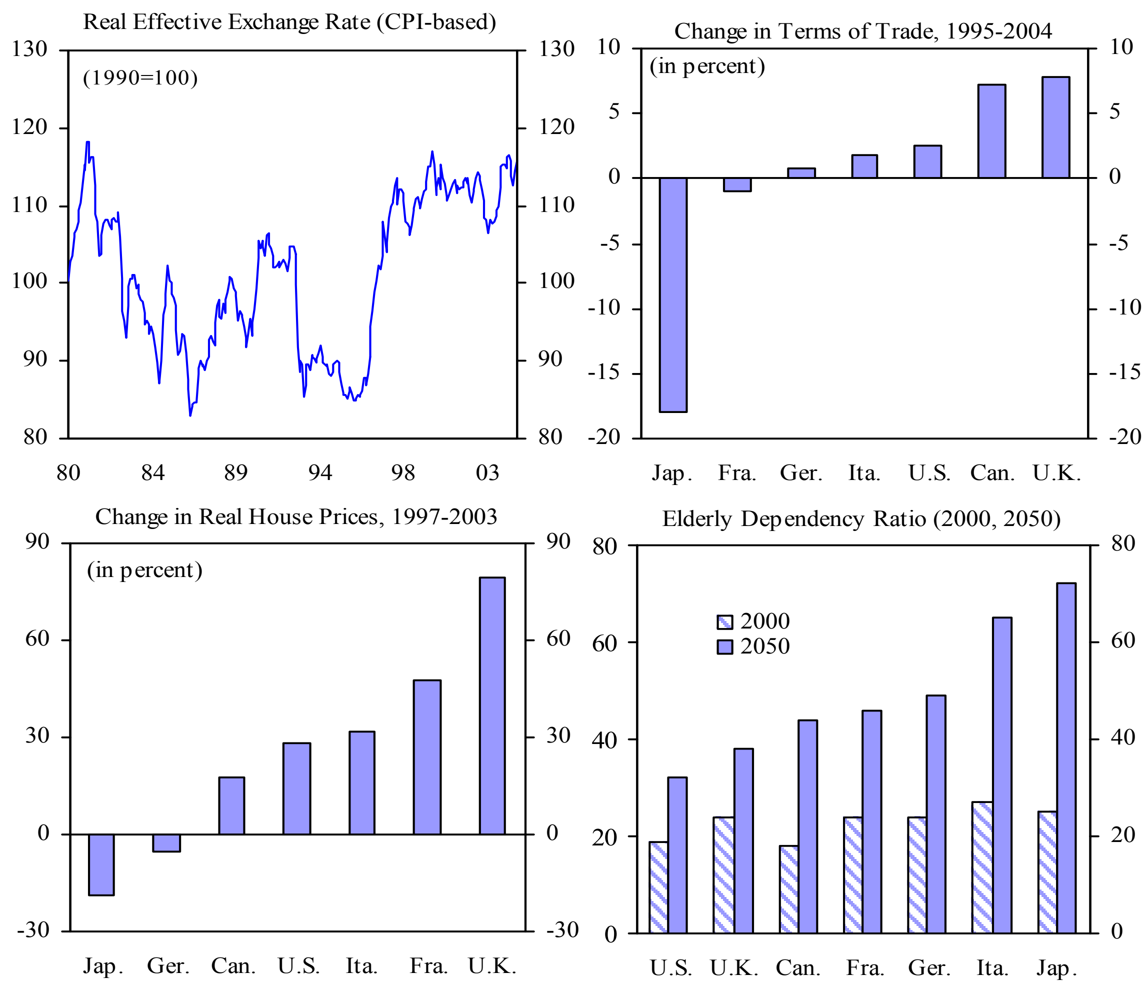
Financial sector stability: Indicators of banking system soundness remained favorable and the health of the insurance sector improved over the past year. The BOE is planning to introduce a voluntary reserve system, which will reduce volatility in overnight money markets and lower intraday credit exposures in the payments system. The AML/CFT regime was strengthened, and the authorities are stepping up their oversight to ensure compliance.

I. Background

1. **Macroeconomic performance in the United Kingdom during the past decade has been strong and steady.** Standing out among G7 countries, the United Kingdom has enjoyed relatively rapid and stable per capita growth. Unemployment has fallen to one of the lowest rates in the industrial world, while inflation has been subdued and current account deficits moderate. This impressive record owes much to improvements in institutions and policies during the past two decades. Structural reforms initiated during the 1980s produced relatively flexible factor and product markets that facilitated responses to technology changes and a shift to a more services-oriented structure of demand. During the 1990s, a series of changes



in macroeconomic policy institutions—the introduction of inflation targeting, Bank of England independence, and, alongside a large fiscal adjustment, fiscal rules—reinforced the benefits of the structural reforms by anchoring expectations and creating scope for a strong countercyclical response to the growth slowdown between mid-2000 and mid-2003. At the same time, the economy benefited from other favorable developments: rising house prices, improving terms of trade, and prospects for less adverse demographics than in other industrial countries. However, a 30 percent real appreciation of sterling in 1996–97 contributed to a deterioration in the trade balance.



2. **Not surprisingly, the economic cycle beginning in 1999 has seen relatively steady growth supported by domestic demand.** The slowdown of domestic demand between mid-2000 and mid-2003 prompted a sizable cut in policy interest rates and fortuitously coincided with a large increase in government spending. Full operation of fiscal stabilizers further supported demand. With this stimulus, alongside a spurt in property prices, both consumption and investment picked up momentum from mid-2003. Concerns about future overheating, especially given developments in the property market, emerged in the second half of 2003, prompting a gradual increase in the policy interest rate from 3½ percent in November 2003 to 4¾ percent in August 2004. Fiscal policy, however, has been steadily stimulative: the public sector balance deteriorated from a surplus of 1¾ percent of GDP in FY1999/2000 to a deficit of 3¼ percent of GDP in FY2003/04.[1] This policy mix kept the value of sterling strong, and net exports remained a drag on growth.

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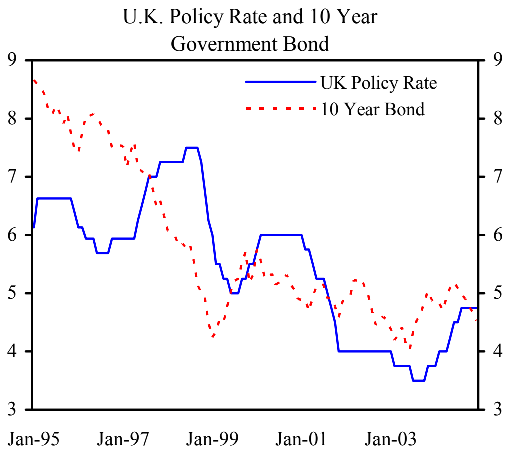
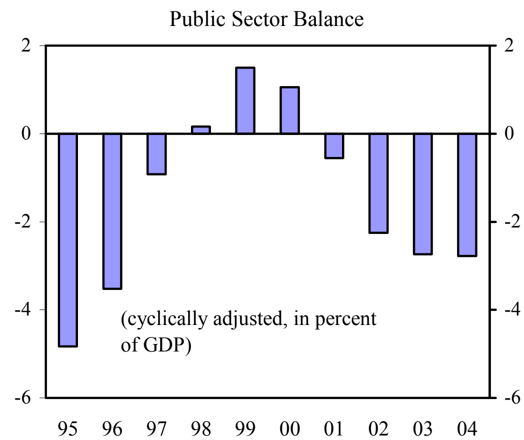
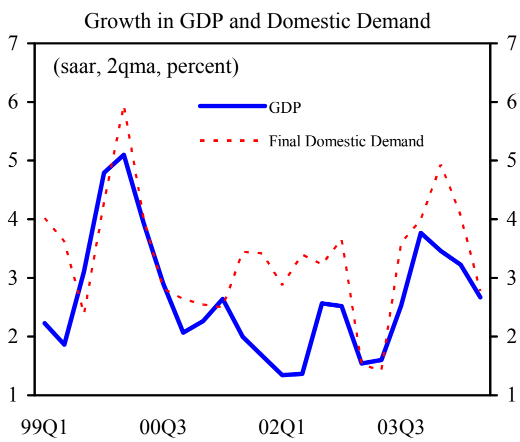
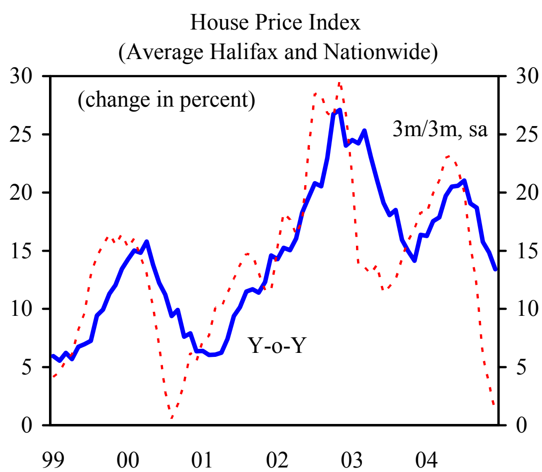
[1] The fiscal year runs from April to March.

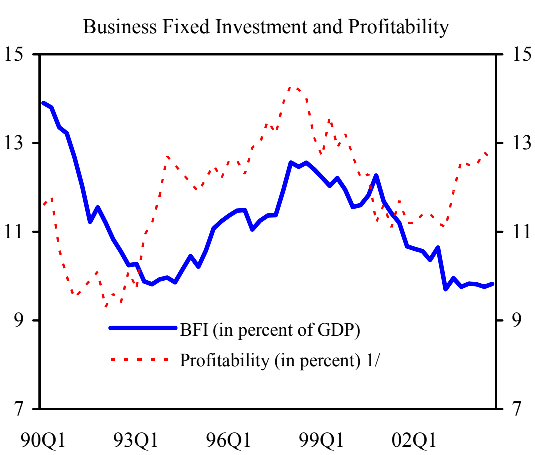




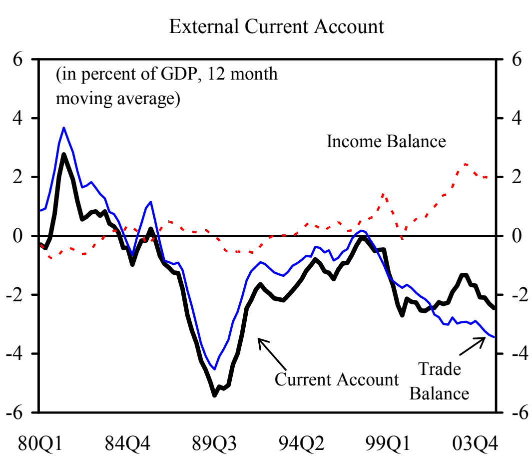
3. **Growth moderated over the past year—reflecting in part the tightening of monetary policy—and appears to be settling at trend**. Real GDP growth eased by end-2004 to its estimated potential rate of about 2½ percent. Household consumption growth slowed, reflecting rising debt service (given the prevalence of variable-rate mortgages) and a sharp diminution in house price appreciation. Supported by strong corporate profitability, business fixed investment growth held up. However, export volume growth disappointed, especially given strong global growth, and the trade deficit widened to 3½ percent of GDP.







1/ Net rate of return on capital employed.



Although increasing productivity growth and limited wage pressures even at the lowest unemployment rate in about 30 years could indicate a shift outward in supply constraints, most observers believe the economy is operating in the neighborhood of full capacity. Core CPI inflation (excluding food, beverages, tobacco, and energy) stayed subdued at about 1¼ percent although CPI inflation edged up to about 1½ percent at end-2004. Most policies remained in line with Fund advice (Box 1).

Box 1. Policy Recommendations and Implementation

The fiscal and monetary policy frameworks remain at the forefront of international best practice and continue to evolve along the lines suggested during consultations. The gradual tightening of monetary policy was consistent with last year's Fund advice to contain strong growth of domestic demand, especially in the face of rapidly rising house prices. Fiscal outturns, however, have remained weaker than budget forecasts, and the authorities have not taken measures to narrow the fiscal deficit, as recommended by staff and many Directors.

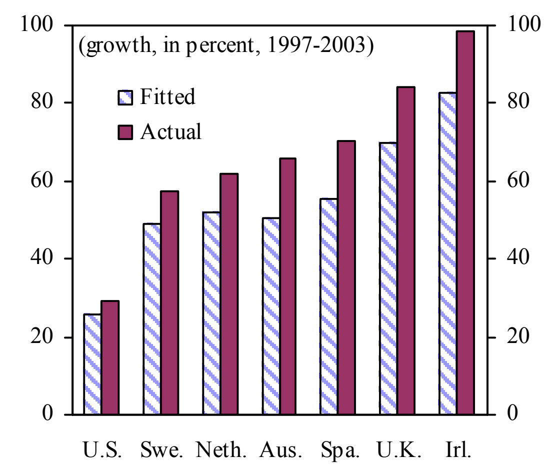
II. Report on the Discussions

4. **The continuing success of the U.K. economy reinforces the staff's long-held view of the powerful effects of good institutions and policy frameworks**. Indeed, the economy remains enviably well-positioned to sustain steady and strong economic growth over the medium term. But staff and the authorities acknowledged that even state-of-the-art policy frameworks constrain but do not eliminate discretion; that the frontiers of best practice are continuously moving outward; and that turbulence from various disturbances is always a risk. The discussions focused on attuning policies to each of these demands.

5. **The most immediate risks to continued strong economic performance stem from fragilities born of the recent economic success and longer-term challenges.**

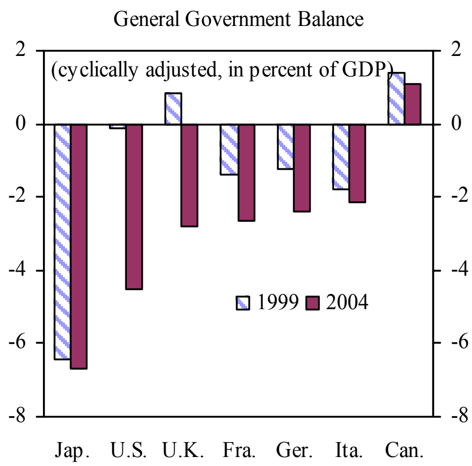
- Signs of overheating are scarce, but the sustained strength of the economy makes it difficult to read capacity constraints. One obvious cause for concern is the sharp rise in house prices over the past cycle—both a sign of confidence in economic developments and reminiscent of past booms. And while rapidly rising property prices are a feature of some other industrial countries, the estimated overvaluation in the United Kingdom is relatively large.

