

**United Kingdom: 2010 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the United Kingdom.**

The following documents have been released and are included in this package:

- The Staff Report for 2010 Article IV Consultation prepared by a staff team of the IMF, following discussions that ended on September 27, 2010, 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 October 21, 2010. 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 supplement of November 2, 2010 updating information on recent economic developments.
- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its November 8, 2010, discussion of the staff report on issues related to the Article IV consultation.
- A statement by the Executive Director for the United Kingdom.

The documents 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.

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INTERNATIONAL MONETARY FUND

UNITED KINGDOM

**Staff Report for 2010 Article IV Consultation**

Prepared by Staff Representatives for the 2010 Consultation with the United Kingdom

Approved by Ajai Chopra and Tamim Bayoumi

October 21, 2010

**Overview:** The UK economy is on the mend. Economic recovery is underway, unemployment has stabilized, and financial sector health has improved. The challenge now is to support a balanced and sustainable recovery. The government's forceful multi-year fiscal deficit reduction plan will promote such rebalancing and is essential to ensure debt sustainability, thereby greatly reducing the risk of a costly loss of confidence in public finances. Fiscal tightening will dampen but not stop growth as other sectors of the economy emerge as drivers of recovery, supported by continued monetary stimulus. Upside and downside risks around this central scenario of rebalancing with moderate growth and gradually falling inflation are symmetric. Monetary policy will need to be nimble if risks materialize, and fiscal automatic stabilizers should operate freely. Meanwhile, the UK authorities should continue to provide leadership and build support for ambitious global reform of financial regulation. Ensuring a smooth transition to a new supervisory architecture at home will also be important to secure a safer post-crisis environment.

**The 2010 Article IV discussions were held in London during September 15–27, 2010.** The team comprised Mr. Chopra (head), Messrs. Fletcher, Meier, and Takizawa, Ms. Barkbu (all EUR), Ms. Le Leslé (MCM), and Mr. Moore (MCM). Ms. Ruiz Arranz (EUR) contributed to the mission's work from headquarters.

**The mission met** with Chancellor Osborne, Bank of England Governor King, Financial Services Authority Chairman Turner, and other senior officials, academics, think tanks, and private sector representatives. Mr. Gibbs (Executive Director) and Ms. Fisher (Advisor, OED) joined selected meetings.

**The mission's concluding statement was published on September 27, 2010 and can be found at:** <http://www.imf.org/external/np/ms/2010/092710.htm>

**Past surveillance:** During the 2009 Article IV Consultation, Directors commended the authorities' response to the financial crisis, but highlighted the significant vulnerabilities related to sharply rising public debt and continued financial sector fragility. The authorities' June 2010 budget lays out a concrete multi-year plan to reverse the deterioration of the public finances and put debt on a firmly downward path, as recommended by Directors. Supporting this process, the creation of the Office for Budget Responsibility (OBR) also matches past IMF advice calling for independent provision of budget assumptions. The health of the financial system has improved over the last year, though further progress is necessary in this area.

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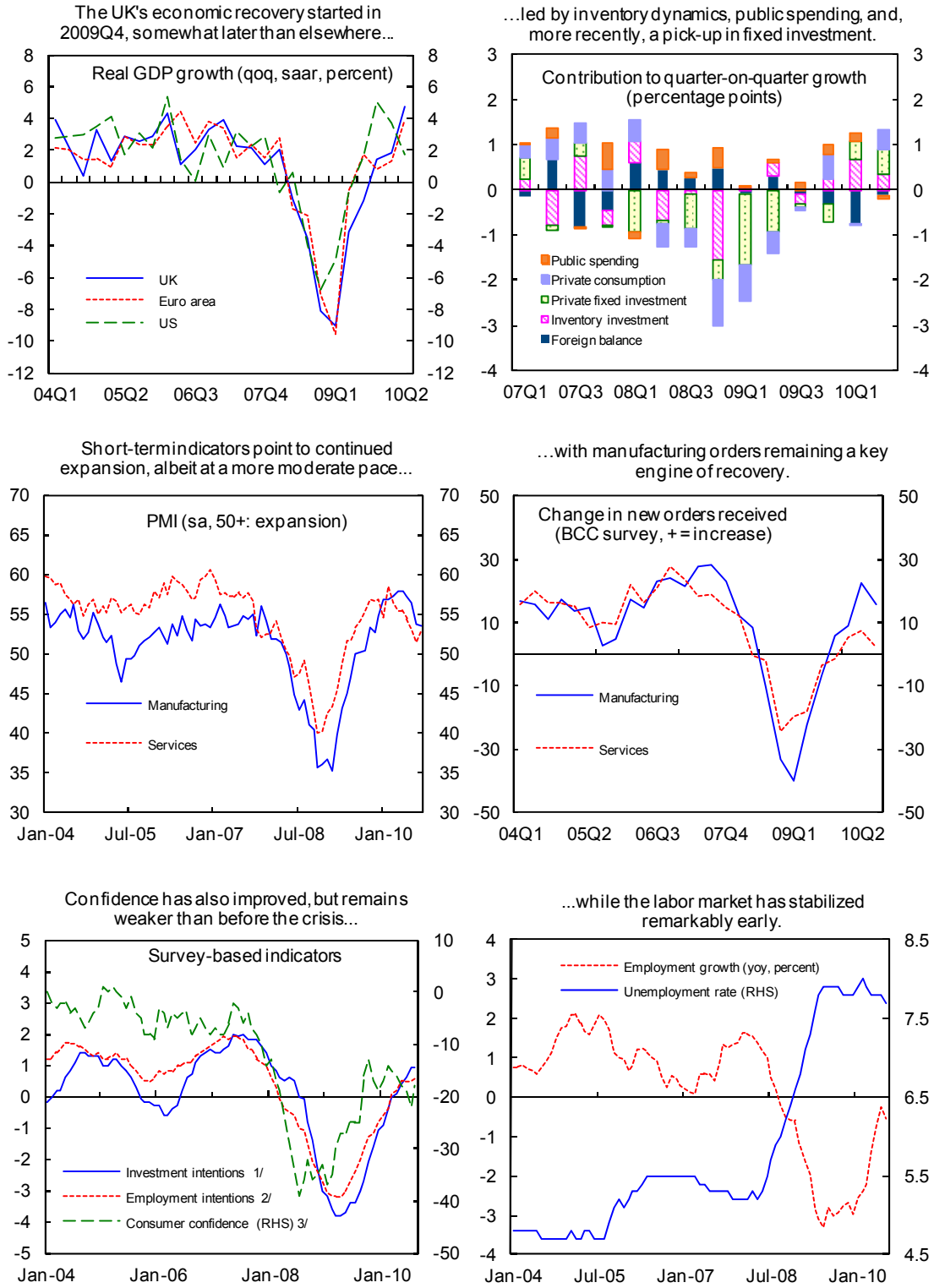
## I. THE ECONOMIC AGENDA

1. **The new Conservative-Liberal Democrat coalition government has launched a number of important policy initiatives in its first few months in office.** Its first budget, released in June, lays out an ambitious multi-year plan for deficit reduction—the centerpiece of the coalition agreement. To underscore its commitment, the government has created an independent Office for Budget Responsibility (OBR), which produces macroeconomic and fiscal forecasts for the budget and assesses whether budget plans are adequate to meet government-set fiscal targets. Separately, the government has set out to revamp the UK’s framework for financial regulation and supervision, consolidating key responsibilities in the Bank of England (BoE).

2. **These initiatives come in response to significant challenges, as the policy focus shifts from immediate fire-fighting to post-crisis repair.** With crisis memories still fresh and lingering risks, the priority is to preserve confidence. To this end, the authorities going forward will need to implement announced plans to restore fiscal sustainability and maintain monetary stimulus to ensure a smooth rebalancing of the economy, while laying the groundwork for a safer financial system.

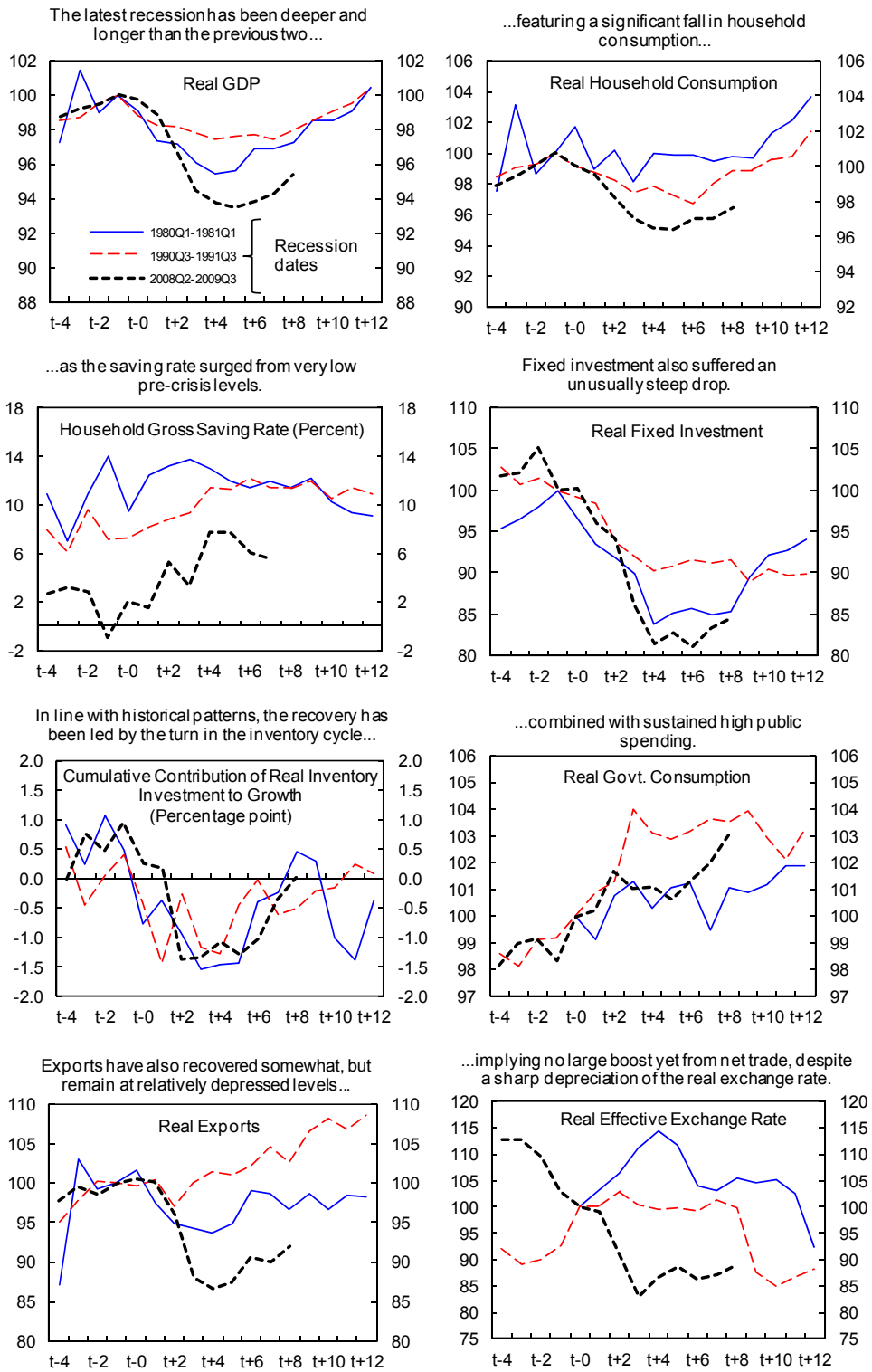
- **Recovery from the financial crisis is underway, despite continued headwinds** (Figure 1). After six quarters of deep recession, the economy started growing again in late 2009, led by a classic turn in the inventory cycle. More recently, final private demand has also rebounded from low levels (Figure 2), causing GDP growth to surprise on the upside. The recovery has been buttressed by the authorities’ forceful policy response, including large-scale interventions to rescue the financial system, temporary fiscal stimulus (though this started phasing out in 2010) along with full operation of automatic stabilizers, and unprecedented monetary easing. However, sterling depreciation has not yet boosted net exports as much as expected, and signs of a softening global recovery have dampened the outlook for external demand. Domestically, still-strained household and bank balance sheets remain a headwind for growth. Meanwhile, inflation has surprised on the upside as a series of price level shocks has more than offset the moderating effect of sizeable economic slack.
- **The challenge going forward will be to ensure sustainable recovery and balance sheet repair while remaining flexible to respond to shocks.** In staff’s central scenario, fiscal consolidation will mend the fiscal position while stimulative monetary policy continues to support private and external sector-led growth. However, there is significant uncertainty surrounding the underlying recovery momentum in the UK and globally. The operation of automatic fiscal stabilizers provides an important safeguard against risks on both sides. Moreover, monetary policy can flexibly increase—via more quantitative easing—or withdraw stimulus so as to deal with a broad range of shocks. Financial sector policies, in turn, face the difficult task of moving to a stronger financial system while ensuring adequate credit supply during the transition.

Figure 1. Real Sector Developments



Sources: Bank of England, British Chambers of Commerce, Office of National Statistics, MarkitEconomics.  
 1/ Bank of England Agents' Survey, manufacturing.  
 2/ Bank of England Agents' Survey, services.  
 3/ GfK Consumer Confidence Barometer.

Figure 2. Behavior of Key Macro Variables Around Recession Times 1/  
(Last pre-recession quarter t-1 = 100, unless otherwise noted)



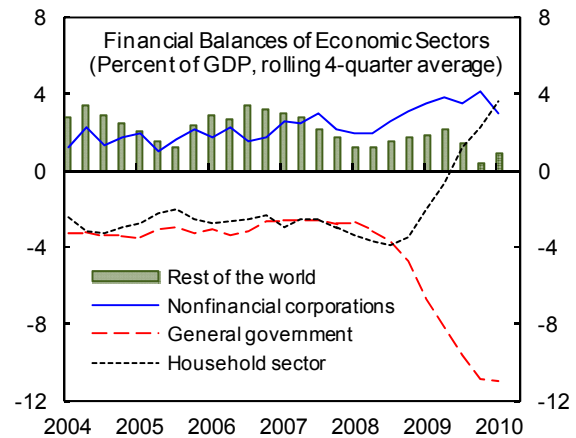
Sources: Haver; and IMF staff calculations.  
1/ The previous two recessions lasted five quarters each, i.e., from t-0 through t-4.

## II. PROGRESS IN REBALANCING AND DELEVERAGING

3. **Continued economic recovery depends on a sustainable revival of private spending, while the public sector retrenches.** The UK economy entered the crisis with a number of pent-up imbalances: overheated property markets, low household saving, high private sector debt, a large and overleveraged financial sector, and high external deficits and debt. Each of these imbalances has corrected to some extent, albeit at the high cost of a protracted economic downturn.

Moreover, some of the earlier imbalances have merely shifted from the private to the public sector, as the government has accommodated a large drop in revenue and bailed out ailing banks. In the period ahead, the government is set to redress its unsustainable financial position, leaving other sectors to reemerge as the drivers of growth. Households are likely to remain thrifter than

before the crisis, but have room to gradually raise consumption as labor market concerns subside and saving rates settle somewhat below their recent peak. The corporate sector, in turn, is projected to lessen its cash preservation effort, as the demand outlook firms up and credit constraints continue to ease. Improved net exports should simultaneously stabilize the external balance around a lower and sustainable deficit. Overall, this gradual rebalancing of the economy is projected to allow moderate growth, with considerable risks on both sides.

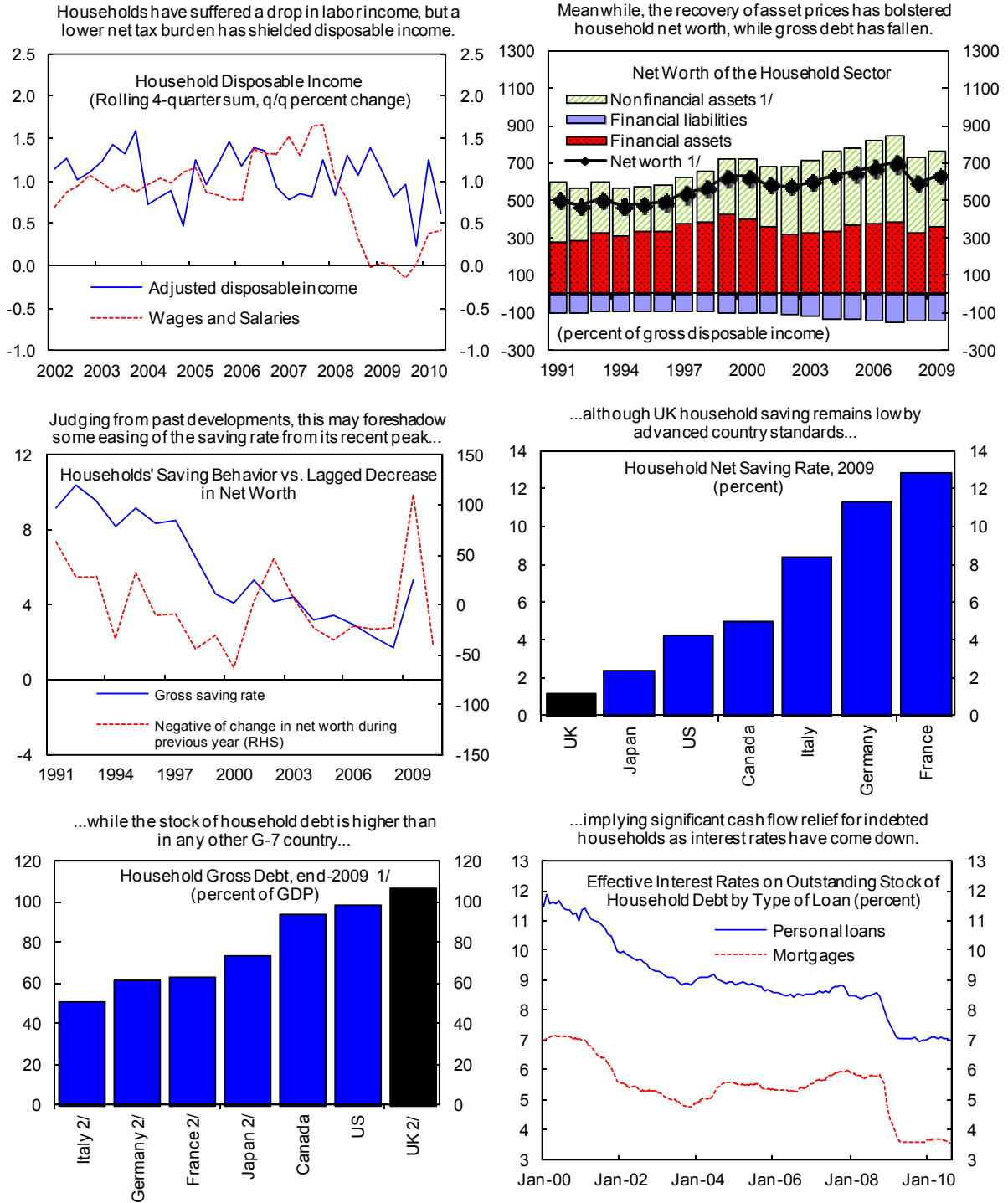


Sources: Haver; and IMF staff calculations.

### A. Sectoral Adjustments and Evolution of Financial Balances

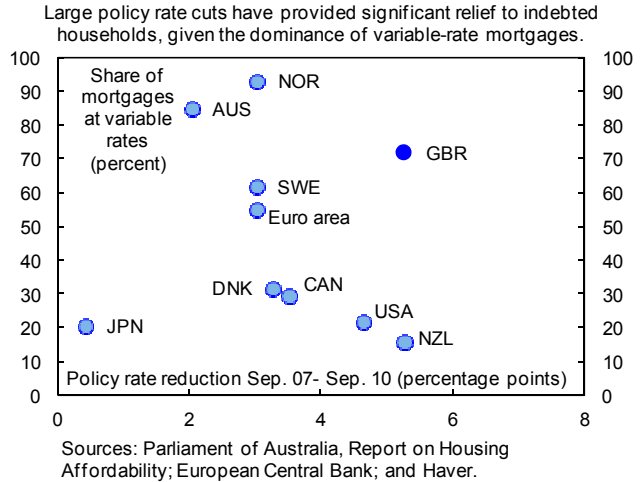
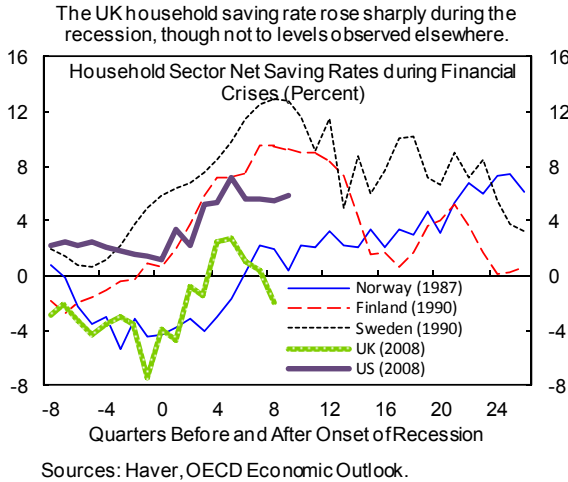
4. **The deleveraging of household balance sheets was a key feature of the downturn, but has recently begun to ease.** Private consumption declined considerably during the recession, as households responded to mounting economic uncertainty and plunging asset prices (Figure 3). Lower net tax payments cushioned the loss in labor income, but the gross household saving rate surged to a peak of 7¾ percent in mid-2009—up six percentage points from its pre-crisis levels. This shift to frugality mimics developments during historical financial crises elsewhere and is likely to have at least some permanent component. Indeed, compared to the UK's OECD peers, household saving rates are still low and debt levels high, reflecting widespread home ownership and high house price levels. Nonetheless, the saving rate already fell back to 4½ percent in the first half of 2010, as recovering asset prices and a stabilizing labor market lifted confidence. At the same time, record-low interest rates significantly reduced debt service costs.

Figure 3. Financial Position of Households

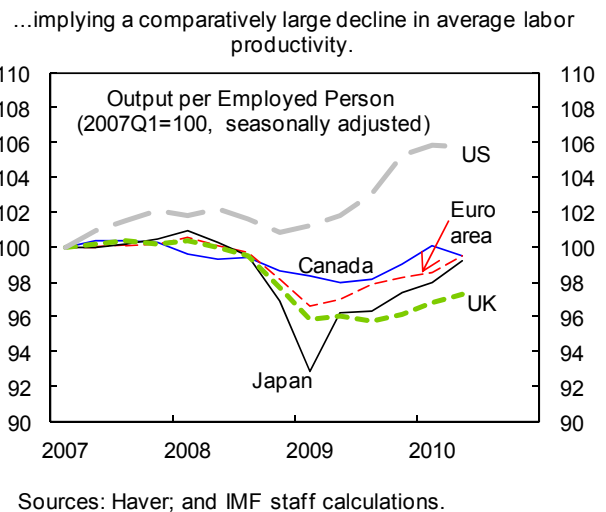
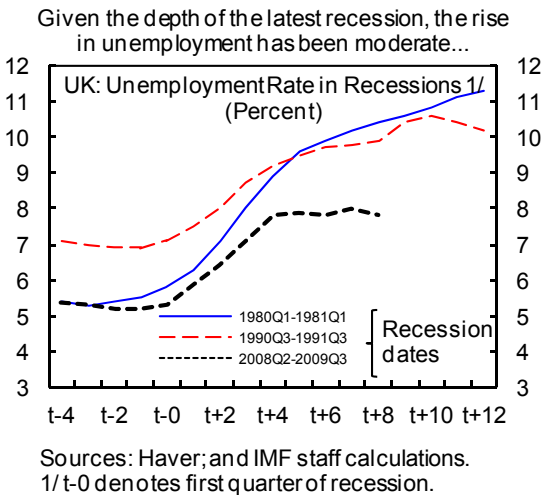


Sources: Haver Analytics; OECD; and IMF staff calculations.  
 1/ For 2009: staff estimate.  
 2/ Data for end-2008.



