2006 International Monetary Fund March 2006
IMF Country Report No. 06/86

United Kingdom: 2005 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the United Kingdom

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2006 Article IV consultation with United Kingdom, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on December 19, 2005, with the officials of the United Kingdom on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on February 15, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its March 1, 2006 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for United Kingdom.

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

Selected Issues Paper

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

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INTERNATIONAL MONETARY FUND

UNITED KINGDOM

Staff Report for the 2005 Article IV Consultation

Prepared by the Staff Representatives for the 2005 Consultation with the United Kingdom

Approved by Michael Deppler and Juha Kähkönen

February 15, 2006

- Article IV consultation discussions were held during December 8–19, 2005. The mission team, which comprised Ms. Schadler (head), Mr. Morsink, Mr. Hunt, Ms. Honjo, Ms. Iakova (all EUR), Ms. Ong (MFD), Mr. Botman (FAD), and Mr. Andersson (Swedish Riksbank), met with the Chancellor of the Exchequer, the Governor of the Bank of England, the Chief Executive Officer of the Financial Services Authority, and other senior government officials, as well as representatives from research institutes, labor and business organizations, and financial institutions. Mr. Scholar and Mr. Gregory (OED) attended most meetings.

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

- The Labour Government was re-elected to a third consecutive term in May 2005.

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

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EXECUTIVE SUMMARY

Background

Macroeconomic performance over the past decade has been strong and steady, due in part to confidence-enhancing policy frameworks and generally sound implementation. However, in 2005, growth slowed and inflation rose, reflecting an abrupt deceleration of house price increases and a sharp increase in oil prices. While public debt is moderate, the fiscal deficit remained above 3 percent of GDP in FY2004/05. The financial system is generally healthy, although a substantial increase in the pricing of risk would pose risks. Evidence that a portion of the population is not saving enough for retirement is raising concerns about the political sustainability of the relatively frugal state pension system.

Key policy issues

Outlook: In 2006–07, growth is likely to pick up and CPI inflation to stabilize at the target. However, large uncertainties—particularly from house prices, energy prices and immigration—surround prospects for demand and supply. The current account deficit and the negative net international investment position are not major concerns. The Treasury sees the output gap as sizable but others—including staff—consider it to be modest.

Monetary policy: Staff agreed with the BOE's response to slowing demand and rising inflation in 2005, including the ¼ percentage point interest rate cut in August. MPC members and staff generally considered the current policy stance to be appropriate, though some MPC members saw downside risks to the growth forecast. Staff advocated that policy rate decisions be focused in the very near term on averting second round effects of the energy price increase and—after the pay rounds in early 2006—on ensuring that the recovery of demand to trend growth is sustained.

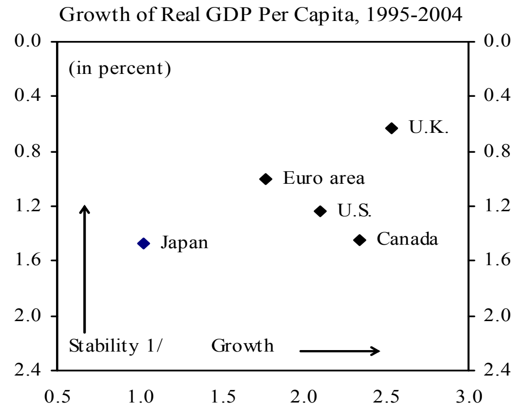
Fiscal policy: The overall deficit is projected to narrow to 3 percent of GDP in FY2005/06, reflecting mainly higher revenues from energy production and the booming financial sector. The deficit is expected to narrow further over the medium term, due to expenditure restraint, a tax increase on North sea oil and gas producers, and revenue buoyancy as the output gap closes. On the basis on the same policy assumptions, the Treasury projects a deficit of 1½ percent of GDP in the medium term, while staff project 2 percent of GDP—still adequate to stabilize debt at about 40 percent of GDP. The main difference between the projections relates to the revenue gain from closing the output gap.

Financial stability: The banking system is well-capitalized and highly profitable. The health of the insurance sector has improved substantially. Credit risk transfer instruments are helping to diversify credit risk, but their rapid growth may also be creating new risks. Payment and settlement systems have been strengthened.

Pensions: The Pensions Commission has proposed reforms that would largely address the main obstacles to private saving for retirement identified last year. Treasury officials raised several questions, including about affordability, a concern shared by staff.

I. Overview

1. **Macroeconomic performance in the U.K. over the past decade has been strong and steady**. Between 1995 and 2004, the growth of real GDP per capita was higher and less volatile than in other G7 countries. Unemployment and inflation were low and stable, and the current account deficit was moderate. This impressive performance was due in part to confidence-enhancing frameworks for monetary, fiscal, financial, and structural policies, as well as generally sound implementation (Box 1).



1/ Standard Deviation (inverted scale).

Box 1. Fund Policy Recommendations and Implementation[1]

Fiscal policy: For several years, the Fund has pressed for policy measures to narrow the large fiscal deficit and ensure that the fiscal rules are met. While the proposed adjustment was not initiated immediately, better-than-expected oil and personal income tax revenue performance and recent commitments have narrowed the gap between policy and Fund advice. The Fund and the authorities share the view that the rules-based fiscal framework has constrained discretion and allowed automatic stabilizers to operate. In the past year, the authorities broadened the scope of independent audit of the budget assumptions, as recommended by the Fund.

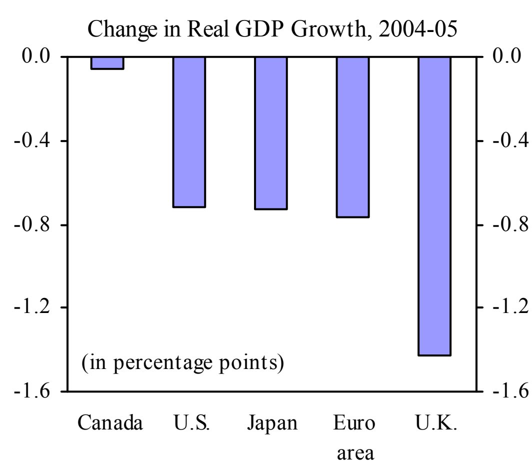
Monetary policy: The Fund has praised the inflation targeting framework for its overall design and consistently strong implementation.

Financial stability: In line with the recommendations of the 2002 FSAP, the authorities have enhanced their surveillance of the financial system, improved the supervision of insurance companies, and strengthened payment and settlement systems.

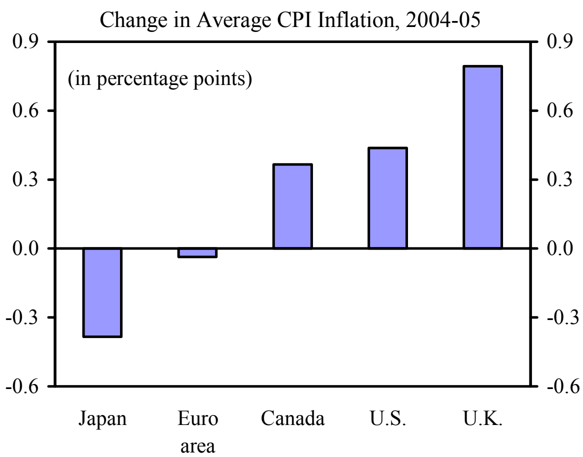
Structural policies: The Fund has supported the authorities' strategies to boost productivity growth, increase labor force participation, and encourage housing supply.

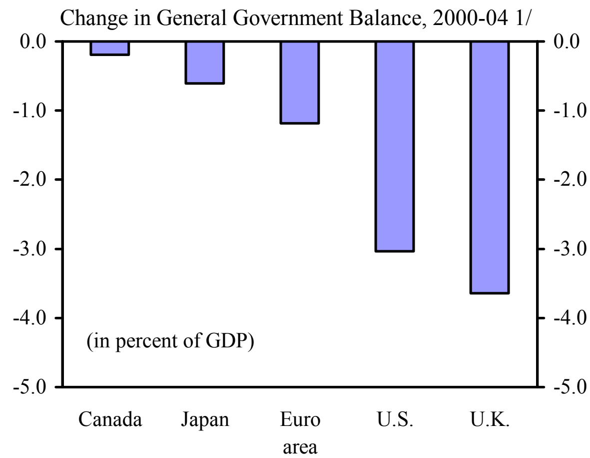
1/ The latest Public Information Notice is available at http://www.imf.org/external/np/sec/pn/2005/pn0527.htm

2. **However, in 2005, policymakers faced their toughest challenges in several years**. The slowdown in real GDP growth and the rise in inflation were sharper than in other G7 countries, presenting a dilemma for monetary policy. The deterioration in the general government balance between 2000–04 was greater than in other G7 countries, so the fiscal deficit was large coming into 2005. While the health of the U.K. banking system compares favorably with that in other G7 countries, the possible reversal of unusually low



long-term interest rates in global financial markets poses a risk to the U.K., given the size of its financial sector. Over the very long term, the political sustainability of the U.K.'s relatively frugal state pension system depends on workers saving enough for retirement, but evidence suggests that they are not doing so.





1/ calendar year.

II. Background

3. **Slowing growth and rising inflation in 2005 reflected the U.K.'s advanced cyclical position, the abrupt deceleration in house prices, and the sharp increase in oil prices** (Table 1). With economic activity above potential in 2004, some easing of growth and rise of inflation were expected. In the event, the slowdown, which may be overstated in the current national accounts data, was sharper than expected.[1] It was driven primarily by private consumption, which reflected previous monetary policy tightening, the cooling of the housing market, and rising tax revenues (Box 2). In line with the deceleration in the increase of house prices, the growth of residential investment fell sharply; business investment growth was steady. As domestic demand decelerated, import growth slowed, but a drop in net services inflows (due in part to insurance payments related to Hurricane Katrina) led to a slight widening of the current account deficit. Employment growth remained surprisingly rapid, owing in part to strong supply effects (immigration and increased labor force participation by older people). The rise in CPI inflation reflected both the earlier testing of supply constraints and the sharp increase in energy prices.

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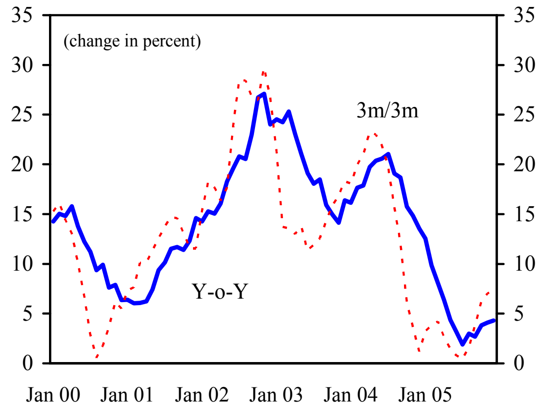
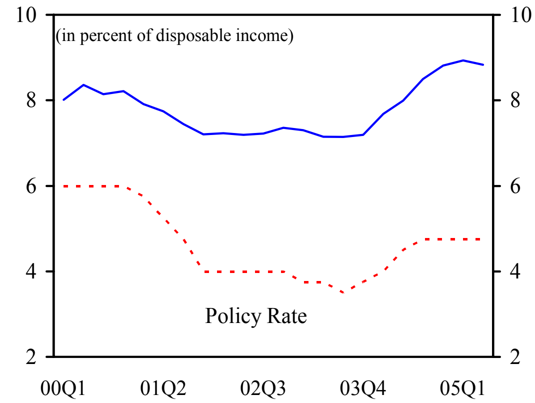
[1] Current national accounts data for the first half of 2005 may overstate the slowdown, as other indicators (employment, business surveys, profits, and tax receipts) imply stronger activity. Real GDP growth is revised up after three years on average by ½ percentage point.

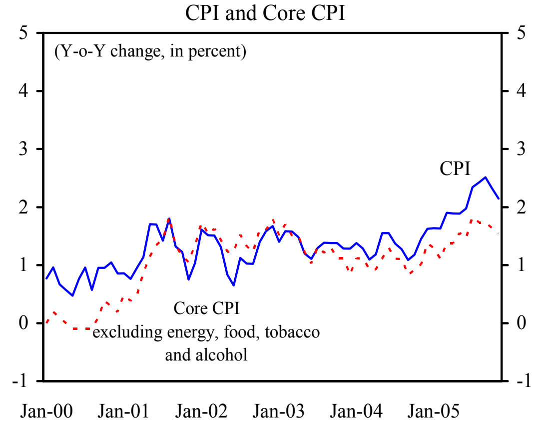
Nominal House Prices



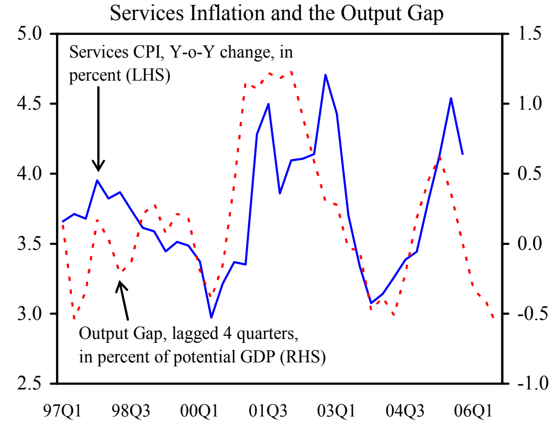
Household Interest Payments and Policy Rate



CPI and Core CPI



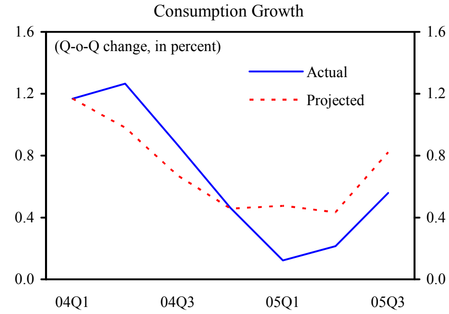
Services Inflation and the Output Gap



Box 2. Consumption and Housing Wealth

The cooling of the housing market over the past year can explain part of the recent weakness in consumption. Staff have re-examined the relationship between consumption, disposable income, unemployment, interest rates, financial wealth, and housing wealth, using data from 1987 (after financial liberalization) –2005.[1] An error-correction model suggests that a 10 percent increase in housing wealth boosts consumption by about 0.7 percent in the long run, though the uncertainty surrounding this estimate is large.

