G R O U P   O F   T W E N T Y

UNITED KINGDOM SUSTAINABILITY REPORT[1]

Prepared by Staff of the

I N T E R N A T I O N A L   M O N E T A R Y   F U N D

[1] *Report 9 of 10.* At the request of the G-20, IMF staff has provided analyses and assessments of member's economies and policies in a *set* of reports for the Mutual Assessment Process (MAP). These reports serve as inputs for the Action Plan agreed by G-20 Leaders at the Cannes Summit. The 2011 Staff Reports for the 20 MAP consist of the following: (i) an Umbrella Report that provides an integrated summary of the component reports and an upside scenario for G-20 collective action; (ii) an Accountability Report that summarizes members' progress toward policy commitments since the Seoul Summit in 2010; (iii) a MAP Report providing analysis of members' medium-term macroeconomic and policy frameworks; and (iv) Sustainability Reports for seven members (China, France, Germany, India, Japan, United Kingdom, and United States)—indentified by G-20 indicative guidelines—to assess the root causes and policy implications of key imbalances.

EXECUTIVE SUMMARY

G-20 indicative guidelines identified the United Kingdom as experiencing low private saving and high public debt. Before the crisis, growth was over-reliant on private and public consumption, financed by high domestic and external borrowing. Household saving fell to unsustainably low levels alongside an overheated housing market. Financial sector excesses contributed to a build-up of imbalances and stability risks. Public finances which entered the crisis with little policy space are now left in a severely weakened state. Thus, the United Kingdom can best contribute to strong, sustainable and balanced global growth by taking prudent steps to restore soundness to public finances and to maintain stability in its systemically important financial sector.

The striking fall in household saving and, distinctly, the rise in private debt was due, in part, to problems in the financial sector and housing market. Relaxed lending conditions, expanded credit availability, and rising net wealth (supported by overshooting house prices) encouraged lower saving and higher borrowing to support consumption. Weaknesses in the financial sector policy framework and housing market distortions—notably constraints on new supply—contributed importantly to these outcomes.

Low public saving and high public debt after the crisis reflect structural weaknesses in the fiscal policy framework. Established fiscal rules were insufficiently strong prior to the crisis. They did not adequately adjust for the cycle and allowed for a structural and excessive increase in discretionary public spending. Economic growth and tax revenues became over-reliant on the financial sector as related business services were taking on more risk. Revenue was also over-reliant on inflated asset prices and related windfall gains were not saved.

High public debt or a return to low private saving could threaten future growth. Crowding out effects and higher tax distortions associated with heavy public debt burdens could weigh on investment and growth down the road. A return to very low private saving could again give rise to widening macroeconomic imbalances and financial stability risks that severely disrupted growth when the crisis materialized. Moreover, given the U.K.'s central role in global finance, ensuring stability is essential for achieving G-20 members' shared growth objectives.

Financial sector reform and prudent fiscal consolidation are central to address key imbalances. To support growth and prevent another buildup of imbalances and stability risks, financial sector reform in key areas is still needed. A sustainable increase in public saving with "growth friendly" composition is needed to stabilize and reduce high public debt that would help rebuild policy space and crowd in private investment. Monetary policy should remain accommodative for some time—so long as underlying inflation remains in check. Housing policy reforms should aim at increasing affordability to mitigate excessive house price volatility (affecting household saving and debt).

INTERNATIONAL MONETARY FUND

UNITED KINGDOM

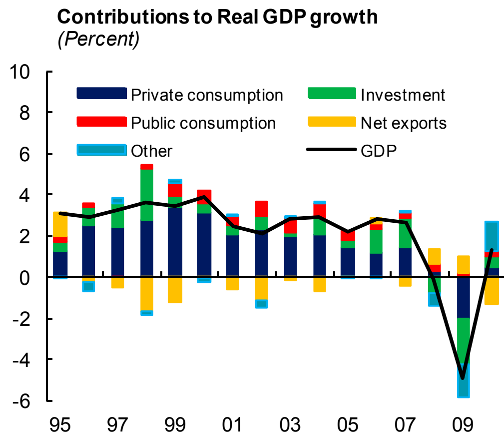
SUSTAINABILITY REPORT 2011[1]

The United Kingdom's key imbalances over the past decade originate in low saving. Growth was reliant on private and public consumption—financed by high domestic and external borrowing. Public finances entered the crisis with little policy space and are now left in a much weakened state. Household saving fell to unsustainably low levels alongside an overheated housing market. Against the backdrop of low interest rates globally, financial sector excesses contributed to a build-up of imbalances and stability risks. Since the crisis, repair of both public sector and household balance sheets is underway, notably through increased saving. Budgetary consolidation efforts will need to be sustained and the performance of the new fiscal framework closely monitored. The rebound in household saving needs to be maintained. Securing strong and sustained growth will therefore require a rebalancing of demand—toward net exports and investment and away from consumption. Stronger financial reform is also crucial to safeguard stability—a key priority given the United Kingdom's role as a global financial center.

