INTERNATIONAL MONETARY FUND

IMF Country Report No. 14/233

UNITED KINGDOM

July 2014

2014 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; 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 2014 Article IV consultation with the United Kingdom, the following documents have been released and are included in this package:

- A **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 23, 2014, following discussions that ended June 6, 2014, 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 July 8, 2014.
- An **Informational Annex** of July 8, 2014 prepared by the IMF.
- A **Press Release** summarizing the views of the Executive Board as expressed during its July 23, 2014 discussion of the staff report that concluded the Article IV consultation.
- A **Statement by the Executive Director** for the United Kingdom.

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

Selected Issues Paper

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: http://www.imf.org
Price: $18.00 per printed copy

International Monetary Fund
Washington, D.C.

©2014 International Monetary Fund

INTERNATIONAL MONETARY FUND

UNITED KINGDOM

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

July 8, 2014

KEY ISSUES

The economy has rebounded strongly and prospects are promising. Headwinds that previously held back the economy—relating notably to credit conditions and confidence—have eased. Nonetheless, sustaining strong growth will depend on a recovery in productivity growth and further demand rebalancing. The housing market brings risks of financial vulnerabilities. Sterling is moderately overvalued.

The overall policy mix is appropriate, but policy settings might need to be adjusted quickly. Effective monetary conditions are very supportive, compensating for ongoing fiscal consolidation:

- Accommodative monetary policy is appropriate for now, given weak inflation pressures, but policy might need to be adjusted quickly if inflation takes off. Interest rate increases may also need to be considered if macroprudential tools are insufficient to deal with financial stability risks from the housing market.
- The authorities have recently implemented macroprudential measures, including limiting the share of high loan-to-income mortgages lenders can issue, establishing them as the primary defense against housing-related risks. They should stand ready to tighten these limits should current settings prove ineffective in reining in those risks.
- A lasting solution to house price pressures requires measures to address insufficient supply. Significant planning reforms have been undertaken, but political consensus is needed to make further progress in this area.
- High deficits and rising debt mean that fiscal consolidation needs to continue. The pace and composition of deficit reduction over the near term is appropriate. Further reducing the deficit over the medium term will be challenging; both revenue and expenditure measures should be considered, keeping in mind both equity and efficiency.
- The financial sector is more robust, the new financial architecture is settling in, and significant changes have been made to banks' liquidity backstops to adapt to changing needs. Implementing macroprudential policy will be a test of the new architecture. Some problems—such as Too Important To Fail and bank misconduct—persist, and new challenges, such as from shadow banking, are emerging.

Approved By
Philip Gerson and Kalpana Kochhar

Discussions took place in London during May 22–June 6, 2014. The staff team comprised Messrs. Srinivasan (head), Scott, Abbas, Ishi, Lama and Gerson (EUR), and Mr. Norat (MCM). The Managing Director met with the Chancellor and BoE Governor and held a Press Conference.

CONTENTS

THE FOCUS OF THE CONSULTATION 4

RECENT DEVELOPMENTS 4

OUTLOOK AND RISKS 7

MONETARY POLICY 8

POLICIES TO ADDRESS HOUSING MARKET RISKS AND PROBLEMS 11

FISCAL POLICY 14

FINANCIAL SECTOR POLICIES 16

STRUCTURAL FINANCIAL REFORMS 19

SUPPLY-SIDE POLICIES 20

THE AUTHORITIES' VIEWS 21

STAFF APPRAISAL 23

RISK ASSESSMENT MATRIX 25

BOX

1. Monetary Policy Communications 10

FIGURES

1. Indicators of Spare Capacity 27
2. Housing Market Developments 28
3. Progress and Challenges in Fiscal Consolidation, 2009/10–2018/19 29
4. Comparison of Major UK, EU, and US Banks 30

TABLES

1. Selected Economic Indicators, 2012–15 ___ 31
2. Medium-Term Scenario, 2012–19 ___ 32
3. Statement of Public Sector Operations, 2010/11–18/19 ___ 33
4. Statement of General Government Operations, 2007–13 ___ 34
5. General Government Stock Positions, 2007–13 ___ 35
6. Balance of Payments, 2012–19 ___ 36
7. Net Investment Position, 2007–13 ___ 37

ANNEXES

1. External Sector Reports ___ 38
2. Debt Sustainability Analysis ___ 39

THE FOCUS OF THE CONSULTATION

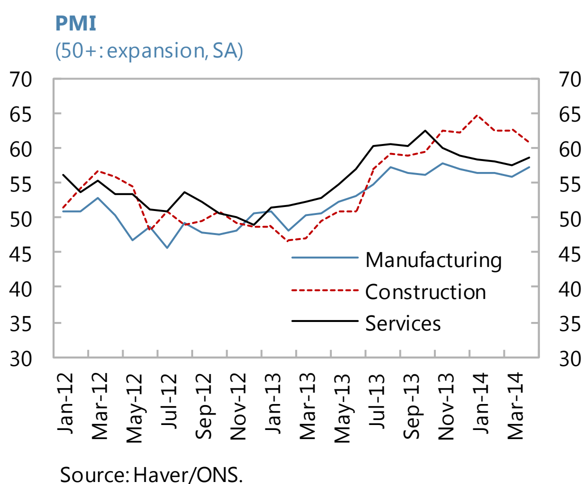
1. **The consultation focused on evaluating policies to counter risks to the UK economy and secure durable and robust growth.** The acceleration in growth is welcome but needs to be sustained. In this respect, staff assessed the balance of the recovery and risks posed by ongoing productivity concerns, the housing market, and external factors. Policy discussions devoted particular attention to the normalization of monetary policy, measures needed to address financial stability risks and ensure a vibrant, but safe financial sector, the pace and composition of fiscal adjustment, and steps to boost housing supply and long-run potential growth.

2. **Economic policy has been broadly in line with past Fund advice.** Consistent with Fund recommendations in the 2013 Article IV consultations, the Bank of England has continued to maintain an accommodative monetary policy stance to support growth. Repair of bank balance sheets has progressed, and the authorities have elaborated a strategy for the two state-owned banks, aimed at returning them to good health and eventually to private ownership. The Bank of England has also outlined a framework for stress-testing bank soundness. The government has also boosted capital spending, within the confines of the well-elaborated medium-term fiscal consolidation strategy, to boost the economy's long-term potential.

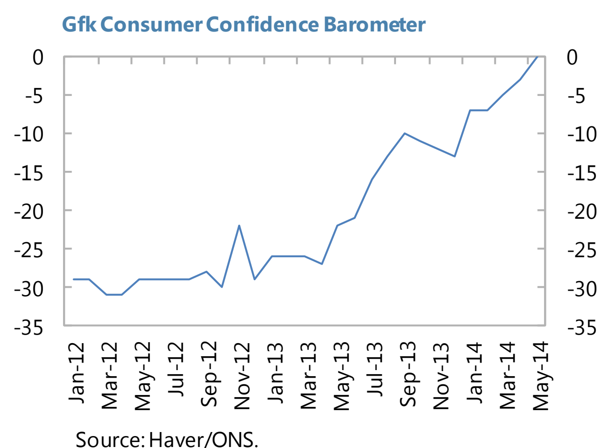
RECENT DEVELOPMENTS

3. **The economy has rebounded strongly:**

- *Growth has accelerated since the second half of 2013* and leading indicators suggest that the recovery has momentum. After expanding by just 0.3 percent in 2012, real GDP grew by 1.7 percent in 2013, nearly twice the projection in the 2013 Article IV Staff Report.[1] Faster-than-expected growth is associated with easier credit conditions and improved consumer confidence.



Source: Haver/ONS.

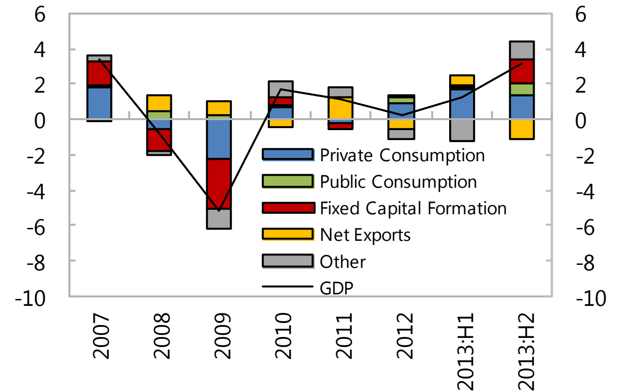


Source: Haver/ONS.

[1] Growth in 2013 was projected to be 0.9 percent in the 2013 Article IV staff report.

- *The recovery is becoming more balanced.* Recovery was initially led by a sharp uptick in private consumption, accounted for by a decline in household saving rates. More recently, business investment has picked up, consistent with a classic "accelerator" cycle, and surveys of investor intentions point to further momentum going forward. Net trade made only a modest contribution to growth in 2013. On the production side, all sectors have performed strongly.

Contributions to Growth
(Annual percent change; percentage points)

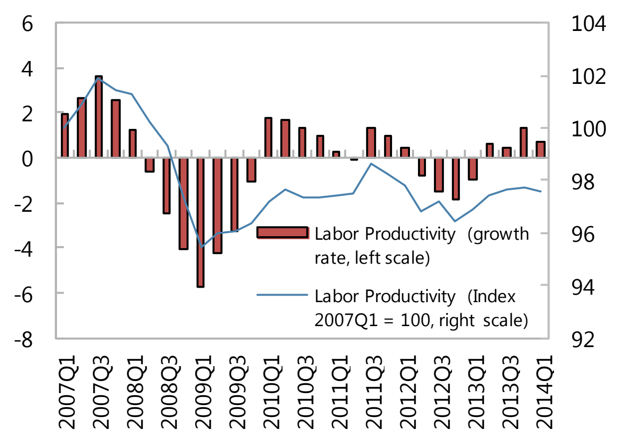


Source: Haver/ONS.

- *But slack remains.* Although surveys show above-average capacity utilization, several indicators suggest that there is spare capacity in the economy from the labor market: for example, even with strong employment growth, unemployment is above average, currently at 6.6 percent, and there remain substantial numbers of involuntarily part-time workers. Staff estimates that the output gap will narrow to 1.3 percent of potential GDP in 2014, consistent with the authorities' estimates (Figure 1).

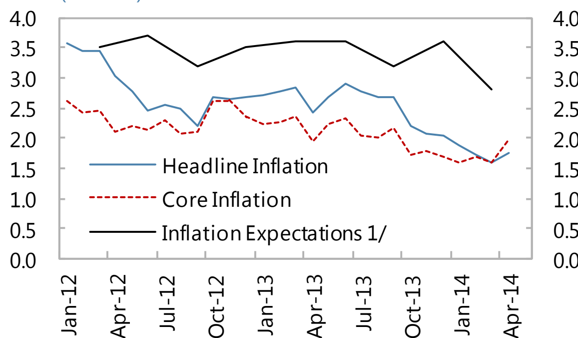
- *Productivity growth has yet to recover.* Low productivity growth has been a striking feature of the recovery. From an accounting perspective, the poor performance is explained by relatively weak GDP growth and strong employment growth. Having persisted for so long, it seems unlikely that weak productivity could be attributed to labor hoarding, and it can only partially be explained by upward revisions in GDP data. Instead, two factors appear relevant: first, previous problems in credit markets appear to have inhibited the flow of investment to more productive sectors; second, an increase in labor supply, reflecting notably a shift towards later retirement, has allowed firms to substitute toward labor relatively easily and cheaply.

Labor Productivity



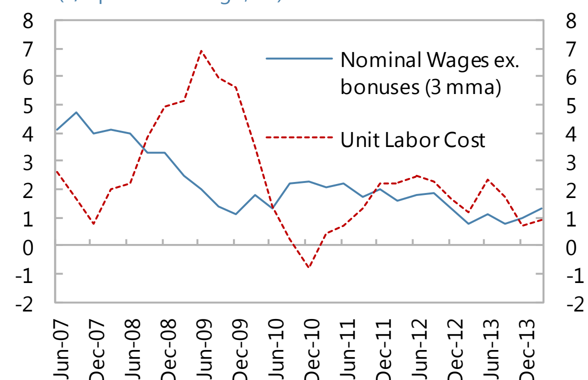
Sources: Haver/ONS; and IMF staff calculations.

Inflation and Inflation Expectations
(Percent)



Sources: Bank of England; and ONS.
1/ BoE/GfK Inflation Survey: Inflation Next 12 Mos: Median Response (NSA).

Nominal Wages and Unit Labor Costs
(Y/Y percent change, SA)



Source: Haver/ONS.

4. **Inflation has fallen and cost pressures are contained.** Despite the recent rebound in demand and flat productivity growth since the onset of the crisis, headline inflation has fallen rapidly, to 1.5 percent, after being well above the 2 percent inflation target over the past four years. This fall reflects the end of administered price increases, reduced pressures from import prices, and weak growth in wages and margins owing to slack in labor and goods markets, despite recent strong employment and output growth.

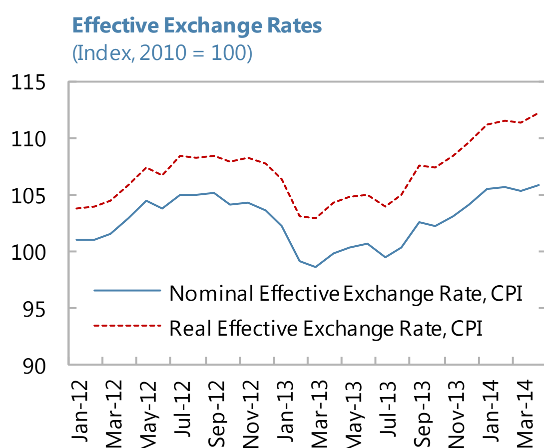
5. **But house prices are rising rapidly, and over an increasingly wide area.** House price inflation is notably high in London, with levels now 32 percent above those before the crisis, reflecting strong foreign demand for premium properties, and demographic pressures (Figure 2). Price rises are becoming geographically more widespread, even though transaction volumes are still below historic averages overall. Price:income multiples—and, with them, loan:income multiples—are increasing. Interest servicing costs remain at historic lows, mitigating the effects of higher prices on affordability, but also implying that households could be vulnerable to interest rate increases. There are some recent signs of deceleration in house prices, but these might only reflect a temporary slow-down as lenders learn new loan approval procedures following the recent implementation of the Mortgage Market Review (MMR). Further, household debt has stabilized at about 140 percent of households' gross disposable income, a historically-high level for the beginning of a house price cycle, and historical experience of the UK's relatively large house price swings suggests caution.[2]

6. **The current account has worsened, and sterling is modestly overvalued.** The current account deficit rose to 4½ percent of GDP in 2013, explained by a large decline in the income balance and lackluster export growth.[3] The net international investment position (NIIP) improved from -15 percent of GDP in 2012 to -2 percent in 2013. As it stands, the net external position is not a concern at the moment. However, given substantial gross positions, revaluations can easily lead to substantial changes in the net position, suggesting that the current value of the NIIP should not lead to complacent view about external sustainability. After depreciating by 23 percent in 2007–09 the real exchange rate has gradually appreciated, and this trend accelerated from the middle of 2013. Staff estimates that the current account balance is 2.6 percent weaker than its equilibrium level, and that the real exchange rate is overvalued by about 5–10 percent.[4] (For further details, see Annex 1.)

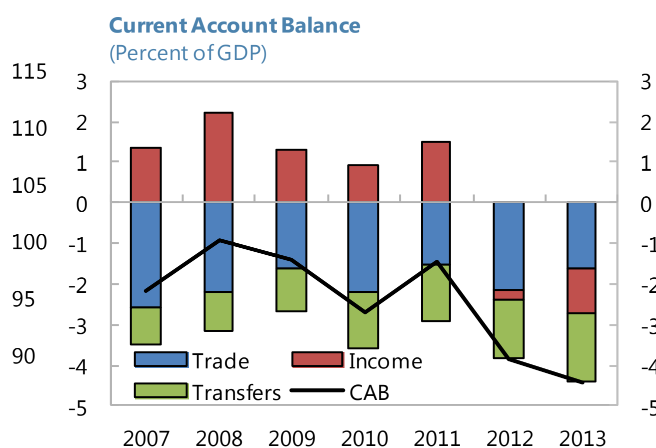
[2] Housing and Business Cycles: Is the UK Different from Other Advanced Economies? Selected Issues Paper.

[3] The income balance in 2013 was the lowest in the post-war period and substantially lower than the average 1 percent surplus of GDP during 1997–2011. The decline appears to be temporary, owing to weak foreign profits, notably of firms exposed to the euro area.

[4] Such estimates are made using historically-typical trade elasticities. It should be noted, however, that the depreciation over the period 2008–09 did not bring about as large an improvement in the trade balance as might be expected, suggesting caution about the effects of a future depreciation.



Source: IMF's Information Notice System.



Source: Haver/ONS.

OUTLOOK AND RISKS

7. **Strong growth and low inflation are expected to persist.** Real GDP is projected to expand by 3.2 percent in 2014 and 2.7 percent in 2015, before growth gradually returns to trend rates. Business investment is expected to be strong, given the sharp decline in uncertainty about the prospects for final demand, relatively healthy corporate balance sheets, and improvements in domestic credit and financial market conditions.[5] The projections also assume a slow recovery in labor productivity growth to average levels, which would support household incomes and allow inflation to remain close to the target. The output gap is expected to close gradually, enabling unemployment to reach its natural rate of 5.5 percent by 2019.

8. **Important political events are on the horizon.** A UK general election is scheduled for May 7, 2015. On September 18, 2014, voters in Scotland will be asked, “Should Scotland be an independent country?” In the event of a “yes” vote, a newly-independent Scotland would face a number of international economic issues, including about the allocation of assets and liabilities currently held by the UK, the exchange rate regime, the financial regulatory and supervisory framework, and membership of international institutions such as the IMF.

9. **Uncertainty about productivity implies upside and downside risks.** Accelerating productivity growth would spur investment and output even further. However, if productivity continues to be flat, the recovery will eventually stall as remaining spare capacity is exhausted. Alternatively, if earnings claims increase ahead of productivity, then inflation risks will accelerate.

10. **The housing market creates domestic risks.** So far, there are few of the typical signs of a credit-led bubble in the housing market: net credit growth is modest, transaction “churn” is relatively low, and households are not drawing on housing equity to finance consumption. Nonetheless, a steady increase in high loan-to-income mortgages implies that households are gradually becoming more vulnerable to falls in income and interest rate shocks.[6]

---

[5] The UK’s Prospects for Strong Growth: The Role of Business Investment, Selected Issues Paper.

[6] The BoE estimates that a hike in interest rates of 2.5 percentage points would increase the average mortgage repayment (principal plus interest rate payments) from 21 to 28 percent of gross disposable income. The effect is relatively large since many mortgagors have fixed-rate contracts that last two to three years (Bank of England *Quarterly Bulletin*, 2013Q4).

11. **External risks are tilted to the downside.** The global economy could see further disruptions arising from the withdrawal of unconventional monetary policies in the US, a sharp slowdown of growth in the euro area and across key emerging economies, and increases in geopolitical tensions. The presence of two globally-systemic UK banks (HSBC and Standard Chartered) with large exposures to China and Asia also implies potential financial stability risks from a sharp China slowdown. Although the UK's direct exposure to these risks through trade and financial channels is in some cases small, the realization of any one of them, in concert with a re-pricing of risk from the current unusually low levels, could depress asset prices and damage confidence.[7]

MONETARY POLICY

12. **Monetary policy has been highly accommodative.** Bank rate and QE balances have remained unchanged, and the Funding for Lending Scheme (FLS) was modified to favor lending to firms.[8] The Bank of England formally implemented a policy of "forward guidance" in August 2013, very similar to that employed by the Federal Reserve.[9]

13. **Effective monetary conditions have eased further:**

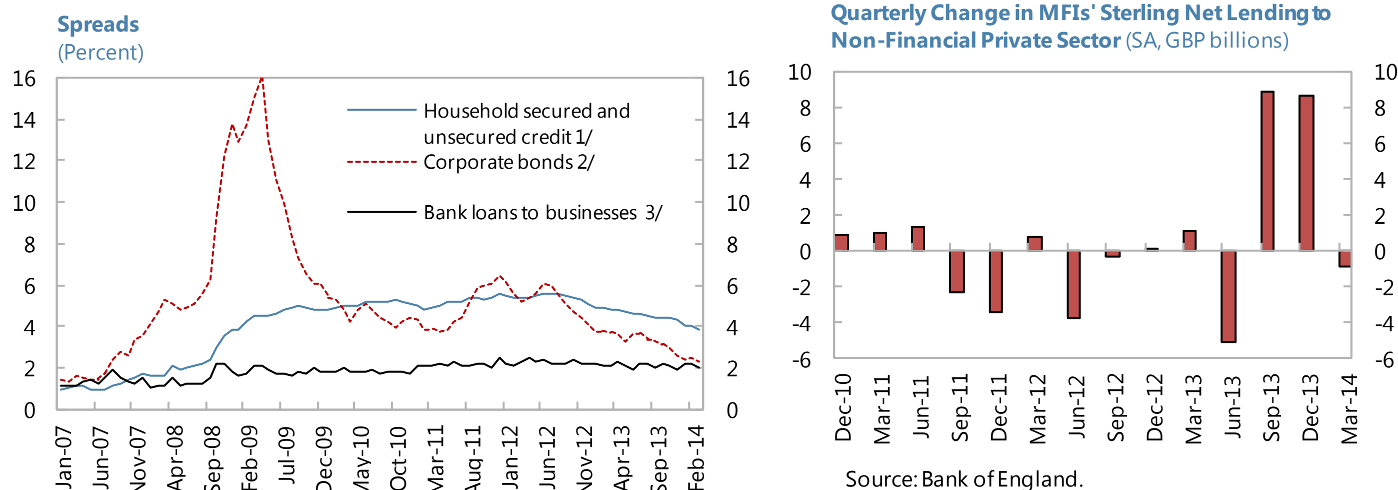
- Spreads over funding rates have compressed, especially for secured lending and consumer credit, and have made corporate debt issuance especially attractive.