Consumption Growth

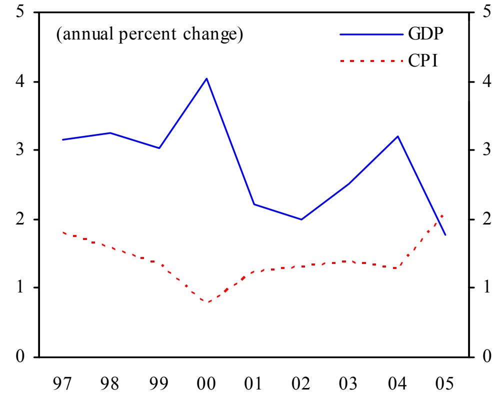


The model captures well the slowdown in consumption growth between mid-2004 and mid-2005. A counterfactual exercise suggests that—if real housing wealth had continued to rise by about 2 percent per quarter (the average in 2003) instead of flattening out—quarterly consumption growth would have been higher by about ¼ percentage point. Looking forward, if house prices grow less quickly than nominal GDP, the household saving rate is likely to rise further.

1/ Selected Issues Paper, *The Link between Private Consumption and the Housing Market.*

4. **The lowest growth rate and highest inflation rate since BOE independence presented monetary policy with conflicting signals**. In the early part of this decade, the desirable direction of monetary policy changes had been more straightforward: loosening during the downturn of 2001–02 and tightening again as growth picked up in 2003–04. In 2005, by contrast, monetary policy confronted a simultaneous slowdown in aggregate demand and a sharp rise in energy prices. The latter produced an increase in the overall price level and the risk of second-round effects on inflation. A further consideration was the strength of immigration, especially from new EU members, which may have boosted labor supply relative to demand for goods and services. The only policy rate change in 2005 was a ¼ percentage point cut to 4½ percent in August.

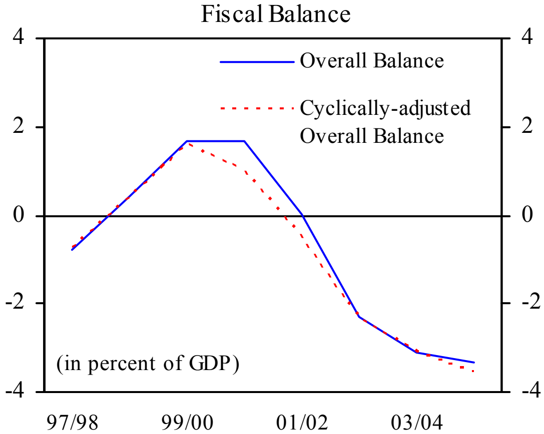
Growth and Inflation 1/



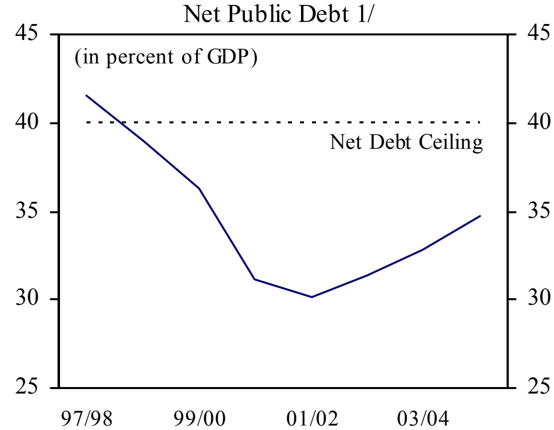
1/ Projections for 2005.

5. **After having a strongly countercyclical influence during FY2001/02 and FY2002/03, fiscal impulses were procyclical in FY2003/04 and FY2004/05.**[2] Over much of the past decade, fiscal policy managed to contain—even reduce—debt while playing a useful countercyclical role; fiscal consolidation during the boom of the late 1990s was followed by fiscal expansion during the downturn of the early part of this decade. However, the sharp increase in government spending on public infrastructure and public services that began in FY2000/01 continued in FY2003/04—FY2004/05. The result, as growth picked up, was a procyclical stimulus, a growing deficit, and a rising debt ratio. Yet, with low debt compared to other G7 countries and a benign international environment, interest rates on government debt remained low.

Fiscal Balance

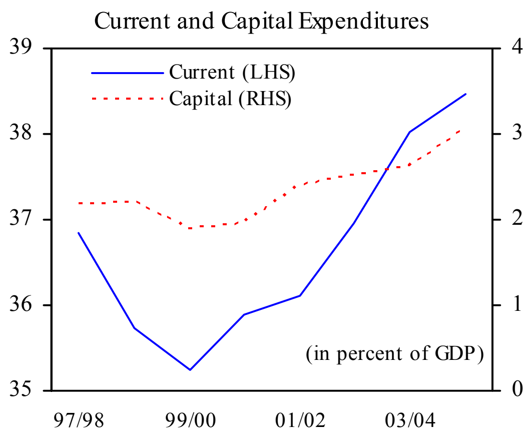


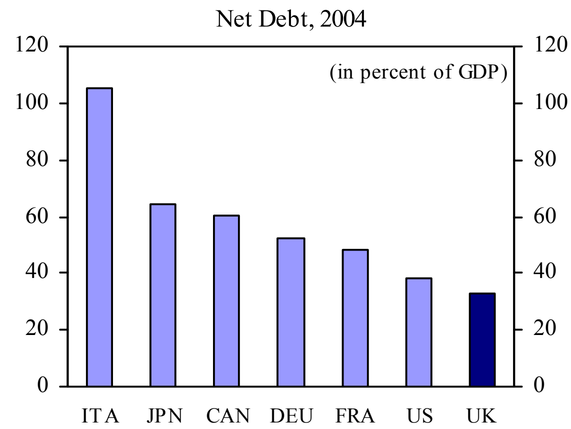
Net Public Debt 1/



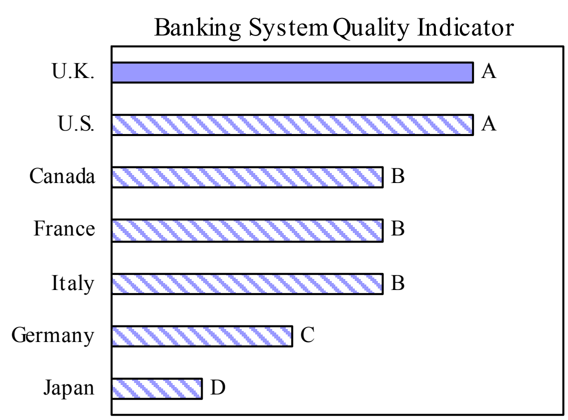
1/ Includes one-off receipts from the sale of mobile telephone licenses (2.3 percent of GDP) in FY2000/01.

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



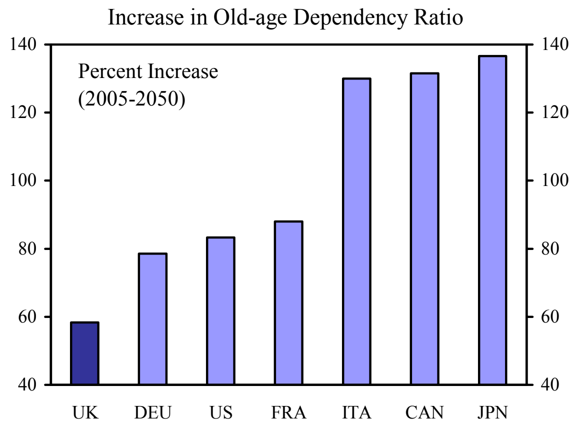


6. **The U.K. banking system is strong, though the possible reversal of the low yield environment in global financial markets poses a risk.** Given the U.K.'s role as a global financial center, financial stability has potentially far-reaching implications beyond its borders. Ratings agencies continue to rank the U.K. banking system as one of the strongest among G7 countries. However, over the medium term, increasing leverage and the continuing search for yield represent downside risks. These risks, while global, are particularly relevant for the U.K. given the size and openness of its financial sector: its banking system, insurance sector, and financial markets are among the largest in the world.

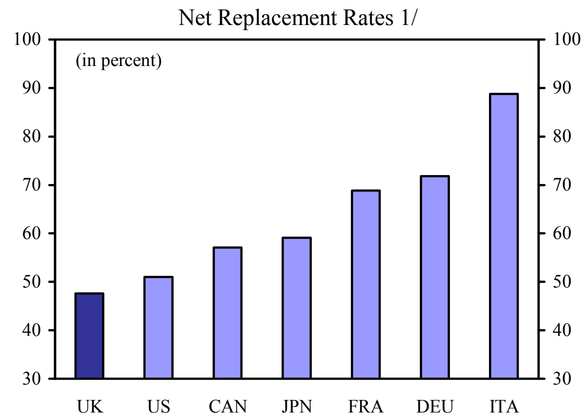


Source: Fitch Ratings.

7. **A longer-term question is whether private saving is adequate to support an aging population in the context of a frugal state pension system.** *Prima facie*, long-term fiscal sustainability in the U.K. is helped by less severe population aging and a less generous state pension system than in other G7 countries. However, if the working generation does not save enough for its own retirement, future governments may be forced to increase state pensions. A year ago, a government-appointed, but independent, Pensions Commission concluded that almost half of the working age population over 35 (mostly middle-income earners) is not saving enough to meet likely expectations of retirement income. The report found that the main obstacles to higher private saving are the complexity of the pension system, disincentives from means testing, the high cost of private pension products, and the difficulty of making rational decisions about long-term saving.



Source: UN.



Source: OECD.
1/ Ratio of pensions to average earnings, net of taxes and social security contributions.

III. Report on the Discussions

A. Introduction

8. **The authorities and staff broadly agreed that policies were successful in the difficult environment of 2005 and are well-positioned to ensure strong performance in the future**. Real GDP growth is expected to pick up in 2006–07 and CPI inflation to settle at the 2 percent target. Monetary policy continues to anchor inflation expectations at the inflation target. The financial sector is well-regulated and well-supervised and the outlook for the sector is favorable, though supervisors are keenly aware of risks in the present global environment. The authorities were confident that, with recently-announced initiatives, fiscal policy will contain debt over the medium term below the 40 percent ceiling and keep the current budget in balance over the officially-projected economic cycle. For the long term, the authorities were less convinced than the Pensions Commission that private saving is inadequate but welcomed the debate started by its final report, released just prior to the mission's arrival. The mission focused on four main questions:

- How is the government responding to persistent large fiscal deficits, which—if unchecked—would pose a threat to the fiscal rules?
- How robust is the emerging recovery and how will it change the balance of risks from weak demand growth and high energy prices in the BOE's assessment?
- How are the supervisory authorities addressing the possibility that low long-term interest rates may reverse?
- How much of a problem is low household saving for retirement and how could shortfalls be remedied given limited public resources?

B. Economic Outlook

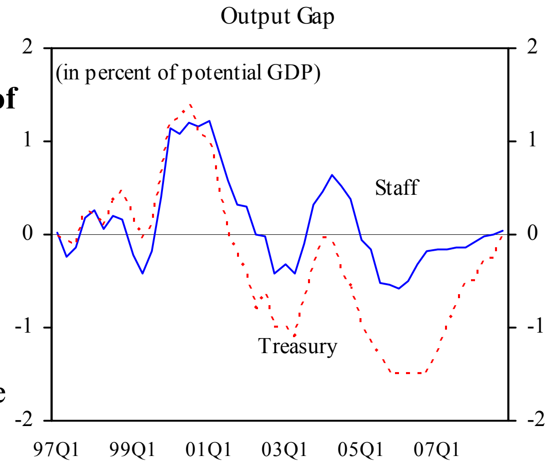
9. **A gentle pickup in economic growth is likely** (Tables 2 and 3). In line with the projections presented by officials at the Treasury and the Bank of England, staff expect that real GDP growth will rise to 2½ percent in 2006 and 2¾ percent in 2007. This assumes a continued favorable external environment. Private consumption growth, supported by continued robust employment growth, is expected to return close to trend as the adverse effects of rising debt service and energy prices, as well as of the deceleration of house prices, wane. Business investment growth is projected to rise modestly, underpinned by robust profitability, ample liquidity, and benign financial market conditions. The size of the increase will be dampened, however, by continued high leverage and pension deficits, as well as the ongoing adjustment to higher energy prices. Export growth is projected to remain strong, in line with robust global growth, while import growth should pick up modestly in line with domestic demand. CPI inflation is expected to fall slightly below the 2 percent target during 2006, as the effects of higher oil prices and previous pressures on capacity wane, and then rise to target during 2007, as output growth picks up and import prices increase.

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

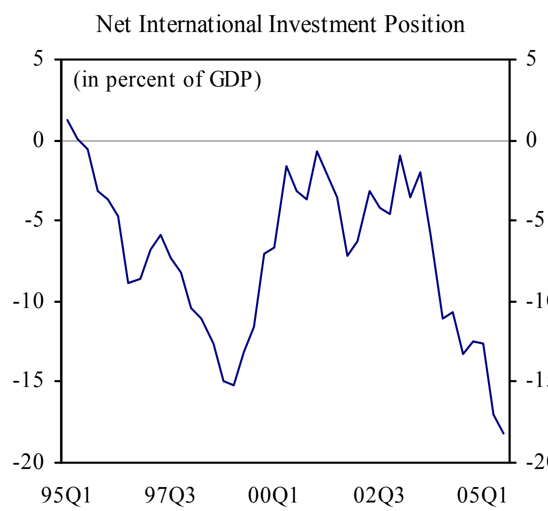
	2004	2005	2006	2007	2008	2009	2010	2011
Real GDP	3.2	1.8	2.5	2.7	2.6	2.6	2.6	2.6
Domestic demand	3.8	1.7	2.4	2.6	2.6	2.6	2.6	2.6
Private consumption	3.6	1.8	2.4	2.6	2.6	2.6	2.6	2.6
Government consumption	3.2	0.8	1.6	2.4	2.4	2.4	2.4	2.4
Fixed investment	5.2	3.0	3.8	3.5	3.2	2.9	2.8	2.8
Public	12.7	12.5	12.5	9.4	6.1	4.8	3.8	3.8
Residential	9.5	-0.2	0.6	2.0	2.5	2.6	2.6	2.6
Business	2.9	2.4	3.1	2.7	2.7	2.6	2.6	2.6
Net exports 1/	-0.8	-0.1	0.0	0.0	-0.1	-0.1	0.0	-0.1
Exports	4.6	4.7	5.5	4.9	4.7	4.7	4.7	4.7
Imports	6.7	4.3	4.8	4.2	4.5	4.4	4.3	4.3
Current account balance 2/	-2.0	-2.3	-2.3	-2.2	-2.3	-2.2	-2.2	-2.2
CPI inflation	1.3	2.1	1.9	1.9	2.0	2.0	2.0	2.0
Output gap	0.5	-0.3	-0.4	-0.1	0.0	0.0	0.0	0.0
Unemployment rate 3/	4.8	4.8	4.8	4.7	4.7	4.7	4.7	4.7

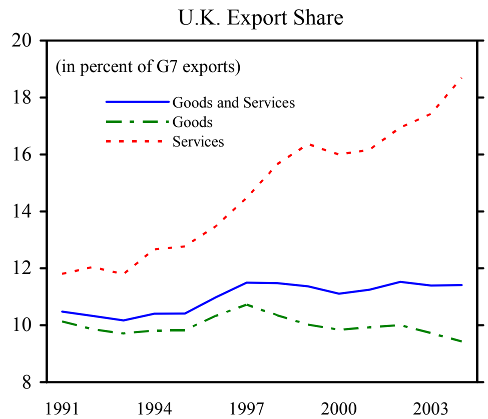
Sources: Office for National Statistics; and IMF staff projections.
1/ Contribution to the growth of GDP.
2/ In percent of GDP.
3/ In percent of labor force; based on Labor Force Survey.