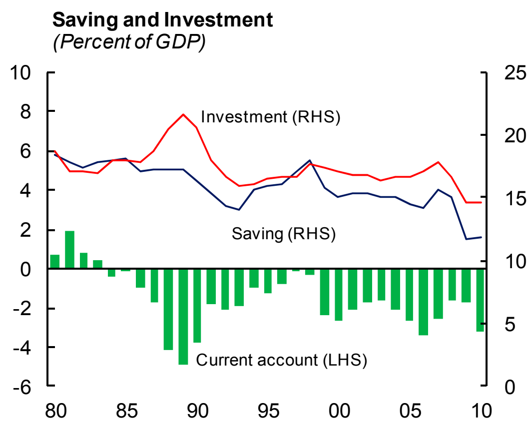
I. BACKGROUND

1. **Leading up to the financial crisis, the United Kingdom enjoyed a sustained period of solid growth, driven largely by consumption**. GDP growth averaged about 2¾ percent per year between 2000 and 2007, close to the average for the previous two decades. Private consumption growth was higher but also close to its long-run average, at about 3 percent; and it remained the most important contributor to overall growth. Investment remained a modest contributor to growth and net exports were a persistent drag. The most notable difference during the 2000–07 period was the pick-up in public consumption growth to around 2½ percent, as fiscal deficits re-emerged following a period of net public saving at the end of the 1990s and early 2000s.

[1] Prepared by Shaun Roache under the guidance of Hamid Faruqee, with the support of Eric Bang, David Reichsfeld, and Anne Lalramnghakhleli Moses.



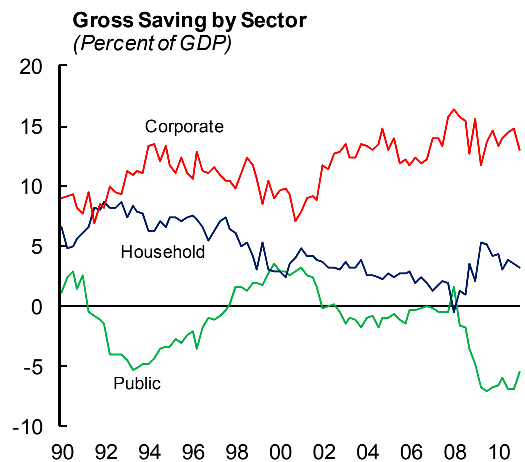
2. **Strong domestic demand, partly from robust private consumption and partly from fiscal expansion, led to sustained growth but a deteriorating current account balance.** The current account deficit increased in the early 2000s and averaged about 2¼ percent during the 2000–07 period. It subsequently fell during the recession, but has begun to rise back towards pre-crisis levels more recently. The accompaniment to this deficit was strong capital inflows into U.K. issued debt, including (as in the United States) securitized residential mortgage instruments.



3. **Similar to the United States, a sharp and sustained decline in national saving explains a rising current account deficit.** National gross saving was lower by about 1 percent of GDP between 2000 and 2007 compared to the previous decade. Gross investment was largely unchanged, but quite low, over the same period. High external (and domestic) borrowing came against the backdrop of low global interest rates, and steady foreign demand for U.K. assets, to finance high private and public spending relative to income and revenue. Specifically:

- *Household saving gradually declined on a trend basis for almost two decades before rising sharply during the recession*. The gross household saving rate (measured as a percent of disposable income) averaged over 9 percent during the 1990s and declined to near zero by 2008 before rebounding by 5 percentage points during 2009–10.

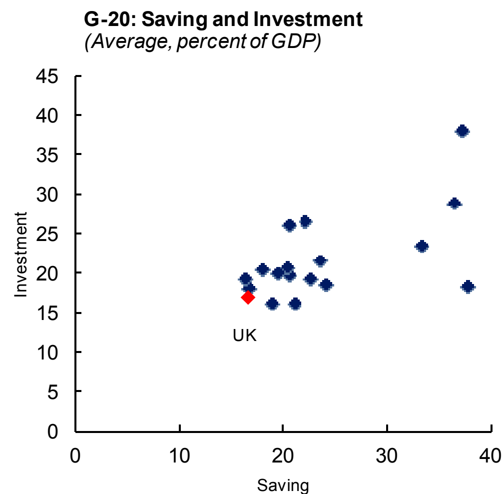
- *Corporate saving increased modestly during the pre-crisis period*. Rising



gross operating surpluses, particularly in the financial sector, and lower dividend growth both contributed to rising saving.[2] Dividend payouts grew more slowly than profits due in part to higher precautionary saving related to expected contributions to corporate pension funds as a result of new accounting standards for defined benefit schemes introduced in 2001.[3]

- *Public saving fell towards zero during the early 2000s and has turned significantly negative as a result of the crisis.* During the late 1990s and through 2001, unexpected revenue buoyancy, faster-than-expected growth, and tight expenditure constraints inherited from the previous government helped public saving rise to over 3 percent of GDP. From 2002–07, saving was slightly negative on average as discretionary consumption spending—particularly non-entitlement National Health Service spending—picked up. Since 2008, public saving has average nearly -5 percent of GDP.