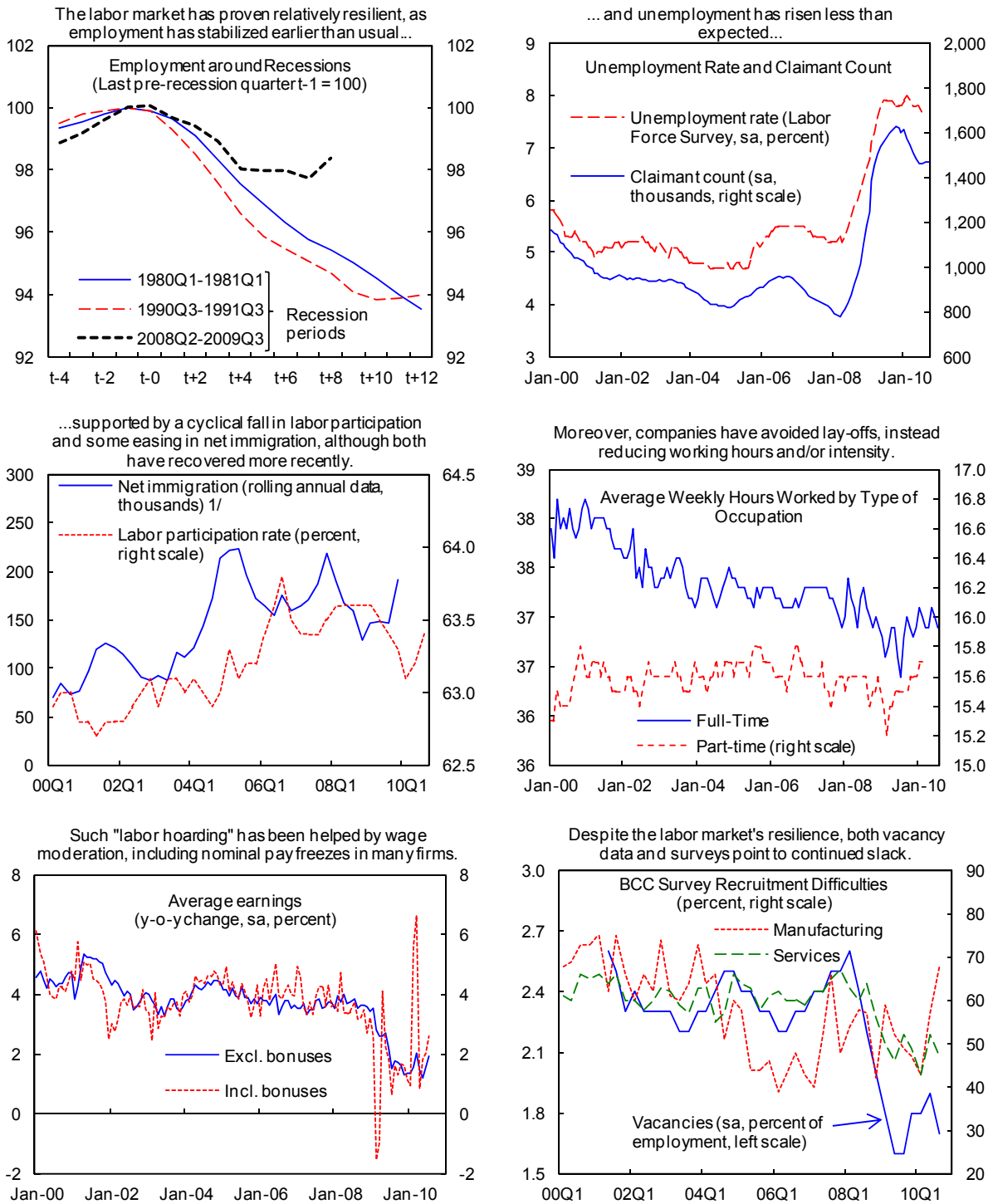


5. **The labor market has proven more resilient than expected.** Although any significant increase in unemployment entails hefty human costs, employment losses have been relatively moderate compared to previous recessions (Figure 4). Unemployment initially rose from 5½ percent to 8 percent, but then stabilized at this level for most of the past year and has edged down slightly in recent months. This resilience partly reflects lower net immigration, reduced labor force participation, and some public sector hiring. However, the data also suggest some labor hoarding in the private sector, induced by wage restraint, firms’ desire to retain talent, and expectations of a recovery in demand.<sup>1</sup> Business surveys continue to show slack in the labor market and generally little difficulty in recruiting staff, especially in services.



<sup>1</sup> The current vintage of national accounts data may, however, understate somewhat the level of GDP, in line with historical patterns. For a fuller analysis of recent labor market developments from a cross-country perspective, see the *World Economic Outlook April 2010*, Chapter 3: <http://www.imf.org/external/pubs/ft/weo/2010/01/pdf/c3.pdf>

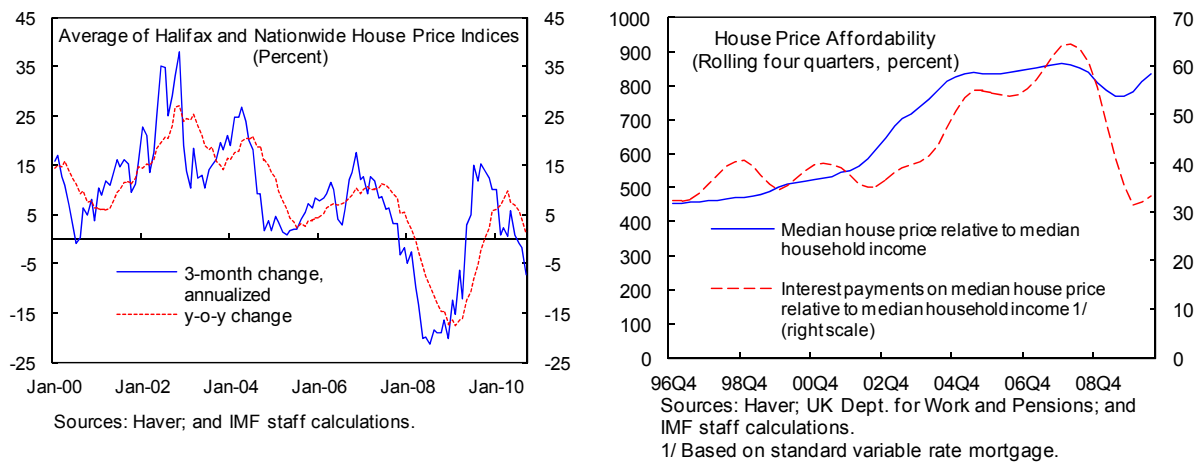
Figure 4. Labor Market Developments



Sources: Haver Analytics; Office for National Statistics; and IMF staff estimates.  
 1/ Estimates based on provisional data from the International Passenger Survey.

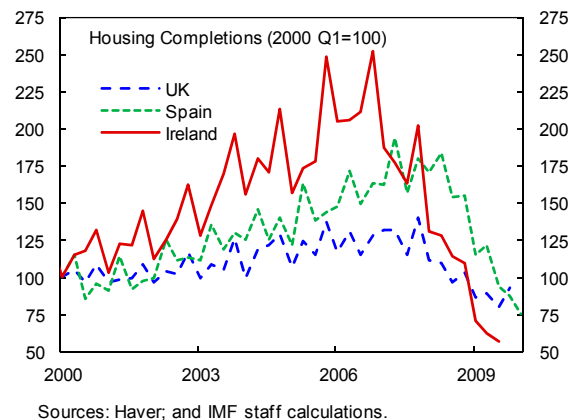
## 6. Residential property prices have recovered but remain below pre-crisis levels.

House prices staged a faster-than-expected recovery in 2009, as financially strong buyers returned to a market still characterized by relatively limited supply (Figure 5). More recently, the upward momentum has dissipated, with the 3-month change in house prices turning negative. Overall, prices remain some 15 percent below their 2007 peak. At this level, valuations continue to appear stretched relative to income, although exceptionally low interest rates have boosted affordability, at least for now. Meanwhile, overall financing conditions are still tight, with average loan-to-value ratios on new first mortgages hovering at 75-80 percent, well below the ratios observed during the pre-crisis boom. Mortgage approvals and net lending amounts have also stayed at low levels. On the positive side, mortgage arrears and repossessions have eased from their (already moderate) peak rates.



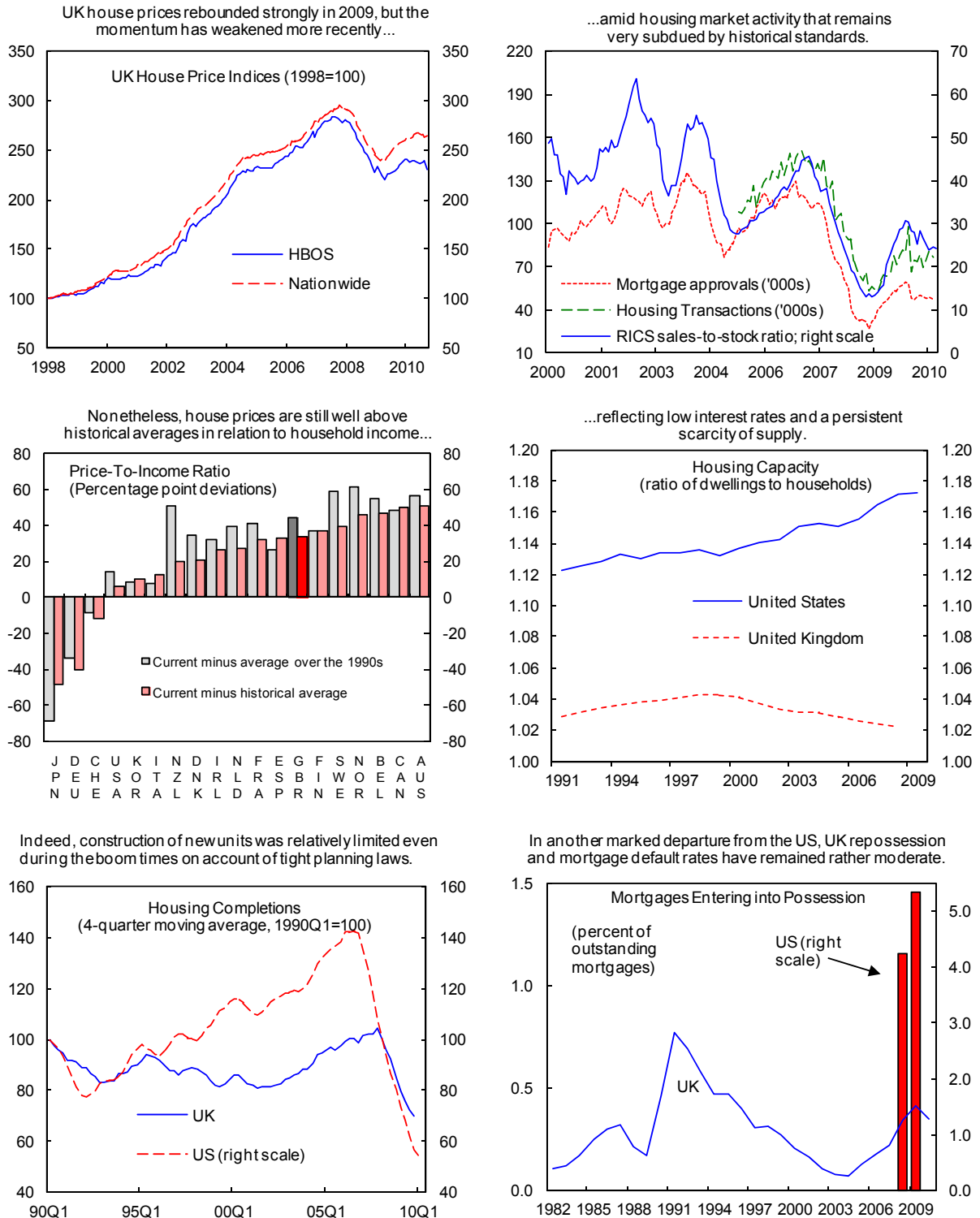
## 7. The relatively benign performance of the UK housing market partly reflects the (otherwise problematic) restrictiveness of the country's planning laws.

Although the UK experienced a strong boom in house prices prior to the financial crisis, construction of new units remained comparatively modest. Likewise, employment in the construction sector did not reach the heights observed in countries like Ireland, Spain, or the US. One important reason appears to be the UK's strict planning law, which has allowed local administrations to severely restrain the designation of new building areas. As a result, excess capacity in the residential housing market remains limited even today. This



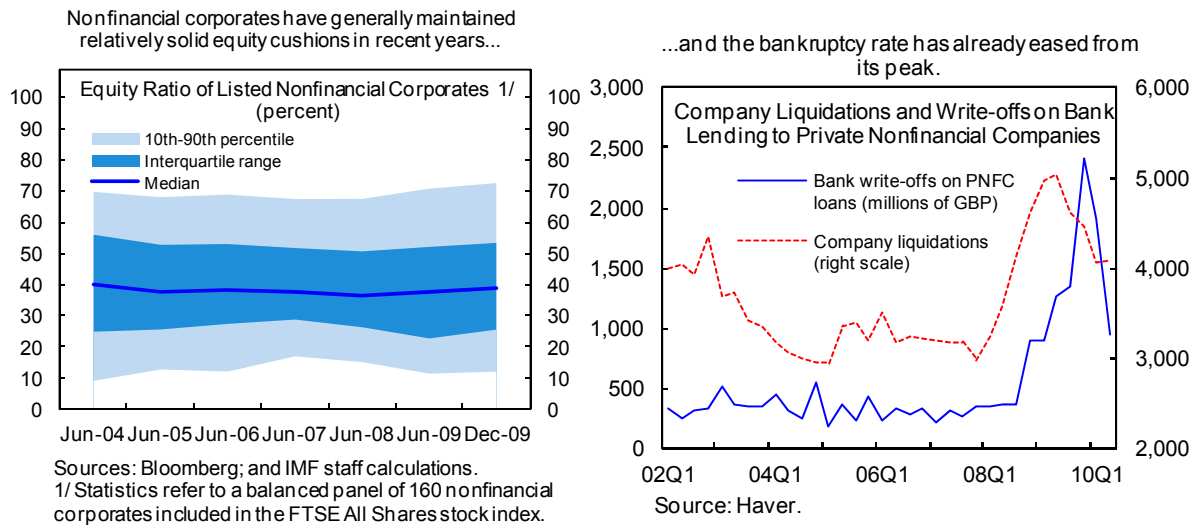
situation has supported relatively high house prices, benefiting older, home-owning generations at the expense of younger households and driving up gross household indebtedness. Wide-spread affordability problems have also given rise to high public outlays for housing support—more than 1 percent of GDP in 2009/10—and reduced labor mobility.

Figure 5. Residential Housing Markets



Sources: Bank of England; Haver; UK Communities and Local Government; UK Council of Mortgage Lenders; UK Department for Work and Pensions; UK Office for National Statistics; US Bureau of Economic Analysis; US Mortgage Bankers Association; and IMF staff estimates and calculations.

8. **Businesses reined in spending during the crisis, but have recently shown signs of reviving investment activity.** The nonfinancial corporate sector entered the recession with relatively solid financial balances, despite high debt levels. As demand contracted and the profit outlook deteriorated, firms cut back sharply on investment to preserve cash flow. From these unsustainably low levels, investment rebounded 13 percent (saar) in the first half of 2010. Recent surveys of investment intentions and falling spare capacity in manufacturing point to continued expansion going forward. Defaults on bank loans and company liquidations have increased from low levels since 2008, but appear to have peaked in 2009. Overall, the financial position of companies remains resilient, but there are areas of vulnerability, especially in commercial real estate, where prices are hovering one-third below pre-crisis levels.



9. **The recession has resulted in a sharp deterioration of the fiscal position**

(Figure 6). The headline public sector deficit (excluding financial sector interventions) increased from 2¼ percent of GDP prior to the crisis to 11 percent of GDP in FY 2009/10 (April 1–March 31). Much of the deterioration is estimated to be structural, reflecting permanent revenue losses and a sharp drop in potential GDP growth. By contrast, discretionary stimulus has contributed relatively little, especially because the previous government already started tightening fiscal policy in early 2010. The new government, in turn, has announced some additional spending cuts for 2010, followed by accelerated deficit reduction from 2011 onward. Nonetheless,

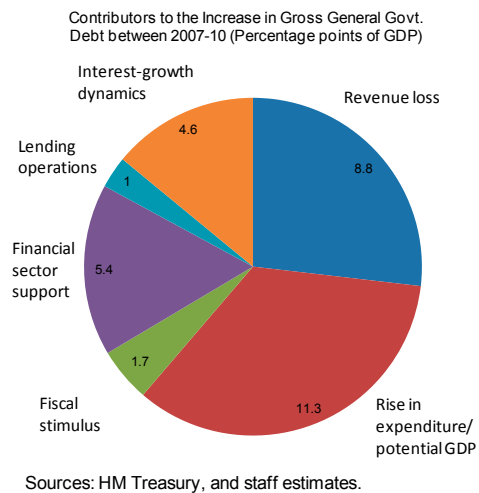
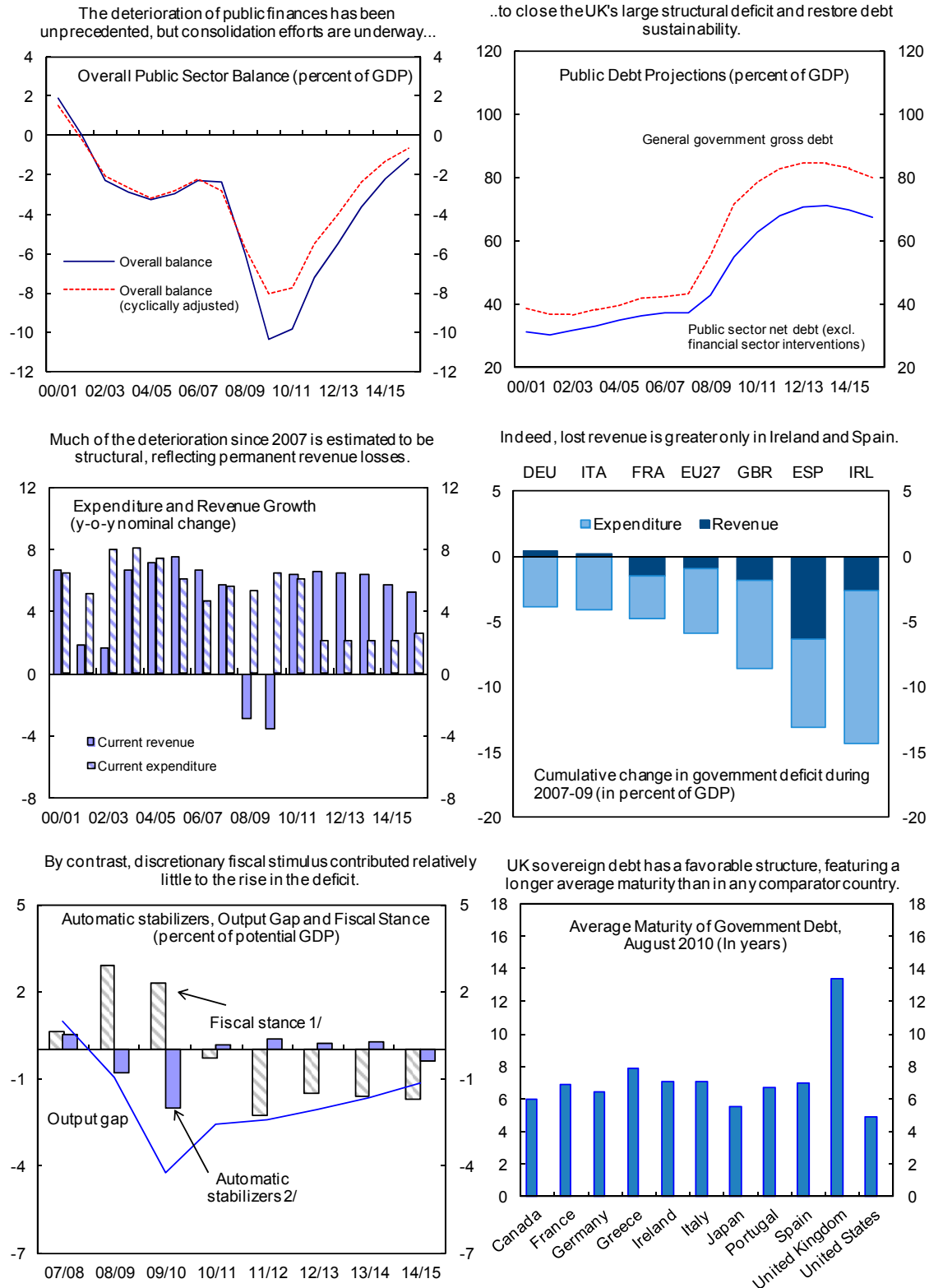
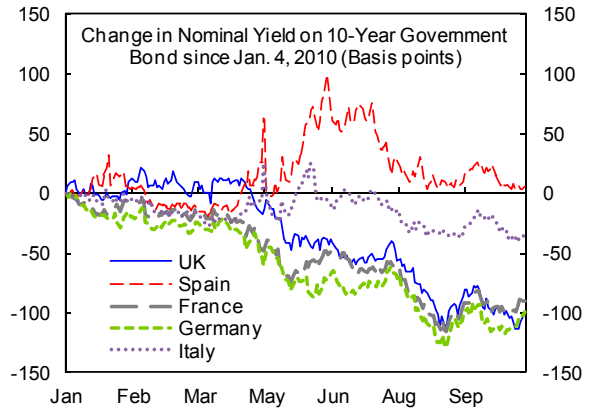


Figure 6. Fiscal Developments



Sources: HMT, DMO and IMF staff estimates.  
 1/ Negative of the change in cyclically adjusted balance.  
 2/ Change in cyclical balance.

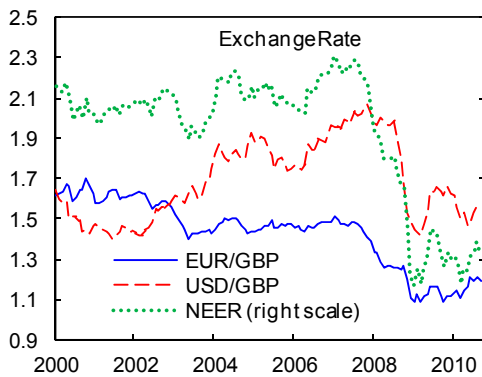
general government gross debt has risen above 70 percent of GDP and is set to reach 85 percent of GDP by 2012, about twice its pre-crisis level. In addition, the government faces large contingent liabilities from its various financial sector interventions, even though direct net costs are estimated to be small so far.<sup>2</sup> Importantly, funding conditions in the gilt market are currently quite favorable, reflecting in part investor confidence in consolidation plans (see Section IV).



Sources: Haver; and IMF staff calculations.

Indeed, UK sovereign bonds have enjoyed a safe-haven bonus in recent months, while market pressures in some Eurozone countries have intensified: the ten-year gilt yield was less than 3 percent in mid-October, more than 100 basis points below its mid-February peak.

**10. Despite significant sterling depreciation, net export volumes have yet to pick up significantly.** Sterling’s real effective exchange rate declined some 25 percent between mid-2007 and early 2009 and has since stabilized around this new level. Based on standard IMF methodologies, the currency appears to be broadly in line with fundamentals. However, the weaker exchange rate has not yet boosted net export volumes as much as expected. Instead, most of the depreciation has so far translated into stronger profit margins for exporters (Figure 7). Consequently, the current account deficit in 2010 is on track to be only slightly below the pre-crisis level of 2½ percent of GDP. Meanwhile, the depreciated exchange rate did improve the UK’s international investment position, as UK external assets have a greater foreign-currency component than external liabilities. However, the IIP has weakened somewhat in recent quarters on the back of higher asset valuations in the UK.



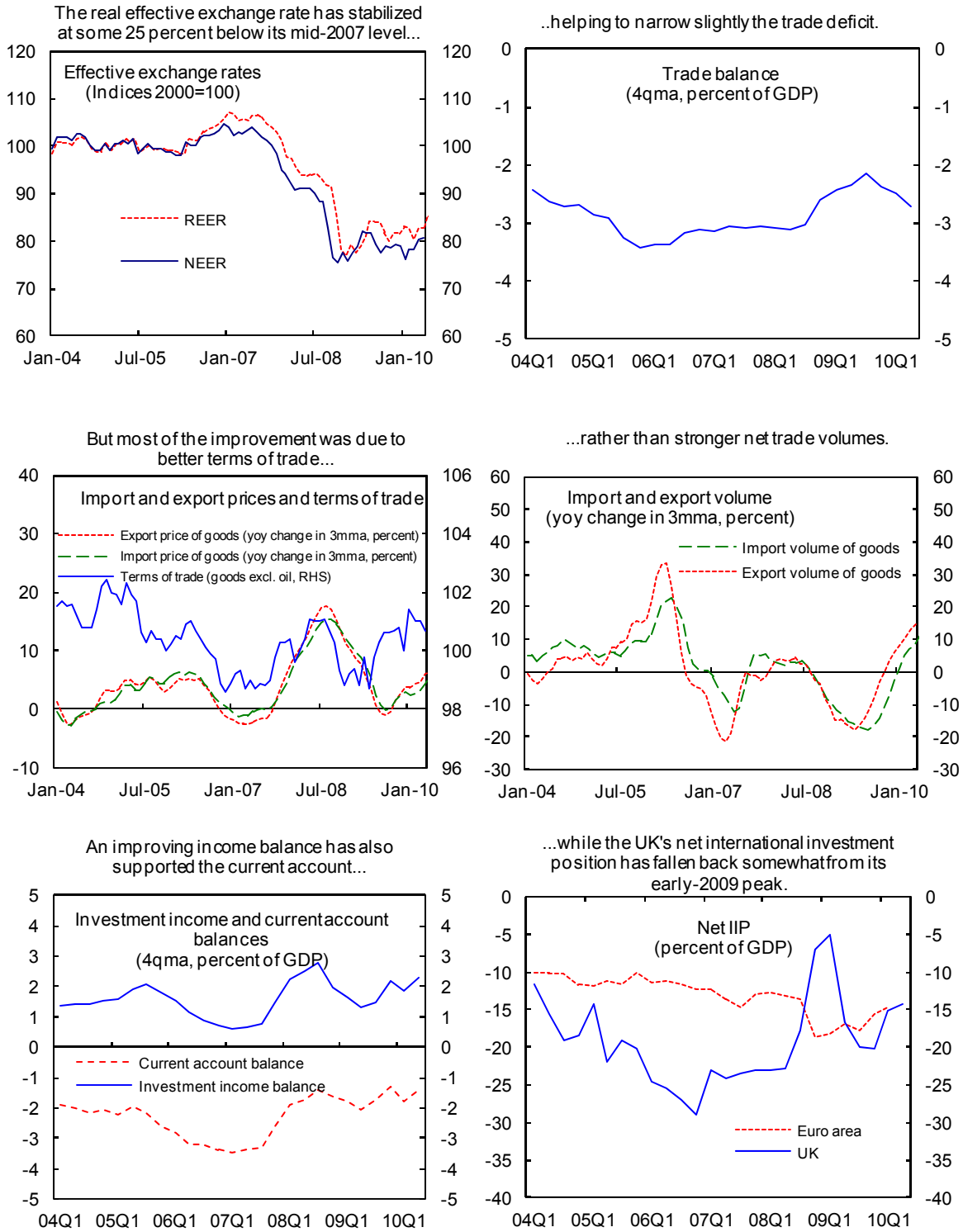
Source: Bank of England.

