© 2002 International Monetary Fund

March 2002
IMF Country Report No. 02/39

United Kingdom: 2001 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the United Kingdom

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2001 Article IV consultation with the United Kingdom, the following documents have been released and are included in this package:

- the staff report for the 2001 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **December 10, 2001,** with the officials of the United Kingdom on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on February 11, 2002.** 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 Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its March 4, 2002 discussion** of the staff report that concluded the Article IV consultation.

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

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

Selected Issues Paper

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

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org Internet: http://www.imf.org

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

UNITED KINGDOM

Staff Report for the 2001 Article IV Consultation

Prepared by the Staff Representatives for the 2001 Consultation

Approved by Michael Deppler and Leslie Lipschitz

February 11, 2002

- The Article IV consultation discussions were held in London during November 28-December 10, 2001.The mission comprised Mr. Cottarelli (Head), Ms. Coorey, Messrs. Escolano, Engels, Tzanninis (all EU1) and Ghosh (PDR). Ms. Schumacher (MAE) joined the mission as part of the preparation for the 2002 Financial Sector Assessment Program. Mr. Scholar, Executive Director for the United Kingdom, and Mr. Kelmanson (OED) participated in the discussions. Staff met with the Chancellor of the Exchequer, the Governor of the Bank of England, the Chairman of the Financial Services Authority, and other senior officials, including members of the Monetary Policy Committee. Staff also met representatives of the Confederation of British Industries, the Trades Union Congress, private think tanks, rating agencies, and banks.

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

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

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

- At the conclusion of the last consultation in February 2001, Executive Directors commended the authorities for the continued strong performance of the economy since the early 1990s. With downside risks to global growth, Directors welcomed the February interest rate cut and encouraged the authorities to stand ready to cut rates further if signs of weaker domestic activity emerged.

Contents

Page

I. Overview and Key Issues 4

II. Report on the Discussions 9

A. Why has the U.K. Economy Performed better than other G-7 Economies in 2001? 9
B. Imbalances and Short-Term Prospects 15
C. Fiscal Policy 24
D. Monetary Policy 28
E. Risks to the Financial Sector 29
F. Structural Policies for Productivity Growth 31
G. Other Issues 33

III. Staff Appraisal 33

Tables

1. Selected Economic Indicators 36
2. Main Components of Aggregate Demand 37
3. Public Sector Budgetary Projections 38
4. Balance of Payments 39
5. Medium-Term Scenario 40
6. Indicators of External and Financial Vulnerability 41

Figures

1. International Comparison of Trends and Forecasts 5
2. Consumer Price Inflation 6
3. Fiscal Indicators 7
4. Productivity—International Comparison 8
5. International Comparison of Short-Term Interest Rates 11
6. Leading Economic Indicators 12
7. Household Savings and Asset Prices. 13
8. Interest Rates 14
9. Cyclical Position, Demand, and Output 16
10. Real Exchange Rate, Current Account, and Trade 17
11. Manufacturing Production 19
12. Indicators of the Corporate Sector 20
13. Debt and Interest Payment Indicators 21
14. Tax and Expenditure Ratios 27
15. Labor Market Indicators 30

Text Boxes

1. The Fiscal Framework 10
2. The Sterling Real Exchange Rate 22
3. Eliminating VAT Zero-Rating 28

Appendices

I. Basic Data 42
II. Fund Relations 43
III. Statistical Information 44

I. Overview and Key Issues

1. **The United Kingdom has experienced nine years of sustained noninflationary growth, the longest such expansion in more than 30 years.** Since the 1991–92 recession, output growth has averaged almost 3 percent a year. In 2001, although output decelerated along with the global slowdown, the United Kingdom grew faster than any other G-7 economy (Figure 1). Unemployment has halved during the 1990s, falling to about 5 percent in 2001 (Table 1). At the same time, inflation has declined from a peak of 9½ percent in late 1991 to about 2 percent in 2001 (Figure 2); on a harmonized basis, it was the lowest in the EU. The external current account deficit averaged 1¾ percent of GDP in 1998–2001 compared with 5 percent of GDP in 1989.

2. **A strong policy framework, sound macroeconomic policies, and sustained structural reform were key to this remarkable performance.** Three factors stand out. First, the fiscal house has been put in order which, together with an explicitly medium-term oriented fiscal framework, has helped to boost confidence and lower long-term real interest rates. The cyclically-adjusted overall balance swung from a deficit of 5½ percent of GDP in FY1993/94 to a surplus of 1½ percent of GDP in FY2000/01, while the public net debt ratio fell from 44½ percent of GDP at end-1996 to 30½ percent of GDP at end-2001 (Figure 3).[1] Second, the inflation-targeting framework adopted in late 1992 was strengthened in May 1997 when the Bank of England was granted operational independence in pursuing a symmetric 2½ percent inflation target. This action, along with the transparency of the monetary framework, has helped anchor inflation expectations at 2½ percent compared with around 5 percent in the early 1990s. Third, labor market and welfare reforms that began in the 1980s have enhanced labor market flexibility, fostering employment growth and allowing unemployment to fall without triggering inflationary wage demands.

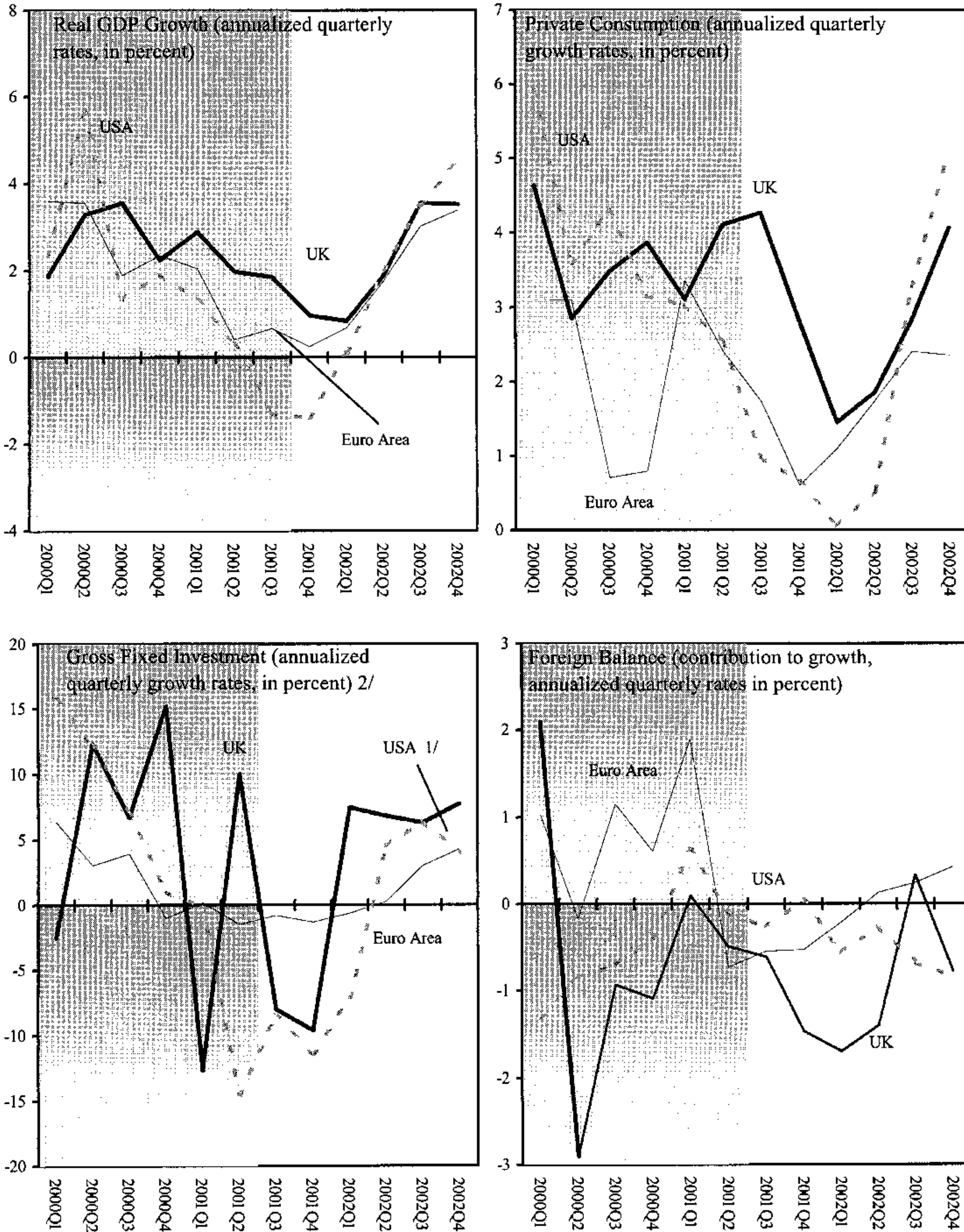
3. **However, the fact that growth has, in some respects, been lopsided has raised doubts about its sustainability.** Since 1996, as sterling appreciated strongly, growth has been sustained primarily by domestic demand (Table 2), and private sector debt ratios have surged. Moreover, in the last year, private consumption and public spending, rather than private investment, have been the main driving forces. Burgeoning house prices and credit to households and corporations, reminiscent of developments at the end of the 1980s, have attracted much attention. On the supply side, reflecting these factors, services have boomed, but manufacturing—which was also hit by external shocks—has slumped recently.

4. **At the structural level, the key challenge remains to raise productivity.** Productivity is significantly lower than in other G-7 countries, even though the gap has narrowed somewhat during the 1990s (Figure 4). Empirical evidence suggests that the main

---

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

Figure 1. United Kingdom: International Comparison of Trends and Forecasts 1/

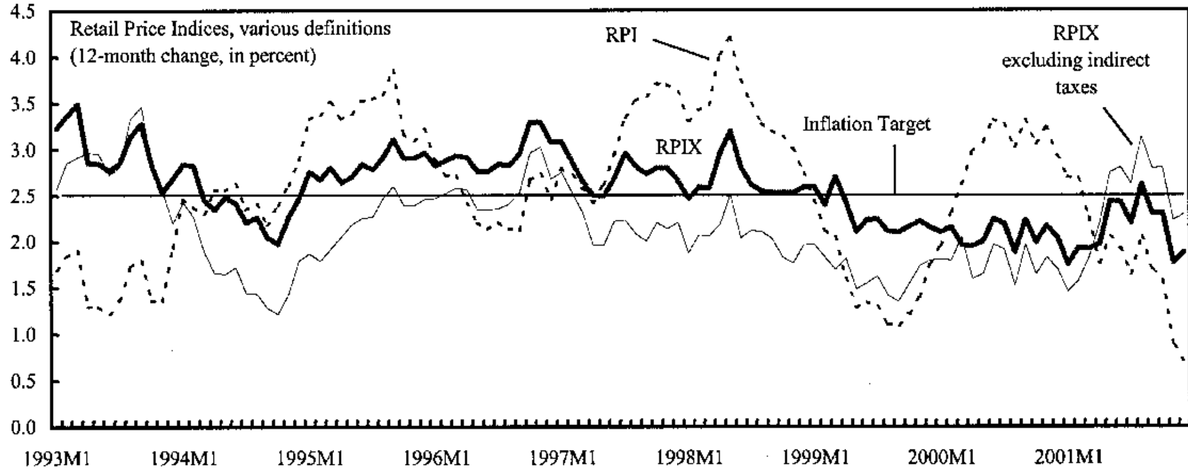


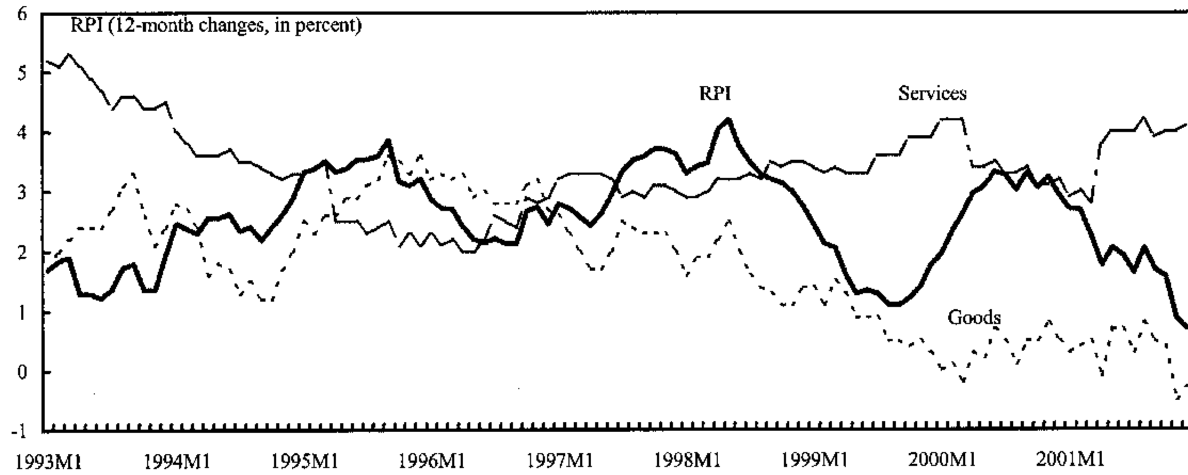
Sources: National Statistics; Bank of England; and IMF staff projections

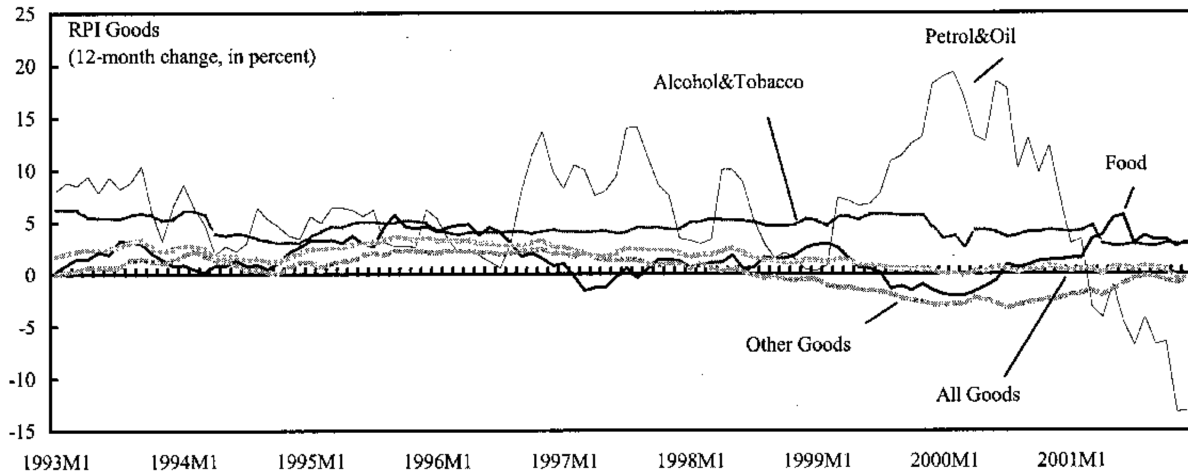
1/ Shaded area represents actual data, unshaded area represents staff projections

2/ For the US, only gross fixed private investment is included.

Figure 2. United Kingdom: Consumer Price Inflation

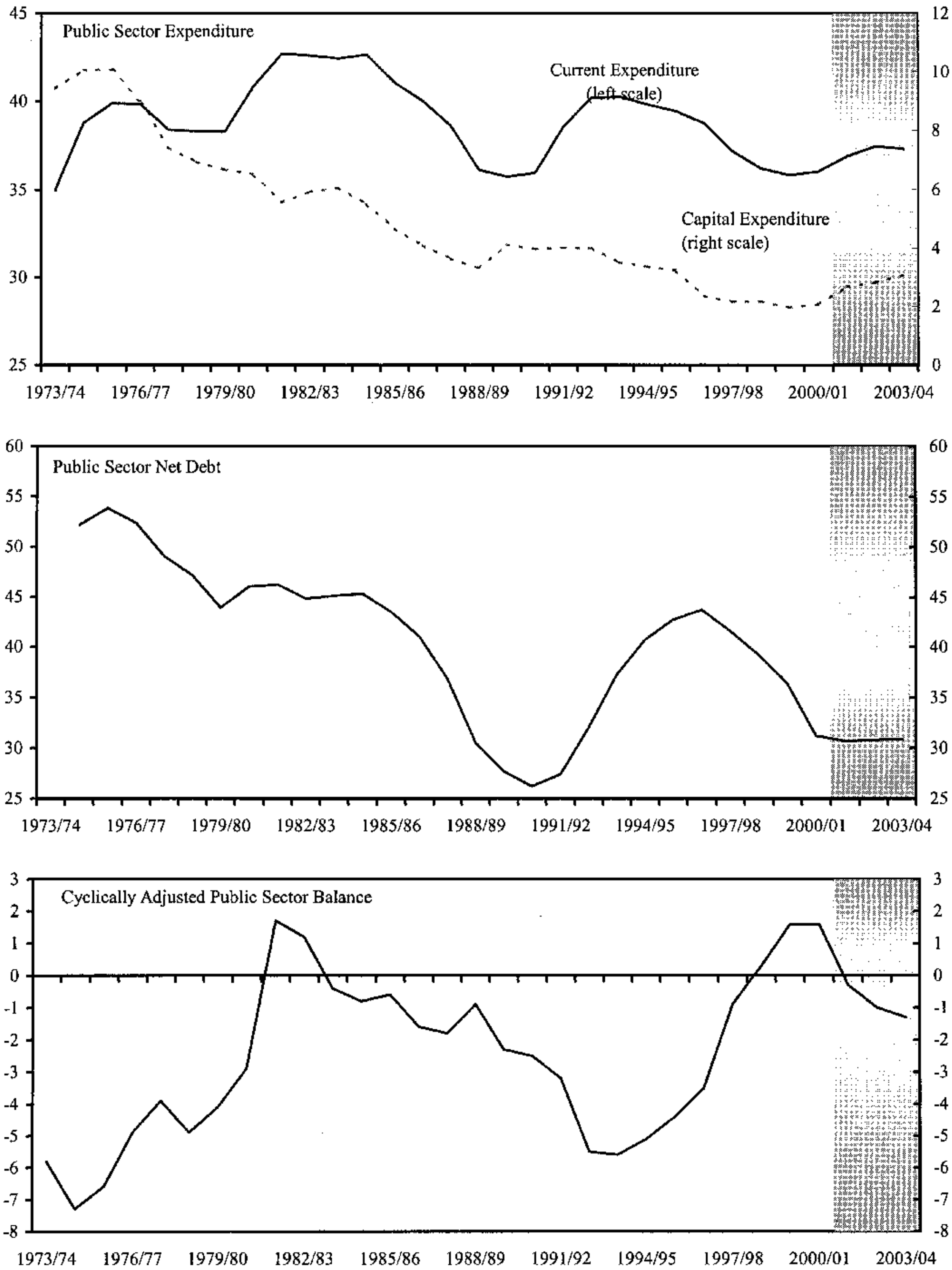






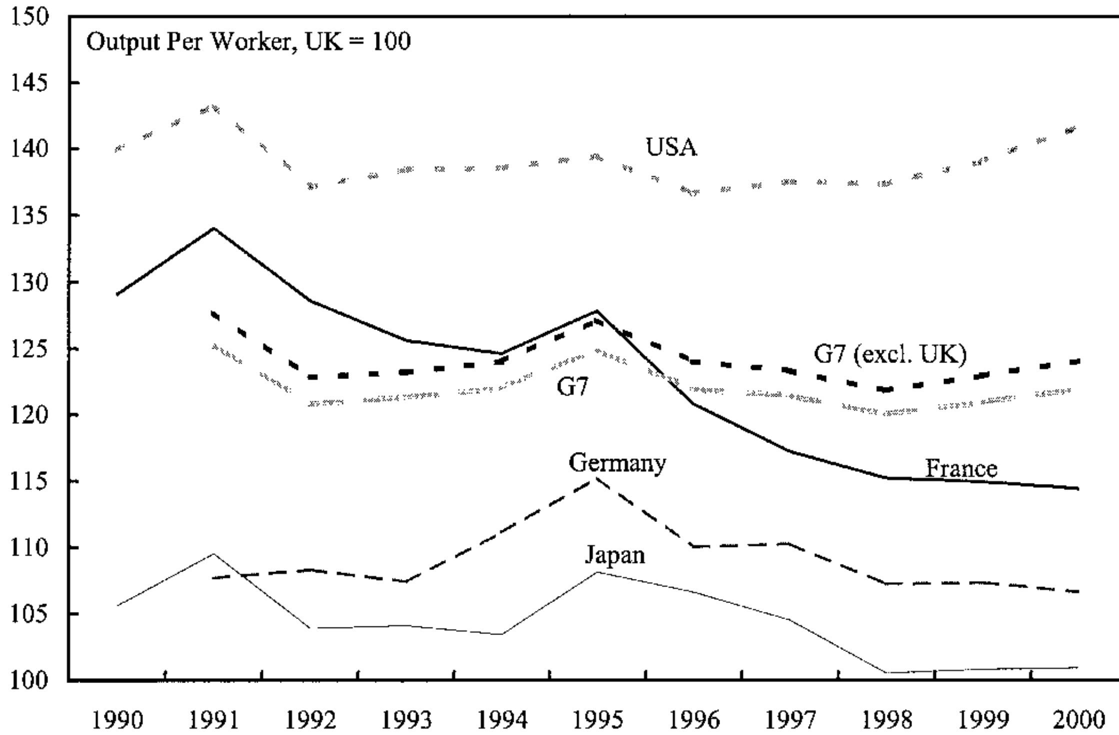
Source: National Statitistics.