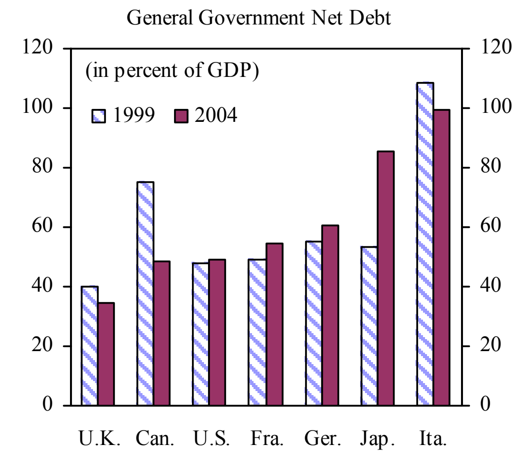
Estimated House Price Overvaluation



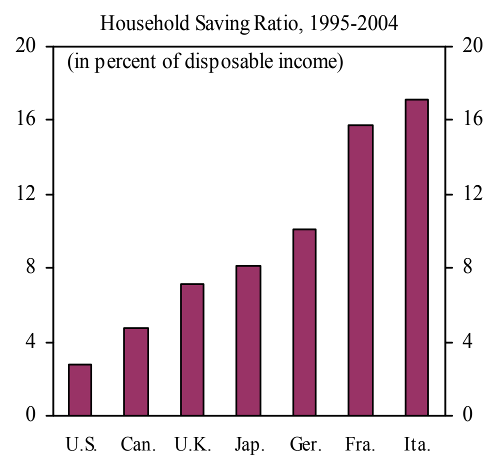
Source: WEO, September 2004, Chapter 2.

- The past five years have seen a sizable deterioration in the fiscal position as spending responded to the perceived demand for better public services while equity bubble revenues subsided. Although the overall deficit is not large by current industrial country standards and the debt burden is low, a persistent deficit at recent levels would challenge the credibility of the government's fiscal rules—a key underpinning of the economy's strength.





- Over the long term, demographic pressures will rise. Recent evidence raises questions about whether a relatively minimal public pension scheme is adequately supplemented by private savings to meet expectations for replacement rates.

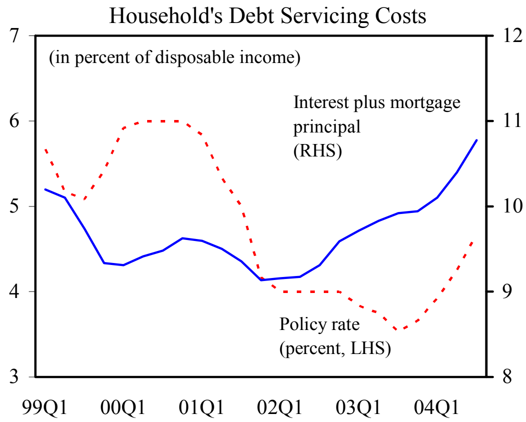


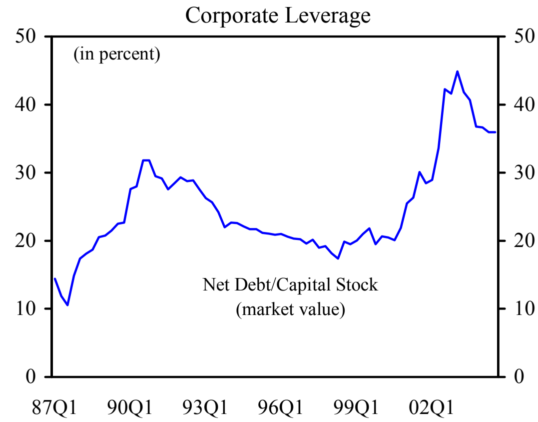
These particular concerns come alongside challenges, common also to other countries, of responding to a possible abrupt unwinding of global imbalances; of maintaining high standards of financial supervision and prudential surveillance; and of pushing the envelope of structural reforms to protect the economy's resilience.

A. Economic Outlook

6. **Views on the short-term outlook were sanguine.** BOE officials, the private consensus, and staff expected output growth to settle at about 2½ percent. Private consumption growth should be underpinned by continued solid earnings growth, largely offsetting the lagged effects of last year's interest rate increases and a projected modest drop in house prices. Business investment was projected to accelerate somewhat, with support from robust corporate profitability more than offsetting the drag from high leverage. Export growth was expected to pick up, although remain below import growth. Treasury officials, who saw coincident indicators as suggesting that output was still about 1 percent below

potential, expected quarterly growth to increase, supported by stronger external demand and government spending. They projected output growth in 2005 at 3¼ percent.





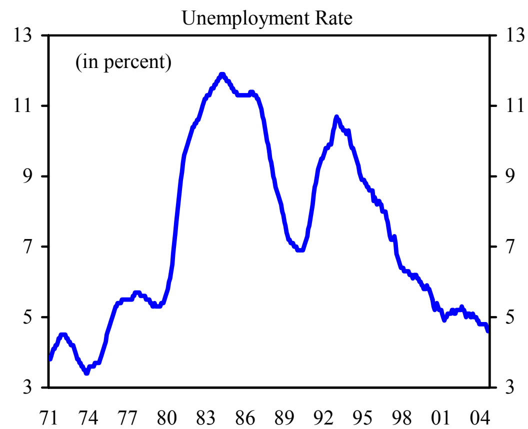
Medium-Term Scenario
(Percentage change, unless otherwise indicated)

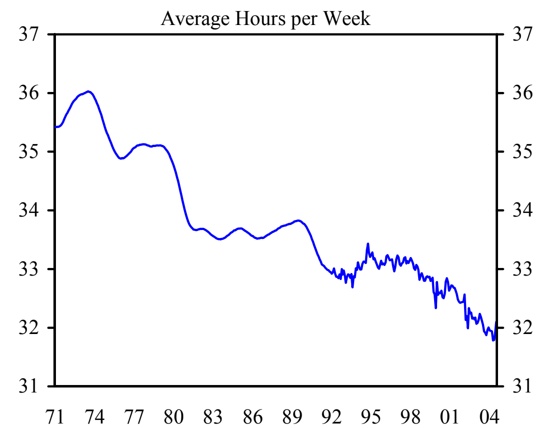
	2003	2004	2005	2006	2007	2008	2009	2010
Real GDP	2.2	3.1	2.6	2.6	2.3	2.2	2.2	2.2
Domestic demand	2.5	3.8	2.9	2.7	2.4	2.2	2.1	2.1
Private consumption	2.3	3.3	2.5	2.3	2.2	2.1	2.0	2.0
Government consumption	3.5	4.5	3.0	3.0	2.5	2.0	2.0	2.0
Fixed investment	2.2	6.1	4.9	4.0	2.9	2.7	2.7	2.6
Public	23.1	11.7	17.8	11.2	5.6	4.6	4.1	4.1
Residential	9.0	8.0	-6.6	-0.5	0.7	0.9	1.2	1.2
Business	-1.8	4.8	6.0	3.8	3.0	2.7	2.7	2.7
Net exports 1/	-0.3	-0.8	-0.5	-0.3	-0.2	-0.1	0.0	0.0
Current account 2/	-1.7	-2.4	-2.5	-2.5	-2.5	-2.5	-2.5	-2.4
CPI inflation	1.4	1.3	1.5	1.8	2.0	2.0	2.0	2.0
Output gap	-0.8	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Unemployment rate 3/	5.0	4.8	4.6	4.6	4.6	4.6	4.6	4.6

Sources: Office for National Statistics; and IMF staff projections.
1/ Contribution to the growth of GDP.
2/ In percent of GDP.
3/ In percent of labor force; based on Labor Force Survey.

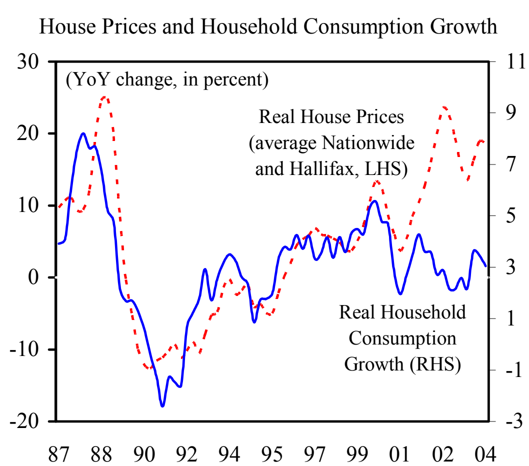
7. **The fundamental question differentiating these projections was where the economy is relative to capacity constraints**. In the Treasury's view, a key indicator of excess capacity was the decline in average hours worked per week over the past three years. Staff, however, viewed the drop in hours worked as more a secular than cyclical development—especially because the recent change is largely accounted for by an increase in part-time employment, which surveys suggest has been voluntary. Staff argued that the historically low unemployment rate and rising survey measures of capacity utilization, as well as its production-function-based estimate of the output gap, suggested that the economy

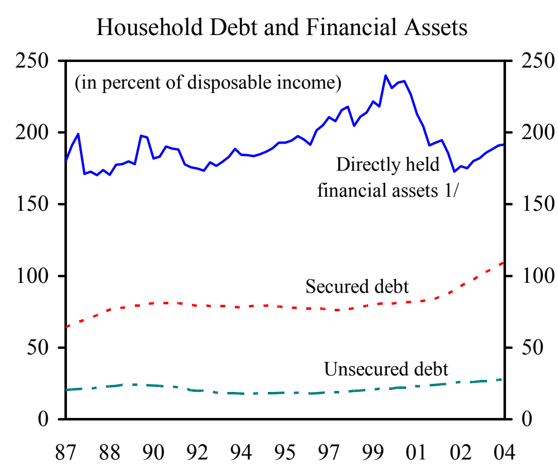
was operating in the neighborhood of full capacity, in line with the BOE's view and the private consensus view. Nevertheless, staff acknowledged important uncertainties about supply potential, given the continued edging down of the unemployment rate, a recent pick-up in productivity growth, and problems with measures of spare capacity.





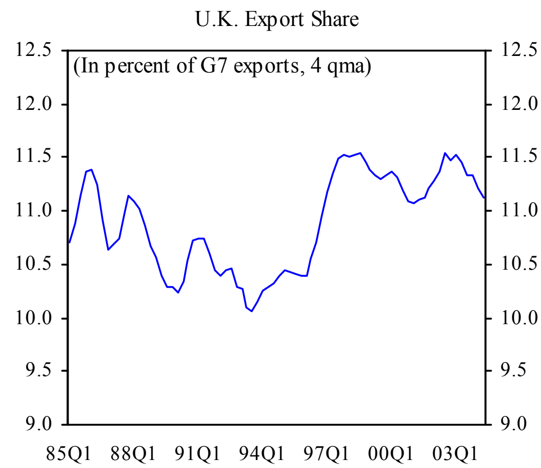
8. **Perhaps the greatest near-term risk to the outlook was the possibility of a sharper-than-expected drop in house prices, though the extent of the risk was debatable**. BOE officials argued that the sensitivity of consumption to house prices had declined in recent years: despite the sharp increase in house prices since 2002, real household consumption growth had remained stable, as increasing mortgage debt had been largely offset by home improvement and financial asset accumulation. Staff responded that, even though the correlation between changes in house prices and changes in consumption may have weakened since 2002, the ratio of consumption to disposable income had risen over the past decade alongside increasing housing wealth. Moreover, the effect of a drop in house prices could be asymmetric if it led banks to tighten lending criteria, constraining some households from borrowing to smooth consumption.



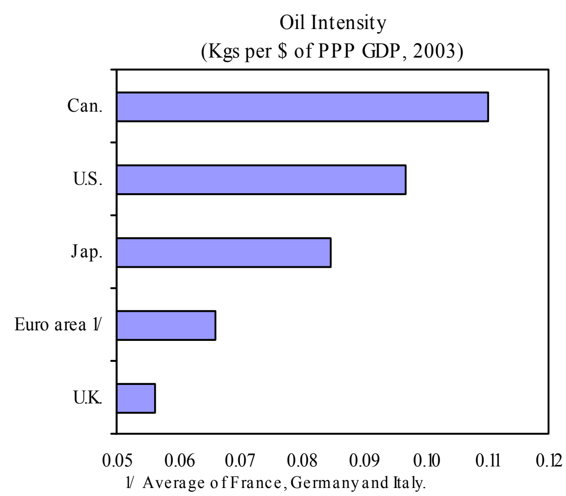


1/ Excluding assets held by life insurance and pension funds.

9. **Staff asked whether the weakness of exports raised concerns about competitiveness**. Officials said that industrial countries generally had been losing export share, probably reflecting the increasing integration of emerging market countries in the global economy; relative to G7 countries, the United Kingdom's export share had remained stable. The increase in the trade deficit in 2004 was partly due to cyclical factors, and the level remained below historical highs. In addition, the United Kingdom's international investment position was only slightly negative—net liabilities were about 5–10 percent of GDP. Although the real effective exchange rate had appreciated slightly over the past 12 months, it remained in the range of the past several years. Staff argued that a further widening of the trade deficit would be a concern, but agreed with officials that—consistent with the latest CGER assessment—there was not strong evidence of major overvaluation.



10. **Higher oil prices were also not a major concern**. The United Kingdom is a small net oil exporter, and the oil intensity of output is the lowest among G7 countries. Officials and staff agreed that higher oil prices could dampen economic activity in the short term, but less so than in other G7 countries. Also, higher oil prices would likely have only a small direct impact on inflation, as energy accounts for only about 5 percent of the CPI basket. Firmly-entrenched inflation expectations and the flexible labor market would likely limit second-round effects.

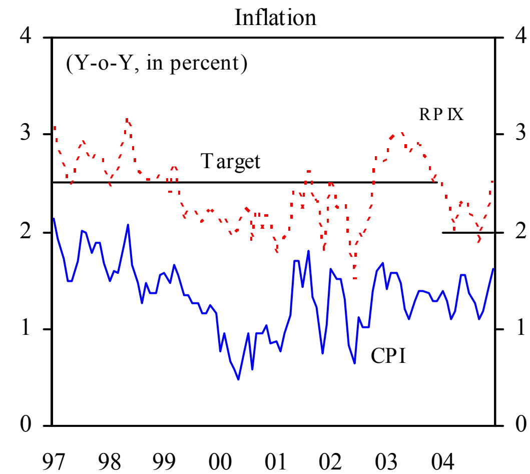


11. **Officials saw global imbalances as a risk to the outlook**. Officials and staff agreed that a disorderly resolution of global imbalances could result in slower global growth, which would hurt U.K. growth. Regarding the possibility of further U.S. dollar depreciation, BOE officials did not see a reason to expect a divergence from recent developments, in which sterling appreciation against the U.S. dollar had been largely offset by depreciation against the euro, implying little change to the effective exchange rate.