	Oct 2010	May 2010
Macro Balance	-4	-6
Equilibrium RER	-4	-13
External Sustainability	0	2
<b>Overall</b>	<b>about 0</b>	<b>0-15 below</b>

1/ +/- indicates exchange rate over/undervaluation; see IMF Occasional Paper No. 261 for details on the methodology underlying the estimates in this table.

<sup>2</sup> Public sector finance statistics are expected to be revised in late 2010 to incorporate the full impact of the October 2008 public sector classification of Lloyds Banking Group and Royal Bank of Scotland.

Figure 7. External Sector Developments

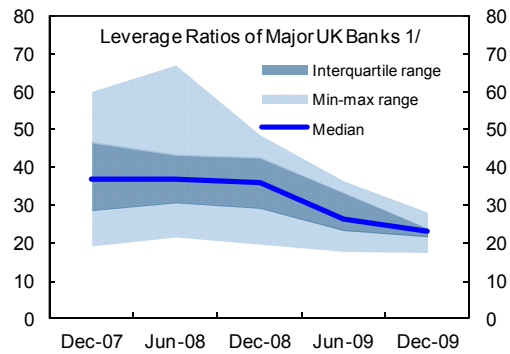


Sources: Haver Analytics; and IMF, *International Financial Statistics*.



## B. Deleveraging and Macro-Financial Links

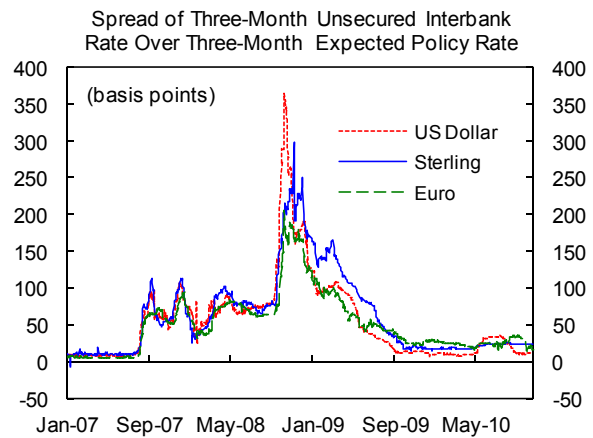
11. **UK Banks have made progress in repairing their balance sheets** (see Figure 8 and companion *Selected Issues* paper for additional details on recent developments). All major banks have raised capital and reduced leverage. Moderate impairment charges, wider lending margins, and higher investment banking revenue have boosted system-wide earnings over the last year, and the two large, part-nationalized banks have returned to profit. The July 2010 EU-wide stress tests and associated disclosure confirmed the improved health of UK banks.



Source: Bank of England.

1/ Adjusted assets over adjusted capital. Assets are adjusted by netting derivatives and adjusting for cash items, tax, and intangible assets. Capital excludes Tier 2 instruments, preference shares, hybrids and intangibles.

12. **Funding conditions have improved since the height of the crisis.** Stress in sterling money markets eased significantly throughout 2009, as banks benefited from improving confidence and massive liquidity support, including through the BoE's quantitative easing. As a result, the Libor-OIS spread fell back to almost pre-crisis levels. Longer-term funding markets also thawed, and banks issued considerable amounts of unsecured debt, gradually reducing their reliance on the government's Credit Guarantee Scheme.<sup>3</sup> Securitization markets have remained more challenging, but several successful transactions indicate the potential for debt instruments that meet investor expectations in terms of



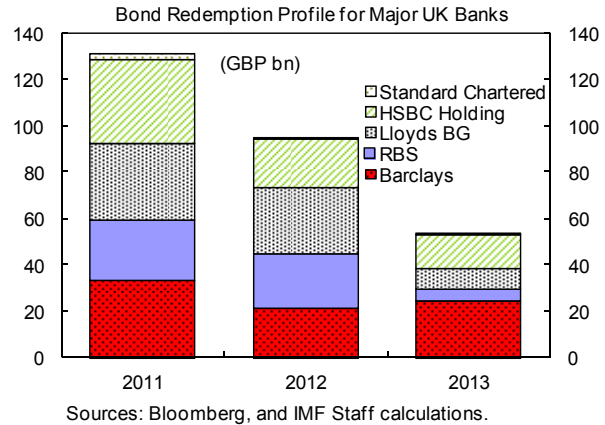
Sources: Bloomberg; and IMF staff calculations.

transparency and risk mitigation. Over the past year, banks have also increased the share of deposit funding. Their dependence on volatile short-term funding sources has simultaneously diminished somewhat.

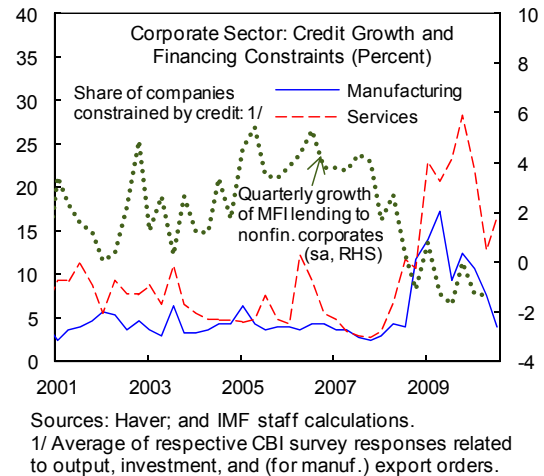
13. **Nonetheless, challenges remain.** UK banks will need to rollover or replace large amounts of wholesale funding coming due over the next few years, including funds received through government support schemes that are being phased out. At the same time, uncertainty about the sustainability of bank profits and the quality of bank assets remains significant. Notable risks include the commercial real estate portfolios of some banks. A

<sup>3</sup> For a description of this and other financial sector public support schemes, see <http://www.imf.org/external/pubs/ft/scr/2009/cr09212.pdf>.

large share of loans is due to be refinanced in the next few years, and default rates could increase. Another source of risks is consumer credit, which could cause higher losses if unemployment were to rise beyond current rates. Faced with such uncertainties and the prospect of tighter regulatory standards, banks have generally stayed cautious about extending new credit.



14. **Corporate credit standards have started easing, but banks' loan portfolio has continued to shrink** (Figure 9). Recent Credit Conditions Surveys indicate some increase in the availability of corporate credit, although lending standards still remain tighter than before the crisis. Moreover, there is a clear distinction by borrower size, with smaller companies continuing to face more restrictive credit supply. Trends in lending spreads confirm this divergence: loan rates for large borrowers have eased, while those for smaller borrowers have remained elevated. However, weak bank lending to corporates over the past year has reflected not only tight supply, but—perhaps more importantly—weak demand for investment finance. In addition, larger corporations have continued to raise net finance in capital markets, while reducing bank debt.



15. **Lending to households also remains weak.** Mortgage lending has continued to grow throughout the downturn, albeit at a very modest rate. According to market intelligence, the number of mortgage products has increased over the last year, with the notable exception of high loan-to-value mortgages, which remain scarce, as many specialist lenders have exited from the market. Effective interest rates have declined, although spreads over the risk-free rate are well above pre-crisis levels. The supply of unsecured household credit is also significantly more restrictive than before the crisis, and spreads over reference rates remain very high. These tight lending conditions, together with households' spending restraint and reduced credit-worthiness, have resulted in a gradual reduction of banks' consumer loan portfolios.

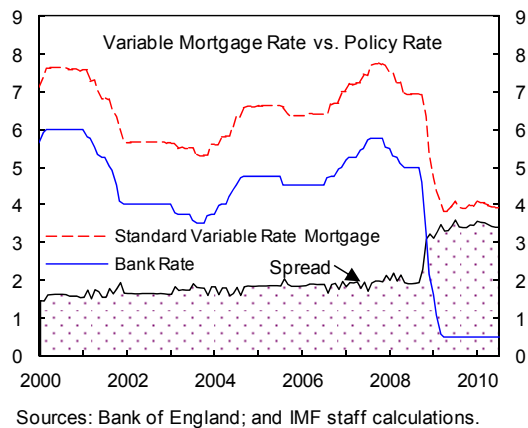
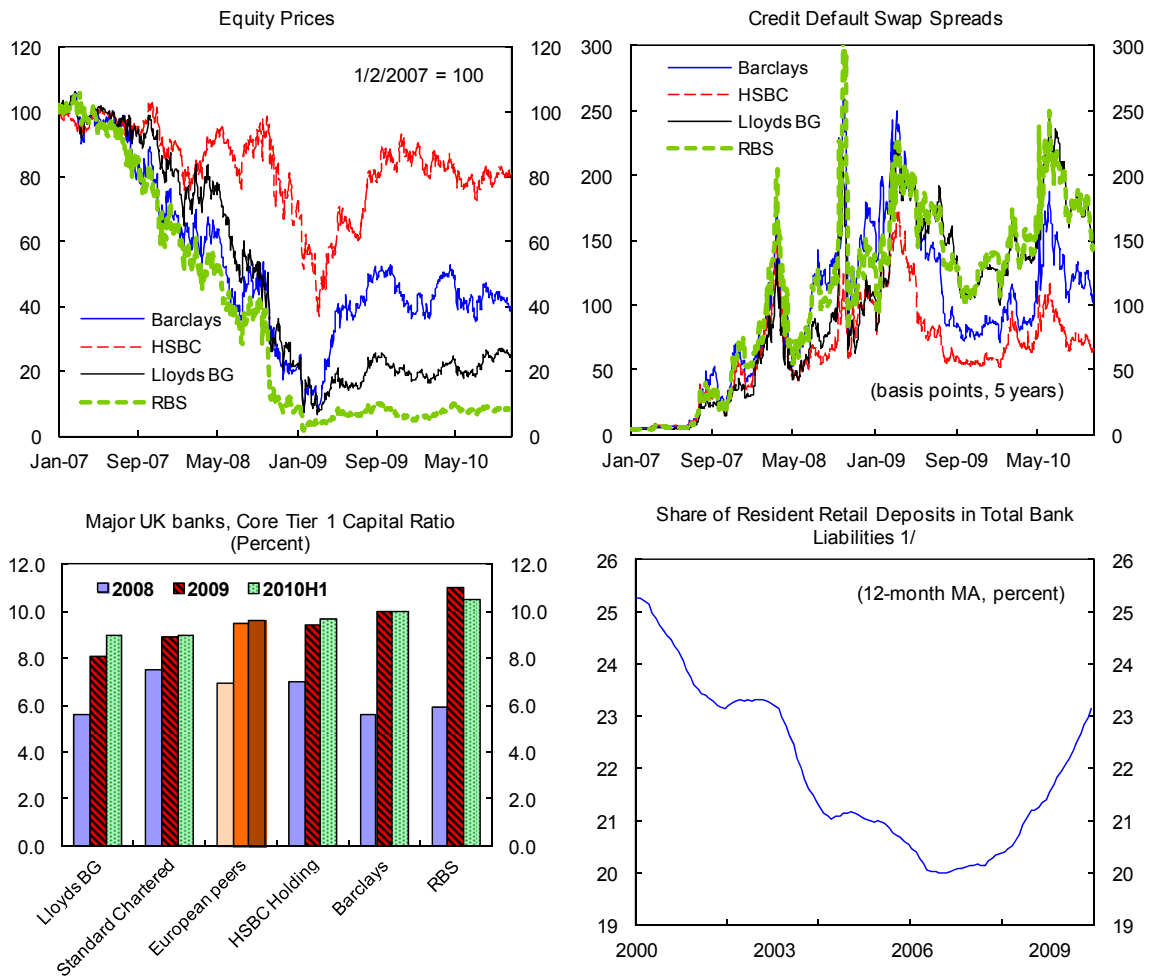


Figure 8. Banking Sector Indicators



Sources: Bank of England, Bloomberg; company data; and IMF staff calculations.

1/ Data series no longer available after Dec. 2009, but new series (covering all MFIs) suggests continuation of recent trend.

#### UK Banking System: Selected Financial Soundness Indicators 1/ (End-of-period, percent)

	2004	2005	2006	2007	2008	2009
Regulatory capital to risk-weighted assets	12.7	12.8	12.9	12.6	12.9	14.8
Regulatory capital to assets	7.0	6.1	6.1	5.5	4.4	5.4
Nonperforming loans to total loans	1.9	1.0	0.9	0.9	1.6	3.5
Provisions to nonperforming loans 2/	61.5	54.0	54.6	...	38.1	41.1
Return on assets 3/	0.7	0.8	0.5	0.4	-0.4	0.1
Return on equity 3/	10.9	11.8	8.9	6.2	-10.3	2.6

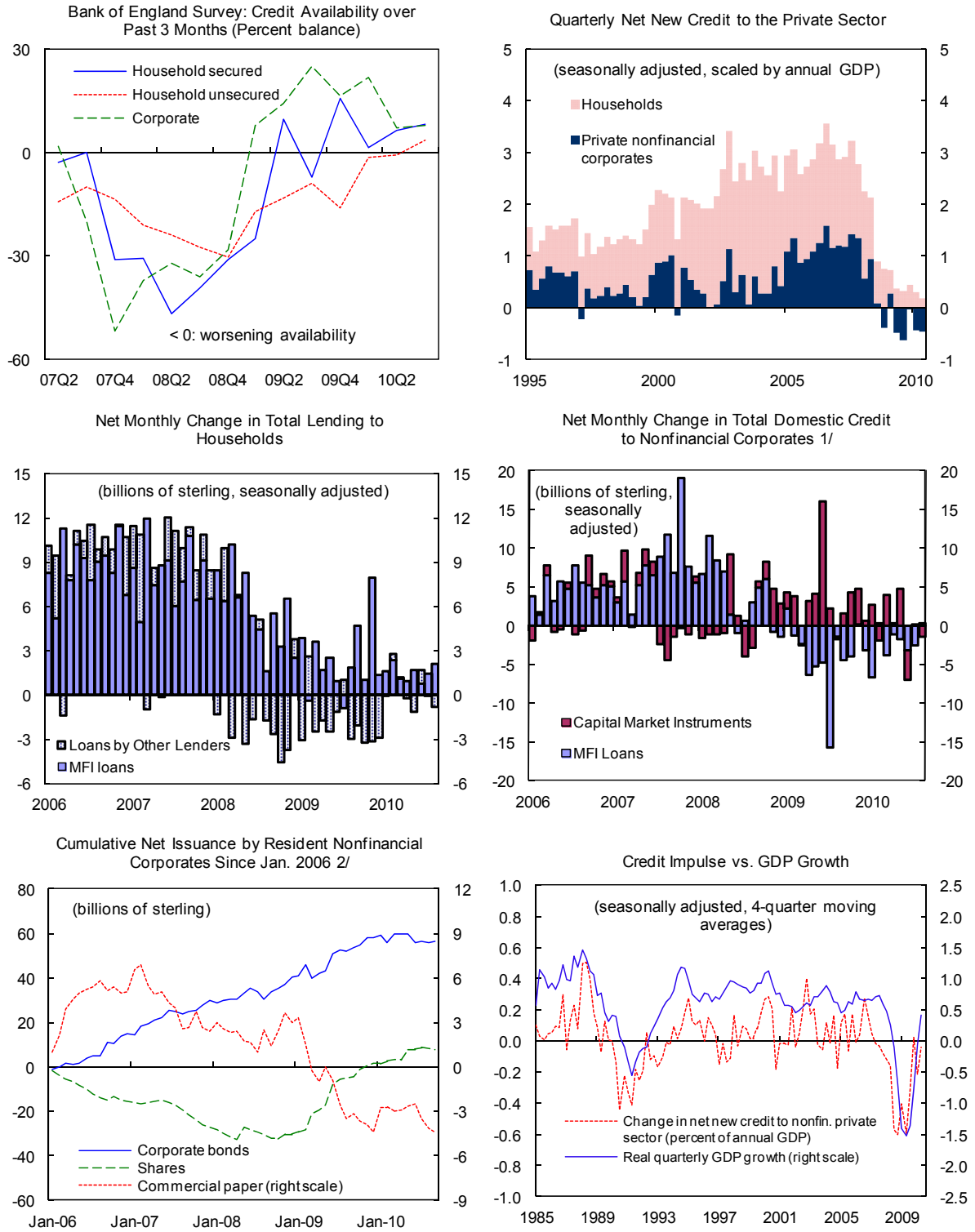
Source: UK authorities.

1/ Domestically controlled banks on a cross-border, cross-sector consolidation basis.

2/ Break in data series in 2006.

3/ Net income after extraordinary items and taxes (period average).

Figure 9. Credit Market Developments



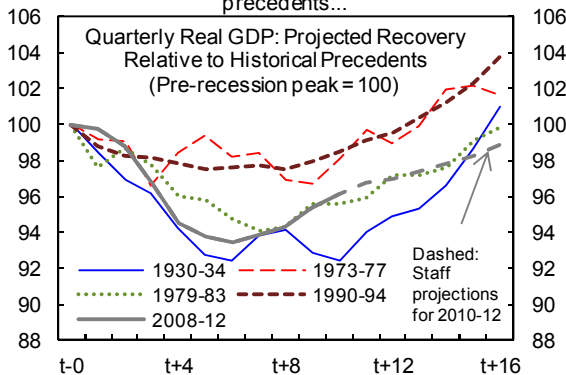
Sources: Bank of England; UK Statistics Authority; and IMF staff calculations.  
 1/ Includes domestic loans and capital issuance in foreign currency.  
 2/ All currencies.

### III. PROSPECTS, RISKS, AND SPILLOVERS

16. **The central scenario envisages economic recovery to continue at a moderate pace, as private and external demand progressively gather strength.** Recent short-term indicators point to solid activity in the third quarter, even though a repeat of the strong second-quarter performance is unlikely. Inventory dynamics and a pick-up in fixed business investment are expected to remain the near-term drivers of growth. Order receipts also foreshadow higher exports, although the overall growth contribution from net trade is likely to be modest. Meanwhile, private consumption and residential investment are likely to be dampened by low real income growth, looming tax hikes, and still-strained balance sheets, but should strengthen gradually as labor market conditions improve. In this scenario, the household saving rate is projected to stabilize below its recent peak, but remain above pre-crisis levels. Taken together, the progressive strengthening of private and external demand would underpin a moderate-paced recovery, even as the public sector retrenches. Annual growth is projected at 1.7 percent this year and 2 percent in 2011.

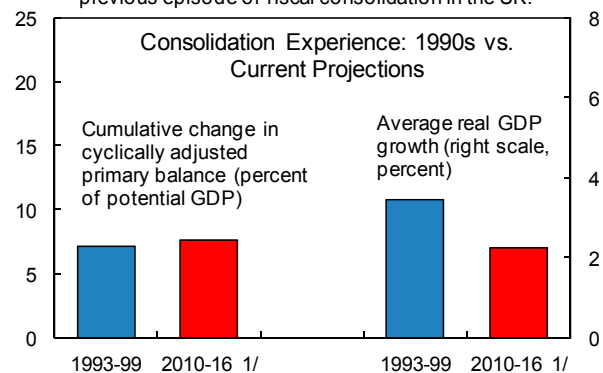
17. **Risks around this forecast are unusually large, though broadly balanced.** Staff's central projection reflects a range of factors, whose precise quantitative effects on growth are difficult to pin down. On the one hand, very low real interest rates, the past depreciation of sterling, and the ongoing recovery of global demand could give a greater boost to UK growth momentum. Indeed, the sharp drop in GDP during the crisis might suggest that the ensuing rebound should also be stronger than historical recoveries, not slightly weaker as projected by staff. On the other hand, the possibilities of further rapid deleveraging among households and banks, a sharp new downturn in the housing market, and greater-than-expected weakness in parts of the euro area constitute important downside risks to growth. Finally, the precise headwinds from fiscal consolidation are difficult to predict—they could turn out more powerful than expected or more modest as during the 1990s consolidation (see text chart). Overall, risks around the central forecast appear substantial, but broadly balanced. A particularly consequential, if unlikely, scenario would see major new shocks—arising from either external or domestic forces—derail confidence and thrust the

There are also upside risks to staff's growth forecasts, as the projected recovery would be slower than historical precedents...



Sources: Haver; NIESR; and IMF staff

...with much more moderate growth than during the previous episode of fiscal consolidation in the UK.



Sources: WEO; IMF staff calculations.  
1/ IMF staff projections.

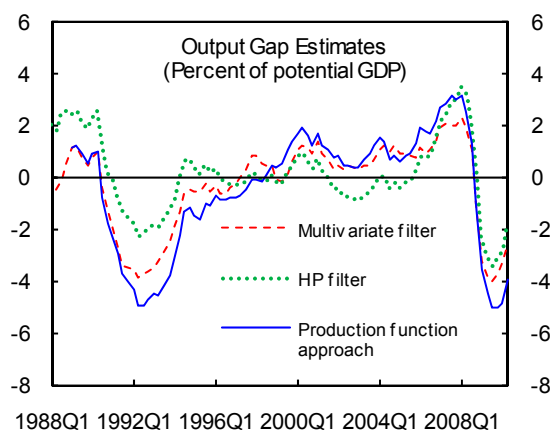
UK economy into another extended recession. In this case, companies might begin large lay-offs of staff they have retained so far, prompting a step increase in unemployment with highly adverse macro-financial feedback effects.

**18. A key underlying vulnerability relates to spillovers from external financial market shocks, given the global reach and connectedness of the UK financial sector.**

UK-owned banks have consolidated foreign assets exceeding 180 percent of GDP, despite some retrenchment over the last two years (Figure 10). Exposures are sizeable vis-à-vis the United States, where the commercial real estate sector remains an area of particular concern, and a number of advanced economies in Asia and Western Europe, including those EU members currently in the spotlight of financial markets. Specifically, claims on Greece, Ireland, Portugal, and Spain account for about 14 percent of GDP—a similar proportion as for French and German banks, although UK bank claims are more strongly concentrated on Ireland. Negative shocks in any of these markets could necessitate further write-downs and weaken UK banks' capacity to support the domestic economic recovery with adequate credit supply. Additional spillovers could arise from the important role that foreign banks play in the UK, mostly via London's wholesale financial services industry, but also in retail finance. Indeed, the tightening of credit supply since the beginning of the crisis partly owes to the sharp retrenchment of lending by some foreign banks. A simple VAR analysis confirms that global financial shocks have significant effects on the UK economy (Box 1).

**19. Looking further ahead, there are also key uncertainties about the UK's medium-term growth potential.**

In staff's assessment, the financial crisis has not only depressed aggregate demand, but also dented potential supply. As a result, spare capacity is far more limited than the drop in GDP would suggest, though probably still significant: using different empirical methodologies, staff estimates the current output gap on the order of 2-4 percent (see companion *Selected Issues* paper). Industry surveys, however, have started pointing to much-reduced slack *within firms*, notably in manufacturing (Figure 11). The significant uncertainty inherent in any estimates of current conditions extends to future potential growth. Overall, staff expects some lasting impact from the crisis, as potential growth is weighed down by higher risk premia, skill losses due to longer-term unemployment, and, perhaps, some permanent shift of demand away from sectors that enjoyed high productivity growth.



Sources: IMF staff estimates.

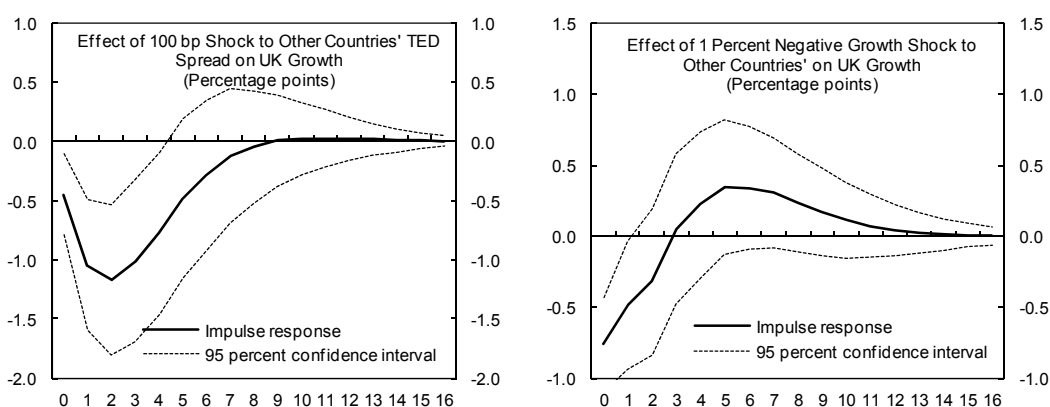


### Box 1. Inward Spillovers to the UK

**Like most other major European countries, the UK has important financial sector links to stressed markets, such as the euro area periphery** (Figure 10).<sup>4</sup> UK banks' consolidated claims on EA-4 countries (Greece, Ireland, Portugal, Spain) stand at about 14 percent of UK GDP. UK banks are also indirectly exposed to the EA-4, for example through claims on French and German banks (around 8 percent of GDP), which in turn have significant exposure to EA-4 countries. Separately, Ireland-owned banks operating in the UK account for 7 percent of domestic corporate loans and 3 percent of household loans. Further financial stress in the EA-4 countries could thus have noticeable effects on the UK economy.