4. **Investment and productivity are both relatively low.** The step-increase in corporate saving in the early 2000s did not lead to higher investment (as it might if firms were, say, credit-constrained). Investment has remained around 17 percent of GDP, towards the bottom end of the range of G-20 countries. There has also been a persistent gap in productivity levels between the United Kingdom and its major competitors that was only partially closed during the modest pick-up in productivity growth during the pre-crisis period. Recent analysis indicates that this is due to lower total factor productivity and, particularly relative to France and Germany, lower capital-to-labor ratios that result from weak investment.[4]



Source: IMF, World Economic Outlook.

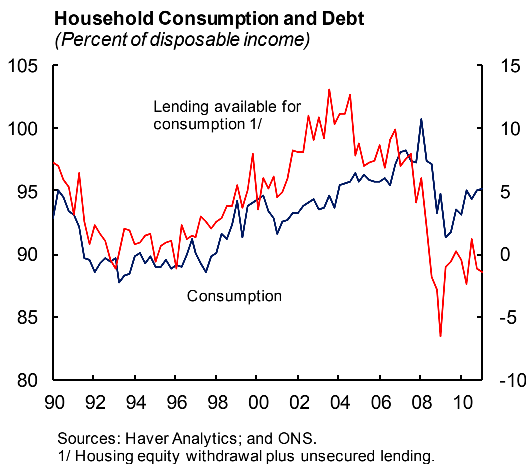
5. **The financial sector played a contributing role in U.K. imbalances, evident in the link between rising household borrowing and consumption.** Rising household borrowing helped sustain consumption's strong contribution to growth. While the household share of national income fell

[2] OECD Economic Outlook 82.

[3] Bunn and Trivedi (2005).

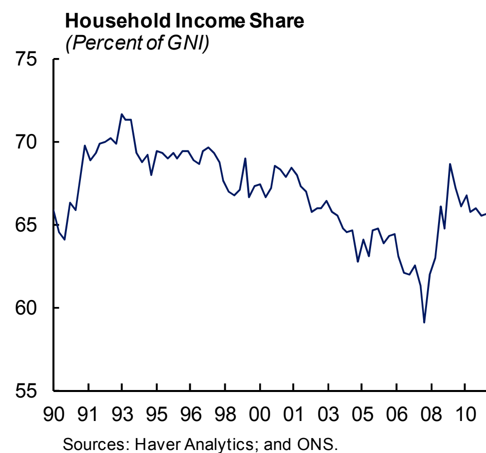
[4] U.K. Department for Business Innovation and Skills, Economic Paper no. 9, November 2010.

(by about 5 percentage points between 2000 and 2008, in part reflecting a declining wage share), households reduced their saving and borrowed more to sustain consumption growth. Lending available for consumption—related to housing equity withdrawals and new unsecured debt—increased from an average of 2½ percent of household disposable income in the 1990s to about 9 percent between 2002 and 2007. This debt can be used to acquire financial assets, enhance home values, or for consumption. Some portion of this new debt was used to acquire financial assets (or upgrade homes), but as the net acquisition of assets of households remained largely unchanged while consumption rose over the period (as a percent of income), a significant part of this borrowing is likely to have been used for consumer spending.

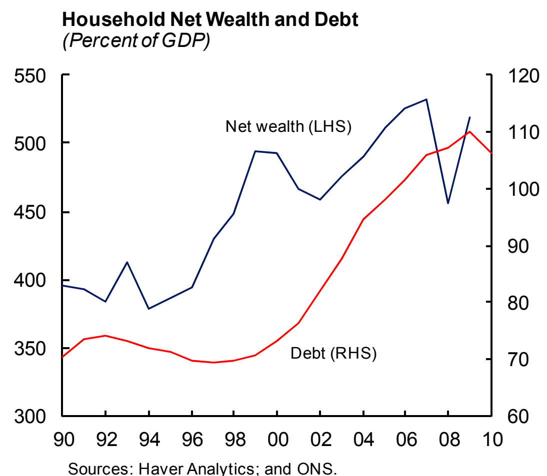


Sources: Haver Analytics; and ONS.
1/ Housing equity withdrawal plus unsecured lending.