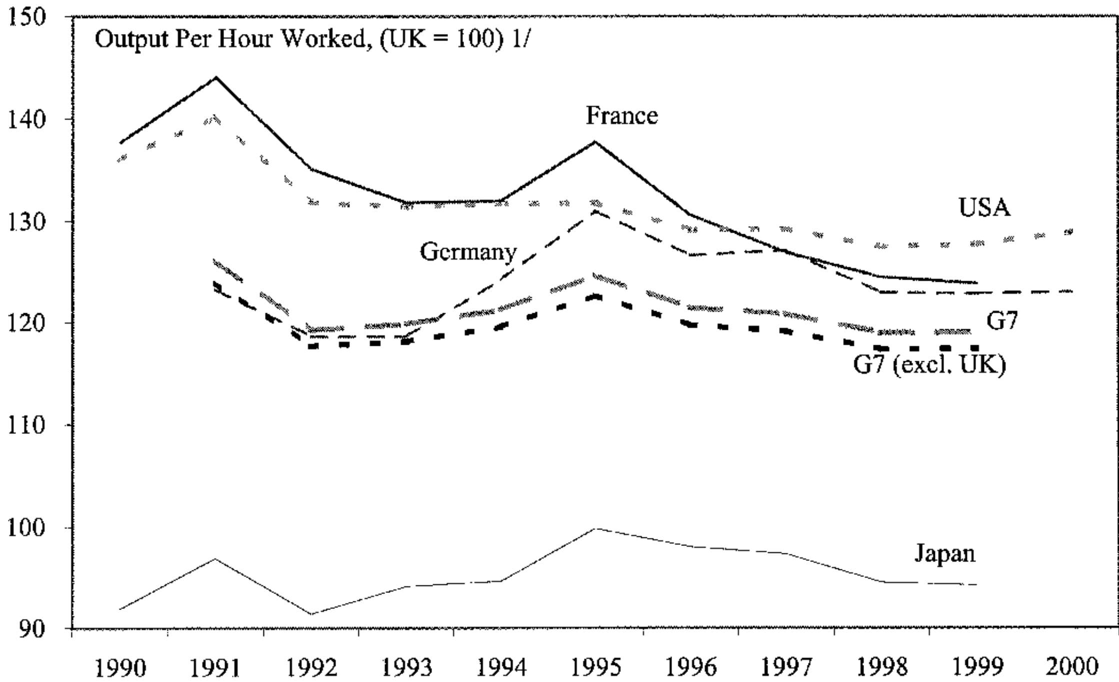
Figure 3. United Kingdom: Fiscal Indicators 1/
(In percent of GDP)



Source: 2001 Pre-Budget Report.
1/ For fiscal year beginning in April.

Figure 4. United Kingdom: Productivity - International Comparison





Source: National Statistics (based in part on OECD Employment Outlook) (http://www.statistics.gov.uk/themes/economy/articles/nationalaccounts/international_comparisons_productivity.asp).

1/ These cross-country data are not fully comparable.

cause is a gap in human and physical capital (both public and private).[2] Years of underinvestment have also led to a deterioration in the quality of public services, which has been a focus of recent political debate.

5. **Against this background, the discussions addressed five key issues.** (i) Why has the U.K. economy outperformed the other G-7 economies in 2001? (ii) Will this superior performance continue in the future, or are some of the recent developments unsustainable? (iii) How should fiscal and monetary policies respond to any emerging risk? (iv) Are there risks to the financial sector? And (v) what structural policies are needed to close the productivity gap?

II. Report on the Discussions

A. Why has the U.K. Economy Performed Better than other G-7 Economies in 2001?

6. **While the United Kingdom has suffered from a contraction of private investment like other G-7 countries, activity has been sustained by the resiliency of other demand components.** U.K. private investment has been severely hit by the crisis of the Information and Communications Technology (ICT) sector and has plunged in 2001. However, in contrast to the other G-7 economies, this decline has been largely offset by the strength of private consumption and public spending.

Comparative Growth Performance in the Second Half of 2001 1/
(Year-on-year growth rates, in percent; contributions to GDP growth in parentheses)

	U.K.	U.S.	euro area
Real GDP growth	2.1	1.1	1.0
Private consumption	3.7	3.0	1.8
Contribution to GDP growth	(2.5)	(2.1)	(1.0)
Private investment	-4.5	-8.0	-1.2
Contribution to GDP growth	(-0.7)	(-1.4)	(-0.3)
Public spending 2/	5.1	3.5	1.4
Contribution to GDP growth	(1.0)	(0.6)	(0.3)
Net Trade Balance			
Contribution to GDP growth	(-0.6)	(-0.2)	(0.7)

Sources: National authorities and staff estimates.
1/ For the U.S., the figures are for the whole year.
2/ For the euro area, public consumption.

7. **There was broad agreement that consumption was sustained by three factors.**[3] *First*, years of strong employment and earnings growth had buoyed consumer confidence. *Second*, unlike in the United States, the impact of the decline in equity prices on U.K. consumer spending had been offset by the increase in house prices. *Third*, the policy stance had turned out to be strongly countercyclical. In particular:

---

[2] See O'Mahony (1999), *Britain's Productivity Performance 1950–96: An International Perspective,* NIESR; and Crafts and O'Mahony (2001), A Perspective on U.K. Productivity Performance, *Fiscal Studies,* Vol. 22, pp. 271–306.

[3] See the *Selected Issues* paper on "Why Has U.K. Household Consumption Been So Strong?"

- In the context of a symmetric inflation target, the Monetary Policy Committee (MPC) had responded preemptively to the deteriorating external outlook—with a cumulative 200 basis point cut in interest rates between February and November 2001 (compared with a 150 basis point cut in the euro area which was in a cyclically weaker position; Figure 5). The rate cuts had helped support consumers' confidence, household borrowing and house prices—the latter rising, on average, by 10½ percent in 2001 (Figures 6 and 7).

- The March 2001 budget had generated a significant fiscal impulse with the cyclically-adjusted balance projected to shift from a surplus of 1½ percent of GDP in FY2000/01 to a deficit of ¼ percent of GDP in FY2001/02 (Table 3). The authorities stressed that the fiscal relaxation had not been motivated by countercyclical goals, which in their policy framework were preferably pursued through monetary policy. Rather, the spending increases in 2001 had been undertaken according to medium-term spending needs—as determined by the 2000 spending review—and consistent with their fiscal rules (see next paragraph). Nevertheless, the timing of the spending increases—along with the operation of the automatic stabilizers—had helped support growth in 2001.

8. **The authorities and staff agreed that these policies had been effective in supporting demand without undermining confidence thanks, not only to the transparency of the policy framework, but also to the underlying strength of the fiscal accounts.** The transparency of the monetary framework had underpinned the MPC's credibility and helped anchor inflation expectations at 2½ percent (Figure 8). Fiscal policy had been managed prudently within the framework introduced in 1997 (Box 1). Upon taking

Box 1. The Fiscal Framework

The authorities' fiscal policy is cast in the context of a fiscal framework comprising two fiscal rules and a panoply of administrative mechanisms aimed at ensuring that public money is well spent.

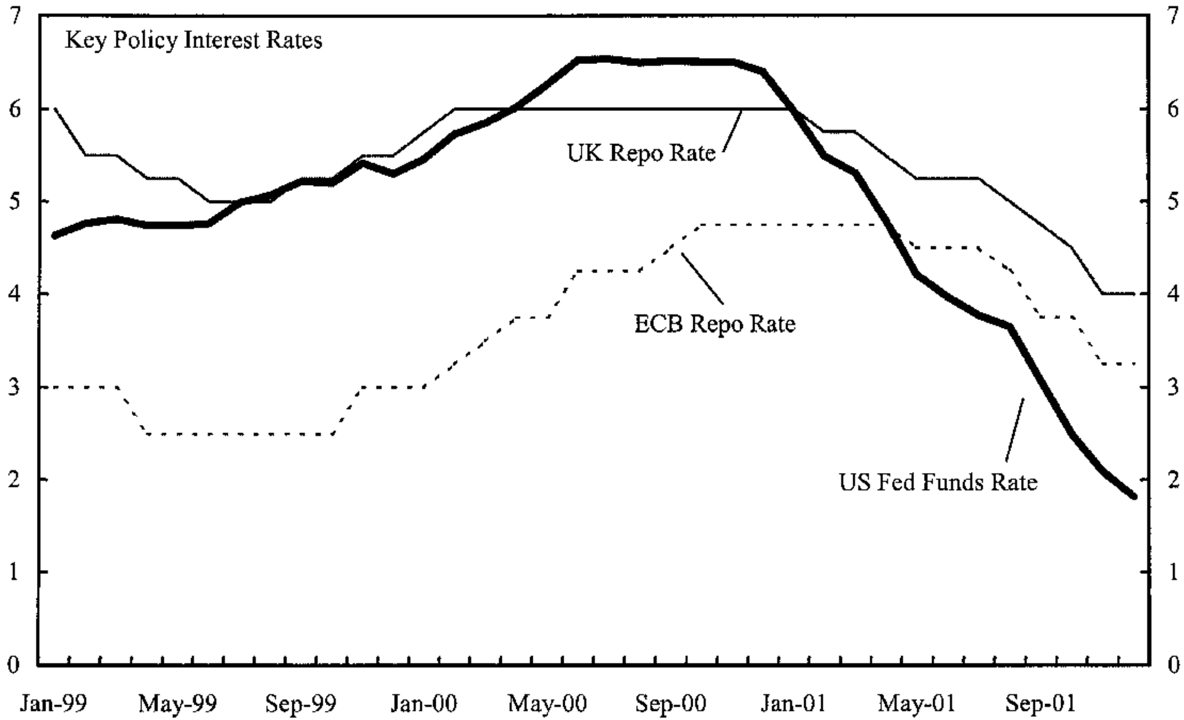
The fiscal rules, which are defined over the cycle, are: (i) the "golden" rule, which prohibits a deficit on the current balance; and (ii) a sustainable investment rule, which stipulates that the ratio of net public debt to GDP should be maintained at a "stable and prudent level", currently interpreted at 40 percent of GDP. A medium-term fiscal path is also published with the budget to provide information on how fiscal policy will be shaped within the fiscal rules, but is subject to annual revisions within the fiscal rules.

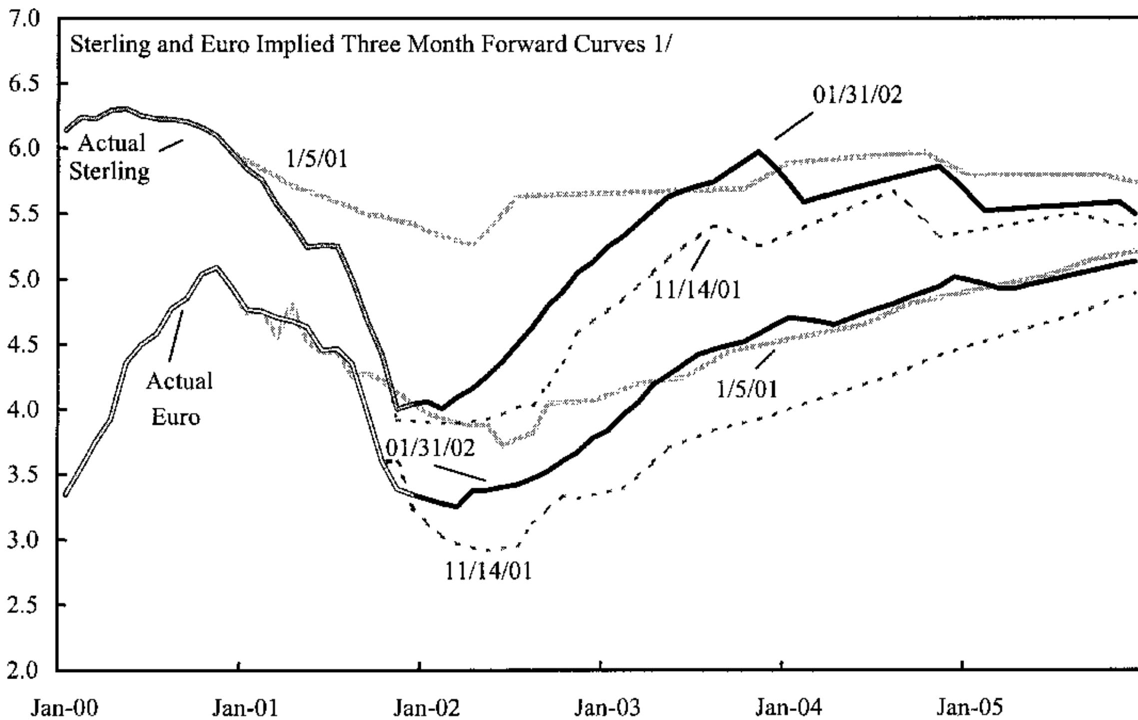
Administrative mechanisms include biennial spending reviews that set binding three-year Departmental Expenditure Limits (DELs) covering most discretionary spending (about half of total spending) and published Public Service Agreements that set quantitative performance targets for departments as well as cost-benefit analysis and other "value for money" criteria in the evaluation of projects.

See, for example, *Reforming Britain's Economic and Financial Policy*, edited by Ed Balls and Gus O'Donnell, HM Treasury, 2001; and the Staff Report for the 1998 Article IV consultation (SM/99/36).

office in that year, the Government had strengthened the fiscal balances through tax increases and expenditure savings beyond what was strictly required by its newly-introduced fiscal

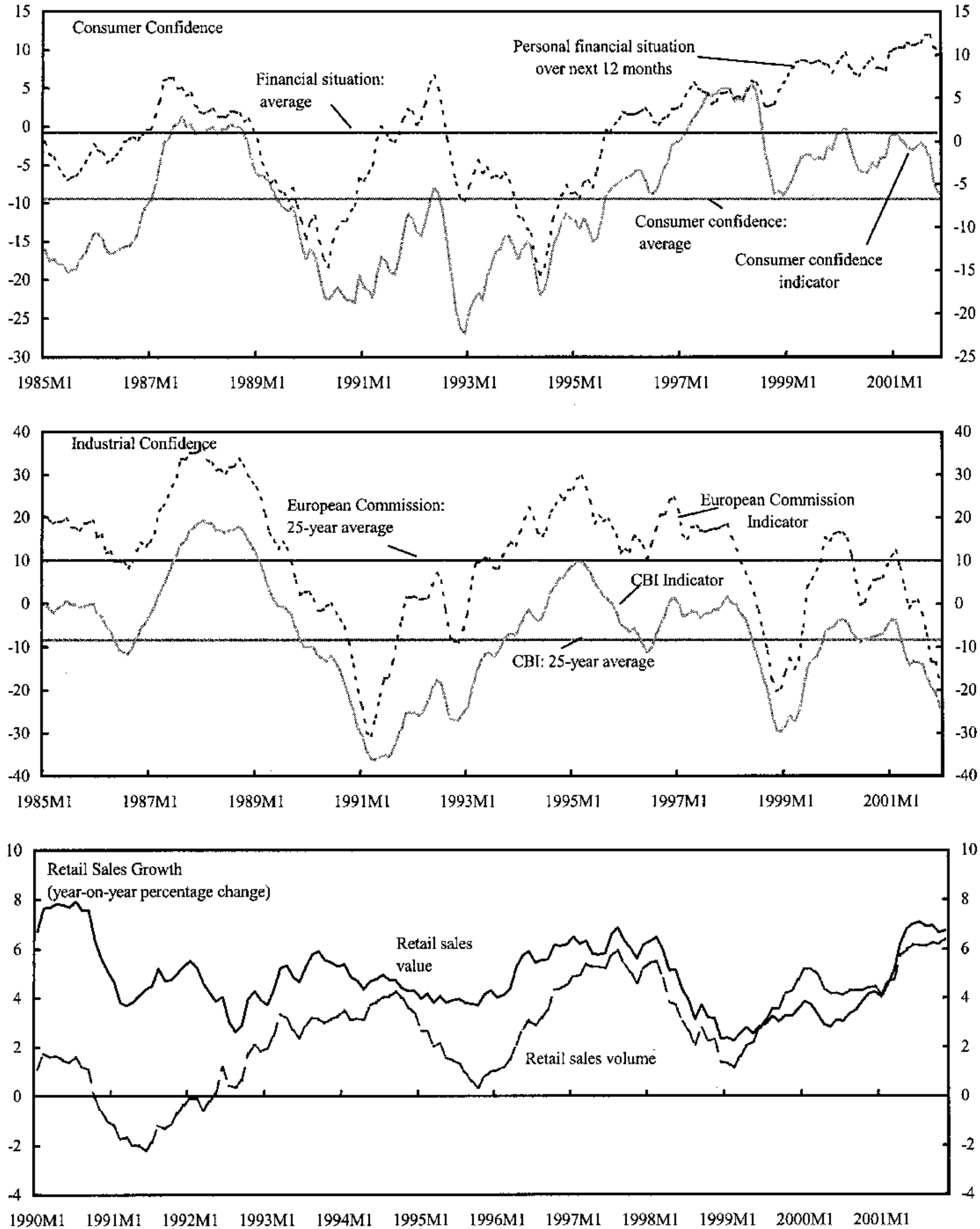
Figure 5. United Kingdom: International Comparison of Short-Term Interest Rates





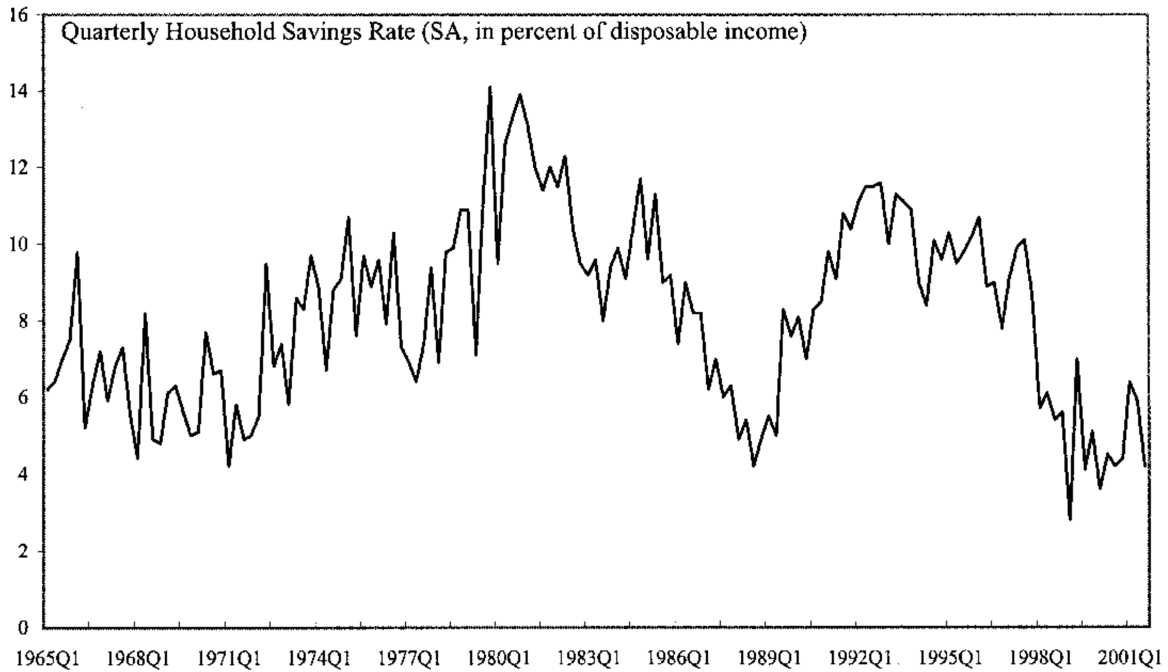
1/ Monthly expectations of future three month interest rates inferred from the yield curve as of the given date.
Source: Board of Governors of the Federal Reserve; Bank of England; and Bloomberg.