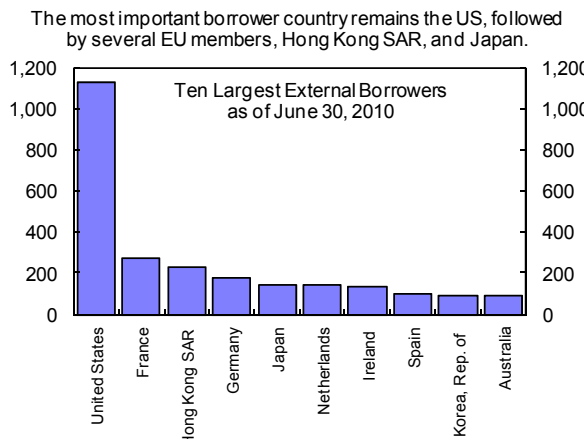
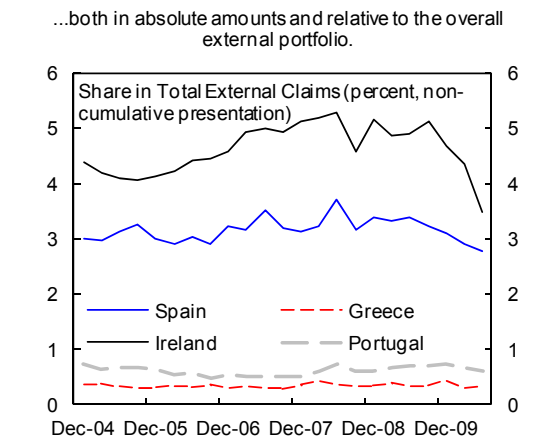
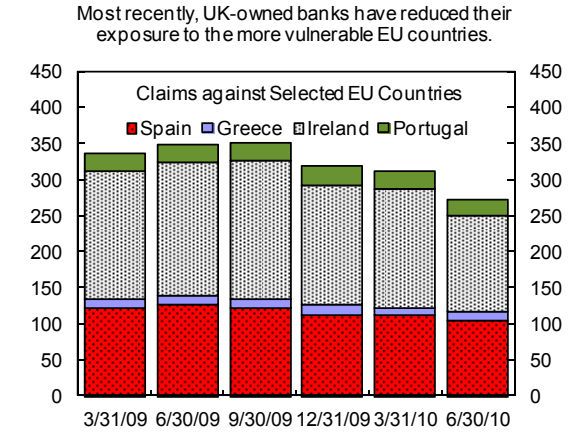
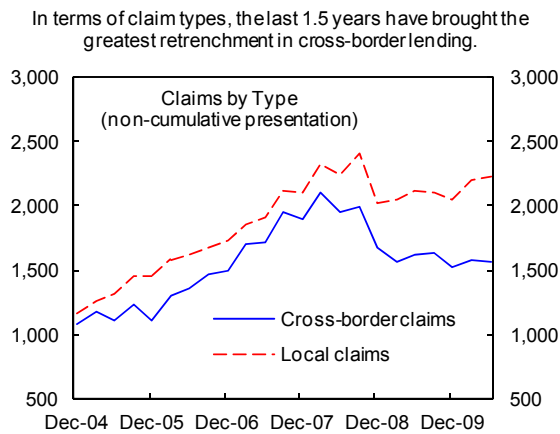
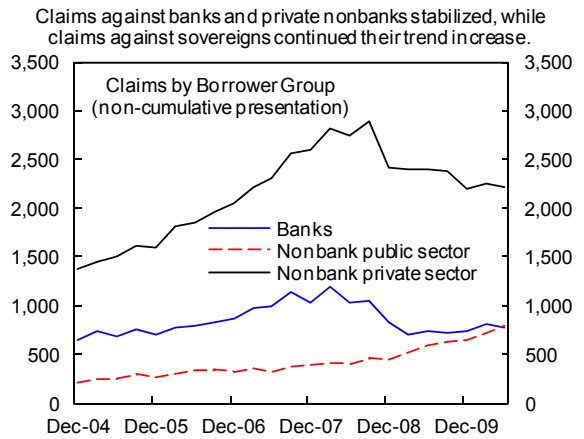
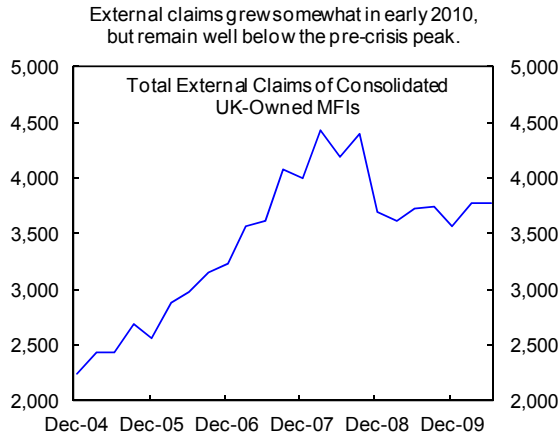
**The UK's position as a global financial center is another important international spillover channel.** A significant downturn in global financial markets—irrespective of the specific origin or trigger—could weaken UK banks' capital base through reduced revenue from trading and investment banking activities, mark-to-market losses on financial assets, and possibly higher funding costs.

**A structural VAR analysis points to large spillovers from shocks to global growth and financial market conditions to the UK economy.** The VAR model comprises the following variables: UK real GDP, a weighted average of real GDP for countries to which UK banks have large exposures, a weighted average of the TED spread for the same countries, and the TED spread for the UK. The following identifying assumptions are imposed: UK variables do not affect variables for other countries; variables for other countries have contemporaneous effects on UK variables; and, within each “block” (i.e., a block of UK variables or other countries' variables), real GDP has a contemporaneous effect on the TED spread, but not vice-versa. The analysis suggests that a structural shock that causes an average 100 basis-point increase in the foreign TED spread results in a 0.4 percentage point decline in the UK's real GDP growth on impact, with the effect widening to 1.2 percentage points over the following two quarters before tapering off. The estimated effect of a structural shock on other countries' GDP is also sizeable: a 1 percentage point decline in other countries' real GDP results in about a 0.8 percentage point decline in the UK's real GDP on impact, and the effect persists for several quarters. Although the model is somewhat mechanical and does not capture all variables and salient features of cross-border spillovers, the analysis suggests significant inward spillovers to the UK economy.



<sup>4</sup> See the BoE's June 2010 *Financial Stability Report* (<http://www.bankofengland.co.uk/publications/fsr/2010/fsrfull1006.pdf>) for a detailed discussion of external risks and spillovers.

Figure 10. External Claims of Consolidated UK-Owned MFIs 1/  
(Billions of US\$, unless indicated otherwise)

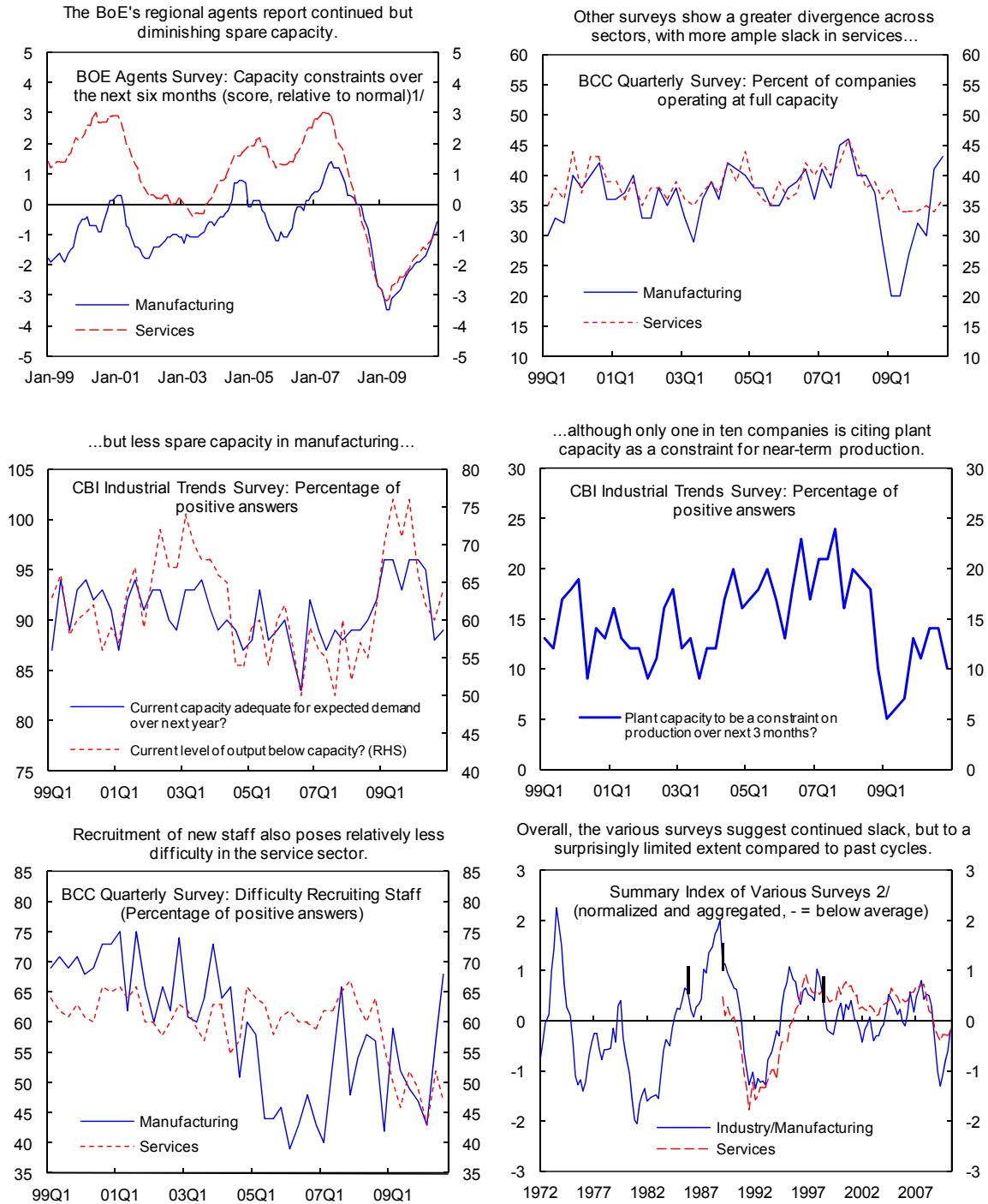


Source: Bank of England.

1/Ultimate risk basis.



Figure 11. Indicators of Capacity Utilization



Sources: Haver; and IMF staff calculations.

<sup>1/</sup> Before January 2005: based on companies' current situation, rather than being forward-looking.

<sup>2/</sup> Based on a range of survey indicators (provided by Bank of England, British Chambers of Commerce, Confederation of British Industry, and Eurostat, respectively) for capacity constraints and recruitment difficulties; normalized to average zero over the cycle, with unit standard deviation. Vertical bars in chart mark structural breaks in series due to inclusion of new indicators.

20. **Against this backdrop, growth is projected to rise gradually to 2½ percent in the medium term, only slowly closing the output gap.** This projection, and the risks around it, reflect many of the same factors that also impinge on the near-term outlook:

- In general, fiscal consolidation could over time have more favorable growth effects, notably if consolidation boosts national saving or if a shift in activity from the public to the private sector raises productivity. However, to the extent that fiscal retrenchment weakens aggregate demand over a period that is more extended than envisaged in the central scenario, the resulting resource slack could also lead to some further scrapping of idle capital and persistent unemployment, reducing both actual and potential output.
- The ultimate growth effect of a weaker exchange rate is equally uncertain. Staff expects domestic firms to gradually shift more production toward export and import-competing sectors in order to benefit from improved competitiveness. Yet, it is also possible that net exports prove to be relatively price-inelastic. In addition, global demand might have shifted away from some of the products and services in which the UK specializes. Compounding this uncertainty, there is a risk that sterling might rebound in the period ahead, as credible fiscal consolidation boosts confidence and strengthens the relative attractiveness of UK assets.
- Lastly, there is considerable uncertainty over the future supply and price of credit to businesses, given the extent of regulatory and financial pressures bearing on banks. Although weak net lending may not hurt the recovery at an early stage, financing constraints could become more onerous as demand picks up over the medium run.<sup>5</sup>

#### **Authorities' views**

21. **The authorities' envisaged somewhat higher growth than projected by staff.** There was essentially no difference in the outlook for 2010 (the OBR's lower growth forecast in the June budget was made before the strong Q2 outturn was released), but both the OBR and BoE projected somewhat stronger growth than staff in 2011 and the medium term (text chart and Table 2). The authorities' stronger growth projections are underpinned by:

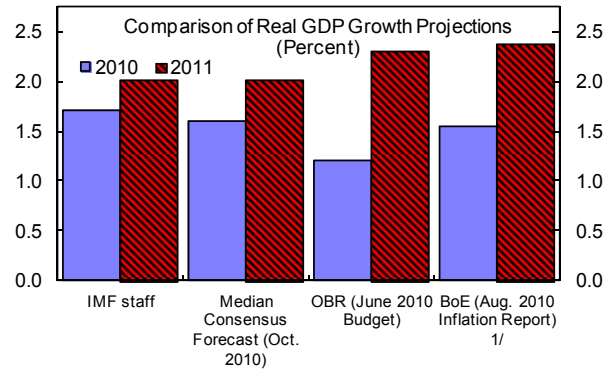
- a larger contribution from *net exports*, driven by a stronger supply-side response to past sterling depreciation; the authorities viewed the weak contribution from net exports so far as partly reflecting temporary factors, such as high imports due to car scrappage schemes and restocking; and

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<sup>5</sup> In a forthcoming IMF working paper on "Creditless Recoveries," Abiad et al. find that recoveries with low or no credit growth are common after recessions linked to a banking crisis. However, growth in such recoveries is on average much lower than growth in recoveries with "normal" credit growth.

- stronger fixed investment as corporates respond to a better demand outlook and planned reductions in the corporate tax rate.

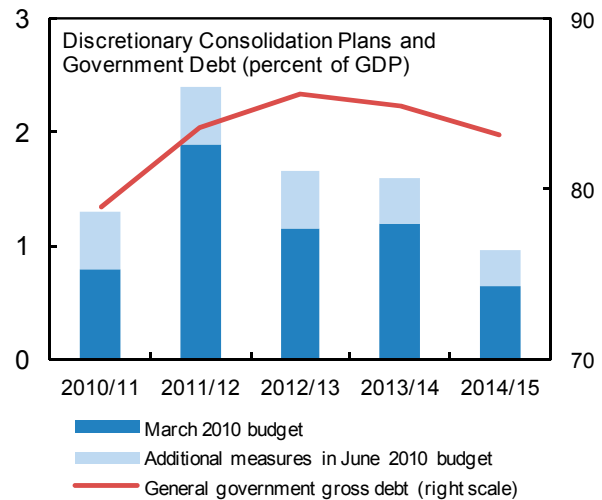
Nonetheless, the authorities acknowledged both upside and downside risks to their central scenario, reflecting similar factors and concerns noted above by staff. At the international level, the authorities stressed that the effectiveness of their policy efforts will be amplified if they are complemented by coordinated multilateral action to rebalance global demand toward more sustainable external positions across countries and to strengthen financial regulation.



Sources: as shown above.  
1/ Calendar-year growth rate computed as average of 4-quarter growth rates (mean forecast at market interest rates).

#### IV. ENSURING FISCAL SUSTAINABILITY

22. **The June budget sets out an ambitious and comprehensive medium-term fiscal consolidation plan.** The government has set itself a fiscal mandate to balance the cyclically-adjusted current budget by the end of a five-year rolling horizon—currently by 2015/16—and put the net debt-to-GDP ratio on a declining path by 2015/16. Announced policy plans have been drawn to meet these goals one year early, thus providing some margin. Correspondingly, the overall fiscal deficit is programmed to fall to 2 percent of GDP by 2014/15, from 11 percent of GDP in 2009/10. This represents an additional tightening of about 2 percentage points relative to the previous government’s plans, bringing the total planned structural adjustment to 8 percent of GDP in the five years to 2014/15. The projected adjustment is relatively frontloaded, with discretionary tightening of 1¼ percentage points in 2010/11 and 2½ percentage points in 2011/12.



Source: HM Treasury.

23. **Although this consolidation effort involves painful decisions and dampens short-run growth, it is necessary to enhance credibility and ensure fiscal sustainability.** The government has rightly emphasized the priority of ensuring debt sustainability to avoid the tail risk of a very costly loss of confidence in the sovereign and to regain fiscal space to cope with future adverse shocks and demographic-related spending pressures (Box 2). Under the announced policy plans, it should be feasible to lower the debt-to-GDP ratio to 60 percent by

### Box 2. To Tighten, or Not to Tighten—UK Fiscal Policy in the Public Debate

**Despite consensus on the need for medium-term fiscal consolidation, a debate has emerged over the appropriate timing of UK budget cuts.** Pre-election policy proposals by all major parties agreed on the priority of deficit reduction. Indeed, the March 2010 budget of the previous government and the June 2010 budget of the new coalition both feature significant fiscal tightening from 2010 onward—differences in the envisaged fiscal effort do not exceed ½ percent of GDP in any year. Nonetheless, the right timing of consolidation has become the subject of a controversial debate, reflecting different views about the economic outlook and key risks.

**Critics of immediate fiscal tightening have stressed the risk of choking off a still-fragile recovery.** The main arguments are as follows:<sup>6</sup>

- There is no guarantee that other sectors will continue expanding while the government retrenches. Additional monetary stimulus may not be powerful enough to offset this risk.
- Beyond the adverse effect on demand, excessive tightening may even destroy supply capacity. In this view, a bleak assessment of the UK's structural deficit could be self-fulfilling: because policymakers assume a large permanent drop in potential output, they tighten policies too early; this causes capital scrapping and human capital losses that a faster recovery would help prevent.
- The need to placate bond markets is overstated. Long-term UK interest rates show no sign of market panic, and commitments to future fiscal consolidation are more important than immediate cuts. In this context, tying consolidation plans to the political cycle imposes unnecessary pain: "A parliamentary term is a political reality, not an economic one."

**Many of these points have merit, but there are strong counterarguments as well:**

- Although fiscal tightening has already started, there are signs of economic recovery led by the private sector. Indeed, the consensus forecast is for solid growth next year, partly reflecting natural cyclical momentum. Moreover, the combination with very loose monetary policy should support the necessary rebalancing of demand, including through higher net exports.
- Spare capacity is notoriously difficult to assess in real time, but the available evidence points to an output gap not far from the estimate underlying the June budget. And while there is a risk to underestimating potential, there is also the opposite risk—of belatedly discovering higher-than-expected structural deficits and greater inflationary pressure. Furthermore, experience from historical financial crises consistently points to a lasting and large drop in potential GDP. Is this time really different?
- A glance at current bond yields does not do justice to the risk of a sovereign funding crisis—a low-probability, but very-high-impact scenario for the UK. To begin with, gilt yields have been depressed by large-scale BoE purchases (see Box 3). More importantly, market assessments can change quickly, as witnessed by the surge in borrowing costs in some Eurozone countries. Indeed, UK spreads also rose in the first few months of this year, but started moving the other way in May/June, not least in response to the budget announcements (chart, p. 32).
- In this context, the critics downplay the importance of political credibility: promises of future consolidation alone are unlikely to be persuasive, especially once they reach beyond the current term of parliament. The novelty of a coalition government may further heighten this concern.

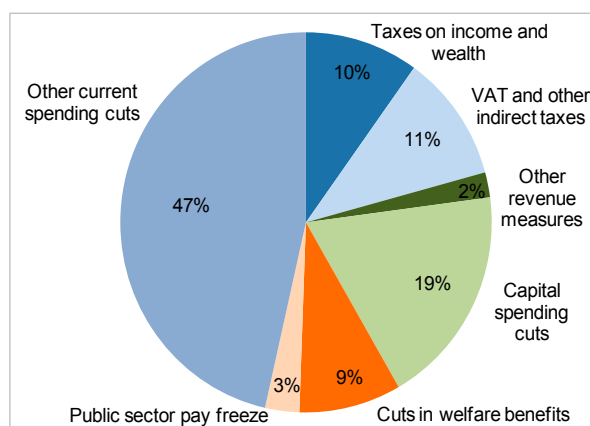
After weighing these different arguments and assessing the outlook and risks, staff's view is that a significant fiscal tightening with frontloading in 2011/12 is appropriate to secure confidence in the UK's debt sustainability. However, the uncertainty surrounding the current cyclical outlook puts a premium on contingency planning. Thus, the authorities need to be prepared to tackle surprises on either side of their central forecast.

<sup>6</sup> See, for example, a series of columns in the *Financial Times*: "The risk of Osborne's pre-emptive strike," June 24, 2010; "Why the Balls critique is correct," September 2, 2010; or "The IMF's foolish praise for austerity," September 30, 2010.

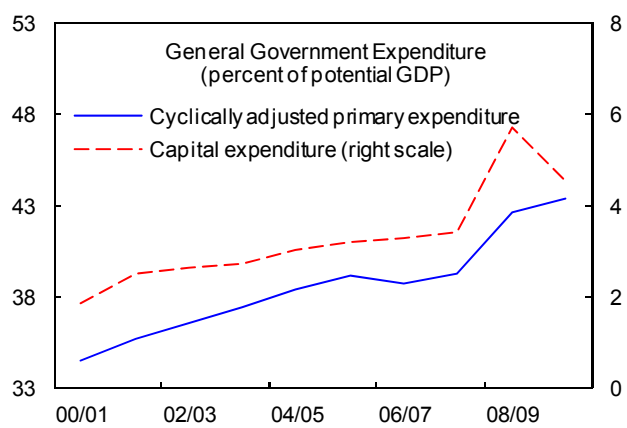
2025, whereas returning to pre-crisis debt levels (40 percent of GDP) would require additional fiscal effort after 2015 (see the debt sustainability analysis in Annex A for a discussion of the required fiscal adjustment to lower the debt-to-GDP ratio). As such, the consolidation plan should help meet the government's central objectives of preserving confidence in the UK's public finances and promoting a gradual rebalancing of the economy away from excessive public deficits toward private sector-led growth. In this context, the decision to frontload the adjustment has helped further dispel market concerns, especially against the backdrop of heightened fiscal stress in parts of the euro area. Decisive policy implementation will contribute to keep a favorable financing environment with low risk premia and might help to mitigate the effects of fiscal tightening on growth.

24. **The budget contains an appropriate mix of concrete spending and revenue measures, lending credibility to the government's consolidation plan.** Although the brunt of the adjustment comes from reductions in public expenditure, the budget also programs several tax measures, including a rise in the standard VAT rate from 17½ percent to 20 percent from January 2011, a hike in capital gains tax from 18 percent to 28 percent, and a small bank levy on selected wholesale liabilities. Corporate income tax, by contrast, will be lowered gradually to support growth during the adjustment period, and the personal income tax allowance will be raised. Expenditure measures, in turn, include a two-year pay freeze for most public sector employees and reductions in social benefits. Overall, the new budget identifies about half of the required discretionary spending cuts. Further details on spending plans by government function will be provided in the October 2010 Spending Review (a supplement to this staff report will provide information on the outcome of this review). The focus on spending measures is appropriate in light of the significant run-up in spending over the last decade and international experience showing that expenditure-based consolidations lead to longer-lasting budgetary improvements (see companion *Selected Issues* paper).

Discretionary Consolidation between 2009/10 and 2014/15  
(Total announced: £128 billion)



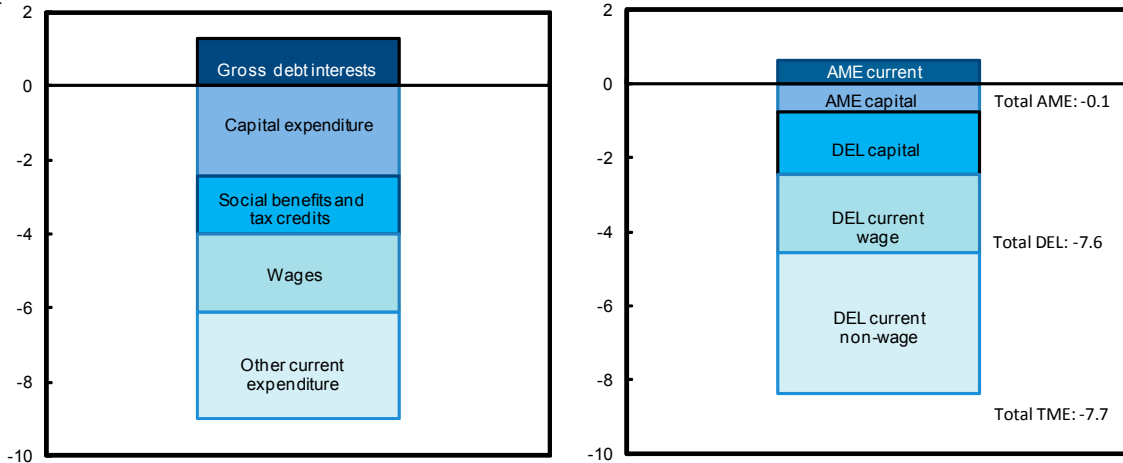
Sources: HM Treasury, and staff estimates.



Source: IMF staff estimates.

25. **The October Spending Review provides an opportunity to strengthen the composition of adjustment.** Total managed expenditure (TME) is set to decline by 7.7 percentage points of GDP over the next six years to 2015/16. Despite announced reductions in social benefits, annual managed expenditure (AME; the nondiscretionary component of spending) will contribute just 0.1 percentage points to the adjustment, as debt interest payments are projected to rise. The bulk of the adjustment falls, therefore, on departmental expenditure limits (DEL; the discretionary component). All government functions, except for health and foreign aid, are projected to face real cuts of 25 percent on average over the next four years. Public investment would be especially affected, falling by one-third in real terms. Implementation of such cuts could prove challenging. Against this background, staff recommends putting greater emphasis on reducing public sector compensation premia and achieving savings in benefits and transfers through better targeting.<sup>7</sup> This would help avoid an excessive squeeze on investment and other non-protected government functions, help mitigate the growth effects of adjustment (because reducing transfers to the less needy may have a smaller effect on consumption), and help shield the vulnerable.

Contribution to the Change in Total Managed Expenditures, 2009/10 - 2015/16  
(in percent of GDP)



Source: Treasury and staff estimates.

Source: Treasury and staff estimates. AME current includes gross interest payments, social benefits and tax credits.