6. **Against the backdrop of low interest rates, household balance sheets correspondingly took on more debt—and became more leveraged—in the run-up to the crisis**. Household debt increased by 34 percentage points of GDP between 2000 and 2008. At the same time, net wealth was rising, in large part due to higher house prices, but was still outpaced by debt accumulation. The result was an increase in household leverage—defined as the ratio of total debt to net worth—by 9 percentage points to 23 percent at its peak in 2008. Since 2008, households have begun to repair their balance sheets by increasing saving (i.e., rebuilding net wealth damaged by house price declines) and reducing debt relative to wealth (i.e., deleveraging), albeit gradually.



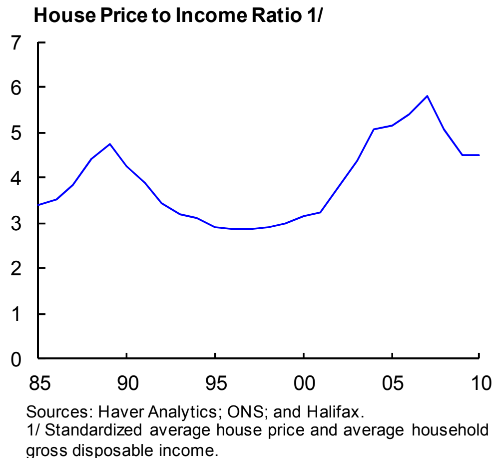
Sources: Haver Analytics; and ONS.



Sources: Haver Analytics; and ONS.

7. **Linked to falling household saving rates, increased borrowing and inflated tax revenues accompanied the**

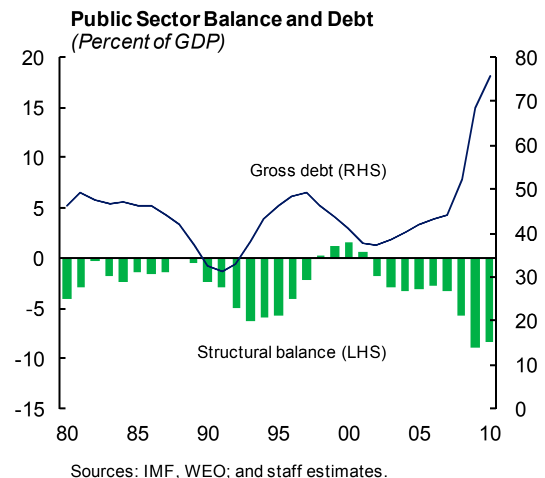
run-up in property prices. U.K. house prices experienced a large and sustained increase (rising by an annualized 8-9 percent between 1993 and 2007) well ahead of modest growth in household incomes. At the time the market peaked, the ratio of house prices to average household disposable income had risen to historically high levels. Notwithstanding recent declines in house prices, housing valuation ratios remain about 30 percent above their historical averages.[5] The combination of low household saving, increased borrowing and indebtedness, and rising property prices against modest income growth was self-reinforcing during this episode before the crisis. Rising asset prices also boosted public sector accounts.



Sources: Haver Analytics; ONS; and Halifax.
1/ Standardized average house price and average household gross disposable income.

8. **Public finances entered the crisis with underlying structural weaknesses and less policy space, before public debt surged when the crisis hit**. Public debt increased by about 7 percentage points in the five years leading into the crisis and rose by 32 percentage points of GDP between 2007-10. A number of factors explain the sharp rise in public debt since the onset of the crisis.

- *Much of the deterioration in the fiscal position is structural*, reflecting permanent revenue losses (including those related to asset prices and the financial sector) and a sharp drop in potential GDP during the crisis that, in part, reflects the adverse shock to the financial sector.
- *Discretionary stimulus has contributed relatively little*, in part because the stimulus has been unwound relatively early and rapidly.
- *The direct net costs of public sector interventions in the financial sector are so far small,* although the government continues to face large contingent liabilities.



Sources: IMF, WEO; and staff estimates.

[5] United Kingdom 2011 Article IV Staff Report.

Prospects[6]

9. **Higher public saving and less consumption growth over the medium term implies that growth must rely more on investment and exports.** Medium-term *fiscal consolidation* is already underway. Specifically, with public finances on an unsustainable path, the government embarked last year on an ambitious 5-year adjustment plan that would cut the deficit from 11 percent of GDP at the peak of the crisis to 1½ percent of GDP by 2016. Similarly, *private consumption* growth is likely to be restrained as cuts in government transfers slow household income growth and as the need to repair balance sheets keeps the household saving rate high. Tighter fiscal policies and subdued private consumption growth provides the room for monetary policy to remain accommodative for some time (consistent with meeting the inflation target). The outlook for *private investment* is brighter, reflecting the likelihood of interest rates remaining low, very high corporate cash surpluses, and relatively faster expected growth in the export sector, which is more capital-intensive. Sterling has depreciated significantly in real effective terms, though net export volumes have yet to pick up significantly.