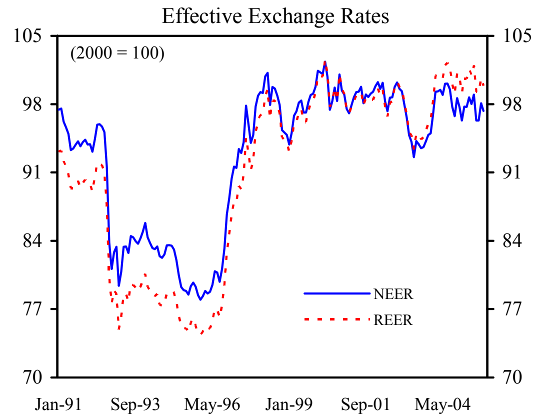
10. **The Treasury's estimate of the output gap in 2005—which matters for the fiscal projections—is considerably larger than those of other forecasters, including staff.** Officials pointed to the slowdown in average earnings growth and increase in jobless claims during 2005 as evidence of sizable labor market slack. Staff agreed that there had been an increase in slack in 2005. But economic indicators (including continued strong employment growth, the small rise in the unemployment rate, the small size of the decline in average earnings growth, and about average readings on survey measures of capacity utilization) and production-function-based estimates of the output gap suggested only a small degree of excess capacity, in line with the view of the BOE and most private analysts. Staff observed that the Treasury's estimate of the output gap indicates excess capacity from 2001 to 2008, a remarkably long period for an economy that is generally regarded as being quite resilient.



11. **The negative international investment position (IIP) and current account deficit are not major concerns**. The U.K.'s role as an international financial center implies large gross external assets and liabilities, much larger (as a share of GDP) than in any other G7 country. As a result, valuation changes have big effects on the IIP, usually bigger than flow effects; the standard deviation for both net portfolio investment and net foreign direct investment is about 10 percent of GDP (Appendix IV). Specifically, the fall in the IIP over the past two years was mostly due to sterling appreciation against the U.S. dollar. The authorities and staff expected the substantial surplus on investment income in the current account to persist, noting that the U.K. earns more on its assets (especially foreign direct investment) than it pays on liabilities (mostly debt). The deficit on trade in goods and services is projected to remain steady relative to GDP over the medium term, given strong growth in trading partners, a stable share of U.K. exports of goods and services in G7 exports (over time, the increase in the services share has been offset by a decline in the goods share), and continued steady effective exchange rates (Table 4). While noting that exchange rate assessments have significant margins of uncertainty, staff observed that the latest CGER exercise suggests that sterling is 0–15 percent above its medium-term equilibrium on a multilateral basis. Officials concurred that there is not strong evidence of overvaluation and that the floating exchange rate system is satisfactory.

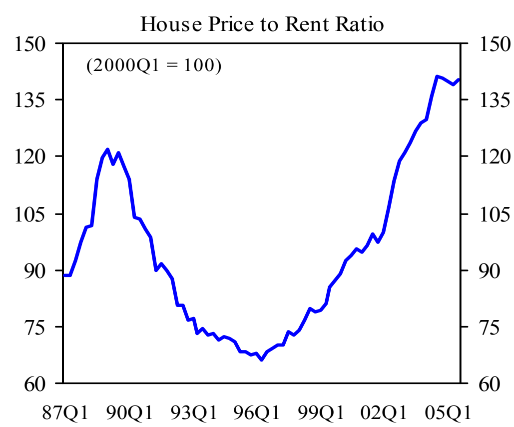


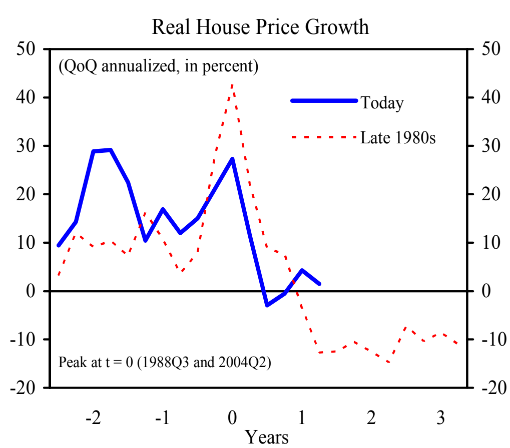


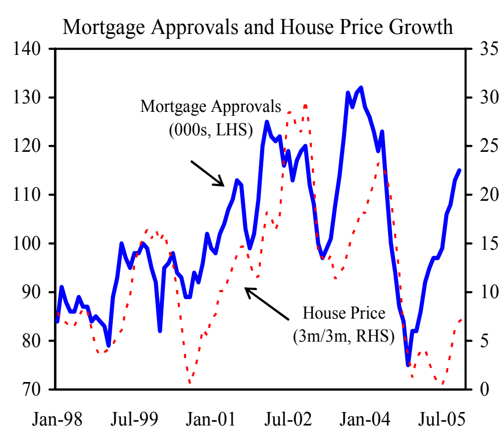


12. **Large uncertainties, however, surround prospects for both demand and supply:**

- **Staff suggested that house prices are likely still overvalued**, noting the elevated ratios of house prices to average earnings and of house prices to rents. BOE officials observed that estimates of overvaluation are highly sensitive to the level of real interest rates—an increase in interest rates would significantly increase estimates of overvaluation. However, the degree of estimated overvaluation is tempered by the growing number of households, constraints on housing supply, and the stabilization of house prices over the past year (in contrast to the sharp decline during the early 1990s). Officials and staff concurred that house price increases are unlikely to exceed nominal GDP growth over the medium term. In the short term, however, forward-looking indicators of housing market activity suggest a pick up in house prices.







- **The sharp increase in energy prices to date has raised the inflation rate and will likely reduce aggregate supply**. Staff analysis suggests that the doubling of energy prices between end-2003 and end-2005 led to a peak first-round effect on inflation of about ¾ percentage point and will cause a cumulative loss of output of about 1 percent, spread over 2006–08 (Box 3). BOE officials noted that their analysis indicates the need for a fall in the real consumption wage of about 1½ percent. Staff cautioned that, because the rise in energy prices has only recently come to be seen as permanent, adverse effects on potential output are still likely. Any further price increases would have negative consequences for growth and inflation.

- **Officials and staff concurred that significant immigration has** likely helped to alleviate specific skill shortages and thus acted to relieve inflationary pressures. However, the magnitude and persistence of supply effects are difficult to judge. Given the lack of reliable statistics, officials offered different views on the extent to which increased immigration is a new phenomenon. Some argued that it has been apparent for a while, for example in the reports of the BOE's regional agents. Others, however, pointed to an increase in immigration following the relaxation of border regulations in May 2004 to allow new members of the EU full access to the U.K. labor market. The latter argued that the number of additional migrants could well be about 100,000 (about ¼ percent of the working-age population). The net impact on economic slack depends on migrants' effect on aggregate demand, but it is likely to be positive. Going forward, immigration from new EU members could slow (if the stock adjustment has already largely occurred) or rise (as migration pathways become more established). In either case, labor supply will likely be more elastic than in the past.

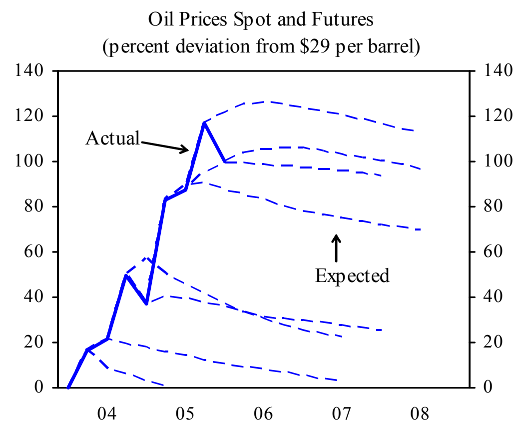
- **Officials acknowledged risks of a sharp change in exchange rates, but thought that they were low probability**. A disorderly resolution of global imbalances could result in exchange rate appreciation, although—in the past—sterling appreciation against the U.S. dollar has been largely offset by depreciation against the euro. In contrast, further increases in US and euro area short-term interest rates (combined with roughly unchanged U.K. rates) could put downward pressure on sterling.

C. Monetary Policy

13. **The combination of slowing house price appreciation and rising energy prices was a challenge for monetary policy in 2005.** Members of the Monetary Policy Committee (MPC) had different perspectives on the extent to which the cooling housing market was a cause rather than a symptom of the economic soft patch. They agreed, however, that the weakness of aggregate demand in 2005 had—other things equal—raised the question of whether monetary policy easing was needed. At the same time, the boost to inflation from

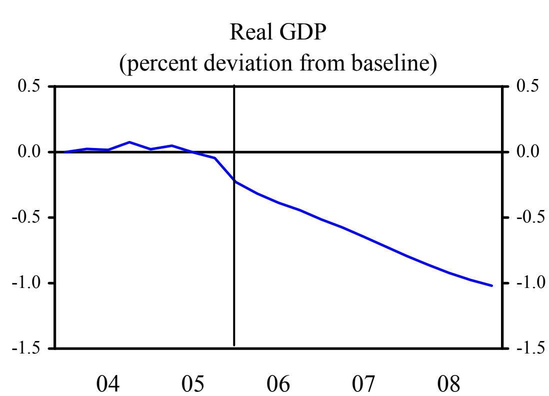
Box 3. The Impact of Higher Energy Prices on Growth and Inflation

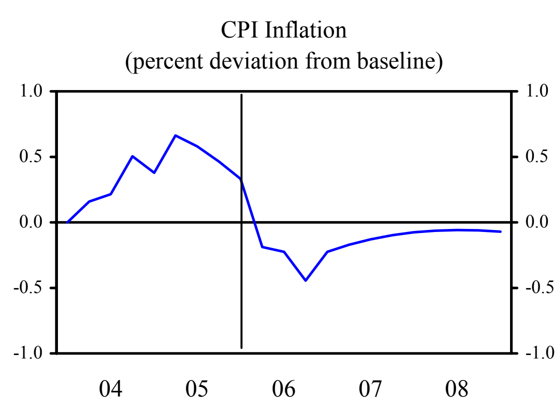
Oil prices roughly doubled between end-2003 and end-2005. The evolution of futures prices suggests that expectations of the permanent component of the price increase rose gradually over that period. Using a variant of the Fund's Global Economic Model incorporating energy (oil and natural gas), staff estimate the impact on the U.K. economy of this price shock.[1]



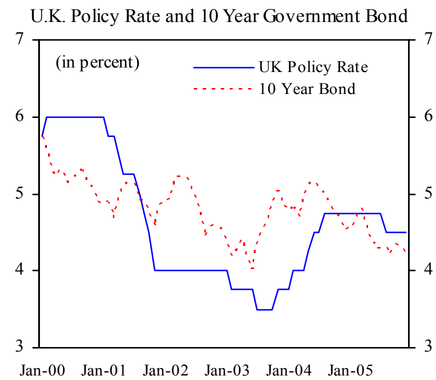
The simulation results suggest that the impact on GDP was small in 2004-05. The terms of trade effect was slightly positive, given the U.K.'s small net exports of energy, while the initial decline in domestic demand was modest, because a large portion of the price increase was expected to be temporary. However, looking ahead, the negative effects on both demand and supply are projected to grow over the next three years to about 1 percent. The adverse supply impact is due to firms' adjustment to the permanent increase in a factor cost, while the negative demand effects reflect households' realization that their real incomes will be permanently lower and firms' reduced demand for investment goods. Over time, the positive effect on energy production is more than offset by the adverse impact on non-energy output.

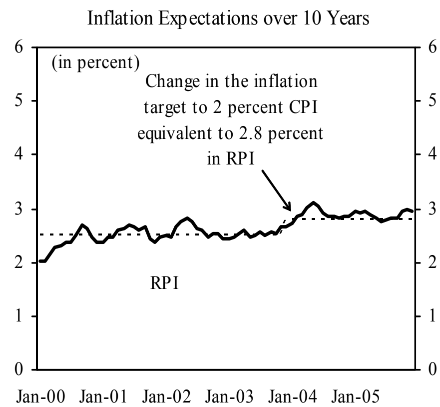
The results suggest that about half of the 1½ percentage points rise in CPI inflation between September 2004 and September 2005 was due to the energy price shock. Inflation should fall back to baseline quickly, as long as three conditions hold: the reduction in the economy's supply capacity is fully recognized in monetary policy, labor suppliers accept the permanent reduction in their real wages, and energy prices do not increase further.





[1]Selected Issues Paper, *The Impact of Rising Energy Prices.*





higher energy prices had risked affecting inflation expectations, suggesting the need for caution in cutting interest rates. Supporting the MPC's decision in August 2005 to cut the policy interest rate by ¼ percentage point to 4½ percent, staff agreed that it had been a finely balanced one.