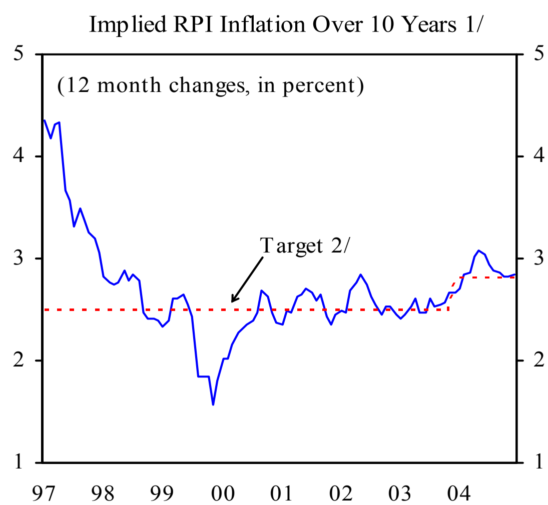
B. Monetary Policy

12. **BOE officials felt that monetary policy had been appropriate over the past several years**. They noted that between 1997 and end-2003 (when the inflation target variable was changed from RPIX to CPI), average RPIX inflation had been almost identical

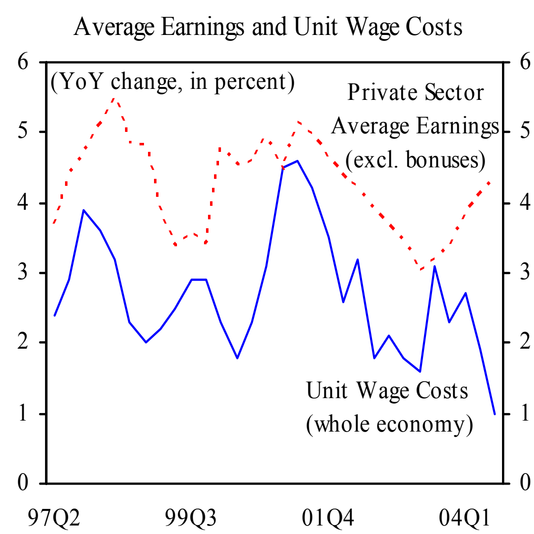
to the 2½ percent target.[2] Low goods price inflation—reflecting falling import prices as well as declining margins and accelerating productivity in the distribution sector—had been offset by high housing depreciation (reflecting booming house prices). Over the past year, the rise in interest rates had helped dampen domestic demand and house price appreciation and thereby contain incipient inflation. The change in the target variable had implied a slight effective increase in the target, as the difference in index methodologies (subtracting about ½ percent) and exclusion of house price depreciation (subtracting about ¼ percent on average) had taken more out of inflation than the ½ percentage point reduction in the target. BOE officials observed, and staff agreed, that an immediate cut in interest rates to accommodate the increase in the target would have been inappropriate; rather, monetary policy was tightened more gradually than it would have been under the old target.



13. **Staff asked whether, nonetheless, the current level of interest rates might be seen as too high**. Specifically, did CPI inflation at the bottom of the target range in the past year risk entrenching below-target inflation expectations? Were projections of a return of inflation to target based on truly central assumptions? And why were interest rates higher than in other higher-inflation G7 countries? On the first question, BOE officials noted that the spread



1/ Differential between 10-year nominal and index-linked bond yields.
2/ After December 2003, this refers to an implied target consistent with the new CPI target.



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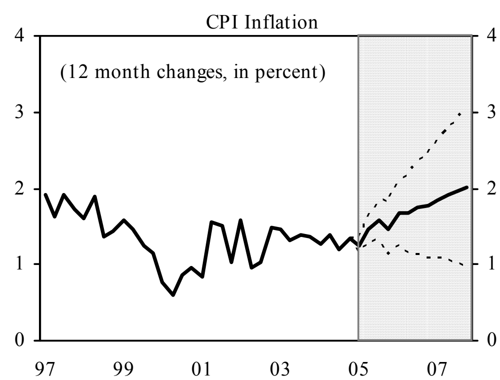
[2] RPIX is the retail price index (RPI) excluding mortgage interest payments.

between nominal and RPI-indexed bond yields was consistent with the new CPI target. On the projections, the BOE assumed that the economy would remain at potential and that unit wage costs would continue to grow modestly, but that increasing import prices would push inflation to target (Box 2). They acknowledged that, like staff, they had been wrong about the strength of import prices in the past, but pointed to current projections for import prices similar to those in the WEO. BOE officials saw the higher level of the policy interest rate in the United Kingdom as mainly reflecting cyclical differences; they noted that implied short-term interest rates 5–10 years out were lower in the United Kingdom than in the United States or the euro area. They acknowledged that recent large fiscal deficits had probably put some upward pressure on interest rates, but would be a major complicating factor only if they persisted.

Box 2. Why Has Inflation Been Low?

Staff analysis suggests that low inflation in recent years can be explained reasonably well by a combination of downward pressure from external shocks and inflation persistence.[1] Specifically, an estimated expectations-augmented Philips curve shows that declining import prices and increased competitive pressures, proxied by sterling's real appreciation, were the main factors behind low inflation. An important degree of persistence in inflation, in turn, helped to spread the effects of the external shocks over time.

Based on this inflation equation, staff forecast that CPI inflation will rise gradually toward the 2 percent target over the next 2–3 years (see figure). The upper and lower bounds in the figure represent the projected mean squared error of the forecast. Three factors will work to push inflation higher: rising import prices, the closing of the small negative output gap, and well-anchored inflation expectations. The significant persistence in inflation is expected to slow the rise in inflation.



[1]Selected Issues Paper, *Why Has Inflation Been Low?*

14. **BOE officials said the direction of the next move in the policy interest rate would depend on changes in economic prospects**. With nominal GDP growth in 2005–06 projected to be about 5 percent, the policy interest rate of 4¾ percent was now in the vicinity of the neutral rate. Given the important uncertainties to the outlook—including the degree of spare capacity and the impact of weakening house prices on consumption—the next move in interest rates could be up or down, depending on how the economy evolves relative to baseline projections.

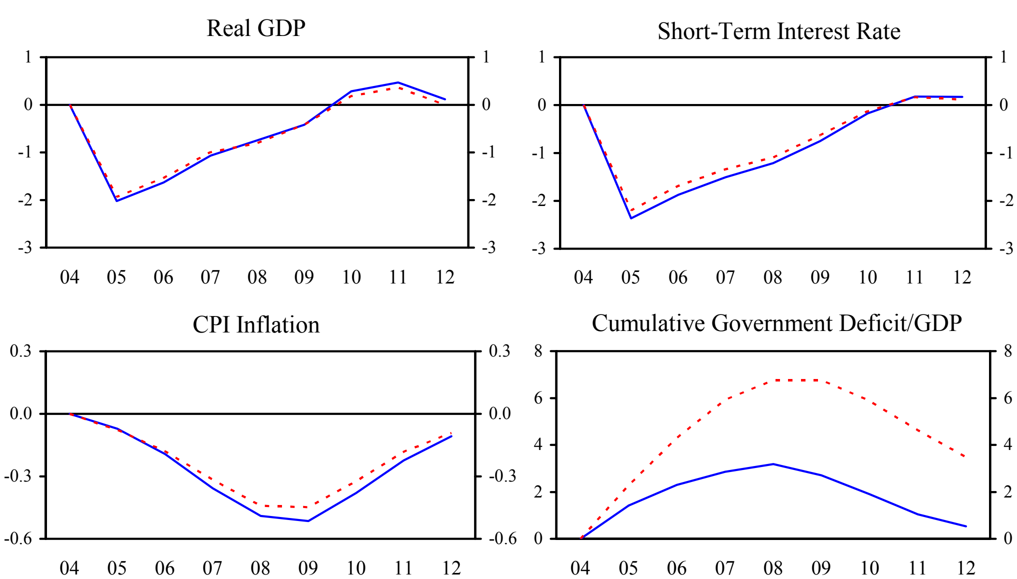
15. **BOE officials saw monetary policy as well-positioned to respond to shocks**. Should house prices fall by more than currently expected, the monetary policy response would depend on the magnitude of the fall and the sensitivity of household consumption.

BOE and Treasury officials concurred with the results of a staff study suggesting that monetary (and not fiscal) policy should bear the burden of the response to a house price shock, especially given the current fiscal position (Box 3). Equally, the monetary policy response to a large change in the exchange rate (as part of an unwinding of global imbalances) would depend on its inflationary impact. With the policy rate at 4¾ percent and inflation expected to rise only gradually to target, BOE officials and staff agreed that there was ample room to tighten or loosen monetary policy.

Box 3. Policy Response to a Sharp Decline in House Prices

Staff analysis suggests that monetary policy is well-positioned to address the potential adverse macroeconomic impact of a sharp decline in house prices.[1] While staff and most observers expect house prices to decline modestly in 2005, there is a risk that house prices could decline sharply, so staff consider the impact of a range of potential declines in house prices relative to baseline in a simulation model of the United Kingdom. The analysis shows that, even if the shock is quite large (30 percent decline and consumption sensitivity in line with historical experience), large interest rate cuts could limit the negative impact on real GDP (solid line in figure). Further, even if monetary policy easing led unexpectedly to a burst in inflation, the risk of inflation rising more than 1 percentage point above target is extremely low because inflation is currently below target.

The analysis further suggests that, with inflation below target but fiscal deficits still quite large, it would be prudent to rely exclusively on monetary policy. Allowing automatic stabilizers to operate fully would of course mitigate the decline in output and increase fiscal deficits (solid line in figure). However, if fiscal policy provided a temporary stimulus, to which monetary policy responded endogenously, the impact on output would be very small, but the deterioration in the fiscal position could be considerable (dashed line in figure).



Source: MULTIMOD.

[1] Selected Issues Paper, *How Should Policymakers Respond to a Decline in House Prices?*

16. **On the whole satisfied with the transparency of the inflation targeting regime, the BOE has continued to experiment with improvements**. Staff welcomed the increased emphasis on inflation projections using market expectations of future interest rates and the extension of the projection horizon from two to three years. To further help financial markets better understand the conduct of monetary policy, staff suggested that the BOE publish numerical projections not just for real GDP and CPI but also for other key macroeconomic variables. BOE officials noted that, as their forecast represented the collective judgment of MPC members, securing agreement on quantitative projections (and error bands) for a wider range of variables would be excessively time consuming. Staff and BOE also discussed the pros and cons of publishing an illustrative path for interest rates consistent with the inflation target. This would represent the actual process of monetary policy making, in which the inflation target was given and interest rates were adjusted to achieve it. As such, it could help guide market expectations more smoothly, a view underlying New Zealand's successful experience with publishing interest rate forecasts. BOE officials had two objections: they noted that it would be inordinately time consuming for MPC members to agree on the path; and they feared that the announcement of an illustrative path could be disruptively misinterpreted as a BOE commitment to follow the path, rather than a view about a path conditional on the information available at a given time.

C. Fiscal Policy

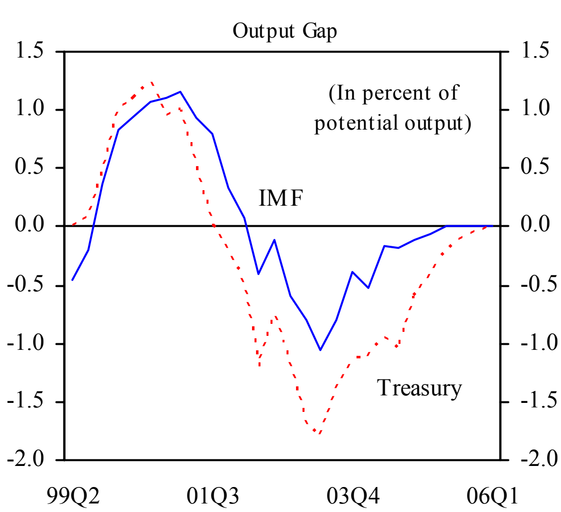
17. **The authorities emphasized that fiscal policy was rooted in medium-term considerations**. Fiscal rules introduced in 1998—a golden rule requiring the public sector's current balance to be non-negative on average over the business cycle and a sustainable investment rule requiring net public sector debt to be kept at a stable and prudent level (which the Treasury regards as below 40 percent of GDP)—were part of a framework assuring fiscal solvency and scope for automatic stabilizers to respond to fluctuations in demand. Discretion focused on decisions about the role of the government in the economy and taxation required to meet that role. In this context, the government had initiated in 2000 a multi-year increase in spending on health, education, transportation, and law and order. This coincided with a drop in revenues relative to GDP as the equity price boom unwound. Thus, the current balance had shifted over the current cycle—which in the Treasury's view began as GDP crossed trend in FY1999/2000 and should end in FY2005/06—from an initial surplus of 2 percent of GDP to a deficit of 2 percent of GDP in FY2003/04. The authorities expected several developments—a tapering off of spending growth and a rebound in the revenue ratio (owing to higher corporate taxes and the closing of a still-substantial output gap)—to partially reverse this deterioration and ensure that the fiscal rules were respected. At this stage, therefore, they saw no need and had no plans for discretionary action. However, clear evidence that projected improvements in the fiscal accounts were in doubt would prompt immediate action.

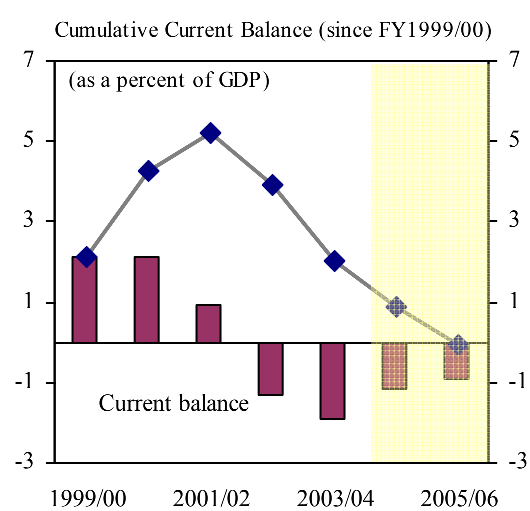
Fiscal Balances and Public Debt 1/ 2/
(In percent of GDP)

	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	...	2009/10
	Actual					Proj.			
Overall balance									
2004 Budget	...	...	-0.1	-2.2	-3.1	-2.9	-2.7		-1.5
Staff	1.7	-0.8	0.0	-2.4	-3.2	-3.0	-3.1		-2.4
Cyclically-adjusted overall balance									
2004 Budget	...	...	-0.4	-1.6	-2.2	-2.2	-2.5		-1.5
Staff	1.5	-1.3	-0.6	-2.3	-2.7	-2.8	-3.1		-2.4
Current balance									
2004 Budget	...	...	0.9	-1.2	-1.9	-1.1	-0.6		0.8
Staff	2.0	2.1	0.9	-1.3	-1.9	-1.1	-1.0		-0.1
Cyclically-adjusted current balance									
2004 Budget	...	...	0.6	-0.6	-1.0	-0.4	-0.4		0.8
Staff	1.9	1.5	0.4	-1.2	-1.4	-0.9	-1.0		-0.1
Output gap									
2004 Budget	...	...	0.0	-1.2	-1.4	-0.8	-0.1		0.0
Staff	0.1	1.1	0.5	-0.5	-0.7	-0.1	0.0		0.1
Net public debt									
2004 Budget	...	...	31.0	32.3	33.7	35.3	36.4		38.0
Staff	37.2	32.0	31.0	32.3	33.7	35.4	37.1		41.4

Sources: Budget 2004, 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 to March.