10. **Repair and reform in the financial sector will strongly influence the rebalancing process and growth**. Most importantly, the supply of credit is likely to be tighter in the post-crisis period and likely to restrain demand growth and price increases for housing. Accordingly, to rebuild net wealth damaged by lower house prices, households will need to maintain higher saving. The financial sector will also likely contribute less to overall GDP growth than it did between 2000-07 and, given its current relatively high share of the economy—at about 10 percent of GDP--this will depress potential growth and tax revenues for some time.[7]

11. **Fiscal adjustment plans give strong reasons to expect a narrowing of the current account deficit**. Fiscal consolidations are associated with current account adjustments because they compress domestic demand directly and allow looser monetary policy, which helps keep the exchange rate competitive. Studies suggest that each 1 percent of GDP of fiscal consolidation typically reduces the current account deficit by 0.2-0.6 percent of GDP. With fiscal adjustment of nearly 7 percent of GDP planned between 2010 and 2015, this implies that the current account deficit might fall by about 2–3 percent of GDP over this period, bringing the current account close to balance.

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[6] This section draws on the 2011 Article IV Staff Report.

[7] See *Economic Contribution of U.K. Financial Services 2010*, www.thecityU.K..com

II. ROOT CAUSES OF KEY IMBALANCES

Based on G-20 indicative guidelines, relatively large U.K. imbalances were identified with respect to low private saving and high public debt. Underlying causes include external factors such as low global interest rates that encouraged borrowing (similar to the United States). On the domestic side, relaxed financing conditions and increased credit availability facilitated the increase in household indebtedness, which supported consumption and lowered saving. Fiscal imbalances partly reflected underlying structural weaknesses—notably, fiscal frameworks that were not able to maintain sufficient budgetary discipline.

Low Household Saving (and High Private Debt)

12. **At the heart of imbalances in the U.K. economy was unusually low and declining saving by households, against the backdrop of relaxed financial conditions**. A number of factors help explain the striking fall in household saving and, separately, the rise in debt. Recent analysis by Fund staff finds a clear link to real interest rates and house prices.[8] Relaxed lending conditions and increased credit availability in the financial sector further encouraged higher borrowing to support consumption relative to subdued growth in incomes. Similar forces were at work in the United States. Some of these developments reflect the natural response of the economy to expanding conditions, but others—notably the high pro-cyclicality of credit supply and overshooting house prices—are due to weaknesses in the financial sector policy framework and market distortions. Specifically:

- *Low real interest rates*. Short and long-term interest rates declined over two decades through 2007, against the background of lower global interest rates. This reduced the real return on saving and redistributed income from savers to borrowers. If borrowers have a higher marginal propensity to consume (as is likely), this would contribute to lower aggregate household saving. Low interest rates also allowed and encouraged households to support larger balance sheets (e.g., indebtedness), against expectations of further asset price increases.
- *Credit conditions*. The supply of credit improved significantly early in the 2000s, which allowed credit-constrained households to borrow more (and save less). The spread of household mortgage rates over the Bank of England's policy rate declined from over 100 basis points to less than 50 basis

[8] *What Drives the U.K.'s Household Saving Rate*, United Kingdom 2011 Article IV Selected Issues Paper.

points in the decade through 2007.[9] At the housing market peak, there was evidence that credit conditions had become excessively lax, but in retrospect financial sector supervisors and policymakers failed to respond appropriately (see below).[10]

- *Rising asset prices, notably housing*. Sharply higher house prices—partly, due to supply constraints on the U.K. housing market—boosted net wealth. For households targeting a specific level of wealth (for example, to fund retirement) this reduced incentives to save.[11] House price gains also increased collateral values, thereby increasing the amount of secured borrowing property-owning households could obtain (notably, through mortgage equity withdrawals) and reinforced borrowing demand. Expectations of further asset price increases may also have contributed to increased borrowing and indebtedness. Higher prices may also have had distributional effects and encouraged higher saving by younger households, but this was partly offset in the U.K. by increased credit availability.

- *Constraints on housing supply* are likely to have contributed to high and rising prices. The U.K. is subject to restrictive planning laws that severely restrain the designation of new building areas. This has lowered the price elasticity of housing supply, which is now very low and has declined in recent decades.[12] As a result, the boom in house prices was *not* accompanied by a construction boom (unlike the United States where residential investment also rose sharply prior to the crisis).

Public Debt

13. **The crisis and recession exposed structural weaknesses in the United Kingdom's fiscal policy framework**. In particular:

- *Established fiscal rules were not sufficiently strong*. The government actually met its own fiscal rules for the 10 years following their adoption in 1998.[13] However in retrospect, these rules and actual policies did not adequately adjust for the cycle. Fund

[9] Bank of England *Quarterly Bulletin*, Q3 2009.