26. **The authorities' fiscal consolidation strategy may be tested in the event risks to growth materialize.** Under staff's central scenario, fiscal tightening is expected to dampen growth, though without stopping the ongoing recovery. This view is consistent with the OBR's assumption of positive, but moderate, fiscal multipliers and the frontloading of

<sup>7</sup> The Institute for Fiscal Studies (IFS) estimates that the average premium of public sector wages over private sector wages is around 5 percent. However, this estimate excludes the effect of relatively more generous pensions in the public sector, which the IFS estimates could add 12 percent to the wage premia, and other nonwage benefits. The premium varies significantly across different regions and skill levels.

measures with the smallest multipliers (e.g., VAT hike). However, consolidation plans could be tested if risks to growth materialize on either the downside (raising calls for stimulus) or the upside (increasing cyclical revenue and reducing the perceived need for structural adjustment). In either case, spending cuts should generally proceed on schedule to maintain the consolidation effort's credibility and avoid inserting undesirable volatility into multi-year expenditure plans. Automatic stabilizers should be allowed to operate freely in both directions to preserve the targeted structural adjustment and help stabilize the economy—supporting growth if downside risks materialize and supporting disinflation if upside risks materialize. In the unexpected but possible case of a significant and prolonged downturn, alongside further support from monetary policy, temporary tax cuts should also be considered. Such tax cuts are faster to implement and more credibly temporary than expenditure shifts and should be targeted to low-income households, employment creation, or investment to increase their multipliers. Simultaneous adoption of entitlement reforms (see below) would be desirable to safeguard fiscal sustainability and market credibility.

#### OBR Assumptions on Fiscal Multipliers

Measure	Impact multiplier
Change in...	
VAT rate	0.35
Income tax	0.3
Welfare benefits	0.6
Public consumption	0.6
Public investment	1

Source: OBR.

#### Public Sector Finances (percent of GDP) 1/

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
	<b>June 2010 Budget</b>						
Overall balance	-11.0	-10.1	-7.5	-5.5	-3.5	-2.1	-1.1
Cyclically adjusted overall balance	-8.7	-7.4	-5.0	-3.4	-1.8	-0.8	-0.3
Current balance	-7.5	-7.5	-5.8	-4.1	-2.4	-1.0	0.1
Cyclically adjusted current balance	-5.3	-4.8	-3.3	-2.0	-0.7	0.3	0.8
Fiscal stance 2/	2.4	-1.3	-2.4	-1.7	-1.6	-1.0	-0.6
<i>of which: new policy measures</i>	...	-0.5	-0.5	-0.5	-0.4	-0.3	...
General government gross debt	71.2	78.9	83.6	85.5	84.9	83.1	80.4
	<b>Staff projections</b>						
Overall balance	-10.4	-9.9	-7.2	-5.5	-3.6	-2.3	-1.2
Cyclically adjusted overall balance	-8.1	-7.7	-5.5	-4.0	-2.4	-1.4	-0.7
General government gross debt	71.6	78.5	82.8	84.8	84.6	82.9	80.2

Sources: Office for National Statistics, HM Treasury, and staff estimates.

1/ Fiscal year starts in April and ends in March.

2/ Negative of the change in cyclically adjusted balance.

#### 27. Entitlement reforms to address long-term fiscal challenges should be pursued.

Although the UK's demographic outlook compares favorably with that of other advanced economies, staff estimates that age-related spending will increase by about 4 percentage points of GDP over the next 20 years under current policies. More than three quarters of this increase is due to higher health and long-term care spending, which highlights the importance of healthcare cost containment and efficiency reforms. On pensions, measures to reduce costs

include accelerating the planned increases in the statutory retirement age for state pensions and gradually aligning the generosity of public pensions with their counterparts in the private sector.<sup>8</sup> These reforms would have at most a minor immediate impact on aggregate demand, but would have long-term effects on fiscal sustainability, thus bolstering the credibility gains of the government's adjustment package. The initiatives launched by the government to review reform options for state and public sector pensions are therefore welcome.

28. **The establishment of a new independent Office for Budget Responsibility is a welcome step toward strengthening the budget process.** Tasks envisaged for the OBR include to provide the macroeconomic and fiscal forecasts for the budget and to assess fiscal sustainability and compliance with the fiscal mandate. The June budget was, for the first time, based on such independent forecasts issued by the interim OBR. The new office should help enhance the transparency and credibility of the budget process and better inform policy decisions (though unbiased forecasts do not by themselves ensure fiscal discipline). As the role and remit of the permanent OBR are finalized, it will be important to incorporate lessons from international best practice. Specifically, the OBR must be fully independent and perceived to be so. To this end, it will be important to ensure an arms-length relationship with Treasury, full-access rights to pertinent information, multi-year budgets, adequate staffing, and a sufficiently broad remit to allow the OBR to achieve its objectives.

29. **The UK's fiscal institutions would further benefit from the eventual adoption of a new rule-based framework.** Although the current fiscal mandate is appropriate to guide the consolidation process, in due course it should be replaced with more permanent fiscal rules. The credibility of a fiscal rule would be supported by input from the OBR. Fiscal rules, such as a structural balance rule or a rule that responds to deviations in output growth relative to trend growth, rather than changes in the output gap, could work well in the UK (see companion *Selected Issues* paper). Notably, such rules would anchor medium-term debt sustainability, provide clear operational guidance for fiscal policy, ensure transparency and ease of monitoring, and promote countercyclical policies.

### **Authorities' views**

30. **The authorities stressed that frontloaded adjustment was necessary to bolster credibility.** With sovereign solvency concerns mounting in many parts of Europe and gilt spreads over German bunds rising in the first half of 2010, the authorities viewed frontloading as imperative to demonstrate strong commitment to fiscal consolidation and differentiate the UK from other fiscally troubled countries. Because spending is difficult to turn around quickly, the frontloading requires some near-term tax increases, though the bulk

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<sup>8</sup> Under current law, the retirement age for state pensions, currently 60 for women and 65 for men, will be gradually equalized at 65 for those retiring in 2020. The retirement age will increase further to 66 between 2024 and 2028, to 67 between 2034 and 2036, and to 68 between 2044 and 46.



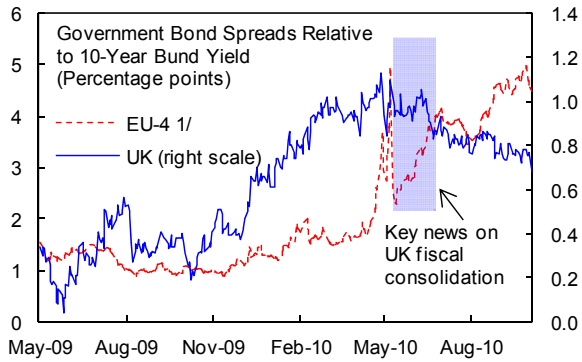
of the multi-year consolidation comes from spending cuts, in line with international evidence on successful consolidations. The authorities acknowledged risks to their baseline scenario and agreed with staff that automatic stabilizers provide an important safeguard against shocks. On strengthening the quality of adjustment and entitlement reform, the authorities saw merit in many of staff's

recommendations and noted that decisions in these areas would be made in the upcoming spending and pension reviews. On fiscal institutions, the authorities emphasized the importance of the new OBR as a critical improvement aimed at addressing deficiencies in the previous fiscal framework. The authorities also agreed that the current fiscal mandate is designed to address the exceptional fiscal challenge and have set out their intention to tighten the mandate (by shortening its horizon) once public finances are closer to balance.

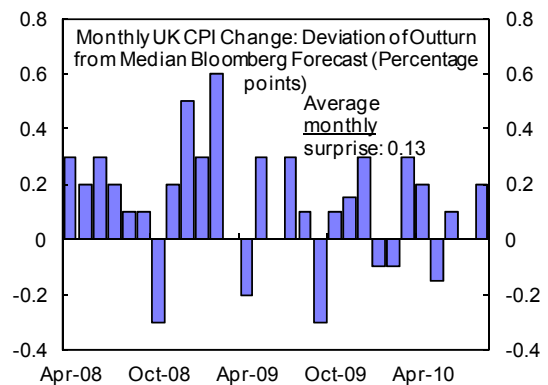
## V. MAINTAINING MONETARY STIMULUS

31. **Unprecedented monetary easing has helped restore confidence and bolster the recovery.** With fiscal policy constrained by the need to ensure sustainability, policy rates at the lower bound, and their effect tempered by high bank lending spreads, the BoE has provided significant additional stimulus through large-scale asset purchases. In total, the central bank bought nearly £200 billion in medium- and longer-term gilts between March 2009 and January 2010, along with small amounts of commercial paper and corporate bonds. Although the precise impact on aggregate demand remains hard to quantify, there is clear evidence that quantitative easing has depressed bond yields and boosted asset prices, thereby shoring up market confidence, household net wealth, and corporate credit supply (see Box 3). Meanwhile, the prudent setup of the Asset Purchase Facility—with full ex-ante indemnity from the Treasury—has preserved trust in the BoE's operational independence.

32. **Yet, inflation over the last year has continued to surprise on the upside** (Figure 12). From a trough at just above 1 percent in September 2009, CPI inflation rose to 3½ percent by early 2010 and has remained elevated since. Much of the rise in the CPI can be attributed to the rebound of commodity prices and the January 2010 hike in the VAT rate. However, the continued overshooting relative to earlier inflation forecasts points



Sources: Haver; and IMF staff calculations.  
1/EU-4: Greece, Ireland, Portugal, and Spain (simple average).

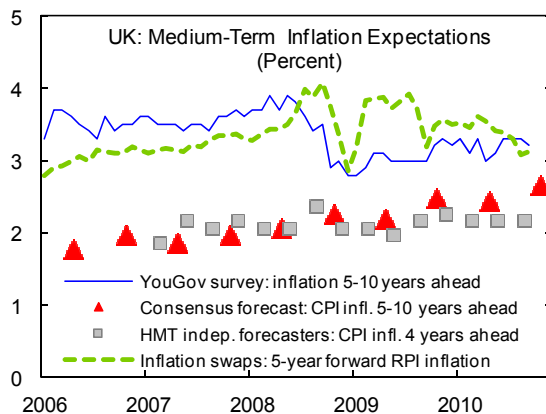


Sources: Bloomberg; and IMF staff calculations.

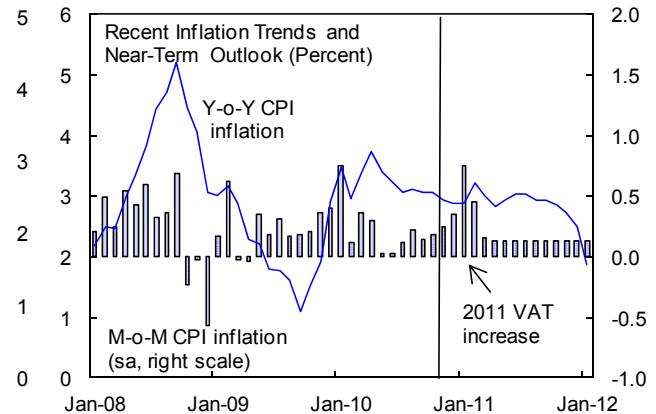
to additional price pressures that have set the UK apart from its advanced country peers:

- A leading explanation is greater-than-expected pass-through from past sterling depreciation (see Box 4). Indeed, allowing for pass-through on the order of 0.15-0.2 explains most of the cross-country dispersion in inflation outcomes over the last three years. More disaggregated CPI data support this argument, as much of the inflation dynamics since mid-2007 reflect a striking surge in goods prices, which have a comparatively large import component.
- A complementary explanation relates to the effect of spare capacity on inflation. Although most indicators, notably unemployment and wage growth, point to continued slack in the economy, corporate profit margins have proven atypically resilient during the latest downturn—and not only among exporters, who have benefited from the weaker currency. To some extent this suggests more limited spare capacity than previously thought. Yet, firms’ unusual pricing behavior might also reflect the particular influence of tight credit. Indeed, surveys show that many firms have sought to avoid price cuts in order to preserve cash flow, implying a relatively low short-term elasticity of demand. This particular influence is likely to wane as credit concerns ease and competition for market share revives.

Arguably as a result of the recent above-target outturns, short-term inflation expectations have edged up, whereas medium-term inflation expectations generally appear to remain well-anchored.

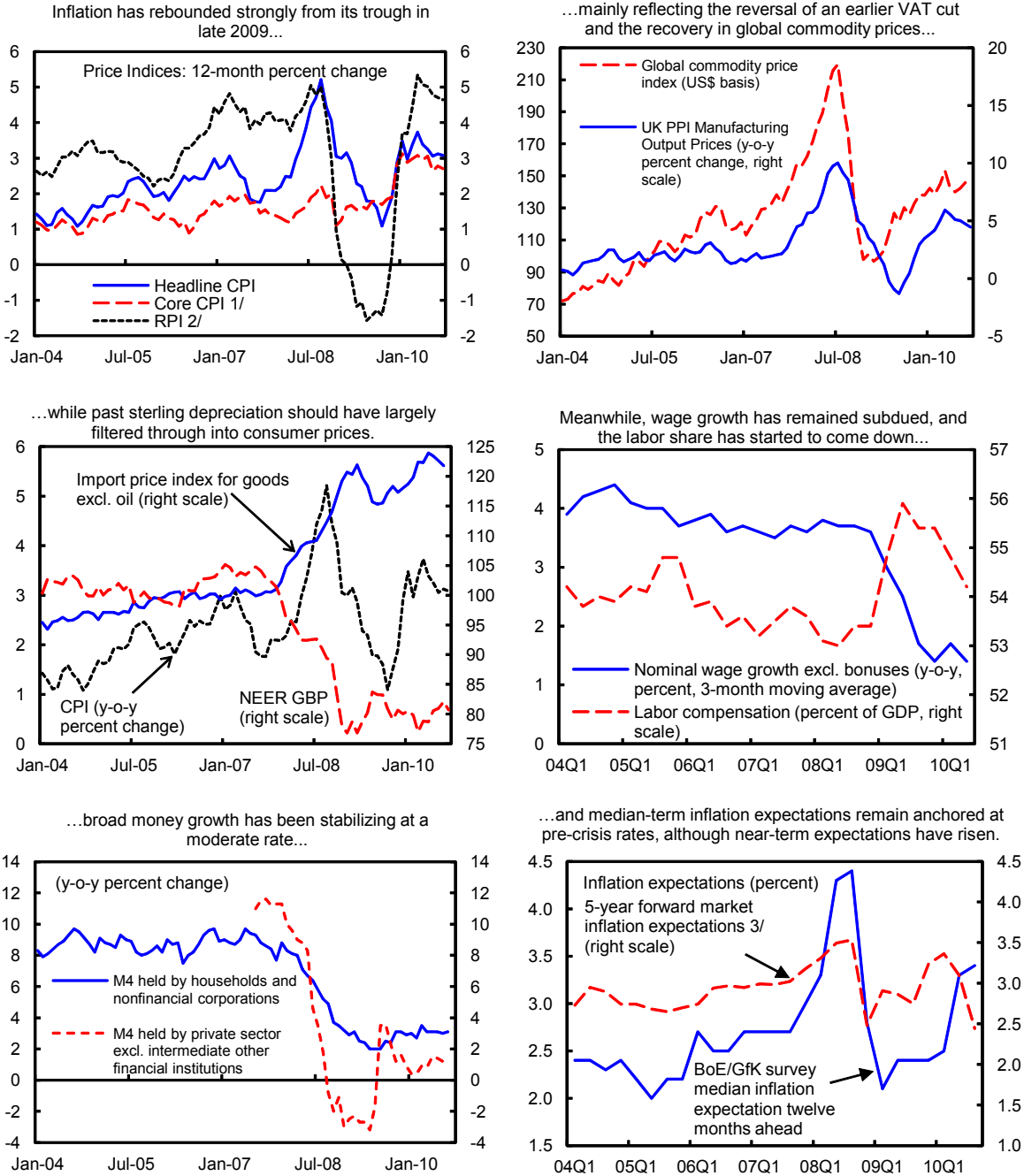


Sources: YouGov; Consensus Economics; HM Treasury; Bloomberg; and IMF staff calculations.



Sources: Haver; and IMF staff projections.

Figure 12. Price Developments

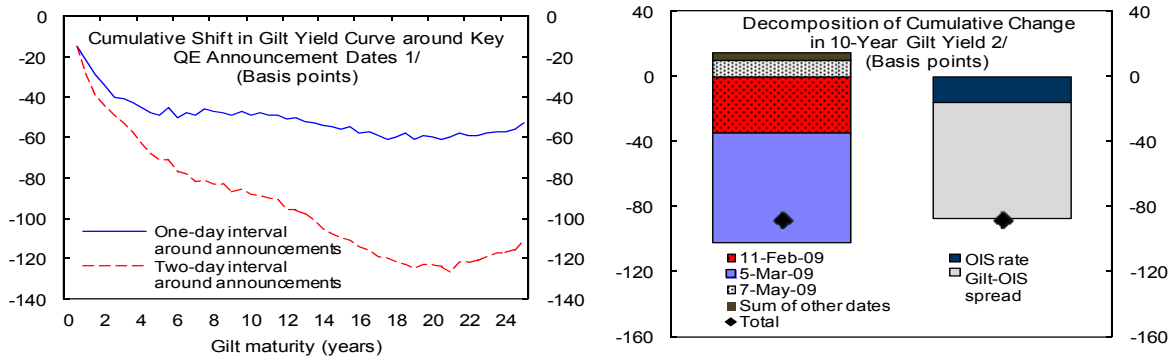


Sources: Bank of England; UK Statistical Office; and IMF, Commodities Database.  
 1/ Core CPI excludes energy, food, alcohol, and tobacco.  
 2/ Retail Price Index; contains cost of housing.  
 3/ Computed as quarterly average of difference between nominal and real (RPI-linked) forward gilt yields. Estimates likely to be biased upward by the presence of an inflation risk premium, and downward by the liquidity risk premium on real gilts.

### Box 3. Effectiveness of the Bank of England's Quantitative Easing

Between March 2009 and January 2010, the BoE bought nearly £200 bn in medium- to long-term gilts, financed by issuing reserve money. These purchases amount to 14 percent of UK GDP, 25 percent of outstanding gilts, and 40 percent of gilts in the relevant market segment (at end-2009).

**Event-study analysis suggests that the purchases have depressed yields by up to 125 basis points.** Judging from a two-day event window around key announcement dates, the gilt yield curve has shifted downward by between 20 and 125 basis points, with the largest drop for long maturities. Using a one-day window, the effects are only half as large, but still significant.<sup>9</sup> The strongest yield response is found for March 5, 2009, when the first set of purchases was announced. Moreover, most of the decline in yields appears to reflect portfolio balance effects caused by a lower net supply of gilts. OIS rates, which would capture market expectations about future interest rate policy, fell by a small amount only.

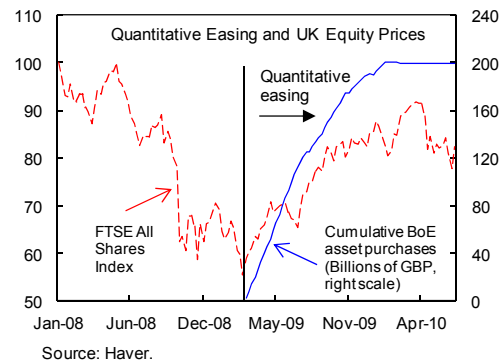


Sources: Bank of England; and IMF staff calculations.

1/ Based on one- or two-day event windows around six key announcement dates, i.e., Feb. 11, 2009; March 5, 2009; May 7, 2009; Aug. 6, 2009; Nov. 5, 2009; and Feb. 4, 2010.

2/ Based on two-day event windows around key dates.

**Lower long-term interest rates have supported the broader recovery in financial markets since March 2009.** A clear-cut causal link from QE to the drawn-out recoveries in equity, corporate bond, and other financial markets is impossible to establish, given the many other influences at work. Yet, it is striking that the launch of QE in the UK—along with similar announcements in the US—coincided with the turn-around in UK and global equities. A positive spill-over from lower long-term yields is also consistent with evidence on the effectiveness of the Fed's asset purchases; see [FRBNY Staff Report No. 441](#).



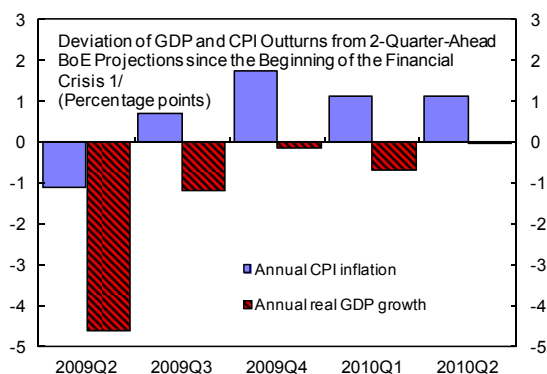
**As such, QE has boosted confidence, created positive wealth effects, and improved the supply of credit to corporates.** The latter effect arose both directly, through small-scale BoE purchases of commercial paper and corporate bonds, and indirectly, as large-scale gilt purchases induced investors to shift funds into other assets, including corporate bonds. Together, these developments have bolstered the recovery, even if the ultimate impact of QE on demand and inflation remains difficult to quantify.

<sup>9</sup> The appropriate length of the event window is unclear, as the market may have taken longer than usual to incorporate the information about so large and unprecedented an operation. For a more detailed analysis, see [IMF Working Paper 2009/163](#) and [Bank of England Working Paper 393](#).

#### Box 4. Accounting for Recent UK Inflation Dynamics

##### UK inflation has consistently exceeded expectations since the beginning of the financial crisis.

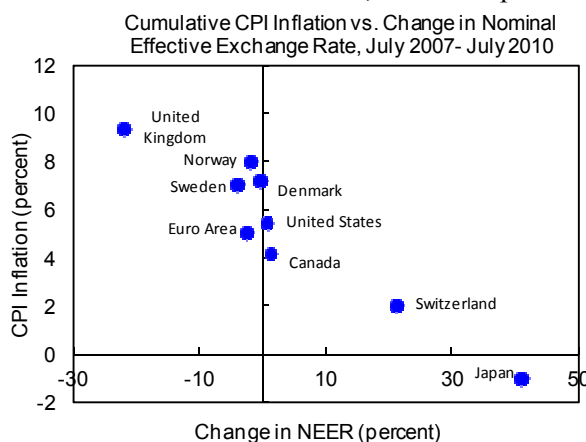
Although growth has fallen short of BoE projections, inflation has surprised on the upside, even relative to near-term forecasts. Tax policy is partly responsible for relatively high inflation outturns, but arguably cannot account for the observed upside surprises: the January 2010 VAT hike was preannounced and is estimated to have added about  $\frac{3}{4}$  of a percentage point to the CPI, in line with prior expectations. Higher commodity prices, in turn, explain some of the forecast error, but still leave open why UK inflation has markedly exceeded that of other advanced economies.



Sources: Bank of England Inflation Reports; Haver; and IMF staff calculations.

1/ Projections for 2009Q2 as reported in the November 2008 Inflation Report (mode forecast under market interest rate expectations), and so forth.

**A leading explanation for the inflation surprises is greater-than-expected pass-through from past sterling depreciation.** Recent research has generally documented low and declining exchange rate pass-through in advanced economies. Based on this evidence, and the experience of large sterling depreciation in the early 1990s that triggered no apparent rise in domestic prices, many forecasters appear to have assumed little impact from recent sterling weakness. Yet, this notion seems at odds with a simple cross-country chart comparing exchange rate developments and cumulative CPI inflation since mid-2007. Indeed, much of the variation in inflation across countries could be readily explained by pass-through on the order of 0.17—a high, but not implausible value, especially when the exchange rate shock is large and widely expected to be permanent.<sup>10</sup>



Sources: Eurostat, Haver, IMF-INS, and IMF staff calculations.

**This explanation is also consistent with cross-sectional evidence.** Relative to euro area inflation since mid-2007, UK inflation has been highest for some elements of the CPI basket that are likely to be very sensitive to exchange rate changes, such as gas and fuels, household appliances, and package holidays. By contrast, inflation has been relatively moderate for accommodation services, rent, and out-patient services.

<sup>10</sup> Choudri and Hakura, for instance, report an average long-term pass-through coefficient of 0.16 for low-inflation economies, although the country-specific estimate for the UK is lower. See the *Journal of International Money and Finance* 25 (2006), 614–639, Table 2.

33. **Underlying price pressures are expected to be moderate in the period ahead, but another looming VAT hike will keep inflation above 2 percent throughout 2011.** As the effects of past price level shocks fade, inflation should continue to ease gradually. However, the announced rise in the VAT rate in January 2011 is set to raise the CPI by another 1-1½ percentage points.<sup>11</sup> Staff therefore projects inflation to remain above 2 percent throughout 2011, although this masks the lingering downward pressure from spare capacity. Indeed, most other pending fiscal measures, notably the two-year freeze of most public sector salaries, will have a moderating effect on underlying inflation. Barring new shocks, this effect should become apparent in headline inflation falling below target by early 2012.

34. **Risks around the central inflation projection are significant, but broadly balanced.** Historical episodes of persistent large output gaps suggest that disinflationary pressures should ultimately take hold (see companion *Selected Issues* paper), but there is considerable uncertainty about the strength of this effect. On the one hand, economic slack and low wage growth could pull down inflation faster in the period ahead, especially if corporate margins were to ease further. On the other hand, spare capacity might turn out to be more limited or less potent than currently assessed. In this context, an extended series of above-target inflation outturns entails the risk that rising inflation expectations might start to feed back into wage and price-setting. In addition to these sources of uncertainty, the inflation outlook is subject to the risk of further fluctuations in commodity prices and the exchange rate.