18. **Staff saw considerably greater risks from unchanged policies.** The cumulative current balance in this cycle is still in small surplus, so the golden rule is likely to be met or missed by an insignificant amount. Net public debt is projected to be well below 40 percent of GDP in FY 2004/05. Staff, however, argued that the next cycle—regardless of when it





begins—would start with a sizable current deficit, in contrast to the present cycle's initial surplus. Staff accepted that spending growth would taper off as planned and that the revenue-to-GDP ratio would rise over the medium term owing to fiscal drag (about 0.1 percent per year) and anti-fraud measures. But staff were less sanguine about the level of potential GDP (and therefore the strength of structural revenues) and the buoyancy of financial sector taxes over the medium term. As a result, without discretionary measures, staff projected an improvement in the overall balance relative to GDP between FY2004/05 and FY2009/10 of ½ percentage point, compared to the Treasury's 1½ percentage point. On staff's projection, the golden rule would not be met in the next cycle and the sustainable investment (debt) rule would be broken eventually.[3]

19. **In this context, Treasury and staff views diverged on the appropriateness of the fiscal stance in FY2004/05**. Notwithstanding higher-than-budgeted current spending and lower-than-budgeted revenue in the first nine months of the fiscal year, staff's projections assume that spending will be in line with the budget and that revenue will rebound due to the acceleration in corporate income and personal bonuses and windfall oil receipts (close to ¼ percent of GDP). Although the cyclically-adjusted current balance relative to GDP is expected to improve by ½ percentage point, the increase in investment implies a roughly unchanged overall balance and a small overall fiscal stimulus. Staff observed that the strengthening economy provided an opportunity for securing an adjustment in the overall fiscal balance, as had been recommended last year. In the authorities' view, however, the critical adjustment was in the current balance where the improvement was indeed substantial.

20. **Treasury officials and staff also differed on whether the overall deficit would narrow in FY2005/06 as projected in the December 2004 Pre-Budget Report (PBR)**. Treasury officials explained that these projections were based on the standard assumptions of no further tax changes and spending within the medium term plan updated in the July 2004 biennial Spending Review. On the assumption that growth would be faster than trend and tax buoyancy would improve, revenues would rise relative to GDP by more than spending: the current deficit was projected to fall to about ½ percent of GDP. Staff took the position that the underpinnings of the projected revenue increase—a sharp increase in corporate revenues alongside a sizable pick-up in income growth during 2005—were overly optimistic.

21. **Given these misgivings, staff argued for near-term adjustment measures**. Immediate action would allow smoother adjustment, lower the risk of an eventual procyclical adjustment, protect against any slippage in the credibility of the fiscal rules, and help build a buffer for future shocks. Ideally, in staff's view, adjustment would focus on containing the growth of current spending. Existing plans already incorporate slower current expenditure growth over the coming three fiscal years than in the previous three years, but current spending is still projected to rise by about ½ percentage point of GDP by FY2007/08. Staff noted that an earlier slowing would help guard against risks of inefficiency, inherent in recent rapid increases in spending.

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[3] Public debt sustainability analysis has not changed significantly from last year.

22. **Treasury officials noted that the program to increase spending on public services would need to be seen through to completion.** They argued that the framework to monitor and improve the delivery of public services had already achieved considerable success. Staff, however, observed that progress had not been uniform (Box 4). Treasury officials emphasized that a new framework to monitor the efficiency of spending was being established and that detailed plans for achieving 1½ percent of GDP of savings by FY2007/08 already existed. Staff acknowledged the scope for efficiency gains, including through improved procurement practices and relocating parts of the civil service to lower-cost areas, but argued that the continued rapid growth of spending would make achieving these gains more difficult. Also, because the government's plan is to plough back any efficiency gains into spending, such gains would not help reduce the fiscal deficit.

Box 4. Public Service Agreements—Are They A Magic Bullet?

Public Service Agreements (PSAs) aim to improve the quality and cost-effectiveness of public services by using specific, quantitative performance targets at the departmental level. The rationale behind setting targets is to communicate the government's objectives in each area of public services and provide a basis for monitoring progress, thereby ensuring accountability. The PSAs of all departments are made public at the time of the biennial Spending Reviews. PSA targets (about 130 at present) are monitored with quantitative indicators, available on the Treasury's website. Government ministers are responsible for achieving the targets.

Progress in attaining the current PSA targets has been mixed, and the PSA framework has evolved in response to the experience gained during its implementation. For instance, the target of the Department of Health to reduce waiting times by end-2005 is on track to be achieved. By contrast, the outlook for the achievement of the Department of Education's targets to improve student attainment is more mixed. Most value-for-money targets have turned out to be more difficult to measure than originally anticipated. In response, the framework has been changed to reduce the number of PSA targets, increase the share of outcome-based targets, increase flexibility in delivery at the local level, and eliminate Service Delivery Agreements, which included lower-level input milestones underpinning the delivery of PSA targets.

Nonetheless, problems remain. First, some targets are still difficult to monitor due to measurement problems, particularly for those involving efficiency or quality improvements. Second, designing and implementing incentives to motivate service providers to deliver higher quality services has often been difficult. Third, some targets—such as raising U.K. productivity growth—are broad and subject to factors beyond the control of a given department or even the government as a whole. Finally, as the focus on certain targets leads to a shift in resources toward the government's priorities, other areas of public service delivery can be affected.

23. **Staff emphasized that adjustment from revenue increases would need to avoid increasing disincentives to work or other distortions.** Wider application of user fees on public services would be an efficiency enhancing option. Treasury officials noted that they were studying the feasibility of national road use fees, but reported no plans to further expand user fees in education or extend user fees to health services. On other revenue

adjustments, staff argued that the emphasis should be on broadening the tax base, for example by eliminating VAT zero-rating, rather than raising tax rates. Treasury officials responded that the government's 2001 election manifesto explicitly ruled out raising VAT rates. Staff argued against raising labor taxes, such as income taxes or National Insurance Contribution rates, because of the adverse effects on labor supply. Staff noted that the planned integration of Inland Revenue and Customs will improve tax collection, but is not expected to have a significant impact on revenue.

24. **Staff discussed ways to further enhance the transparency and credibility of the fiscal projections**. Regarding transparency, staff noted that, given the asymmetry of the golden rule (current balance *or better* over the cycle) and the inevitability of economic shocks, ensuring that the rule would be met in any circumstances would be costly in terms of requiring a sizable average current surplus target (Box 5). Therefore, staff recommended that

Box 5. The Golden Rule—How Much Safety Margin Does It Need?

Given that the golden rule is asymmetric (current balance *or better* over the cycle) and that shocks are inevitable, the government would need to target a large current surplus if it wanted the probability of meeting the rule to be large. Using a reduced-form stochastic model of the current balance based on the output and asset price shocks experienced by the U.K. economy over the past four decades, staff analysis explores the relationship between the probability of meeting the golden rule and the targeted average current surplus.[1] The analysis incorporates exogenous shocks to discretionary fiscal policy but assumes no endogenous discretionary fiscal policy response to economic shocks over the cycle.

The results show that increasing the desired probability of meeting the rule has a large impact on the implied target for the average current surplus (see table). The safety margin needed to meet the golden rule with a 75 percent chance is ½ percent of GDP; increasing this probability to 99 percent requires a safety margin of 2¼ percent of GDP. In other words, attempting to drive the risk of breaching the rule to close to zero is very costly from macroeconomic and intergenerational perspectives. Thus, it is important to be explicit about both the desired probability of meeting the rule and the associated target for the average current surplus.

Sources of Uncertainty and the Safety Margin

Probability of Meeting the Golden Rule	75 percent	95 percent	99 percent
Overall safety margin 1/	**0.60**	**1.50**	**2.30**
Output uncertainty only	0.45	1.06	1.71
Asset price uncertainty only	0.30	0.90	1.44
Discretionary policy uncertainty only	0.17	0.44	0.63

1/ The overall safety margin is smaller than the sum of the individual safety margins because different shocks partly offset each other.

[1] Selected Issues Paper, *The Implementation of the Golden Rule Over the Cycle.*

the Treasury be explicit about the probability of meeting the rule and about the implied target for the average current surplus over the cycle. Fiscal projections based on central (not "cautious") assumptions and uncertainty around them should be shown in fan charts. Treasury officials responded that the visible buffer created by using central assumptions could produce additional spending pressures. Regarding credibility, staff noted that the National Audit Office—which is independent of the government and reports directly to Parliament—currently audits eleven assumptions used in the revenue projections, but recommended that the reach of independent assessment of assumptions underlying the fiscal projections, including the timing of the economic cycle, be broadened. Treasury officials felt that the fiscal projections already received extensive and adequate outside scrutiny, including from research institutes that provide testimony to Parliament.

D. Structural Issues

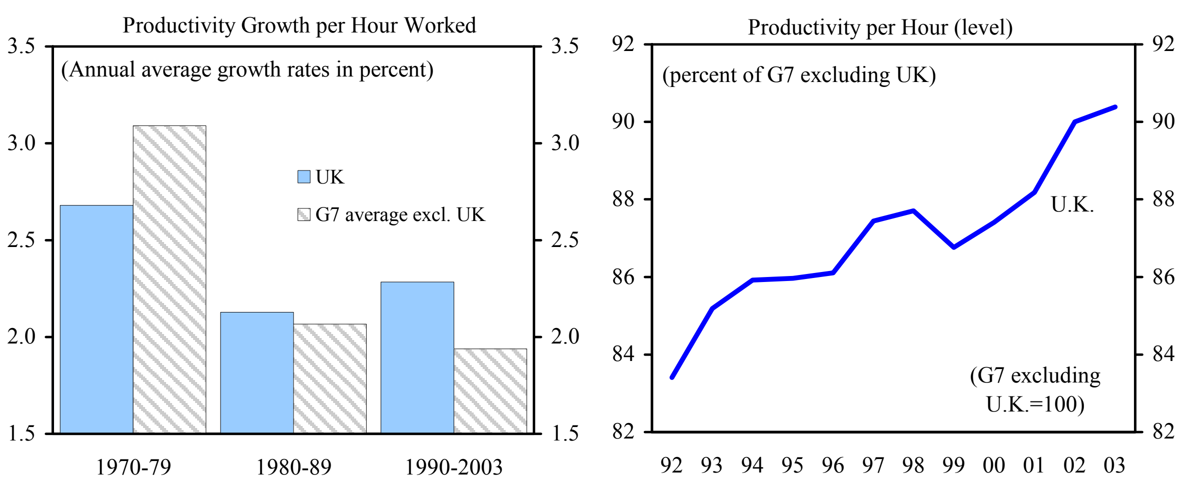
25. **The mission found that the challenges of population aging, though less severe than in most other industrial countries, had moved to the forefront of public debate.** Just prior to the mission, a government-appointed independent Pensions Commission, charged with studying the adequacy of the pension system and private saving to meet retirement needs over the long term, had published its interim report. Laying out the key issues and likely scenarios, the study concludes that, based on a variety of assumptions (including about desired replacement ratios), some 9½ million people (almost half of the working age population over 35) have inadequate saving to meet their likely expectations about retirement incomes. The saving gap reflects several factors: the difficulty that most people face in making rational decisions about long-term saving; the complexity of the existing pension system; the high cost of selling and administering private pension products; and the lack of trust in the retail financial industry following a series of mis-selling scandals. The Commission has opened a year-long public debate and will make concrete proposals in late 2005.

26. **Staff probed the robustness of the conclusions on the saving gap**. A member of the Commission explained that even though the central projection had enormous error bands—reflecting uncertainties about issues ranging from demographics, to life-cycle spending patterns, to activity rates of old people, and to rates of return on investment—he was confident that a substantial saving gap existed. He added that the key issue was the middle class, as the poor were covered by means tested supplements to standard state pension benefits, and the rich generally save enough. Asked about the exclusion of housing from the calculation of the saving gap, the Commission member explained that, with sharply higher house prices, people can only afford to buy houses later in life, future house values are highly uncertain particularly insofar as they may be affected by demographics themselves, and pension gaps are not necessarily matched by housing assets across individuals. Treasury officials welcomed the Report and the public debate it has generated. They noted that its conclusions were similar to those of the 2002 Green Paper on Pensions, which had found that 3 million people were seriously undersaving and an additional 5–10 million would have to save more or work longer. Staff agreed that there was strong evidence that many people were not saving enough to meet their likely expectations of retirement income.

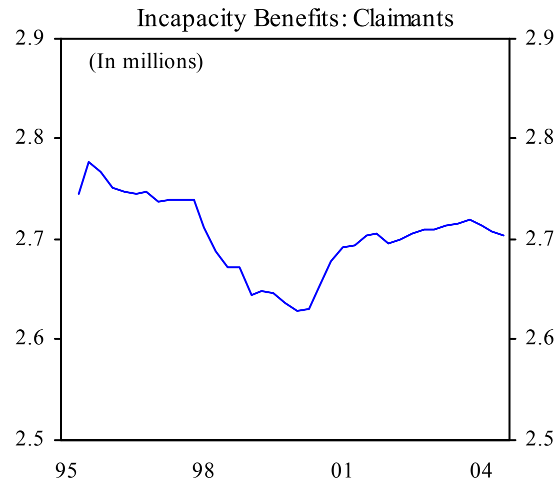
27. **Views on the solution to the saving gap covered a wide spectrum**. Most interlocutors, except the trade unions, agreed that an increase in the pensionable age (in

addition to the extension to 65 years currently scheduled to be phased in for women between 2010 and 2020) and greater flexibility for people to trade off working longer for higher pensions would be essential parts. Staff also supported the development of deeper markets for long-term, fixed-income and longevity-linked financial instruments. Beyond that, however, views differed widely on the appropriate role of government in promoting private saving. Treasury officials tended toward the view that results of existing measures to encourage private saving, including the effort to improve the financial education of households (which is at the forefront of international practice), simplification of the taxation of pensions, the creation of a Pension Protection Fund to protect occupational pension schemes, and the reform of stakeholder products (simple pension-saving vehicles for individuals), needed to be assessed before new schemes were introduced. The Commission member, however, cautioned that it would take too long to see whether encouragement is enough to ensure adequate saving. One view was that a more proactive approach would be needed to strike the right balance between the risk of having too many disappointed pensioners and the risk of motivating or forcing people to save more than they need. The debate, he expected, would come down to expanding the state pension system (currently the U.K. system is one of the least generous among industrial countries), increasing compulsion beyond that which already exists, or strengthening voluntary saving (for example by introducing automatic enrolment, using the tax system to reduce collection costs, or having the government negotiate on behalf of savers to lower mutual fund fees).