14. **Most MPC members and staff considered the current stance of monetary policy to be appropriate**. In the BOE's—and staff's—baseline projections, CPI inflation is expected to reach the 2 percent target at the 2-year horizon, assuming no second-round effects from oil prices, a narrowing of the small output gap, continued increases in import prices, and well-anchored inflation expectations. The spread between nominal and RPI-indexed bond yields is stable at 2¾ percent, consistent with the CPI target of 2 percent.[3] Some MPC members were concerned about downside risks to the growth forecast and the minutes of the MPC meeting immediately preceding the mission showed that one MPC member felt that rates should be lower. The authorities and staff saw the current policy rate as broadly within a neutral range, though some MPC members characterized it as mildly accommodative.

15. **The flat yield curve reflects low long-term interest rates rather than tight monetary policy**. The decline in long-term rates over the past year could be due to a variety of factors, including a fall in the risk premium (possibly reflecting the entrenchment of macroeconomic stability), increased household saving for retirement, and a portfolio shift toward long-term bonds (especially by pension funds). More generally, low long-term rates are a worldwide phenomenon, likely reflecting a combination of high desired saving relative to desired investment and a possible under-pricing of risk.

16. **The next policy move should depend mainly on wage developments and evolving evidence on strengthening demand, an approach staff supported**. Some MPC members saw avoiding second-round effects from higher energy prices as the priority, while others were more concerned about prospects for a recovery of demand growth. Thus far, there is no sign that workers are resisting the decline in the real consumption wage implied by higher energy prices, with average earnings growth subdued and pay settlements steady at their recent historical average. However, many wage negotiations are traditionally concluded in the early part of the year, so it will be important to monitor them for evidence of real wage

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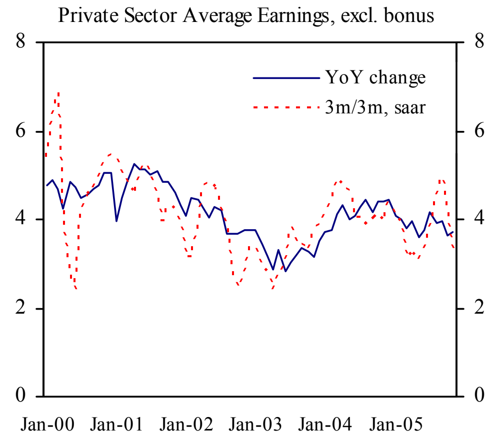
[3] The difference between RPI and CPI inflation is due largely to index methodologies (about ½ percent) and the treatment of house price depreciation (about ¼ percent on average).

resistance. At the same time, with a rebound in consumption already underway, MPC members would be looking for evidence that other components of demand—notably business investment and exports—are picking up as envisaged in their baseline projections. Staff observed that opposing effects on aggregate supply from higher energy prices and increased immigration would also influence prospects for inflation. An important medium-term consideration is whether the government will deliver on promised expenditure restraint starting in 2008, potentially producing a negative fiscal impulse. The authorities noted that this is still beyond the 2-year horizon relevant for monetary policy decisions.



D. Fiscal Policy

17. **The expected improvement in the fiscal balance in FY2005/06 is the beginning of a planned medium-term reversal of recent large deficits** (Table 5). The December 2005 Pre-Budget Report (PBR05) projects a reduction in the cyclically-adjusted *overall* deficit relative to GDP of ¾ percentage point in FY2005/06. The cyclically-adjusted *current* deficit is expected to narrow even more, given the projected increase in capital spending. The two main factors behind the improvement are higher tax revenues from North Sea energy production and higher tax revenues from the financial sector, reflecting a combination of the continued strength of global financial activity, the relatively high effective tax rates on financial sector incomes, and anti-avoidance measures. Staff concur with the changes in the cyclically-adjusted balances in FY2005/06 relative to FY2004/05, though not with the levels of the cyclically-adjusted balances in FY2005/06, reflecting the differences between the Treasury's and staff's estimates of the output gap.

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

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
		Proj.						
Overall balance								
PBR05	-3.2	-3.3	-3.0	-2.6	-2.3	-1.8	-1.6	-1.4
Staff	-3.1	-3.3	-3.0	-2.9	-2.8	-2.4	-2.1	-2.0
Cyclically-adjusted overall balance								
PBR05	-2.7	-2.9	-2.2	-1.6	-1.6	-1.6	-1.5	-1.4
Staff	-3.1	-3.6	-2.9	-2.7	-2.6	-2.3	-2.1	-2.0
Current balance								
PBR05	-1.8	-1.7	-0.9	-0.3	0.0	0.5	0.7	0.8
Staff	-1.9	-1.6	-1.0	-0.7	-0.5	-0.1	0.1	0.3
Cyclically-adjusted current balance								
PBR05	-1.4	-1.3	-0.1	0.7	0.7	0.7	0.7	0.8
Staff	-1.9	-1.9	-0.9	-0.5	-0.3	-0.1	0.1	0.3
Output gap								
PBR05	-0.5	-0.5	-1.4	-1.5	-0.7	-0.1	0.0	0.0
Staff	0.1	0.4	-0.4	-0.3	-0.1	0.0	0.0	0.0
Net public debt 3/								
PBR05	32.8	34.7	36.5	37.4	37.9	38.2	38.2	38.2
Staff	32.8	34.7	36.4	37.8	38.9	39.6	39.9	40.1

Sources: Pre-Budget Report 2005 and staff projections.
1/ Official projections based on official GDP, and staff projections based on staff's GDP.
2/ In fiscal years, which run from April to March.
3/ Based on centered GDP.

18. **Treasury officials expected the overall deficit to narrow to about 1½ percent of GDP over the medium term.** The further improvement in the cyclically-adjusted deficit relative to GDP by ¾ percentage point during FY2005/06—FY2010/11 reflects three main factors: fiscal drag; expenditure restraint starting in FY2008/09; and a recently-announced increase in the supplementary income tax rate on North Sea corporations. Specific plans to underpin the envisaged expenditure restraint are currently being developed as part of an overall review of government spending, the Comprehensive Spending Review (CSR), due to be completed in mid-2007. The Treasury expects the non-cyclically adjusted balance to improve by an additional ¾ percentage points of GDP. The underlying and unadjusted current balances would improve by similar amounts, as capital spending is projected to remain roughly constant as a share of GDP.

19. **Staff welcomed both the intention to further reduce the overall deficit and the emphasis on spending restraint, which are in line with Fund advice**. The desirability of early adjustment based on slowing the growth of current spending is underlined by staff analysis (Box 4). With nondiscretionary spending (Annually Managed Expenditure), such as social security benefits and interest payments, amounting to about 40 percent of total spending, the real growth of discretionary spending (Departmental Expenditure Limits) will need to fall to less than half of recent rates. Regarding the possible adverse effect of the

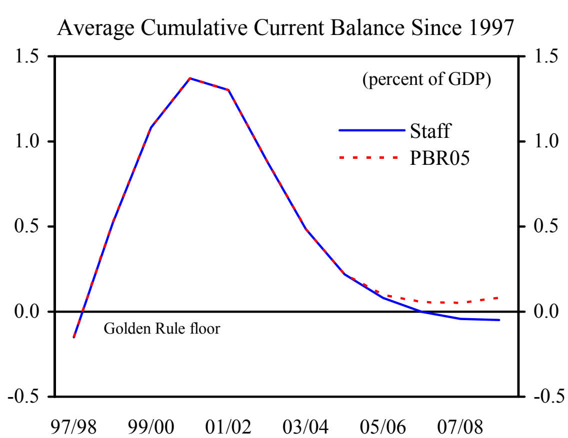
announced increase in income taxes on North Sea corporations for incentives to invest in energy extraction, Treasury officials noted that—with higher energy prices—expected after-tax rates of return on investment are still high (above 20 percent). Staff analysis suggests that corporate taxation becomes less distortionary as profit margins rise.

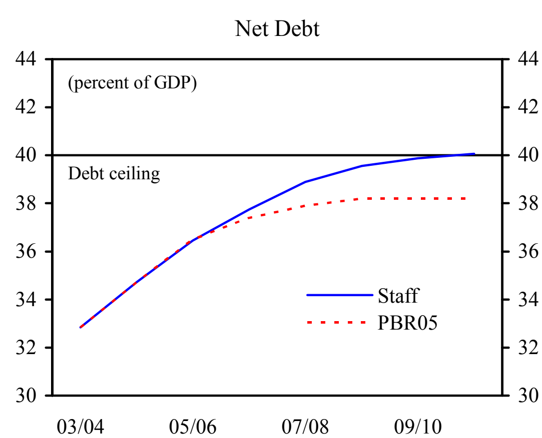
Box 4. Fiscal Adjustment—Timing and Composition

Early fiscal adjustment focused on containing the growth of spending would have the most favorable impact on output in the medium term, according to staff estimates based on simulations using the IMF's Global Fiscal Model calibrated to the U.K..[1] In the baseline scenario (delayed consolidation), fiscal deficits are financed for five years by issuing debt, before taxes are eventually raised. Alternatively, early consolidation dampens aggregate demand in the short term but increases output in the long term because the government's interest payments—and thus tax rates—are lower. Regarding the composition of adjustment, spending restraint has a more favorable effect on output than tax increases because of the adverse supply effects of higher taxes. In net present value terms, the gain is about 6 percent of one year's GDP for early consolidation through spending restraint and about 3 percent through higher revenue. Corporate income taxation is less distortionary if profit margins are higher, because a larger share of the tax burden falls on rents rather than the return to capital.

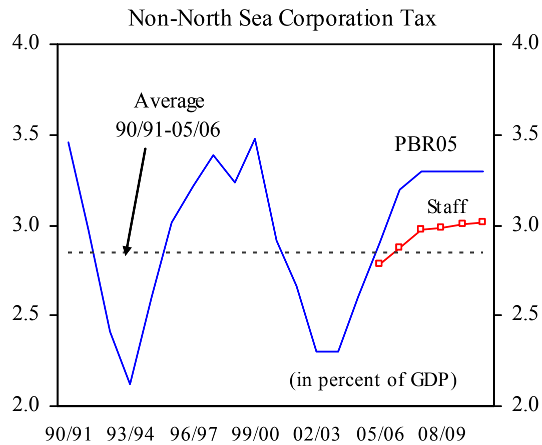
1/ Selected Issues Paper, *Options for Fiscal Consolidation in the U.K.*.

20. **Staff projections suggest that the overall deficit will narrow to 2 percent of GDP by FY2010/11, somewhat less than projected by the Treasury but still adequate to stabilize debt.** Given expected nominal GDP growth of about 5 percent over the medium term, an overall deficit of about 2 percent of GDP is sufficient to contain net debt at about 40 percent of GDP. Staff project the current balance to improve to about ¼ percent of GDP





by FY2010/11. Given that the policy assumptions are the same, the main difference between staff's and Treasury's medium-term projections relates to the revenue gain from closing the output gap. In addition, staff projects a more gradual improvement in the cyclically-adjusted balances, especially in FY2006/07, when the main factors behind the increase in underlying revenue are the tax increase on North Sea corporations (amounting to 0.2 percentage points of GDP) and fiscal drag (amounting to 0.1 percentage points of GDP). By contrast, the Treasury expects a sharper increase in underlying revenue in FY2006/07, in line with the momentum of FY2005/06. Treasury officials envisage a much bigger increase in non-North Sea corporation tax revenue as a share of GDP.



21. **Staff noted that the fiscal framework is at the forefront of international best practice**. Although fiscal policy has recently produced large deficits and not avoided procyclical behavior, there appears to be widespread acceptance that the framework has constrained discretion. Moreover, the framework—which goes well beyond the rules per se—has particular strengths, including clarity, transparency, and reliance on independent audit. The National Audit Office (NAO), which is independent of the government and reports directly to Parliament, audits key assumptions and conventions underpinning the fiscal projections (Box 5). Staff welcomed the Treasury's recent decision to ask the NAO to audit the redesignation of the start of the current economic cycle from 1999 to 1997.[4] Treasury officials noted that the NAO had found the Treasury's methodology to be reasonable. Staff suggested that, for the government to get due credit for its fiscal framework, transparency would be improved by extending the reach of NAO audit.

[4] The dating of the economic cycle is critical to measuring fiscal performance against the golden rule (current balance or better over the cycle).

Box 5. National Audit Office (NAO)

The NAO was established with a view to creating robust arrangements to ensure the independence of public auditors from the government. The 1983 National Audit Act gave the Comptroller and Auditor General express power to report to Parliament at his own discretion on the economy as well as on the efficiency and effectiveness of government spending. In 1997, the government invited the NAO to audit key assumptions and conventions underpinning the fiscal projections, so as to ensure that the forecasts are consistent with the principles of transparency and responsibility. This role was formalized under the Code for Fiscal Stability in 1998, which also requires the Treasury to publish any advice it receives. Since 2000, the NAO has audited key assumptions at the time of the Budget and Pre-Budget Report on a three-year rolling basis.

Audited Assumptions

	Key determinants	**Audited assumptions**
Tax receipts	Economic growth	Trend GDP growth Dating of the cycle
	Inflation Composition of GDP Asset prices	Consistency of price indices Factor shares Equity prices Oil prices
	VAT shortfall Anti-evasion measures	Effective VAT rate Tobacco smuggling
Cyclical benefit spending	Claim count	Unemployment
Debt services	Interest rates Composition of debt	Short-term interest rates Funding assumptions
Other		Privatization proceeds

22. **Staff asked whether the precise dating of the cycle might be undermining the objective of the golden rule.** Staff supported the rule as a means of protecting investment spending and guarding against procyclical fiscal policy, but noted two problems with its current application. First, different methodologies yield different interpretations of the economic cycle, so the attempt to be precise about dating the cycle inevitably leads to controversy.[5] Second, meeting the rule could require procyclical policy toward the end of a cycle.[6] Staff suggested that an exclusively forward-looking interpretation of the golden rule—for example, a rolling target of balance 3-years hence for the current budget—would reduce these drawbacks. However, to preserve credibility, a new interpretation of the golden rule should not be introduced until the current budget is back in balance. The authorities responded that precise dating provides a clear *ex post* test of whether the golden rule has been met, arguing that under previous governments fiscal rules had foundered because they lacked such a test.