35. **A highly accommodative monetary stance remains appropriate for now, but the Monetary Policy Committee (MPC) will have to be nimble in responding to new developments.** The current stance reflects the need to maintain overall policy stimulus, as economic activity remains below potential, fiscal policy is set to tighten sharply, and financial intermediation normalizes only gradually. Near-term adjustments to the monetary stance should be guided by incoming data. Developments in effective labor costs, other input prices, and inflation expectations bear particularly close monitoring in this regard:

- **If a stalling recovery were to heighten disinflationary forces, quantitative easing should be expanded.** In the first instance, a resumption of gilt purchases represents a natural policy option. The marginal effect of additional purchases is uncertain, but some further flattening of the yield curve clearly seems achievable. If necessary, the authorities should also consider the case for buying larger amounts of private sector assets, chosen to target specific market dysfunctions or valuation anomalies that might emerge in a renewed sharp downturn. However, such purchases may best be framed as a fiscal operation—financed by the issuance of gilts, which the BoE could separately decide to buy—to ensure proper accountability for the resulting financial

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<sup>11</sup> This is larger than the estimated effect of the temporary VAT cut in late 2008 (and subsequent reversal in 2010), as pass-through should be higher for permanent VAT changes, in line with international evidence.

and political risk. More generally, decisions on further quantitative easing need to bear in mind their effect on the risk profile of the consolidated public sector balance sheet, as they involve issuing a short-term liability (bank reserves) in exchange for extinguishing a long-term liability (gilts) or acquiring a risky private-sector asset.

- **Conversely, the MPC must stand ready to start a gradual tightening if incoming data raise the prospect of above-target inflation over the policy horizon.** In this case, the MPC intends to give standard Bank Rate increases priority over asset sales. Staff concurs with this strategy, as changes in policy rates—the central bank’s standard and proven tool—are easiest to fine-tune and best understood in terms of their effects. Importantly, there is no reason to suspect that the expanded stock of base money will compromise effective monetary control, given that reserves are fully remunerated. Asset sales can, therefore, be programmed to occur at a pace that does not interfere with stable gilt market conditions.

### **Authorities’ views**

36. **The authorities generally agreed with staff’s views on the inflation outlook and monetary stance, but opinions on the MPC have recently become more divided.** The majority of MPC members viewed the current policy stance as appropriate and favored a data-dependent approach to next steps. For one MPC member, the balance of risks was such that it was appropriate to start to [withdraw some of the exceptional monetary stimulus](#) provided by the easing in policy in late 2008 and 2009. Another MPC member made the case for [expanding the asset purchase program](#) so as to engineer a faster recovery, lest inflation fall below target in the medium term. MPC members also differed on the likely effectiveness of further gilt purchases—some could see arguments for “diminishing returns” from an additional round of quantitative easing, while others were more optimistic.

## **VI. STRENGTHENING THE FINANCIAL SYSTEM**

### **A. Financial Sector Soundness and Public Support**

37. **Banking sector health has improved, but continued progress is needed to enhance resilience and reduce risks to the economy and the taxpayer.** To these ends:

- **Banks’ capital buffers should be strengthened further** over time to prepare for tighter regulatory requirements in the future, taking into account bank-specific circumstances. Continued restraint on dividends and remuneration will be critical in this regard. Although higher capitalization will decrease expected returns on equity, this should be compensated by lower risks for bank stakeholders and society at large. Larger capital buffers will also enhance banks’ ability to raise longer-term funds at reasonable costs and maintain adequate credit supply to the private sector at all times.



- **Public funding support should be unwound** in line with initial program design to gradually reduce taxpayer risk and restore private sector responsibility. The crisis exposed UK banks' excessive reliance on unstable funding sources. Extensive public support has provided temporary relief. However, the key facilities—the Special Liquidity Scheme and the Credit Guarantee Scheme, which originally accounted for a combined £320 billion in support—are set to wind down gradually in the coming years. Against this backdrop, supervisors need to keep up the pressure on banks to develop robust new funding models based upon a sound mix of simpler and more transparent instruments. Progress in this direction would benefit from timely clarification of how international and EU regulators will treat different capital and funding instruments in the future.
- **The case for deeper structural changes** to the UK financial sector needs to be examined. Thus, the public debate on possible reforms, informed by the government-appointed Independent Commission on Banking, which is to present a final report by September 2011, is welcome.<sup>12</sup> These issues, along with broader questions of systemic stability, will also be taken up in a comprehensive assessment to be conducted by staff in 2011, under the IMF's "Financial Sector Assessment Program" (FSAP).

## B. Regulatory Reform

38. **The authorities should continue to work toward an ambitious international package of regulatory reform and rigorous implementation of this package in the EU.** The UK has played a constructive role in the global regulatory debate, with innovative proposals in many policy areas, pioneering work on recovery and resolution plans (RRPs), and a blueprint set of new liquidity rules (see companion *Selected Issues* paper). The authorities should continue to provide intellectual leadership, while cooperating closely with their international partners to secure agreement on a suitable set of reforms. Building on the recent Basel III and Financial Stability Board proposals, the following priorities stand out:

- The UK is home to a number of very large financial institutions. Thus, the authorities have rightly emphasized the need for concrete tools, such as capital and liquidity surcharges, to address the resulting systemic risk.
- In the same vein, greater international cooperation is needed to facilitate the resolution of complex, cross-border financial institutions, as envisaged under the authorities' pilot exercise on RRPs. The UK's 2009 Banking Act has provided an

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<sup>12</sup> The issues paper prepared by the commission is available at <http://bankingcommission.independent.gov.uk/bankingcommission/news-and-publications/>.



effective national special resolution regime for banks.<sup>13</sup> However, greater international cooperation is indispensable to develop credible policy tools for handling the failure of systemically important entities with complex, cross-border activities. In this context, the UK authorities should support the EU’s ongoing efforts to enhance the framework for cross-border supervision and resolution.

**39. The development of macroprudential instruments to mitigate the amplitude of credit cycles is another key policy priority.** Under the new prudential architecture, the government will create a Financial Policy Committee (FPC) in the BoE with an explicit mandate for macroprudential oversight, thus addressing a critical gap in the previous framework. To perform its task, the FPC will require a well-defined financial stability objective and adequate tools—such as variation in capital risk weights on specific asset classes and in prudential standards, including limits on loan-to-value ratios. The authorities have published a set of proposals along these lines, but many details remain to be settled. Calibrating and communicating the FPC’s policy decisions will represent a particular challenge, as little is known about their quantitative impact and interaction with monetary policy. Moreover, some measures will need to be coordinated with foreign regulators, especially within the EU, to be effective. The new European Systemic Risk Board provides a useful forum for such coordination.

### C. Moving to a New Regulatory Architecture

**40. Continued emphasis on proactive microprudential oversight is critical as the UK moves to a new regulatory architecture.** The government has decided to abolish the tripartite system and charge the BoE—via a new subsidiary, the Prudential Regulation Authority (PRA)—with the prudential regulation of deposit-taking institutions, investment banks, and insurance companies. A separate new entity, the Consumer Protection and Markets Authority, will be charged with ensuring consumer protection as well as regulation of financial markets. Although this new setup should facilitate the integration of micro- and macroprudential oversight, institutional changes alone are no guarantee for superior outcomes, and any reorganization of this scale poses operational risks. It will thus be crucial to carefully manage the transition while continuing to enhance the more intrusive, proactive, and strategic approach to supervision adopted since the crisis.<sup>14</sup> In this context:

- In order to enhance consolidated supervisions, the PRA should have the authority to directly supervise and, if necessary, give formal directions at the financial holding company level.

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<sup>13</sup> HM Treasury is currently consulting on a special administration regime for investment firms, taking into account the lessons learned from the collapse of Lehman Brothers.

<sup>14</sup> See the recent IMF Staff Position Note on [“The Making of Good Supervision—Saying “No” and Meaning it.”](#)

- Adoption of a “prompt corrective action” regime would further strengthen the supervisor’s capacity to address emerging risks at an early stage.<sup>15</sup>
- Prudential oversight should be supported by market discipline. A useful tool in this regard would be the regular public disclosure by the supervisor of non-confidential firm-level prudential returns.
- The tightening of banking sector regulation might cause risks to migrate into less regulated parts of the financial system. A key task for the FPC, therefore, will be to identify such risk migration and ensure a commensurate widening of the regulatory perimeter.

### **Authorities’ views**

41. **There was agreement on the reform agenda, although specific outcomes will need to reflect international developments and domestic consultation processes.** The authorities expressed broad satisfaction with the initial set of Basel III proposals, but stressed the need to make swift progress on outstanding items, notably a firming-up of liquidity standards and creation of robust tools to contain systemic risk. The UK’s policy line, in this regard, would be to push for ambitious reform, while seeking broad-based international agreement to limit scope for regulatory arbitrage. In terms of the domestic reform agenda, the government has laid out its priorities in a series of consultation papers and set up the Independent Commission on Banking, and now awaits the outcome of these processes. In this context, the authorities noted that they would consider staff’s specific proposals on enhancing supervision.

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<sup>15</sup> The adoption of a prompt corrective action regime is one of the options cited in Treasury’s recent consultation paper ([“A New Approach to Financial Regulation: Judgement, Focus and Stability.”](#)) to enhance the regulator’s intervention powers.

## VII. STAFF APPRAISAL

42. **The UK economy is on the mend, but crisis-related scars still need healing.** Economic recovery is underway, unemployment has stabilized, and financial sector health has improved. These developments reflect both a natural cyclical rebound and the authorities' forceful policy actions, including large-scale financial-sector interventions, temporary fiscal stimulus, unprecedented monetary easing, and the announcement of a strong and credible multi-year fiscal consolidation strategy. The challenge going forward will be to support sustainable economic recovery as the policy focus shifts from crisis management to post-crisis repair. With the private sector running high financial surpluses and the public sector posting record-high deficits, sustainable growth requires a gradual rebalancing toward private and external sector-led demand.

43. **Consistent with these objectives, the government's fiscal consolidation plans have been instrumental in preserving confidence in debt sustainability.** The plans are also necessary to regain fiscal space to cope with future shocks. The fiscal mandate of balancing the cyclically-adjusted current budget over a five-year rolling horizon—currently by 2015/16—is ambitious but feasible, and its credibility has been bolstered by frontloaded actions to achieve the mandate one year early. Market reaction has been positive, as the consolidation greatly reduces the risk of a costly funding crisis and supports rebalancing. These benefits outweigh expected costs in terms of adverse effects on near-term growth.

44. **A highly accommodative monetary stance remains appropriate to offset the contractionary impulse from fiscal policy and keep inflation close to target over the policy horizon.** Barring unforeseen shocks, inflation should revert to target over the policy horizon, as one-off price level shocks dissipate and disinflationary forces—existing spare capacity and public sector wage restraint—keep underlying price pressures in check. The BoE's accommodative stance thus reflects the need to maintain overall policy stimulus as fiscal tightening takes hold and financial intermediation normalizes only gradually.

45. **This policy mix should facilitate the necessary rebalancing while supporting a moderate-paced recovery.** With interest rates low and spare capacity within firms falling, corporates are drawing on their strong financial positions to raise investment from its current low levels. Similarly, although households are likely to remain thriftier than before the crisis, they have begun to raise their consumption amid stabilizing labor markets and recovering asset prices. Over time, past sterling depreciation should also boost net exports as higher profit margins encourage expansion in import-competing and export sectors. This progressive strengthening of private and external demand should underpin a moderate-paced recovery, even as the public sector retrenches.

46. **Risks to this central scenario are substantial and policies will need to adapt if they materialize.** Downside risks include the continued fragility of confidence, still-strained balance sheets among households and banks, and possible resurgence of sovereign and

47. banking market turmoil in the euro area markets. Further, headwinds from fiscal consolidation could turn out to be more powerful than expected. On the upside, expansionary impulses from very low real interest rates, past sterling depreciation, and the ongoing recovery of global demand could be greater than expected. This would boost the UK economy onto a faster-than-expected growth path, but could also entail stronger inflationary pressure. A key safeguard against these risks is the free operation of automatic fiscal stabilizers in both directions. In addition, monetary policy must remain nimble: asset purchases should resume if the recovery weakens and disinflationary pressures mount; conversely, policy rates should tighten gradually if output recovers apace and inflation continues to surprise on the upside. In the unexpected but possible case of a significant and prolonged downturn, temporary targeted tax cuts should also be considered (alongside further monetary easing), ideally combined with longer-term entitlement reforms to safeguard fiscal sustainability and market credibility.

48. **The current spending and pension reviews provide an opportunity to further mitigate risks by strengthening the quality of fiscal adjustment.** International evidence suggests that the planned emphasis on spending reduction increases the likelihood of a successful consolidation. Within the spending envelope, however, more weight should be given to reducing public sector compensation premia and achieving savings in benefits and transfers through better targeting. This would help shield the vulnerable, mitigate the growth effects of adjustment (as such cuts likely have smaller fiscal multipliers), and allow relatively more spending on infrastructure investments that could boost potential growth. Entitlement reforms, such as accelerating retirement age increases for state pensions and gradually aligning the generosity of public sector pensions with those in the private sector, would similarly bolster fiscal sustainability while having limited adverse effects on aggregate demand now. The initiatives launched by the government to review such reforms are therefore welcome.

49. **The authorities should continue to fortify fiscal institutions, building on significant progress in this area.** The establishment of a new independent OBR is an important and welcome step. Though not a substitute for strong commitment to fiscal discipline, the OBR should enhance the transparency and credibility of the budget process and help inform policy decisions. As the role and remit of the permanent OBR are finalized, its independence should be underpinned by sufficient legal authority and safeguards. In due course the current fiscal mandate—an appropriate guide for the consolidation period—should be replaced with a more permanent rule-based framework that would also be monitored by the OBR.

50. **Efforts should continue to strengthen financial sector health and reduce related risks to the economy and taxpayer.** Toward these ends:

- Capital buffers should be raised further, notably by restraining dividend payouts and remuneration budgets, taking into account bank-specific circumstances.

- Crisis-related public interventions should be unwound in line with initial program design to gradually reduce taxpayer risk and restore private sector responsibility. To help replace this support, supervisors should maintain pressure on banks to develop robust new funding models based on a broad mix of simpler and more transparent instruments.
- The creation of an FPC with an explicit macroprudential mandate is welcome. To be effective, many macroprudential measures will need to be closely coordinated with regulators in other countries, notably within the EU. One critical task for the FPC will be to identify risk migration into less regulated parts of the financial system and ensure a commensurate widening of the regulatory perimeter.
- The transition toward a new prudential architecture needs to be managed carefully to mitigate operational risks. At the same time, the authorities should continue enhancing the more intrusive, judgment-based, and strategic approach to supervision adopted since the crisis. To assist this objective, it would be useful to: (i) provide the PRA with authority to supervise and, if necessary, give formal directions at the financial holding company level in order to enhance consolidated supervision; (ii) adopt a “prompt corrective action” regime to strengthen the supervisor’s capacity to address emerging risks at an early stage; and (iii) have the supervisor regularly disclose nonconfidential firm-level prudential returns.
- The UK authorities should continue their constructive efforts to secure an ambitious international package of regulatory reform and rigorous implementation of this package in the EU. In this regard, the authorities have rightly emphasized the need for concrete tools to address risks arising from systemic financial institutions (e.g., through capital and liquidity surcharges and cross-border resolution frameworks).

In general, it will be important to promote internationally coordinated financial sector reform to minimize regulatory arbitrage and to phase in reforms gradually to avoid strangling near-term credit supply.

51. It is recommended that the next Article IV consultation with the United Kingdom be held on the standard 12-month cycle.

Table 1. United Kingdom: Selected Economic and Social Indicators, 2005-11

	2005	2006	2007	2008	2009	2010 Proj.	2011 Proj.
<b>Real Economy</b> (change in percent)							
Real GDP	2.2	2.8	2.7	-0.1	-5.0	1.7	2.0
Domestic demand	2.1	2.5	3.1	-0.7	-5.5	2.6	1.5
Private final domestic demand	2.0	2.7	3.3	-1.4	-6.6	1.3	2.6
CPI, end period	1.9	3.0	2.1	3.1	2.9	2.8	2.5
Unemployment rate (in percent) 1/	4.8	5.4	5.4	5.6	7.5	7.9	7.5
Gross national saving (percent of GDP)	14.5	14.1	15.6	15.0	12.3	12.1	12.9
Gross domestic investment (percent of GDP)	17.1	17.5	18.2	16.6	13.6	14.5	15.2
<b>Public Finance</b> (fiscal year, percent of GDP) 2/							
General government balance	-2.9	-2.3	-2.7	-6.7	-11.3	-9.9	-7.4
Public sector balance	-2.9	-2.3	-2.4	-6.0	-10.4	-9.9	-7.2
Cyclically adjusted balance (staff estimates)	-2.8	-2.2	-2.9	-5.8	-8.1	-7.7	-5.5
Public sector net debt	35.5	36.0	36.5	42.7	53.5	61.2	66.3
FX-denominated public debt (percent of gross debt)	0.3	0.3	0.2	0.0	0.0	...	...
<b>Money and Credit</b> (end-period, 12-month percent change) 3/							
M4	12.8	12.5	12.7	15.5	6.6	1.9	...
M4 excluding holdings of other financial corporations (OFCs)	8.6	8.9	8.8	3.2	2.9	3.1	...
M4 lending excluding OFCs (adjusted for effects of securitization)	11.9	12.5	10.8	4.9	0.6	0.1	...
Unsecured Consumer Credit	9.6	7.4	7.0	4.1	-1.7	-1.0	...
<b>Interest rates</b> (percent; year average) 4/							
Three-month interbank rate	4.7	5.3	6.0	5.8	1.2	0.7	...
Ten-year government bond yield	4.4	4.5	5.0	4.7	3.6	3.7	...
<b>Balance of Payments</b> (percent of GDP)							
Current account balance	-2.6	-3.4	-2.6	-1.6	-1.3	-2.4	-2.3
Trade balance	-3.4	-3.1	-3.1	-2.6	-2.4	-2.9	-2.5
Net exports of oil	-0.2	-0.2	-0.3	-0.4	-0.2	-0.2	-0.3
Exports of goods and services (volume change in percent)	7.9	11.1	-2.6	1.0	-11.1	5.5	6.3
Imports of goods and services (volume change in percent)	7.1	9.1	-0.8	-1.2	-12.3	8.2	4.3
Terms of trade (percent change)	-2.6	-0.1	1.4	0.0	-1.0	0.9	-0.5
FDI net	4.3	3.0	-4.4	-2.6	-1.1	...	...
Reserves (end of period, billions of US dollars)	46.2	51.8	57.9	53.9	66.4	...	...
<b>Fund Position</b> (as of September 30, 2010)							
Holdings of currency (in percent of quota)							78.01
Holdings of SDRs (in percent of allocation)							90.29
Quota (in millions of SDRs)							10,739
<b>Exchange Rates</b>							
Exchange rate regime							Floating
Bilateral rate (September 30, 2010)							US\$ = £0.6347
Nominal effective rate (2005=100) 3/ 5/	100.0	100.8	103.3	90.7	80.3	80.1	...
Real effective rate (2005=100) 5/ 6/ 7/	100.0	101.6	105.2	92.2	80.9	83.1	...

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

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

2/ The fiscal year begins in April. Debt stock data refers to the end of the fiscal year using centered-GDP as a denominator.

3/ 2010: actual data as of August.

4/ 2010: actual data through September.

5/ Average. An increase denotes an appreciation.

6/ 2010: actual data through July.

7/ Based on consumer price data.

Table 2. United Kingdom: Public Sector Operations, 2008/09–15/16 1/  
(Percent of GDP)

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
	Budget June 2010							
Total revenue	39.1	36.7	37.2	38.0	38.4	38.8	38.9	38.8
Current revenue	37.2	36.5	37.2	37.9	38.4	38.7	38.8	38.7
Primary revenue	36.7	36.3	36.9	37.6	37.9	38.2	38.2	38.1
Tax revenue	35.0	34.5	35.1	35.6	35.9	36.2	36.3	36.2
Non-tax revenue	1.7	1.8	1.8	2.0	2.0	2.0	1.9	1.9
Interest revenue	0.5	0.2	0.3	0.4	0.5	0.5	0.6	0.6
Capital revenue	1.9	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Total expenditure	45.2	47.7	47.3	45.5	43.9	42.3	41.0	39.8
Current expenditure	39.4	42.7	43.2	42.3	41.0	39.7	38.4	37.4
Primary expenditure	37.2	40.4	40.2	39.2	37.8	36.3	34.9	33.8
Interest payments	2.2	2.2	3.0	3.1	3.3	3.4	3.5	3.5
Capital expenditure	5.8	5.0	4.1	3.2	2.9	2.6	2.5	2.5
Depreciation	1.3	1.4	1.4	1.4	1.4	1.3	1.3	1.3
Current balance 2/	-3.4	-7.5	-7.5	-5.8	-4.1	-2.4	-1.0	0.1
Overall balance	-6.0	-11.0	-10.1	-7.5	-5.5	-3.5	-2.1	-1.1
Cyclically adjusted								
Current balance 2/	-3.0	-5.3	-4.8	-3.3	-2.0	-0.7	0.3	0.8
Overall balance	-5.7	-8.7	-7.4	-5.0	-3.4	-1.8	-0.8	-0.3
Memorandum items (Budget June 2010)								
Output gap	-1.0	-4.1	-3.7	-3.5	-2.8	-2.3	-1.6	-0.9
Deflator growth	2.5	1.9	2.9	1.9	2.3	2.6	2.7	2.7
Real GDP growth	-1.4	-3.7	1.8	2.4	2.9	2.8	2.7	2.7
Public sector net debt (excl. temporary effects of FS interventions) 3/	44.1	53.9	61.9	67.2	69.8	70.3	69.4	67.4
Public sector net debt (incl. temporary effects of FS interventions) 3/	53.1	62.1	71.8	77.2	79.2	79.2	77.9	75.4
General government gross debt 4/	55.4	71.2	78.9	83.6	85.5	84.9	83.1	80.4
	Staff projections 5/							
Total revenue	39.1	37.2	37.3	38.0	38.3	38.7	38.8	38.8
Current revenue	37.2	37.1	37.2	37.9	38.3	38.6	38.8	38.7
Primary revenue	36.7	36.8	36.9	37.6	37.8	38.1	38.2	38.1
Tax revenue	35.0	34.6	35.1	35.6	35.8	36.1	36.2	36.2
Non-tax revenue	1.7	2.2	1.8	2.0	2.0	2.0	2.0	1.9
Interest revenue	0.5	0.3	0.3	0.4	0.5	0.5	0.6	0.6
Capital revenue	1.9	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Total expenditure	45.1	47.6	47.1	45.2	43.8	42.3	41.1	40.0
Current expenditure	39.4	42.8	43.0	42.0	40.9	39.7	38.5	37.5
Primary expenditure	37.2	40.6	39.9	38.7	37.6	36.3	35.1	34.1
Interest payments	2.2	2.2	3.1	3.3	3.4	3.4	3.4	3.4
Capital expenditure	5.8	4.7	4.1	3.2	2.9	2.6	2.5	2.5
Depreciation	1.3	1.4	1.4	1.4	1.4	1.3	1.3	1.3
Current balance 2/	-3.5	-7.2	-7.2	-5.5	-4.0	-2.5	-1.1	0.0
Overall balance	-6.0	-10.4	-9.9	-7.2	-5.5	-3.6	-2.3	-1.2
Primary balance	-4.4	-8.4	-7.0	-4.3	-2.6	-0.7	0.6	1.6
Cyclically adjusted								
Current balance 2/	-3.2	-4.9	-5.1	-3.8	-2.5	-1.2	-0.2	0.5
Overall balance	-5.8	-8.1	-7.7	-5.5	-4.0	-2.4	-1.4	-0.7
Memorandum items (staff)								
Output gap	-1.0	-4.2	-2.5	-2.4	-2.1	-1.6	-1.2	-0.6
Deflator growth	2.8	1.7	3.0	2.8	2.4	2.7	2.7	2.7
Real GDP growth	-1.9	-3.7	2.5	1.8	2.4	2.5	2.5	2.6
Public sector net debt (excl. temporary effects of FS interventions) 3/	42.7	53.5	61.2	66.3	68.9	69.2	69.9	67.7
Public sector net debt (incl. temporary effects of FS interventions) 3/	51.3	61.7	71.2	76.7	79.2	79.4	78.0	75.4
General government gross debt	55.4	71.6	78.5	82.8	84.8	84.6	82.9	80.2

Sources: Office for National Statistics (ONS), HM Treasury, and staff estimates.

1/ Historical data include the temporary effects of financial interventions.

2/ Including depreciation.

3/ End of fiscal year using centered-GDP as the denominator.

4/ From 2010/11 onwards, Budget projections for general government gross debt are on a Maastricht basis.

5/ Staff projections based on Budget June 2010 expenditure plans and staff's growth assumptions for revenue projections and cyclical adjustment.

Table 3. United Kingdom: Balance of Payments, 2003–15

	2003	2004	2005	2006	2007	2008	2009	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.
	(In percent of GDP)												
<b>Current account</b>	-1.6	-2.1	-2.6	-3.4	-2.6	-1.6	-1.3	-2.4	-2.3	-2.0	-1.7	-1.4	-1.3
Trade balance	-2.3	-2.7	-3.4	-3.1	-3.1	-2.6	-2.4	-2.9	-2.5	-2.1	-1.6	-1.2	-0.9
Trade in goods	-4.3	-5.1	-5.5	-5.7	-6.4	-6.4	-5.9	-5.9	-5.5	-5.1	-4.8	-4.4	-4.2
Exports	16.5	15.9	16.9	18.3	15.7	17.4	16.3	17.7	17.9	18.2	18.4	18.6	18.7
Imports	20.8	20.9	22.3	24.1	22.1	23.9	22.3	23.6	23.4	23.4	23.2	23.0	22.9
Trade in services	2.0	2.4	2.1	2.6	3.3	3.8	3.5	3.0	3.0	3.1	3.2	3.3	3.3
Exports	9.0	9.4	9.5	10.1	10.9	11.8	11.4	10.7	10.5	10.6	10.6	10.6	10.5
Imports	7.0	7.0	7.5	7.5	7.6	8.0	7.8	7.7	7.6	7.5	7.4	7.3	7.2
Income balance	1.5	1.5	1.7	0.6	1.4	1.9	2.2	1.7	1.2	1.1	1.0	0.8	0.6
Current transfers	-0.9	-0.9	-0.9	-0.9	-1.0	-1.0	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
<b>Capital and financial account</b>	2.1	2.6	2.4	3.2	1.9	2.0	0.7	...	...	...	...	...	...
<i>Of which:</i>													
Direct investment	-2.1	-1.7	4.3	3.0	-4.4	-2.6	-1.1	...	...	...	...	...	...
Portfolio investment	6.1	-3.6	-1.7	1.0	9.0	22.4	3.0	...	...	...	...	...	...
Other investment	-2.1	7.8	-0.2	-0.9	-2.7	-18.1	-1.1	...	...	...	...	...	...