28. **Officials and staff welcomed the narrowing of the gap between productivity in the United Kingdom and the average in other G7 countries, but were unsure how much further this would go**. Officials attributed the more rapid productivity growth in the United Kingdom since the early 1990s to structural reforms and macroeconomic stability. They had difficulty, however, identifying the precise reasons for the remaining productivity shortfall of about 10 percent. Consequently, they had adopted a multi-pronged approach to eliminating it. As previous staff work had found that this gap is due to a variety of factors, staff concurred. Beyond this broad approach, officials were systematically monitoring and



evaluating the government's various initiatives, modifying (such as the small-firm loan guarantee program) or eliminating (such as the zero corporate income tax rate for small firms) them as indicated. Officials were also considering how to streamline business regulation, as surveys show that firms are concerned about regulatory burden (even though work by the OECD suggests that regulation in the United Kingdom is light compared with other industrial countries).



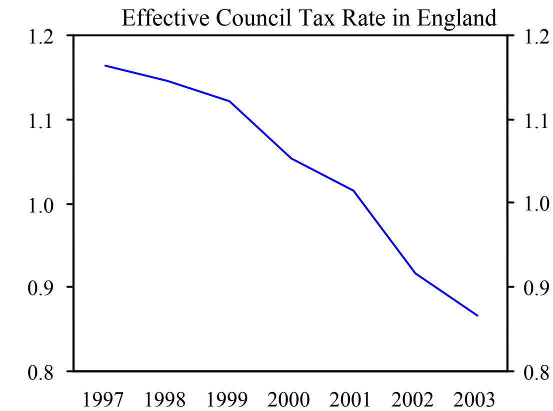
29. **Staff asked about efforts to help the large number of incapacity benefit (IB) recipients move into work**. Officials noted that, following reforms in 1995 to eliminate the earnings-related component of the benefit and tighten qualifying conditions, the flows into IB had slowed. In recent years, the focus has been on using active labor market policies to help IB recipients move into work. Over the past year, a pilot program ("Pathways to Work") introduced a range of interventions at job centers, such as work-focused interviews for IB recipients. Staff welcomed the apparent early success of this program and its planned extension to about one-third of the country.

30. **Another ongoing structural concern—rigidities on both the demand and supply side of the housing market—had been the subject of two government-sponsored reports in the past year.** The Barker Report, addressing supply side problems, had recommended increasing the price sensitivity of housing supply and reducing delays in the planning process. Treasury officials said that the government had accepted the Report's recommendations and was working on reforming complicated housing market regulations. Public consultation was planned for mid-2005. On the demand side, the Miles Report had suggested promoting long-term, fixed-rate mortgages by increasing the transparency of mortgage pricing and improving funding options for lenders. With the FSA having taken on mortgage regulation in 2004, some changes to improve information available to households on mortgages had already been made. The FSA will consider other Miles recommendations in its forthcoming review of mortgage regulation. Potential funding barriers were also being addressed: legislation now before Parliament would remove a constraint on the future ability of building societies to own securitized assets, and the government planned to review minimum funding limits for building societies.

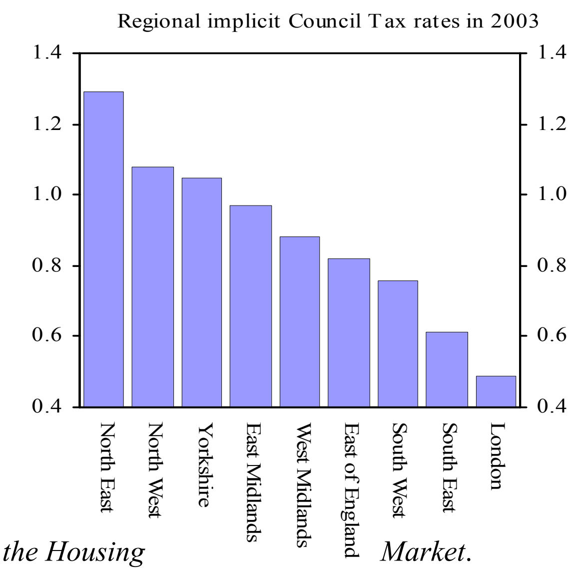
31. **Some observers have speculated that the structure of property taxation has contributed to house price volatility**. With the long interval between property assessments for the Council Tax, effective property tax rates have fallen by the largest amounts for houses whose prices have risen the most. Staff empirical work on the effect of lower user costs on house price appreciation, however, showed that the tax impact was small (Box 6). Also, staff

Box 6. Property Taxation—Need for Reform?

Residential property is subject to the Council Tax, a local tax introduced in 1993 that is based on property assessments in 1991. The effective Council Tax rate (tax divided by current market value) has therefore declined as house prices have increased and is now much lower in parts of the country (such as London) where house prices have risen the most. Thus, the current structure of property taxation has in principle contributed to the run-up in house prices by reducing the user cost of housing as house prices have risen. However, empirical work by staff suggests that this effect is small.[1]



The government has asked Sir Michael Lyons to review local government finance and make recommendations by the end of 2005. In parallel, a reassessment of property values is planned for 2005, to come into effect in 2007. In this context, the Lyons review will make recommendations on how best to reform the Council Tax, taking into account the forthcoming property revaluation.



[1] Selected Issues Paper, *Property Taxes and the Housing Market*.

noted that attempts to mitigate this effect (for example through more frequent assessments of property values) would contribute to unwelcome volatility in local tax revenues. Officials said that a review, currently underway, of the entire structure of local government finance would examine these issues.

E. Financial Sector Stability

32. **The authorities observed that virtually all indicators suggested that the banking system remained sound and risks were low**. Profitability, capitalization, and credit quality were strong: the median return on large banks' equity rose from 24 percent in 2003 to 27 percent in the first half of 2004; total and tier-I capital ratios remained well above regulatory minima; and mortgage arrears and corporate insolvencies continued to fall. Although weakening house prices would likely reduce credit growth and thus dampen bank

profitability, officials and private analysts said that mortgage lending did not constitute an important risk to financial stability: not only were household debt service ratios low, but also average loan-to-value ratios had declined to 40–50 percent. However, the rapid growth of unsecured debt (especially credit card debt) was a concern, especially because borrowing rates were high and debt was not evenly spread across households. Another potential vulnerability was corporate lending related to commercial property, especially given its recent rapid growth and signs of a deteriorating office market. A third important vulnerability was that the search for yield posed challenges for risk management, not least because it may have led some financial institutions to build up positions in what could prove to be relatively illiquid assets.

Bank Credit Exposures
(in percent of bank capital)

Lending to:	end-2004
Households	319
Secured	265
Unsecured	54
of which: Credit card	18
Private nonfinancial corporations	101
of which: Real-estate related	55

Source: Bank of England.

33. **The BOE is planning to introduce a voluntary reserve system as part of a wider reform of the sterling money markets, the core objectives of which are to reduce volatility in overnight money markets and improve banks' liquidity management**. The reform may also encourage more banks to join the real time gross settlement system, which would lower intraday credit exposures between banks in the payments system, consistent with FSAP recommendations. In response to staff's question about the reaction of financial market participants, BOE officials said that early feedback suggested that the proposal was welcome and that participation in the system would be more than sufficient to achieve the BOE's objectives. BOE officials added that they would publish in early 2005 a new Payments Systems Oversight Report, in line with FSAP recommendations.

34. **The authorities highlighted improvement in the health of the insurance sector over the past year**. Among life insurers, solvency margins had increased as equity prices rose. Among nonlife insurers, profitability had increased, reflecting improving claims experience, firm premium rates, and better investment returns. Officials and private analysts added that risk management was improving, owing in part to the introduction in 2004 of a new risk-based capital adequacy regime that went beyond the EU Solvency I framework. The FSA was to start to regulate brokers in 2005 and expected that improvements in risk management, which had lagged, would accelerate.

35. **The authorities noted that the AML/CFT regime had been strengthened in line with FSAP recommendations**. Officials observed that the regime's coverage was extensive, given that it included, beyond the financial sector, lawyers and accountants and that all suspicious transactions must be reported. The authorities were stepping up their oversight to ensure compliance with the legal and regulatory requirements, and are keeping the regime under review in order to make it more effective. This was illustrated in a recent report, which showed that the authorities' efforts to sensitize senior financial sector managers to money laundering were producing results. Officials also noted that they had implemented the EU

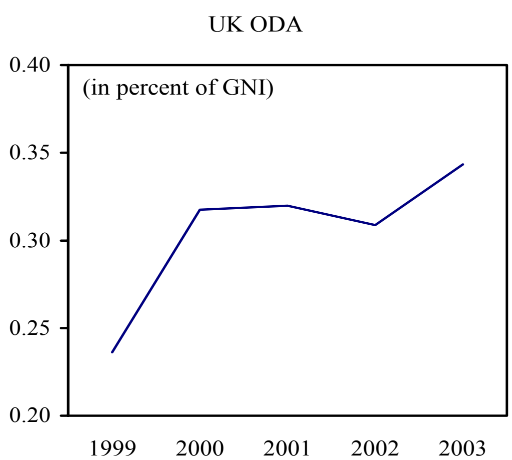
second AML directive and were reviewing regulations to ensure full compliance with the updated FATF recommendations.

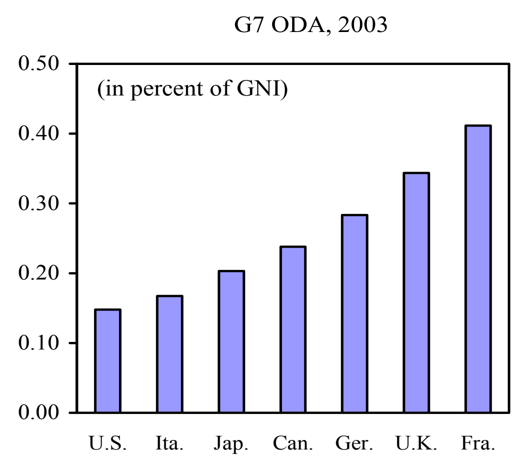
F. Other Issues

36. **Regarding euro adoption, the authorities said that the government remained in principle in favor of joining the single currency**. In practice, the economic conditions needed to be right. Staff concurred, noting that the float was now satisfactory and that—given the irreversibility of euro entry—the authorities needed to feel confident that the case for entry had been established with a sufficient degree of certainty. The authorities said that progress on the reform agenda set out in the 2003 assessment of the five tests for euro adoption had been reviewed in the 2004 Budget and would be reviewed again in the forthcoming Budget. The authorities hoped that convergence would occur in both directions, for example the German mortgage market would be liberalized as long-term, fixed-rate mortgages were promoted in the United Kingdom. Staff asked about the authorities' view on the growing empirical evidence of the favorable effect of euro adoption on cross-border trade. The authorities noted the large range of estimates and inter-country differences. Staff agreed and said that further research was needed to pinpoint the reasons for the differences.

37. **Staff praised the government's consistent support for trade liberalization within the European Union**. Officials welcomed the July 2004 framework agreements for the Doha Round, especially their detail on domestic support and export subsidies, and regretted that the agricultural market access pillar is the least detailed. Officials advocated elimination of trade-distorting effects of the Common Agricultural Policy and said that the EU can and should push ahead with agricultural reform so that border protection is substantially reduced, export subsidies are no longer an issue for world trade by 2010, and all agricultural tariff peaks are reduced towards the maximum level for non-agricultural products. The United Kingdom has consistently supported in the WTO and the EU the liberalization of services trade and sees itself benefiting from a less restrictive environment.

38. **Staff welcomed the increase in the U.K. ODA**. Even before recent commitments in response to the tsunami, officials said that the 2004 Spending Review foresaw a further increase in ODA to 0.47 percent of GNI by FY2007/08, with the goal of reaching the United Nations target of 0.7 percent of GNI by 2013. Officials said that, with the United Kingdom's





leadership of the G7 in 2005, the government would press for increasing aid flows, by implementing the International Finance Facility and extending debt relief.

III. Staff Appraisal

39. **Economic performance in the United Kingdom remains impressive**. Now in the sixth year of a cycle that has seen shallow fluctuations in output growth and a robust expansion, the economy continues to be supported by resilient domestic demand. At the same time unemployment has fallen to historic lows without signs of wage pressures. This success owes much to strong institutions underpinned by clear and well-designed policy frameworks that have helped sustain stability and anchor expectations through a global economic and equity cycle, a sizeable countercyclical policy stimulus, and a sharp increase in housing prices. The challenge ahead is to ensure that the institutions are sustained and supported by the right policy decisions.

40. **The economic environment for these decisions is likely to be benign, but macroeconomic policies will need to be attuned to important uncertainties.** With earnings growth and corporate profitability likely to remain strong, domestic demand should keep real GDP growth at about 2½ percent through 2006, while inflation moves toward the target of 2 percent. However, uncertainties surrounding these projections are large. In the short term, three stand out: how quickly the widely perceived overvaluation of house prices is resolved and how private consumption will be affected; how and when global imbalances will be unwound and with what effects on the external sector and value of sterling; and how to gauge the economy's resource constraints when traditional yardsticks may be breaking down. Over the medium term, uncertainties are structural in nature: will fiscal revenues regain turn-of-the-century peaks and is private saving adequate to support the aging population.

41. **Amidst these uncertainties, monetary policy is well-positioned to maintain the credibility of low inflation.** Increases in interest rates since late 2003 appear to have been effective in preempting the emergence of excess demand and, in so doing, helping to cool the housing market. More recently, with interest rates in a broadly neutral range, easing demand growth, and the sharp slowdown in house price appreciation, interest rates have been appropriately held constant. Larger, unexpected changes in house prices in either direction, however, could have significant effects on activity and future inflation, and would thus warrant decisive policy action. Another challenge for monetary policy will be judging incipient resource constraints. Although a sharp drop in unemployment would point to the need to tighten, a gradual edging down would be more difficult to interpret. At a time when years of structural and macroeconomic policy improvements may boost the sustainable level of output, it will be important to probe limits, but to do so cautiously: missing warning signs could be costly.

42. **The recent success of monetary policy stems in no small part from a strong policy and institutional framework.** Credibility is underpinned by the success in achieving low and stable inflation and is reflected in well-anchored expectations. Commendably, the implementation of monetary policy within the framework continues to evolve, and changes

over the past year in BOE communications to markets are welcome. For the future, it would be worthwhile for the BOE to consider expanding the number of key macroeconomic variables for which quantified projections are published.