- The flow of credit has increased, reflecting both demand and supply factors. After declining during 2010–12, consumer credit rebounded strongly in 2013 and has continued to grow at rates of around 5 percent, year-on-year. The growth of net secured lending has been less spectacular, at around 1 percent, year-on-year, but both gross lending and repayments have picked up strongly. Net lending to businesses over the year is still negative, but the rate of decline has slowed and shows signs of stabilizing.

[7] The impact of a disorderly exit from accommodative monetary policy in the US, which leads to a sharp rise in yields and affects non-banks and banks through the collateral channel, has been a particular focus of this year's Spillover Report analysis for the UK.

[8] Bank of England has maintained Bank rate at 0.5 percent since April 2009. The Bank has kept a stock of £375bn of gilts on the books of the Asset Purchase Facility since October 2012. The FLS, introduced in 2012, provided a collateral swap to lower funding costs for banks that increase any net lending. A new version of the FLS, which came into effect in February 2014 and runs into 2015, no longer supports new loans to households and favors SME lending. Since its inception, lenders have drawn £43.3 billion from the FLS, and marginal wholesale funding costs have fallen around 150–200 basis points.

[9] The policy was that policy rates would be held fixed and the stock of assets purchased not reduced at least until the unemployment rate had fallen to 7 percent, so long as: (i) projected CPI inflation 18 to 24 months ahead were no more than ½ percentage point above the 2 percent target; (ii) medium-term inflation expectations remained sufficiently well anchored; and (iii) there were no substantial threat to financial stability that could not be contained by tools available to the Financial Policy Committee. In February 2014, the unemployment threshold the Bank had set as a precondition for a rate hike was de-emphasized, with the Bank now communicating that the appropriate path for Bank rate to eliminate slack over the next 2-3 years and keep inflation at target would likely be gradual.



Sources: Bank of England; BofA; Merrill Lynch; and IMF staff estimates.
1/ Weighted average of interest rates charged on, inter alia, high-LTV and low-LTV mortgages, and unsecured loans, over corresponding risk-free reference rates (for methodology, see BoE Quarterly Bulletin 2014 Q2, pp. 140-141).
2/ Average of option-adjuted spreads for investment-grade and high-yield bonds over risk-free reference rates.
3/ Spread (over Bank rate) charged on new business loans.

Source: Bank of England.

14. **Monetary policy should stay accommodative—for now.** With cost pressures contained and still some excess supply, accommodative monetary policy is appropriate. Policy might, however, have to be tightened quickly if costs run ahead of productivity growth or slack is absorbed, and should be considered if financial stability concerns cannot otherwise be addressed.

15. **There are important macroeconomic arguments for raising Bank rate before reducing QE balances, but operational imperatives may warrant a more flexible approach to sequencing.** When the time comes to begin normalizing monetary conditions, raising the policy rate first is preferable, from a macroeconomic policy point of view, to selling off assets: the MPC will likely find it easier to fine tune policy tightening using familiar tools like interest rate increases, an important consideration while the recovery is still gathering strength, and should changing conditions require reversing the normalization, the MPC would likely find it easier to calibrate the response by decreasing the policy rate rather than by repurchasing gilts.[10] There is considerable uncertainty about the equilibrium level of demand for central bank reserves due to the new regulatory liquidity requirements. Ensuring the smooth functioning of the money market during policy renormalization may imply that the Bank has to drain some central bank reserves, for example, issuing at the same time as it starts to increase Bank rate.

[10] If interest rates rose and the BoE were to sell gilts, financial losses would likely be realized. However, the QE operation is fully indemnified by HMT: any financial losses (gains) as a result of the asset purchases should be borne by (owed to) HMT. The BoE has so far made profits from holding gilts, which have been transferred to HMT. However, based on the market's expectations for interest rates, the OBR projects that the BoE would incur cash flow losses from 2017/18 onward, and the HMT would need to transfer cash to the BoE to cover these losses.

Box 1. Monetary Policy Communications

The Bank of England has made important changes to its communications over past year, notably with the formal implementation of "forward guidance". Looking ahead, the process of normalizing monetary conditions will put a premium on effective communication: the Bank will want to reduce the risks of adverse effects from surprises about changes in policy settings, yet not feed spurious certainty about future interest rates. This context raises questions: (i) how effective has forward guidance been, and (ii) what improvements could be made, if any, to communications about monetary policy?

The introduction of forward guidance in August 2013 was associated with some confusion by markets and commentators as to its purpose. As characterized by MPC members, forward guidance was intended to improve *transparency* about the Bank's reaction function. Nonetheless, many interpreted it as an attempt to directly stimulate by *committing* to "lower-for-longer" interest rates. Because forward guidance did not prevent UK yields rising with US yields as expectations of Fed "tapering" increased (even at short maturities), some concluded forward guidance had failed.[1] In February 2014, the unemployment threshold was de-emphasized, causing some to question whether the policy was still active.

With regard to its effectiveness in terms of transparency, data on implied volatilities indicate that uncertainty about future rates did indeed fall after introduction of forward guidance. But this evidence is not clear cut—implied vols of many asset classes have been falling steadily since the implementation of unconventional monetary policies. Viewed this way, it might be that the observed decline in volatility was a reversion to trend, after an exceptional period from the first "taper talk" in May to the "no taper" announcement in September, that should not necessarily be attributed to the introduction of forward guidance.

The Bank has also used other forms of communication: speeches by MPC members have tried to alert markets to future interest rate increases, while the *Inflation Report* is now more explicit about key judgments and risks to projections. Currently, the *Report* stops short of showing what the *MPC believes* should happen to interest rates—the forecast is "conditioned" on market expectations. Forecasts could be based on the MPC's preferred path for interest rates, removing a step markets have to take to deduce the MPC's thinking. Uncertainty around the interest rate path could be indicated by a fan chart, just as with the current GDP and inflation forecasts, to make it clear that the path is simply a projection rather than a promise.[2]

MPC members might argue that a given interest rate path is not their preference; one approach would be to show how individual members place themselves relative to a "median" path. There remains, however, the problem that there is no guarantee that *any* exogenous interest rate path—regardless of whether it is from the market or an MPC member's preferred reaction—is intertemporally consistent. That would require employing "target criteria"—rules to determine which of the many possible paths consistent with achieving the Bank's mandate would be selected—and openly discussing these criteria with the public; in practice, that would probably require clear statements about how variables other than inflation, including financial market variables, affected judgments about desired interest rates.[3] So far, few institutions have shown a willingness to be so transparent, and a move in that direction would require careful thought about interactions with FPC decisions.

1\ In fact, yield correlations *increased* compared with those before taper talk. Moreover, the exchange rate did not play the role of a buffer but *appreciated* during this period. One possibility is that there was also positive news about the UK economy, but that cannot completely account for the degree of comovement at daily frequencies.

2\ Interest rate projections have been shown for some years now by the central banks of the Czech Republic, Norway, Sweden, and New Zealand, the first three also showing fan charts.

3\ See Woodford, Michael, "Forward guidance by inflation-targeting central banks" *Sveriges Riksbank Economic Review* 2013:3, Special Issue.

16. **Clarity is needed on the operational framework that will deliver the Bank's target interest rate in the future.** At the start of QE, the Bank moved away from its reserve averaging-cum-"corridor system" for Bank rate targeting, to the current "floor system" in which reserves are remunerated at the Bank rate. With prospects of a rate rise strengthening, the Bank will need to announce soon what the new monetary control framework will be and how the transition to it will be managed. An early pronouncement will enable banks to plan accordingly, and help reduce the possibility of a sudden surge in the volatility of short-term rates (after a long period of very low volatility) during renormalization.

17. **The Bank of England should continue to point to a forthcoming normalization of monetary policy, while avoiding spurious precision about either the timing or the size of the move.** The Bank of England has taken important steps toward greater transparency, including the introduction of forward guidance and discussion of key assumptions and alternative scenarios in the Bank's *Inflation Report*.

- With policy rates having been so low for so long, and retail spreads having compressed further since the market stresses in 2012, there is a risk that borrowers and lenders could make decisions based on assumptions that monetary conditions will remain accommodative indefinitely. Hence, going forward, the Bank faces the challenge of reducing the risk of potential market surprises, yet without imparting a false sense of certainty about the evolution of interest rates (see Box 1).
- Further, now that the Financial Policy Committee (FPC) also plays a key role in affecting economic conditions, the Bank faces the additional challenge of explaining the coordination of monetary and macroprudential policies, especially as macroprudential measures will have implications for the pace of economic activity and changes in interest rates will have an impact on prudential risks.

POLICIES TO ADDRESS HOUSING MARKET RISKS AND PROBLEMS

18. **Prudential, rather than monetary policy tightening, tools should be the first line of defense against financial risks from the housing market.** The objective of policy should be to address systemic financial risks, such as the increasing vulnerabilities of households to income and interest rate shocks, rather than to dampen house price growth per se. The first-best response would be to use more targeted prudential tools, rather than the blunter instrument of interest rate increases.

19. **A number of micro-prudential and credit policy measures have already been introduced in an effort to take some of the steam out of the housing market.**[11] In particular:

[11] In addition to the measures listed here, the authorities are planning to remove the capital gain tax exemption for non-residents disposing of residential property, starting from April 2015.

- Micro-prudential policies have, over the last year, been targeted to strengthen banks' buffers against their mortgage exposures, both through the application of more stringent mortgage risk weights and higher provisioning for forborne retail mortgages.
- In November 2013, the Funding for Lending Scheme was refocused towards businesses, with emphasis on SME loans, while household lending is no longer eligible for additional borrowing allowances from the Bank.
- Following the MMR, underwriting standards for owner-occupier mortgages were tightened in April 2014 to ensure better borrower protection.

20. **But in an environment where expectations of capital gains can quickly drive up household indebtedness—and thus systemic risk for financial institutions—macro-prudential policy action is also warranted.**

- Consistent with previous staff advice, the Chancellor has indicated that the Financial Policy Committee (FPC) would be given explicit powers of direction to limit loan-to-income and loan-to-value ratios. The FPC currently has powers of direction to set sectoral capital requirements (including on mortgage exposures) and countercyclical capital buffers for lenders, tools which are more helpful for targeting banks' health than for addressing household vulnerabilities.
- In June, the FPC has recommended that the PRA and FCA apply a 15 percent limit, effective October 1, on the proportion of new mortgage loans with loan-to-income at or above 4.5 that any lender can issue.[12] This is a helpful first step toward addressing excessive household indebtedness at the system-wide level, while allowing individual lenders some flexibility to lend to households with low current, but high prospective, incomes, or sizable other assets.
- The 15 percent limit is presently non-binding for most lenders, is imposed on the flow of new mortgages rather than on the stock, and does not cover certain types of mortgages (e.g. buy-to-let and some remortgages) and lenders (e.g. small lenders).[13] It will therefore be important to monitor carefully the adequacy of the current settings and coverage in coming months. For instance, should housing-related financial risks fail to respond adequately to the measure, tightening limits on the percentage of loans with high income multiple that lenders can grant—by lowering the 15 percent ceiling, having it apply to loans starting at a lower income multiple, and/or broadening coverage to more types of loans or lenders—would be warranted.
- Should these measures prove insufficient to contain financial risks from the housing market, outright caps on LTIs or LTVs may need to be considered. Raising lenders' sectoral capital requirements would build additional buffers against increased exposures to the housing sector.

[12] In parallel, in June the FPC recommended lenders assess mortgage affordability against a 3 percentage point increase in Bank rate over the first five years of the loan. This measure does not appear to be binding at this time as most lenders are already using a similar stress interest rate.

[13] Only 11 percent of mortgages issued in 2014Q1 had loan-to-income multiples exceeding 4.5.

21. **If macroprudential policy—appropriately calibrated and targeted—proves ineffective at alleviating risks to financial stability, interest rate hikes should be considered.** There is significant uncertainty around the efficacy of, and lags associated with, macro-prudential measures; even the best designed measures may not achieve the authorities' objectives in relation to addressing risks from the housing market over a given period of time.[14] Should macroprudential measures appear to be ineffective, policy makers would need to weigh the likely collateral damage to output and employment from a rate hike against the potential costs of an extended period of household or renewed bank weakness.

22. **Supply-side measures are crucial to safeguard affordability and mitigate financial risks.** Fundamentally, house prices are rising because demand outstrips supply. The UK has secular problem with inadequate housing supply, amplified by a high rate of household formation. The aftermath of the financial crisis, in which housing starts plummeted, has compounded this problem and makes addressing "pent-up" demand all the more difficult. Moreover, in an environment in which trend house price increases are high, surges in house prices can easily be interpreted as signals that even higher prices are yet to come, reinforcing individuals' perceptions that they must do whatever it takes to get on the housing ladder. In such a situation, macroprudential and monetary policies will only ever be temporary palliatives to an underlying structural problem.

23. **New initiatives to spur house building are welcome, but political consensus for further reform is needed.** The government has introduced major changes to the planning system (the National Planning Policy framework) to create incentives for local councils to increase available land for housing development, and there are some signs of recovery in housing construction. Nonetheless, key inefficiencies remain. These include unnecessary constraints on brownfield and greenfield developments and tax policies that discourage the most economically-efficient use of property.

24. **Help to Buy (HtB) has given lower income households access to mortgage credit, but should regularly be re-assessed.** In the aftermath of the crisis, credit for lower income households at higher LTVs shrunk considerably. The aim of the second part of HtB is to enable creditworthy lower-income households to access finance.[15] Data show that guaranteed mortgages so far have, on average, been few (relative to the volume of housing transactions), small in value (relative to national averages), and mostly for properties outside of London and the south east, where price increases have been most dramatic. The program has also played a role in unlocking mortgage credit for lower-income borrowers from other sources. If these alternative flows increase significantly, the FPC and the Treasury may wish to consider whether HtB should be modified or

[14] See Macroprudential Policy: Lessons from Advanced Economies, Selected Issues Paper, for an evaluation of macroprudential measures used in other countries.

[15] HtB has two components. The first consists of a home-equity loan to finance the purchase of newly-built houses. The second provides a government guarantee for mortgages provided by banks and other lenders. The first part of HtB, the equity loan scheme, provides interest-free loans for 5 year up to 20 percent of the value of a new-build home. The benefit of this part of HtB is that it stimulates housing supply. By April, there were 20,548 new properties purchased with this scheme, where the average price was £205,424. 87 percent of the equity loans were offered to first-time buyers.

even remains necessary for the full three years of the policy. And as the volume of high-LTV transactions rises, the FPC will need to evaluate if the program is contributing to financial risks.[16]

FISCAL POLICY

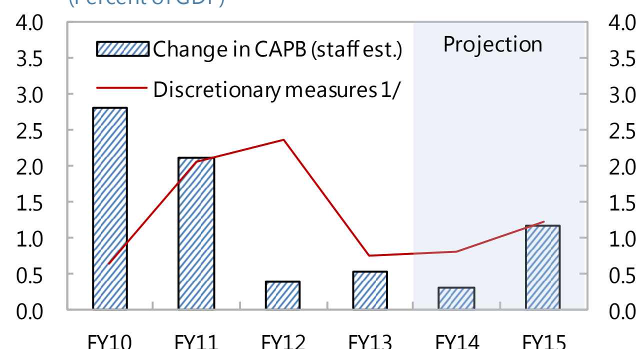
25. **The UK has been undertaking an ambitious fiscal consolidation program** (Figure 3)**.** Following the crisis, the UK's public finances deteriorated sharply, with the overall deficit widening to 11 percent of GDP in FY2009/10.

- In response, the government announced a package of fiscal consolidation measures that have helped reduce the overall deficit to 5¾ percent of GDP by the end of FY2013/14. The government remains fully committed to fiscal consolidation, with the aim of bringing the overall balance to a small surplus by FY2018/19.

- After rapid tightening at the outset, the pace of discretionary tightening has moderated, relative to that in FY2011/12–FY2012/13, with total discretionary measures falling to ¾ percentage points of GDP in FY2013/14. Meanwhile, automatic stabilizers have been allowed to operate fully in response to slower-than-expected growth, while the government has also reoriented expenditures from current to capital to support longer-term growth.

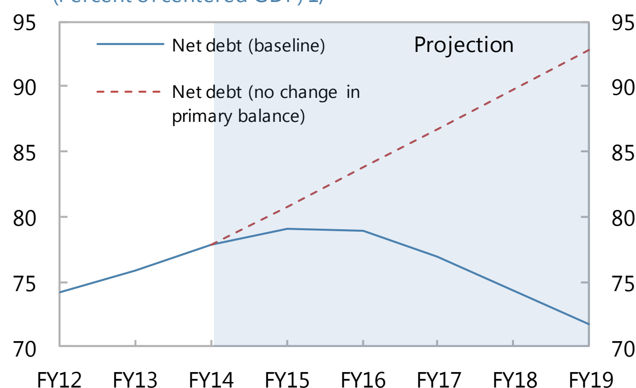
26. **Fiscal tightening planned for FY2014/15 is appropriate.** The 2014 Budget shows a reduction in the overall deficit to 4¾ percent of GDP in FY2014/15 from 5¾ percent in FY2013/14. This implies a ½ percentage point change in the cyclically-adjusted primary balance, further strengthening the public finances without creating an undue drag on growth.[17]

Fiscal Stance
(Percent of GDP)



Sources: HM Treasury; and IMF staff projections.
1/ Calculated as an annual change in "Total Discretionary Consolidation" presented in "Total Consolidation Plans over the Parliament" in the authorities' budget documents.

Public Sector Debt
(Percent of centered GDP) 1/



Sources: Office for National Statistics; and IMF staff projections.
1/ GDP centered on end-March.

---

[16] As part of the macro-prudential measures announced on June 26, mortgages with LTIs above 4.5 will no longer be covered by the mortgage guarantee leg of the scheme.

[17] Total revenues are projected at 37¾ percent of GDP, unchanged from FY2013/14. Revenue losses—owing mainly to a reduction in the corporate tax rate from 23 to 21 percent, the temporary cut in the business rate, and the personal allowance increases—are budgeted to be fully offset by increases in corporate profits and earnings. Total expenditure is projected to fall by 1 percentage point to 42½ percent of GDP in FY2014/15, reflecting a cut in current spending and a small increase in investment.

27. **There is a clear need to put debt on a downward path to ensure long term fiscal sustainability.** Despite the significant consolidation over the past few years and faster output growth, public debt dynamics are yet to stabilize. Public sector net debt is projected to increase to about 80 percent by FY2015/16, due to still-large primary deficits and rising interest costs. In this context, the government's objective of eliminating the overall deficit by FY2018/19, implying some 6 percentage point of GDP reduction in the overall deficit over the next five years, is appropriate.[18]

28. **But the overall consolidation plan implies difficult choices.** Because national elections are scheduled for May 2015, fiscal plans are specified only through FY2015/16. However, achieving the required medium-term deficit reduction only through spending measures would likely require some combination of cuts to previously prioritized areas (such as health and education), further reductions in the budgets of departments that have already faced significant cutbacks, or cuts in social security spending.

29. **A wider range of options—including both revenue and expenditure items—should be explored to meet the medium-term fiscal objectives.** Consolidation efforts should also carefully consider issues of equity and efficiency.