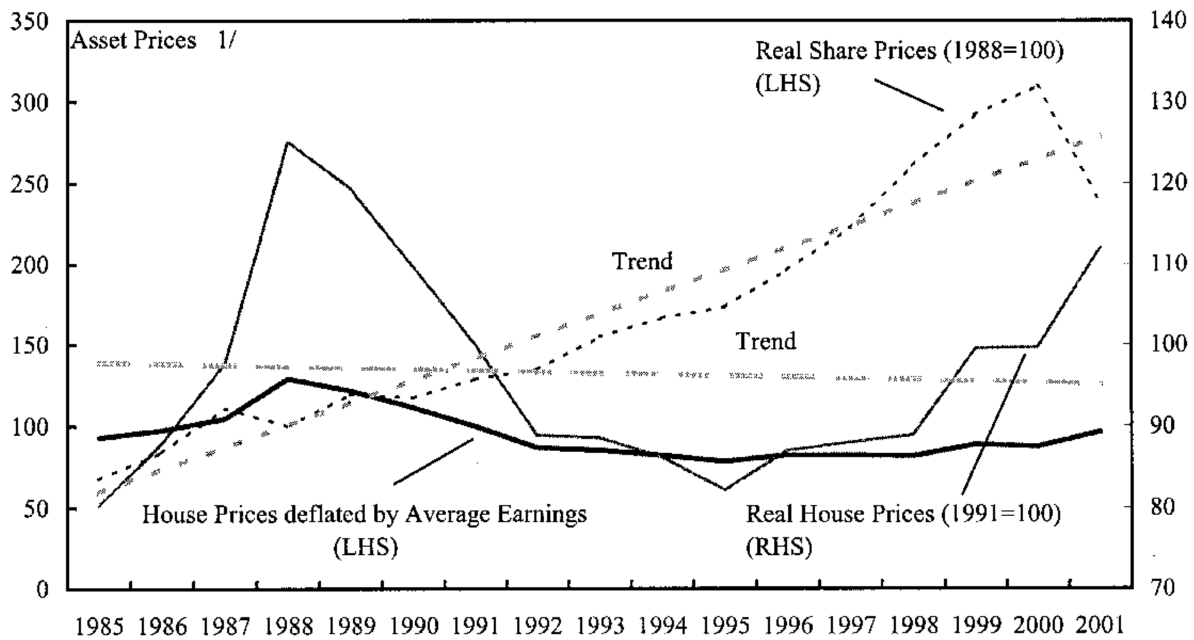
Figure 6. United Kingdom: Leading Economic Indicators 1/



Sources: WEFA, Bloomberg, National Statistics.
1/ 3-month moving averages.

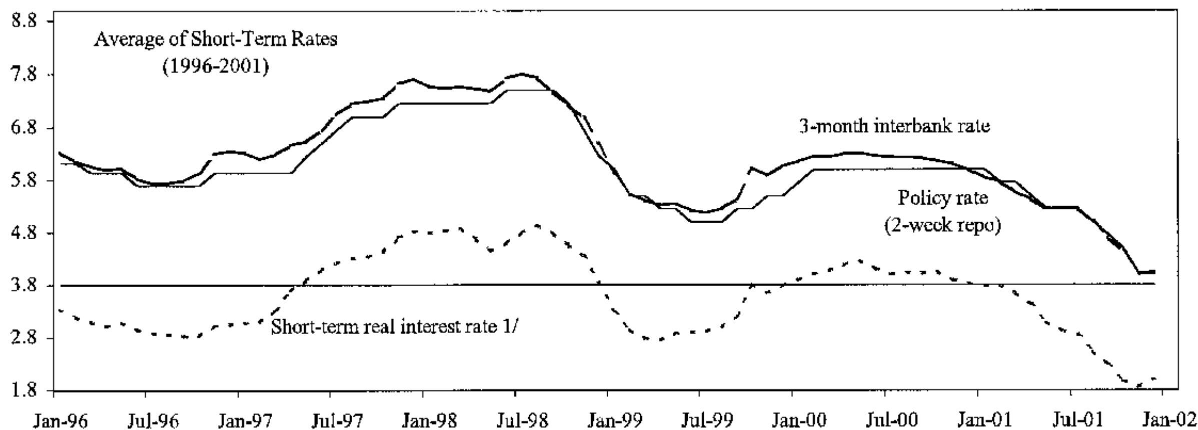
Figure 7. United Kingdom: Household Savings Rate and Asset Prices

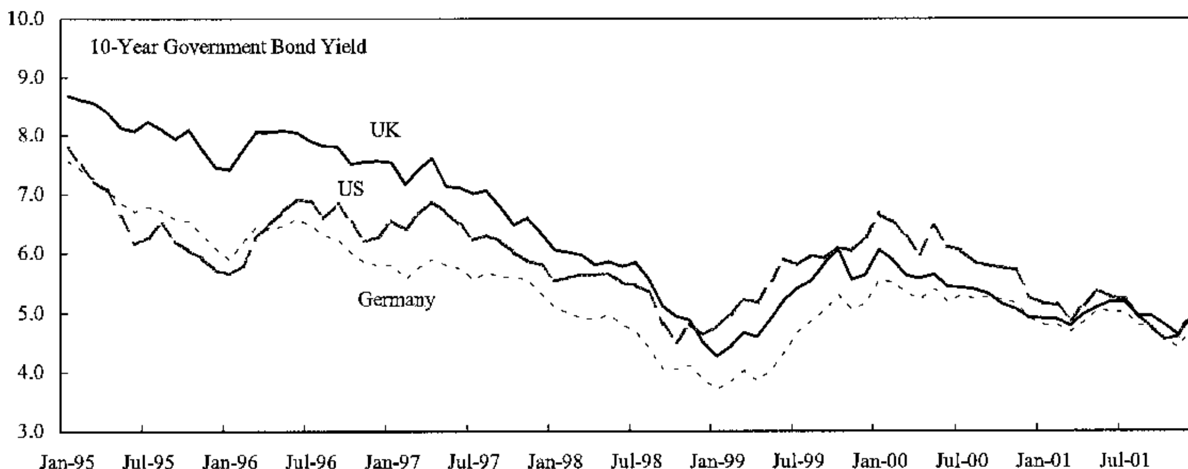


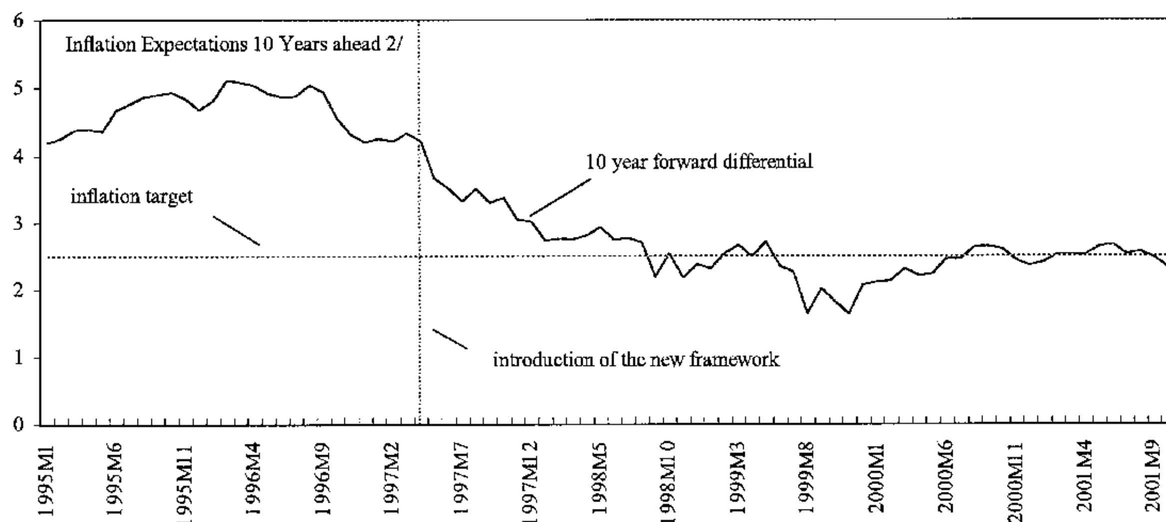


Sources: Bank of England; Bloomberg; and National Statistics.
1/ Figures for 2001 are as of November 2001.

Figure 8. United Kingdom: Interest Rates.







Source: National Statistics; Bank of England; and Bloomberg.

1/ The short term real interest rate is [{(1+i)/(1+n)-1}*100], using three month treasury rate and RPIX inflation rate.

2/ Differential between 10-year nominal and index-linked bond yields, which can be intepreted as a measure of inflation expectations.

rules. Together with the resulting fall in long-term real interest rates, this initial tightening had enabled spending to be raised later in areas where outlays were structurally too low (health, education, infrastructure). The "save first-spend later" strategy had been effective in keeping real interest rates stable and private confidence strong at the time of the 2000 spending review and the March 2001 budget announcement. By contrast, in the past, increased government spending had been associated with rising real interest rates and private sector contraction, possibly because of concerns about sustainability.[4]

B. Imbalances and Short-Term Prospects

9. **In the context of this strong performance, the policy debate in the United Kingdom had recently focused on some developments resembling those that eventually led to the early-1990s crisis.** As in the run up to that crisis, the recent years had witnessed a strong appreciation of sterling, a widening of the external current account deficit, a drop in household saving, and booms in house prices, mortgage equity withdrawal, and bank lending. Some of these trends had deepened during 2001 as the manufacturing sector slipped into recession. Were these developments revealing underlying imbalances that would eventually be resolved through a sudden and disorderly correction? In particular, might a change in market sentiment lead to a sharp drop in house prices, consumption, and lending with possible stresses to the financial system?

10. **On the whole, staff agreed with the authorities' view—also shared by market analysts—that, while some of these developments might reflect underlying imbalances, they were likely to be resolved gradually, provided prudent policies were maintained.** The reasons were twofold.

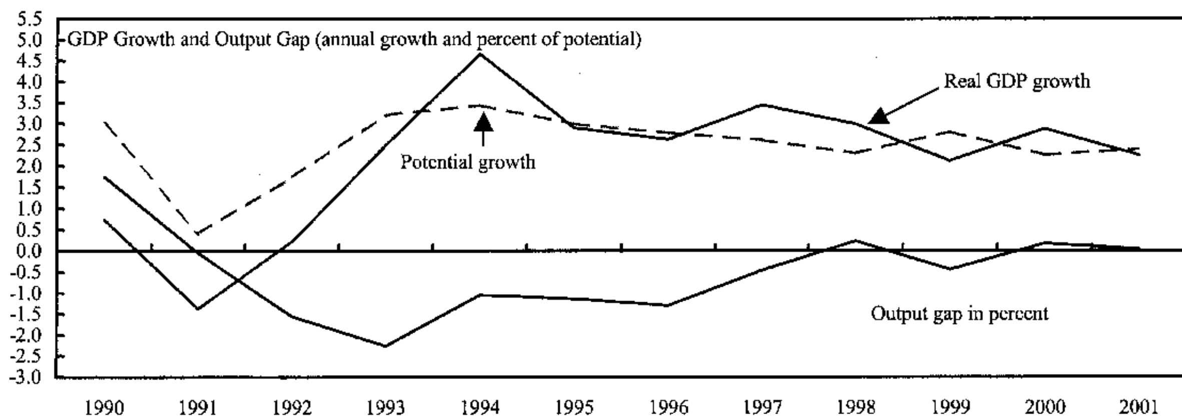
11. **First, compared with the late 1980s, the United Kingdom was in a better fundamental position to face the risks arising from potential imbalances.** The policy framework was credible, as evidenced by low inflation expectations and long-term interest rates (Figure 8). Moreover, in contrast to the late 1980s, the current economic expansion had been stable, with output remaining broadly around potential since 1997 (Figure 9). Finally, the floating exchange rate regime was less exposed to the risks arising from any possible overvaluation.

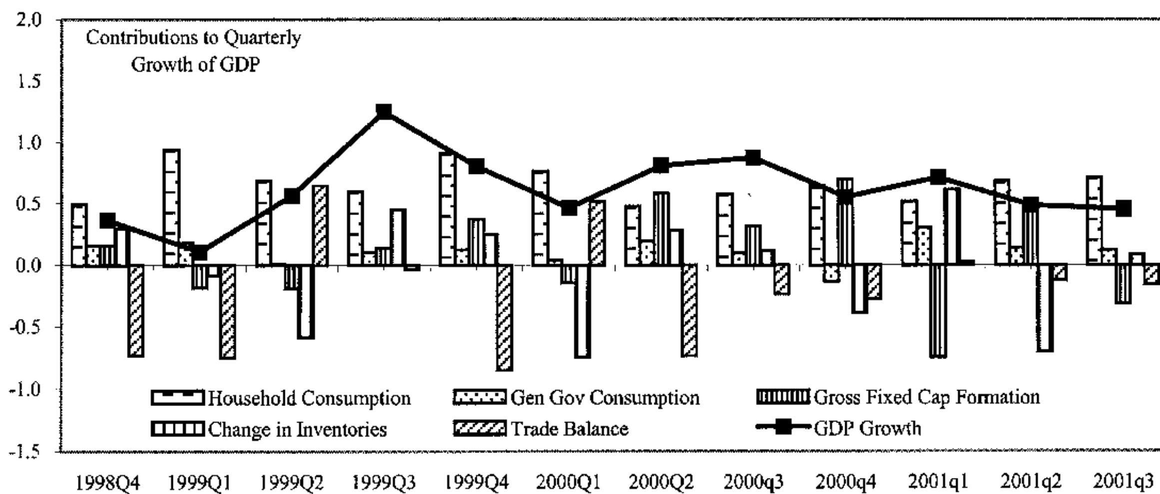
12. **Second, the existing imbalances were not as pronounced as those of the late 1980s.**

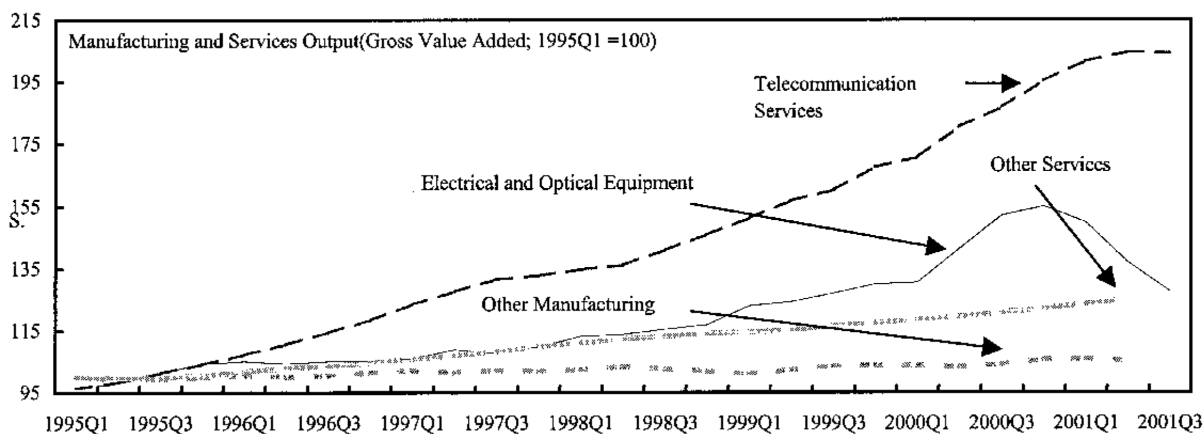
- Sterling had appreciated strongly in real terms: in late 2001, both the CPI- and ULC-based real effective exchange rates stood at or close to a thirty-year peak (Figure 10). However, the external current account deficit had widened less than in the past and, in

[4] See the *Selected Issues* paper on "The Macroeconomic Effects of U.K. Fiscal Policies: an Empirical Exploration."

Figure 9. United Kingdom: Cyclical Position, Demand, and Output.

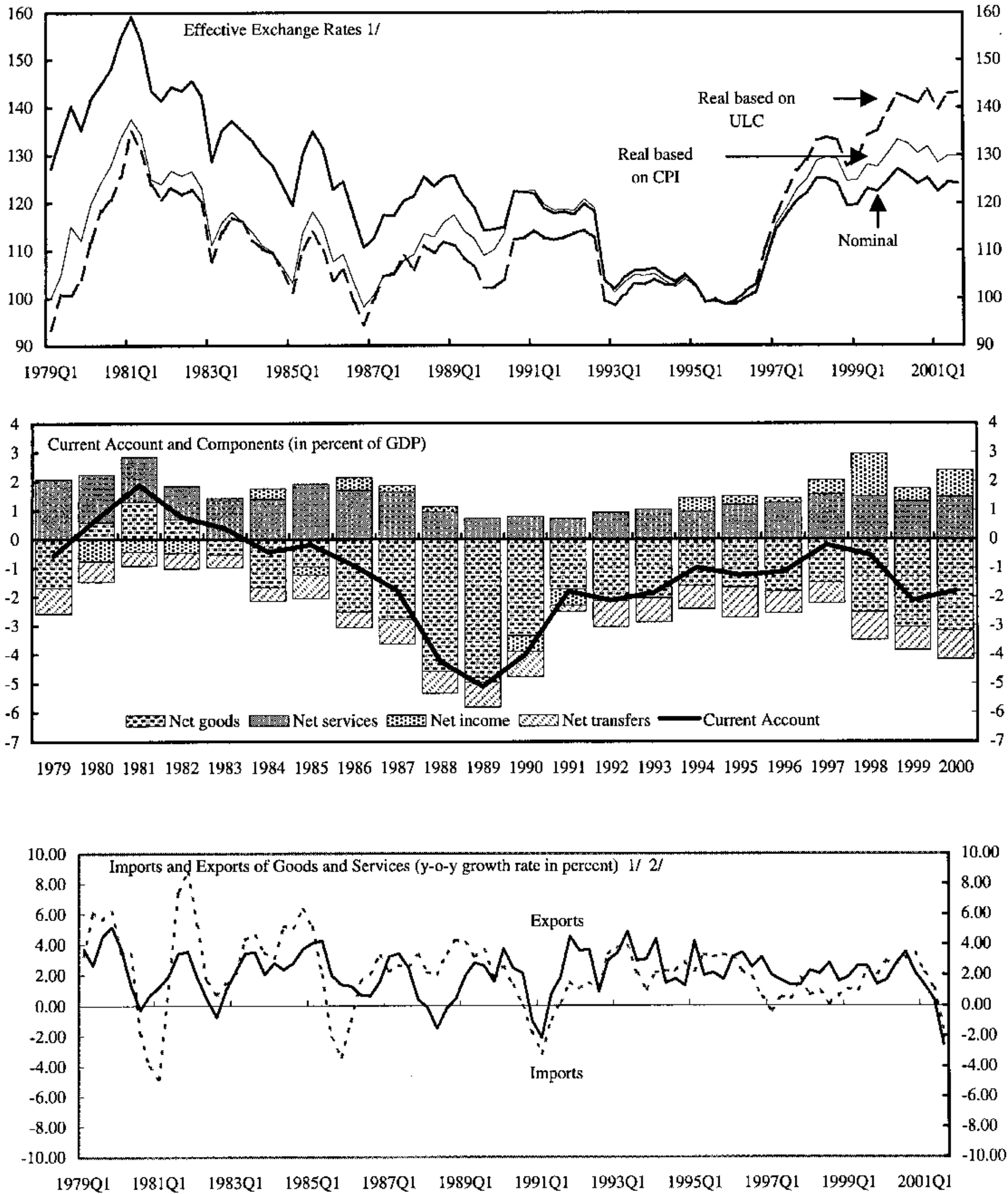






Source: National Statistics; IMF staff estimates.