43. **Fiscal policy decisions pose more of a challenge.** The deterioration in the fiscal position since FY2000/01 raises questions about how and when the necessary correction will take place. At stake is not meeting the fiscal rules in the current cycle, when the sizable initial current and overall surpluses virtually ensure that the rules will be met or missed by an insignificant margin. Rather, an early correction is needed to position the public finances to meet the rules in the next cycle. In staff's view, the authorities' projection of a substantial, autonomous rise in revenues relative to GDP and shift of the current balance to surplus over the next few years is too sanguine. More realistic projections of the level of potential output and of the scope for higher corporate tax revenues point to the need for a fiscal adjustment relative to GDP of about 1 percentage point. This would both reinforce the government's commitment to its fiscal rules and build in a buffer to meet the rules even in the face of plausible future adverse shocks. Undertaking this mild fiscal adjustment expeditiously would allow the consolidation to be spread over time, starting in strong economic conditions.

44. **Adjustment measures should be designed to minimize any adverse effects on efficiency, work effort, and growth.** This argues for current spending restraint—both to reduce the risks of running into limits on absorptive capacity and to allow more time to assess value for money. Wider application of user fees, which would raise efficiency and revenue, is another good option. If more reliance on revenue measures were desired, broadening the tax base would be preferable to raising tax rates, given potential adverse effects on supply.

45. **Keeping the fiscal policy framework at the forefront of international best practice will require constant self-appraisal.** A review of the framework as the cycle closes would be timely. The experience over this cycle suggests three questions for consideration. First, how transparently should budgets incorporate prudence? At present, fiscal projections do not link the desired probability of meeting the golden rule with the targeted current surplus. To increase transparency, this link could be made explicit by basing fiscal projections on central assumptions and mapping uncertainty in fan charts. A second question concerns the optimal reach of independent assessment of assumptions in the budget. Independent assessment of key variables beyond the eleven now audited by the National Audit Office could enhance credibility. A third question concerns how to ensure the efficiency of spending, particularly given the rapid increase in recent years. Quantitative targets to help monitor public services and recently established efficiency targets to improve procurement and increase the flexibility of work practices are welcome. But how well these procedures meet the inherent challenges in measuring outputs and their quality, linking policies to targets, and avoiding resource diversion remains a question.

46. **A critical debate about the government's role in ensuring adequate retirement income over the long term is underway**. The Interim Report of the Pensions Commission provides strong evidence that a sizable swath of the middle-class is not saving enough to ensure retirement income that will meet their aspirations. How to address this problem raises

difficult questions. Certainly simplifying the now-complex pension system and promoting longer active participation in the work force make sense. But beyond this, the costs of motivating or forcing higher private saving must be weighed against risks of future demands by pensioners on public resources.

47. **The recent sharp slowing of the housing market underlines the importance of reducing house price volatility by implementing the recommendations of the Miles and Barker Reviews**. Specifically, it is important that the FSA incorporate the Miles recommendations in its forthcoming review of the statutory regime for mortgage lending. Equally, it is important that the Barker Review's general recommendations regarding the role of price signals and delays in the planning process be formulated into concrete legislative proposals.

48. **Despite relatively rapid growth over the past decade, labor productivity below the average in other G7 countries represents a challenge.** As the gap is due to a variety of factors, the relative importance of which is unclear, the government's multi-pronged strategy is appropriate. The systematic monitoring and evaluation of ongoing programs is essential and will be served by the recent introduction of specific performance indicators.

49. **Indicators of the health of the financial sector remain favorable**. Bank capitalization, credit quality, and profitability continue to be strong. However, slower credit growth will likely dampen profitability and there are some downside risks, including from unsecured lending to households, lending related to commercial property, and the ongoing search for yield. The health of the life insurance sector has improved substantially over the past year, partly reflecting increases in equity prices. The resilience of the financial sector is being enhanced by the FSA's introduction of risk-based capital measures in insurance firms and of broker regulation in the nonlife insurance sector, and the BOE's strengthening of the supervisory and institutional aspects of payments and settlement systems.

50. **The United Kingdom continues to play a leadership role in trade and aid.** Its strong stand in favor of trade liberalization, especially of agricultural trade, is commendable. The recent and planned increases in ODA are welcome.

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

Table 1. United Kingdom: Selected Economic and Social Indicators

	2000	2001	2002	2003	2004 Proj.	2005 Proj.
Real Economy						
Real GDP (change in percent)	3.9	2.3	1.8	2.2	3.1	2.6
Domestic demand (change in percent)	3.8	2.9	2.9	2.5	3.8	2.9
CPI	0.8	1.2	1.3	1.4	1.3	1.5
Unemployment rate (in percent) 1/	5.5	5.1	5.2	5.0	4.8	4.6
Gross national saving (percent of GDP)	15.0	15.0	15.0	14.8	14.6	14.8
Gross domestic investment (percent of GDP)	17.5	17.3	16.7	16.5	17.0	17.2
Public Finance 2/						
General government balance	3.9 3/	0.0	-2.2	-3.2	-2.9	-3.1
Public sector balance	3.9 3/	0.0	-2.4	-3.2	-3.0	-3.1
Public sector cyclically adjusted balance 4/	1.1	-0.6	-2.3	-2.7	-2.8	-3.1
Public sector net debt	32.0	31.0	32.3	33.7	35.4	37.1
Money and Credit (end-period, 12-month percent change)						
M0	4.5	8.0	6.1	7.2	5.8	...
M4	8.2	6.8	7.3	7.2	9.0	...
Consumer Credit	12.5	14.0	15.2	12.1	11.7 5/	...
Interest rates (year average)						
Three-month interbank rate	6.1	5.0	4.0	3.7	4.6	...
Ten-year government bond yield	5.2	4.9	4.9	4.5	4.9	...
Balance of Payments						
Trade balance (in percent of GDP)	-2.1	-2.8	-3.0	-2.9	-3.4	-3.5
Current account balance (in percent of GDP)	-2.5	-2.3	-1.7	-1.7	-2.4	-2.5
Exports (percent of GDP)	28.1	27.4	26.2	25.4	24.4	24.1
Export volume (change in percent)	9.4	2.9	0.1	0.9	2.0	4.1
Imports (percent of GDP)	30.1	30.2	29.2	28.3	27.8	27.6
Import volume (change in percent)	9.1	4.9	4.1	1.8	4.5	5.1
Net exports of oil (in billions of U.S. dollars)	9.9	8.0	8.6	6.7	3.7	...
Reserves (end of period, in billion of US dollars)	48.2	40.4	42.8	46.0	49.7	...
Fund Position (as of December 31, 2004)						
Holdings of currency (in percent of quota)					66.8	
Holdings of SDRs (in percent of allocation)					11.0	
Quota (in millions of SDRs)					10,738.5	
Exchange Rates						
Exchange rate regime					Floating	
Bilateral rate (December 31, 2004)					US$ = £0.5188	
Nominal effective rate (1995=100) 5/	126.8	124.7	125.0	118.1	122.8	...
Real effective rate (1995=100) 5/ 6/	139.6	139.0	141.9	136.9	144.3	...

Social Indicators (reference year):

Income per capita (in US dollars, 2003) : 30,904; **Income distribution** (ratio of income received by top and bottom quintiles, 2001): 4.9; **Life expectancy at birth** (2003): 76.2 (male) and 80.7 (female); Automobile ownership (2000): 420 per thousand; **CO2 emissions** (ton per capita, 2001): 9.37; **Population** (in millions, 2003) 59.3; **Population density** (2002): 246 inhabitants per sq. km.

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

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

2/ The fiscal year begins in April. For example, fiscal balance data for 2002 refers to FY2002/03. 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/ Staff estimates.

5/ Average. An increase denotes an appreciation.

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

Table 2. United Kingdom: Quarterly Growth Rates

	2003					2004					2005				
	Q1	Q2	Q3	Q4	Q4/Q4	Q1	Q2	Q3	Q4 Prj.	Q4/Q4 Prj.	Q1 Prj.	Q2 Prj.	Q3 Prj.	Q4 Prj.	Q4/Q4 Prj.
	Quarter-on-quarter annualized														
Real GDP	1.7	1.5	3.6	4.0	2.7	3.0	3.5	1.8	2.7	2.7	2.7	2.6	2.6	2.6	2.6
Domestic demand	-0.6	0.3	5.5	4.4	2.3	4.8	2.9	2.7	2.8	3.3	3.1	3.0	3.0	3.0	3.0
Private consumption	-0.8	3.5	3.8	2.2	2.2	4.9	2.9	2.4	2.6	3.2	2.5	2.4	2.3	2.3	2.3
Government consumption	4.4	2.9	6.4	8.6	5.6	3.2	2.0	5.6	1.0	2.9	3.2	3.2	3.2	3.2	3.2
Gross fixed investment	-7.8	5.0	1.9	7.1	1.4	11.5	4.4	2.3	4.4	5.6	5.5	5.7	6.0	5.5	5.7
Public investment	175.7	-17.2	28.7	15.4	35.7	12.6	3.3	21.0	8.2	11.1	21.6	21.6	21.6	21.6	21.6
Residential investment	-3.9	15.7	2.7	6.4	5.0	39.5	-8.0	-7.7	-7.8	2.2	-7.8	-5.9	-3.9	-2.2	-5.0
Business investment	-20.6	6.0	-1.6	6.2	-3.2	4.9	8.3	2.4	7.2	5.7	6.6	6.1	5.9	4.7	5.8
Foreign Balance 1/	2.3	1.2	-1.9	-0.4	0.3	-1.8	0.6	-0.8	-0.2	-0.7	-0.4	-0.4	-0.4	-0.4	-0.5
Exports of goods and services	23.1	-8.4	-0.6	12.4	5.9	-6.8	8.0	3.0	5.8	2.3	3.4	3.5	3.5	3.6	3.5
Imports of goods and services	10.5	-11.0	6.4	12.7	4.2	0.3	5.3	5.3	6.8	4.4	4.6	4.6	4.7	4.7	4.6

Sources: Office for National Statistics (ONS); and staff projections.
1/ Contribution to the growth of GDP.

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

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Real GDP	2.3	1.8	2.2	3.1	2.6	2.6	2.3	2.2	2.2	2.2
Real domestic demand	2.9	2.9	2.5	3.8	2.9	2.7	2.4	2.2	2.1	2.1
Private consumption	2.9	3.3	2.3	3.3	2.5	2.3	2.2	2.1	2.0	2.0
Government consumption	2.6	3.8	3.5	4.5	3.0	3.0	2.5	2.0	2.0	2.0
Fixed investment	2.6	2.7	2.2	6.1	4.9	4.0	2.9	2.7	2.7	2.6
Public	16.0	4.9	23.1	11.7	17.8	11.2	5.6	4.6	4.1	4.1
Residential	1.0	7.7	9.0	8.0	-6.6	-0.5	0.7	0.9	1.2	1.2
Business	1.6	1.3	-1.8	4.8	6.0	3.8	3.0	2.7	2.7	2.7
Stocks 1/	0.1	-0.4	0.0	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
External balance 1/	-0.7	-1.2	-0.3	-0.8	-0.5	-0.3	-0.2	-0.1	0.0	0.0
Exports	2.9	0.1	0.9	2.0	4.1	4.9	5.0	4.8	4.7	4.6
Imports	4.9	4.1	1.8	4.5	5.1	5.0	4.8	4.4	4.1	4.0
Current account 2/	-2.3	-1.7	-1.7	-2.4	-2.5	-2.5	-2.5	-2.5	-2.5	-2.4
CPI Inflation	1.2	1.3	1.4	1.3	1.5	1.8	2.0	2.0	2.0	2.0
Output gap	0.8	-0.3	-0.8	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Employment and productivity										
Employment	0.8	0.8	0.9	0.9	0.6	0.5	0.4	0.2	0.2	0.2
Unemployment rate 3/	5.1	5.2	5.0	4.8	4.6	4.6	4.6	4.6	4.6	4.6
Productivity 4/	1.4	0.7	1.3	2.4	2.1	2.1	2.0	2.0	2.0	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 of labor force; based on Labor Force Survey.
4/ Whole economym, per worker.

Table 4. United Kingdom: Balance of Payments

	2001	2002	2003	2004 Proj.	2005 Proj.	2006 Proj.	2007 Proj.	2008 Proj.	2009 Proj.
					(£ billion)				
Current account	-22.4	-17.6	-18.6	-27.7	-29.9	-31.9	-33.6	-35.2	-36.6
Trade balance	-27.4	-31.1	-31.8	-39.6	-42.7	-45.3	-47.4	-49.6	-51.7
Trade in goods	-40.6	-46.7	-47.4	-58.3	-61.7	-65.3	-68.3	-71.3	-74.2
Exports	190.1	186.5	188.6	188.3	197.8	209.7	223.2	238.2	253.7
Imports	230.7	233.2	236.0	246.5	259.6	274.9	291.5	309.5	328.0
Trade in services	13.2	15.6	15.6	18.7	19.0	19.9	20.9	21.7	22.6
Exports	82.3	87.2	91.1	94.0	95.8	101.5	107.7	113.9	120.0
Imports	69.1	71.6	75.5	75.3	76.8	81.6	86.8	92.2	97.4
Income balance	11.7	22.0	23.1	22.8	24.0	25.1	26.1	27.4	28.8
Current transfers	-6.6	-8.5	-9.9	-10.8	-11.3	-11.7	-12.3	-13.0	-13.8
Central government	-2.6	-5.6	-7.0	-8.3	-8.6	-9.0	-9.4	-9.9	-10.4
Other sectors	-4.0	-2.9	-2.9	-2.6	-2.6	-2.8	-2.9	-3.1	-3.3
Capital account	1.2	0.9	1.3	...	...	...	...	...	...
Financial account	23.8	10.3	14.8	...	...	...	...	...	...
Direct investment	-4.0	-17.7	-27.9	...	...	...	...	...	...
Portfolio investment	-38.4	50.1	57.6	...	...	...	...	...	...
Financial deriviatives	8.4	1.0	-5.4	...	...	...	...	...	...
Other investment	54.7	-23.6	-11.1	...	...	...	...	...	...
Reserve assets	3.1	0.5	1.6	...	...	...	...	...	...
Net errors and omissions	-2.6	6.5	2.5	...	...	...	...	...	...
					(In percent of GDP)				
Current account	-2.3	-1.7	-1.7	-2.4	-2.5	-2.5	-2.5	-2.5	-2.5
Trade balance	-2.8	-3.0	-2.9	-3.4	-3.5	-3.5	-3.5	-3.5	-3.5
Trade in goods	-4.1	-4.5	-4.3	-5.0	-5.1	-5.1	-5.1	-5.0	-5.0
Exports	19.1	17.9	17.1	16.3	16.2	16.4	16.6	16.8	17.1
Imports	23.2	22.3	21.4	21.3	21.3	21.4	21.6	21.9	22.1
Trade in services	1.3	1.5	1.4	1.6	1.6	1.6	1.6	1.5	1.5
Exports	8.3	8.4	8.3	8.1	7.9	7.9	8.0	8.0	8.1
Imports	6.9	6.9	6.9	6.5	6.3	6.4	6.4	6.5	6.6
Income balance	1.2	2.1	2.1	2.0	2.0	2.0	1.9	1.9	1.9
Current transfers	-0.7	-0.8	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9
Capital and financial account	2.5	1.1	1.5	...	...	...	...	...	...
Of which:									
Direct investment	-0.4	-1.7	-2.5	...	...	...	...	...	...
Portfolio investment	-3.9	4.8	5.2	...	...	...	...	...	...
Other investment	5.5	-2.3	-1.0	...	...	...	...	...	...