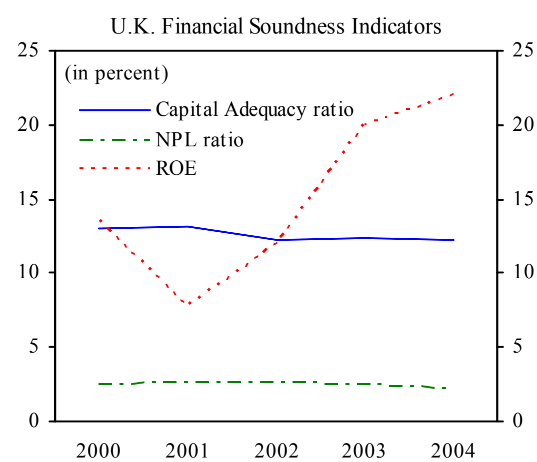
[5] For example, on staff's estimate of the output gap, the previous cycle ended in FY2003/04. Had a new cycle of FY2004/05 to FY2008/09 been designated, the golden rule would not be met on the authorities' or staff's current projections.

[6] See Selected Issues Paper for 2004 consultation, *The Implementation of the Golden Rule Over the Cycle,* IMF Country Report No. 05/81.

E. Financial Stability

23. **Increased macroeconomic stability and financial innovation are positive developments, but are also changing the landscape of risk.** Low and stable inflation and less volatile economic growth have reduced uncertainty about future cash flows, but this may be leading some investors to be overly optimistic about policymakers' ability to offset macroeconomic shocks. At the same time, rapid financial innovation, notably in derivative and securitization markets, has facilitated risk diversification, allowing banks in particular to transfer credit risk to a wide base of investors, and thus increased the capacity of the financial system to bear risk. However, the authorities and staff agreed that risk transfer markets have made the ultimate destination of these risks more opaque, complicated contract enforcement problems, and enabled the build-up of leverage. Together, macroeconomic stability and financial innovation have contributed to expectations of continued low asset price volatility and low risk premia, though some investors may be overly sanguine about the underlying risks of some financial products, particularly in the current low yield environment.

24. **In this environment, the authorities are pursuing several policy strategies**. First, they are raising awareness by publicizing risks to the outlook, to focus attention on common exposures. Second, they are continuously improving their ability to respond to shocks, including through crisis simulation exercises based on natural disasters, terrorist attacks, and macroeconomic events. Third, they are broadening and deepening their analysis, for example to smaller financial institutions and to the strategic interactions between investors.



25. **The banking system is healthy, but there are some risks.**[7] Banks are well capitalized, highly profitable, and very cost efficient. Levels of nonperforming loans are very low. Credit default swap premia, which reflect the willingness to pay for protection against default, for the major U.K.-owned banks are exceptionally low. That said, valuations across a wide range of assets, including property, depend on currently low—by historical standards—global interest rates. In addition, retail asset quality has deteriorated somewhat with the uptick in personal insolvency rates and the growth in sub-prime lending. Banks' exposures to commercial property have grown rapidly, and concerns about overvaluation in this sector are increasing. There are also some signs of a loosening in corporate lending standards, as banks compete with each other and with capital markets to provide funding in a low-yield

[7] Selected Issues Paper, *United Kingdom—FSAP Follow-Up Report* for detailed discussion of these risks.

environment. Staff asked about risks posed by global imbalances. Officials responded that sudden shifts in international capital flows could disrupt a wide range of asset markets, potentially leading to costly and disorderly adjustments in banks' balance sheets. Staff and officials agreed that the banking system is well-positioned to absorb substantial shocks.

26. **The health of the insurance sector has improved substantially over the past three years**. Balance sheets have benefited from rising equity prices, and progress has been made in reducing risk within investment portfolios. Officials agreed that the quality of capital remains weak for some insurers and that risk management expertise is still variable across firms. Accordingly, the authorities introduced in January 2005 a risk-based approach to determining capital adequacy (the Individual Capital Assessment regime), which aims to improve risk management through an interactive process between insurance companies and the FSA. The FSA is also pushing for greater contract certainty.

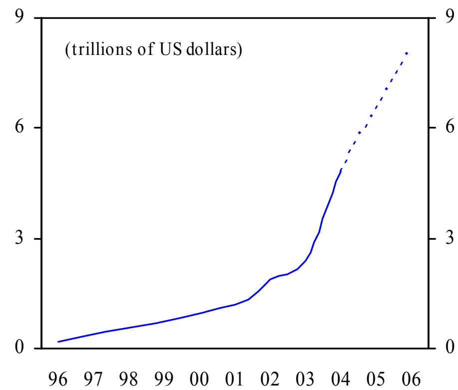
27. **Credit risk transfer (CRT) instruments are helping to diversify credit risk, but their rapid growth is creating new risks.** Noting that London, along with New York, is a global center for the CRT market, officials shared staff's concern that the pace of innovation may have exceeded the development of market infrastructure and financial institutions' risk management systems, leading to a risk that a shock to the financial system could be exacerbated by increased exposures to these instruments. Recognizing that the confirmation and assignment backlogs in structured credit markets could give rise to settlement problems, officials said that market participants have been collaborating with regulators in the U.K. and abroad to eliminate these backlogs. While staff analysis suggests that exposures may be well-diversified across large U.K. banks and insurance companies (Box 6), staff asked about the scope to increase market participants' disclosure to the FSA of exposures to CRT instruments. Officials acknowledged that supervisors in other major financial centers collect more data, but were reluctant to increase the formal reporting burden on U.K. financial institutions, especially when they are not sure which data series would adequately capture key risks.[8] For the time being, they preferred to focus on gathering market intelligence.

[8] Officials noted the high regulatory burden on financial institutions from the implementation of Basel II, IOSCO rules, IFRS, and other EU and U.K. initiatives.

Box 6. Financial Stability and the Credit Risk Transfer Market

Staff analysis suggests that the rapidly-growing global credit derivatives and structured credit market does not pose a substantial threat to large U.K. financial institutions.[1] A direct assessment of financial institutions' exposures is not possible, given the lack of information on their portfolio holdings. An indirect approach is to proxy exposures by the extent to which the variability of a financial institution's equity returns is explained by the variability of actively-traded collateralized debt obligation (CDO) tranches. In this market, banks have traditionally been net sellers of CDOs (buyers of protection) and insurance companies net buyers of CDOs (sellers of protection). The empirical results suggest that large insurance companies are more exposed to volatility in the more senior (i.e. less risky) CDO tranches, while large banks are more exposed to the junior tranches. The results also suggest that large U.K. financial institutions as a group have diversified holdings across tranches. However, this indirect approach cannot address the exposures of financial institutions that do not have market-traded instruments, underlining the need for supervisors to continually enhance their surveillance of the credit risk transfer market.

Global Credit Derivatives Market 1/



Source: British Bankers Association and JP Morgan.
1/ Estimated for 2005 and 2006.

1/ Selected Issues Paper, *The Credit Risk Transfer Market and Implications for Financial Sector Stability.*

28. **Officials pointed to the strengthening of payment and settlement systems in line with the recommendations of the 2002 FSAP**. Over the past two years, actions have been taken to reduce the level of intraday interbank exposures and to reduce settlement risk in money market instruments and retail payments. The mission observed that clearing activities are increasingly being undertaken *within* banks, for example in the processing of CRT transactions, so these activities are becoming more important for financial stability.

F. Population Aging

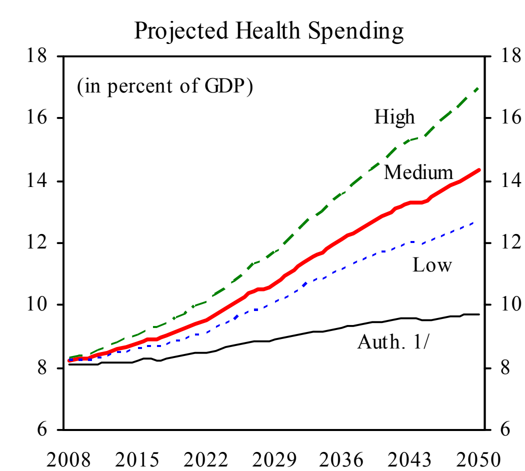
29. **Population aging will increase pressures on pension and health spending**. Officials noted that the Budget presents illustrative 30-year fiscal projections and the *Long-Term Public Finance (LTPF) Report* provides more detailed scenarios and sensitivity analysis of long-term risks. The baseline projections in the December 2005 LTPF Report suggest that, to stay below the 40 percent of GDP net debt ceiling, the required improvement in the primary balance is only about ¼–½ percentage points of GDP *per decade* starting in the 2040s.

30. **The Pensions Commission has proposed reforms that would largely address the main obstacles to private saving for retirement identified last year** (complexity, means-testing, cost, and myopia). There are three key recommendations: (i) to reduce the spread of

means testing by indexing the flat-rate state pension to average earnings from 2010 (it is now indexed to inflation), (ii) to introduce a national defined-contribution scheme with automatic enrolment and low operating costs, and (iii) to raise the state pensionable age from 2020, which would help offset the fiscal cost of the more generous flat-rate state pension. Staff observed that the recommendations would retain the complexity of the current system. A member of the Pensions Commission did not disagree, but noted that over the long term the system would become simpler and that a radical shift to a simpler system now would be too disruptive and costly.

31. **Treasury officials had mixed reactions to the Pensions Commission's proposals, ahead of the government's official response expected in the spring.** First, officials noted—as in the past—that the Pensions Commission does not take housing wealth into account in forecasting the saving gap. Staff concurred that estimates of the gap are uncertain. Second, to the extent that a saving gap exists, officials agreed with staff that a defined-contribution scheme with automatic enrolment could be useful. Third, regarding the state pension system, officials noted that the Commission's proposals would involve higher government spending, especially during 2010–20. They argued that this spending would have to compete with other government priorities and should be considered as part of the CSR. Staff agreed with this concern, but observed that the reform proposals would be close to fiscally neutral by 2050. Fourth, officials saw no definitive evidence that means testing reduced saving and that—in any event—the spread of means testing could be reduced by lowering the minimum guaranteed pension income relative to average earnings. Staff observed that, under reasonable assumptions and in the absence of reform, about 70–80 percent of retirees would be subject to means-tested benefits by 2050. Moreover, the introduction of a defined-contribution scheme would be less successful if the state pension system were not reformed, as the spread of means testing would discourage private saving.

32. **The Treasury projects that health spending will rise by only 1½ percentage points of GDP between 2007–50**. This relatively small increase in spending is consistent with less pronounced population aging in the U.K. compared to other industrial countries. However, the relative price of health services has increased steadily over the past 50 years, reflecting technology-driven cost increases and shifts in consumer preferences. In staff's central scenario, based on historical trends in the price of health services, health spending will rise relative to GDP by 6 percentage points between 2007–50.[9] Treasury officials said that uncertainties surrounding prospects for nondemographic factors



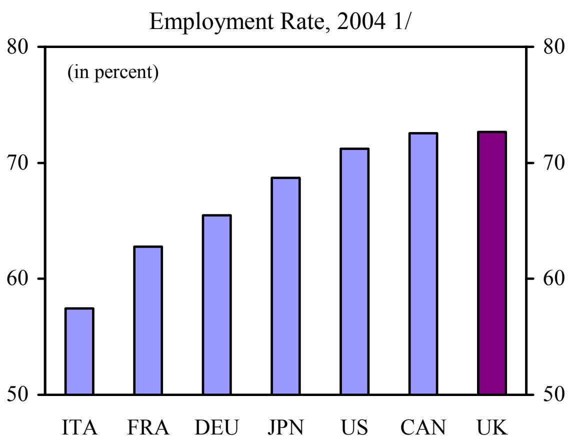
1/ 2005 Long-term Public Finance Report.

[9] Selected Issues Paper, *Long-Term Health Care Costs: Will They Make the Budget Sick?*

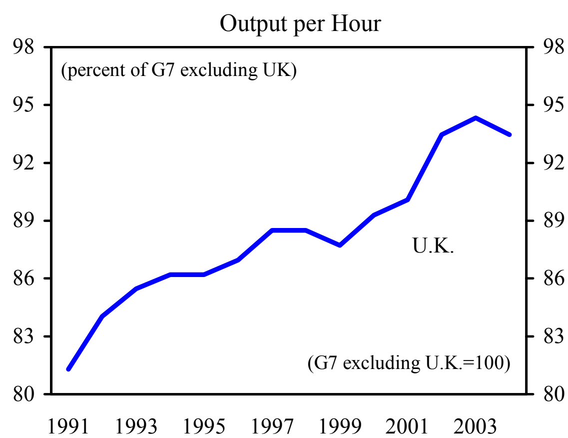
are large and noted that the EU Aging Working Group has not yet reached a consensus on how to incorporate such factors. Staff welcomed the discussion in the LTPF Report of these uncertainties and urged that quantitative analysis of nondemographic factors be published to promote fiscal transparency and thus raise the level of the public debate.

G. Other Issues

33. **The labor market is flexible and dynamic, though labor productivity lags the G7 average**. The employment rate is the highest among the G7 countries and the government's aspiration is to increase it further. In line with OECD recommendations, staff supported the authorities' strategy to lower the inactivity rate due to incapacity through a combination of expanded active labor market policies and a planned reform of the incapacity benefit, which would increase conditionality and reduce complexity. Although the growth of output per hour in the U.K. has been faster than in other G7 countries over the past decade, a productivity gap remains. Staff backed the authorities' strategy of addressing the five main drivers of productivity growth (innovation, enterprise, competition, investment, and skills), including its current focus on regulatory reform. Staff and the authorities agreed that immigration, particularly from new EU members since mid-2004, was helping to relieve skill shortages.



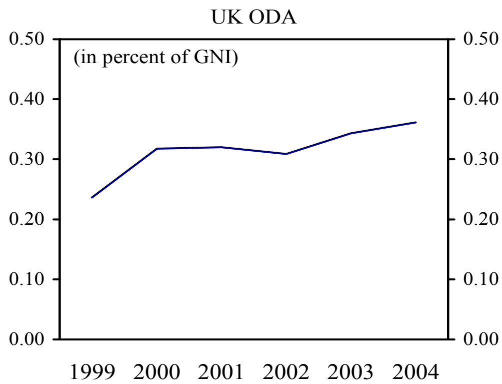
1/ Employment divided by population (15-64 year olds).