Figure 10. United Kingdom: Real Exchange Rate, Current Account, and Trade.



1/ Includes data throughout 2001Q3.
2/ Three quarter moving average.
Source: National Statistic; IFS.

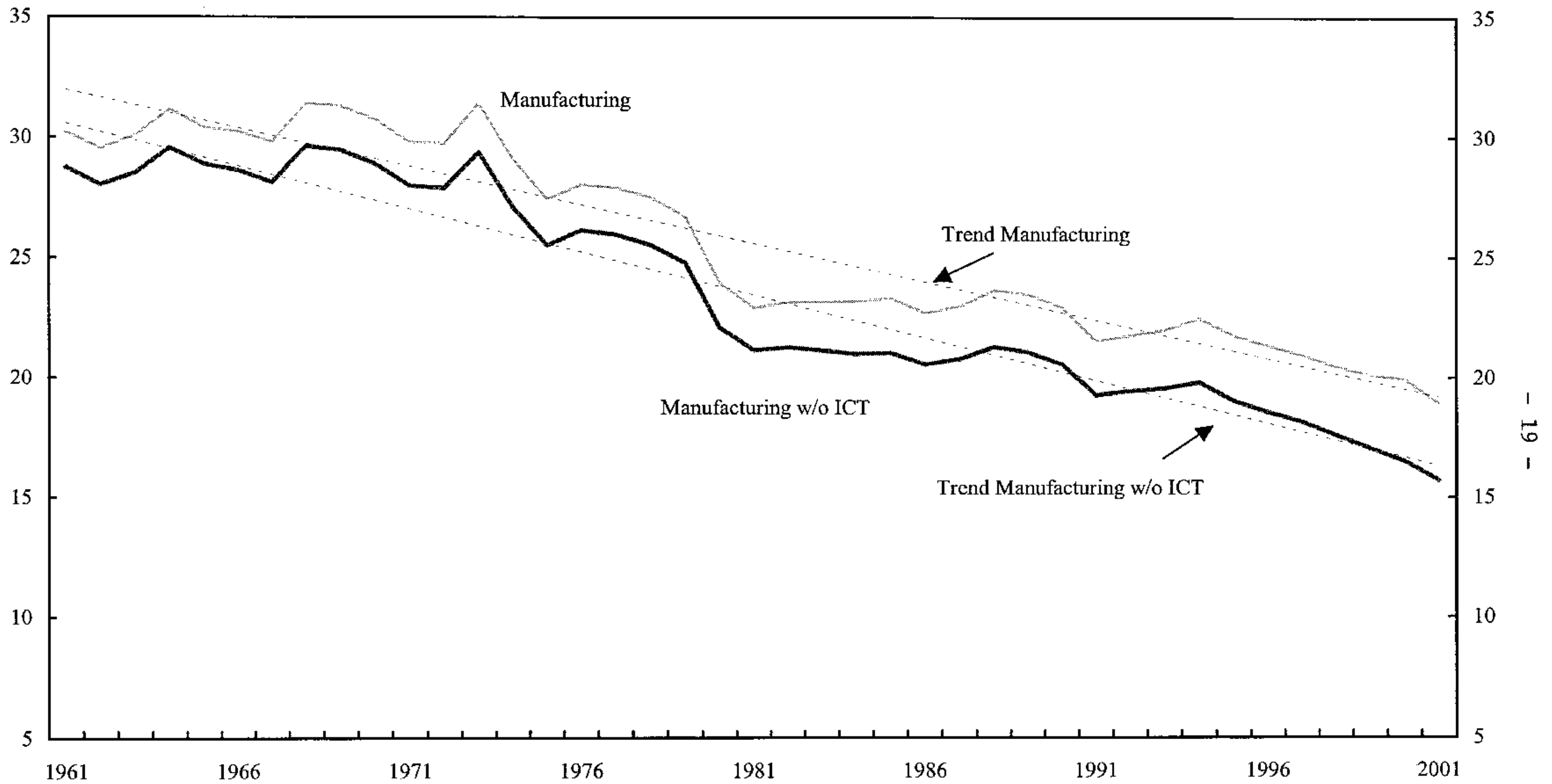
spite of weaker world demand and the troubles in the key ICT sector, it had actually declined to 1¼ percent of GDP in 2001 (Table 4). Moreover, the share of manufacturing in total output was only slightly below its secular trend, the latter being driven by a shift in demand toward services as incomes rose (Figure 11). Finally, while manufacturing profitability had declined, it fell below its 20-year average only around mid-2000 (Figure 12). In sum, while the causes of sterling's appreciation were not yet fully understood, the overvaluation was probably not as large as cursory observation of the data might suggest (Box 2).

- Household and corporate borrowing had surged, with capital gearing ratios reaching levels comparable to those of the late 1980s (Figure 13). Moreover, while corporate borrowing had recently declined, private consumption, household borrowing, equity withdrawal, and house prices were still rising, in what could be seen as a potentially dangerous bubble fueled by low interest rates. The household saving ratio had fallen to 5½ percent in 2001, comparable to the level seen during the late 1980s (Figure 7). The authorities noted that they were closely monitoring these developments, but that the risks were tempered by a number of considerations. In particular, while capital gearing ratios were high, structurally lower interest rates had kept debt service ratios (income gearing) below the 1980s' peak—thus suggesting an increase in sustainable debt levels. Moreover, house prices were well below their end-1980s peak, particularly in relation to earnings (Figure 7). Finally, much of the strength of consumption was due to earnings and employment growth (factors that may not reverse quickly), rather than housing prices/mortgage equity withdrawal (factors that could reverse quickly), a view also supported by staff work.[5]

13. **Against this background, the staff's and the authorities' short-term outlook was moderately optimistic**. Staff's baseline projection envisaged a temporary deceleration of growth to 1¾ percent in 2002 from almost 2½ percent in 2001, followed by a recovery toward potential in subsequent years (Table 5). Private consumption was projected to slow down and business investment to increase only modestly in the first half of 2002, as households and corporations rebuilt their balance sheets, unemployment increased somewhat, and confidence temporarily softened. The slowdown in output, however, was envisaged to be modest owing to the significant fiscal stimulus implied by budgetary plans already in motion, the lagged effects of the monetary easing in 2001, and the projected recovery in world demand in the second half of 2002. The authorities' forecast of GDP growth in 2002 was somewhat higher than that of the staff (in the range of 2-2½ percent), mainly reflecting stronger private consumption. The external current account deficit was expected to edge up

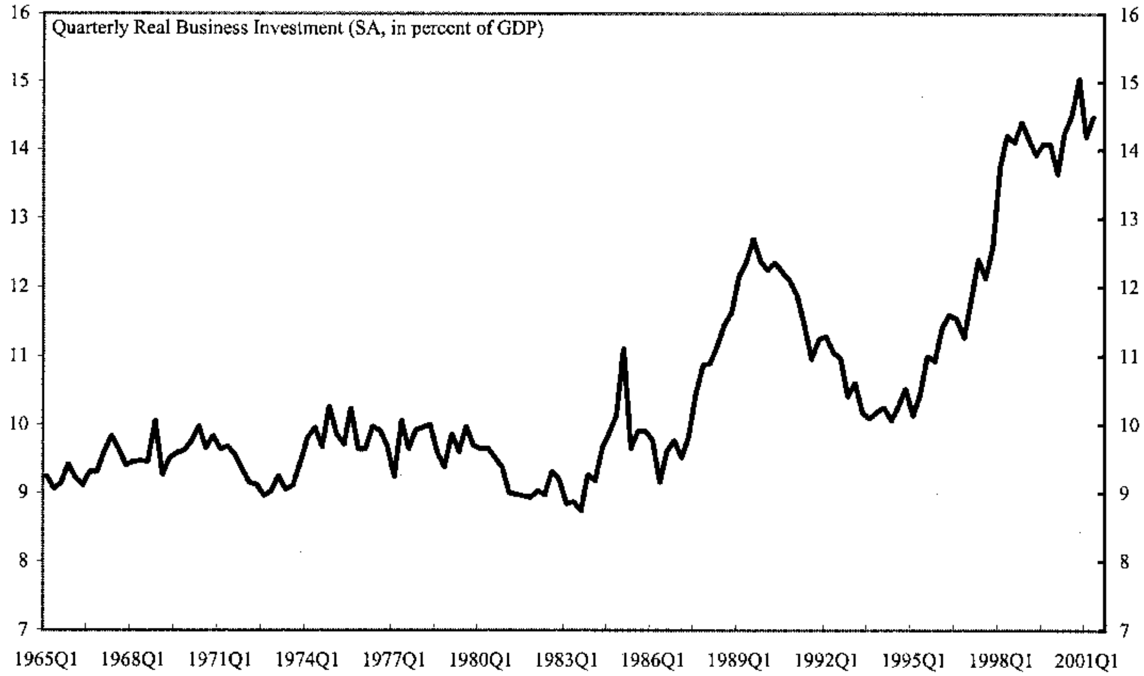
[5] See *Selected Issues* paper "Why Has U.K. Household Consumption Been So Strong?"

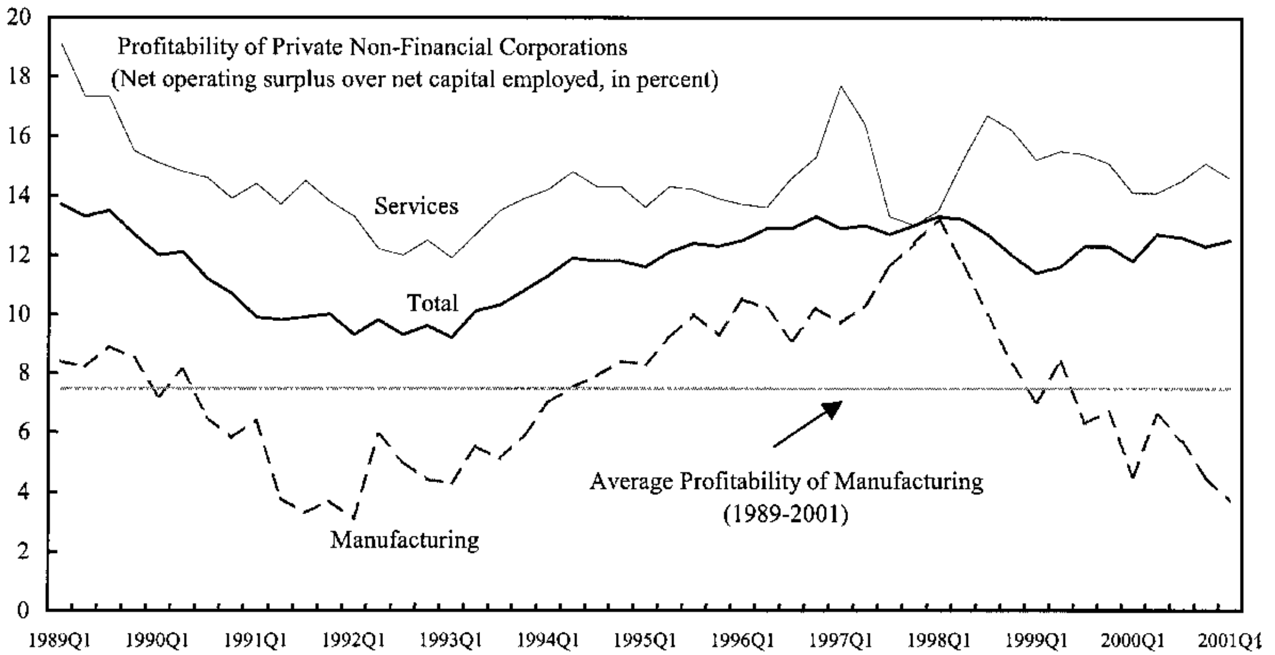
Figure 11. United Kingdom: Manufacturing Production
(share in total gross value added at constant 1995 prices, in percent)



Source: National Statistics; IMF staff estimates.

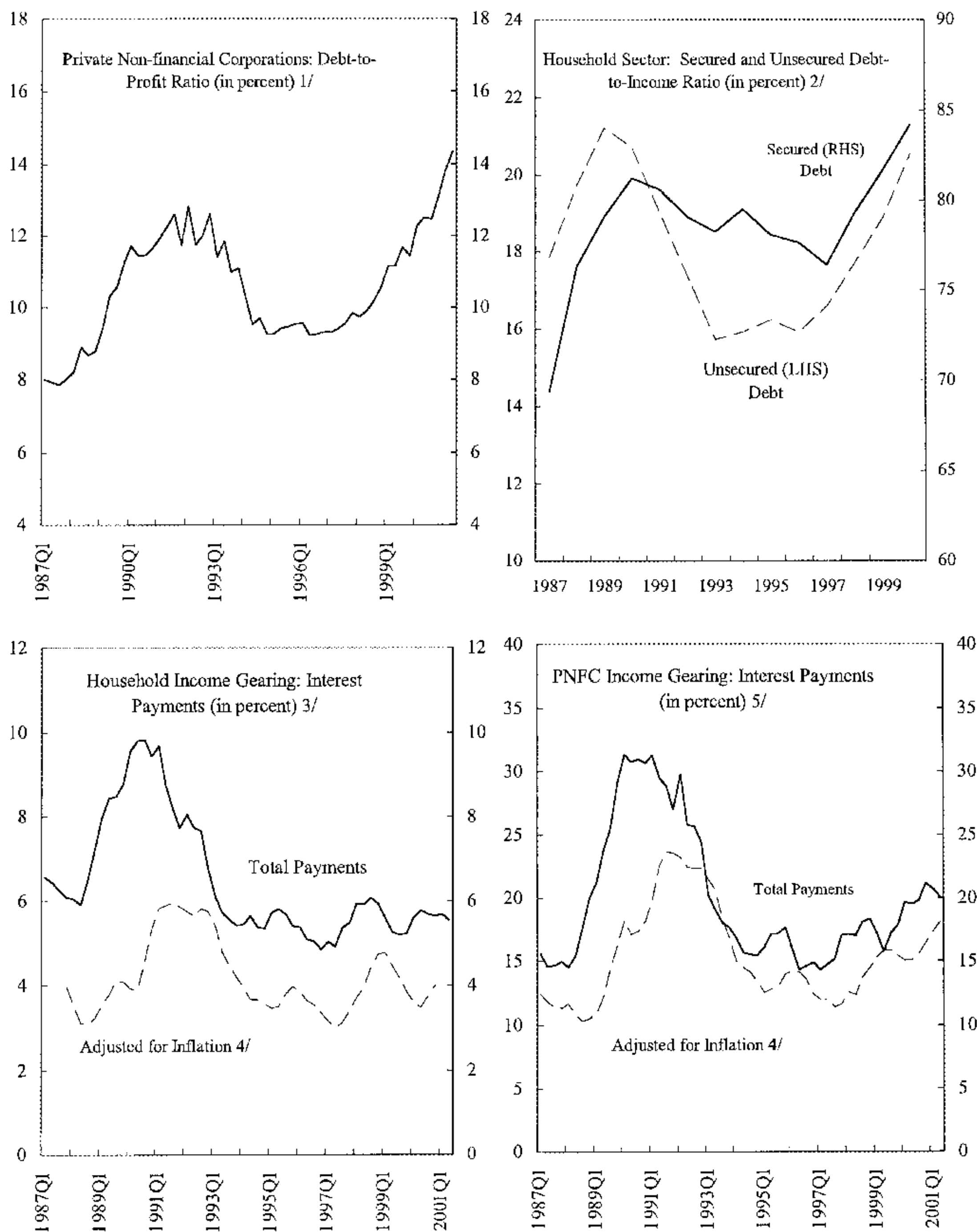
Figure 12. United Kingdom: Indicators of the Corporate Sector





Sources: Bank of England; National Statistics.

Figure 13. United Kingdom: Debt and Interest Payment Indicators, 1987-2001



Sources: National Statistics; Bank of England; and IMF staff estimates.

1/ Ratio of gross debt (loans) to operating profits.

2/ In terms of gross disposable income.

3/ Total household interest payments (nominal or adjusted) over total nominal household disposable income.

4/ Adjusted payments are derived from total payments after subtracting the quarter-on-quarter inflation rate times the stock of outstanding debt. Adjusted payments are smoothed using an HP filter.

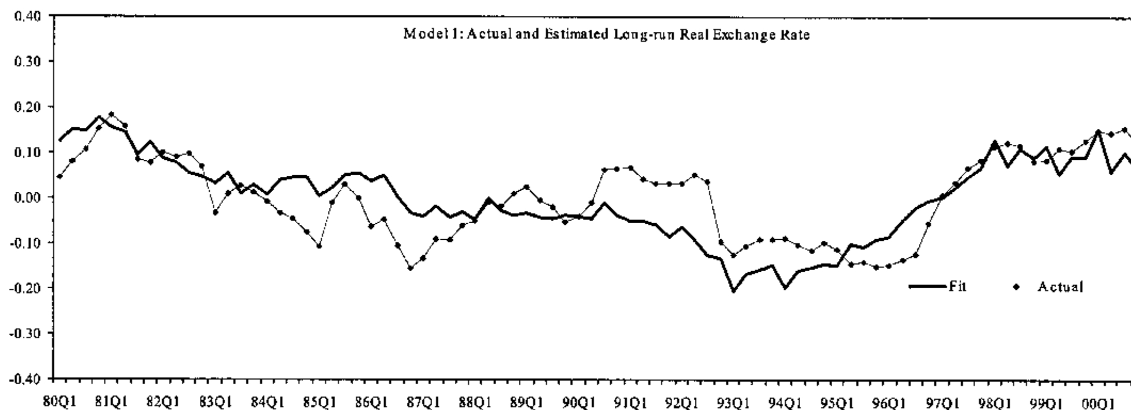
5/ Total interest payments (nominal or adjusted) over nominal pre-tax profits.

Box 2. The Appreciation of the Sterling Real Exchange Rate (RER)

It has been argued that the real appreciation of sterling over the past few years might reflect a speculative bubble, or monetary factors, such as the opening of the U.K.-euro area interest rate differential. In either case, the appreciation would be unsustainable: the tradable sector would shrink and the current account deficit would widen—eventually requiring a sharp correction.

But further analysis suggests that, at least in part, the appreciation of sterling—irrespective of its original causes — may be sustainable over time as the *equilibrium* RER may have appreciated. This conclusion is first supported by the fact that the appreciation has been accompanied by only a moderate deterioration of the trade balance and continued strong net service exports. Could this be due to long reaction lags, with profit margins and investment in manufacturing eventually shrinking by an unsustainable degree? Only partly, because, as noted in the text, low profit margins, investment, and the share of manufacturing in GDP also reflects cyclical and long-term trend factors. More formally, the "macroeconomic balance" approach (see Isard et al. *Methodology for Current Account and Exchange Rate Assessments*, IMF Occasional Paper 209, 2001), which takes explicit account of lags and cyclical factors, suggests that only a relatively moderate real depreciation would be required to bring the saving-investment balance closer to its historical norm.

But why should the equilibrium RER have appreciated? One possibility (difficult to prove econometrically) is that the shift, in recent years, toward higher value-added, and (especially financial) service-oriented exports has improved the U.K.'s terms of trade. This shift, may have made the higher RER more sustainable. Some support for this hypothesis is provided by the fact that (until the recent downturn) the output of high "knowledge-content" products (machinery, scientific equipment, chemicals) and services has grown robustly compared with low value-added manufactures (food, clothing).



An alternative explanation (empirically testable) is based on the existence of market power and differences in productivity growth between the United Kingdom and its trading partners. Under the assumption that countries' exports are imperfect substitutes and exporters have market power, standard trade models imply that an increase in productivity—and hence supply—of exports requires a depreciation of the RER (i.e. a fall in their relative price) essentially because of the downward sloping demand curve. A simple econometric exercise, detailed in the *Selected Issues* Paper on "The Rise of the Sterling Real Exchange Rate," indeed shows that as productivity in the U.K. traded goods sector was outstripped by that of other countries, its relative price increased, thus raising the U.K.'s manufacturing terms of trade and the real exchange rate.[1/] The fit of this model is remarkably good (see above).