- Efforts to enhance efficiency have already lowered spending. In searching for further efficiency gains, the government should prioritize the delivery of quality health and education services, as well as infrastructure, to help bolster the productive capacity of the economy. Means testing for social benefits could be used more widely, to reduce spending while ensuring that basic needs continue to be met. Entitlement reforms could both yield budgetary savings and improve labor supply incentives.
- Revenue measures could include reducing tax expenditures (such as VAT zero-ratings, which amount to some 2½ percent of GDP annually) and greater reliance on Pigouvian taxes (including those on carbon and congestion). Property taxation could be reformed, to stimulate housing supply, improve housing allocation, and boost revenues. This could include appropriately updating valuations for taxable property.
- Recent efforts by the government to analyze and document the distributional impact of the consolidation are welcome. In developing and implementing its medium-term plans, the government should continue to undertake and publicize this type of analysis to allow for an informed public discussion.

30. **The planned review of the fiscal framework is opportune.** Fiscal policy is currently framed by two objectives: (i) balancing the structural current budget by the end of a rolling 5-year period; and (ii) putting the net debt-to-GDP ratio on a downward path by FY2015/16. The first of these objectives is expected to be met within a few years, and the latter will be redundant soon. Hence, a new framework will be needed. The new framework should have clearly defined operating targets that can be directly controlled by policymakers and are closely linked to debt and its sustainability (such as overall deficits), while allowing for flexibility to deal with unexpected shocks.

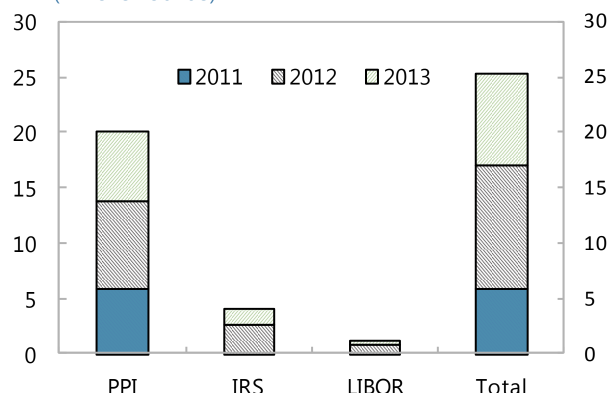
[18] See also the Debt Sustainability Analysis in Annex 2.

Formalization of the Spending Review process could help reduce uncertainty about the medium-term expenditure framework.

FINANCIAL SECTOR POLICIES

31. **Important progress has been made to strengthen banks' balance sheets and ability to lend.** Following the Bank of England's 2013 capital-building exercise, major UK banks' common equity tier 1 ratios (on a fully-loaded Basel-III basis) have risen above 9 percent, while provisioning for future loan losses and conduct-related costs has strengthened. Encouragingly, the capital build was largely driven by new capital issuance and non-core deleveraging. Liquidity indicators have also improved, with a further reduction in wholesale funding. Overall, faster balance sheet repair has been associated with a fall in banks' borrowing costs to historic lows, and rising equity valuations. In turn, credit conditions have eased and loan growth is resuming.

Major Banks' Provisions for Conduct-Related Costs
(Billions Pounds)



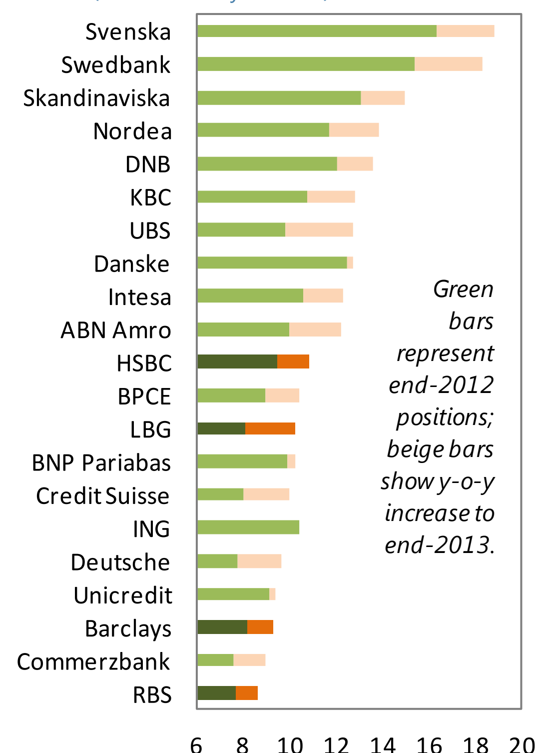
Source: Annual statements for RBS, HSBS, Barclays and LBG.

Financial Soundness Indicators for Major UK Banks 1/
(Percent)

	2012	2013	Change
Capital adequacy			
Total capital ratio	16.2	18.8	2.5
Tier 1 ratio	13.2	14.5	1.3
Tangible common equity ratio	4.1	4.5	0.3
Leverage ratio	4.6	4.8	0.2
Asset quality			
Provision for loan loss / total loans	0.9	0.9	0.0
Reserves for loan loss (% of non-performing asset	39.4	49.3	9.9
Non-performing assets / total loans	6.8	5.6	-1.2
Loan growth (including to banks)	-2.1	-2.7	-0.6
Profitability			
Net interest income / avg. earning assets	1.40	1.39	-0.01
Efficiency ratio (overheads/revenue)	60.6	65.0	4.4
Return on assets	-0.02	-0.06	-0.04
Return on common equity	-1.2	-1.6	-0.4
Trading income (% of total revenue)	8.4	15.0	6.5
Liquidity			
Total loans to total deposits	104.2	98.1	-6.1
Wholesale funding / total liabilities	59.3	53.5	-5.9
ST borrowings / total liabilities	5.9	5.4	-0.5
Liquid assets / total assets	16.3	16.4	0.1

Source: Bloomberg, based on data published by individual banks. Indicators reported on a Basel-II basis.
1/ Simple average for Barclays, HSBC, LBG and RBS.

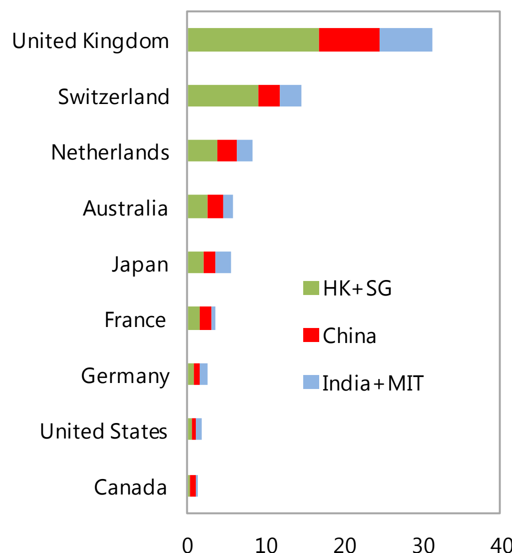
End-2013 Basel-III Common Equity Tier 1 Ratios Reported by Selected European Banks (Percent; fully-loaded)



Source: SNL Financial. Ratios reported by banks may not be strictly comparable given differences in banks' definitions and assumptions about Basel III end-point rules.

32. **But further capital effort will likely be needed over the medium-term, and in the face of structural headwinds to profitability.** Some major UK banks' capital positions still fall short of most European peers'. Banks are factoring into their capital plans expectations of higher capital in the future, and these plans should receive helpful support from the recovery in the UK economy and global demand for financial services. However, building internal equity will remain challenging due to a longer- and larger-than-expected drag from conduct-related costs; a weak outlook for investment banking returns; and the associated need—in some cases—to undertake and/or complete costly business restructuring.

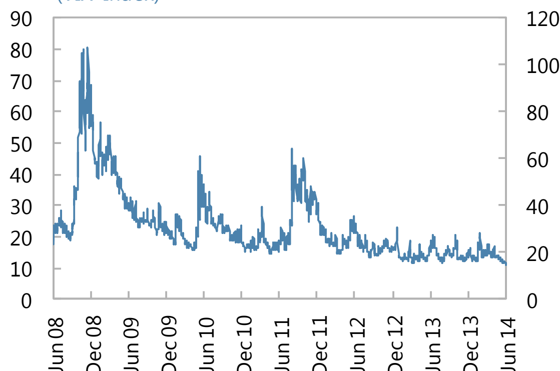
Banks' Consolidated Foreign Claims on Selected Asian Economies
(Percent of GDP; end-Sep-2013)



Source: BIS Consolidated Banking Statistics (Ultimate Risk Basis). HK denotes China: Hong Kong SAR, and MIT denote Malaysia, Indonesia and Thailand.

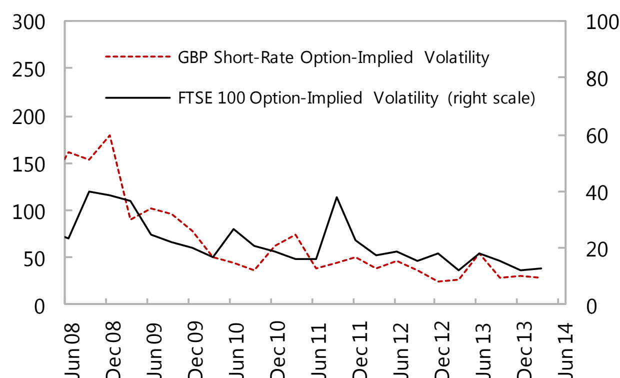
33. **There are also new risks looming on the horizon.** Banks' exposures to the housing market have increased over the last two years, with the share of residential mortgages in earning assets among the five major lenders rising by an average of almost 4 percentage points. Other new risks include the exposure of the two international banks, HSBC and Standard Chartered, to a China slowdown; and indirect financial spillovers from a potential geopolitical crisis involving Russia (banks' direct exposures are small). Overlaying these is the concern that a disorderly correction in markets' pricing of risk could entail losses for many globally-connected UK-resident banks and dealers.

US Implied Volatility
(VIX Index)



Source: Bloomberg.

UK Implied Volatilities



Source: Bloomberg.
1/ Short-rate volatilities represent the 3-month option-implied volatilities of 1-year swaps.

34. **The two government-intervened banks face divergent challenges.** Returning RBS to profitability has proven difficult, due partly to its complex business model, but also to its outsized operating costs. The new strategy—featuring an internal bad bank and refocusing a more efficient core bank on UK retail and corporate activity—seems appropriate, but execution risks remain. By contrast, LBG's strong performance has enabled the government to sell one third of its shareholding (which is now below 25 percent) over the past year, but the bank's large and rising exposure to the UK housing market remains a source of risk.

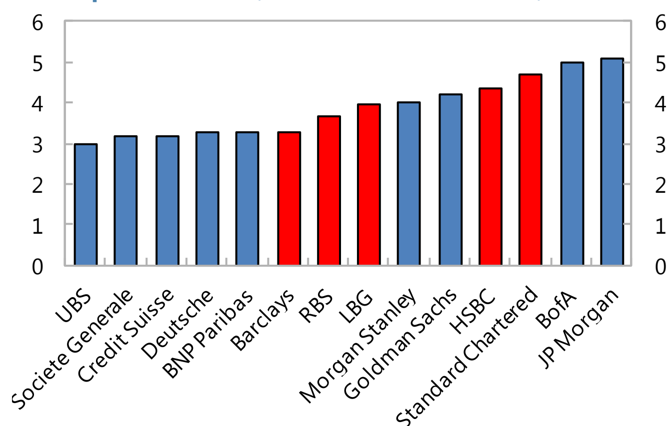
Residential mortgage loans-to-total earning assets ratio for major UK lenders

In percent	2011	2013	Increase (ppt)
Barclays plc	12.0	14.4	2.5
HSBC Bank plc	10.4	11.6	1.2
LBG Group plc	39.4	44.6	5.2
Nationwide BS	68.8	75.0	6.2
RBS	10.2	14.1	3.9
Average	28.2	32.0	3.8

Sources: Fitch; RBS Annual Reports; and IMF staff estimates.

35. **The authorities are seeking to institute a robust regulatory capital framework for banks based on risk-weighted capital, the leverage ratio and stress testing.** This multi-pronged approach is an appropriate response to dangers revealed by the crisis of relying on a single measure of capital adequacy. Given the size and systemic nature of the UK financial system, there is a strong case to fully utilize the flexibility afforded under the Capital Requirements Regulation and Capital Requirements Directive (CRDIV) in relation to Pillar-II and countercyclical buffers; and to introduce a leverage ratio requirement above Basel minima. However, the authorities will need to communicate clearly and early their regulatory expectations under this more complex regime to alleviate uncertainty for complying institutions.

Tier 1 Leverage Ratios for Selected Systemically-Important Banks (Percent; end-March-2014)



Sources: Citi Research, 19 June 2014; Company accounts; and IMF staff calculations.

1/ Includes impact of Deutsche's capital raise and Credit Suisse's US conduct settlement in May-June 2014.

2/ Supplemental leverage ratios for US banks; CRDIV definition for EU banks (except Swiss banks, for which FINMA definition).

3/ For LBG and HSBC, data is end-2013.

36. **The 2014 concurrent stress tests, coordinated with the European Banking Authority (EBA), will offer a timely assessment of the ability of the eight major UK banks to withstand large shocks.** The EBA's common adverse scenario and the Bank's UK-specific scenario helpfully complement each other.[19] The success of the stress tests will rest on maintaining the improved coordination between macro- and micro-prudential authorities; clear communication about capital definitions, hurdle rates and any required capital actions by banks (including on capital planning frameworks); and sufficiently-disaggregated disclosure of results. It would also be important for any required capital actions (especially those for the two international banks) to be fully informed by the

[19] The former features a rise in bond yields and reversal in risk assessment, especially toward emerging markets; the latter combines a negative productivity surprise, a snapback in the policy rate, and a 35 percent fall in house prices.

results of sequential stress tests conducted by the Prudential Regulation Authority (PRA) to assess banks' resilience to a sharp China slowdown.

37. **To more comprehensively identify risks in the system, broadening the institutional perimeter of the stress tests and strengthening supervision beyond the major banks would be important.** The authorities have laid out medium-term plans that could see the concurrent stress testing framework extended to systemic entities beyond major UK banks. In addition, there are broader efforts aimed at strengthening the monitoring of risks in the shadow banking system. These efforts are critical given the size of shadow banking activity routed through the UK, recent evidence of search-for-yield and leverage build-up outside the banking system, and the associated risk of outward financial spillovers in the event of an abrupt change in risk sentiment.[20] Any additional budgetary resources, regulatory perimeter adjustments, and international coordination initiatives (in relation to "global" shadow banking), required to support these efforts should be prioritized.

STRUCTURAL FINANCIAL REFORMS

38. **The new regulatory architecture is settling in.** The new structure of the FPC, the PRA and the Financial Conduct Authority (FCA) has functioned relatively smoothly over the last year, and is helping to deliver a more resilient financial system. Looking ahead, maintaining strong coordination across bodies (on microprudential and macroprudential matters) and ensuring coherent communication will be vital to avoid uncertainty, such as of the kind faced by banks around the 2013 Asset Quality Review, or by insurers earlier this year. Separately, given the Bank of England's expanded mandate and potential for future changing demands, it would be important to maintain and further develop effective internal and external oversight arrangements.

39. **Reforms to the Bank of England's Sterling Monetary Framework will provide a further buffer against shocks.** The recently strengthened liquidity backstops should help solvent UK banks ride out temporary funding stresses, which otherwise carry the potential for disruptive domestic and outward credit spillovers. However, easier access to the backstops could increase banks' appetite for risk-taking, unless supervision is commensurately strengthened. This consideration should also guide the implementation of the authorities' recent decision to offer backstops to major broker-dealers and central counterparties. Separately, there may be a need to ensure that the EU Bank Recovery and Resolution Directive (BRRD) does not inhibit the Bank's ability to extend emergency liquidity support.[21]

[20] A companion Selected Issues Paper on outward financial spillovers from the UK finds that a sharp worldwide interest rate increase (or "snapback") could place leveraged global shadow banks under pressure, opening the possibility of contagion to the G-14 dealer banks sitting at the center of world repo markets, and leading, eventually, to external deleveraging by those banks and, hence, adverse outward credit spillovers.

[21] The Bank's lean capital position effectively requires that it be indemnified by the government against any losses on its emergency liquidity assistance to illiquid, but solvent institutions, which is a form of State Aid. However, under the recently-enacted EU BRRD it could be interpreted that State Aid would trigger mandatory write down or conversion of certain capital instruments, which could prove counterproductive to stabilization efforts. If the Bank were not indemnified, this could result in negative Bank equity should losses materialize; this would argue for an ex ante increase in the level of Bank capital.

40. **Measures to address the problem of Too-Important-To-Fail institutions are advancing, but are not yet complete.** The ring-fencing of banks' retail operations, new bail-in and other resolution powers for the Bank of England, and the development of resolution strategies and plans for systemically important banks all constitute important reforms. As the authorities have acknowledged, completing the task requires a clear strategy for systemic entities outside the ring fence and maintaining positive momentum on cross-border cooperation on resolution of global banks (including international agreement on gone-concern loss-absorbing capacity). This agenda must be implemented in a way that ensures international consistency of national reforms, and guards against regulatory arbitrage. In particular, it will be important to ensure that excessive penalization and/or reduced profitability of certain activities (such as investment banking) does not stifle market making or result in a migration of risks elsewhere (such as to non-bank financial institutions).

41. **The authorities are adopting a more determined approach to tackling rogue banking practices.** A new legal regime to hold senior bank managers more directly accountable for misconduct is being extended to all UK-resident banks and, subject to consultation, branches of foreign banks. A "Fair and Effective Markets Review" has been launched with a view to: strengthen the governing principles and oversight tools for already-regulated wholesale fixed income, commodity and currency markets; assess the case for extending the regulatory perimeter for unregulated wholesale markets (such as FX and precious metals) where international coordination may be required; and subject additional benchmarks (other than LIBOR) to recent UK legislation providing for, inter alia, criminal sanctions for market manipulation. These measures should help to reform banking culture, ensure the integrity of financial markets, and strengthen confidence in the UK's financial center as a global public good.

42. **Ongoing efforts to enhance entity transparency and address tax evasion are welcome.** Following-up on its G8 presidency objectives, the UK aims to fight tax evasion including by improving transparency of companies' and trusts' ownership, both in the UK and in British overseas territories (BoTs) and Crown dependencies (CDs), and by mobilizing the anti-money laundering (AML) framework. The consultation process has concluded and primary legislation is expected to be introduced in Parliament soon. Depending on the extent to which the international standards are reflected in the new legislation, its implementation may necessitate economic adjustments, particularly in BoTs and CDs. This could also generate spillovers on other financial centers as a consequence of the transmission of UK regulation through global banks located in the UK. In this regard, the UK authorities indicated that they do not play any role in ensuring corporate transparency or in enforcing legislation on tax crimes in the BoTs and CDs.

SUPPLY-SIDE POLICIES

43. **To continue growing at historical trends the UK economy needs to address structural impediments in the economy.** Although cyclical factors could partially account for the weakness in productivity growth, several structural factors in the UK economy are dampening long-run potential growth:

- *Infrastructure:* Reducing bottlenecks in infrastructure, notably in transportation and energy, is a prerequisite to sustaining higher productivity gains. Currently, road congestion in the UK remains among the highest in the EU, and 20 percent of electricity generating capacity is expected to close within the next decade. A further expansion in public investment in infrastructure projects, within the medium-term fiscal framework, along with the implementation of well-designed guarantee schemes, could provide the necessary infrastructure to address capacity constraints.

- *Education:* Improving the economy's skill base by investing in human capital not only can enhance the potential growth of the economy, but can also foster more inclusive growth. While the UK leads OECD countries in terms of educational attainment in tertiary education, it lags in the educational attainment of the population aged 15–19 years old. Only 78 percent of this population segment is enrolled in education, below the OECD average. A further expansion in vocational training and apprenticeship programs could provide the needed skills for the young and reduce the double-digit youth unemployment rate.

- *Immigration:* Restrictive immigration policies could have a negative impact on productivity growth. Relaxing immigration requirement in areas with labor shortages, such as manufacturing, could provide a boost to productivity and facilitate the rebalancing of the UK economy. In addition, loosening the visa regime for foreign students could contribute to expanding the skilled labor force and to improving the prospects of higher education exports.

THE AUTHORITIES' VIEWS

44. **The authorities had broadly similar views on recent developments.** Staff at the Treasury and Bank of England shared the view that the recovery has momentum and is becoming more balanced. Uncertainty about productivity remained high. The authorities noted regional differences in house prices and their driving factors and, while cautious about future prospects, noted that there had not so far been widespread deterioration in lending standards or signs of "bubble"-like behavior.

45. **The authorities also had qualitatively very similar views on prospects for the UK economy,** with strong growth in 2014 reverting to trend, moderate increases in productivity growth, and little contribution from net exports. There was also broad agreement about risks: on the domestic side, from productivity and vulnerability of indebted households to interest rate and income shocks; on the external side, from potential for financial disruption from normalization of monetary policy in the US; risks associated with a sharper-than-expected slowdown in China; and weak demand from significant export economies, especially the euro area. More generally, the authorities expressed concern about under-pricing of risk by markets.