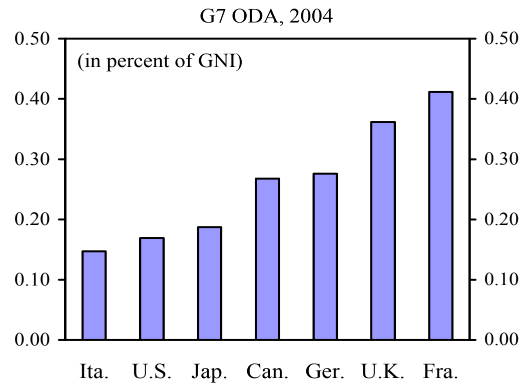


Source: Office for National Statistics.

34. **The U.K. is a strong supporter of the Doha Round and of further reform of the EU's Common Agricultural Policy (CAP).** While the EU has agreed, within the Doha Round negotiations, to end all agricultural export subsidies by 2013, the authorities would have prefered an end date of 2010. The authorities support a WTO agreement that reduces trade-distorting agricultural protection. Officials added that the government is working through the EU to ensure that WTO members, particularly industrial countries, make significant offers on financial services in the coming negotiation round. Within the EU, where financial services are already covered by a number of legislative measures designed to open up the single market, notably under the Financial Services Action Plan, the U.K. will continue to work toward the liberalization of markets for other services.

35. **The U.K. is committed to achieving the United Nations' target for ODA of 0.7 percent of GNI**. On current plans, the ratio is projected to rise to 0.47 percent of GNI in FY2007/08, with the goal of reaching the target by 2013. Officials noted that, if the proposed International Finance Facility were accepted, the U.K. could expect to achieve the target by FY2008/09.





36. **The U.K. is continuing to strengthen its AML/CFT regime, in line with FSAP recommendations.** New guidance, produced by the financial sector to help implement legislative requirements, came into effect in January 2006. This guidance will allow financial firms to take responsibility for establishing their own risk-based approaches for focusing compliance resources on the most vulnerable areas. Officials emphasized that proposals for new measures should be assessed using cost-benefit principles, as with other aspects of financial sector regulation. On the international front, the U.K. drafted a joint proposal and action plan for AML/CMT, which was endorsed by the G7 in April 2005 and has subsequently improved collaboration in asset freezing, information sharing, and the disruption of criminal activity.

IV. Staff Appraisal

37. **Macroeconomic performance in the United Kingdom remains remarkable**. The economy has now expanded continuously for more than 13 years, with only shallow fluctuations in growth. Employment has risen strongly as temporary slowdowns in demand were absorbed mainly by moderation of wage growth rather than by increases in unemployment, which remains close to its historic low. The economy is in the longest period of sustained low inflation since the 1960s. This success is due in part to monetary, fiscal, financial, and structural policy frameworks that have increasingly instilled confidence that policies will be conducted to achieve a strong and stable economy.

38. **In 2005, these frameworks were tested**. The slowdown in real GDP growth and rise in inflation were the sharpest in a decade, presenting the Bank of England with unusually difficult choices. The slowdown also complicated fiscal policy: with no adjustment during the cyclical upswing in 2003–04 and a fiscal deficit above the Maastricht limit of 3 percent of GDP, policy action needed to be initiated in a weaker setting. On the financial side, supervisors, overseeing a system with strong performance indicators, were cognizant of the

need to stay abreast of financial innovations in an environment marked by concerns about possible global underpricing of risk. And in a longer term perspective, the authorities are confronting evidence that inadequate private savings for retirement may threaten the sustainability of a relatively frugal state pension system.

39. **Prospects for 2006–07 suggest a more favorable environment.** As the factors that dampened demand in 2005—especially the deceleration of house prices and earlier monetary policy tightening—start to wane, real GDP growth is projected to rise to 2½ percent in 2006 and 2¾ percent in 2007. CPI inflation is expected to fall slightly below target in 2006, reflecting the opening of the output gap, and then to rise to target in 2007. The current account should remain in moderate deficit. A risk to the outlook is the housing market, where valuations remain high by some metrics despite the stabilization of prices during the past year.

40. **Against this background, monetary policy decisions remain delicately balanced.** In 2005 monetary policy successfully navigated the slowdown in demand and rise in energy prices. With no signs of second-round effects of the oil price increase but a sharp deceleration in demand, the ¼ percentage point cut in the policy interest rate in August acknowledged the downside risks to demand, while keeping the rate in a neutral range. Looking ahead, the immediate focus of policy should be on remaining risks of second-round effects from the oil price increase. Once such risks have eased further, interest rate decisions should be increasingly guided by whether demand remains on track to close the output gap. Decisions will also need to take into account the experience of the next year with immigration, which should help resolve questions about the size and duration of the surge in inflows.

41. **The authorities' plans for fiscal adjustment are welcome.** The underlying overall and current deficits are on track to narrow substantially this fiscal year, reflecting windfall revenues from higher energy prices as well as strong personal income and corporate tax revenues, especially from the booming financial sector. A plan to reduce the fiscal deficit—including fiscal drag, current spending restraint to start in FY2008/09, and the recently-announced increase in the tax rate on energy company profits—is coming increasingly into focus. On staff's projections, these actions would move the current budget to a small surplus and the overall deficit to about 2 percent of GDP. This would be sufficient to stabilize net debt at 40 percent of GDP, though not to reach the government's target of an overall deficit of 1½ percent of GDP. Nor would these measures be sufficient to avoid the risk of procyclical policy under the present interpretation of the golden rule (current balance or better over the cycle).

42. **The envisaged expenditure restraint will require careful planning.** Given the relatively small share of discretionary spending in total and the government's intention to keep capital spending at post build-up levels, the choices will be extremely difficult. The test will be to ensure that early promises do not fade in the face of what will undoubtedly be tough decisions and that these decisions truly target the least productive or essential

expenditures. The process will benefit from the zero-based approach to the forthcoming Comprehensive Spending Review, due for completion in mid-2007.

43. **The fiscal framework, combining a high standard of transparency and concrete measures of performance, remains impressive.** One particular strength of the fiscal framework is the use of independent auditing, which puts the U.K. at the forefront of international best practice. Since 1997, the government has asked the NAO—which is independent of the government and reports directly to parliament—to audit 11 assumptions and conventions underlying the fiscal projections. This has been instrumental in building confidence in the bases for the projections. In the past year, the government added to that role by subjecting to audit the decision to move the start of the present cycle back two years. Further extending the range of NAO audit—for example, to include the current amount of economic slack—would be welcome.

44. **However, the important role of the fiscal framework is being weakened by a peripheral controversy regarding the dating of the economic cycle**. While staff see the framework as having constrained discretion, the authorities' redating of the cycle—both backward and forward—has generated public criticism and even skepticism. Therefore, once current balance is regained, consideration should be given to alternative interpretations of the golden rule that place less emphasis on the definition of the cycle—a difficult concept in an economy that displays unusually muted cyclical behavior. In this vein, the government could consider a more forward-looking formulation that ensures fiscal policy is positioned to produce current balance in a set number of years. A shift to a more forward-looking interpretation of the golden rule would best be accompanied by an extension of the range of independent audit to bolster credibility.

45. **Financial authorities are skillfully meeting the challenge of overseeing a global financial center.** Well-capitalized and cost-efficient, banks appear to be well-positioned to absorb losses that might arise from the most likely types of financial market disturbances. Supervisors' judgment that specific risks—including from exposures to commercial property, a possible loosening of corporate lending standards, and the growth of sub-prime lending—are manageable seems reasonable. Nevertheless, the authorities' warnings that investors may be underpricing risk, particularly given concerns about global imbalances, are welcome. The rapid growth of credit risk transfer instruments, which are providing important diversification benefits, is also creating some risks. The authorities' efforts, again, to publicize risks, but also to address the transactions backlog are right. And with due attention to the costs and benefits of new regulatory burdens, the authorities should continue to strengthen surveillance of the market and encourage initiatives to improve disclosure CRT exposures.

46. **Evidence that a portion of the population is not saving enough to meet retirement income expectations requires attention.** The findings and recommendations of the independent Pensions Commission are a key first step in the process. The government now needs to develop a consensus on the extent of the problem and measures that address it. The Commission has made a rather compelling case for the introduction of a national defined-contribution scheme with automatic enrollment and low

operating costs, changes to the state pension system to simplify it and strengthen incentives for private saving, and increases in the state pensionable age to reflect longer life expectancy. Any changes, however, must recognize that increasing the generosity of the currently frugal pension system will come at the cost of other public expenditures. Ensuring that the trade-offs are accurately and circumspectly considered will be critical.

47. **The flexible and dynamic labor market is one of the economy's key strengths**. The policy of allowing new members of the EU full access to the labor market has likely helped relieve specific skill shortages and thus acted to relieve inflationary pressures. The authorities' strategy to stimulate productivity growth is appropriate, including the current emphasis on further reducing the regulatory burden and developing additional policies to improve the skills base. The government's aspiration of further increasing the already high employment rate—including through innovative measures to help incapacity benefit claimants find work—is ambitious and welcome.

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

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

Table 1. United Kingdom: Selected Economic and Social Indicators

	2001	2002	2003	2004	2005 Proj.	2006 Proj.	2007 Proj.
Real Economy							
Real GDP (change in percent)	2.2	2.0	2.5	3.2	1.8	2.5	2.7
Domestic demand (change in percent)	2.8	3.2	2.7	3.8	1.7	2.4	2.6
CPI	1.2	1.3	1.4	1.3	2.1	1.9	1.9
Unemployment rate (in percent) 1/	5.1	5.2	5.0	4.8	4.8	4.8	4.7
Gross national saving (percent of GDP)	15.0	15.2	14.8	14.9	14.7	15.1	15.5
Gross domestic investment (percent of GDP)	17.2	16.7	16.3	16.9	17.0	17.4	17.7
Public Finance 2/							
General government balance	0.0	-2.1	-3.1	-3.3	-2.9	-2.8	-2.6
Public sector balance	0.0	-2.3	-3.1	-3.3	-3.0	-2.9	-2.8
Cyclically adjusted balance (staff estimates)	-0.5	-2.3	-3.1	-3.6	-2.9	-2.7	-2.6
Public sector net debt	30.1	31.4	32.8	34.7	36.4	37.8	38.9
FX-denominated public debt (percent of gross debt)	1.3	0.4	0.4	0.3	...	...	...
Money and Credit (end-period, 12-month percent change)							
M0	7.6	6.4	7.4	5.7	5.0	...	...
M4	6.7	7.0	7.2	8.8	12.6	...	...
Consumer Credit	12.6	14.0	10.6	11.2	8.5	...	...
Interest rates (year average)							
Three-month interbank rate	4.9	4.0	3.7	4.6	4.7	...	...
Ten-year government bond yield	4.9	4.8	4.5	4.9	4.4	...	...
Balance of Payments							
Current account balance (in percent of GDP)	-2.2	-1.6	-1.4	-2.0	-2.3	-2.3	-2.2
Trade balance (in percent of GDP)	-2.7	-3.0	-2.8	-3.3	-4.0	-3.9	-3.7
Net exports of oil (in percent of GDP)	0.6	0.6	0.4	0.2	0.0	0.0	0.0
Exports of goods and services (volume change in percent)	2.9	0.2	1.2	4.6	4.7	5.5	4.9
Imports of goods and services (volume change in percent)	4.8	4.5	1.8	6.7	4.3	4.8	4.2
Terms of trade (percent change)	-0.7	2.8	1.1	0.0	-2.2	-0.2	0.2
FDI net (percent of GDP)	-0.4	-1.7	-1.9	-0.9	...	...	...
Reserves (end of period, in billion of US dollars)	40.4	42.8	46.0	49.7	...	...	...
Fund Position (as of December 31, 2005)							
Holdings of currency (in percent of quota)							84.8
Holdings of SDRs (in percent of allocation)							10.5
Quota (in millions of SDRs)							10,738.5
Exchange Rates							
Exchange rate regime							Floating
Bilateral rate (January 30, 2006)							US$ = £0.5664
Nominal effective rate (2000=100) 3/ 5/	98.6	99.3	94.6	98.7	97.3	...	...
Real effective rate (2000=100) 3/ 4/ 5/	98.3	98.9	95.4	100.8	100.2	...	...

Social Indicators (reference year):

Income per capita (in US dollars, 2004) : 36,419; **Income distribution** (ratio of income received by top and bottom quintiles, 2001): 4.9; **Life expectancy at birth** (2003): 76.2 (male) and 80.7 (female); **Automobile ownership** (2001): 438 per thousand; **CO2 emissions** (ton per capita, 2002): 9.06; **Population density** (2002) 244 inhabitants per sq. km.; **Poverty rate** (share of the population below the established risk-of-poverty line, 2003): 18%.

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

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

2/ The fiscal year begins in April. For example, fiscal balance data for 2002 refers to FY2002/03. Debt stock data refers to the end of the fiscal year using centered-GDP as a denominator.

3/ Average. An increase denotes an appreciation.

4/ Based on Consumer Price data.

5/ As of November 2005.