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



Table 4. United Kingdom: Net Investment Position, 2003–09 1/  
(Percent of GDP)

	2003	2004	2005	2006	2007	2008	2009
<b>Assets</b>	304	325	383	456	551	760	623
Direct investment abroad	61	56	56	55	64	72	74
Portfolio investment abroad	82	91	109	115	121	115	136
Other investment abroad	159	176	216	220	267	290	253
Reserve assets	2	2	2	2	2	3	3
<b>Liabilities</b>	314	343	403	485	574	767	643
Direct investment in the UK	31	32	39	43	44	46	48
Portfolio investment in the UK	95	102	117	128	139	137	171
Other investment in the UK	188	210	247	246	293	313	272
<b>Net investment position</b>	-10	-18	-20	-29	-23	-7	-20
Direct investment	29	25	17	12	20	26	25
Portfolio investment	-13	-11	-8	-13	-18	-22	-36
Other investment	-29	-33	-31	-27	-27	-23	-19
Reserve assets	2	2	2	2	2	3	3
Monetary Financial Institutions	-14	-16	-12	-13	-17	-10	-18
Other Sectors	6	2	-2	-8	4	15	11
Public Sector	-3	-4	-6	-8	-9	-12	-14
<b>Memorandum items:</b>							
Change in the net investment position	0.9	-8.1	-1.8	-8.9	6.0	16.0	-13.2
o/w valuation change	2.9	-5.6	0.5	-6.0	8.3	17.0	-12.5
Current account balance	-1.6	-2.1	-2.6	-3.4	-2.6	-1.6	-1.3

Source: Office for National Statistics.

1/ Data corresponds to the end of indicated period, expressed as a percent of the cumulated GDP of the four preceding quarters.

Table 5. United Kingdom: Medium-Term Scenario, 2005-15  
(Percentage change, unless otherwise indicated)

	2005	2006	2007	2008	2009	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.
Real GDP	2.2	2.8	2.7	-0.1	-5.0	1.7	2.0	2.3	2.4	2.5	2.6
Q4/Q4 1/	2.4	2.7	2.4	-2.7	-3.0	2.9	1.6	2.5	2.5	2.5	2.6
Real domestic demand	2.1	2.5	3.1	-0.7	-5.5	2.6	1.5	1.8	1.8	1.9	2.1
Private consumption	2.2	1.8	2.2	0.4	-3.3	1.1	1.5	1.8	2.1	2.3	2.3
Government consumption	2.0	1.4	1.3	1.6	1.0	1.9	-1.0	-2.0	-2.3	-3.0	-2.1
Fixed investment	2.4	6.4	7.8	-5.0	-15.1	1.5	3.7	7.0	6.2	6.7	6.1
Public 2/	14.8	4.4	6.4	24.5	20.4	-1.2	-16.1	-8.6	-6.7	0.7	2.1
Residential	0.7	8.4	2.8	-11.8	-25.5	0.7	5.4	9.4	6.0	5.5	4.2
Business 2/	4.5	4.8	12.5	-1.1	-18.8	2.1	9.0	10.2	8.9	8.0	7.1
Stocks 3/	0.0	0.0	0.1	-0.5	-1.1	1.3	0.3	0.0	0.0	0.0	0.0
External balance 3/	0.0	0.2	-0.5	0.7	0.7	-0.9	0.4	0.5	0.6	0.5	0.4
Exports of Goods and Services	7.9	11.1	-2.6	1.0	-11.1	5.5	6.3	5.7	5.6	5.5	5.5
Imports of Goods and Services	7.1	9.1	-0.8	-1.2	-12.3	8.2	4.3	3.7	3.4	3.5	3.9
Exports of Goods and Services (ex. fraud) 4/	5.2	8.1	3.0	1.0	-11.1	5.7	6.6	5.7	5.6	5.5	5.5
Imports of Goods and Services (ex. fraud) 4/	4.8	6.4	4.3	-1.2	-12.3	8.4	4.6	3.7	3.4	3.5	3.9
Current account 5/	-2.6	-3.4	-2.6	-1.6	-1.3	-2.4	-2.3	-2.0	-1.7	-1.4	-1.3
CPI inflation, end period	1.9	3.0	2.1	3.1	2.9	2.8	2.5	1.8	1.9	2.0	2.0
Output gap 6/	-0.3	0.0	0.7	0.4	-4.2	-2.9	-2.5	-2.1	-1.7	-1.3	-0.7
Employment and productivity											
Employment	1.0	0.9	0.7	0.7	-1.6	0.0	1.0	1.1	1.0	0.9	0.8
Unemployment rate 7/	4.8	5.4	5.4	5.6	7.5	7.9	7.5	6.9	6.4	6.1	5.8
Productivity 8/	1.4	2.1	2.0	-1.0	-3.4	2.0	1.0	1.2	1.5	1.6	1.7
<u>Memorandum</u>											
Private finanl domestic demand	2.0	2.7	3.3	-1.4	-6.6	1.3	2.6	3.2	3.2	3.3	3.2
HH saving rate 9/	4.0	3.5	2.7	2.0	6.2	4.7	4.6	4.4	4.3	4.1	3.7

Sources: Office for National Statistics; and IMF staff projections.

- 1/ Percentage change in quarterly real GDP in the fourth quarter on four quarters earlier.  
2/ Public investment and business investment in 2005 and 2006 exclude the transfer of nuclear reactors.  
3/ Contribution to the growth of GDP.  
4/ These numbers exclude VAT-related fraudulent activity.  
5/ In percent of GDP.  
6/ In percent of potential GDP.  
7/ In percent of labor force, period average; based on the Labor Force Survey.  
8/ Whole economy, per worker.  
9/ Percent of total HH available resources.

## Annex A: Public Sector Debt Sustainability

**General government gross debt is projected to increase from 43 percent of GDP in 2007/08 to about 85 percent of GDP in 2012/13 under the government’s planned consolidation.** The debt ratio would come down to 80 percent of GDP by 2015/16 (Table A1). The baseline scenario for this debt sustainability analysis builds on staff’s central scenario, hence taking into account the announced policies, and focuses on general government gross debt. The primary deficit is expected to have peaked in 2009/10 at 9 percent of GDP and reach a 2 percent of GDP surplus in 2015/16. In cyclically-adjusted terms, the primary balance would improve from 6 percent of GDP in 2009/10 to 2 percent in 2015/16. As a result, the debt ratio would be on a downward path from 2013/14, reaching 60 percent of GDP by 2025/26 if policies were unchanged after 2015/16 (Annex Box). Gross financing needs in the near term are high—they are expected to reach 17 percent of GDP in 2010/11, driven by the high overall deficit, amortization, and an increased share of short-term debt.

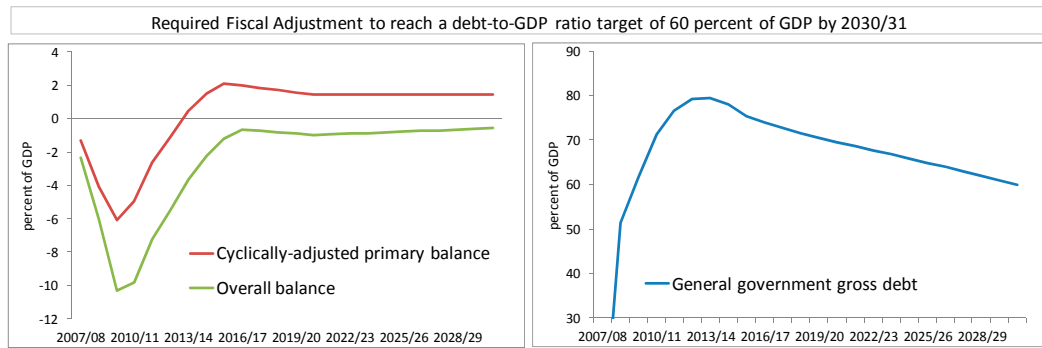
**Alternative scenarios and bound tests highlight the uncertainties surrounding the projected debt path (Figure A1).** Higher interest rates, different growth scenarios, and assumptions on primary balances as outlined below significantly affect debt outcomes. In particular:

- **Debt would increase rapidly in the absence of fiscal consolidation.** In a scenario with a constant primary balance (in percent of GDP) over 2010/11-15/16, debt would increase to 110 percent of GDP by 2015/16 and be on a firm upward path. The impact of unchanged policies could be even higher, as concerns about sovereign debt dynamics could lead to higher interest rates, adding to the interest bill and hence accentuating the debt dynamics by increasing the distance from a debt-stabilizing primary balance.
- **The debt projections are sensitive to interest rate developments.** Real interest rates in the baseline scenario are assumed to average 1.7 percent over the projection period, reflecting the current low interest rate environment. Nonetheless, interest expenditure is projected to rise significantly as a share of total expenditure. Should real interest rates increase by half a standard deviation above the baseline, debt would increase to 82 percent of GDP by 2015/16, some 2 percentage points of GDP above the baseline.
- **If medium-term growth rates are persistently lower than anticipated, stabilizing the debt ratio would require further adjustment.** Assuming expenditure plans remain unchanged, the debt-to-GDP ratio could reach 96 percent of GDP by 2015/16 should growth be  $1\frac{1}{4}$  percentage points ( $\frac{1}{2}$  a standard deviation) lower each year.

**Annex Box. Required Fiscal Adjustment to Lower the Debt-to-GDP Ratio**

*Commandment III: you should target a long-term decline in the public debt-to-GDP ratio, not just its stabilization at post-crisis levels (Ten Commandments for Fiscal Adjustment in Advanced Economies, IMF, 2010).*

Under current policies, staff projects that the gross general government debt-to-GDP ratio will peak at 85 percent in 2012/13 before declining to 80 percent by 2015/16. Lowering the debt ratio to 60 percent by 2030/31 would require improving the cyclically-adjusted primary balance (CAPB) by 7.5 percentage points of GDP between 2009/10 and 2020/21. More specifically, the CAPB will need to improve from a deficit of 6.1 percent to GDP in 2009/10 to a surplus of 1.5 percent of GDP by 2020/21 and be maintained at this higher level through 2030/31. However, staff estimates that the measures laid out in the June budget would bring the CAPB to a surplus of 2 percent of GDP by 2015/16 – if the CAPB is maintained at this level, the debt ratio would reach 60 percent by 2025/26.



Lowering the debt-to-GDP ratio to 40 percent by 2030/31 would require improving the cyclically-adjusted primary balance (CAPB) by 9 percentage points of GDP between 2009/10 and 2020/21. That is, the CAPB will need to reach a surplus of 2.9 percent of GDP by 2020/21 and be maintained constant at this higher level for the subsequent decade. In addition to announced policy plans through 2015/16, further discretionary tightening of about ¾ percentage point of GDP over the following five years to 2020/21 would be needed to achieve the debt target. Under this scenario the debt-to-GDP ratio would fall below 60 percent of GDP by 2023/24.

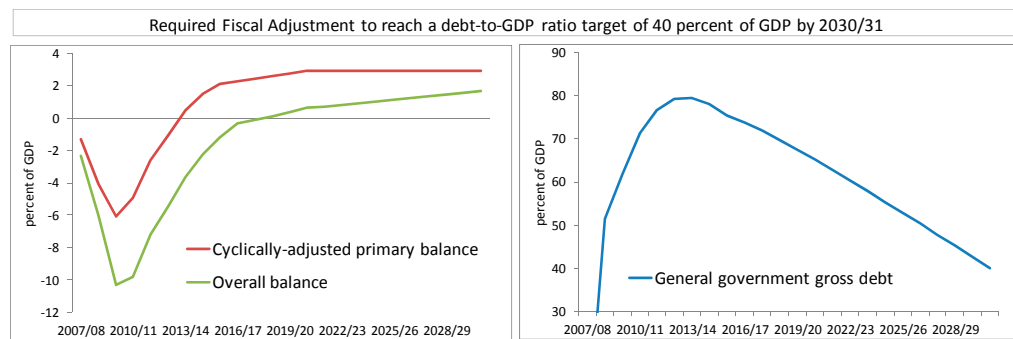


Table A1. United Kingdom: Public Sector Debt Sustainability Framework, 2005-2015  
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing primary balance 9/
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	
<b>Baseline: Public sector debt 1/</b>	41.7	42.4	43.1	55.4	71.6	<b>78.5</b>	<b>82.8</b>	<b>84.8</b>	<b>84.6</b>	<b>82.9</b>	<b>80.2</b>	<b>-0.7</b>
o/w foreign-currency denominated	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Change in public sector debt	2.1	0.7	0.7	12.3	16.2	7.0	4.2	2.1	-0.2	-1.7	-2.7	
Identified debt-creating flows (4+7+12)	1.4	0.2	0.5	7.1	13.1	6.1	3.9	1.9	-0.3	-1.7	-2.7	
Primary deficit	1.0	0.5	0.5	4.6	9.1	6.8	4.1	2.3	0.5	-1.0	-2.0	
Revenue and grants	37.6	38.0	38.1	37.2	36.2	36.6	37.4	37.7	38.0	38.2	38.1	
Primary (noninterest) expenditure	38.6	38.5	38.6	41.8	45.3	43.4	41.5	40.0	38.5	37.2	36.1	
Automatic debt dynamics 2/	0.4	-0.3	0.0	1.9	3.4	-0.6	-0.2	-0.4	-0.7	-0.7	-0.7	
Contribution from interest rate/growth differential 3/	0.4	-0.3	0.0	1.8	3.4	-0.6	-0.2	-0.4	-0.7	-0.7	-0.7	
Of which contribution from real interest rate	1.4	0.7	1.0	1.0	1.3	1.1	1.2	1.4	1.2	1.3	1.3	
Of which contribution from real GDP growth	-1.0	-1.0	-1.0	0.8	2.1	-1.7	-1.4	-1.9	-2.0	-2.0	-2.0	
Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	0.0	0.7	0.5	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (capital injection, depositor compensation)	0.0	0.0	0.0	0.7	0.5	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	0.7	0.5	0.2	5.2	3.1	0.8	0.3	0.2	0.1	0.0	0.0	
Public sector debt-to-revenue ratio 1/	110.9	111.7	113.2	148.9	197.8	214.4	221.5	225.1	222.5	217.2	210.3	
<b>Gross financing need 6/</b>	5.7	6.2	6.0	9.3	15.8	16.7	14.5	12.9	11.1	10.3	7.3	
in billions of U.S. dollars	133.8	153.3	157.5	266.9	425.7	455.9	415.2	389.8	353.7	348.3	263.4	
<b>Scenario with key variables at their historical averages 7/</b>						<b>78.5</b>	<b>81.2</b>	<b>83.7</b>	<b>86.1</b>	<b>88.5</b>	<b>90.9</b>	<b>1.2</b>
<b>Scenario with no policy change (constant primary balance) in 2010-2015</b>						<b>78.5</b>	<b>85.4</b>	<b>91.9</b>	<b>97.9</b>	<b>103.9</b>	<b>109.7</b>	<b>-1.0</b>
<b>Key Macroeconomic and Fiscal Assumptions Underlying Baseline</b>												
Real GDP growth (in percent)	2.5	2.6	2.5	-1.9	-3.7	2.5	1.8	2.4	2.5	2.5	2.6	
Average nominal interest rate on public debt (in percent) 8/	5.4	5.3	5.4	5.1	3.9	4.6	4.4	4.3	4.3	4.4	4.5	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	3.6	1.9	2.5	2.3	2.2	1.6	1.6	1.9	1.6	1.7	1.7	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-10.8	14.0	2.1	-27.2	11.1	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	1.8	3.4	2.9	2.8	1.7	3.0	2.8	2.4	2.7	2.7	2.7	
Growth of real primary spending (deflated by GDP deflator, in percent)	3.7	2.2	2.8	6.2	4.3	-1.8	-2.7	-1.2	-1.5	-0.9	-0.4	
Primary deficit	1.0	0.5	0.5	4.6	9.1	6.8	4.1	2.3	0.5	-1.0	-2.0	

1/ General government consolidated gross debt (series: BKPX).

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

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as  $r - \pi(1+g)$  and the real growth contribution as  $-g$ .

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as  $\alpha\varepsilon(1+r)$ .

5/ For projections, this line includes exchange rate changes.

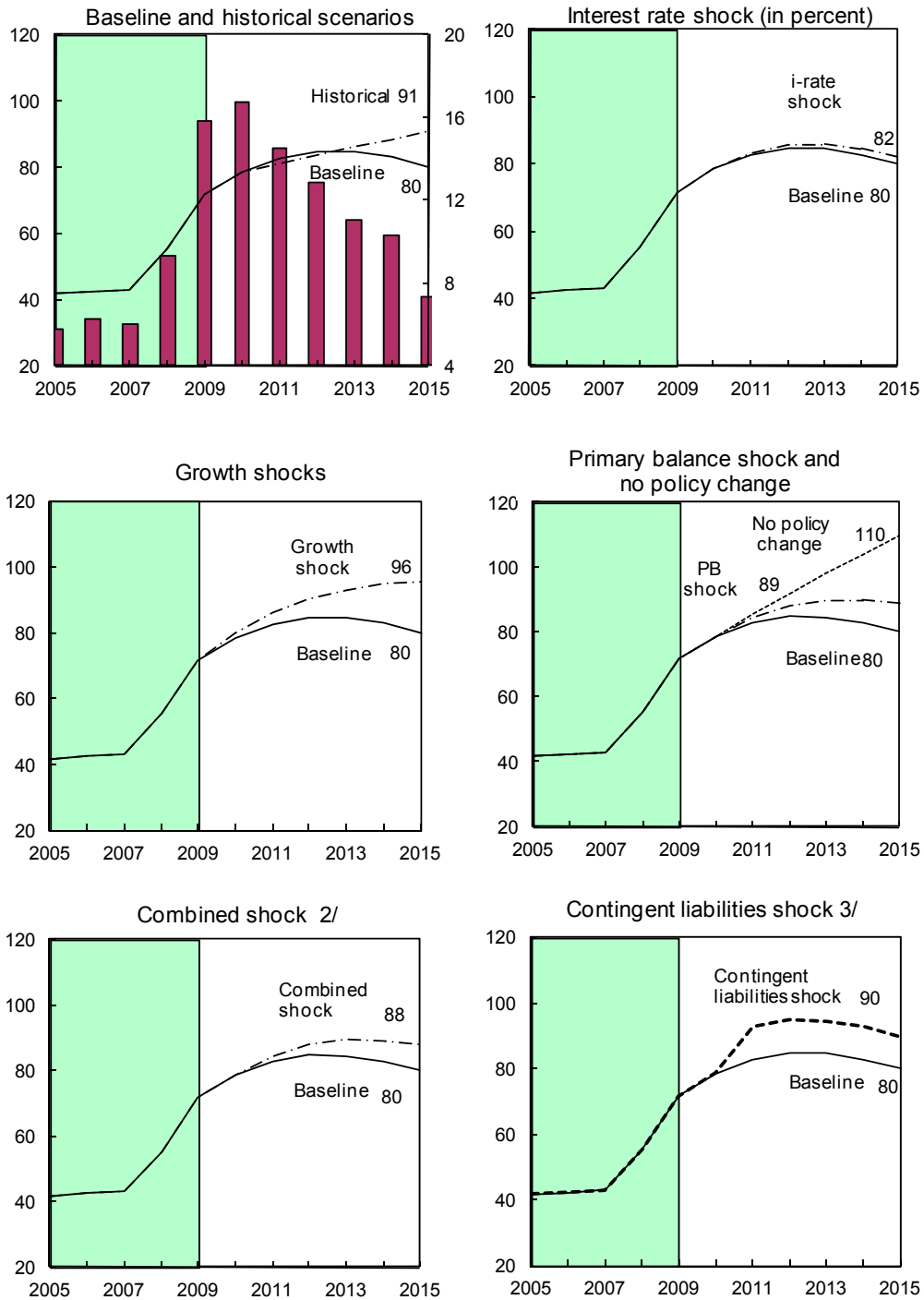
6/ Defined as the general government deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

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

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure A1. United Kingdom: Public Debt Sustainability: Bound Tests 1/  
(General government gross debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates. Data for fiscal years.  
 1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviations shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.  
 2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.  
 3/ A 10 percent of GDP shock to contingent liabilities occur in 2010.

## **Annex B: Background Work**

The analysis in this report is supported by staff research listed below.

### ***Previously published work:***

- [Inflation dynamics during episodes of persistent large output gaps](#) (IMF WP 10/189); a summary of this paper is included in the companion *Selected Issues* paper
- [Debt consolidation and fiscal stabilization in deep recessions](#)
- [The economics of pre-announced government spending cuts](#) (IMF WP 09/106)

### ***Companion Selected Issues paper:***

- Estimating the size of the UK's current output gap
- Lessons from large fiscal adjustments in other advanced economies
- Designing an appropriate new fiscal rule for the UK
- Recent developments and outlook for the UK banking sector
- Recent and pending reforms to the UK financial sector's regulatory and supervisory framework

INTERNATIONAL MONETARY FUND

UNITED KINGDOM

**Staff Report for the 2010 Article IV Consultation—Informational Annex**

Prepared by Staff Representatives for the 2010 Consultation with the United Kingdom

(In consultation with other departments)

October 21, 2010

	Contents	Page
I.	Fund Relations .....	2
II.	Statistical Issues .....	4



**ANNEX I. FUND RELATIONS**  
(Data as of September 30, 2010)

I. **Membership Status:** Joined December 27, 1945; accepted Article VIII.

II. <b>General Resources Account:</b>	<b>SDR Million</b>	<b>Percent Quota</b>
Quota	10,738.50	100.00
Fund holdings of currency	8,377.10	78.01
Reserve Tranche Position	2,361.47	21.99
Lending to the Fund	760.00	

III. <b>SDR Department:</b>	<b>SDR Million</b>	<b>Percent Allocation</b>
Net cumulative allocation	10,134.20	100.00
Holdings	9,150.60	90.29
Designation Plan	0.00	

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

V. **Financial Arrangements:** None

VI. **Projected Payments to Fund:**<sup>1/</sup> (SDR million; based on present holdings of SDRs):

Forthcoming

	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>
Principal					
Charges/Interest	0.74	3.03	3.03	3.03	3.03
Total	0.74	3.03	3.03	3.03	3.03

<sup>1/</sup> When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section

VII. **Exchange Rate Arrangement:**

The U.K. authorities maintain a free floating regime. As of October 20, 2010 the exchange rate for sterling was \$1.58. In accordance with UN resolutions and EU restrictive measures, the United Kingdom applies targeted financial sanctions under legislation relating to Al-Qaeda and Taliban, and individuals, groups, and organizations associated with terrorism; and certain persons associated with: the former Government of Iraq, the former Government of Liberia, the current Government of Burma (aka Myanmar), the former Government of the Republic of Yugoslavia and International Criminal Tribunal Indictées, the current Government of Zimbabwe, the current government of Belarus, the current government of North Korea; the current government of Iran and persons considered to be a threat to peace and reconciliation in Sudan, Cote d'Ivoire, and Democratic Republic of Congo; and persons considered by the UN to have been involved in the assassination of former Lebanese Prime Minister Rafik Hariri. These restrictions have been notified to the Fund under Decision 144–(52/51).

**VIII. Article IV Consultation:**

Discussions for the 2010 Article IV consultation were conducted in London during September 15-27, 2010. The Staff Report (IMF Country Report) was considered by the Executive Board on November 5, 2010.

**IX. FSAP**

The FSAP was completed at the time of the 2002 Article IV Consultation. An update is scheduled in 2011.

X. **Technical Assistance:** None

XI. **Resident Representative:** None

## ANNEX II. STATISTICAL ISSUES—UNITED KINGDOM

Economic and financial data provided to the Fund are considered adequate for surveillance purposes. The United Kingdom subscribes to the Special Data Dissemination Standard (SDDS) and meets the SDDS specifications for the coverage, periodicity, and timeliness of data. SDDS metadata are posted on the Dissemination Standard Bulletin Board (DSBB).

### TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(As of October 21, 2010)

	Date of latest observation	Date received	Frequency of Data <sup>7</sup>	Frequency of Reporting <sup>7</sup>	Frequency of Publication <sup>7</sup>
Exchange Rates	20/10/2010	21/10/2010	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities <sup>1</sup>	September 2010	05/10/2010	M	M	M
Reserve/Base Money	22/09/2010	29/09/2010	W	M	M
Broad Money	August 2010	29/09/2010	M	M	M
Central Bank Balance Sheet	22/09/2010	29/09/2010	W	W	W
Consolidated Balance Sheet of the Banking System	August 2010	29/09/2010	M	M	M
Interest Rates <sup>2</sup>	20/10/2010	21/10/2010	D	D	D
Consumer Price Index	September 2010	12./10/2010	M	M	M
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> – General Government <sup>4</sup>	Q2 2010	12/10/2010	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> – Central Government	August 2010	9/21/2010	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt <sup>5</sup>	Q1 2010	12/10/2010	Q	Q	Q
External Current Account Balance	Q2 2010	28/09/2010	Q	Q	Q
Exports and Imports of Goods and Services	August 2010	12/10/2010	M	M	M
GDP/GNP	Q2 2010	28/09/2010	Q	Q	Q
Gross External Debt	June 2010	12/10/2010	Q	Q	Q
International Investment Position <sup>6</sup>	June 2010	28/09/2010	Q	Q	Q

<sup>1</sup> Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

<sup>2</sup> Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

<sup>3</sup> Foreign, domestic bank, and domestic nonbank financing.