In practice, both explanations are likely to have been at play.

1/ This result, which is consistent with the theoretical prediction, may appear counter-intuitive for two reasons. First, according to the Balassa-Samuelson effect, a fall in productivity in tradables relative to nontradables (vis-à-vis other countries) would lead to a depreciation of the RER. But this effect is quite distinct from the effect arising from the difference in tradable productivity (vis-à-vis other countries) and is found, empirically, to be dominated by it in the United Kingdom in the late 1990s. Second, in some models, increases in tradable productivity appreciate the RER—usually for demand-based reasons—but this is usually an appreciation of the actual, not the equilibrium RER. For a further discussion of these issues, see *Selected Issues* paper.

to 2 percent in 2002, with net external demand increasing its drag on growth to 1 percent of GDP as a result of the differential in domestic demand growth with respect to trading partners. Inflation was projected to edge up to the target of 2½ percent over the medium term as the temporary effects of the oil price decline and some indirect tax changes wore off.

14. **Nevertheless, the authorities acknowledged that the risks to this outlook, even if balanced, were large.** On the downside, the external outlook could deteriorate by more than anticipated, especially if the recovery in external demand was delayed beyond mid-2002. This would adversely affect not only exports, but also consumption and investment through confidence effects. Moreover, the ongoing investment correction might prove sharper than expected, given the investment boom of the preceding years and declining manufacturing profitability (Figure 12). In addition, a sizeable drop in asset prices could lead to a credit squeeze. On the upside, the U.K.'s cyclical position was not nearly as weak as that of other G7 economies, and, with interest rates at historically low levels, there was also a risk that domestic consumption may not slow as presently projected. In the background, the difficulty in assessing the size and nature of the potential imbalances, particularly those arising from the rise in bank lending, consumption, and house prices, added to the uncertainty of the current situation.

15. **Uncertainties also arose from possible exchange rate movements, although the short-run effects of an eventual correction were not thought to be major**. The authorities shared the staff assessment that, while the margin of error was large, sterling seemed to be somewhat overvalued against euro. They indicated that they would like to see a stable and competitive pound over the medium term and observed that manufacturing profits were being adversely affected by the weakness of the euro, which they felt had the potential to appreciate. They noted that an exchange rate correction was unlikely to have major balance sheet effects, a view confirmed by market analysts. Views on the impact on inflation were more varied, but econometric research suggested that, at least initially, importers (and exporters) might absorb any exchange rate change through profit margins, which had been built up (or compressed) under the strong exchange rate—thus, spreading price pressures over time.

16. **Turning to economic policies, the authorities reiterated their commitment to the policy framework of recent years, which was seen as key in successfully navigating through this uncertain environment.** Fiscal policy would continue to focus on medium-term goals, while leaving to monetary policy the task of responding to cyclical demand pressures. In particular, the case for an activist approach aimed at engineering an exchange rate correction through a rebalancing of the policy mix was weak, not least because staff's empirical analysis suggested that in the United Kingdom the link between fiscal policy, output, and the real exchange rate had been tenuous, at least in recent decades.[6] While agreeing that an activist approach was not warranted, staff noted that, in achieving the

[6] See *Selected Issues* paper on "The Macroeconomic Effects of U.K. Fiscal Policies: an Empirical Exploration."

inflation target, monetary policy would need to give due consideration to not exacerbating potential imbalances (see Section D).

C. Fiscal Policy

17. **Although the November Pre-Budget Report (PBR) envisaged somewhat weaker fiscal balances over the short run than previously announced, the authorities and staff agreed that the fiscal stance remained appropriate.** The authorities' medium-term plans had envisaged a shift from a surplus in FY2000/01 to a deficit over the medium term (see text table, lines on the "2001 Budget"). The revised PBR projected the deficit in FY2002/03 at about 1 percent of GDP (against the original ½ percent of GDP) and a correspondingly larger fiscal impulse. The authorities noted that this deviation—while strictly speaking not a direct result of U.K. cyclical factors—was not due to discretionary actions and was temporary: it mostly reflected lower expected profits of financial companies (particularly international financial firms in London), and the decline in oil and equity prices. Although, various lags implied that the deficit would widen again slightly in 2003/04, it would return to the originally envisaged level of about 1 percent of GDP by the end of the forecast horizon. Staff noted that a medium-term deficit of some 1 percent of GDP would not compromise the U.K.'s strong underlying fiscal position, particularly given the projected stability of the public net debt ratio at the modest level of 31 percent of GDP (Table 3 and Figure 3).[7] In addition, the deviation of the fiscal balances over the next fiscal years from the original path was not large and was acceptable from a cyclical perspective.

Projections of Cyclically-Adjusted Fiscal Balances
(in percent of GDP)

	Outturn	Projections		
	2000/01	2001/02	2002/03...	2005/06
Overall balance				
2001 budget	1.3	0.1	-0.4	-1.1
November PBR	1.6	-0.3	-1.1	-1.1
Staff	1.6	-0.2	-0.9	-1.0
Current balance				
2001 budget	2.0	1.2	1.0	0.7
November PBR	2.3	0.9	0.3	0.7
Staff	2.3	1.1	0.5	0.9
Fiscal Impulse 1/				
2001 budget	...	1.2	0.5	0.1
November PBR	0.0	1.9	0.8	-0.1
Staff	0.0	1.8	0.7	0.0

1/ Positive number indicates expansionary impulse.
Sources: HMT, Pre-Budget Report, November 2001 and staff estimates.

[7] The European Council has noted, that the deficit target of 1 percent of GDP is in conflict with the requirement in the Stability and Growth Pact (SGP) for the fiscal position to be close to balance or in surplus in the medium term. The authorities indicated that they regarded their fiscal targets as consistent with the SGP, taking into account prudent borrowing for investment as specified in the EU Treaty.

18. **Staff stressed, however, that the cyclically-adjusted overall deficit should not be allowed to rise above the PBR path.**[8] There were tangible risks that the public spending projections underlying the PBR—which already involved sizable increases (see below)—would be revised further up: the deficit path did not include certain measures that were yet to be decided or costed, nor naturally did it reflect the outcome of the upcoming 2002 spending review, which could be influenced by pressures to improve further the quality of public services, particularly health care and transport. Staff argued that if additional spending were deemed necessary on structural grounds, offsetting measures should be taken. There were several reasons for being prudent. First, large discretionary deviations from the announced deficit path would weaken policy predictability, which remained key to a credible fiscal framework. Second, there were some risks on the revenue side: while the revenue projections were based, as in the past, on conservative assumptions on trend growth and VAT receipts, the buoyancy of revenues in the last few years remained partly unexplained and, thus, the revenue shortfall observed in FY2001/02 might not turn out as temporary as the PBR expected. Third, further fiscal expansion might—if upside risks to the outlook materialized—later require a sharper rise in interest rates with undesirable consequences for private investment, private sector balance sheets, and possibly the exchange rate.

19. **The authorities took note of these views and emphasized their commitment to operating a prudent fiscal policy within the fiscal rules.** While final decisions would be taken only at the time of the March 2002 budget and the 2002 spending review, they emphasized their willingness to take tough decisions as needed to maintain fiscal credibility. Indeed, they had opened a public debate over possible tax increases precisely because they did not want to automatically widen the deficit should public spending need to be increased beyond existing plans.

20. **Over and above the issue of the appropriate size of the deficit, discussions then moved to whether it would be appropriate to raise public spending, with offsetting tax increases, beyond the amounts envisaged in the PBR.** On current plans, primary spending was already projected to rise by 14 percent in real terms during FY2001/2 –FY2003/04. Staff acknowledged that this rise was acceptable because at the end of the 1990s public spending was low not only by U.K. historical standards (a thirty-year low;

United Kingdom: Public Expenditure Growth
(Real growth in percent, unless otherwise noted)

	2000/01	2001/02	2002/03	2003/04
Current expenditure	3.4	4.4	3.7	3.1
Gross public investment [1/]	21.1	32.0	8.0	12.2
Departmental Expenditure Limits				
Health	7.8	10.0	8.3	4.0
Education	11.1	6.0	5.8	5.8
Transport and the regions	-6.0	24.0	7.8	15.8

[1/] Including capital grants to the private sector.
Source: HMT, Pre-Budget Report, November 2001.

[8] Such an increase in the deficit would be permissible under the fiscal rules since the cyclically-adjusted current surplus was projected to remain largely positive (the "golden rule" requires a nonnegative current balance), and the public debt ratio to remain well below the current 40 percent ceiling (Box 1).

Figure 3), but also in comparison with the rest of the EU (Figure 14). However, staff urged caution both with regard to the amounts and the speed of any upward revision to the spending plans. Even assuming that a clear-cut economic case could be found for additional spending, an excessive expenditure acceleration would run the risk of incurring significant inefficiencies. While acknowledging this risk, the authorities pointed out that ongoing improvements in the expenditure management framework (Box 1), together with their openness to greater private sector participation in the provision of public services—including health care—should help significantly in this regard. Staff acknowledged that there was some evidence of improved spending outcomes in specific areas such as education, but noted that it would take much longer to assess whether the new framework was effective in reducing waste.[9]

21. **Staff suggested that should a strong case for additional spending be found, the tax measures to finance it should safeguard the relative neutrality of the U.K. tax system.** Rather than an increase tax rates, measures to broaden the tax base—for instance of the VAT (Box 3)—would be preferable. In addition, a broader application of user fees for public services would promote the efficient use of resources. In both cases, targeted transfers, for instance working through the existing tax credit mechanisms (see paragraph 31), could offset any resulting decline in the purchasing power of the poor. While not taking issue with the economic rationale underlying these suggestions, the authorities indicated that they were bound by election manifesto commitments, especially regarding the VAT coverage and ensuring access to the National Health Service.

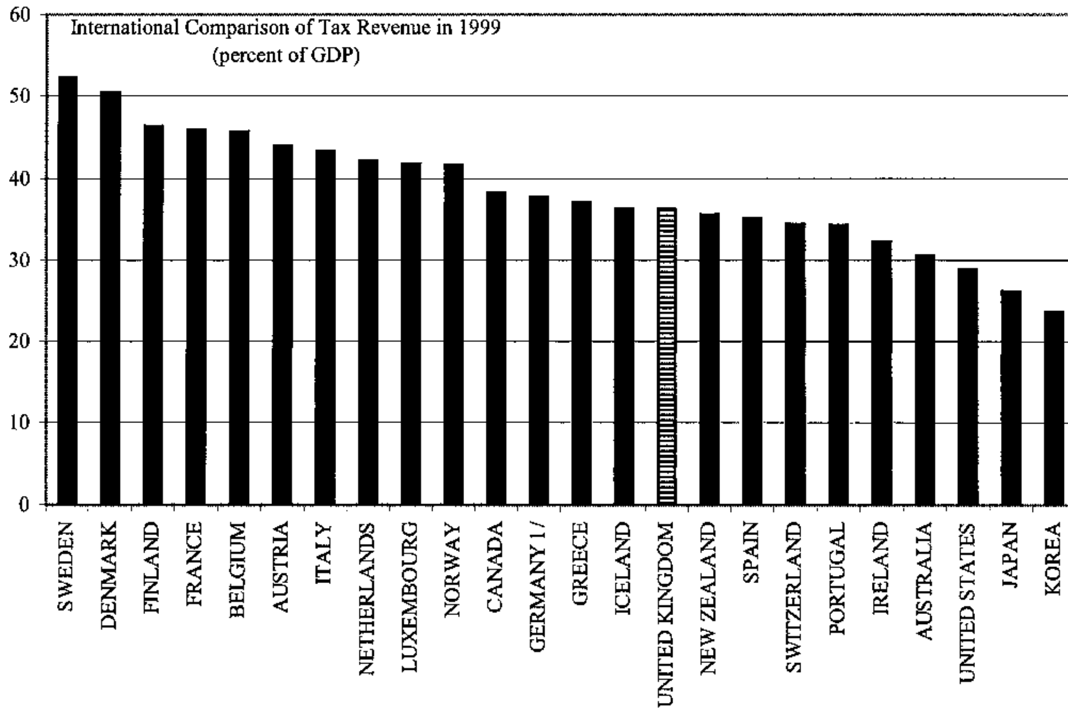
22. **Finally, the discussions focused on possible ways to further improve fiscal predictability and transparency.** Staff noted that, with the fall in the public debt ratio to some 31 percent of GDP at end-2001, the current debt ceiling of 40 percent of GDP had become largely irrelevant as an anchor for the fiscal deficit path. The medium-term projections provided in the budget—including the target for public investment of 1.8 percent of GDP—while useful, did not reflect a formal commitment. In the absence of a limit on the overall deficit in the fiscal rules,[10] lowering the debt ceiling to a level closer to the current debt ratio would make the government's intentions with regard to the deficit path more predictable. The authorities regarded the staff's argument as "food for thought," but indicated that they were wary of changing the framework too frequently. Staff acknowledged this concern, but observed that the spirit of the sustainable investment rule—which was expected to enhance the predictability of fiscal deficits over the medium term—would be better

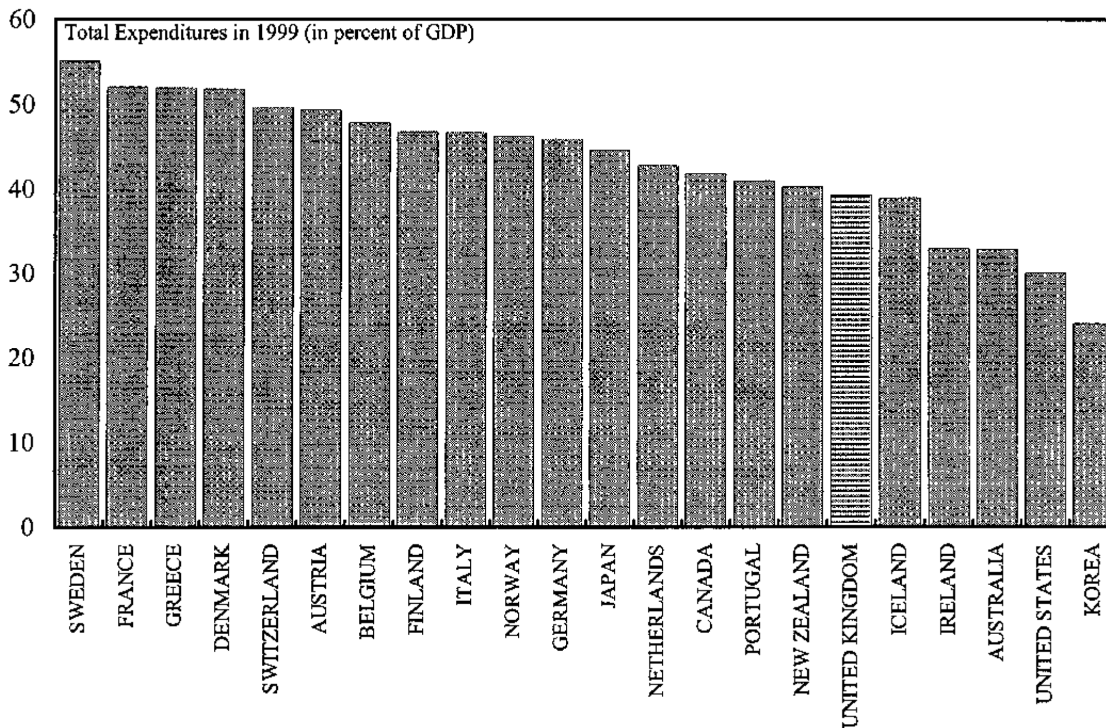
---

[9] Recommendations for improving public expenditure management are given in OECD, *2001 Annual Review—United Kingdom* and the National Audit Office, *March 2001 Report.*

[10] Issues of predictability and transparency arising from the fiscal rules are discussed in the Staff Report for the 1998 Article IV consultation (SM/99/36).

Figure 14. United Kingdom: Tax and Expenditure Ratios





Source: OECD.

1/ According to the EU Commission, Germany's tax ratio was 43.3 percent of GDP in 1999.

Box 3. Eliminating VAT Zero-Rating

Treasury revenue estimates indicate that zero-rating under the VAT cost the Exchequer an annual loss in tax receipts of about 1½ percent of GDP.[1] The zero-rating of food, the item with the largest revenue impact, costs some 0.9 percent of GDP.

In the U.K., the common rationale for VAT zero-rating is to increase the progressivity of the tax system by alleviating the burden of the VAT on low-income earners who presumably spend a relatively high share of their income on zero-rated items. Is this an efficient way of supporting the poor? The staff's analysis suggests that the answer is no. The reason is that, while the poor may benefit proportionately more from the zero-rating, the latter also provides an unintended subsidy to the rich. Indeed, this subsidy, in absolute terms, accrues more to the rich than to the poor because the rich, in absolute terms, consume more than the poor. Thus, redistributional goals can be more effectively achieved through transfers to the poor.

Focusing, for example, on the zero-rating of food, staff estimates—based on the 1999/00 U.K. Family Expenditure Survey—show that for every £100 foregone by the Exchequer, £11½ accrues to the poorest 20 percent of the population, while £28¾ accrues to the 20 percent of highest income earners. If the zero-rating of food were eliminated and £12 for every £100 of increased tax revenue were redistributed to the poorest 20 percent of the population through targeted transfer programs, revenues from VAT could be increased while compensating the poor for the increase in their food bills.

Thus, combining the elimination of the zero-rating on food and other items with increased income transfers to the poor could raise revenues while not making the poor worse off.

[1] This estimate excludes items that typically have a special treatment (although not usually zero-rating) in other countries, such as construction of new dwellings, international passenger transport, and prescription drugs.

preserved by making the limit more binding. Further on transparency, the mission observed that the high standard of the budget and pre-budget documents were exemplary from an international perspective. Staff suggested that public understanding of fiscal developments might be further enhanced by the publication of quarterly Treasury reports explaining fiscal developments, including in relation to budget projections.

D. Monetary Policy

23. **The MPC has kept rates unchanged since mid-November,** noting that the risks were balanced between doing too little to support domestic demand—and so allowing inflation to move further below target—and doing too much—possibly creating difficulties in meeting the inflation target further out, including by allowing excessive debt accumulation. A number of factors were considered. On the one hand, investment was weak and likely to remain so for some months; external and domestic price pressures continued to be subdued, even excluding the temporary effect of the decline in oil prices; and the global slowdown, particularly the weakness in the euro area, remained worrying. On the other hand, consumption indicators were surprisingly strong, consumer confidence had stabilized, and

the effects of recent policy actions had not yet been fully felt.[11] Some members also felt that the worsening imbalances posed a particular risk via a possible sharp correction to domestic demand as consumers retrenched in the face of rising indebtness. A further rate cut could worsen the imbalances and make it more difficult to keep inflation close to target in the medium term.

24. **While supporting the rate cuts so far, staff agreed that the authorities would need to stand ready to act in either direction, depending on how the risks to the outlook played out**. In particular, unit labor costs had picked up (Figure 15), despite the weakening of some labor market indicators, while house prices and credit to households remained on the rise. While the 12-month RPIX inflation rate fell to a low of 1.9 percent in December, inflation, net of indirect taxes, was higher (2.3 percent; Figure 2). If consumer demand failed to slow down as envisaged, rates might have to be raised promptly—particularly if the external outlook also improved. Conversely, if domestic demand faltered unexpectedly, or the global slowdown proved deeper than anticipated, a further monetary easing might be warranted. Staff noted that in cutting rates, due regard would need to be paid to the risks arising from the resultant increase in already high levels of private debt. Markets placed only a small probability on further rate cuts and, in the view of some analysts, the next move could mark a change in policy direction (Figure 5).