46. **Monetary policy settings were viewed as appropriate.** Careful communications would be needed to make sure that the public understood that the MPC would, in time, need to raise rates from current levels. The process of normalizing monetary policy should begin with rises in Bank rate

and should proceed gradually. And the "natural" rate of interest is likely to remain below levels seen prior to the financial crisis. Asset sales should only be considered once Bank Rate had reached a level from which it could be cut in the face of a negative shock. Compared with the pre-crisis period, increased demand for liquid assets could mean that the Bank of England's balance sheet would remain large by historical standards.

47. **Macroprudential policies were widely agreed to be the first response to risks from the housing market.** The MMR and lenders' own tighter lending standards should act to limit some risks. Nonetheless, additional macroprudential measures were justified, as reflected in the FPC's recent recommendations for mortgage lenders to apply more stringent interest rate stress tests (an increase in Bank rate of 3 percentage points) as part of their MMR affordability assessments and to limit the proportion of new lending at high loan-to-income multiples. Uncertainty about the effects of such tools implied taking early and gradual steps. However, it would also be important to improve the understanding of the general public and of the other domestic institutions for the active use of macroprudential tools.

48. **The authorities emphasized supply-side constraints and regional disparities behind house prices.** Supply had picked up during the past year in response to policy initiatives, but was well below levels needed to satisfy demand. Further progress on planning reform was needed and would require broad political consensus. There are no plans for property tax reform at present. Help to Buy had brought about some increase in construction, while transactions so far under the mortgage guarantee part of the scheme were not playing a significant role in rising house prices.

49. **The overall fiscal deficit had come down, but further consolidation efforts would be needed to bring down public debt.** Given national elections in 2015, the details of medium-term consolidation plans have not yet been specified. Given that revenue measures had been front loaded and risks to future revenue (especially, arising from structural changes to the oil and financial sectors), consolidation should seek to find the appropriate mix between expenditure and revenue measures, ideally from including additional gains in expenditure efficiency, with due attention to social equity. Spending decisions should look to prioritize efficiency gains and areas of spending that provide value for money, while continuing to provide high quality outputs in key areas including science, infrastructure, education, and health.

50. **Financial policies were seen as successful in bringing banks to better health, but many challenges remained.** Banks had more capital, and significant progress had been made on the two state-intervened entities, with a complete sale of the government's stake in LBG feasible over the medium term. The authorities judge RBS's recently-announced restructuring strategy to be on course, but acknowledge the scale of the ambition means that some challenges remain. The three-pronged capital framework, including a leverage ratio requirement, was viewed as particularly important, moving banks away from a single concept or target number for capital adequacy. The authorities emphasized the importance of the concurrent stress tests in targeting UK-specific risks and global shocks.

51. **Structural financial reforms had been far reaching and were now having significant effects.** The new architecture focuses on coordination and communication, with the ultimate goal of ensuring forward-looking, judgment-based supervision of the UK financial system (as an important public good), which has required culture reforms for both firms and regulators. The introduction of ring fencing and, in particular, new resolution and bail-in powers for the Bank of England, and the continuing development of resolution strategies and plans, is helping to make systemically-important firms more resolvable and so help to address the Too-Important-to-Fail problem. Securing international agreements on GLAC and cross-border enforceability of resolution actions later this year (in line with the FSB's commitments to the G20 leaders) will also be critical in this respect. Reforms to the Sterling Monetary Framework, accompanied with deeper and broader supervision of the backstopped entities, would ensure that the UK financial system is resilient to shocks, and remains a global public good, with favorable spillovers to the rest of the world.

52. **The authorities noted the importance of accurate and reliable data in forming an assessment of the economy.** Analysis of some important areas—notably business investment—was constrained by the level of detail available. National accounts investment and trade data were sometimes at odds with other survey sources, and revisions in recent years had been substantial. New accounts to meet ESA requirements, forthcoming toward the end of the year, could have potentially significant changes.

STAFF APPRAISAL

53. **The rebound in growth is strong and welcome.** There are promising signs that demand is becoming more balanced, with growth in business investment now running ahead of private consumption. Employment growth has remained strong. Despite this, inflation has been contained, justifying the Bank of England's stance of "looking through" above-average headline inflation and focusing on underlying pressures. With better growth has come an improvement in the public finances, albeit one that has been somewhat less "tax rich" than might be hoped for based on the improvement in GDP growth.

54. **The exchange rate appears moderately overvalued.** Although the net external asset position has improved, due largely to revaluation effects, the persistent trade deficit suggests an overvaluation in the order of 5–10 percent. However, such measures come with a wide range of uncertainty.

55. **An immediate challenge to the authorities is to ensure that strong growth persists, without creating inflationary pressures or financial stability risks.** Much depends on productivity developments—even a relatively modest increase in labor productivity would facilitate higher real wages, which will be needed to sustain the recovery. Should productivity fail to pick up, the MPC would eventually have to tighten monetary conditions to dampen inflationary pressures, in keeping with its mandate. As with many previous cycles in the UK, the housing market is becoming buoyant, creating risks to household finances and affordability and standards of living. Compared with previous cycles, however, the Bank of England is equipped with a clear mandate and tools to

address such risks, which it has already begun to use. The impact of these tools will need to be monitored closely, and settings (including with respect to coverage) may need to be modified over time to maximize their benefits. Interest rate increases could be considered, should macroprudential tools prove ineffective, with careful consideration to the tradeoff between damage to the real economy and the ultimate costs of financial vulnerabilities.

56. **The UK's distinct role as a global financial centre necessitates ongoing efforts to strengthen bank balance sheets and implement durable structural reforms**. The new financial regulatory architecture is helping to build a more resilient financial system. The recent Bank of England initiatives to raise bank capital and provisioning, institute a robust multi-pronged framework for assessing capital adequacy, stress test major banks for large shocks, and strengthen liquidity backstops for banks and some systemic nonbanks are welcome. Looking ahead, it will be important to strengthen the monitoring of risks in the shadow banking system; maintain clear communication and coordination across regulatory bodies; and ensure effective oversight arrangements at the Bank of England (given its expanded mandate). The authorities are alert to the remaining work needed on banking culture and Too-Important-To-Fail reforms. It would be important to implement these in a way that ensures international consistency of national reforms, and avoids regulatory arbitrage.

57. **Fiscal policy is appropriate for the immediate term, but a range of options will need to be considered to achieve further consolidation over the medium term.** The measures budgeted for this fiscal year strike an appropriate balance by strengthening the public finances without creating undue drag on growth. To put debt on a downward path, more consolidation will be needed over the medium term. There remains potential for further revenue gains, notably from eliminating tax expenditures; the alternative of relying entirely on expenditure cuts would likely imply reduced delivery of key public services and/or highly regressive policies.

58. It is recommended that the next Article IV consultation with the United Kingdom be held on the standard 12-month cycle. An FSAP assessment is expected to be conducted in time for 2016 Article IV consultation discussions, in line with the usual five-year cycle for jurisdictions with systemically important financial sectors.

United Kingdom: Risk Assessment Matrix[1] (Potential Deviations From Baseline)		
Source of Risks and Relative Likelihood (high, medium, or low)	**Expected Impact of Risk** (high, medium, low)	**Policy Recommendations**
Medium • **Protracted period of stagnant productivity**: The recovery of productivity growth does not materialize.	High • Increase in unit labor costs. • Loss of competitiveness. • Slowdown of GDP growth.	• Accelerate the implementation of productivity-enhancing structural reforms. • Tighten monetary policy if earnings increase ahead of productivity.
Medium • **Financial stability risks arising from the housing market**: Increase in leverage that would raise the vulnerability of banks' and households' balance sheets to negative shocks to house prices, income, and interest rates.	High • Increase in household debt leverage. • Rapid expansion of mortgage credit growth. • Higher exposure of the financial system to the housing market.	• Tighten macroprudential policy by imposing caps on high loan-to-income mortgages. • Tighten underwriting standards. • Tighten parameters of Help-to-Buy by restricting the qualification criteria (i.e., reducing the maximum house price). • Consider raising policy rate (if above measures prove inadequate).
Low • **Bond market stress from a reassessment in sovereign risk in the Euro area:** Sovereign stress re-emerges due to incomplete reforms, unanticipated outcomes from the AQR, and stress tests in the absence of a fiscal backstop.	Medium • Tightening financial conditions if funding costs rise for banks with large EA exposures. • Potential safe haven inflows and lower sovereign yields.	• Adjust monetary policy, depending on net impact on inflation, asset prices and financial conditions.

<table>
<tr>
<td>High

• Surges in global financial market volatility, triggered by geopolitical tensions, revised market expectations on UMP exit/emerging market fundamentals, and more generally a re-pricing of risk.</td>
<td>High

• Tightening of financial conditions and market discontinuity.
• Increased uncertainty could depress investment, consumption, and GDP growth.
• Sharp reduction in house prices and asset prices, with implications for aggregate demand.</td>
<td>• Continue with accommodative monetary policy to offset market volatility.
• Consider providing backstops for systemic non-banks (along with enhanced regulation and supervision) in addition to existing enhanced liquidity facilities for banks.</td>
</tr>
<tr>
<td>High

Protracted period of slower growth:
• Advanced economies: Lower-than-anticipated potential growth and persistently low inflation due to a failure to fully address legacies of the financial crisis, leading to secular stagnation.
• Emerging economies: Maturing of the cycle, misallocation of investment, and incomplete structural reforms leading to prolonged slower growth.</td>
<td>Medium

• Reduction in GDP growth; current recovery could stall.
• Widening of the current account deficit.</td>
<td rowspan="2">• Continue with accommodative monetary policy for longer to support demand.
• Move to neutral fiscal policy stance; allow automatic stabilizers to fully operate.
• Implement structural policies to boost investment, productivity and competitiveness.</td>
</tr>
<tr>
<td>Medium

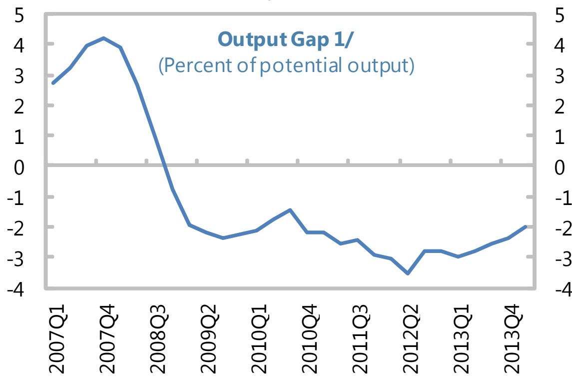
• Growth slowdown in China: Continued buildup and eventual unwinding of excess capacity, eventually resulting in a sharp growth slowdown and large financial and fiscal losses (medium-term).</td>
<td>Medium

• Substantial financial linkages through G-SIB's (HSBC and Standard Chartered).
• Limited impact through trade (3 percent of exports are directed to China).</td>
</tr>
</table>

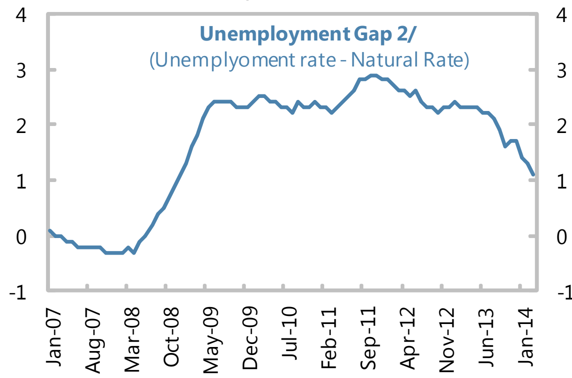
1. The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Figure 1. United Kingdom: Indicators of Spare Capacity

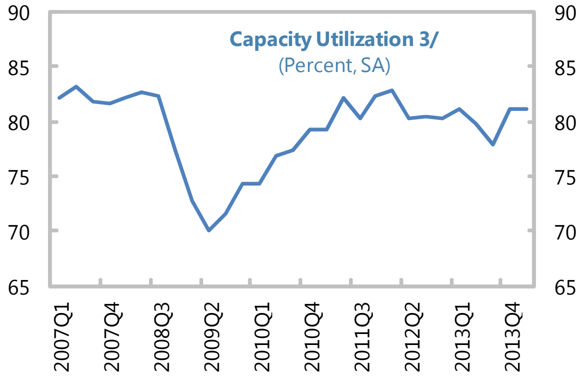
The output gap has been closing since the beginning of 2012, but still remains large.



The unemployment gap has narrowed at a faster pace than the output gap.

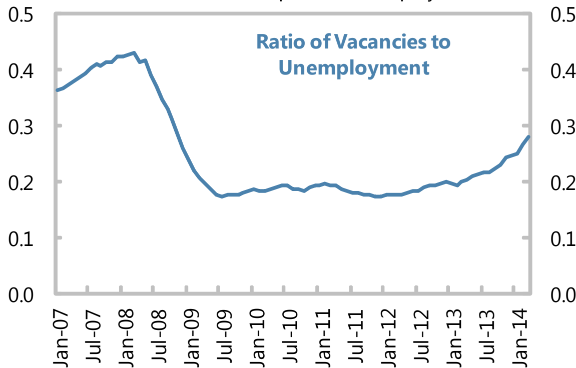


Survey indicators suggest that most of the excess capacity has been absorbed.

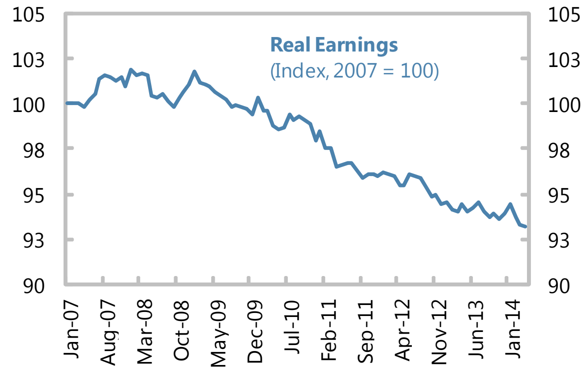


However, there is significant mismatch in the labor market...

...and a substantial reduction in the number of vacancies relative to the pool of unemployed workers...



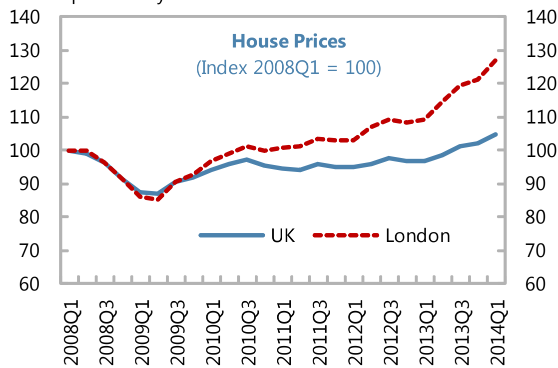
...resulting in a large decline in real earnings.



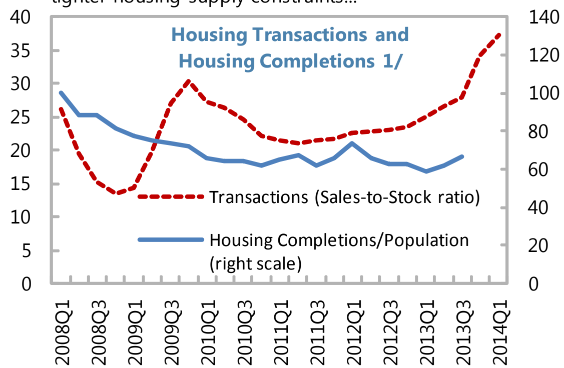
Sources: European Commission; Haver Analytics; ONS; and IMF staff calculations.
1/ IMF staff estimate.
2/ IMF staff estimate.
3/ European Commission.

Figure 2. United Kingdom: Housing Market Developments

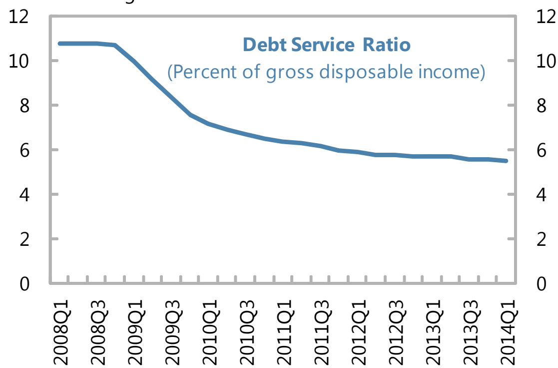
House prices are increasing at a fast pace in the UK, particularly in London...



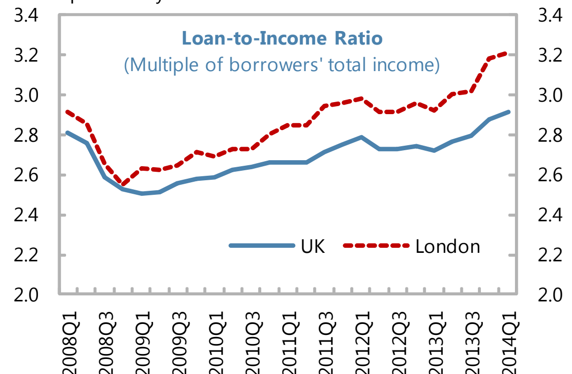
As a result of an increase in housing demand and tighter housing supply constraints...



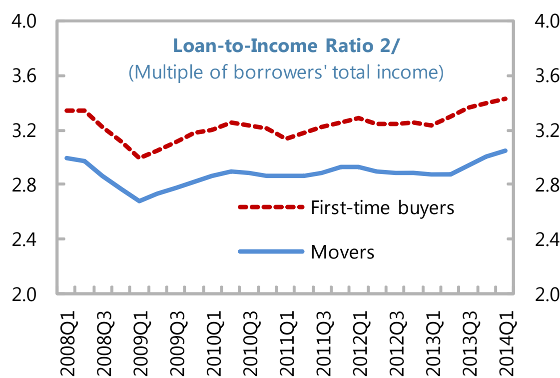
In an environment of low interest rates that is reducing the debt service ratio...



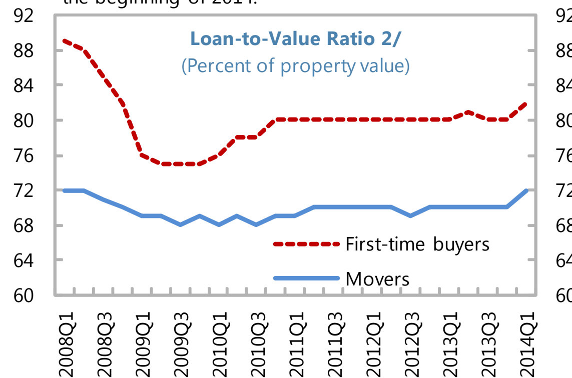
But the loan-to-income ratio is increasing, particularly in London...



...and among first-time buyers.



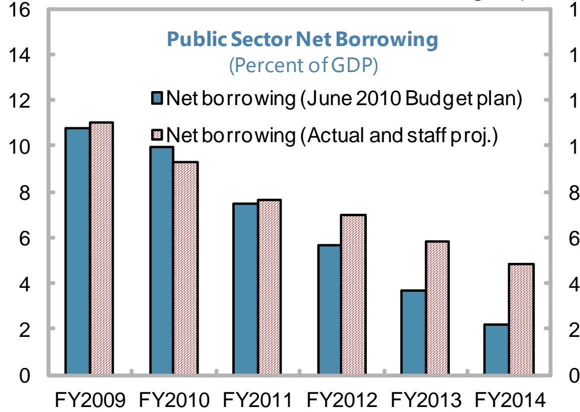
The loan-to-value ratio has also started to increase at the beginning of 2014.



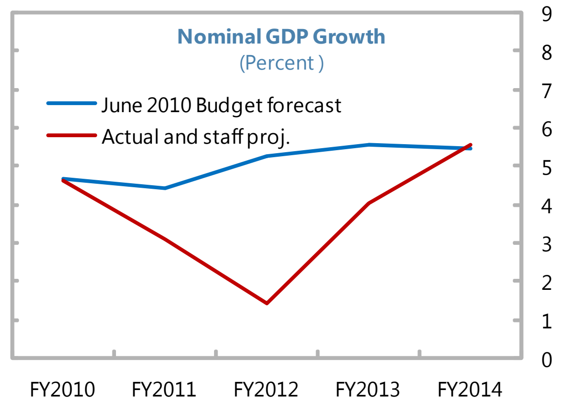
Sources: Haver Analytics; ONS; RICS; OBR; and IMF staff calculations.
1/ Housing transactions are defined as the ratio of sales to stock of housing. Supply constraints are measured as the ratio of housing completions to the population stock. This ratio is normalized to 100 in 2008.
2/ Source: Council of Mortgage Lenders (CML).