[10] For example, the FSA estimates that of total mortgage approvals: 45 percent were not income verified; 35 percent were interest only; and 15 percent were at a loan-to-value ratio of 90 percent of above Adair Turner, "The Mortgage Market: Issues for Debate," FSA Mortgage Conference, 12 May 2009.

[11] The effect of housing wealth on saving is not straightforward theoretically, since higher house prices imply both more wealth and higher implicit housing costs going forward (*What Drives the U.K's Household Saving Rate*, 2011 Selected Issues Paper).

[12] Barker Review of Housing Supply, Interim Report, 2003.

[13] Specifically, these were: the *golden rule*, which stated that over the economic cycle, the government will borrow only to invest and not to fund current spending (equivalently that public saving will be positive, on average over the cycle); and the *sustainable investment rule*, which stated that public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level.

staff estimate that the United Kingdom was running a sizable structural deficit at the same time as the economy's output gap was either closed or positive between 2000 and 2007. The bulk of the deterioration in public finances before the crisis was structural and primarily reflected increases in spending on public services. The rules also failed to build in a sufficient safety margin for uncertainty, which may have been underestimated.

- *Projections for the public finances were consistently over-optimistic and not subject to formal independent review*. The fiscal policy framework in place before the crisis was often criticized because it provided insufficient monitoring, transparency, and accountability. Institutional reforms recently adopted by the government should address these weaknesses. In particular, the government recently passed legislation to put the independent OBR on a permanent footing. This new institution should help strengthen the credibility of fiscal analysis and forecasts.

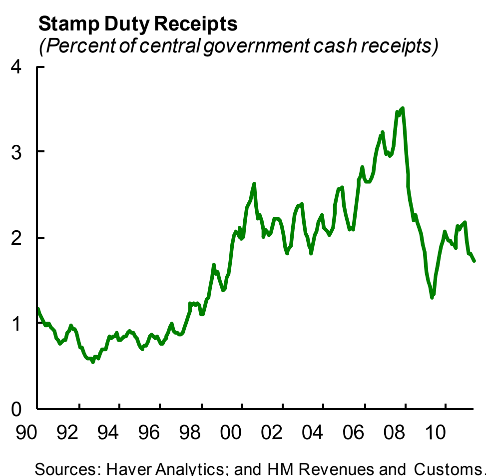
- *Economic growth, estimates of potential growth, and tax revenues became over-reliant on the financial sector and related business services which were taking on more risk*. Thin fiscal buffers became more important over time as the U.K. economy and tax revenues grew increasingly reliant on the financial sector for growth. Between 2000 and 2007, the financial and business services sector (including real estate) accounted for just over half of overall GDP growth. To some extent, higher growth contributions reflected greater risk-taking by the financial sector rather than an underlying increase in productivity.[14] In turn, the financial sector is estimated to have contributed about 14 percent of government's total tax receipts in 2007. This tax stream is relatively volatile, as shown by the 21 percent decline in the total collected by the financial sector between the fiscal years 2006/07 and 2009/10.[15]

- *Revenue was over-reliant on inflated asset prices and windfall gains were not saved*. The United Kingdom taxes both capital gains (although not on an individual's main residence) and equity and property market transactions (through stamp duty). Stamp duty on property is progressively graduated based on its value and this amplifies the sensitivity of the duty's receipts to prices. The OECD has estimated that "excess" revenue related to asset prices at

[14] As noted by Haldane (2010), three related balance sheet strategies boosted the added value and risk exposure of the U.K. financial sector: increased leverage (on and off balance sheet); an increasing share of assets held at "fair value" as asset prices rose; and writing deep out-of-the-money options.

[15] *Total Tax Contribution*, PricewaterhouseCoopers LLP study of the U.K. Financial Services Sector for the City of London Corporation (December 2008). This includes tax payments collected from firms and income and national insurance payments by sector employees.

cyclical peaks can lead to the over-estimation of structural budget balances of the order of 1½ to 3 percentage points in some countries, including the United Kingdom.[16] Revenue windfalls, for example from stamp duty receipts, in turn, were not saved and left a shortfall relative to spending when they disappeared as asset markets declined.



Sources: Haver Analytics; and HM Revenues and Customs.

Financial Sector—Lending Practices, Leverage, and Funding

14. **The financial sector contributed importantly to private and public sector imbalances.** Banks and other financial institutions aggressively expanded credit, contributing to inflated output growth, asset values and tax revenues, and eventually, creating large public sector contingent liabilities. Households' heightened access to expanding credit, in turn, lowered saving and increased debt. This boom-bust pattern reflected market failures and distortions, as well as shortcomings in policies. Banks were increasingly reliant on short-term funding, including from foreign counterparties, to finance the credit boom. Alongside weaker credit standards, this allowed banks to expand credit much more aggressively than would have been the case if constrained by deposit growth.