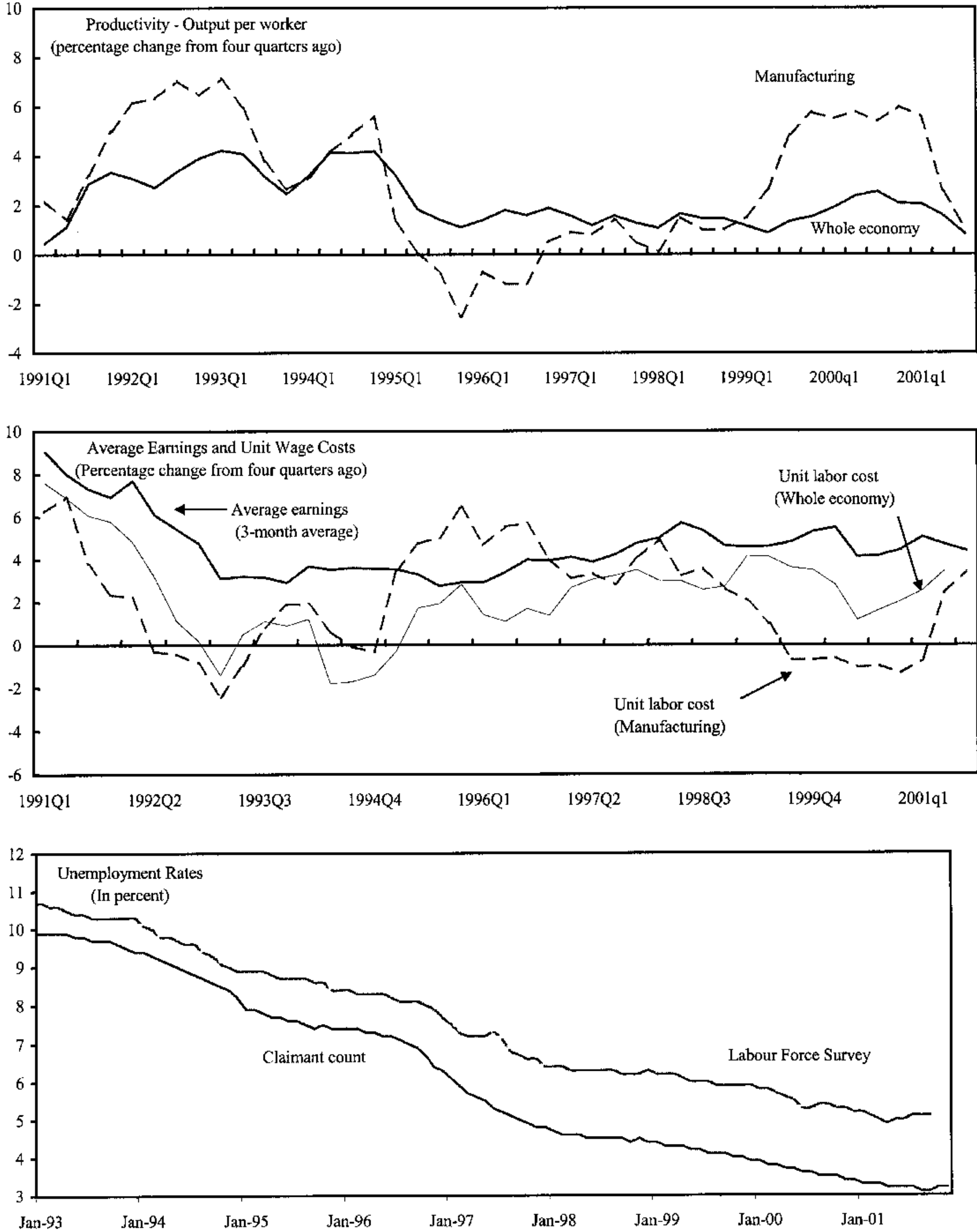
E. Risks to the Financial Sector

25. **The domestic banking sector was regarded as sound by the authorities and markets, given its strong profitability and capitalization** (Table 6). Market indicators, such as risk premia on instruments issued by financial institutions and bank stock prices and commercial ratings, were all suggestive of this strength. However, the authorities agreed that there were risks to the financial system stemming from high private debt ratios, a possible sustained decline in asset prices, and the relatively large exposures of U.K. banks to the highly geared U.S. private sector. Against these risks, staff noted that provisioning levels had declined since the early 1990s, reflecting low bad loan ratios, and stressed the need for vigilance to ensure that capital and provisions remained adequate during the ongoing slowdown and in the event of a rise in interest rates. This required among other things, close collaboration between the Financial Services Authority (FSA), which is responsible for supervision, and the Bank of England, which is responsible for systemic stability. The authorities indicated that, if asset quality deteriorated, banks had a sufficiently robust capital position and earnings stream to increase provisions as necessary. They were also monitoring carefully banks' foreign exposures.

---

[11] In the Bank's view, rate changes have typically their full impact on output with a lag of one year and on inflation with a lag of 18–24 months.

Figure 15. United Kingdom: Labor Market Indicators.



Source: National Statistics (ONS).

26. **The events of September 11, lower bond yields, and stock price declines have strained the insurance industry, but both the authorities and market analysts considered the sector, on the whole, to be stable.** The recapitalization of the property and casualty insurance sector had already begun, as indicated by rising premia. Following years of declining profits, the insurance industry faced increased pressures from exposures to equity and credit derivatives markets, given the current economic slowdown and credit events such as the collapse of Enron and Railtrack. Moreover, the distribution of risk exposures stemming from these instruments was uncertain. Given these weaknesses, the FSA planned to reform the regulatory framework for insurance to improve solvency ratios, minimize regulatory arbitrage, and strengthen consumer protection.

27. **On December 1, 2001 the FSA assumed full regulatory powers under the Financial Services and Markets Act as the single statutory regulator for financial services, including deposit taking, insurance and investment businesses.** Although the FSA had already assumed most of these responsibilities since its creation in 1997, this step completed a crucial phase in the authorities' strategy to strengthen the supervision of increasingly interconnected financial activities as well as consumer protection. In consultation with the industry, the FSA is in the process of consolidating all sectoral financial regulations in a single regulatory handbook, based on a risk-by-risk approach that will set prudential requirements for each of the main risk categories (credit risk, market risk, operational risk, etc.) across the different lines of financial activity. These and other issues will be examined in greater depth during the 2002 Financial Sector Assessment Program (FSAP).

F. Structural Policies for Productivity Growth

28. **Structural policies remain a key part of the government's strategy to boost growth.** There was broad agreement that the productivity gap reflected an inadequate level of human and physical capital, both public and private (footnote 2). Thus, the government's agenda on growth covered a broad front, which, in addition to increasing public spending on education and infrastructure, included: (i) tackling market failures in areas such as product market competition, innovation, workforce skills, and private saving; and (ii) increasing employment through labor market and welfare reform.

29. **The government has aimed public interventions at specific market failures in areas relevant to productivity growth.** The authorities intend to continue overhauling the competition regime—within the EU framework for competition policies—including by granting full operational independence to the competition authorities and by strengthening their powers.[12] They also plan to publish a paper setting out proposals to improve the land use planning system as current regulations may inhibit retail competition. With regard to

---

[12] New powers include final decision-making authority on mergers and power to levy fines and impose criminal sanctions on individuals engaged in anti-competitive practices.

promoting innovation, the PBR proposes extending a volume-based R&D tax credit to all enterprises and further modernizing the corporate tax system in order to foster corporate restructuring and investments.[13] In view of the evidence that the United Kingdom lags other G-7 countries in lower-intermediate workforce skills, the PBR also includes proposals to improve basic and intermediate education among adult workers.[14]

30. **The government has taken steps to promote saving, including pension reform and the introduction of several tax-supported savings vehicles, but staff saw a case for some streamlining.** While there might be a case for pension and saving schemes to target the needs of various socio-economic groups, the complexity of these schemes made it difficult for individuals to choose the optimal saving strategy.[15] In addition, the proposed Savings Gateway and Child Trust Fund were not only likely to reduce the attractiveness of other saving vehicles, but also raised doubts about effectiveness of targeting and openness to abuse. The authorities acknowledged these points and indicated their intention to closely scrutinize the merits of the two new saving schemes through pilot projects.

31. **The government's efforts to increase employment and reduce poverty have been met with some success, but challenges remain**. Active labor market programs, such as the New Deal, and welfare reform—particularly the working families tax credit—have led efforts to break intergenerational patterns of low skills, joblessness, and poverty.[16] Since 1997, a strong economy—along with these programs—has helped lower long-term unemployment among young people by more than 75 percent and, among the over-25 age group, by more than two-thirds. However, employment rates among certain groups, such as lone parents, are well below the national average while inactivity rates among the unskilled have risen across all age groups. Poverty rates, especially among pensioners, have fallen, but child poverty remains high.[17] The government recently announced further reforms, including a new Working Tax Credit (WTC) to extend in-work support to those on low incomes without children, and a new Child Tax Credit to streamline the system of child support. Staff suggested that work incentives could be further enhanced by linking the housing benefit for

---

[13] Proposed modernization includes a more neutral tax treatment of corporate restructuring.

[14] Options under consideration include financial incentives for employers; free learning provision; and an entitlement for employees to paid time off for learning.

[15] For a description of the pension system, see Annex I of the Staff Report for the 1999 Article IV consultation (SM/00/28).

[16] Joblessness is a key cause of child poverty—61 percent of poor households with children are jobless. Recent labor market and welfare reforms were discussed in the *Selected Issues* volume for the 1999 Article IV Consultation, SM/00/33.

[17] See A. Goodman, "Inequality and Living Standards in Great Britain: Some Facts," Institute for Fiscal Studies Briefing Note No. 19, July 2001.

the working-age population to job search and by integrating it with the WTC. The authorities agreed that the housing benefit needed reform, but stressed that this would be a complex and difficult process.

G. Other Issues

32. **The government remains, in principle, in favor of joining EMU, but a decision to join would be made only if the economic case is clear and unambiguous.**[18] The five "tests" for deciding the case were set out by the Chancellor in October 1997 and the government intends to make an assessment against these tests by June 2003. If the assessment is positive, the case for joining EMU will be submitted to Parliament and, eventually, to a national referendum. In the fall of 2001, the authorities published technical work on the methodology to be used in evaluating the five tests. The authorities are also continuing their policy of making preparations for entry should a decision to join be made.

33. **The U.K. anti-money laundering system is considered by the FATF to meet its forty recommendations.** The Financial Services and Markets Act of December 1, 2001 complemented the existing 1993 criminal legislation against money laundering by making some actions offenses under civil law and investing the FSA with enforcement powers, including imposing fines and publicly naming noncompliant institutions. The new legislation will also allow the integration of anti-money laundering rules within the overall regulation and supervisory framework. The upcoming FSAP will include a detailed assessment of the United Kingdom's legal, institutional, and supervisory regimes for combating money laundering and the financing of terrorism.

34. **The United Kingdom was among the first countries to accede to the OECD anti-bribery convention, but new legislation aimed at implementing the convention has not yet entered into force.**

35. **Official development assistance (ODA) is set to increase** from 0.31 percent of GNP (US$4.3 billion) in FY2001/02 to 0.33 percent of GNP (US$5.2 billion) by FY2003/04. The HIPC element represents 7 percent of total ODA in 2001/02.

III. Staff Appraisal

36. **The performance of the U.K. economy remains impressive**. Nine years of sustained noninflationary growth and a fall in the unemployment rate to its lowest level in a quarter century have placed the United Kingdom in a relatively strong position to weather the recent global slowdown.

37. **These achievements owe much to the government's sound macroeconomic policies, the strong policy framework, and to sustained structural reform.** The fiscal

[18] The costs and benefits of the United Kingdom joining EMU were discussed in SM/00/33.

position has been placed on a solid footing under the guidance of the two fiscal rules, and the strengthening of the monetary framework has helped anchor inflation expectations around the inflation target. In addition, sustained structural reform since the 1980s, especially labor market and welfare reform, has allowed unemployment to fall without triggering inflationary wage demands.

38. **The outlook for the economy is relatively benign, but risks remain.** Based on an improvement in world demand in the second half of 2002, the ongoing slowdown is expected to be modest and short-lived, and inflation pressures appear weak. However, prospects for the projected recovery in world demand remain uncertain. Domestically, the potential imbalances that have emerged during the last few years—including the demand boom and strong growth of private debt ratios—appear less worrisome than those seen in the late 1980s. Nevertheless, they need to be watched closely and macroeconomic and financial sector policies will need to be mindful of the attendant risks.

39. **The cyclically-adjusted fiscal deficit should not rise above the path projected in the November PBR.** The reasons for prudence are clear: policy predictability remains key to preserving credibility in the fiscal framework and the revenue shortfall experienced this year may not be as temporary as expected. Moreover, an excessive push on demand may require sharper increases in interest rates with undesirable consequences for investment, private sector balance sheets and, possibly, the exchange rate. The automatic stabilizers should be allowed to operate fully. In the absence of a medium-term overall deficit limit under the fiscal rules, lowering the net public debt ceiling from 40 percent of GDP to a level closer to the current debt ratio would signal clearly the government's commitment to containing budget deficits and make fiscal policy more predictable.

40. **Given the already sharp acceleration in public spending, caution will need to be exercised on new spending measures, both with regard to the amounts and speed with which targets are met.** Additional spending—beyond the already sizeable increases underlying the PBR—should be undertaken only if a clear-cut economic justification can be found. Even in this case, it may be necessary to postpone some new spending initiatives to avoid an excessive acceleration in spending from leading to waste. The ongoing strengthening of the expenditure management framework is welcome and should continue.

41. **Should a strong case for additional spending be found, offsetting tax measures would be needed and these should focus on safeguarding—or indeed improving—the relative neutrality of the U.K. tax system.** Broadening the tax base by minimizing exemptions and closing loopholes would be preferable to increasing tax rates or introducing new taxes. In addition, a broader application of user fees for public services would promote the efficient use of resources. In both cases, targeted transfers could offset any resulting adverse impact on the poor.

42. **Monetary policy has been managed skillfully and should continue to respond flexibly to evolving conditions.** The rate cuts so far have bolstered consumer spending at a time of deteriorating global prospects. Given the balanced risks to the outlook, policy will

need to stand ready to act in either direction, depending on how the risks play out. Any monetary easing will need to be mindful of the risk that economic imbalances—particularly the high levels of private debt—could be exacerbated, possibly complicating the task of meeting the inflation target further down the road.

43. **The high levels of profitability and capitalization of domestic banks appear to provide an adequate buffer if asset quality prospects deteriorate.** Nevertheless, vigilance is needed to ensure that capital and provisions remain adequate during the ongoing slowdown and in the event of a sharp increase in interest rates. It will be important for the FSA and the Bank of England to collaborate closely in ensuring systemic stability. We welcome the FSA's plans to reform the insurance regulatory framework.

44. **Boosting productivity growth remains a key challenge for the U.K. economy over the medium term.** Staff welcomes the focus on improving product market efficiency by further strengthening the competition regime and reforming land use regulation. Proposals to extend the scope of R&D tax credits and further modernize the corporate tax system should help foster an environment conducive to innovation and enterprise. Promoting basic and intermediate skills among adult workers will, over time, narrow the productivity gap vis-à-vis other G-7 countries. With regard to fostering private saving, staff suggests that the current complex array of pension and saving vehicles be streamlined and the effectiveness of the new proposed schemes—the Child Trust Fund and the Savings Gateway—be scrutinized carefully.

45. **Staff welcomes the government's efforts to increase employment.** Remarkable progress has been made in this area. Challenges remain on reducing labor market inactivity among specific groups. The WTC should help increase work incentives for low-income earners. The transition from inactivity to work could be further eased by reforming housing benefits.

46. **The decision to join EMU remains a key strategic issue.** The government's five tests for assessing the case for entry remain broadly appropriate, as does the policy of proceeding with entry preparations should a decision to join be eventually made.

47. We welcome the authorities' commitment to increasing **official development assistance** and encourage the establishment of a time path to accelerate progress toward achieving the U.N. target of 0.7 percent of GNP. The government's efforts at **combating money laundering** and other financial crimes are noteworthy, particularly given the importance of London as an international financial center.

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

Table 1: Selected Economic Indicators

	1997	1998	1999	2000	2001 1/	2002 Staff Proj.
Real Economy (change in percent)						
Real GDP	3.4	3.0	2.1	3.0	2.4	1.8
Domestic demand	3.9	5.1	3.4	3.6	3.0	2.8
CPI (excluding mortgage interest; RPIX)	2.8	2.7	2.3	2.1	2.2	2.3
Unemployment rate (in percent) 2/	6.5	6.2	5.9	5.3	5.2	5.4
Gross national saving (percent of GDP)	16.9	17.6	15.7	15.9	16.0	14.9
Gross domestic investment (percent of GDP)	17.1	18.1	17.8	17.7	17.4	17.1
Public Finance (in percent of fiscal year GDP) 5/						
General government balance	-0.8	0.6	1.7	4.4 6/	-0.1	-1.2
Public sector balance	-0.7	0.6	1.8	4.3 6/	-0.1	-1.1
Public sector structural balance	-0.2	0.5	1.6	1.6	-0.3	-1.1
General government gross debt	48.8	45.9	43.2	39.9	37.2	35.3
Public sector net debt	42.8	40.1	37.3	32.0	30.6	31.1
Money and Credit (end-year, percent change)						
M0	6.4	5.3	11.7	4.8	7.8 3/	...
M4	5.7	9.8	5.5	8.3	8.2 3/	...
Consumer Credit	13.8	15.3	9.7	9.1	13.1 3/	...
Interest rates (year average)						
Three-month interbank rate	6.9	7.4	5.5	6.1	3.9 4/	5.0
Ten-year Government bond yield	7.4	5.4	5.4	5.4	4.6 4/	5.1
Balance of Payments						
Trade balance (in percent of GDP)	-1.5	-2.5	-3.1	-3.2	-3.4	-3.7
Current account (in percent of GDP)	-0.2	-0.6	-2.1	-1.8	-1.3	-2.2
Reserves (national valuation of gold, end of period, in billions of SDRs)	27.5	26.5	30.5	37.0	32.2 4/	...
Fund Position (As of December 31, 2001)						
Holdings of currency (in percent of quota)					64.8	
Holdings of SDRs (in percent of allocation)					12.2	
Quota (in millions of SDRs)					10,738.5	
Exchange Rate						
Exchange rate regime	Floating exchange rate					
Present rate (February 8, 2002)	US $1 = £0.7067					
Nominal effective rate (1995=100) 7/	118.5	122.5	122.3	126.7	124.3	...
Real effective rate (1995=100) 8/	124.6	137.3	134.5	142.3	143.9	...

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

1/ Staff estimates, except otherwise indicated.
2/ ILO unemployment, based on Labor Force Survey data; October -December.
3/ November 2001.
4/ December 2001.
5/ Fiscal year beginning April 1.
6/ Includes 2.4 percentage points of GDP in 2000/01 corresponding to the auction proceeds of spectrum licenses.
7/ An increase denotes an appreciation. The 2001 figure refers to November.
8/ Based on relative normalized unit labot costs in manufacturing. The 2001 figure refers to November.

Table 2. United Kingdom: Main Components of Aggregate Demand

	1996	1997	1998	1999	2000	2001 Est.	2002 Prj.
	Contribution to growth, in percent						
Domestic demand	3.1	4.0	5.2	3.5	3.8	3.2	2.8
Private consumption	2.4	2.5	2.5	2.8	2.7	2.4	1.8
Public consumption	0.2	0.0	0.3	0.5	0.4	0.7	0.9
Private investment	1.2	1.5	2.2	0.2	0.7	0.0	0.1
Public investment	-0.4	-0.2	0.0	0.0	0.2	0.2	0.3
Stockbuilding	-0.4	0.3	0.1	0.1	-0.3	-0.1	-0.2
Other domestic demand	0.0	0.1	0.2	0.0	0.1	0.0	0.0
Foreign balance	-0.4	-0.5	-2.2	-1.4	-0.7	-0.7	-1.1
Imports	2.8	3.0	3.1	3.1	4.0	1.0	1.1
Exports	2.3	2.5	1.0	1.7	3.3	0.3	0.1
	Year-on-year growth rate, in percent						
Domestic demand	2.6	3.4	3.0	2.1	3.0	2.4	1.8
Private consumption	3.8	3.8	3.8	4.2	4.1	3.6	2.6
Public consumption	1.2	0.1	1.5	2.8	1.9	3.7	4.8
Private investment	8.7	10.2	14.2	1.1	4.3	-0.2	0.7
Public investment	-20.1	-11.7	2.5	-1.4	11.5	13.8	17.7
Stockbuilding	-0.4	0.3	0.1	0.1	-0.3	-0.1	-0.2
Other domestic demand	0.9	3.0	9.8	1.7	5.9	1.3	1.6
Foreign balance							
Imports	9.6	9.7	9.6	8.9	10.9	2.6	2.8
Exports	8.2	8.3	3.0	5.4	10.3	0.8	0.2
	In percent of GDP						
Domestic demand	101	101	103	105	105	106	107
Private consumption	65	65	65	67	68	68	69
Government consumption	19	19	18	19	18	19	19
Private investment	15	16	17	17	18	17	17
Public investment	1.7	1.5	1.5	1.4	1.5	1.7	2.0
External demand	-1	-1	-3	-5	-5	-6	-7

Sources: UK National Statistics and IMF staff estimates, and projections.