Figure 3. United Kingdom: Progress and Challenges in Fiscal Consolidation, 2009/10–2018/19

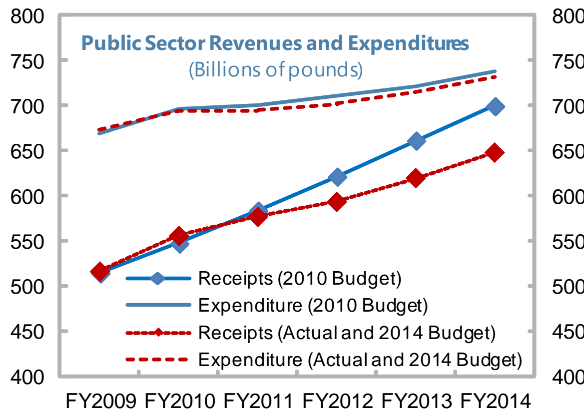
The deficit has been nearly halved, although the pace of consolidation has been slower than that in the original plan...



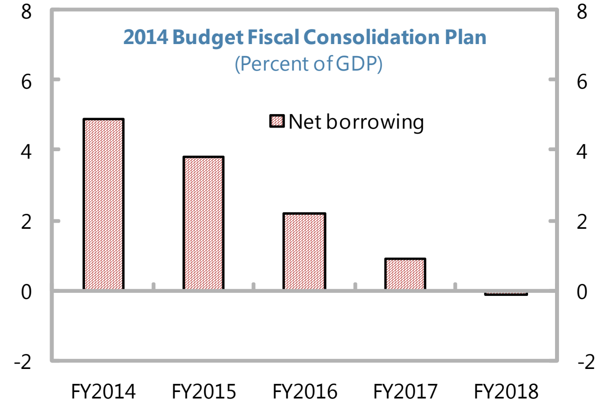
...largely because nominal GDP growth significantly underperformed...



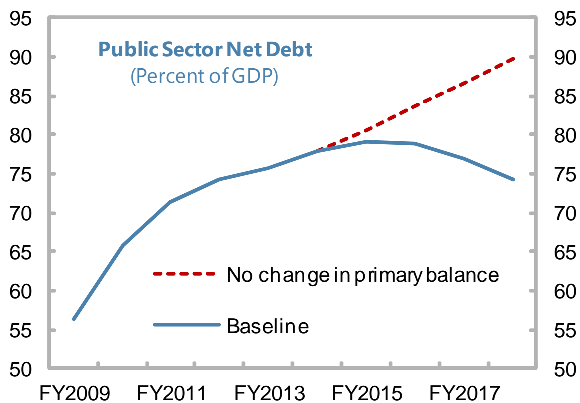
...and revenue collections fell short of projections.



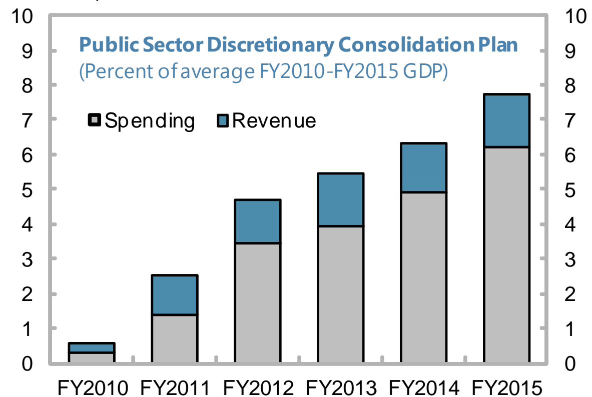
The current government envisages balancing the budget by FY2018...



...aimed at putting debt on a firmly downward path in the medium term.

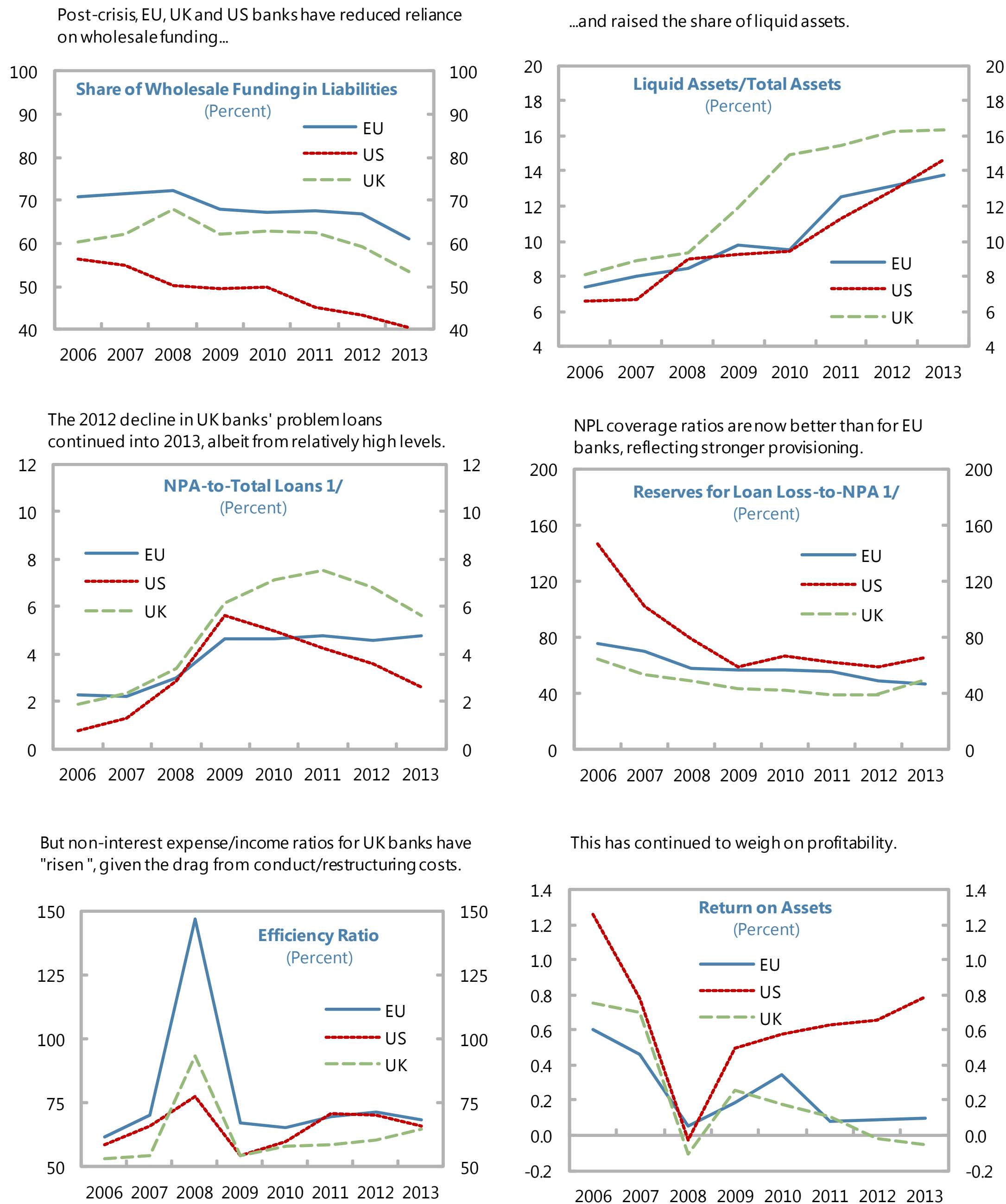


The consolidation thus far has mainly driven by expenditure-measures. A plan for beyond FY2016 will be specified after the elections.



Sources: HMT; Office for National Statistics (ONS); and IMF staff estimates.

Figure 4. Comparison of Major UK, EU, and US Banks



Sources: Bloomberg.; and IMF staff calculations. Ratios shown are not adjusted for accounting differences across regions (such as GAAP for US vs. IFRS for UK). UK refers to the average for HSBC, Barclays, RBS and LBG. EU and US indicators are weighted averages (by total assets) of the following major banks. *EU banks:* Cooperatieve Centrale Raiffeisen-Boerenleenbank, BNP Paribas, Credit Agricole, Societe Generale, Bayerische Landesbank, Commerzbank, Deutsche Bank, DZ Bank AG Deutsche Zentral-Genossenschaftsbank, LBBW, Credit Suisse Group, UBS, Banca Monte dei Paschi di Siena, Intesa Sanpaolo, UniCredit, Unione di Banche Italiane, Banco Bilbao Vizcaya Argentaria, Banco Popular Espanol, Banco Santander, Danske Bank, DNB, Nordea Bank, Skandinaviska Enskilda Banken, Svenska Handelsbanken and Swedbank. *US banks:* Bank of America, Bank of New York Mellon, BB&T, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street Corp., SunTrust Banks and Wells Fargo.

1/ For US banks, FDIC series on commercial banks for "non-recurrent loans to total loans", and "coverage ratio" were used as proxies for the NPA-to-total loans and loan loss reserves to NPA, respectively.

Table 1. United Kingdom: Selected Economic Indicators, 2012–15

	2012	2013	2014 Proj.	2015 Proj.
Real Economy (change in percent)				
Real GDP	0.3	1.7	3.2	2.7
Domestic demand	1.2	1.7	3.0	2.6
Private final domestic demand	1.3	2.0	3.3	3.5
CPI, end-period	2.6	2.1	1.9	2.0
Unemployment rate (in percent) 1/	8.0	7.6	6.5	6.3
Gross national saving (percent of GDP)	10.9	10.1	11.2	12.1
Gross domestic investment (percent of GDP)	14.7	14.5	15.2	15.6
Public Finance (fiscal year, percent of GDP) 2/				
Public sector overall balance	-6.9	-5.8	-4.8	-3.6
Public sector cyclically adjusted primary balance (staff estimates) 3/	-2.6	-2.1	-1.8	-0.7
General government gross debt	88.5	91.2	92.1	93.0
Public sector net debt	74.2	75.8	77.9	79.1
Money and Credit (end-period, 12-month percent change)				
M4	-1.0	0.2	...	...
Net lending to private sector	-0.2	0.9	...	...
Interest rates (percent; year average)				
Three-month interbank rate	0.8	0.5	...	...
Ten-year government bond yield	1.9	2.5	...	...
Balance of Payments (percent of GDP)				
Current account balance	-3.8	-4.4	-4.0	-3.5
Trade balance	-2.1	-1.7	-1.3	-1.3
Net exports of oil	-1.0	-1.1	-0.9	-0.9
Exports of goods and services (volume change in percent)	1.7	1.0	1.9	3.3
Imports of goods and services (volume change in percent)	3.4	0.5	1.4	3.0
Terms of trade (percent change)	-0.3	0.9	0.3	-0.1
FDI net	-0.4	-0.7	-0.5	-0.6
Reserves (end of period, billions of US dollars)	99.9	101.5	...	...
Fund Position (as of May 31st, 2014)				
Holdings of currency (in percent of quota)		75.8		
Holdings of SDRs (in percent of allocation)		95.2		
Quota (in millions of SDRs)		10,738.5		
Exchange Rates				
Exchange rate regime		Floating		
Bilateral rate (June 17th, 2014)		US$1 = £0.5896		
Nominal effective rate (2005=100) 4/	82.1	80.1	...	...
Real effective rate (2005=100) 4/ 5/	89.3	88.5	...	...

HM Treasury; Office for National Statistics; and IMF staff estimates.

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

2/ The fiscal year begins in April. Data exclude the temporary effects of financial sector interventions. Debt stock data refers to the end of the fiscal year using centered-GDP as a denominator.

3/ In percent of potential output.

4/ Average. An increase denotes an appreciation.

5/ Based on relative consumer prices.

Table 2. United Kingdom: Medium-Term Scenario, 2012–19

(Percentage change, unless otherwise indicated)

	2012	2013	2014 Proj.	2015 Proj.	2016 Proj.	2017 Proj.	2018 Proj.	2019 Proj.
Real GDP	0.3	1.7	3.2	2.7	2.5	2.4	2.4	2.4
Q4/Q4 1/	0.2	2.7	3.4	2.2	2.6	2.3	2.4	2.4
Real domestic demand	1.2	1.7	3.0	2.6	2.3	2.2	2.3	2.3
Private consumption	1.4	2.2	2.5	2.9	2.7	2.7	2.6	2.6
Government consumption	1.6	0.7	1.2	-0.5	-1.2	-1.8	-0.9	-0.4
Fixed investment	0.8	-0.6	7.8	5.6	5.8	5.6	4.8	4.5
Public	1.1	-8.0	10.7	1.0	2.2	0.8	-0.5	-0.5
Residential	-4.1	4.7	6.4	6.4	6.4	6.4	6.0	5.5
Business	3.9	-1.0	8.0	7.0	7.0	7.0	6.0	5.5
Stocks 2/	-0.2	0.3	0.1	0.0	0.0	0.0	0.0	0.0
External balance 2/	-0.5	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Exports of Goods and Services	1.7	1.0	1.9	3.3	4.1	4.4	4.7	5.0
Imports of Goods and Services	3.4	0.5	1.4	3.0	3.7	3.9	4.2	4.7
Current account 3/	-3.8	-4.4	-4.0	-3.5	-3.1	-2.5	-1.9	-1.2
CPI Inflation, end period	2.6	2.1	1.9	2.0	2.0	2.0	2.0	2.0
Output gap 4/	-3.0	-2.7	-1.3	-0.6	-0.3	-0.1	0.0	0.0
Potential output	0.8	1.3	1.8	1.9	2.1	2.2	2.3	2.4
Employment and productivity								
Employment	1.2	1.3	1.9	1.3	1.1	1.0	1.0	1.0
Unemployment rate 5/	8.0	7.6	6.5	6.3	5.9	5.7	5.6	5.5
Productivity 6/	-0.9	0.4	1.3	1.3	1.4	1.4	1.5	1.5
Memorandum items:								
Private final domestic demand	1.3	2.0	3.3	3.5	3.3	3.3	3.2	3.1
Household saving rate 7/	7.4	5.1	4.3	3.2	2.7	2.3	2.1	1.9
Private saving rate	16.4	13.4	13.9	13.5	13.3	13.1	13.1	13.9

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

1/ Percentage change in quarterly real GDP in the fourth quarter on four quarters earlier.

2/ Contribution to the growth of GDP.

3/ In percent of GDP.

4/ In percent of potential GDP.

5/ In percent of labor force, period average; based on the Labor Force Survey.

6/ Whole economy, per worker.

7/ Percent of total household available resources.

Table 3. United Kingdom: Statement of Public Sector Operations, 2010/11–18/19[1]

(Percent of GDP, unless otherwise noted)

	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
				March 2014 Budget					
Revenue	37.1	37.3	37.8	37.7	37.7	37.8	38.0	38.0	38.1
Taxes	28.4	28.6	28.4	28.3	28.4	28.7	28.7	28.8	28.8
Social contributions	6.5	6.6	6.7	6.5	6.4	6.4	6.7	6.7	6.8
Other revenue	2.1	2.1	2.8	2.9	2.8	2.7	2.5	2.5	2.5
Of which: Interest income	0.4	0.4	0.9	1.2	1.1	0.9	0.8	0.8	0.8
Expenditure	46.3	44.9	44.8	43.5	42.5	41.6	40.2	38.9	38.1
Expense	44.8	43.8	44.0	42.6	41.6	40.8	39.4	38.2	37.5
Consumption of fixed capital	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Interest	3.1	3.2	3.1	3.0	3.1	3.4	3.5	3.8	3.9
Others	40.3	39.3	39.5	38.2	37.1	36.0	34.5	33.1	32.2
Net acquisition of nonfinancial assets	1.6	1.1	0.8	0.9	1.0	0.8	0.8	0.7	0.6
Gross operating balance	-7.7	-6.5	-6.1	-4.9	-3.9	-3.0	-1.4	-0.2	0.6
Net lending/borrowing (overall balance)	-9.3	-7.6	-6.9	-5.8	-4.9	-3.8	-2.2	-0.9	0.1
Current balance 2/	-6.7	-5.8	-5.5	-4.3	-3.3	-2.3	-0.7	0.4	1.3
Primary balance	-6.6	-4.8	-4.8	-4.0	-2.9	-1.4	0.5	2.1	3.2
Cyclically adjusted overall balance	-7.2	-5.7	-4.9	-4.2	-3.8	-3.1	-1.7	-0.7	0.1
Cyclically adjusted current balance 2/	-4.6	-3.8	-3.5	-2.8	-2.2	-1.6	-0.2	0.6	1.4
Cyclically adjusted primary balance (CAPB)	-4.5	-2.9	-2.8	-2.5	-1.9	-0.6	1.0	2.3	3.2
General government gross debt 3/	79.1	85.1	88.3	89.6	91.8	93.1	91.9	89.4	86.6
Public sector net debt 4/	65.9	71.4	74.2	74.5	77.3	78.7	78.3	76.5	74.2
Memorandum items:									
Output gap (percent of potential) 5/	-2.6	-2.9	-2.8	-2.0	-1.3	-1.0	-0.6	-0.2	0.0
Real GDP growth (percent)	2.0	0.8	0.3	2.3	2.6	2.4	2.6	2.6	2.4
Nominal GDP (in billions of pounds)	1,499	1,546	1,568	1,644	1,721	1,788	1,871	1,956	2,042
Potential GDP growth (percent)	1.6	1.1	0.2	1.5	1.9	2.1	2.2	2.2	2.2
					Staff projections				
Revenue	37.1	37.3	37.9	38.0	37.7	37.9	38.1	38.1	38.1
Taxes	28.4	28.6	28.4	28.5	28.5	28.8	28.8	28.9	28.9
Social contributions	6.5	6.6	6.7	6.6	6.4	6.4	6.7	6.7	6.7
Other revenue	2.1	2.1	2.8	2.9	2.8	2.6	2.5	2.5	2.5
Of which: Interest income	0.4	0.4	0.9	1.1	1.1	0.9	0.8	0.8	0.8
Expenditure	46.3	44.9	44.8	43.8	42.5	41.4	40.2	38.9	37.9
Expense	44.8	43.8	44.0	42.8	41.5	40.6	39.5	38.2	37.3
Consumption of fixed capital	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Interest	3.1	3.2	3.1	2.9	3.1	3.3	3.5	3.7	3.7
Other	40.3	39.3	39.5	38.4	37.1	35.9	34.5	33.1	32.2
Net acquisition of nonfinancial assets	1.6	1.1	0.8	1.0	1.0	0.8	0.8	0.7	0.6
Gross operating balance	-7.7	-6.5	-6.1	-4.8	-3.8	-2.8	-1.4	-0.1	0.8
Net lending/borrowing (overall balance)	-9.3	-7.6	-6.9	-5.8	-4.8	-3.6	-2.2	-0.8	0.2
Current balance 2/	-6.7	-5.8	-5.4	-4.3	-3.2	-2.1	-0.7	0.5	1.5
Primary balance	-6.6	-4.8	-4.8	-4.0	-2.9	-1.2	0.5	2.1	3.2
Cyclically adjusted overall balance	-7.9	-5.9	-4.9	-4.0	-3.8	-3.1	-2.0	-0.7	0.2
Cyclically adjusted current balance 2/	-5.3	-4.0	-3.4	-2.5	-2.2	-1.6	-0.5	0.6	1.5
Cyclically adjusted primary balance (CAPB)	-5.2	-3.1	-2.7	-2.2	-1.9	-0.7	0.7	2.2	3.2
CAPB (percent of potential GDP)	-5.1	-3.0	-2.6	-2.1	-1.8	-0.7	0.7	2.2	3.2
General government gross debt 3/	79.1	85.1	88.5	91.2	92.1	93.0	92.4	90.3	87.4
Public sector net debt 4/	65.9	71.4	74.2	75.8	77.9	79.1	78.9	76.9	74.3
Memorandum items:									
Output gap (percent of potential)	-1.9	-2.7	-3.0	-2.4	-1.0	-0.6	-0.2	-0.1	0.0
Real GDP growth (percent)	2.0	0.8	0.3	2.3	3.2	2.5	2.5	2.4	2.4
Nominal GDP (in billions of pounds)	1,499	1,546	1,568	1,631	1,722	1,794	1,870	1,955	2,042
Potential GDP growth (percent)	1.6	1.7	0.6	1.7	1.8	2.0	2.1	2.2	2.3

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

1/ Excludes the temporary effects of financial sector interventions, as well as the one-off effect on public sector net investment in 2012/13 of transferring assets from the Royal Mail Pension Plan to the public sector, unless otherwise noted.

2/ Includes depreciation.

3/ On a Maastricht treaty basis. Includes temporary effects of financial sector intervention.