15. **Shortcomings with a "light touch" regulation and supervision facilitated financial sector excesses**. The FSA's focus on outcomes rather than business practices and rules enforcement obscured how risks were rapidly changing as new financial markets and instruments developed. Supervision of liquidity risks was inadequate, as financial firms became increasingly reliant on term funding markets. Cross-border supervision was also insufficient, including the inherent risks in foreign exposures of U.K. banks, particularly to U.S. subprime mortgages. Insufficient monitoring contributed to a buildup of financial sector vulnerabilities that, in turn, contributed to macro imbalances.

[16] Girouard and Price, 2004 and Price and Dang, 2011.

III. ARE U.K. IMBALANCES A PROBLEM?

National Perspective

16. **Large deficits and high public debt reduce policy space and threaten to crowd out private investment—and impede rebalancing**. The current very high fiscal deficit, if left unaddressed, would cause debt to balloon to over 100 percent of GDP by 2016 and be on a steeply rising path to even higher levels. Notwithstanding the likelihood that interest rates will remain low for some time, over the medium term as activity returns to potential, interest costs on public debt are likely to rise, although this would be limited by the relatively long maturity of outstanding U.K. debt. This would reduce available fiscal space. Higher interest rates would also adversely affect investment, which must contribute more to growth in a rebalancing scenario. Higher (distortionary) taxes associated with high public debt may also weigh on growth. Moreover, market sentiment should not be taken for granted as it may change suddenly—possibly affecting risk spreads, fiscal financing costs and debt dynamics.

17. **A return to low household saving and high leverage, given large public debt burdens, may give rise again to widening imbalances or financial stability risks**. U.K. Imbalances are all linked to some degree and reducing fiscal, financial, and external imbalances and their vulnerabilities will all serve to reinforce balanced and sustained growth. If left unchecked, key financial risks—were they again to materialize—could severely disrupt growth.

Global Perspective

18. **The United Kingdom plays a central role in global finance and, thus, avoiding large financial imbalances and ensuring stability is essential for strong, sustainable and balanced growth in the G-20**. U.K. external assets and liabilities account for ¼ of world GDP, far greater than its share in global trade and output. Global spillovers are therefore limited largely to the financial sector, while trade and other real economy links are modest.[17] Thus, U.K. financial sector stability is a global public good, requiring the highest quality regulation and supervision. The gradual repair of U.K. fiscal and financial sector balance sheets and limiting distortions that encouraged previous excesses should benefit global financial stability and growth.[18]

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[17] See IMF (2011) U.K. spillover report SM/11/181.

[18] Given its role in global financial markets, corrective policy actions themselves in the United Kingdom—to prevent future imbalances and mitigate systemic risk—could affect partner countries. Coordinated efforts will thus be needed to ensure reform consistency and to minimize unintended consequences (e.g., arbitrage, location shifts, etc.) See IMF U.K. spillover report.

IV. HOW TO ADDRESS IMBALANCES

Rebalancing in the United Kingdom requires a rise in public saving and greater reliance of demand on investment and net exports.[19] *While the near-term policy mix of fiscal consolidation and monetary accommodation is broadly helpful, important challenges remain and risks should be carefully monitored. Securing fiscal sustainability will need further structural reforms that address longer-term imbalances and bolster medium-term growth. Housing policies should address distortions that have contributed to large swings in household saving and debt. Additional efforts are also required to address shortcomings in the regulation and supervision and to enhance the macroprudential toolkit to prevent key imbalances from re-emerging and to safeguard financial stability.*

19. **A sustainable increase in public saving should be secured by additional structural reforms that address longer-term fiscal imbalances**. Higher public saving would raise national saving and lower the external deficit. The pace of fiscal adjustment though will need to take account of its dampening effect on growth in the short run as the recovery gains traction. A stronger improvement in net exports would allow for stronger consolidation, which will need to be sustained over the medium term. In particular, further accelerating increases in the state pension age and indexing it to longevity would reduce the fiscal burden of an ageing society. Reform of public-service pensions (along the lines of the *Independent Public Service Pensions Commission*) would help improve their structure and better align average public-service compensation with private-sector equivalents. The new fiscal framework that is anchored by medium-term targets and enhanced independent oversight would complement these efforts, but its performance should be closely monitored.

20. **Monetary policy should remain accommodative for some time—so long as underlying inflation remains in check**. With public finances being consolidated, accommodative monetary policy will help keep real interest rates low and sterling competitive, thereby promoting expansion of investment and net exports. However, attendant risks associated with low interest rates will need to be watched closely.