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

Table 5. United Kingdom: Public Sector Budgetary Projections 1/
(Percent of GDP and percent of potential GDP)

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
	Staff							**PBR 2004**						
Total revenue	37.7	38.4	38.9	39.3	39.6	39.7	39.8	37.6	38.5	39.3	39.8	40.3	40.5	40.6
Current revenue	37.6	38.3	38.8	39.2	39.5	39.7	39.8	37.5	38.4	39.2	39.8	40.2	40.4	40.5
Primary revenue	37.2	37.9	38.4	38.8	39.1	39.3	39.4	37.1	37.9	38.8	39.4	39.8	40.0	40.1
Tax revenue	35.5	36.0	36.5	37.0	37.2	37.4	37.5	35.4	36.1	36.9	37.5	37.9	38.1	38.2
Non-tax revenu	1.7	1.9	1.9	1.8	1.9	1.9	1.9	1.7	1.9	1.9	1.8	1.9	1.9	1.9
Interest revenue	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Capital revenue	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Total expenditure	40.9	41.4	42.0	42.1	42.4	42.2	42.2	40.8	41.4	42.0	42.1	42.3	42.1	42.1
Current expenditure	38.2	38.2	38.5	38.5	38.7	38.6	38.6	38.1	38.1	38.5	38.5	38.6	38.5	38.5
Primary expenditu	36.1	36.1	36.4	36.4	36.6	36.4	36.4	36.1	36.1	36.4	36.4	36.6	36.4	36.4
Interest payments	2.0	2.1	2.1	2.1	2.1	2.2	2.2	2.0	2.1	2.07	2.1	2.1	2.1	2.1
Capital expenditure 2	2.7	3.2	3.5	3.6	3.7	3.6	3.6	2.6	3.2	3.48	3.6	3.6	3.6	3.6
Depreciation	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Current balance 3/	-1.9	-1.1	-1.0	-0.6	-0.5	-0.2	-0.1	-1.9	-1.1	-0.6	0.0	0.3	0.6	0.8
Overall balance	-3.2	-3.0	-3.1	-2.8	-2.8	-2.5	-2.4	-3.1	-2.9	-2.7	-2.2	-2.0	-1.6	-1.5
Net debt 4/	33.7	35.4	37.1	38.3	39.7	40.6	41.4	33.7	35.3	36.4	37.0	37.6	37.9	38.0
Cyclically adjusted 5/														
Current balance 3/	-1.4	-0.9	-1.0	-0.6	-0.6	-0.3	-0.1	-1.0	-0.4	-0.4	0.1	0.3	0.6	0.8
Overall balance	-2.7	-2.8	-3.1	-2.9	-2.9	-2.5	-2.4	-2.2	-2.2	-2.5	-2.2	-2.0	-1.6	-1.5
Output gap	-0.7	-0.1	0.0	0.0	0.1	0.0	0.1	-1.4	-0.8	-0.1	0.0	0.0	0.0	0.0
Deflator growth	2.8	2.1	2.5	2.7	2.7	2.8	2.7	2.8	2.3	2.5	2.7	2.7	2.7	2.7
Real GDP growth	2.4	3.0	2.6	2.6	2.3	2.2	2.2	2.6	3.2	3.0	2.5	2.2	2.2	2.2

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

1/ Staff estimates are based on staff's growth projection. Official estimates reflected in the 2004 Budget based on official GDP data and official GDP projections.
2/ Capital expenditure data reported here may differ from official publications since the latter typically focus on capital expenditure net of capital receipts and depreciation.
3/ Including depreciation.
4/ Debt stock refers to the end of the fiscal year.
5/ Staff estimates are based on staff's projections of potential output. Official estimates are based on official projections of potential output.

United Kingdom: Basic Data

Demographic and other data:

Area	94,247 square miles (244,100 sq. km.)
Population (2003)	59.3
Infant mortality (per 1,000 live births)	5.3
Doctors per 1,000 inhabitants	0.5
GDP per capita (2001)	SDR 18,360

Composition of GDP in 2003, at current prices	In billions of Pounds	Distribution in Percent
Private consumption	721.8	65.9
Public consumption	229.8	21.0
Total investment (including stockbuilding)	179.4	16.4
Total domestic demand	1130.9	103.3
Exports of goods and services	279.7	25.5
Imports of goods and services	315.3	28.8
GDP at market prices	1095.3	100.0

Selected economic data	2001	2002	2003	2004		2005 Proj.
Output and unemployment:		(Annual percentage change)				
Real GDP (at market prices)	2.3	1.8	2.2	3.1		2.6
Industrial production	-4.6	-0.2	-0.2	-0.9	1/	...
Unemployment (in percent)	5.1	5.2	5.0	4.7	1/	4.6
Earnings and prices:						
Average earnings in manufacturing	4.3	3.5	3.6	2.9	1/	3.9
CPI inflation	1.2	1.3	1.4	1.3		1.5
Money and interest rates:						
M0 (end of period)	8.0	6.1	7.2	5.8		...
M4 (end of period)	6.8	7.0	7.2	9.0		...
3-month Interbank rate	5.0	4.0	3.7	4.6		...
10-year government bond yield	4.9	4.9	4.5	4.9		...
		(In billions of pounds sterling)				
Fiscal accounts (In percent of GDP): 4/						
General government balance	0.0	-2.2	-3.2	-2.9		-3.1
Public sector balance	0.0	-2.4	-3.2	-3.0		-3.1
Public sector net debt	31.0	32.3	33.7	35.4		37.1
Balance of payments (4 quarters moving sum):						
Current account balance	-22.4	-17.6	-18.6	-23.7	2/	-29.9
(In percent of GDP)	-2.3	-1.7	-1.7	-2.1	2/	-2.5
Trade balance	-27.4	-31.1	-31.8	-38.5	2/	-42.7
Exports	272.4	273.7	279.7	281.0	2/	293.7
Imports	299.8	304.8	311.5	319.5	2/	336.4
Direct investment (net)	-4.0	-17.7	-27.9	20.0	2/	...
Portfolio investment (net)	-38.4	50.1	57.6	76.3	2/	...
Reserve assets	3.1	0.5	1.6	0.4	2/	...

Source: National Statistics; HM Treasury; and IMF staff estimates.
HM Treasury and staff estimates.
1/ As of November 2004.
2/ As of 2004Q3.
3/ Fiscal year beginning April 1.

United Kingdom: Fund Relations
(As of December 31, 2004)

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	7,176.19	66.83
Reserve position in Fund	3,562.41	33.17

III. **SDR Department**:	SDR Million	% Allocation
Net cumulative allocation	1,913.07	100.00
Holdings	211.29	11.04
Designation Plan	0.00	

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

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund**: None

VII. **Exchange Rate Arrangement**:

The U.K. authorities maintain a floating regime. As of December 31, 2004 the exchange rate for sterling was $1.92. In accordance with UN resolutions and EU restrictive measures, the United Kingdom applies targeted financial sanctions under legislation relating to Al-Qaeda or Taliban, and individuals, groups, and organizations associated with terrorism; certain persons associated with the former Government of Iraq; and on Liberia, Myanmar, the former government of the Republic of Yugoslavia, and Zimbabwe. These restrictions have been notified to the Fund under Decision 144-(52/51).

VIII. **Article IV Consultation**:

Discussions for the 2003 Article IV consultation were conducted in London during December 3-18, 2003. The Staff Report (IMF Country Report No. 04/56) was considered by the Executive Board on March 3, 2004.

IX. **FSAP**

The FSAP was completed at the time of the 2002 Article IV Consultations.

X. **Technical Assistance**: None

XI. **Resident Representative**: None

United Kingdom: Statistical Information

The United Kingdom maintains high standards of economic data provision. 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. In 2003 the authorities introduced further revisions reflecting a shift to annual chain-linking, corrections for import fraud, and revisions in some volatile construction data.

United Kingdom: Core Statistical Indicators
(as of February 8, 2005)

	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	2/8/2005	December 2004	December 2004	December 2004	December 2004	2/8/2005	December 2004	November 2004	2004 Q3	December 2004	2004 Q4	2004 Q3
Date Received	2/8/2005	January 2005	January 2005	January 2005	January 2005	2/8/2005	January 2005	January 2005	December 2004	January 2005	January 2005	December 2004
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly	Quarterly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly	Quarterly
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	Publication/ Electronic	Publication/ Electronic	Publication/ 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	Quarterly

Statement by the IMF Staff Representative
March 2, 2005

1. **This note reports on recent developments since the staff report was issued.** These developments do not alter the thrust of the staff appraisal.

2. **Economic growth increased somewhat in the fourth quarter of 2004, as envisaged in the staff report.** Data on expenditure components indicate that, relative to projections, household consumption growth was slightly weaker than expected, while government expenditure growth was a little stronger than expected. Coincident and leading indicators continue to suggest that growth will settle at about 2½ percent in 2005–06, in line with potential growth:

- Recent **housing market** indicators have been at least as strong as expected at the time of the staff report, though a sharp decline in house prices remains the key near-term risk to the outlook. House prices rose a little in January, raising the three-month on three-month rate of change to about 3 percent. BOE data on mortgage approvals increased a little in December after six months of declines.

- Real **retail sales** growth rebounded in January, following the significant easing in the fourth quarter of 2004. However, this series is volatile and on average monthly growth has slowed substantially since mid-2004.

- The **composite output PMI** remained close to its ten-year average in January, suggesting continued trend growth in the near term. A fall in the manufacturing PMI was offset by a rise in the services PMI.

3. **CPI inflation remained at 1.6 percent in January.** Core CPI inflation (excluding food, beverages, tobacco, and energy) stayed subdued at around 1¼ percent. Growth in **private sector earnings excluding bonuses** continued to be stable at about 4½ percent.

4. **The Bank of England left its policy interest rate unchanged at 4¾ percent in early February.** The MPC lifted a little its forecasts for CPI inflation in the February *Inflation Report* (compared to the November report), reflecting the somewhat higher level of current CPI inflation and slightly higher-than-expected producer and import price inflation. Under the MPC's central projection, inflation will rise gradually to about 2 percent over the next two years. However, risks to the central projection continue to be skewed somewhat to the downside.

5. **Fiscal data for January were in line with the Pre-Budget Report and staff's projections for FY2004/05.** Over the first ten months of the fiscal year, the growth rate of central government current receipts (including corporation and personal income tax receipts) was in line with PBR and staff projections for the year as a whole. On the expenditure side, central government current spending was a little higher than expected while net investment

spending was slightly lower than projected. The Budget for FY2005/06 is scheduled to be released on March 16.

6. **The government announced in early February a strategy to boost labor participation of older workers, people with temporary disabilities, and single parents.** To encourage working past the state pension age of 59/64, a more generous and flexible option for deferring state pension will become available in April 2005. For people with disabilities, a new benefit system will be in place for new claimants by 2008. In the new system, benefits will depend on whether a person is assessed to have a manageable or severe condition, and there will be financial incentives for those with manageable conditions to attend work-focused interviews. For single parents, a new pilot program will be introduced to provide additional support and financial incentives to move back into work. These initiatives are consistent with the staff's recommendations.

7. **The Bank of England issued its first *Payment Systems Oversight Report*, as anticipated in the staff report**. The report clarifies the rationale and objectives of the BOE's oversight, gives an account of the BOE's activities during 2004, and identifies priorities for 2005. While the U.K. payment systems exhibits a high level of robustness by international standards, the BOE continued to address systemic risks linked to tiering and worked toward improving liquidity funding and collateralization agreements. Progress was also made on implementing FSAP recommendations. A priority for 2005 is to strengthen arrangements for cooperative oversight of cross-border infrastructures. The Report appears to extend international best practice with respect to transparency about payment systems oversight and assessment.

Statement by Tom Scholar, Executive Director for the United Kingdom
March 2, 2005

My authorities are most grateful to staff for their work and will take careful note of their comments. There is a broad measure of agreement between staff and the authorities on most aspects of economic policy.

Economic prospects

The economic fundamentals in the UK remain sound: 50 consecutive quarters of growth, the longest unbroken expansion on record; growth in 2004 of 3.1 percent; CPI inflation currently at 1.6 percent, short term interest rates at 4.75 percent, and employment at record levels of 75 percent. Growth is forecast (in the 2004 Pre-Budget Report) to remain at 3 percent to 3½ percent in 2005, before returning to trend (2.5 percent to 3 percent) in 2006; with inflation at or close to target. As staff note, there are risks: my authorities remain vigilant to these and agree with staff on the need for cautious macroeconomic polices, to which they are fully committed.

Monetary and fiscal policy

My authorities 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 percent or less;
- Monetary policy set by the Bank of England's Monetary Policy Committee (MPC) to meet a symmetric inflation target.

My authorities agree with staff that the fiscal and monetary policy frameworks have served the UK well, anchoring expectations and sustaining stability. The fiscal framework is based on strict rules backed by cautious, audited assumptions. These rules are set over the cycle to allow the automatic stabilisers to operate freely and fully and fiscal policy to support monetary policy when the economy is below trend. My authorities feel that the current fiscal stance remains consistent with these rules and appropriate for this point in the economic cycle.

Fiscal policy will, as usual, be set in the Budget. The latest available projections (in the Pre-Budget Report) show a gradual reduction in the deficit to 1½ percent of GDP; with an average annual surplus on the current budget of 0.1 percent in this cycle, and ¼ percent from

2005-06 to 2009-10; and net debt stabilising at 37 percent of GDP. My authorities are thus on course to meet the fiscal rules in this cycle and the next.

Staff see downside risks to the revenue projections. My authorities are confident about these projections and note that they are based on deliberately cautious assumptions (e.g. growth at the lower end of the forecast range, and trend growth 0.25 percent below the neutral view). Data released since the IMF mission supports the view that there remains a significant output gap, and that above trend growth is continuing, with rising real incomes and a sizeable pick-up in tax revenues including in corporation tax. They therefore do not agree with staff that there is a need for 'an early correction' and believe that the latest data confirms this view.

They have noted staff's suggestions for minor modifications to the fiscal and monetary framework. They welcome the opportunity to discuss these issues with staff, but are not attracted to these specific proposals. In particular, they see considerable costs in the publication by the MPC of quantitative projections (and error bands) for a further set of variables; they doubt whether a probabilistic approach to fiscal policy would improve public understanding or confidence in the framework; and they regard the use of cautious (rather than central) assumptions as key to the prudent conduct of fiscal policy. They agree on the importance of external scrutiny of macroeconomic policy, a central objective of the policy framework, and believe this is achieved through independent auditing of key economic assumptions, high level of transparency in the fiscal framework through publications like the End of Year Fiscal Report and Long-term Public Finances Report, and the continuous and vibrant public debate around economic policy that this transparency engenders, including contributions from expert commentators such as the IMF.