Table 3. United Kingdom: Public Sector Budgetary Projections
(Percent of GDP and percent of potential GDP)

	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06
Non-cyclically adjusted								
Total revenue	39.0	39.6	42.5	39.3	38.9	39.2	39.4	39.4
Current revenue 3/	39.0	39.5	40.0	39.2	38.8	39.1	39.3	39.4
Tax revenue	36.1	36.9	37.4	36.7	36.4	36.7	36.9	37.0
Non-tax revenue	2.8	2.6	2.6	2.5	2.4	2.4	2.4	2.4
Capital revenue 4/	0.0	0.0	2.4 4/	0.1	0.1	0.1	0.1	0.1
Total expenditure	38.4	37.8	38.1	39.5	40.0	40.5	40.5	40.5
Current expenditure	36.2	35.8	36.1	36.8	37.2	37.4	37.4	37.4
Primary expenditure	32.8	33.0	33.3	34.6	35.2	35.3	35.3	35.3
Interest payments	3.4	2.8	2.8	2.3	2.1	2.1	2.1	2.1
Capital expenditure 5/	2.2	2.0	2.1	2.7	2.8	3.1	3.1	3.2
Current balance 6/	1.3	2.3	2.6	1.0	0.3	0.4	0.6	0.7
Overall balance	0.6	1.8	4.3	-0.3	-1.1	-1.3	-1.2	-1.1
Excluding proceeds from spectrum licenses			2.0					
Public sector net debt 7/	40.1	37.3	32.0	30.7	30.6	31.0	31.1	31.1
Cyclically adjusted 8/								
Total revenue	39.1	39.5	40.0	39.2	38.9	39.2	39.3	39.4
Current revenue	39.0	39.5	40.0	39.1	38.9	39.1	39.3	39.4
Tax revenue	36.2	36.9	37.3	36.7	36.4	36.7	36.9	37.0
Non-tax revenue	2.8	2.6	2.6	2.5	2.4	2.4	2.4	2.4
Capital revenue	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Total expenditure	38.5	37.9	38.4	39.5	40.0	40.6	40.6	40.5
Current expenditure	36.3	35.9	36.4	36.9	37.2	37.5	37.4	37.4
Primary expenditure	32.9	33.2	33.6	34.6	35.1	35.4	35.3	35.3
Interest payments	3.4	2.8	2.8	2.3	2.1	2.1	2.1	2.1
Capital expenditure	2.2	2.0	2.1	2.7	2.8	3.1	3.1	3.2
Current balance 6/	1.2	2.1	2.3	0.9	0.3	0.3	0.5	0.7
Overall balance	0.5	1.6	1.6	-0.3	-1.1	-1.4	-1.2	-1.1
Real growth	2.6	2.4	2.8	2.0	2.3	2.5	2.3	2.3
Output gap (official estimate)	0.4	0.2	0.6	-0.1	-0.1	0.2	0.0	0.0

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

1/ Official estimates reflected in the Pre-Budget Report are based on pre-December 20 national accounts data.

2/ Data have been adjusted to include the full spectrum license revenue in 2000/01 as capital revenue. This revenue is excluded from the structural estimates.
Data on current revenue have also been adjusted accordingly to exclude the annual allocation of the spectrum license revenue made in the authorities' accounting meth

3/ Includes 2.4 percentage points of GDP in 2000/01 corresponding to the auction proceeds of spectrum licenses. This revenue is excluded from the structural estimates.

4/ Capital expenditure data reported here may differ from official publications since the latter typically focus on capital expenditure net of capital receipts and depreciatio

5/ Including depreciation.

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

7/ For comparability, the potential output used for all columns is the authorities' official estimate.

Table 4. United Kingdom: Balance of Payments

	1996	1997	1998	1999	2000	2001 Qtr 1	2001 Qtr 2	2001 Qtr 3
				Billions of sterling				
Trade balance	-4.1	0.2	-9.1	-15.9	-15.7	-4.3	-5.1	-5.4
Net exports of goods	-13.7	-12.3	-21.8	-27.5	-30.4	-7.9	-9.3	-8.0
Net exports of services	9.6	12.5	12.7	11.7	14.7	3.6	4.2	2.6
Income Balance	1.2	3.9	12.6	4.0	6.1	4.3	3.3	3.5
Compensation of employees	0.1	0.1	0.0	0.2	0.1	-0.1	0.1	0.0
Investment income	1.1	3.8	12.6	3.8	6.0	4.3	3.2	3.4
Net current transfers	-5.8	-5.8	-8.2	-7.2	-8.8	-2.1	-2.7	-0.1
Central government	-2.5	-3.1	-4.8	-3.7	-5.4	-0.8	-1.2	0.8
Other sectors	-3.3	-2.7	-3.4	-3.5	-3.4	-1.3	-1.5	-0.9
Current acount	-8.7	-1.7	-4.8	-19.1	-18.4	-2.1	-4.6	-2.0
Capital account	0.7	0.8	0.5	0.8	2.0	0.3	0.8	0.3
Financial account	5.5	-5.1	0.2	21.5	16.5	3.0	-0.4	4.2
Net direct investment	-4.7	-15.4	-28.3	-74.5	-89.4	0.3	0.9	11.4
Net portfolio investment	-16.6	-25.3	-11.0	87.4	101.0	-9.5	-27.0	-8.4
Net other investment	25.4	32.1	42.4	5.3	7.3	7.3	27.2	-5.2
Reserve assets	0.5	2.4	0.2	0.6	-3.9	2.6	0.0	0.5
Errors and Omissions	2.5	6.0	4.1	-3.2	-1.5	-0.6	3.0	-1.5
				in percent of GDP				
Trade balance	-0.5	0.0	-1.1	-1.8	-1.7	-1.7	-2.1	-2.2
Income balance	0.2	0.5	1.5	0.4	0.6	1.8	1.3	1.4
Net current transfers	-0.8	-0.7	-1.0	-0.8	-0.9	-0.9	-1.1	0.0
Current account	-1.1	-0.2	-0.6	-2.1	-2.0	-0.8	-1.9	-0.8
Capital and financial account	0.8	-0.5	0.1	2.5	2.0	1.4	0.1	1.8
Net direct investment	-0.6	-1.9	-3.3	-8.3	-9.5	0.1	0.3	4.6
Net portfolio investment	-2.2	-3.1	-1.3	9.7	10.7	-3.9	-10.9	-3.4
Net other investment	3.3	4.0	4.9	0.6	0.8	3.0	11.0	-2.1

Source: National Statistics.

Table 5. United Kingdom: Medium-Term Scenario

(Percentage change, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006
Real domestic demand	5.1	3.4	3.6	3.0	2.7	2.9	3.1	3.0	2.9
Private consumption	3.8	4.2	4.1	3.6	2.6	2.8	3.3	3.0	3.0
Government consumption	1.5	2.8	1.9	3.7	4.8	2.0	2.1	2.2	2.1
Fixed investment	13.2	0.9	4.9	0.9	2.0	4.2	3.2	3.6	3.6
Residential	0.7	-2.4	2.6	-2.0	-0.8	0.7	1.6	2.3	3.2
Business	17.1	1.7	4.6	0.1	0.6	3.8	3.0	3.7	3.5
Stocks 1/	0.1	0.1	-0.3	-0.1	-0.2	0.0	0.0	0.0	0.0
External balance 1/	-2.2	-1.4	-0.7	-0.7	-1.1	-0.3	-0.4	-0.2	-0.2
Exports	3.0	5.4	10.3	0.8	0.2	5.7	6.3	6.6	6.4
Imports	9.6	8.9	10.9	2.6	2.9	5.6	6.2	5.9	5.8
Current account 2/	-0.6	-2.1	-1.8	-1.3	-2.1	-2.3	-2.4	-2.3	-2.2
Real GDP	3.0	2.1	3.0	2.4	1.8	2.8	2.9	3.0	3.0
Inflation									
RPI (excluding mortgage interest)	2.7	2.3	2.1	2.2	2.2	2.3	2.5	2.5	2.5
Employment and productivity									
Employment	1.1	1.3	1.0	0.7	-0.2	0.3	0.6	0.5	0.5
Average unemployment rate 3/	6.3	6.0	5.6	5.1	5.4	5.4	5.4	5.4	5.4
Productivity 4/	1.4	1.2	2.2	1.6	2.0	2.4	2.3	2.5	2.5

Sources: National Statistics; IMF staff projections.

1/ Contribution to the growth of GDP.
2/ In percent of GDP, assuming unchanged real exchange value at 2001 level.
3/ ILO unemployment rate in percent; based on Labor Force Survey data.
4/ Whole economy.

Table 6. United Kingdom: Indicators of External and Financial Vulnerability 1/
(In percent of GDP, unless otherwise indicated)

	1996	1997	1998	1999	2000	2001	as of:
External indicators							
Exports (annual percentage change, in U.S. dollars)	8.5	8.9	-0.1	1.1	5.1	-3.7	2001q3
Imports (annual percentage change, in U.S. dollars)	8.6	6.8	4.0	3.7	4.5	-1.6	2001q3
Terms of trade (annual percentage change)	0.8	1.4	0.9	0.3	-0.4	1.4	2001q3
Current account balance	-1.1	-0.2	-0.6	-2.1	-1.8	-1.2	2001q3
Capital and financial account balance	-0.6	-0.5	0.1	2.5	2.0	0.1	2001q3
Of which: Foreign direct investment (net)	-0.6	-1.9	-3.3	-8.3	-9.5	5.0	2001q3
Portfolio investment (net)	-2.2	-3.1	-1.3	9.7	10.7	-3.4	2001q3
Other investment (net)	3.3	4.0	4.9	0.6	0.8	-2.1	2001q3
Net errors and omissions	0.3	0.7	0.5	-0.4	-0.2	0.4	2001q2
Official reserves (in billions of U.S. dollars, end of period) 3/	45.4	37.1	37.3	41.8	48.2	43.7	2001q3
Central bank net foreign assets (in billions of U.S. dollars)	-1.5	-1.1	7.0	-2.7	-2.9	7.8	2001q3
Foreign assets of banking institutions (in billions of U.S. dollars)	1306	1705	1895	1835	2150	2188	2001q3
Foreign liabilities of banking institutions (in billions of U.S. dollars)	1319	1722	1857	1828	2141	2186	2001q3
Exchange rate against U.S. dollar (period average)	1.56	1.64	1.66	1.62	1.52	1.43	
Financial markets indicators							
Public sector net debt	43.7	42.7	40.2	38.2	32.7	30.8	2001q3
3-month T-bill yield	5.8	6.5	6.8	5.0	5.8	3.9	
3-month T-bill yield (real) 5/	3.2	4.5	5.4	4.7	5.3	1.9	
Change in stock market index (percent, end of period)	13.3	13.2	17.3	11.9	6.0	-24.0	
Spread of 3-month T-bill vs. the U.S. (percentage points, end of period)	0.8	1.4	2.0	0.4	-0.4	2.0	
Credit indicators 6/							
M4 lending	8.8	7.9	7.0	7.3	11.1	8.2	Nov-01
M4 lending to individuals							
Secured on dwellings	4.7	5.4	5.2	6.7	8.2	8.0	Nov-01
Consumer credit	11.3	13.8	14.2	12.3	13.7	13.7	Nov-01
Credit card	15.3	17.3	22.0	43.9	17.2	10.0	Nov-01
M4 lending to private non financial corporations	12.5	10.1	9.5	4.4	12.3	8.3	Nov-01
Lending to construction sector	-10.9	-3.8	10.9	7.1	29.3	...	Nov-01
Lending to real estate sector	1.0	-3.8	14.7	15.6	22.2	...	Nov-01
Interest rate on personal loans 7/	...	18.1	18.0	14.9	15.7	16.0	Nov-01
Interest rate on fixed rate mortgages 7/	...	7.6	6.5	7.1	6.5	5.7	Nov-01
Interest rate on time deposits 7/	...	5.8	5.1	4.2	4.4	2.9	Nov-01
Financial sector risk indicators 8/							
Total loans to assets (percent)	85.1	83.9	82.4	82.5	82.0	82.2	2001q3
Total loans to deposits (percent)	94.0	94.5	93.1	93.5	92.9	91.5	2001q3
Foreign exchange loans (in US$bn)	1241.2	1431.0	1515.7	1443.5	1698.5	1,837.3	2001q3
Share of foreign exchange loans in total lending (percent)	40.3	42.2	41.1	39.2	41.4	42.5	2001q3
Deposits in foreign exchange (in US$bn)	1470.1	1651.1	1768.6	1698.7	1995.0	2,232.2	2001q3
Share of foreign deposits in total deposits (percent)	51.1	55.7	55.5	54.9	57.3	58.8	2001q3
Share of foreign denominated liabilities in total liabilities (percent)	49.0	50.9	50.7	48.5	51.5	54.4	2001q3
Share of real estate sector in private credit (percent) 9/	48.9	47.3	48.2	48.6	46.9	47.1	2001q3
Share of real estate sector in loans to non financial private corporations (percent) 7/	24.9	20.7	23.0	24.9	28.1	30.3	2001q3
Share of non-performing loans in total loans (%) 10/	2.3	2.4	2.2	1.9	1.5	1.4	2001q3
Share of non-performing loans in total assets sector (%) 10/	1.4	1.7	2.1	2.4	1.0	0.8	2001q3
Capital asset ratio	11.8	12.5	12.6	12.2	11.8	12.2	2001q3
Profitability ratio	22.1	19.2	16.8	18.6	17.5	16.2	2001q3

Sources: National Statistics; Bank of England; and IMF, International Financial Statistics.
1/ For 2001, annual figures, unless otherwise noted.
2/ Cumulative flow during the period indicated.
3/ Including gold, national valuation.
4/ Monthly average.
5/ Calculated as 3-month T-bill over actual 12-month RPI inflation in Dec of relevant year.
6/ Twelve-month growth rates.
7/ Weigthed averages for banks and building societies.
8/ Building societies and insurance companies are excluded from this sample. 'Deposits' includes currency, deposits and money market instruments.
9/ Excludes investments.
10/ The figures for non-performing loans represent the gross value of loans against which specific provisions have been made.

United Kingdom: Basic Data

Demographic and other data:

Area	94,247 square miles (244,100 sq. km.)
Population (mid-2001)	59.5 million
Infant mortality (per 1,000 live births)	6.1
Doctors per 1,000 inhabitants	0.5
GDP per capita (2000)	SDR 18,360

Composition of GDP in 2000, at current prices	In billions of Pounds		Distribution in Percent	
Private consumption	611.7		62.9	
Public consumption	174.2		17.9	
Total investment (including stockbuilding)	161.8		16.6	
Total domestic demand	953.19		98.0	
Exports of goods and services	254.3		26.2	
Imports of goods and services	272.2		28.0	
GDP at market prices (average estimate)	972.6		100	
Selected economic data	1999	2000	2001	
Output and unemployment:	(Annual percentage change)			
Real GDP (at market prices, average estimate)	2.3	2.9	2.3	1/
Manufacturing production	0.8	0.3	0.6	1/
Average unemployment (in percent)	6.0	5.6	5.1	1/
Earnings and prices:				
Average earnings in manufacturing	4.1	4.6	4.8	1/
Retail price index, excluding mortgage interest	2.2	2.1	2.4	1/
Money and interest rates:				
M0 (end of period)	11.7	4.8	6.3	2/
M4 (end of period)	4.2	8.3	8.1	2/
3-month Interbank rate	5.4	6.1	4.0	3/
10-year government bond yield	5.6	4.9	4.9	3/
	(In billions of pounds sterling)			
Fiscal accounts (In percent of GDP): 5/				
General government balance	1.9	2.7	-1.3	4/
Public sector balance	1.8	4.3 6/	-1.1	4/
Public sector net debt	38.2	32.7	30.8	4/
Balance of payments:				
Current account balance	-19.1	-17.0	-20.3	1/
(In percent of GDP)	-2.1	-1.8	-0.8	1/
Trade balance	-26.2	-28.8	-34.0	
Exports	166.2	187.7	191.0	
Imports	-193.7	-218.0	-225.0	
Direct investment (net)	-76.0	-78.9	-77.5	6/
Portfolio investment (net)	104.5	89.1	96.8	6/
Gross reserves, official basis	22.2	28.3	26.4	2/

Sources: National Statistics; HM Treasury; and IMF staff estimates.
1/ As of 3rd quarter 2001.
2/ November 2001.
3/ December 2001.
4/ Includes 2.4 percentage points of GDP in 2000/01 corresponding to the auction proceeds of spectrum licenses.
5/ Fiscal year beginning April 1.
6/ Includes 2.4 percentage points of GDP in 2000/01 corresponding to the auction proceeds of spectrum licenses.
7/ January-June 2001.

UNITED KINGDOM: Fund Relations
(As of December 31, 2001)

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

II. **General Resources Account**:	**SDR Million**	**% Quota**
Quota	10,738.50	100.0
Fund holdings of currency	6,719.00	62.6
Reserve position in Fund	4,019.55	37.4

III. **SDR Department**:	**SDR Million**	**% Allocation**
Net cumulative allocation	1,913.07	100.0
Holdings	234.07	12.2
Designation Plan	0.00	

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

V. **Financial Arrangements**: None

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

VII. **Exchange Rate Arrangement**:

On September 16, 1992, the U.K. authorities withdrew the pound sterling from the exchange rate mechanism of the European Monetary System and have since maintained a floating regime. As of February 8, 2002 a representative market exchange rate for sterling was $1.415. In accordance with U.N. Security Council Resolutions or EC Regulations, the United Kingdom apply exchange restrictions vis-à-vis Iraq, the Taliban, Usama bin Laden, Al-Qa'ida and other terrorists or suspected terrorists, transfers to or for the benefit of UNITA, certain assets in relation to Mr. Milosevic and associates, and certain persons related to important government functions in Myanmar. These restrictions have been notified to the Fund under Decision 144-(52/51) (see EBD/90/242 in respect of Iraq, EBD/01/15 in respect of the Taliban and UNITA, EBD/01/16 in respect of Mr. Milosevic and Myanmar and EBD/02/25 in respect of the Taliban, Usama bin Laden, Al-Qa'ida and other terrorists or suspected terrorists).

VIII. **Article IV Consultation**:

Discussions for the 2001 Article IV consultation were conducted in London during November 28-December 10 , 2001. The Staff Report (SM/01/32) was considered by the Executive Board on February 23, 2001 (EBM/01/17).

IX. **FSAP**

The FSAP will be completed at the time of the 2002 Article IV Consultations, based on three FSAP missions scheduled for early February 2002, early May, and mid-July. In addition, MAE conducted preliminary technical discussions in mid-November 2001.

X. **Technical Assistance**: None

XI. **Resident Representative**: None

United Kingdom—Statistical Information

The United Kingdom maintains high standards of economic data provision. The authorities publish a full range of economic and financial data that is available electronically and have subscribed to the Special Data Dissemination Standard (SDDS). The UK shifted to ESA95 in September 1997. While most of the changes related to the introduction of ESA95 have been implemented, the timetable for the implementation of the reminder of ESA95 extends to 2005. The main statistical change in 2000 was the adoption of a wider concept of capital formation, to include computer software, mineral exploration, and military dual-use assets. It also reclassified some expenditures from net investment to depreciation. Other changes included a rebasing of the constant price estimates to a price base of 1995, a new constant price estimate of government output, and major improvements to the business register.