Table 2. United Kingdom: Quarterly Growth Rates

	2005					2006					2007				
	Q1	Q2	Q3	Q4 Prj.	**05/04 Annual**	Q1 Prj.	Q2 Prj.	Q3 Prj.	Q4 Prj.	**06/05 Annual**	Q1 Prj.	Q2 Prj.	Q3 Prj.	Q4 Prj.	**07/06 Annual**
	Quarter-on-quarter annualized, except where indicated														
Real GDP	0.9	1.9	1.7	2.4	**1.8**	2.3	2.8	3.1	3.0	**2.5**	2.6	2.6	2.6	2.6	**2.7**
Domestic demand	-0.6	-0.5	4.6	2.1	**1.7**	1.9	2.4	2.9	2.8	**2.4**	2.5	2.6	2.6	2.6	**2.6**
Private consumption	0.5	0.9	2.3	2.6	**1.8**	2.6	2.6	2.6	2.6	**2.4**	2.6	2.6	2.6	2.6	**2.6**
Government consumption	0.6	0.3	-0.1	1.6	**0.8**	2.0	2.0	2.4	2.4	**1.6**	2.4	2.4	2.4	2.4	**2.4**
Gross fixed investment	2.5	0.8	8.9	-0.8	**3.0**	4.3	4.5	4.7	4.3	**3.8**	2.8	2.9	2.9	2.9	**3.5**
Public investment	87.5	-47.4	86.6	-18.5	**12.5**	21.6	21.6	21.6	17.0	**12.5**	4.1	4.1	4.1	4.1	**9.4**
Residential investment	-5.4	0.9	-2.1	0.4	**-0.2**	0.8	1.2	1.6	1.6	**0.6**	2.0	2.4	2.4	2.4	**2.0**
Business investment	-5.7	12.9	2.3	2.5	**2.4**	2.5	2.5	2.5	2.6	**3.1**	2.7	2.8	2.8	2.8	**2.7**
Stockbuilding 1/	-0.4	-0.3	0.5	0.1	**-0.1**	-0.2	-0.1	0.0	0.0	**-0.1**	0.0	0.0	0.0	-0.1	**0.0**
Foreign Balance 1/	0.4	0.5	-0.7	0.1	**-0.1**	0.1	0.1	0.0	0.0	**0.0**	0.0	0.0	0.0	0.0	**0.0**
Exports of goods and services	-1.6	18.9	-1.6	6.7	**4.7**	5.6	5.5	4.9	4.9	**5.5**	4.8	4.8	4.8	4.8	**4.9**
Imports of goods and services	-6.4	9.0	7.6	4.9	**4.3**	3.8	3.8	4.0	4.0	**4.8**	4.0	4.6	4.6	4.6	**4.2**

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

1/ Contribution to the growth of GDP

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

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Real GDP	2.5	3.2	1.8	2.5	2.7	2.6	2.6	2.6	2.6
Real domestic demand	2.7	3.8	1.7	2.4	2.6	2.6	2.6	2.6	2.6
Private consumption	2.6	3.6	1.8	2.4	2.6	2.6	2.6	2.6	2.6
Government consumption	4.5	3.2	0.8	1.6	2.4	2.4	2.4	2.4	2.4
Fixed investment	0.0	5.2	3.0	3.8	3.5	3.2	2.9	2.8	2.8
Public	15.9	12.7	12.5	12.5	9.4	6.1	4.8	3.8	3.8
Residential	3.2	9.5	-0.2	0.6	2.0	2.5	2.6	2.6	2.6
Business	-2.8	2.9	2.4	3.1	2.7	2.7	2.6	2.6	2.6
Stocks 1/	0.2	0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0
External balance 1/	-0.2	-0.8	-0.1	0.0	0.0	-0.1	-0.1	0.0	-0.1
Exports of Goods and Services	1.2	4.6	4.7	5.5	4.9	4.7	4.7	4.7	4.7
Imports of Goods and Services	1.8	6.7	4.3	4.8	4.2	4.5	4.4	4.3	4.3
Current account 2/	-1.4	-2.0	-2.3	-2.3	-2.2	-2.3	-2.2	-2.2	-2.2
CPI Inflation	1.4	1.3	2.1	1.9	1.9	2.0	2.0	2.0	2.0
Output gap	-0.1	0.5	-0.3	-0.4	-0.1	0.0	0.0	0.0	0.0
Employment and productivity									
Employment	1.0	1.0	1.0	0.5	0.6	0.2	0.4	0.5	0.6
Unemployment rate 3/	5.0	4.8	4.8	4.8	4.7	4.7	4.7	4.7	4.7
Productivity 4/	1.6	2.2	0.8	2.0	2.1	2.4	2.3	2.1	2.0

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

1/ Contribution to the growth of GDP.
2/ In percent of GDP.
3/ In percent of labor force, period average; based on the Labor Force Survey.
4/ Whole economy, per worker.

Table 4. United Kingdom: Balance of Payments

	2003	2004	2005 Proj.	2006 Proj.	2007 Proj.	2008 Proj.	2009 Proj.	2010 Proj.	2011 Proj.
					(£ billion)				
Current account	-15.9	-23.2	-28.4	-29.9	-29.6	-31.9	-33.2	-34.1	-35.8
Trade balance	-31.0	-39.0	-47.9	-49.4	-49.4	-52.5	-54.8	-56.9	-59.8
Trade in goods	-47.9	-60.4	-64.1	-65.4	-67.8	-71.7	-74.9	-78.1	-81.9
Exports	188.6	190.9	209.6	227.9	241.9	256.2	271.9	288.6	305.7
Imports	236.5	251.3	273.7	293.3	309.7	327.8	346.8	366.7	387.7
Trade in services	16.9	21.4	16.2	16.0	18.4	19.2	20.1	21.2	22.1
Exports	93.6	103.0	101.5	105.2	112.6	119.3	125.7	132.3	138.8
Imports	76.7	81.6	85.3	89.2	94.2	100.1	105.6	111.1	116.7
Income balance	25.0	26.7	31.9	32.5	33.5	35.0	36.8	38.8	40.9
Current transfers	-10.0	-10.9	-12.4	-13.0	-13.7	-14.4	-15.2	-16.0	-16.9
Central government	-7.0	-8.3	-9.5	-9.9	-10.4	-11.0	-11.6	-12.2	-12.9
Other sectors	-3.0	-2.6	-2.9	-3.1	-3.3	-3.4	-3.6	-3.8	-4.0
Capital account	1.3	1.9	...	...	...	...	...	...	...
Financial account	28.9	15.4	...	...	...	...	...	...	...
Direct investment	-20.5	-10.2	...	...	...	...	...	...	...
Portfolio investment	59.6	-54.5	...	...	...	...	...	...	...
Other investment	-11.7	80.2	...	...	...	...	...	...	...
Reserve assets	1.6	-0.2	...	...	...	...	...	...	...
Net errors and omissions	-14.2	5.9	...	...	...	...	...	...	...
					(In percent of GDP)				
Current account	-1.4	-2.0	-2.3	-2.3	-2.2	-2.3	-2.2	-2.2	-2.2
Trade balance	-2.8	-3.3	-4.0	-3.9	-3.7	-3.7	-3.7	-3.6	-3.6
Trade in goods	-4.3	-5.2	-5.3	-5.1	-5.1	-5.1	-5.0	-5.0	-5.0
Exports	17.1	16.4	17.3	17.9	18.0	18.1	18.3	18.4	18.5
Imports	21.4	21.6	22.6	23.0	23.1	23.2	23.3	23.4	23.4
Trade in services	1.5	1.8	1.3	1.3	1.4	1.4	1.3	1.4	1.3
Exports	8.5	8.8	8.4	8.3	8.4	8.4	8.4	8.4	8.4
Imports	6.9	7.0	7.0	7.0	7.0	7.1	7.1	7.1	7.1
Income balance	2.3	2.3	2.6	2.6	2.5	2.5	2.5	2.5	2.5
Current transfers	-0.9	-0.9	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Capital and financial account	2.7	1.5	...	...	...	...	...	...	...
Of which:									
Direct investment	-1.9	-0.9	...	...	...	...	...	...	...
Portfolio investment	5.4	-4.7	...	...	...	...	...	...	...
Other investment	-1.1	6.9	...	...	...	...	...	...	...

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

Table 5. United Kingdom: Public Sector Budgetary Projections 1/

(Percent of GDP and percent of potential GDP)

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
				PBR 2005				
Total revenue	37.5	38.2	39.5	40.3	40.6	40.7	40.8	40.8
Current revenue	37.4	38.1	39.4	40.2	40.5	40.6	40.7	40.7
Primary revenue	37.0	37.7	39.0	39.9	40.1	40.2	40.3	40.3
Tax revenue	35.3	36.2	37.4	38.2	38.5	38.5	38.6	38.6
Non-tax revenue	1.7	1.5	1.6	1.6	1.7	1.7	1.7	1.7
Interest revenue	0.4	0.5	0.4	0.4	0.4	0.4	0.4	0.4
Capital revenue	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Total expenditure	40.6	41.5	42.6	43.0	42.9	42.5	42.4	42.2
Current expenditure	37.9	38.6	39.0	39.3	39.2	38.8	38.7	38.5
Primary expenditure	35.9	36.5	36.9	37.2	37.1	36.7	36.6	36.4
Interest payments	2.0	2.1	2.2	2.1	2.1	2.1	2.1	2.1
Capital expenditure	2.7	3.0	3.5	3.7	3.7	3.6	3.7	3.6
Depreciation	1.2	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Current balance 2/	-1.8	-1.7	-0.9	-0.3	0.0	0.5	0.7	0.8
Overall balance	-3.2	-3.3	-3.0	-2.6	-2.3	-1.8	-1.6	-1.4
Net debt 3/	32.8	34.7	36.5	37.4	37.9	38.2	38.2	38.2
Cyclically adjusted 4/								
Current balance 2/	-1.4	-1.3	-0.1	0.7	0.7	0.7	0.7	0.8
Overall balance	-2.7	-2.9	-2.2	-1.6	-1.6	-1.6	-1.5	-1.4
Output gap	-0.5	-0.5	-1.4	-1.5	-0.7	-0.1	0.0	0.0
Deflator growth	2.6	2.1	2.4	2.5	2.7	2.7	2.7	2.7
Real GDP growth	2.8	2.7	1.7	2.3	3.0	2.7	2.3	2.2
					Staff projections			
Total revenue	37.5	38.2	39.4	39.9	40.2	40.2	40.3	40.3
Current revenue	37.4	38.1	39.3	39.8	40.1	40.1	40.3	40.3
Primary revenue	37.0	37.6	38.9	39.4	39.7	39.7	39.9	39.9
Tax revenue	35.2	36.1	37.3	37.8	38.0	38.0	38.1	38.2
Non-tax revenue	1.7	1.5	1.6	1.6	1.7	1.7	1.7	1.7
Interest revenue	0.4	0.5	0.4	0.4	0.4	0.4	0.4	0.4
Capital revenue	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Total expenditure	40.6	41.5	42.4	42.8	43.0	42.5	42.5	42.3
Current expenditure	38.0	38.5	39.0	39.3	39.3	38.9	38.8	38.6
Primary expenditure	36.0	36.4	36.9	37.2	37.1	36.7	36.6	36.4
Interest payments	2.0	2.1	2.2	2.1	2.2	2.2	2.2	2.2
Capital expenditure	2.6	3.1	3.4	3.6	3.7	3.6	3.7	3.6
Depreciation	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Current balance 2/	-1.9	-1.6	-1.0	-0.7	-0.5	-0.1	0.1	0.3
Overall balance	-3.1	-3.3	-3.0	-2.9	-2.8	-2.4	-2.1	-2.0
Net debt 3/	32.8	34.7	36.4	37.8	38.9	39.6	39.9	40.1
Cyclically adjusted 4/								
Current balance 2/	-1.9	-1.9	-0.9	-0.5	-0.3	-0.1	0.1	0.3
Overall balance	-3.1	-3.6	-2.9	-2.7	-2.6	-2.3	-2.1	-2.0
Output gap	0.1	0.4	-0.4	-0.3	-0.1	0.0	0.0	0.0
Deflator growth	2.6	2.1	2.1	2.8	2.5	2.6	2.7	2.7
Real GDP growth	2.8	2.8	1.8	2.7	2.7	2.7	2.7	2.6

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

1/ Staff estimates are based on staff growth projection. Official estimates are based on official growth projections.

2/ Including depreciation.

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

4/ Staff estimates are based on staff projections of potential output. Official estimates are based on official projections of potential output.

United Kingdom: Basic Data

Demographic and other data:

Area	94,247 square miles (244,100 sq. km.)
Population (2004)	59.8
Infant mortality (per 1,000 live births, 2004)	5.1
GDP per capita (2003)	SDR 22,925

Composition of GDP in 2004, at current prices	In billions of Pounds	Distribution in Percent
Private consumption	760.8	65.6
Public consumption	247.0	21.3
Total investment (including stockbuilding)	190.5	16.4
Total domestic demand	1198.2	103.4
Exports of goods and services	293.9	25.4
Imports of goods and services	332.9	28.7
GDP at market prices	1159.3	100

Selected economic data	2001	2002	2003	2004	2005 Proj.	2006 Proj.
	(Annual percentage change)					
Output and unemployment:						
Real GDP (at market prices)	2.2	2.0	2.5	3.2	1.8	2.5
Industrial production	-4.5	-0.6	0.3	0.6	...	
Unemployment (in percent)	5.1	5.2	5.0	4.7	4.8	4.8
Earnings and prices:						
Average earnings in manufacturing	4.3	3.5	3.6	3.7	4.2	4.1
CPI inflation (average)	1.2	1.3	1.4	1.3	2.1	1.9
Money and interest rates:						
M0 (end of period)	7.6	6.4	7.4	5.7	5.0	...
M4 (end of period)	6.7	7.0	7.2	8.8	12.6	...
3-month Interbank rate	4.9	4.0	3.7	4.6	4.7	...
10-year government bond yield	4.9	4.8	4.5	4.9	4.4	...
	(In billions of pounds sterling)					
Fiscal accounts (In percent of GDP): 1/						
General government balance	0.0	-2.1	-3.1	-3.3	-2.9	-2.8
Public sector balance	0.0	-2.3	-3.1	-3.3	-3.0	-2.9
Public sector net debt	30.1	31.4	32.8	34.7	36.4	37.8
Balance of payments (4 quarters moving sum):						
Current account balance	-22.2	-16.5	-15.9	0.0	-28.4	-29.9
(In percent of GDP)	-2.2	-1.6	-1.4	-2.0	-2.3	-2.3
Trade balance	-26.9	-31.6	-31.0	76.0	-47.9	-49.4
Exports	273.1	274.9	282.2	76.0	311.0	333.0
Imports	300.1	306.5	313.2	0.0	359.0	382.5
Direct investment (net)	-4.0	-17.7	-20.5	-10.2	...	...
Portfolio investment (net)	-38.4	50.0	59.6	-54.5	...	...
Reserve assets	3.1	0.5	1.6	-0.2	...	...

Source: National Statistics; HM Treasury; and IMF staff estimates.
HM Treasury and staff estimates.
1/ Fiscal year beginning April 1.

United Kingdom: Fund Relations
(As of December 31, 2005)

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

II. **General Resources Account**:

	SDR Million	% Quota
Quota	10,738.50	100.00
Fund holdings of currency	9,110.76	84.84
Reserve position in Fund	1,627.83	15.16
23.27		

III. **SDR Department**:

	SDR Million	% Allocation
Net cumulative allocation	1,913.07	100.00
Holdings	200.59	10.49
Designation Plan	0.00	

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

V. **Financial Arrangements**: None

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

VII. **Exchange Rate Arrangement**:

The U.K. authorities maintain a floating regime. As of December 31, 2005, the exchange rate for sterling was $1.76. 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, the current Government of Zimbabwe; and persons considered to be a threat to peace and reconciliation in Sudan, Cote d'Ivoire, and Democratic Republic of Congo; and persons considered by the UN to have been involved in the assassination of former Lebanese Prime Minister Rafik Hariri. These restrictions have been notified to the Fund under Decision 144-(52/51).