Structural issues

Staff have rightly noted the legacy of under-investment in public services. Public sector net investment fell by 15 percent 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, and recognising the importance of public sector infrastructure for private sector productivity, my authorities aim to raise public sector net investment to 2¼ percent of GDP by 2007-08.

My authorities agree with staff on the need to ensure efficiency and value for money, and have set out a broad agenda for reform with a clear focus on outcomes, extra investment linked to reforms, civil service reform, and stretching efficiency targets. Improvements in central government procurement, for example, have delivered £2 billion of savings in 2003-04 alone; and my authorities have published plans to achieve £20 billion of efficiency gains (or 1½ percent of GDP) by 2007-08.

My authorities agree with staff on the central importance of raising productivity, and have set out a comprehensive programme of microeconomic reform to remove the barriers that prevent markets from functioning efficiently. These measures aim to improve competition, promote enterprise, support science and innovation, raise skills and encourage investment; and they are regularly monitored and assessed. A major review of regulation is underway, and the Budget will set out proposals to remove barriers that are not justified.

My authorities' policy on membership of the single currency remains unchanged. The June 2003 assessment set out a reform agenda to promote convergence and flexibility, and progress on this will be reviewed in the Budget.

My authorities agree with staff on the importance of the work of the Pensions Commission; on the need to address housing market reform through implementation of the Miles and Barker Reviews; and on their overall assessment on the UK financial system.

Other issues

My authorities will continue to support trade liberalization, a successful completion of the Doha Round, and common agricultural policy (CAP) reform. They will increase ODA to 0.47 percent of GNI in 2007-08, with a timetable to reach 0.7 percent of GNI by 2013. They are seeking international agreement on a doubling of global aid flows through their proposal for an International Finance Facility; and greater debt relief for the poorest countries, with multilateral debt cancellation of up to 100 percent.

Public Information Notice (PIN) No. 05/27
FOR IMMEDIATE RELEASE
March 8, 2005

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

IMF Executive Board Concludes 2004 Article IV Consultation with the United Kingdom

On March 2, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the United Kingdom.[1]

Background

Macroeconomic performance over the past decade has been strong and steady, owing much to structural reforms and improvements in macroeconomic policies and policy frameworks. Having slowed gradually over the past year, as higher mortgage interest rates and weaker house price appreciation dampened household consumption, real GDP growth is estimated at about 3 percent in 2004 and is expected to stay stable at about 2½ percent in 2005–06, in line with potential growth. Domestic demand remains the key driver of growth, underpinned by continued strong earnings growth and robust corporate profitability. Even though the unemployment rate fell to a 30-year low, wage growth stabilized and inflation remained subdued. Notwithstanding the recent cooling of the housing market, house prices are widely seen as overvalued.

The policy interest rate has been stable since August 2004, when it was raised to 4¾ percent, which is generally viewed as in a neutral range. Although headline CPI inflation edged up to 1½ percent at end-2004, core inflation remained subdued at 1¼ percent. The economy is widely

[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.

seen as operating in the neighborhood of full capacity and, given the outlook for growth, is expected to remain so. The spread between nominal and inflation-indexed bonds suggests that inflation expectations remain well-anchored. Rising import prices are expected to push inflation toward the 2 percent target over the coming 2–3 years.

The fiscal position deteriorated sharply over the past five years, although the overall deficit is not large compared to other major industrial countries and the debt burden is relatively low. The widening of the deficit reflected an increase in government spending in response to the perceived demand for better public services and a decline in equity-bubble-related revenues. The December 2004 Pre-Budget Report projects that slower spending growth and a rebound in revenues will reverse this deterioration and ensure that the fiscal rules are respected now and in the future. However, there are questions about how much revenues will rebound in the absence of further policy measures.

The October 2004 Interim Report of the Pensions Commission suggested that many people are not saving enough for retirement. Based on a variety of assumptions, the Report found that some 9½ million people (about half of the working-age population over 35) have inadequate saving to meet their likely expectations about retirement incomes. The saving gap reflects several factors: the difficulty that most people face in making rational decisions about long-term saving; the complexity of the existing pension system; the high cost of selling and administering private pension products; and the lack of trust in the retail financial industry following a series of mis-selling scandals.

Executive Board Assessment

Executive Directors commended the United Kingdom authorities for their skillful macroeconomic management and flexibility in responding to changing economic circumstances, and welcomed the continued robust performance of the economy. Economic growth has been relatively rapid and stable, unemployment has fallen to one of the lowest rates among industrial countries, and inflation has been subdued. Directors noted that underlying this impressive performance have been clear and “state-of-the-art” policy frameworks underpinned by strong institutions, as well as a sizable countercyclical policy stimulus and a sharp increase in house prices. Looking ahead, Directors considered that the key challenge will be to ensure that the strong policy frameworks are sustained and supported by the right policy decisions.

The economic environment in the period ahead is expected to be benign, with strong growth supported by resilient domestic demand, and inflation moving toward the target of 2 percent. Directors noted, however, that this outlook is subject to significant short-term uncertainties. These include, first, how quickly the widely perceived overvaluation of house prices will be resolved and its effect on private consumption; second, how and when global imbalances will be unwound and their impact on the external sector and the value of sterling; and third, how to assess the economy’s resource constraints, when standard yardsticks may be breaking down. Directors also acknowledged important uncertainties in the medium term about whether fiscal revenues will recover to their turn-of-the-century peaks, and whether private saving will be adequate to support the aging population in retirement.

Directors agreed that monetary policy is well positioned to maintain low and stable inflation and to respond to unexpected developments. They observed that the early but gradual strategy of increasing interest rates since late 2003 appears to have preempted the emergence of excess demand and helped cool the housing market. Directors also noted that, in response to easing demand growth and slowing house price growth, interest rates have been held constant recently, and appropriately so. With interest rates in a broadly neutral range and important but balanced uncertainties in the outlook, Directors noted that the next move in interest rates could be in either direction. They considered that the key challenges for monetary policy will be to judge incipient resource constraints, and to respond promptly to unexpected changes in aggregate demand in either direction.

Recognizing that the success of monetary policy stems in no small part from a strong policy and institutional framework, Directors welcomed the increased emphasis on inflation projections based on market expectations of future interest rates, and the extension of the projection horizon from two to three years. Directors considered the suggestion that the Bank of England publish numerical projections not just for real GDP and CPI but also for other key macroeconomic variables. Many Directors expressed reservations, noting the considerable costs this would involve. Directors also considered the pros and cons of publishing an illustrative path for interest rates consistent with the inflation target. Many Directors considered that this would be risky, as such forecasts could be misinterpreted as a policy commitment.

Directors agreed that the rules-based fiscal framework has served the United Kingdom well by underpinning fiscal discipline and assuring scope for automatic stabilizers to operate freely. They noted that the fiscal support provided to growth has contributed to a weakening in the fiscal position over the past four years, but that, in the current cycle, the sizable initial current and overall surpluses virtually ensure that the rules will be met, or will be missed by an insignificant margin. Looking ahead to the next cycle, Directors took note of the authorities' view that slower spending growth and a rebound in revenues would reverse the past fiscal weakening and ensure that the fiscal rules were respected, and welcomed their intention to take remedial measures if the envisaged improvement did not materialize. However, many Directors viewed the authorities' projections, based on a substantial rise in revenues relative to GDP, to be somewhat more optimistic than warranted. They considered that more realistic projections of the level of potential output and of the scope for higher corporate tax revenues would point to a need for fiscal adjustment if the United Kingdom were to continue to meet the fiscal rules.
On the appropriate policy response, Directors noted the authorities' commitment to take measures should they prove necessary. However, many Directors recommended that a mild fiscal adjustment be started expeditiously, in the current favorable economic conditions, to allow the consolidation to be spread over time.

Directors considered that fiscal adjustment measures should be designed to minimize any adverse effects on efficiency, work effort, and growth. With this in view, they suggested restraint in current spending, in order to reduce the risks of running into limits on absorptive capacity and to allow more time to assess value for money. Several Directors also favored the wider application of user fees as another good way of raising efficiency and revenue. Directors concurred that, if more reliance on revenue measures were desired, broadening the tax base would be preferable to raising tax rates, given potential adverse effects on supply.

Directors considered some suggestions on possible ways to modify the authorities' fiscal framework as the economic cycle comes to a close. First, Directors discussed the pros and cons of publishing fiscal projections based on central (rather than cautious) assumptions, with an explicit margin for adverse developments through the cycle or with a fan chart of fiscal outcomes. Many Directors doubted whether a probabilistic approach to fiscal policy would improve public understanding or confidence in the framework. Second, while recognizing that fiscal projections already receive extensive scrutiny and that U.K. economic policy more generally is subject to vibrant public debate, a few Directors saw merit in the suggestion that consideration be given to broadening the scope of independent assessment of the fiscal projections by the National Audit Office. Finally, Directors welcomed the recently established efficiency targets at the departmental level. In this regard, they underlined the inherent challenges in ensuring the efficiency of public spending, especially given the rapid increase in recent years.

Directors noted that the challenges of population aging, although less severe than in most other industrial countries, were moving to the forefront of public debate in the United Kingdom. They welcomed the current debate about the government's role in ensuring adequate retirement income, including the Interim Report of the Pensions Commission, which provides strong evidence that a sizable swathe of the middle-class is not saving enough to ensure retirement income that will meet their aspirations. Directors acknowledged that addressing the problem of under-saving raises difficult questions, and concurred that simplifying the now-complex pension system and encouraging longer active participation in the work force make sense. Directors stressed that, in general, the costs of motivating or forcing higher private saving must be weighed against risks of future demands by pensioners on public resources.

Directors supported the authorities' multi-pronged strategy for raising productivity. At the same time, Directors emphasized the importance of systematic monitoring and evaluation of ongoing programs, including through the recent introduction of specific performance indicators. Directors welcomed the authorities' intention to address structural rigidities in the housing market by making further progress in implementing the recommendations of the Miles and Barker reviews.

Directors concurred that indicators of the health of the financial sector remain quite favorable. Noting that capitalization, credit quality, and profitability in the banking sector continue to be strong, Directors nevertheless cautioned that slower credit growth will likely dampen profitability and that there are downside risks stemming from unsecured lending to households, lending related to commercial property, and the ongoing search for yield. Directors welcomed the signs of improved health of the life insurance sector over the past year, and the introduction of risk-based capital measures in insurance firms and of broker regulation in the non-life insurance sector. They also noted the strengthening of the supervisory and institutional aspects of payment and settlement systems. Finally, Directors welcomed the strengthening of the Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) regime in line with Financial Sector Assessment Program (FSAP) recommendations.

Directors praised the United Kingdom for its leadership role in promoting trade liberalization, especially with respect to agricultural trade, and looked forward to further progress in this area. They commended the United Kingdom's commitment to increasing aid flows and welcomed the increases in official development assistance, aimed at reaching the goal of 0.7 percent of GNI by 2013.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The Staff Report for the 2004 Article IV Consultation with the United Kingdom is also available.

United Kingdom: Selected Economic and Social Indicators

	2000	2001	2002	2003	2004 Proj.	2005 Proj.
Real Economy						
Real GDP (change in percent)	3.9	2.3	1.8	2.2	3.1	2.6
Domestic demand (change in percent)	3.8	2.9	2.9	2.5	3.8	2.9
CPI	0.8	1.2	1.3	1.4	1.3	1.5
Unemployment rate (in percent) 1/	5.5	5.1	5.2	5.0	4.8	4.6
Gross national saving (percent of GDP)	15.0	15.0	15.0	14.8	14.6	14.8
Gross domestic investment (percent of GDP)	17.5	17.3	16.7	16.5	17.0	17.2
Public Finance 2/						
General government balance	3.9 3/	0.0	-2.2	-3.2	-2.9	-3.1
Public sector balance	3.9 3/	0.0	-2.4	-3.2	-3.0	-3.1
Public sector cyclically adjusted balance 4/	1.1	-0.6	-2.3	-2.7	-2.8	-3.1
Public sector net debt	32.0	31.0	32.3	33.7	35.4	37.1
Money and Credit (end-period, 12-month percent change)						
M0	4.5	8.0	6.1	7.2	5.8	...
M4	8.2	6.8	7.3	7.2	9.0	...
Consumer Credit	12.5	14.0	15.2	12.1	11.7 5/	...
Interest rates (year average)						
Three-month interbank rate	6.1	5.0	4.0	3.7	4.6	...
Ten-year government bond yield	5.2	4.9	4.9	4.5	4.9	...
Balance of Payments						
Trade balance (in percent of GDP)	-2.1	-2.8	-3.0	-2.9	-3.4	-3.5
Current account balance (in percent of GDP)	-2.5	-2.3	-1.7	-1.7	-2.4	-2.5
Exports (percent of GDP)	28.1	27.4	26.2	25.4	24.4	24.1
Export volume (change in percent)	9.4	2.9	0.1	0.9	2.0	4.1
Imports (percent of GDP)	30.1	30.2	29.2	28.3	27.8	27.6
Import volume (change in percent)	9.1	4.9	4.1	1.8	4.5	5.1
Net exports of oil (in billions of U.S. dollars)	9.9	8.0	8.6	6.7	3.7	...
Reserves (end of period, in billion of US dollars)	48.2	40.4	42.8	46.0	49.7	...
Fund Position (as of December 31, 2004)						
Holdings of currency (in percent of quota)					66.8	
Holdings of SDRs (in percent of allocation)					11.0	
Quota (in millions of SDRs)					10,738.5	
Exchange Rates						
Exchange rate regime					Floating	
Bilateral rate (December 31, 2004)					US$ = £0.5188	
Nominal effective rate (1995=100) 5/	126.8	124.7	125.0	118.1	122.8	...
Real effective rate (1995=100) 5/ 6/	139.6	139.0	141.9	136.9	144.3	...

Social Indicators (reference year):
Income per capita (in US dollars, 2003) : 30,904; Income distribution (ratio of income received by top and bottom quintiles, 2001): 4.9; Life expectancy at birth (2003): 76.2 (male) and 80.7 (female); Automobile ownership (2000): 420 per thousand; CO2 emissions (ton per capita, 2001): 9.37; Population (in millions, 2003) 59.3; Population density (2002): 246 inhabitants per sq. km.

Sources: National Statistics; HM Treasury; Bank of England; International Financial Statistics; INS; World Development Indicators; and IMF Staff estimates.
1/ ILO unemployment; based on Labor Force Survey data.
2/ The fiscal year begins in April. For example, fiscal balance data for 2002 refers to FY2002/03. 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/ Staff estimates.
5/ Average. An increase denotes an appreciation.
6/ Based on relative normalized unit labor costs in manufacturing.