In 2001, the authorities implemented a number of important methodological changes to the national accounts dataset, most of which were related to the adoption of ESA95. As a consequence of these revisions, many of the national accounts time series have been revised back to the start of the dataset, with the level of GDP being revised upwards for all years back to 1987. The main causes of the revisions have been the following: (i) inclusion of the results of the new Annual Business Inquiry, resulting in improved estimates for the distribution of value added by industry and higher quality of Input-Output tables; (ii) inclusion of estimates for tobacco and alcohol smuggling, leading to increased estimates of household expenditures, imports of goods, household income, and value added of the distribution sector; (iii) exclusion of the UK offshore territories (Isle of Man, Channel Islands) from the UK national accounts, resulting in a reduction in the income and current balance; (iv) reclassification of the settlement flows on interest rate swaps and forward rate arrangements, leading to a lower income balance; (v) re-estimation of tax paid on foreign direct investment, resulting in a decline in the transfer balance; (vi) inclusion of new indicators of public sector output for the probation service, fire service and local authority social services; and (vii) inclusion of revisions to computer prices incorporated in the producer price index released in June 2001.

While the U.K. high standards of economic data provision are adequate for Fund surveillance, there is room for improvement in the quality of labor statistics. At present, workforce jobs is the concept of the labor force used in domestic measures of productivity, whereas other countries, for instance the U.S., use the concept of labor hours for official productivity measures. Although hours worked is collected and published in the U.K., these data are thought to be imprecisely measured and are usually not used in productivity studies. Against this background, the ONS has indicated its intention to improve the data quality of labor hours and published an experimental dataset of GDP per hour worked on basis of the OECD's Employment Outlook. The dataset of ICT investment deflators could also be improved. Given that no specific price indices currently exist for computer software, general investment-based price indices have to be used instead.

Table 6. United Kingdom: Core Statistical Indicators
(as of February 11, 2002)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Govern-ment Balance	GDP/ GNP	External Debt/ Debt Service
Date of Latest Observation	02/11/2002	January	December	December	December	02/11/2002	12/2001	11/2001	2001Q3	December	2001Q3	2000
Date Received	02/11/2002	February	January	January	January	02/11/2002	January	December	December	January	December	Sept. 2001
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly	Annual
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly	Annual
Source of Update	Bloomberg	BOE TRE	BOE Press Rel.	BOE Press Rel.	BOE Press Rel.	RES Reuters Bloomberg	ONS Press Rel.	ONS Press Rel.	ONS Press Rel.	ONS Press Rel.	ONS Press Rel.	ONS
Mode of Reporting	Electronic	Electronic	Publica./ Electronic	Publica./ Electronic	Publica./ Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic
Confidentiality	Published	Published	Published	Published	Published	Published	Published	Published	Published	Published	Published	Published
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly	Annual

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 02/22
FOR IMMEDIATE RELEASE
March 7, 2002

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

IMF Concludes 2001 Article IV Consultation with the United Kingdom

On March 4, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the United Kingdom.[1]

Background

The United Kingdom has experienced nine years of sustained noninflationary output growth, the longest such expansion in more than 30 years. Since the 1991–92 recession, output has increased by an average of almost 3 percent a year. Inflation has declined from a peak of 9½ percent in late 1991 to about 2 percent, and on a harmonized basis was the lowest in the EU in 2001. At the same time, the unemployment rate has halved during the 1990s, falling to about 5 percent last year—the lowest in over a quarter century. The current account deficit averaged 1¾ percent of GDP in 1998-2001, compared with a deficit of 5 percent of GDP in 1989.

In 2001, the U.K. economy grew faster than any other G-7 economy. Despite the slowdown in world demand, output grew by 2.4 percent reflecting strong domestic demand. Private consumption remained buoyant, fueled by several years of strong earnings and employment growth, low interest rates, and rising housing wealth, which largely offset the adverse impact of lower equity prices on consumer spending. Following several years of robust growth, private investment was hit by the downturn in the information and telecommunications sector and contracted sharply in the second half of the year. With both exports and imports falling, the

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

trade balance continued to make a negative contribution to growth. Inflation averaged about 2 percent and the unemployment rate edged up slightly to reach some 5.2 percent by year end.

Nevertheless, after a decade of continuous expansion, some potential imbalances have emerged. Beginning in late 1996, as sterling appreciated in real effective terms, growth has been sustained primarily by domestic demand and net exports have weakened. Moreover in the last year, private consumption and public spending, rather than private investment, have been the main driving forces. Household saving has dropped and private sector debt ratios have surged. House prices have continued to rise strongly while mortgage equity withdrawals have approached the levels of the1980s.

At the structural level, raising productivity has been a key issue. Productivity in the United Kingdom is still significantly lower than in other G-7 countries, even though the gap has narrowed during the 1990s. Empirical evidence suggests that the main cause is a gap in public and private human and physical capital. Years of underinvestment have also led to deterioration in the quality of public services, which has been a focus of recent political debate.

The fiscal position has been strengthened significantly in recent years. The cyclically-adjusted overall balance swung from a deficit of 5½ percent of GDP in FY1993/94 to a surplus of 1½ percent of GDP in FY2000/01, while the public net debt ratio fell from 44½ percent of GDP at end-1996 to 31½ percent of GDP at end-2001. The November pre-budget report (PBR) envisages a sizeable fiscal impulse in FY2001/02, with the cyclically-adjusted overall fiscal balance projected to shift from a surplus of 1.6 percent of GDP in FY2000/01 to a deficit of 0.3 percent of GDP in FY2001/02, mostly due to sizeable spending increases (mainly on infrastructure investment, health, and education) and lower tax revenues reflecting the decline in profits of financial companies as well as oil and equity prices. With the revenue shortfalls expected to be temporary, the deficit is projected to return to the originally envisaged level of about 1 percent of GDP by the end of the forecast horizon.

The inflation-targeting framework was substantially strengthened in 1997 through the granting of operational independence to the Bank of England to pursue a symmetric 2½ percent inflation target. This action, together with improvements in transparency, has helped anchor inflation expectations. Between February and November 2001, the Bank responded preemptively to the weakening external environment with a cumulative 200 basis point interest rate cut. These rate cuts helped support consumer confidence, as well as household borrowing and house prices—the latter rising, on average, by 10½ percent in 2001. Since November 2001, the Bank has kept interest rates unchanged noting that the risks were finely balanced between doing too little to support domestic demand—and so allowing inflation to move further below target—and doing too much—possibly creating difficulties in meeting the inflation target further out, including by allowing excessive private debt accumulation.

Executive Board Assessment

Executive Directors commended the authorities for the impressive performance of the U.K. economy as reflected in nearly a decade of noninflationary output and employment growth. Directors noted that this performance owes much to sound macroeconomic policies, the unwavering observance of a strong policy framework, and sustained structural reforms. The public finances, guided by the fiscal rules, are on a sound footing; the monetary policy framework has anchored inflation expectations at the 2½ percent target; and sustained labor market and welfare reforms have facilitated a marked reduction in unemployment without triggering wage pressures.

Looking ahead, Directors agreed that the current slowdown in output growth is likely to be relatively brief owing to the fiscal stimulus imparted by the present budget, the delayed effects of the monetary easing in 2001, and the recovery in external demand projected for later this year. They noted that the outlook is, nonetheless, subject to risks. On the downside, the global recovery could be weaker than anticipated. The investment slowdown could turn out to be deeper, particularly given low manufacturing profitability, which a number of Directors related to the continued high value of the pound sterling. Moreover, asset prices could decline unexpectedly. Directors noted that the potential imbalances that have emerged in the last few years—particularly house price increases, and rising private sector debt ratios—although less pronounced than in the 1980s, warrant careful watching. On the upside, private consumption growth might not decelerate as anticipated. Against this background, Directors agreed that the government's policy framework is appropriate for the present conjuncture, with fiscal policy remaining oriented towards the medium term, monetary policy being the instrument of choice to respond to cyclical price pressures, and structural policies aiming at increasing productivity.

Directors noted that policy predictability will remain key to preserving the credibility of the fiscal framework. While supporting the full operation of the automatic stabilizers, they stressed that it will be important not to raise the structural deficit beyond the path envisaged in the November pre-budget report. In recommending continued fiscal prudence, some Directors also cautioned that the recent revenue shortfall experienced this year may not prove as temporary as expected, and that an excessive push on demand could require sharper increases in interest rates in the future. Several Directors suggested that the predictability of budget policies could be further enhanced by lowering the 40 percent net public debt-to-GDP ceiling to a level closer to the current ratio, but several other Directors saw no pressing need to change the fiscal rules, considering that stability in the framework has served fiscal policies well.

Directors noted that the fiscal credibility earned from the strict adherence to a sound policy framework has greatly improved the UK's flexibility to respond to new challenges. In this regard, they welcomed the authorities' plans to increase public investments in education and infrastructure from their current low levels. Given the rapid increase in outlays over the coming years that existing plans already encompass, Directors stressed that any additional spending should be undertaken only if it is based on a clear-cut economic justification, and if risks of spending inefficiencies are adequately addressed. They welcomed the recent measures to improve the efficiency and effectiveness of public services, and encouraged the authorities to continue the ongoing strengthening of the expenditure management framework.

Directors underscored that an increase in public expenditure beyond current plans would need to be funded by offsetting tax measures, and they noted, in this regard, the public debate over possible tax increases. To preserve the neutrality and efficiency of the U.K. tax system, they considered that broadening the base of existing taxes by eliminating remaining exemptions would be preferable to raising tax rates. In this context, several Directors suggested that the authorities should consider the possible elimination of zero-rating under the VAT. In addition, it was suggested that a broader application of user fees for public services would promote the efficient use of resources. Directors noted that, in both cases, targeted transfers could offset any resulting adverse impact on the poor.

Directors commended the authorities for their skillful management of monetary policy, including their prompt response to the deterioration of the economic outlook in 2001. Looking ahead, they agreed that, given the balanced risks to the outlook, the authorities should continue to monitor developments closely, and be prepared to adjust policy in either direction, consistent with the symmetric nature of the inflation targeting framework. A number of Directors noted that, in considering any further monetary easing, the authorities should be especially mindful of the risk of

an excessive rise in debt ratios with the attendant possibility of a disruptive demand correction if consumers retrenched in the face of rising indebtedness.

Directors considered the banking system to be sound, noting that high profitability and capitalization levels provide an adequate buffer if asset quality were to deteriorate unexpectedly. Continued vigilance will help to ensure that capitalization and provisions remain appropriate, and that other parts of the financial system, including insurance, also remain sound. In this regard, Directors stressed the importance of close cooperation between the Financial Services Authority (FSA), the Bank of England, and the Treasury to ensure systemic stability, and they welcomed the assumption by the FSA of full regulatory powers under the new Financial Services and Markets Act as the single statutory regulator for financial services. Directors welcomed the authorities' decision to participate in a Financial Sector Assessment Program (FSAP) in 2002. They also commended their strong commitment and comprehensive efforts to combat money laundering and the financing of terrorism.

Directors endorsed the authorities' medium-term objective of raising productivity and growth prospects through targeted structural reforms aimed at identifiable market failures. They welcomed the drive to strengthen the competition regime and improve land use regulation. Directors also agreed that efforts to promote savings through pension reforms and various tax-supported saving vehicles should enhance long-term economic growth, but they saw scope for simplifying the range of publicly-supported saving options and improving their efficiency and targeting.

Directors commended the authorities for their consistent implementation over many years of labor market and welfare reforms that contributed to greater labor market flexibility and high rates of employment. They welcomed ongoing efforts aimed at addressing remaining challenges, notably the reduction of inactivity among the unskilled and of child poverty. Directors also encouraged the continued streamlining of work incentives by reforming housing benefits, particularly for the working-age population.

Directors noted that the decision on whether to join European Monetary Union (EMU) remains a key issue for the United Kingdom. They considered that the five economic tests announced in 1997 continue to be broadly appropriate to guide this decision, and welcomed the initiation of the technical work on the methodology to be used in evaluating the five tests.

Directors praised the authorities' commitment to write off the debt of the poorest countries in the context of the HIPC Initiative and to increase official development assistance (ODA). They encouraged the authorities to continue their efforts towards reaching the U.N. target for ODA of 0.7 percent of GNP.

The United Kingdom publishes data on a sufficiently timely and comprehensive basis to permit effective surveillance.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2001 Article IV Consultation with the United Kingdom is also available.

Table 1. Selected Economic Indicators

	1997	1998	1999	2000	2001 1/	2002 Staff Proj.
Real Economy (change in percent)						
Real GDP	3.4	3.0	2.1	3.0	2.4	1.8
Domestic demand	3.9	5.1	3.4	3.6	3.0	2.8
CPI (excluding mortgage interest; RPIX)	2.8	2.7	2.3	2.1	2.2	2.3
Unemployment rate (in percent) 2/	6.5	6.2	5.9	5.3	5.2	5.4
Gross national saving (percent of GDP)	16.9	17.6	15.7	15.9	16.0	14.9
Gross domestic investment (percent of GDP)	17.1	18.1	17.8	17.7	17.4	17.1
Public Finance (in percent of fiscal year GDP) 5/						
General government balance	-0.8	0.6	1.7	4.4 6/	-0.1	-1.2
Public sector balance	-0.7	0.6	1.8	4.3 6/	-0.1	-1.1
Public sector structural balance	-0.2	0.5	1.6	1.6	-0.3	-1.1
General government gross debt	48.8	45.9	43.2	39.9	37.2	35.3
Public sector net debt	42.8	40.1	37.3	32.0	30.6	31.1
Money and Credit (end-year, percent change)						
M0	6.4	5.3	11.7	4.8	7.8 3/	...
M4	5.7	9.8	5.5	8.3	8.2 3/	...
Consumer Credit	13.8	15.3	9.7	9.1	13.1 3/	...
Interest rates (year average)						
Three-month interbank rate	6.9	7.4	5.5	6.1	3.9 4/	5.0
Ten-year Government bond yield	7.4	5.4	5.4	5.4	4.6 4/	5.1
Balance of Payments						
Trade balance (in percent of GDP)	-1.5	-2.5	-3.1	-3.2	-3.4	-3.7
Current account (in percent of GDP)	-0.2	-0.6	-2.1	-1.8	-1.3	-2.2
Reserves (national valuation of gold, end of period, in billions of SDRs)	27.5	26.5	30.5	37.0	32.2 4/	...
Fund Position (As of December 31, 2001)						
Holdings of currency (in percent of quota)					64.8	
Holdings of SDRs (in percent of allocation)					12.2	
Quota (in millions of SDRs)					10,738.5	
Exchange Rate						
Exchange rate regime	Floating exchange rate					
Present rate (February 8, 2002)	US $1 = 0.7067					
Nominal effective rate (1995=100) 7/	118.5	122.5	122.3	126.7	124.3	...
Real effective rate (1995=100) 8/	124.6	137.3	134.5	142.3	143.9	...

Source: National Statistics; HM Treasury; Bank of England; International Financial Statistics; INS; and IMF staff estimates.
1/ Staff estimates, except otherwise indicated.
2/ ILO unemployment, based on Labor Force Survey data; October-December.
3/ November 2001.
4/ December 2001.
5/ Fiscal year beginning April 1.
6/ Includes 2.4 percentage points of GDP in 2000/01 corresponding to the auction proceeds of spectrum licenses.
7/ An increase denotes an appreciation. The 2001 figure refers to November.
8/ Based on relative normalized unit labot costs in manufacturing. The 2001 figure refers to November.

Statement by Thomas W. Scholar, Executive Director for the United Kingdom
March 4, 2002

Let me begin by expressing my authorities' appreciation for the work of Carlo Cottarelli and his team. As always, staff have produced an extremely interesting report and my authorities will take careful note of their comments.

Economic fundamentals

The economic fundamentals in the UK remain sound: growth in 2001 of 2.4%, inflation at 2.6% (1.6% HICP), interest rates at 4%, and employment at a record rate of over 74%. Growth slowed during 2001 and is expected to remain below trend during the first quarter of 2002, reflecting the global slowdown. But with improving world conditions from the middle of 2002, and supportive UK monetary and fiscal policy, my authorities expect growth of 2 to 2½ % in 2002 and 2¾ to 3¼% in 2003. Inflation is expected to remain close to target over the next two years.

Short-term prospects and the policy framework

My authorities agree with staff that the new policy framework and sound fundamentals mean that the UK is better placed than in the past to cope with turbulence in the world economy. **However, as staff note, there are risks**. A weaker global recovery poses a clear downside risk to the UK. Continued weakness in business investment or unexpected falls in asset prices would also have implications. Conversely, a stronger global recovery or unexpectedly strong domestic consumption could pose upside risks.

So my authorities will continue to set policy on the basis of the macroeconomic policy framework established in 1997, and based on the principles of transparency, responsibility and accountability:

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

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

The symmetric inflation target allows the MPC to act to support growth when inflationary pressures are weak: interest rates were cut seven times - by a total of 200 basis points - over the course of 2001. **They will remain vigilant and forward-looking to ensure that inflation remains at or near target.**

On fiscal policy my authorities will remain prudent and cautious, with policy guided by the fiscal rules. Public sector net debt has fallen from 44% in 1996/97 to around 31% in 2001/02, and is projected to remain at this level over the medium term. My authorities' medium term fiscal projections are based on cautious and independently-audited assumptions. They show public sector net borrowing of around 1% over the medium term, reflecting the plans for public investment. **Even on the most cautious assumptions, the UK is on track to meet the fiscal rules over the cycle.**

My authorities have noted staff's proposal on the sustainable investment rule (paragraph 22). They agree with staff on the importance of clarity and predictability in fiscal policy. But they think that these objectives are best served by the existing framework. They also note that stability in the framework over time further enhances the credibility of fiscal policy.

The staff report discusses the contrast between the current conjuncture and the situation towards the end of the 1980s. My authorities agree with staff that any imbalances are likely to be resolved gradually, provided prudent policies are maintained. In particular, they note that output is close to trend, inflation is low and stable, consumption growth has been driven by strong underlying fundamentals, and households' debt-servicing costs have remained stable and affordable over time, suggesting that debt levels are sustainable.

Medium and Long-term Issues

My authorities agree with staff that the main structural challenge is to raise productivity. This is the key to higher long-term growth and living standards. They have therefore set out a strategy, based on macroeconomic stability and microeconomic reform, to tackle the productivity gap. Specific reforms have already been introduced to strengthen competition, stimulate enterprise and innovation, support investment, increase participation in the labour market, improve skills and training, and raise public sector productivity. **My authorities will continue to pursue this agenda over the coming years.**

Staff rightly note the legacy of under-investment in public services. In 1996/97, public sector net investment stood at 0.6% of GDP, having fallen by 15% annually in real terms between 1991/92 and 1996/97 and leaving the UK with the lowest level of public investment of any large EU country. As staff note, the result was a deterioration in public services, which has been a major issue of recent debate. **My authorities are determined to address this.** They have therefore set out medium-term plans, consistent with the fiscal rules, for substantial increases in the funding of essential public services, including a rise in net public investment to 1.8% of GDP by 2006/07.

However, the key issue is not the level of spending but the quality of the public services delivered. My authorities agree with staff on the need to improve efficiency and effectiveness. To that end, they have introduced results-based Public Service Agreements (PSAs), with each department publishing clearly-designed output indicators. This output-oriented approach will guide the forthcoming spending review. Furthermore, through Public

Private Partnerships (PPPs) my authorities continue to work actively with the private sector to improve the provision of public services. PPPs will enhance investment, encourage innovation and bring the expertise and efficiency of private sector practices into public service delivery.

My authorities' policy on the single European currency remains unchanged. In principle they are in favour of UK membership; in practice, the economic conditions must be right. They will make an assessment of the five economic tests for UK membership within the first two years of this Parliament. This assessment will be rigorous and comprehensive, and will be published. On the basis of this assessment my authorities will decide whether to recommend membership to the UK Parliament, and then to the British people in a referendum. The assessment has not yet started but the necessary preliminary and technical work is underway. My authorities published further details of this work in November 2001.

My authorities agree with staff that the financial sector remains sound. They look forward to continued cooperation with staff on financial sector issues in the context of this year's FSAP. As staff note, the UK meets the forty recommendations of the Financial Action Task Force (FATF). The UK also complies with the eight special recommendations agreed by FATF in October 2001 and has established a Financial Intelligence Unit. The Financial Services and Markets Act 2001 strengthened existing legislation against money laundering and gives the FSA enforcement powers against non-compliant institutions. Since completion of the staff report, legislation has been passed implementing the OECD anti-bribery convention (see paragraph 34).

Conclusion

The benefits of the new policy framework can be seen in sound fundamentals. My authorities are cautiously optimistic about the outlook. But there are risks and they remain vigilant to them. They are also committed to meeting the challenges of closing the productivity gap and improving public services.