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

Table 4. United Kingdom: Statement of General Government Operations, 2007–13

(Percent of GDP)

	2007	2008	2009	2010	2011	2012	2013
Revenue	40.5	42.1	39.6	39.8	40.3	42.0	41.3
Taxes	28.8	30.1	27.4	28.2	28.9	28.6	28.7
Social contributions	8.1	8.3	8.4	8.3	8.3	8.4	8.4
Other	3.5	3.7	3.8	3.4	3.2	5.0	4.2
Expense	43.3	47.1	50.8	49.9	47.9	48.1	47.1
Expense	42.5	45.8	49.3	48.5	46.9	47.2	46.5
Compensation of employees	10.8	10.8	11.5	11.4	10.9	10.7	10.1
Use of goods and services	11.4	12.2	13.5	13.0	12.2	12.3	12.4
Consumption of fixed capital	0.9	1.0	1.0	1.0	1.1	1.1	1.1
Interest	2.2	2.2	1.9	2.9	3.3	3.0	3.0
Subsidies	0.7	0.7	0.7	0.7	0.6	0.6	0.6
Social benefits	12.5	13.0	14.9	14.9	14.9	15.5	15.3
Other	4.0	5.8	5.8	4.6	4.0	4.0	3.9
Net acquisition of nonfinancial assets	0.8	1.3	1.6	1.3	1.0	1.0	0.6
Consumption of fixed capital	-0.9	-1.0	-1.0	-1.0	-1.1	-1.1	-1.1
Gross operating balance	-1.1	-2.7	-8.7	-7.6	-5.6	-4.1	-4.1
Net operating balance	-2.0	-3.7	-9.7	-8.7	-6.6	-5.2	-5.2
Net lending/borrowing (overall balance)	-2.8	-5.0	-11.3	-10.0	-7.6	-6.1	-5.8
Net financial transactions	-2.6	-5.0	-11.2	-10.3	-7.4	-5.9	-5.5
Net Acquisition of Financial assets	0.5	4.7	3.6	0.4	1.5	0.7	-0.8
Currency and deposits	0.7	0.8	0.2	-0.6	1.0	0.1	0.4
Securities other than shares	0.1	0.3	0.1	0.5	0.5	0.1	-0.2
Loans	0.3	1.5	0.8	0.6	-0.3	0.2	0.2
Shares and other equity	-0.5	0.7	2.5	0.0	0.0	0.1	-1.7
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives	0.0	0.0	0.1	0.0	0.0	0.0	0.0
Other accounts receivable	-0.1	1.4	0.0	0.0	0.2	0.2	0.4
Monetary gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Incurrence of Liabilities	3.1	9.6	14.8	10.7	8.9	6.7	4.6
Currency and deposits	0.6	1.3	0.5	-0.3	0.5	-0.2	-0.5
Securities other than shares	2.7	7.4	15.6	10.9	8.2	6.8	4.7
Loans	0.1	0.6	-1.3	-0.1	0.1	0.0	0.1
Shares and other equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts receivable	-0.1	0.3	0.0	0.2	0.1	0.0	0.3

Source: IMF's International Finance Statistics.

Table 5. United Kingdom: General Government Stock Positions, 2007–13

(Percent of GDP)

	2007	2008	2009	2010	2011	2012	2013
Net worth	...	...	...	...	...	...	...
Nonfinancial assets	...	...	...	...	...	...	...
Net financial worth	-26.3	-31.1	-41.0	-48.3	-62.1	-65.0	-64.6
Financial assets	20.7	26.4	31.3	37.5	38.0	38.9	35.9
Currency and deposits	3.3	4.2	4.5	4.2	4.8	4.8	4.8
Securities other than shares	1.9	2.8	2.1	3.2	3.5	3.4	3.0
Loans	2.5	3.9	4.8	9.8	9.2	9.3	9.2
Shares and other equity	9.3	10.6	13.9	13.9	14.0	14.8	12.5
Insurance technical reserves	0.1	0.1	0.1	0.0	0.0	0.0	0.0
Financial derivatives	0.0	-0.2	-0.1	0.1	0.1	0.2	0.1
Other accounts receivable	3.3	4.7	4.9	5.1	5.1	5.2	5.2
Monetary gold and SDRs	0.3	0.4	1.1	1.2	1.3	1.2	1.0
Liabilities	47.0	57.6	72.3	85.8	100.2	103.9	100.5
Currency and deposits	7.1	8.3	9.0	8.6	8.8	8.6	7.8
Securities other than shares	35.8	44.5	60.4	74.3	88.5	92.6	89.8
Loans	3.5	3.9	1.9	1.7	1.7	1.6	1.6
Shares and other equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives	0.0	0.0	0.0	0.1	0.1	0.1	0.0
Other accounts payable	0.6	0.9	1.0	1.1	1.0	1.0	1.3

Source: IMF's International Finance Statistics.

Table 6. United Kingdom: Balance of Payments, 2012–19

(Percent of GDP)

	2012	2013	2014 Proj.	2015 Proj.	2016 Proj.	2017 Proj.	2018 Proj.	2019 Proj.
Current account	-3.8	-4.4	-4.0	-3.5	-3.1	-2.5	-1.9	-1.2
Trade balance	-2.1	-1.7	-1.3	-1.3	-1.2	-0.9	-0.7	-0.6
Trade in goods	-7.0	-6.7	-6.4	-6.3	-6.3	-6.2	-6.2	-6.2
Exports	19.3	19.0	17.4	17.4	17.6	18.0	18.3	18.7
Imports	-26.3	-25.7	-23.8	-23.7	-23.9	-24.1	-24.5	-24.9
Trade in services	4.8	5.0	5.0	5.0	5.1	5.3	5.5	5.6
Exports	12.5	12.4	12.1	12.1	12.2	12.5	12.7	13.0
Imports	-7.7	-7.4	-7.1	-7.0	-7.1	-7.2	-7.3	-7.4
Income balance	-0.2	-1.1	-1.0	-0.6	-0.2	0.0	0.4	1.0
Current transfers	-1.4	-1.7	-1.7	-1.7	-1.7	-1.7	-1.7	-1.7
Capital and financial account	4.2	4.2	4.0	3.5	3.1	2.5	1.9	1.2
Capital account	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Financial account	4.1	4.1	3.9	3.5	3.0	2.5	1.9	1.1
Direct investment	-0.4	-0.7	-0.5	-0.6	-0.5	-0.5	-0.5	-0.5
Domestic	-1.9	-1.5	-1.6	-1.4	-1.4	-1.3	-1.3	-1.2
Abroad	1.4	0.8	1.0	0.8	0.9	0.8	0.8	0.7
Portfolio investment balance	12.0	-1.9	4.6	1.3	2.7	1.9	2.2	1.9
Other financial transactions 1/	-14.2	-1.8	-7.4	-4.1	-4.9	-3.7	-3.3	-2.4
Change in reserve assets	0.5	0.3	0.4	0.3	0.3	0.3	0.3	0.3
Net errors and omissions	-0.4	0.2	0.0	0.0	0.0	0.0	0.0	0.0

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

1/ Includes net financial derivatives

Table 7. United Kingdom: Net Investment Position, 2007–13[1]

(Percent of GDP)

	2007	2008	2009	2010	2011	2012	2013
Assets	538	749	602	665	708	656	593
Direct investment abroad	63	73	69	70	71	71	70
Portfolio investment abroad	118	114	132	139	135	147	154
Other investment abroad	258	284	244	252	263	238	215
Reserve assets	2	2	3	3	4	4	4
Liabilities	553	744	615	670	707	671	595
Direct investment in the UK	43	45	48	49	50	60	61
Portfolio investment in the UK	141	138	171	172	161	162	152
Other investment in the UK	272	293	248	254	266	254	235
Net investment position	-15	5	-13	-5	1	-15	-2
Direct investment	20	28	21	21	22	10	10
Portfolio investment	-22	-25	-38	-33	-26	-15	2
Other investment	-14	-9	-4	-2	-3	-17	-20
Reserve assets	2	2	3	3	4	4	4
Monetary financial institutions	-19	-13	-17	-11	-8	-9	-7
Other sectors	13	30	17	24	30	17	27
Public sectors	-9	-11	-12	-17	-22	-22	-21
Memorandum items:							
Change in the net investment position	-0.1	20.1	-18.4	7.6	5.4	-16.0	12.8
Current account balance	-2.2	-0.9	-1.4	-2.7	-1.5	-3.8	-4.5

Source: Office for National Statistics.

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

Annex 1. External Sector Report

	United Kingdom	Overall Assessment
Foreign asset and liability position and trajectory	**Background.** The net international investment position (NIIP) improved from -15 percent of GDP in 2012 to -2 percent in 2013, as a result of valuation effects and changes in the stock of portfolio investment. Although the net position is relatively small relative to the size of the UK economy, gross positions are about 600 percent of GDP. Staff projections for the current account and GDP suggest that the NIIP to GDP ratio would decline to about -8 percent by 2019. **Assessment**. While the net external position and sustainability issues are not a concern, fluctuations in the underlying gross positions are sources of external vulnerability to the extent that they could lead to large changes in the net position.	**Overall Assessment:** *The external position is moderately weaker than implied by medium-term fundamentals and desirable policy settings.* External deficits reflect insufficient public and private saving rates. More fundamentally, the external position is influenced by the lack of competitiveness and limited export diversification. **Potential policy responses** Sustaining a strong and durable recovery in the UK requires a rebalancing away from public support toward private-sector led demand, along with a greater reliance on external demand. The current fiscal consolidation plan implemented within a medium-term framework and an accommodative monetary policy stance contribute to the goal of external rebalancing. Further structural reforms focused on broadening the skill base and investing in public infrastructure will boost productivity, improving the competitiveness of the economy.
Current account	**Background.** Before the crisis, the UK experienced persistent current account (CA) deficits as a result of an overreliance on public and private consumption. In the aftermath of the crisis, the CA balance deteriorated primarily as a consequence of a decline in the income balance. This reflects a fall in earnings on UK's foreign direct investment abroad, notably earnings on investment exposed to the euro area. The trade balance deficit has remained stable around 2 percent of GDP, despite 16 percent real exchange rate depreciation between 2007 and 2013. The lack of external adjustment is a result of high trade exposure to the euro area and weak growth of financial service exports. While investment declined in the aftermath of the crisis, national savings experienced an even larger contraction primarily as a result of lower public savings. More recently, the household sector savings rate has declined, also contributing to the increase in the CA deficit. **Assessment.** The EBA CA regression approach estimates a CA gap of around -2.6 percent of GDP. Based on alternative models and historical CA analysis, staff's assessment find a cyclically-adjusted CA balance that is 1–2 percent weaker than the current account norm. 1/	
Real exchange rate	**Background**. In the decade preceding the global crisis (1997–2007), the real effective exchange rate (REER) appreciated 16 percent; since 2007, the REER has depreciated by 16 percent. Moreover, the UK experienced an increase in unit labor costs (ULC) of 16 percent since 2007, the largest increase in ULC among G7 economies. Since July 2013, sterling has appreciated in real effective terms. By May 2014, the REER was 6 percent stronger than its average level in 2013. **Assessment**. The EBA exchange rate assessment implied by the EBA CA regression model indicates an overvaluation in the range 10–15 percent. The staff assesses the 2013 REER as 5–10 percent above the level consistent with fundamentals and desirable policy settings; this assessment is consistent with the staff's CA assessment. 2/ 3/	
Capital and financial accounts: **flows and policy measures**	**Background.** Given the UK's role as an international financial center, portfolio investment and financial derivatives are the key components of the financial account. **Assessment**. Large fluctuations in capital flows are inherent to financial transactions in countries with a large financial services sector. This volatility is a potential source of vulnerability.	
FX intervention and reserves level	**Background.** The pound has the status of a global reserve currency. **Assessment.** Reserves held by the UK are typically low relative to standard metrics (4 percent of GDP at the end of 2013), and the currency is free floating.	
Technical Background **Notes**	1/ The difference between the EBA and staff's CA gap estimate is explained by the treatment of the income balance. Staff has taken the view that recent fluctuations in the income balance are almost entirely cyclical, leading to a smaller estimate of the CA gap. 2/ The estimate from the EBA REER regression-based approach (which tends to be less reliable than the CA regression-based approach) would suggest an 2013 average REER *under*valuation (of 5 percent); this estimate is discarded as implausible, including in light of the assessment that the CA is too weak as well as evidence on competitiveness. 3/ The difference between the EBA and staff's exchange rate assessment is accounted by the alternative approaches to estimate the CA balance gap.	

Annex 2. Debt Sustainability Analysis[1]

Despite substantial efforts in fiscal consolidation, public sector debt continues to rise. Accordingly, there is a clear need for the authorities to continue with medium term fiscal consolidation to put debt on a downward path. Staff forecast that the gross public sector debt-to-GDP ratio will peak at around 93 percent in FY2015/16, before declining to 83 percent by FY2019/20. However, gross financing needs are relatively moderate compared to other economies with a similar level of debt. All debt profile vulnerabilities are below early warning benchmarks, but the projected debt trajectory is susceptible to various shocks, especially a negative real GDP growth shock.

Baseline and Realism of Projections

- **Macroeconomic assumptions.** Real GDP growth in FY2014/15 is projected at 3.2 percent, on the back of strong consumption, a rebound in investment, and a smaller drag from net trade. In the subsequent years, growth is projected to moderate somewhat. Inflation is projected to stay broadly at around 2 percent throughout the projection horizon, while short-term interest rates are projected to start rising from 2015/16, gradually by 250 basis points by 2019/20.
- **Fiscal adjustment.** The authorities continue to implement its fiscal consolidation program with the aim of eliminating the overall budget deficit by FY2018/19. In staff's baseline projections, the primary balance strengthens over the medium term from a deficit of 4 percent of GDP in FY2013/14 to a surplus of 3¼ percent of GDP in FY2019/20.
- **Heat map and debt profile vulnerabilities.** Risks from the debt level are deemed high as the level of debt exceeds the benchmark of 85 percent of GDP under baseline and stress scenarios. However, gross financing needs (estimated at around 13 percent of GDP in FY2013/14) remain comfortably below the benchmark of 20 percent of GDP, and all debt profile vulnerability indicators are below early warning thresholds.[2]
- **Realism of baseline assumptions.** The median forecast errors for real GDP growth and inflation (actual minus projection) in FY2005/06−FY2013/14 were -0.6 percent and -0.2 percent, respectively, suggesting a slight upward bias in staff's past projections. The median forecast error for the primary balance is 0.4 percent of GDP, suggesting that staff projections have been slightly pessimistic. The cross-country experience suggests that the envisaged CAPB adjustment of over 4 percentage points of GDP in FY2015/16−FY2017/18 appears to be slightly ambitious. However, given the authorities' commitment to fiscal consolidation, provided that output continues to grow in line with the baseline projections, the fiscal consolidation plan appears to be credible.

---

[1] The data are presented on a fiscal year (April–March) basis with ratios calculated using fiscal year GDP (not centered-fiscal year GDP).

[2] Gross financing needs are defined as overall new borrowing requirement plus debt maturing during the year (including short-term debt).

Shocks and Stress Tests

The DSA framework suggests that medium-term debt dynamics are not highly sensitive to interest rate shocks given the long average maturity of government debt (about 14 years) but highly susceptible to growth shocks.

- **Growth shock.** Real output growth rates are lower by one standard deviation in FY2015/16 and FY2016/17. The primary balance would improve much more slowly than in the baseline, reaching only 1 percent of GDP by FY2019/20. The debt-to-GDP ratio reaches 100 percent of GDP by FY 2016/17 and declines only gradually thereafter. Gross financing needs rise to about 15 percent of GDP by FY2016/17 and stays relatively high through FY2019/20.

- **Primary balance shock.** Assume that fiscal consolidation stalled between FY2014/15 and FY2015/16 (no change in the primary balance). The debt-to GDP ratio rises to nearly 95 percent of GDP by FY2016/17 and thereafter falls to 89 percent of GDP by FY2019/20, about 6 percentage points of GDP higher than the baseline. Gross financing needs reach about 14 percent of GDP by FY2016/17.

- **Interest rate shock.** Assume a 200 basis points increase in interest rates throughout the projection period. The effective interest rate edges up to 5¼ percent, only ½ percentage points higher than the baseline, by FY2019/20. The impact on debt and gross financing needs are expected to be mild.

- **Combined macro-fiscal scenario.** This scenario aggregates shocks to real growth, the interest rate, and the primary balance. The debt-to-GDP ratio would exceed 100 percent of GDP in FY2016/17 and remain at around 100 percent of GDP through the rest of the projection period. The impact on financing needs would also be significant, raising them to over 15 percent of GDP after FY2016/17.

- **Contingent fiscal shock.** Assume hypothetically that a banking crisis leads to one-time bail out of the financial sector, raising non-interest expenditures by 3 percent of banking sector assets. Real GDP is also reduced by one standard deviation for two years. Under this hypothetical scenario, the debt-to-GDP ratio would rise to over 110 percent of GDP, while gross financing needs would exceed 25 percent of GDP at its peak.

- **Stagnant growth scenario.** There is risk that the recent pick-up in growth would not sustain, because the UK's economy fails in raising productivity and rebalancing. Potential growth would not recover, and actual GDP growth is one percentage point lower than in the baseline. With subdued growth rates, revenue growth would lack buoyancy, and the revenue to GDP ratio falls short of that in the baseline by one percentage points of GDP. Under this scenario, debt would not be put clearly on a downward path, with the debt ratio staying at around 98 percent of GDP. Gross financing needs would hover around 15 percent of GDP.

United Kingdom: Public Sector Debt Sustainability Analysis (DSA)–Baseline Scenario

(in percent of GDP unless otherwise indicated)[1]

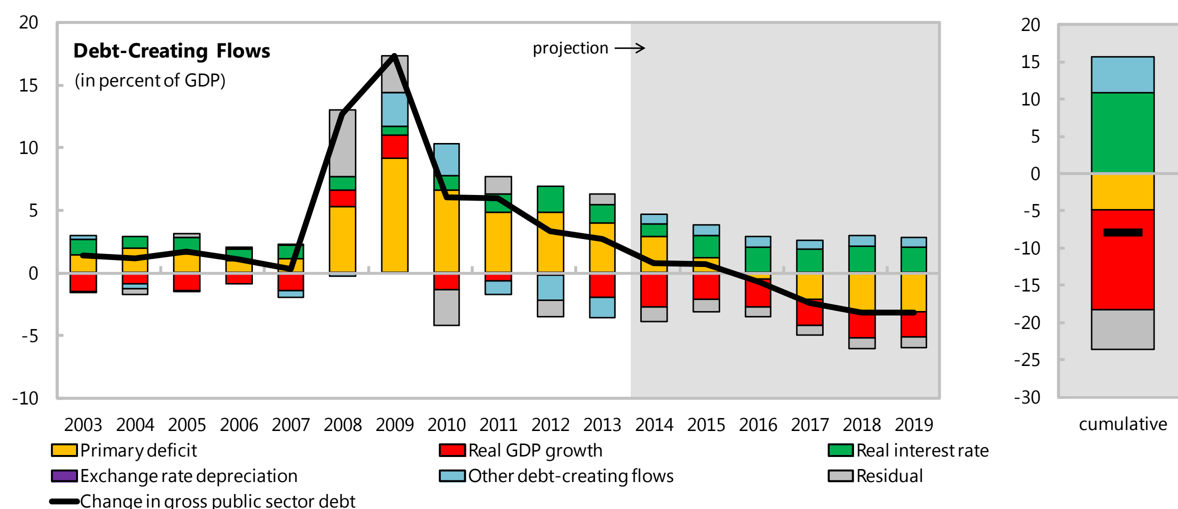
Debt, Economic and Market Indicators [2/]

	Actual			Projections					
	2003-2011 [3/]	2012	2013	2014	2015	2016	2017	2018	2019
Nominal gross public debt	55.5	88.6	91.3	92.0	92.7	92.0	89.6	86.5	83.4
Public gross financing needs	9.1	14.3	13.3	11.7	12.1	11.5	10.7	9.0	9.0
Real GDP growth (in percent)	1.4	0.3	2.3	3.2	2.5	2.5	2.4	2.4	2.4
Inflation (GDP deflator, in percent)	2.5	1.2	1.7	2.3	1.7	1.7	2.1	2.0	2.1
Nominal GDP growth (in percent)	3.9	1.4	4.0	5.6	4.2	4.2	4.5	4.5	4.6
Effective interest rate (in percent) [4/]	5.0	3.7	3.5	3.6	3.8	4.0	4.3	4.5	4.6

As of June 23, 2014		
Sovereign Spreads		
EMBIG (bp) 3/	142	
5Y CDS (bp)	19	
Ratings	Foreign	Local
Moody's	Aa1	Aa1
S&Ps	AAA	AAA
Fitch	AA+	AA+

Contribution to Changes in Public Debt

	Actual			Projections							
	2003-2011	2012	2013	2014	2015	2016	2017	2018	2019	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	5.3	3.4	2.7	0.8	0.7	-0.7	-2.4	-3.1	-3.1	-7.9	
Identified debt-creating flows	4.6	4.6	1.9	1.9	1.7	0.1	-1.6	-2.3	-2.3	-2.6	
Primary deficit	3.6	4.8	4.0	2.9	1.2	-0.5	-2.1	-3.2	-3.2	-5.0	0.8
Primary (noninterest) revenue and grants	36.8	37.0	37.0	36.6	37.0	37.3	37.3	37.3	37.3	222.9	
Primary (noninterest) expenditure	40.5	41.8	40.9	39.5	38.1	36.8	35.2	34.2	34.2	217.9	
Automatic debt dynamics [5/]	0.6	1.9	-0.5	-1.7	-0.4	-0.2	-0.2	0.0	0.0	-2.5	
Interest rate/growth differential [6/]	0.6	1.9	-0.5	-1.7	-0.4	-0.2	-0.2	0.0	0.0	-2.5	
Of which: real interest rate	1.1	2.1	1.5	1.1	1.8	2.0	1.9	2.1	2.0	10.9	
Of which: real GDP growth	-0.6	-0.2	-2.0	-2.8	-2.2	-2.2	-2.1	-2.1	-2.0	-13.4	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.4	-2.0	-1.6	0.8	0.9	0.8	0.7	0.8	0.8	4.8	
Cash adjustments incl. privatization(-)	0.4	-2.0	-1.6	0.8	0.9	0.8	0.7	0.8	0.8	4.8	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	0.7	-1.3	0.8	-1.1	-0.9	-0.8	-0.8	-0.8	-0.8	-5.3	



Source: IMF staff.