<sup>4</sup> The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

<sup>5</sup> Including currency and maturity composition.

<sup>6</sup> Includes external gross financial asset and liability positions vis-à-vis nonresidents.

<sup>7</sup> Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

INTERNATIONAL MONETARY FUND

UNITED KINGDOM

Staff Report for the 2010 Article IV Consultation—Supplementary Information

Prepared by the European Department  
(In consultation with other departments)

Approved by Ajai Chopra and Tamim Bayoumi

November 2, 2010

*This supplement provides an update on key economic and policy developments that occurred after the staff report was finalized. These developments do not affect the thrust of the staff appraisal. Indeed, several of the announced policies in the recently released Spending Review go in the direction recommended by staff (see paragraphs 25 and 47 in the staff report).*

**Third quarter GDP release**

1. **Third quarter GDP growth came in at a relatively strong 3.2 percent (q-o-q, saar).** This preliminary estimate was much higher than the consensus forecast and moderately above staff's projection (text table).

Construction growth was especially strong (up 17 percent); services and manufacturing also expanded at a solid pace (both up 2.4 percent).<sup>1</sup> Nonetheless, staff still expects GDP growth to moderate to about 2 percent in 2011, reflecting headwinds from accelerating fiscal consolidation and near-term indicators that suggest some cooling of construction growth.

Real GDP Growth, Q3 2010  
(Percent)

	SA quarter-on-quarter change, annualized	Change over Q3 2009
Actual outturn 1/	3.2	2.8
<b>Pre-release forecasts</b>		
IMF staff (Oct. 2010 WEO)	2.7	2.7
Consensus Forecast (Sep. 2010) 1/	1.9	2.4
Bank of England (Aug. 2010 Inflation Report) 2/	2.4	2.5

Sources: Bank of England (BoE), Consensus Forecast, ONS, and IMF staff projections.

1/ Annualization is an IMF staff calculation.

2/ The Bank of England publishes only 4-quarter growth rate forecasts and hence the annualization is an IMF staff calculation of the mode forecast at market interest rates.

<sup>1</sup> Details on the expenditure side will not be released until November 24.

## Spending Review

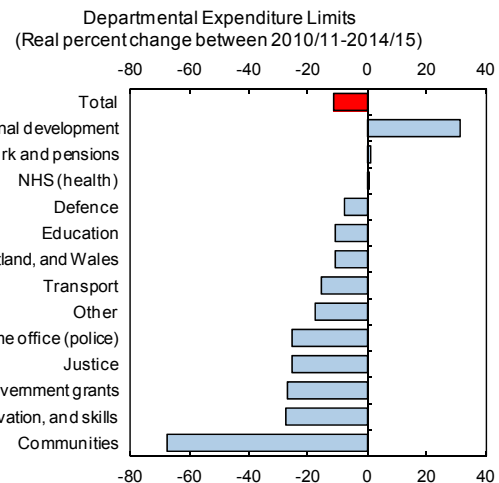
2. **The government recently announced the results of its 2010 Spending Review, which specifies plans to reduce public expenditure at an even nominal pace over the next four years.** The total consolidation, however, remains frontloaded due to frontloaded tax measures. Notable elements of the Spending Review include the following:

- Relative to previous announcements, by FY 2014/15 annual spending on social benefits will be reduced by an additional £7 billion (0.4 percent of GDP). Of these savings, £2.5 billion come from the elimination of the child benefit for higher-income taxpayers (this benefit is currently universal), starting in 2013.<sup>2</sup> Another £2.0 billion in savings comes from placing a one-year time limit on certain benefits available to those who have a disability but are deemed able to work.<sup>3</sup>
- The additional reduction in social benefits lessens the required retrenchment of other government functions: excluding the protected areas of health and foreign aid, departmental spending will be reduced by 19 percent in real terms by 2014/15—less than the 25 percent real cuts announced in the June budget.

Fiscal Consolidation Plan  
(Cumulative £ billion, unless otherwise indicated)

	2011/12	2012/13	2013/14	2014/15
Total consolidation plan	39	64	87	111
Total spending reductions	21	40	61	81
Total tax changes	18	24	27	29
<b>Memorandum</b>				
Cumulative proportion of four-year consolidation plan (Percent)	35	58	78	100

Sources: HM Treasury and IMF staff calculations.



Sources: HM Treasury, and IMF staff calculations.

<sup>2</sup> The full elimination of this benefit once a certain income threshold is reached implies very high effective marginal tax rates right at the threshold. However, the government views the simplicity of the reformed scheme as a higher priority than avoiding such “cliff effects.”

<sup>3</sup> With the new reductions, changes to social benefits now account for 25 percent of the reduction in total primary expenditure, up from 15 percent in the June budget. The costing of savings from reductions in social benefits was vetted by the newly established independent Office for Budget Responsibility. The OBR will also take into account the effect of the revised spending plans on its economic growth projections when it next updates its forecasts. However, staff does not expect the Spending Review to result in large growth revisions, as it was largely in line with expectations.

- Within departmental spending, transfers to local governments and public security face some of the largest spending reductions (text chart).
- The government plans to accelerate the increase in the state pension age (state pensions are the universal scheme for both private and public employees). Proposed legislation would equalize the pension age for women with that of men at 65 by 2018 (instead of 2020 as under current law) and raise it to 66 for both men and women by 2020 (instead of 2026 as under current law).
- Public employee pension contributions will rise by 3 percentage points on average, yielding 0.1 percent of GDP by 2014/15. The ongoing review of pensions for public sector employees (due by the time of the FY 2011/12 budget) is likely to yield additional long-run savings in this area.
- The total spending envelope remains very close to previous announcements. One modest adjustment is a slight increase (by 0.1 percent of GDP by FY 2014/15) in the allocation for capital expenditure, easing the real reduction in this category (relative to FY 2010/11) from 33 percent to 29 percent. Although this increase in capital expenditure is not offset by new savings elsewhere, the change does not affect achievement of the government's fiscal mandate, which aims to balance the cyclically adjusted *current* budget.

3. **Several of the announced policies go in the direction recommended by staff.**

Specifically, the government's plans have (i) restricted some universal benefits—notably the child benefit—to lower-income families in order to improve targeting; (ii) reduced somewhat the reliance on capital expenditure cuts; (iii) lowered public sector compensation premia (in the context of reforming public employee pensions); and (iv) modestly accelerated increases in the state pension age. However, scope for reform, especially in the latter two areas, is not yet exhausted. In this regard, the outcome of ongoing studies on public employee pension reform and the further acceleration of increases in the state pension age will have important effects on longer-run fiscal sustainability.

4. **Implementation of expenditure reductions remains a risk.** Cuts of this magnitude will be challenging to implement and may strain public service delivery in some areas. However, the roughly even distribution of spending reductions across the next four years should help ease adjustment costs. The effect of spending reductions on vulnerable segments of society will need to be monitored closely.

### Upgrade of ratings outlook

5. **Standard & Poor's revised its outlook for the UK's AAA rating from Negative to Stable on October 26.** S&P cited the Spending Review as a key factor behind the upgraded outlook, noting that the Review had reduced uncertainty regarding the political resolve to

tackle the deficit. The rating agency's decision reversed an earlier outlook revision from May 2009.

### **Draft legislation for the Office for Budget Responsibility (OBR)**

6. **Draft legislation to establish the OBR on a permanent basis has been presented to parliament.** The draft legislation includes a number of safeguards to protect the OBR's independence, including fixed terms for members of the OBR's executive committee, a statutory veto for the Treasury Select Committee over their appointment and dismissal, and an explicit statement that the OBR has discretion in performing its required duties, including in determining its own work program beyond its statutory tasks. The draft law also gives the OBR full access rights to information required to discharge its duties. To help safeguard the OBR's financial independence, Treasury has agreed to provide the OBR with a multi-year budget for the period of the Spending Review.



INTERNATIONAL MONETARY FUND

*Public Information Notice*

EXTERNAL  
RELATIONS  
DEPARTMENT

Public Information Notice (PIN) No. 10/147  
FOR IMMEDIATE RELEASE  
November 9, 2010

International Monetary Fund  
700 19<sup>th</sup> Street, NW  
Washington, D. C. 20431 USA

## **IMF Executive Board Concludes 2010 Article IV Consultation with the United Kingdom**

On November 8, 2010 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the United Kingdom.<sup>1</sup>

### **Background**

Economic recovery is underway in the UK. After six quarters of deep recession, the economy started growing again in late 2009, led by a classic turn in the inventory cycle. More recently, private final demand has also begun to recover modestly as the labor market has stabilized, household saving rates have begun to ease, and corporates have begun to increase investment from its low levels. However, past sterling depreciation has not yet boosted net exports as much as expected. Meanwhile, inflation has surprised on the upside as a series of price level shocks has more than offset the moderating effect of sizeable economic slack on underlying inflation.

The financial crisis has taken a toll on the fiscal position, with the overall deficit (excluding financial sector interventions) in FY 2009/10 (April 6, 2009-April 5, 2010) rising to 11 percent of GDP, one of the highest in the world. To ensure confidence in public finances and avoid adverse market reactions, the government has set itself a fiscal mandate of balancing the cyclically adjusted current budget (by the end of a rolling five-year horizon) and putting the net debt-to-GDP ratio on a declining path by 2015/16, and it has announced plans to achieve these

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<sup>1</sup> 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. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.



goals one year early. The adjustment is frontloaded and relies mainly on spending restraint, with support from an increase in the VAT rate and other tax measures.

To counter disinflationary pressures and bolster economic recovery, the Bank of England (BoE) has provided unprecedented monetary stimulus: the policy rate has been kept near zero, while £200 billion in asset purchases (mostly of longer-term government bonds) have helped depress bond yields and boost asset prices, thereby supporting market confidence, household net wealth, and corporate credit supply.

Banking sector health has improved, as banks have raised capital, reduced leverage, and increased earnings. Nonetheless, important challenges remain: regulatory requirements are set to tighten over time; uncertainty about the sustainability of bank profits and the quality of some exposures remains significant; and banks will need to raise significant amounts of new funding as public support schemes taper off. Meanwhile, the authorities have laid out plans to revamp the UK's prudential architecture, consolidating key responsibilities in the BoE.

Looking ahead, economic recovery is expected to continue at a moderate pace as private and external demand progressively gather strength while the public sector retrenches. GDP is projected to grow at 1.7 percent this year and 2.0 percent in 2011. Risks around this forecast are considerable, though broadly balanced, reflecting continued economic uncertainty both globally and in the UK.

### **Executive Board Assessment**

Executive Directors welcomed the stabilization of the UK economy and its return to growth reflecting the authorities' strong policy actions, including large-scale financial-sector interventions, unprecedented monetary easing, and temporary fiscal stimulus followed by the announcement of a strong and credible multi-year fiscal consolidation strategy. The challenge going forward will be to support a balanced and sustainable economic recovery. With the private sector running high financial surpluses and the public sector running high deficits, sustainable growth will require a gradual rebalancing toward private and external sector-led demand.

Directors generally supported the government's frontloaded fiscal consolidation, as it preserves confidence in debt sustainability, restores fiscal space to cope with future shocks, and supports rebalancing. They agreed that these benefits outweigh expected costs in terms of a moderate dampening of near-term growth.

Directors noted that the fiscal consolidation plans include an appropriate mix of tax and expenditure measures. They welcomed the authorities' efforts to preserve priority expenditures, especially those that promote growth, protect vulnerable groups, and support official development assistance. Directors commended the creation of an independent Office for

Budget Responsibility and encouraged the authorities to strengthen the fiscal framework further by eventually replacing the current fiscal mandate, an appropriate guide for the consolidation process, with more permanent fiscal rules.

Directors agreed that a highly accommodative monetary stance remains appropriate given the need to maintain overall policy stimulus as fiscal tightening takes hold and financial intermediation normalizes only gradually. This policy mix would facilitate the necessary rebalancing while supporting a moderate-paced recovery and maintaining inflation near the target over the policy horizon.

Directors noted that risks around this central scenario are substantial in both directions. They agreed that a key safeguard against risks is the free operation of automatic fiscal stabilizers. In addition, monetary policy must remain nimble. Policy rates should be raised gradually if output recovers apace and inflation continues to surprise on the upside. Conversely, asset purchases should resume if the recovery weakens and disinflationary pressures mount. In the unexpected case of a significant and prolonged new downturn, some Directors considered that the pace of structural fiscal consolidation could be adapted, market conditions permitting and ideally combined with longer-term entitlement reforms to safeguard fiscal sustainability and market credibility.

Directors supported continued efforts to strengthen financial sector health and reduce related risks to the economy and taxpayer. This includes raising capital buffers over time, unwinding crisis-related public interventions, and maintaining pressure on banks to develop robust new funding models.

Directors welcomed the creation of a Financial Policy Committee with an explicit macroprudential mandate. They emphasized that, to be effective, some macroprudential measures should be internationally coordinated. The transition toward a new prudential architecture also needs to be managed carefully to mitigate operational risks. In addition, Directors encouraged the authorities to continue enhancing the more intrusive, judgment-based, and strategic approach to supervision adopted since the crisis. They also looked forward to the results of the 2011 Financial Sector Assessment Program update, including analysis of issues such as the supervision of foreign banks in the UK and the resolution framework for non-banks.

**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](#) (use the free [Adobe Acrobat Reader](#) to view this pdf file) for the 2010 Article IV Consultation with United Kingdom is also available.

**United Kingdom: Selected Economic and Social Indicators, 2006–11**

	2006	2007	2008	2009	2010 Proj.	2011 Proj.
<b>Real Economy</b>						
Real GDP (change in percent)	2.8	2.7	-0.1	-5.0	1.7	2.0
Domestic demand (change in percent)	2.5	3.1	-0.7	-5.5	2.6	1.5
CPI (change in percent, period average)	2.3	2.3	3.6	2.1	3.2	2.8
Unemployment rate (percent) 1/	5.4	5.4	5.6	7.5	7.9	7.5
Gross national saving (percent of GDP)	14.1	15.6	15.0	12.3	12.1	12.9
Gross domestic investment (percent of GDP)	17.5	18.2	16.6	13.6	14.5	15.2
<b>Public Finance 2/</b>						
General government balance	-2.3	-2.7	-6.7	-	-9.9	-7.4
Public sector balance	-2.3	-2.4	-6.0	-	-9.9	-7.2
Cyclically adjusted balance (staff estimates)	-2.2	-2.9	-5.8	-8.1	-7.7	-5.5
Public sector net debt	36.0	36.5	42.7	53.5	61.2	66.3
<b>Money and Credit (end-period, 12-month percent change) 3/</b>						
M4	12.5	12.7	15.5	6.6	1.9	...
Consumer Credit	7.4	7.0	4.1	-1.7	-1.0	...
<b>Interest rates (year average) 4/</b>						
Three-month interbank rate	5.3	6.0	5.8	1.2	0.7	...
Ten-year government bond yield	4.5	5.0	4.7	3.6	3.7	...
<b>Balance of Payments</b>						
Trade balance (percent of GDP)	-3.1	-3.1	-2.6	-2.4	-2.9	-2.5
Current account balance (percent of GDP)	-3.4	-2.6	-1.6	-1.3	-2.4	-2.3
Exports (percent of GDP)	28.5	26.6	29.3	27.7	28.4	28.4
Export volume (change in percent)	11.1	-2.6	1.0	-	5.5	6.3
Imports (percent of GDP)	31.6	29.7	31.9	30.1	31.3	30.9
Import volume (change in percent)	9.1	-0.8	-1.2	-	8.2	4.3
Net exports of oil (billions of US dollars)	-5.1	-8.1	-10.8	-4.7	-5.2	-6.4
Reserves (end of period, in billion of US dollars)	51.8	57.9	53.9	66.4	...	...
<b>Fund Position (as of September 30, 2010)</b>						
Holdings of currency (percent of quota)						78.0
Holdings of SDRs (percent of allocation)						90.3
Quota (millions of SDRs)						10,738.5
<b>Exchange Rates</b>						
Exchange rate regime						Floating US\$ = £0.6347
Bilateral rate (September 30, 2010)						
Nominal effective rate (2000=100) 3/ 5/	100.8	103.3	90.7	80.3	80.1	...
Real effective rate (2000=100) 5/ 6/ 7/	101.6	105.2	92.2	80.9	83.1	...

**Social Indicators (reference year):**

Income per capita (US dollars, 2008): 43,541; Income distribution (ratio of income received by top and bottom quintiles, 2008): 5.6;

Life expectancy at birth (2008): 77.9 (male) and 82.0 (female); Automobile ownership (2006): 471 per thousand;

CO2 emissions (ton per capita, 2006): 9.37; Population density (2008) 254 inhabitants per sq. km.;

Poverty rate (at-risk-of-poverty rate after social transfers, 2008): 19 percent

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 2006 refers to FY2006/07. Debt stock data refers to the end of the fiscal year using centered-GDP as a denominator.

3/ 2010: actual data as of August.

4/ 2010: actual data through September.

5/ Average. An increase denotes an appreciation.

6/ 2010: actual data through July.

7/ Based on consumer price data.

**Statement by Alex Gibbs, Executive Director for the United Kingdom  
November 8, 2010**

We thank staff for a very good report which is based on a productive staff mission to the UK in September. My authorities' views are appropriately described in the report. They agree with staff's main messages and welcome staff support for their strategy for fiscal consolidation. This strategy has reduced the risk of adverse market conditions and is expected to underpin household, business and market confidence, providing the conditions for sustainable private sector-led growth in due course.

**Outlook and recent economic developments**

At the time of the last UK Article IV in summer 2009, the UK, along with other advanced economies, was undergoing a severe contraction with risks to the outlook from rising unemployment, falling house prices, deleveraging, tight credit conditions and losses in the financial system. Since then, conditions have stabilised and the economy has returned to growth. Real GDP has now grown for four consecutive quarters to a level 2.8 per cent higher than in the last quarter of falling output (Q3 2009).

The economic forecast that underpins the UK budget is now the responsibility of the newly created and independent Office for Budget Responsibility (OBR). Its central economic forecast is for the recovery to gather pace - 1.2% this year, 2.3% next – rising to above trend rates from 2012 as the private sector recovery strengthens and the economy becomes more balanced. Growth in the second and third quarters of 2010 was higher than the OBR forecast in June. The reasons for the OBR's slightly stronger growth projections for 2011 as compared with staff are explained in the staff report, and include a larger contribution from net exports and stronger fixed investment. Global demand, however uneven, is necessary to sustain the UK recovery, and domestic demand is likely to be supported by some gradual moderation in private savings.

As staff mention in their report, labour market performance has been better than envisaged at the time of last year's assessment. Although output fell by more than 6% during the recession, employment fell by less than 2%. Employment increased by 178,000 in the 3 months to August, and is now at the level projected to be reached by mid 2012 in the OBR forecast.

Significant uncertainties remain, especially around the strength of the global recovery. My authorities' strategy is to mitigate risks and address the underlying economic imbalances that contributed to the crisis in order to promote sustainable, private sector-led growth. Alongside the consolidation of fiscal policy they have introduced measures to support investment and growth. They have avoided sharply raising taxes on capital and labour, focusing instead on reforming corporation tax to reduce the cost of capital and promote investment. Welfare reforms are designed to encourage and reward work while protecting the most vulnerable in society. Efficiency savings are sought across the public sector.

On the inflation outlook, my authorities agree with the staff that the forthcoming VAT increase means that inflation is likely to remain above the 2% target until the end of 2011. While there is some risk that a prolonged period of above target inflation may cause medium-term inflation expectations to increase, we expect inflation to fall back below the target, given the spare capacity in the economy and labour market.

### **Fiscal policy**

In their 2009 Article IV assessment of the UK, staff sought a stronger commitment to fiscal consolidation and a more ambitious medium-term fiscal adjustment path. Staff urged greater clarity on specific adjustment measures with a focus on expenditure reduction. The new Government, which took office in May 2010, agrees with this advice. Tackling the fiscal deficit in a way that will help promote growth is the most urgent task facing the UK economy.

The Government's June Budget therefore set out an accelerated plan for fiscal consolidation, which at around 2% of GDP by 2014-15 was toward the upper end of outside expectations. This has been received positively by the markets. Around three quarters of the consolidation will come from spending restraint, in line with staff advice and international evidence on what determines an effective and lasting consolidation.

Following the June Budget, the October Spending Review set out £81 billion of spending reductions to deliver the consolidation plan, while at the same time seeking to protect priority areas of expenditure, including those that promote economic growth. Key transport and infrastructure projects have been supported, and areas of resource spending that are important for growth have also been prioritised, including through a real terms increase in the core schools budget of 0.1% a year, spending on science being maintained in cash terms and a £1.4 billion regional growth fund. My authorities are also committed to protecting the UK's budget for overseas development assistance from expenditure cuts and to delivering the target of ODA at 0.7 per cent of GDP.

A particular focus of policy has been to achieve the consolidation in a way that helps address longer-term fiscal pressures. Therefore my authorities are reforming State Pension provision by bringing forward the equalisation of State Pension Age for men and women at 65 to November 2018, and accelerating subsequent increase to 66 by 2020. This will significantly offset the cost to the public sector of increasing longevity, and my authorities are also considering bringing forward further planned pension age increases. Public sector employees' pension contributions will rise, leading to additional savings of £1.8 billion a year by 2014-15. Further savings will be those delivered through reforms to social benefits and transfers from central to local government.

According to OBR projections, these measures taken together should eliminate the cyclically-adjusted current deficit by 2014-15 and place public sector net debt on a downward path in the same year.

### **Fiscal Framework**

The staff report describes well the steps my authorities have taken to strengthen the fiscal framework and provide greater transparency and credibility to the UK's official economic and fiscal forecasts in particular by creating the new independent Office for Budget Responsibility (OBR). The need for a reform on these lines has been a theme of staff advice to the UK in several previous Article IV cycles. The OBR will produce independent macroeconomic and fiscal forecasts on which all budget decisions will be based, judge the consistency of the Government's fiscal policy with its fiscal mandate, and assess the sustainability of the public finances. The OBR has been operating on an interim basis since May 2010, and legislation was introduced to Parliament on 21 October to establish the OBR and its core functions in statute.

The fiscal mandate my authorities have adopted to guide policy decisions over the medium term is to set policy to achieve cyclically-adjusted current balance by the end of the rolling, five-year forecast period. This fiscal mandate is supplemented by a target for public sector net debt as a percentage of GDP to be falling at a fixed date of 2015-16. On current plans, the UK is forecast by the OBR to meet the mandate and supplementary debt target a year early.

### **Monetary policy**

With fiscal policy constrained, and the recovery still fragile, the Bank of England has maintained a supportive monetary stance with policy rates at the lower bound and additional stimulus provided through large scale asset purchases. As shown in the staff report, the programme of asset purchases have had a significant impact on financial markets and particularly gilt yields, and its effects should continue to be felt on the wider economy for some time to come.

The current weakness in broad money growth is likely to be related to continued adjustment of bank balance sheets, and could be seen as a corollary of bank deleveraging. The Monetary Policy Committee (MPC) judges it appropriate to maintain Bank Rate at 0.5% and the stock of assets financed by reserves at £200bn; the Committee will continue to assess month by month whether a change in policy in either direction is warranted (the MPC's next decision will be this Thursday, 4 November). When and if it feels it is appropriate to begin tightening policy, this is most likely to occur through a rise in Bank Rate with asset sales being conducted later in an orderly programme over a period of time.

### **Financial policy and framework**

Conditions in the UK's financial sector are much improved with higher bank capital ratios, increasing bank profitability and a successful conclusion to CEBS stress testing for UK banks. This has helped build resilience to further shocks.

However, my authorities remain vigilant and mindful that funding challenges remain, exacerbated by renewed uncertainty over the macro outlook. UK banks envisage (realised and prospective) balance sheet reduction as central to helping meet this funding challenge. Central to addressing all these issues is the need for appropriate risk

management – with close monitoring of firms’ governance, culture, policy, processes and systems.

As explained in the staff report, the case for structural reform in the UK banking sector is currently being assessed by an Independent Commission on Banking which will report in September 2011.

Systemic risk in the financial system is being addressed through regulatory and institutional reform. The staff report and Selected Issues paper (chapter VI) explain the Government’s wide ranging programme, an important part of which is to give the Bank of England responsibility for macro-prudential regulation and oversight of micro-prudential regulation. As part of this, a new Prudential Regulatory Authority will be created, as a subsidiary of the Bank, and a separate, independent Consumer Protection and Markets Authority (CPMA) will also be established. The Government will also legislate for the creation of a new Financial Policy Committee with macro-prudential oversight.

My authorities are committed to full implementation of the recently agreed Basel III requirements and UK banks appear well placed to meet these new requirements in a timely manner. My authorities intend to continue to play a full role in international and EU discussions on strengthening the financial sector, and enhancing international cooperation. They are fully cognizant of the risks as well as benefits posed by interconnected global markets and firms, and are supportive of the drive to build a strategic global approach to regulation, enabling effective risk management through coordinated macro-prudential analysis, harmonised prudential rules, effective supervision of cross-border firms and fair, and orderly global markets.

As staff note, my authorities look forward to exploring many of the issues relating to the financial sector in more detail in the forthcoming Financial Sector Assessment Programme which will be conducted during the first half of 2011 and be discussed by the Board alongside the 2011 Article IV report, in conjunction with a pilot Spillover Report for the UK.