21. **Housing policy reforms should aim at increasing affordability to mitigate excessive house price volatility (affecting household saving and debt)**. Policies to increase supply should focus on lowering barriers to land access for housing and providing sufficient incentives for local communities to allow development. One aspect of the current system of housing taxation (the council tax) is regressive,

[19] This section draws on the 2011 Article IV staff report, 2011 U.K. Financial Sector Stability Assessment, and the 2011 U.K. spillovers report.

encouraging excess demand for housing and should be modified to better reflect the value of ownership. This would reduce distortions that have contributed, in the past, to excessive swings in household saving and debt. Reforms would also contribute to improved competitiveness by increasing household (and labor market) mobility and, by reducing the cost of living, helping to contain labor costs.

Financial Sector Policies

22. **To support growth and prevent another buildup of imbalances and stability risks, financial sector reform in key areas is still needed**. Liquidity buffers need to be increased, although progress has been made in building capital buffers with core tier 1 ratios now above 10 percent for all major banks. Enhanced supervision and oversight are needed to prevent imprudent credit lending and excessive leverage that contributed to low saving. These are elaborated below**.**

23. **The macroprudential toolkit should be enhanced and actively used**. Monetary policy working alone through interest rates may not be sufficient to safeguard both price and financial stability. The newly-formed Financial Policy Committee (FPC) should focus on tools that are most effective against the credit cycle—including loan-to-value ratios—and minimize efficiency costs and scope for regulatory arbitrage.

24. **To safeguard stability, continued build up of capital and liquidity buffers is essential for resilience to shocks**. Capital buffers should continue to be built up ahead of Basel III requirements, and approval of dividend and variable remuneration should continue to be linked to the outcome of stress tests. Liquidity requirements should be accompanied by home-host coordination to help address cross-border liquidity needs in times of stress. Requirements currently more stringent than in other major jurisdictions are appropriate given the specific vulnerabilities of the U.K. financial system.

25. **Further enhancements to the supervisory framework should remain a priority to promote prudent lending.** To avoid a return to weaker lending standards and mispricing of credit risks that contributed to excessive borrowing and low household saving, efforts should be made to:

- *Strengthen the FSA's assessment of banks' processes*, including loan classification, impairment determination, and valuation practices.[20]
- *Introduce a proactive intervention framework*. It is important that framework legislation include explicit support for early intervention by the supervisor in dealing with prudential problems.
- *Provide the regulatory authority with oversight powers at the holding company level*. This will improve consolidated supervision.

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[20] The FSA is conducting a review of mortgage markets that addresses some of these issues. See *Mortgage Market Review*, FSA Discussion Paper 09/3.

- *Enhance data reporting standards*. The U.K. lags behind many other countries in standards for the public disclosure of bank and insurance sector data. Regular and comparable data on an institution basis should be published, including non-confidential data from prudential returns.

26. **Progress made in addressing "too-important-to-fail" needs to be further advanced to restrain excessive risk taking**. Specifically, incentives for excessive leverage could be reduced through further tax reform. Ring-fencing of retail operations and establishment of depositor preference[21] would improve resolvability of the retail entity. However, ring-fencing should be weighed against the costs and does not necessarily improve resolvability of the whole entity, unless complemented by more comprehensive measures on which international coordination is critical.

A. Toward an Upside Scenario

27. **The U.K.'s contribution to the upside scenario for the G-20 as a whole would rely mainly on longer-term fiscal consolidation measures**. This reflects that the government's planned near-term fiscal consolidation is sufficiently strong given the current output gap and the projected path for economic growth. In particular, further reforms to entitlement programs such as the state pension and public service pensions that would be announced soon but implemented beyond the MAP 2011-16 horizon are included. Other measures include further reforms to reduce the relatively high share of the working age population that receives disability benefits. As well as contributing to the fiscal consolidation effort, this would also boost the supply of labor.[22]

28. **These measures would have significant effects near the end of the MAP horizon**. In 2015, when the additional consolidation measures start to be implemented, UK authorities will have built up considerable fiscal credibility and the analysis assumes that households believe that all the announced policies will be fully implemented. Consequently, households recognize the need to substitute toward foreign assets in their wealth portfolios given the reduction in UK government bonds. This increased desire to accumulate foreign assets leads to a depreciated pound and an improvement in the current account balance. Over the map horizon, the impact on GDP of the consolidation measures is negative. However, beyond the map horizon, lower debt service costs eventually lead to lower tax rates. Lower tax rates combined with slightly lower real interest rates, owing to less public demand for savings, leads to a higher level of GDP.

[21] This would elevate claims of depositors on assets of a failed institution over claims of general creditors.

[22] *Economic Policy Reforms 2011: Going for Growth*, OECD.

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