1/ In percent of fiscal year GDP, different from Table 3 where centered-fiscal year GDP is used.

2/ Public sector is defined as consolidated public sector.

3/ Based on available data.

4/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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

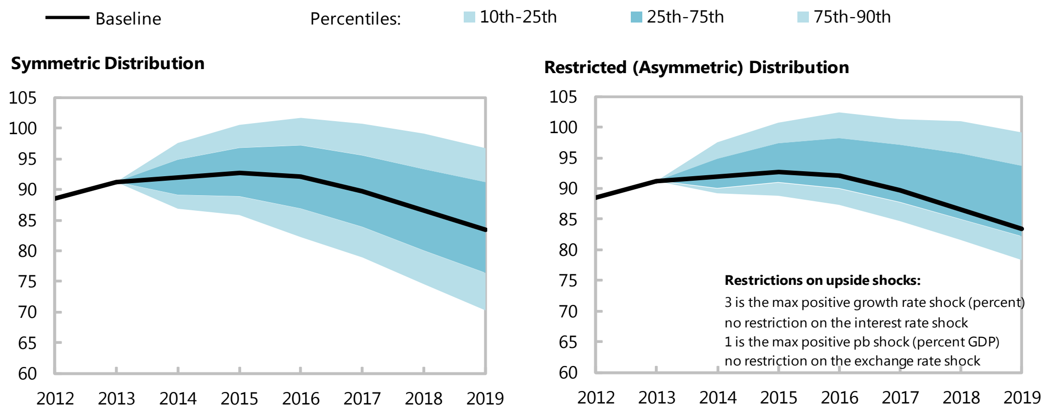
United Kingdom: Public DSA Risk Assessment

Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

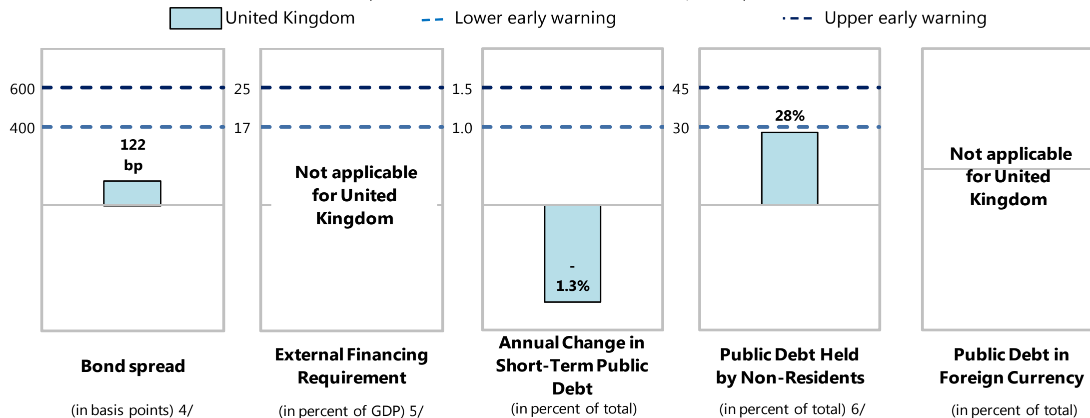
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2013)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

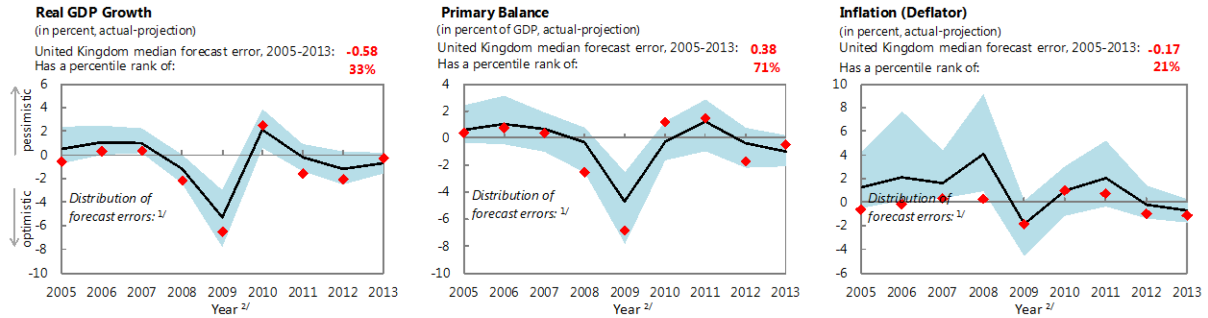
4/ Long-term bond spread over German bonds, an average over the last 3 months, 25-Mar-14 through 23-Jun-14.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

6/ Overseas holding of gilts.

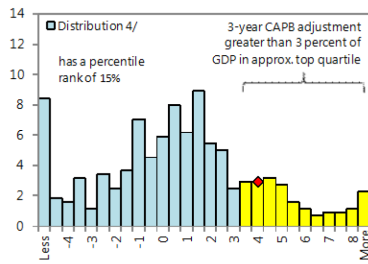
United Kingdom: Public DSA–Realism of Baseline Assumptions

Forecast Track Record, versus surveillance countries

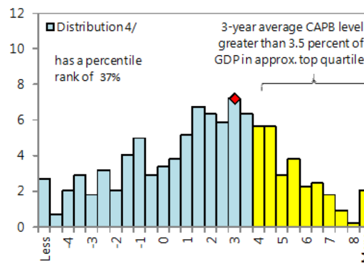


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)

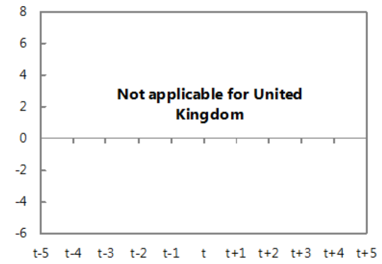


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Boom-Bust Analysis 3/

Real GDP growth
(in percent)

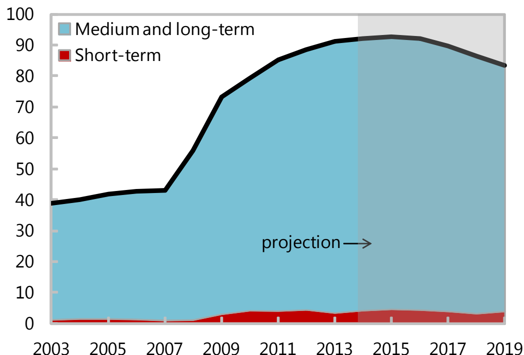


Source : IMF Staff.
1/ Plotted distribution includes surveillance countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for United Kingdom, as it meets neither the positive output gap criterion nor the private credit growth criterion.
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

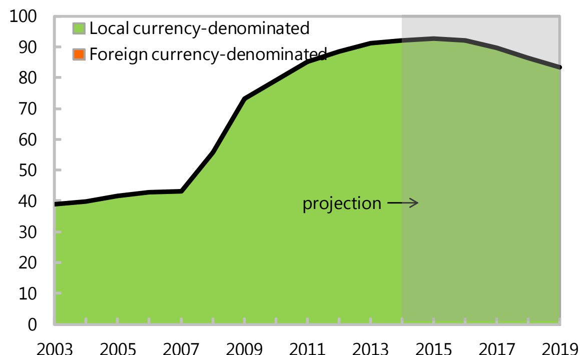
United Kingdom: Public DSA–Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



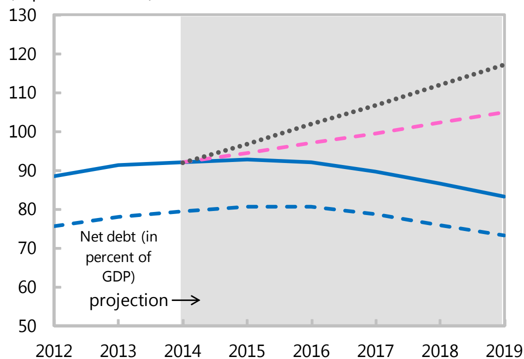
By Currency
(in percent of GDP)



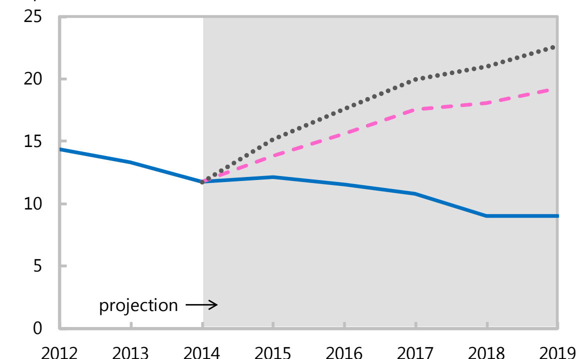
Alternative Scenarios

Baseline — Historical — Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

Baseline Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	3.2	2.5	2.5	2.4	2.4	2.4
Inflation	2.3	1.7	1.7	2.1	2.0	2.1
Primary Balance	-2.9	-1.2	0.5	2.1	3.2	3.2
Effective interest rate	3.6	3.8	4.0	4.3	4.5	4.6
Constant Primary Balance Scenario						
Real GDP growth	3.2	2.5	2.5	2.4	2.4	2.4
Inflation	2.3	1.7	1.7	2.1	2.0	2.1
Primary Balance	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9
Effective interest rate	3.6	3.8	4.0	4.2	4.3	4.4

Historical Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	3.2	1.1	1.1	1.1	1.1	1.1
Inflation	2.3	1.7	1.7	2.1	2.0	2.1
Primary Balance	-2.9	-4.0	-4.0	-4.0	-4.0	-4.0
Effective interest rate	3.6	3.8	4.0	4.2	4.3	4.4

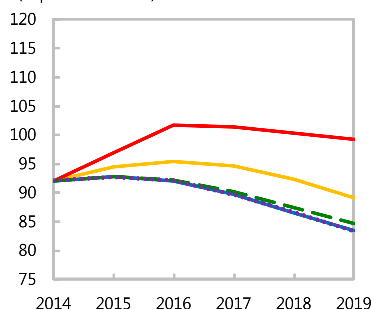
Source: IMF staff.

United Kingdom–Public DSA: Stress Test

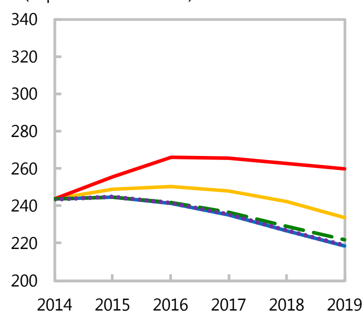
Macro-Fiscal Stress Tests

Baseline
Real GDP Growth Shock
Primary Balance Shock
Real Exchange Rate Shock
Real Interest Rate Shock

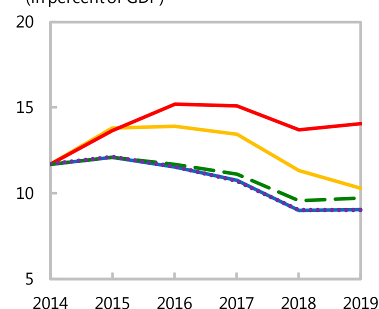
Gross Nominal Public Debt
(in percent of GDP)



Gross Nominal Public Debt
(in percent of Revenue)



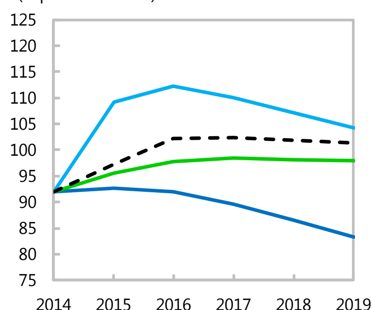
Public Gross Financing Needs
(in percent of GDP)



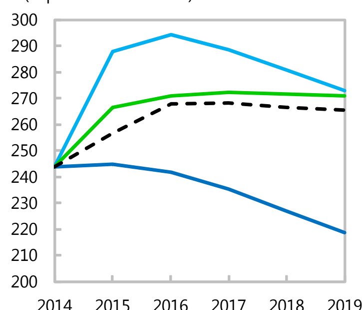
Additional Stress Tests

Baseline
Stangant growth
Combined Macro-Fiscal Shock
Contingent Liability Shock

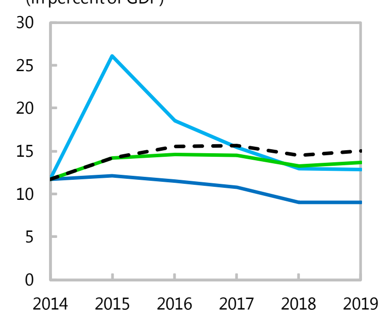
Gross Nominal Public Debt
(in percent of GDP)



Gross Nominal Public Debt
(in percent of Revenue)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

	2014	2015	2016	2017	2018	2019
Primary Balance Shock						
Real GDP growth	3.2	2.5	2.5	2.4	2.4	2.4
Inflation	2.3	1.7	1.7	2.1	2.0	2.1
Primary balance	-2.9	-2.9	-1.2	0.5	2.1	3.2
Effective interest rate	3.6	3.8	4.0	4.2	4.4	4.5
Real Interest Rate Shock						
Real GDP growth	3.2	2.5	2.5	2.4	2.4	2.4
Inflation	2.3	1.7	1.7	2.1	2.0	2.1
Primary balance	-2.9	-1.2	0.5	2.1	3.2	3.2
Effective interest rate	3.6	3.8	4.2	4.6	4.9	5.2
Combined Shock						
Real GDP growth	3.2	-0.1	0.0	2.4	2.4	2.4
Inflation	2.3	1.1	1.1	2.1	2.0	2.1
Primary balance	-2.9	-2.9	-1.9	-0.1	1.0	1.0
Effective interest rate	3.6	3.8	4.2	4.6	4.9	5.1
Stangant growth						
Real GDP growth	3.2	1.5	1.5	1.4	1.4	1.4
Inflation	2.3	1.7	1.7	2.1	2.0	2.1
Primary balance	-2.9	-3.2	-1.5	0.1	1.2	1.2
Effective interest rate	3.6	3.8	4.0	4.2	4.4	4.6

	2014	2015	2016	2017	2018	2019
Real GDP Growth Shock						
Real GDP growth	3.2	-0.1	0.0	2.4	2.4	2.4
Inflation	2.3	1.1	1.1	2.1	2.0	2.1
Primary balance	-2.9	-2.4	-1.9	-0.1	1.0	1.0
Effective interest rate	3.6	3.8	4.0	4.2	4.4	4.5
Real Exchange Rate Shock						
Real GDP growth	3.2	2.5	2.5	2.4	2.4	2.4
Inflation	2.3	1.7	1.7	2.1	2.0	2.1
Primary balance	-2.9	-1.2	0.5	2.1	3.2	3.2
Effective interest rate	3.6	3.8	4.0	4.3	4.5	4.6
Contingent Liability Shock						
Real GDP growth	3.2	-0.1	0.0	2.4	2.4	2.4
Inflation	2.3	1.1	1.1	2.1	2.0	2.1
Primary balance	-2.9	-14.7	0.5	2.1	3.2	3.2
Effective interest rate	3.6	3.9	4.3	4.5	4.7	4.8

Source: IMF staff.

INTERNATIONAL MONETARY FUND

UNITED KINGDOM

July 8, 2014

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By | **European Department**

CONTENTS

FUND RELATIONS ____ **2**

STATISTICAL ISSUES ____ **4**

FUND RELATIONS

(Data as of May 31, 2014)

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

General Resources Account

	SDR Million	Percent Quota
Quota	10,738.50	100.00
Fund holdings of currency	8,134.09	75.75
Reserve position in Fund	2,604.50	24.25
New arrangement to borrow	2,275.84	

SDR Department

	SDR Millions	Percent Allocation
Net cumulative allocations	10,134.20	100.00
Holdings	9,646.23	95.18

Outstanding Purchases and Loans: None

Financial Arrangements: None

Projected Payments to Fund (SDR million; based on present holdings of SDRs):

	Forthcoming				
	2014	2015	2016	2017	2018
Principal					
Charges/Interest	0.25	0.56	0.56	0.56	0.56
Total	0.25	0.56	0.56	0.56	0.56

Exchange Rate Arrangement:

The UK authorities maintain a free floating regime.

The United Kingdom accepted the obligations of Article VIII, Sections 2, 3, and 4 on February 15, 1961. It maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, except for exchange restrictions imposed solely for the preservation of national or international security. In accordance with UN resolutions and EU restrictive measures, the United Kingdom applies targeted financial sanctions under legislation relating to Al-Qaeda and Taliban, and individuals, groups, and organizations associated with

terrorism; and certain persons associated with: the former Government of Iraq, the former Government of Liberia, the current Government of Burma (aka Myanmar), the former Government of the Republic of Yugoslavia and International Criminal Tribunal Indictees, the current Government of Zimbabwe, the current government of Belarus, the current government of North Korea; the current government of Iran and persons considered to be a threat to peace and reconciliation in Sudan, Cote d'Ivoire, and Democratic Republic of Congo; and persons considered by the UN to have been involved in the assassination of former Lebanese Prime Minister Rafik Hariri. These restrictions have been notified to the Fund under Decision 144–(52/51).

Article IV Consultation:

The last Article IV consultation was concluded on July 15, 2013. The UK is on the standard 12 –month consultation cycle.

FSAP

The FSAP update was completed at the time of the 2011 Article IV Consultation. The next FSAP assessment is expected to be conducted in time for 2016 Article IV consultation discussions, in line with the usual five-year cycle for jurisdictions with systemically important financial sectors.

Technical Assistance: None

Resident Representatives: None

STATISTICAL ISSUES

Economic and financial data provided to the Fund are considered adequate for surveillance purposes. The United Kingdom subscribes to the Special Data Dissemination Standard (SDDS) and meets the SDDS specifications for the coverage, periodicity, and timeliness of data. SDDS metadata are posted on the Dissemination Standard Bulletin Board (DSBB). The UK plans to adopt the European System of National and Regional Accounts 2010 (ESA 2010) and the Balance of Payment and International Investment Position Manual, sixth edition (BPM6) in September 2014.

Table of Common Indicators Required for Surveillance
(As of June 16, 2014)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	Same day	Same day	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	May 2014	06/04/2014	M	M	M
Reserve/Base Money	May 2014	06/05/2014	W	M	M
Broad Money	April 2014	06/02/2014	M	M	M
Central Bank Balance Sheet	May 2014	05/29/2014	W	W	W
Consolidated Balance Sheet of the Banking System	April 2014	06/02/2014	M	M	M
Interest Rates[2]	Same day	Same day	D	D	D
Consumer Price Index	April 2014	05/20/2013	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q4 2013	05/23/20143	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	April 2014	05/22/2014	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	April 2014	05/22/2014	M	M	M
External Current Account Balance	Q4 2013	05/28/2014	Q	Q	Q
Exports and Imports of Goods and Services	April 2014	06/06/2014	M	M	M
GDP/GNP	Q1 2014	05/22/2014	Q	Q	Q
Gross External Debt	Q4 2013	05/28/2014	Q	Q	Q

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local government

[5] Including currency and maturity composition.

[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

INTERNATIONAL MONETARY FUND
COM
COMMUNICATIONS DEPARTMENT

Press Release No.14/365
FOR IMMEDIATE RELEASE
July 28, 2014

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Concludes 2014 Article IV Consultation with the United Kingdom

On July 23, 2014 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the United Kingdom.[1]

The economy has rebounded strongly and prospects are promising. Headwinds that previously held back the economy—including adverse credit conditions and diminished confidence—have eased. There are signs that demand is becoming more balanced, with growth in business investment now ahead of private consumption. Employment growth has remained strong. Despite this, inflation has been contained.

Nonetheless, sustaining strong growth will depend on a recovery in productivity growth and real wages. In addition, the housing market is becoming buoyant, potentially creating financial stability risks. Further demand rebalancing is needed: net trade has made only a modest contribution to the recovery, and the real exchange rate is moderately overvalued.

Policies have been directed toward supporting growth, while strengthening public finances through a mix of revenue and expenditure measures and ensuring financial stability. Monetary policy remains highly accommodative, and effective monetary conditions have eased compared with last year. A number of micro-prudential and credit policy measures have been introduced in an effort to take some of the steam out of the housing market, such as modification of the Funding for Lending Scheme and the introduction of tighter underwriting standards for owner-occupier mortgages. The Financial Policy Committee of the Bank of England has also recommended the implementation of macroprudential measures aimed at insuring against excessive household indebtedness. Meanwhile, the 2014 Budget implies a half-percentage point tightening in the cyclically-adjusted primary balance. Going forward, fiscal policy aims to eliminate the budget deficit by FY2018 and to put the debt

[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.

ratio firmly on a downward path while preserving the delivery of quality public services and paying due attention to social equity.

After the overhaul of the UK's financial regulatory architecture in 2013, which saw the establishment of the Prudential Regulation Authority, Financial Conduct Authority, and Financial Policy Committee, efforts to strengthen bank balance sheets and implement durable structural reforms to the financial sector have continued. These include higher bank capital and provisioning, a robust multi-pronged framework for assessing capital adequacy, and stress testing of major banks for large shocks. Liquidity backstops have been strengthened, which should help solvent UK banks ride out temporary funding stresses that could otherwise create domestic and outward credit spillovers. But easier access to liquidity requires commensurately strong supervision of banks and other financial intermediaries.

Executive Board Assessment[2]

Executive Directors welcomed the rebound in output and employment in the UK economy amid improved credit conditions and confidence. They agreed that the overall policy mix is appropriate in view of remaining slack in the economy and a continued weak external environment, but encouraged the authorities to readily adjust the policy settings should inflation accelerate. Directors emphasized that sustaining strong growth and improving competitiveness will require a recovery in productivity growth and further demand rebalancing.

Directors supported the authorities' near-term fiscal consolidation efforts, stressing the importance of strengthening public finances without undermining economic growth. They saw a need to continue these efforts in the medium term in order to put debt on a downward path. They encouraged the authorities to explore both revenue and expenditure measures, taking into account efficiency and equity considerations, while maintaining delivery of key public services. In this regard, Directors also welcomed the authorities' efforts to analyze the distributional impact of fiscal consolidation.

Directors agreed that maintaining the accommodative monetary policy stance is appropriate in the immediate term. They noted the Bank of England's strategy and intentions to raise the policy rate first when the time comes for normalizing monetary policy, and pointed out the need for flexibility in policy sequencing as developments warrant. In this context, Directors highlighted the particular importance of clear communications on the factors that would guide the decisions of the Monetary and Financial Policy Committees.

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Directors agreed that macroprudential measures should be the first line of defense against financial stability risks arising from the housing market, and welcomed the micro- and macroprudential measures that have already been taken. They encouraged the authorities to stand ready to adjust the limits under the existing measures, modify the terms of the Help to Buy scheme, or undertake new steps, should financial vulnerabilities escalate. They noted that the Bank of England may need to consider raising interest rates in case macroprudential measures prove insufficient, but called for careful consideration of potential implications for growth and employment of such policy action. Directors agreed that strong house price growth in the U.K. may ultimately reflect inadequate supply and that further supply-side measures would be needed, including eliminating unnecessary restrictions on development and reforming property taxation.

Directors concurred with the importance of safeguarding the financial sector, and welcomed the measures to raise bank capital, strengthen the financial system's resilience, and enhance prudential supervision. They noted that further efforts to bolster bank capital over the medium term are likely to be needed, and that ongoing efforts to address bank misconduct and the Too-Important-to-Fail problem remain essential. Directors encouraged the authorities to be alert to a build-up of risks in the shadow banking system, maintain strong coordination across regulatory bodies, and ensure international consistency of national reforms. They also underscored the importance of broadening the institutional perimeter of the stress tests and strengthening supervision beyond the major banks.

Over the medium term, Directors encouraged the authorities to undertake the necessary structural reforms to raise productivity, enhance competitiveness, and bolster the economy's long-term growth potential. They agreed that priority areas could include infrastructure, especially transportation and energy, education and training, immigration, and financial intermediation.

United Kingdom: Selected Economic Indicators, 2012–15

	2012	2013	2014 Proj.	2015 Proj.
Real Economy (change in percent)				
Real GDP	0.3	1.7	3.2	2.7
Domestic demand	1.2	1.7	3.0	2.6
Private final domestic demand	1.3	2.0	3.3	3.5
CPI, end-period	2.6	2.1	1.9	2.0
Unemployment rate (in percent) 1/	8.0	7.6	6.9	6.3
Gross national saving (percent of GDP)	10.9	10.1	11.2	12.1
Gross domestic investment (percent of GDP)	14.7	14.5	15.2	15.6
Public Finance (fiscal year, percent of GDP) 2/				
Public sector overall balance	-6.9	-5.8	-4.8	-3.6
Public sector cyclically adjusted overall balance (staff estimates) 3/	-2.6	-2.1	-1.8	-0.7
General government gross debt	88.5	91.1	92.0	92.9
Public sector net debt	74.2	75.8	77.8	79.0
Money and Credit (end-period, 12-month percent change)				
M4	-1.0	0.2	...	...
Net lending to private sector	-0.2	0.9	...	...
Interest rates (percent; year average)				
Three-month interbank rate	0.8	0.5	...	...
Ten-year government bond yield	1.9	2.5	...	...
Balance of Payments (percent of GDP)				
Current account balance	-3.8	-4.4	-4.0	-3.5
Trade balance	-2.1	-1.7	-1.3	-1.3
Net exports of oil	-1.0	-1.1	-0.9	-0.9
Exports of goods and services (volume change in percent)	1.7	1.0	1.9	3.3
Imports of goods and services (volume change in percent)	3.4	0.5	1.4	3.0
Terms of trade (percent change)	-0.3	0.9	0.3	-0.1
FDI net	-0.4	-0.7	-0.5	-0.6
Reserves (end of period, billions of US dollars)	99.9	101.5	...	...
Fund Position (as of May 31st, 2014)				
Holdings of currency (in percent of quota)			75.8	
Holdings of SDRs (in percent of allocation)			95.2	
Quota (in millions of SDRs)			10,738.5	
Exchange Rates				
Exchange rate regime			Floating	
Bilateral rate (June 17th, 2014)			US$1 = £0.5896	
Nominal effective rate (2005=100) 4/		82.1	80.1	...
Real effective rate (2005=100) 4/ 5/		89.3	88.5	...

Sources: Bank of England; IMF's International Finance Statistics; IMF's Information Notic System; HM Treasury; Office for National Statistics; and IMF staff estimates.

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

2/ The fiscal year begins in April. Data exclude the temporary effects of financial sector interventions. Debt stock data refers to the end of the fiscal year using centered-GDP as a denominator.

3/ In percent of potential output.

4/ Average. An increase denotes an appreciation.

5/ Based on relative consumer prices.

Statement by Mr. Steve Field, Executive Director for United Kingdom
July 23, 2014

I thank staff for a very productive mission and thorough Article IV report. My authorities broadly agree with the staff analysis, note that staff considers the overall policy mix appropriate and, notwithstanding the entrenched recovery, agree with staff that efforts should continue to ensure the UK is more resilient to ongoing domestic and external challenges.

Economic Outlook

The UK economy is moving into expansion with the composition of the economic recovery broadening and becoming more sustainable.

WEO projections show the UK is expected to grow at 3.2 per cent this year, faster than any other major advanced economy, and 2.7 per cent in 2015. GDP growth in Q1 was 0.8 per cent, the fourth consecutive quarter of growth around or above its pre-crisis average rate. Recent survey data for the services, construction and manufacturing sectors remains strong, pointing to growth continuing around these rates.

The recovery now appears more broad-based than previously estimated, with the pickup in growth in 2013 associated with an increase in both household consumption and business investment growth (with investment increasing 10.6 per cent over the year to the first quarter of 2014).

Sustained output growth has not yet been accompanied by a material pickup in productivity. Looking forward, the Bank of England's Monetary Policy Committee (MPC) expects there will be a gradual recovery in productivity as demand strengthens and the economy recovers. The pickup in business investment gives some positive indications, but the rate of productivity growth over the next couple of years is unlikely to materially exceed pre-crisis rates. Nevertheless, this anticipated gradual improvement in supply capacity means that, on the basis of the current forecasts for demand growth, the absorption of slack is expected to slow over the forecast period compared with the recent past.

The employment picture has been positive. Over 1.5 million jobs have been created in less than three years. Unemployment has fallen from a peak of 8.4 per cent in 2011 to 6.5 per cent – its lowest level for over five years.

Over the same period, inflationary pressures have abated, with inflation falling from a peak of 5.2 per cent in 2011 to 1.9 per cent in June, close to the Bank's 2 per cent inflation target. In June, the MPC judged that under market interest rate expectations, the economy remained on course to meet the 2 per cent inflation target and to eliminate spare capacity over the next two to three years.

The UK's current account deficit is large by historical standards, at 4.5 per cent of nominal GDP in 2013. The recent widening primarily reflects the investment income surplus reversing to a deficit driven by falling profits abroad of UK firms. The MPC expects the trade deficit to be broadly stable over the next three years. The Office for Budget Responsibility's (OBR) projections are consistent with a narrowing of the current account deficit to 1.5 per cent by 2018.

Whilst the global outlook is improving, ongoing domestic and external challenges remain. The Government's strategy to promote a strong and sustainable recovery is built on: monetary activism; deficit reduction; structural reforms; and reform of the financial system.

Monetary activism

Monetary policy continues to play an important role in supporting the economy. Following the global financial crisis, the MPC reduced and held Bank Rate to its historically low level of 0.5 per cent and purchased a stock of assets amounting to £375 billion.

In last year's Article IV the Fund recommended that reassurance could be provided that policy rates will remain low until the recovery reaches full momentum and noted that greater transparency about future policy rates could therefore be a useful tool. Consistent with this, in August 2013, the MPC provided guidance on the future stance of monetary policy, stating its intention not to raise Bank Rate at least until the unemployment rate fell to a threshold of 7 per cent, subject to maintaining price and financial stability. Unemployment has since fallen sharply as the recovery has gained momentum and fell below 7 per cent in April. Reflecting that good news, the MPC provided new guidance in February to make clear that when the MPC does start to raise Bank Rate, it expects to do so gradually, and to a level materially below its pre-crisis average.

Forward guidance has been a useful tool. Surveys of businesses to assess the effects of the initial phase of guidance found that the majority of companies consider policy guidance had made them more confident about UK economic prospects. On balance, companies indicated it had caused them to bring forward or increase spending and increase hiring. There was little reaction in financial markets to the transition between the two phases of policy guidance.

Macroprudential policies and the housing market

UK house price inflation has strengthened in line with the improved economic outlook, reflecting increasing demand for house purchases, which in turn has been supported by reduced economic uncertainty and improved credit conditions. UK house prices have increased by 10.5 per cent in the year to May 2014. Price increases have been most pronounced in London and the South East, while house prices excluding these regions have only increased by 6.4 per cent in the year to May. House prices in real terms remain around 5 per cent lower than they were in 2007. The Bank's central view suggests annual house price inflation will continue at current levels until mid-2015, after which it is expected to slow and grow broadly in line with incomes from 2016.

Debt-servicing ratios have remained low, reflecting longer mortgage terms and low mortgage rates. The average gross debt-servicing ratio on new mortgage lending has been less than 19 per cent of borrowers' incomes in recent quarters, lower than at any point since at least 2005. Loan to value (LTV) ratios on new mortgages have risen modestly, but remain below historical averages. More generally, housing market activity has shown early signs of a cooling since the start of the year. Most notably, mortgage approvals fell for the third consecutive month in April and were 17 per cent below the January 2014 peak.

Currently there is no imminent financial risk associated with the housing market, but there is a need to remain vigilant. Over the past year, house price inflation has begun to broaden geographically across the UK. The share of lending at higher loan to income (LTI) multiples on new lending for owner-occupier house purchase has increased. In the four quarters to 2014 Q1, around 10 per cent of lending for house purchase was extended at an LTI at or above four-and-a-half times income; this compares to 6.5 per cent in the immediate pre-crisis period, 2005–07. Continued growth in housing activity and sustained increases in house prices relative to incomes could to lead to further increases in the share of mortgages advanced at higher LTI multiples, increasing the proportion of highly indebted households. To guard against these risks the authorities have taken policy action.

The new Financial Policy Committee (FPC) in the Bank of England has been given the authority to act should housing market pressures represent a threat to the resilience of the UK financial system and economy. In June, the Government announced that the FPC would be given explicit powers of direction to limit the proportion of high LTI and LTV mortgages. The authorities had taken a number of measures before the Article IV mission: at the end of last year they refocused the Funding for Lending Scheme away from mortgages towards small business lending; earlier this year more rigorous mortgage standards were introduced; and a UK tailored stress test (part of the EU-wide stress test coordinated by the European Banking Authority (EBA)) will assess the resilience of system to a marked fall of 35 per cent in house prices and substantial increase in interest rates.

Since the mission, the FPC has announced two further measures to protect against the risk of a marked loosening in underwriting standards and a further significant rise in the number of highly indebted households. First, that when lenders are assessing applications for mortgages they test whether the mortgage would be affordable if the prevailing Bank Rate were to be 3 per cent higher than at loan origination. And second, that no more than 15 per cent of a lender's flow of new mortgages should be at or above four-and-a-half times the borrower's income.

The LTI ratio is <u>not</u> designed to bite now on the market as a whole, nor in the future, if the economy evolves in line with the Banks central forecasts. Rather it will only bind if pressures increase above current forecasts. In addition, most lenders are already testing whether borrowers could afford mortgages if interest rates were to rise by around 3 per cent, but the FPC's recommendation is intended to stop that from slipping. Both measures would act to constrain risks if house prices grow more than we expect, incomes grow less, or underwriting standards slip. The FPC will keep these measures under review.

The fundamental problem, however, is that the growing demand for homes must be met by growing supply. The Government is committed to reforms to address the long term structural issues in the housing market, including increasing housing supply and reform of the planning system. At Budget 2014 the Government announced measures to support the building of over 200,000 new homes, including the extension of Help to Buy equity-loan scheme to March 2020. The Government has also introduced the National Planning Policy Framework (NPPF) that replaces the previous fragmented system with a unified framework. Planning approvals are now at their highest level since 2008 with 88 per cent of applications approved in Q4 2013 and 174,000 planning permissions granted in England in 2013, the highest annual figure since 2007.

Deficit reduction

The deficit is forecast to have fallen by a half as a percentage of GDP by 2014-15, but it will still be too high at 5.5 per cent. Faster growth alone will not balance the books. The OBR expects public sector net debt to be 74.5% of GDP this year and expects it to peak at 78.7% in 2015-16 – lower than the 80% previously forecast - before falling. General government gross debt is expected to peak at 93.1 per cent in 2015-16. Continued implementation of the government's medium-term fiscal consolidation plan is necessary to tackle these high levels of public debt, which divert resources toward higher interest payments and away from public services, and increase the UK's vulnerability to future shocks. The government welcomes the IMF's judgment that the pace and composition of the deficit reduction in the near-term and the goal to eliminate the overall deficit by 2018-19 is appropriate.

The UK general election is scheduled for 7 May 2015 and as such detailed fiscal consolidation plans are only specified through 2015/16. Further savings will be required to support the government's commitment to put the public finances on a sustainable path. The Chief Secretary to the Treasury has asked the Minster for the Cabinet Office to set out an ambitious new efficiency programme to deliver savings from 2016-17 and across the next Parliament.

The government's fiscal consolidation plan envisaged a split of 80 - 20 between spending and tax. All the tax measures have been delivered. Efforts to drive efficiencies and reduce wasteful expenditure have already yielded savings of £20 billion a year compared to 2009-10. Spending Round 2013 identified a further £5 billion additional efficiency savings in 2015-16. At the same time significant reductions in overall departmental spending have been delivered while protecting education and health and maintaining broader public service outcomes.

To further manage spending pressures, the government has brought a material amount of spending under new controls through the introduction of the welfare cap. The welfare cap is a nominal spending limit for "welfare in scope" (state pension and counter-cyclical spending excluded) in each year of the forecast starting from 2015-16. The OBR will report annually on the government's performance against the cap, starting in Autumn 2014. This is an important improvement in spending control and budget management.

As highlighted in the IMF's analysis, the government publishes analysis at each fiscal event showing the breakdown of the cumulative impact of the fiscal policy changes on households by income distribution. The government is mindful of the distributional impacts of fiscal consolidation and the analysis shows that households in the top income quintile make the greatest contribution towards reducing the deficit, both in cash terms and as a percentage of their income and benefits in kind from public services.

In December 2013 the government announced a review of the current fiscal framework – in line with the objective to revisit the design of the fiscal framework once the public finances were closer to balance. The outcome of the review will inform an updated Charter for Budget Responsibility, which will be presented to Parliament alongside Autumn Statement 2014.

Structural reform

Structural reforms remain very high on the government's agenda to rebalance and strengthen the economy. Particular focus has been placed on prioritising infrastructure investment. In this context, and as the IMF have recognised, the government has already taken a number of steps to switch current spending to capital spending to support the quality of the fiscal consolidation and long-term productivity growth. In June 2013, the government provided greater long-term certainty by setting out commitments for over £100bn of capital spending out to 2020-21.

The National Infrastructure Plan 2013 sets out a refreshed infrastructure pipeline of investment worth over £375 billion. The NIP also includes a provision of up to £40 billion of support for critical infrastructure projects through the UK Guarantees Scheme.

The government has also taken action to equip young people with the skills they need to compete in the labour market. At Budget 2014 the government expanded the Apprenticeship Grants for Employers scheme, by providing an extra £85 million in both 2014-15 and 2015-16 for over 100,000 grants to employers.

Reform of the Financial System

Delivering and completing necessary financial regulatory reforms and repair continues to be a priority, building on recent progress.

The new more focused architecture for judgment-led financial regulation and supervision has been up and running since April 2013. Since the crisis broke, banks in the UK and elsewhere have made significant progress in rebuilding capital. The FPC therefore decided in June to close its recommendation of March last year that the largest UK banks and building societies should meet a minimum 7 per cent Common Equity Tier One ratio (set out in the EU rules to implement Basel III) after adjustments for expected future losses, future conduct costs, and a more prudent calculation of risk weights. The capital adequacy framework has made much needed progress in recent years. The leverage ratio is a very useful complement, which is why the Prudential Regulation Authority has moved to using a baseline leverage ratio more

rapidly than the international standard requires. The FPC is currently consulting on the scope and form of its application.

As part of this, further improvements to the quantity and quality of banks' capital should bolster their resilience to unexpected shocks. Earlier this year, the EBA announced details of its 2014 stress-testing exercise. In addition, several UK banks and building societies will participate in a UK variant of the EBA's stress test focusing on a housing shock. In combination, these measures can enhance the safety and soundness of firms and improve the resilience of the financial system as a whole by ensuring that institutions fund their activities with sufficient capital.

Many of the key pieces of structural banking reform have been agreed and are already in the process of being implemented. The Banking Reform Act, which received Royal Assent in December 2013, introduces significant structural and cultural changes to the banking system. This includes giving the government the power to require the 'ring-fencing' of the deposits of individuals and small businesses and the authorities power to ensure that banks are more able to absorb losses. In June, the Bank announced it would extend the scope of its liquidity facilities to the UK's biggest broker dealers and to central counterparties. Progress also continues to implement the global financial reform agenda, including enhancing competition in the financial sector, with work towards policy agreement ongoing in areas like shadow banking and completing reforms to enhance cross-border resolution.

The government recently announced further steps to raise standards of conduct in the financial system with a joint review by the Treasury, the Bank and the Financial Conduct Authority (FCA) into the way wholesale financial markets operate. It builds upon the tough action the UK has already taken to tackle misconduct, including the work of the FCA to reform LIBOR and the Parliamentary Commission on Banking Standards which has led to a new legal regime for senior managers. Strong and successful financial services that set the highest standards are an essential part of building a resilient economy and ensuring the UK financial system remains a global public good.