VIII. **Article IV Consultation**:

Discussions for the 2004 Article IV consultation were conducted in London during December 8–20, 2004. The Staff Report (IMF Country Report No. 05/80) was considered by the Executive Board on March 2, 2005 (EBM/05/20).

IX. **FSAP**

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

X. **Technical Assistance**: None

XI. **Resident Representative**: None

United Kingdom: Statistical Issues

The United Kingdom maintains high standards of economic data provision. The authorities publish a full range of economic and financial data that is available electronically and have subscribed to the Special Data Dissemination Standard (SDDS). The U.K. shifted to ESA95 in September 1997. In recent years, the authorities have implemented a number of important methodological changes to the national accounts dataset, most of which were related to the adoption of ESA95. In 2003 the authorities introduced further revisions reflecting a shift to annual chain-linking, corrections for import fraud, and revisions in some volatile construction data.

Table of Common Indicators Required for Surveillance
(As of January 30, 2006)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	1/30/06	1/30/06	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Dec 2005	1/3/06	M	M	M
Reserve/Base Money	Dec 2005	Jan 2006	M	M	M
Broad Money	Dec 2005	Jan 2006	M	M	M
Central Bank Balance Sheet	Dec 2005	Jan 2006	M	M	M
Consolidated Balance Sheet of the Banking System	Dec 2005	Jan 2006	M	M	M
Interest Rates[2]	1/30/06	1/30/06	D	D	D
Consumer Price Index	Dec 2005	Jan 2006	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Dec 2005	Jan 2006	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Dec 2005	Jan 2006	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Dec 2005	Jan 2006	M	M	M
External Current Account Balance	Q3 2005	Dec 2005	Q	Q	Q
Exports and Imports of Goods and Services	Nov 2005	Jan 2006	M	M	M
GDP/GNP	Q4 2005	Jan 2006	Q	Q	Q
Gross External Debt	Q3 2005	Dec 2005	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 governments.
[5] Including currency and maturity composition.
[6] Daily (D), weekly (W), monthly (M), quarterly (Q), annually (A), irregular (I), and not available (NA)

United Kingdom: Sustainability Exercises

Fiscal sustainability

The analysis, conducted using the standard template, shows that the rise in public debt is unlikely to cause financing difficulties over the next few years, given that net public sector debt starts from a low level and increases only slowly over time.

In the *baseline scenario*, which assumes that no policy action is taken, the net public debt-to-GDP ratio grows from 37¾ percent of GDP in 2005 to 44¼ percent of GDP in 2010, given the staff projection that the primary balance remains in deficit during this period (Table A1). This rise in the public debt ratio is unlikely to create debt management problems, given that it is relatively slow and from a level that is one of the lowest among industrial countries. The stabilization of the public debt ratio would require an improvement of the primary balance.

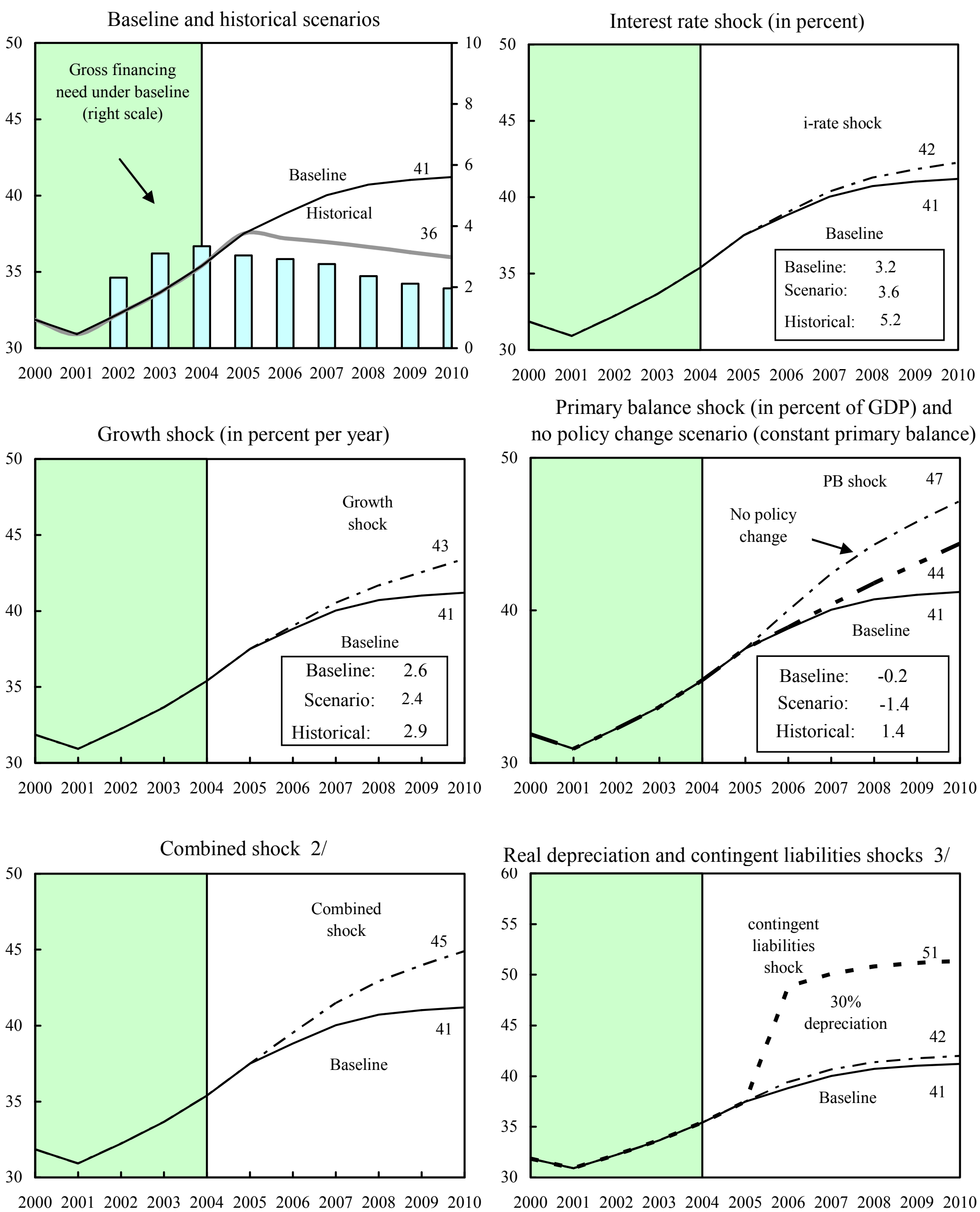
In the *alternative scenarios*, the evolution of the public debt-to-GDP ratio is generally similar to that in the baseline. Only Scenario A1 shows a decline in the debt ratio, reflecting the assumption (consistent with the historical average) that the primary balance is in surplus. Scenario A2 indicates a somewhat larger increase in the debt ratio, consistent with the assumption of constant primary balance in 2006–10.

In the *bound test scenarios*, the debt ratio stays below 50 percent of GDP in most cases. The worst deterioration—to just about 55 percent of GDP—occurs under the assumption that contingent liabilities amounting to 10 percent of GDP materialize in 2006.

External sustainability

External debt sustainability does not appear to be an issue in the United Kingdom (Table A2). The U.K.'s role as an international financial center implies large gross external assets and liabilities (gross external liabilities in 2004 were 350 percent of GDP, compared to about 100 percent of GDP in the United States). The impact of revaluations on the net external position has been greater than that of financial flows in all but one year since 1990 (valuation changes have been dominated by currency effects). Cross-border mergers and acquisitions can also have a sizable impact on the net external position. As a result, one standard deviation for both net portfolio investment and net foreign direct investment (calculated over the last ten years) is about 10 percentage points of GDP. The recent widening of net external liabilities reflects primarily valuation changes and is not especially large. It is mainly due to a reduction in the net foreign asset holdings of the private non-financial sector (the reduction is concentrated in their net portfolio investment position). The FSAP concluded in 2003 found that the large cross-border financial operations associated with the role of London as an international financial center do not pose a systemic risk to the domestic financial system.

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



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data.Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2006, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table A1. United Kingdom: Public Sector Debt Sustainability Framework, 2000-2010
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2000	2001	2002	2003	2004			2005	2006	2007	2008	2009	2010	
								I. Baseline Projections						Debt-stabilizing primary balance 10/
Public sector debt 1/	31.9	30.9	32.2	33.7	35.4			**37.5**	**38.8**	**40.0**	**40.7**	**41.0**	**41.2**	**0.1**
o/w foreign-currency denominated	2.4	1.8	1.6	1.4	1.3			1.3	1.3	1.3	1.3	1.3	1.3	
Change in public sector debt	-5.3	-0.9	1.3	1.4	1.7			2.1	1.3	1.2	0.7	0.3	0.2	
Identified debt-creating flows (4+7+12)	-3.3	-1.3	0.6	1.3	1.6			3.1	1.1	0.9	0.4	0.0	-0.1	
Primary deficit	-4.4	-2.3	0.3	1.1	1.3			0.9	0.8	0.6	0.2	-0.1	-0.3	
Revenue and grants	39.5	38.5	37.1	37.5	38.2			39.4	40.0	40.3	40.3	40.4	40.4	
Primary (noninterest) expenditure	35.1	36.3	37.4	38.6	39.4			40.3	40.8	40.9	40.5	40.3	40.1	
Automatic debt dynamics 2/	1.2	0.9	0.3	0.2	0.4			0.9	0.3	0.3	0.2	0.1	0.1	
Contribution from interest rate/growth differential 3/	1.0	0.9	0.5	0.3	0.5			0.9	0.2	0.2	0.2	0.1	0.1	
Of which contribution from real interest rate	2.3	1.5	1.1	1.2	1.4			1.4	1.1	1.2	1.2	1.1	1.1	
Of which contribution from real GDP growth	-1.3	-0.6	-0.6	-0.9	-0.9			-0.6	-0.9	-1.0	-1.0	-1.0	-1.0	
Contribution from exchange rate depreciation 4/	0.2	0.1	-0.2	-0.2	-0.1			0.0	0.0	0.0	0.0	0.0	0.0	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0			1.3	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3)	-2.0	0.4	0.8	0.2	0.1			-1.0	0.3	0.4	0.3	0.3	0.3	
Public sector debt-to-revenue ratio 1/	80.6	80.3	86.8	89.7	92.7			95.1	97.0	99.3	101.1	101.5	102.0	
Gross financing need 5/	-1.7	0.0	2.3	3.1	3.3			3.0	2.9	2.8	2.4	2.1	2.0	
in billions of U.S. dollars	-24	0	37	57	72	10-Year Historical Average	10-Year Standard Deviation	67	66	65	58	54	52	Projected Average
Key Macroeconomic and Fiscal Assumptions														
Real GDP growth (in percent)	3.6	2.0	2.1	2.8	2.8	2.9	0.5	1.7	2.6	2.6	2.6	2.6	2.6	2.6
Average nominal interest rate on public debt (in percent) 6/	7.8	7.3	6.9	6.7	6.5	7.7	0.9	6.3	6.0	5.9	5.8	5.7	5.7	5.8
Average real interest rate (nominal rate minus change in GDP deflator, in percent	6.4	4.9	3.8	4.0	4.4	5.2	0.9	4.2	3.2	3.4	3.2	3.0	3.0	3.2
Nominal appreciation (increase in US dollar value of local currency, in percent)	-7.7	-2.8	11.1	10.7	8.2	2.3	6.9	-0.9	-3.5	-1.0	-1.1	-1.0	-1.0	-1.5
Inflation rate (GDP deflator, in percent)	1.3	2.5	3.2	2.6	2.1	2.6	0.6	2.1	2.8	2.5	2.6	2.7	2.7	2.6
Growth of real primary spending (deflated by GDP deflator, in percent)	5.7	5.4	5.4	6.1	5.1	2.9	3.1	3.9	3.8	2.9	1.6	2.4	2.1	2.6
Primary deficit	-4.4	-2.3	0.3	1.1	1.3	-1.4	2.4	0.9	0.8	0.6	0.2	-0.1	-0.3	0.2
								II. Stress Tests for Public Debt Ratio						Debt-stabilizing primary balance 10/
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2006-10 7/								**37.5**	**37.2**	**36.9**	**36.6**	**36.3**	**36.0**	**0.8**
A2. No policy change (constant primary balance) in 2006-10								**37.5**	**38.9**	**40.4**	**41.8**	**43.0**	**44.4**	**0.1**
B. Bound Tests														
B1. Real interest rate is at baseline plus one standard deviations								**37.5**	**39.0**	**40.4**	**41.3**	**41.8**	**42.3**	**0.3**
B2. Real GDP growth is at historical average minus two standard deviations in 2006 and 2007								**37.5**	**39.0**	**40.5**	**41.7**	**42.6**	**43.4**	**0.2**
B3. Primary balance is at historical average minus two standard deviations in 2006 and 2007								**37.5**	**40.0**	**42.4**	**44.3**	**45.8**	**47.2**	**0.2**
B4. Combination of B1-B3 using one standard deviation shocks								**37.5**	**39.5**	**41.5**	**42.9**	**44.0**	**44.9**	**0.3**
B5. One time 30 percent real depreciation in 2006 9/								**37.5**	**39.4**	**40.7**	**41.4**	**41.7**	**42.0**	**0.1**
B6. 10 percent of GDP increase in other debt-creating flows in 2006								**37.5**	**48.8**	**50.1**	**50.8**	**51.2**	**51.4**	**0.2**

1/ Defined as net debt, which includes liquid assets (mainly official reserve assets and bank deposits) amounting to about 5 percent of GDP. Based on fiscal year (April-March). Definition of net public debt ratio in this exercise differs from official and staff projections. Official and staff projections use centered-GDP as the denominator. Public sector includes general government and public companies.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi\ (1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ The implied change in other key variables under this scenario is discussed in the text.
9/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
10/ 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.

Table A2. United Kingdom: Net Investment Position 1/
(Percent of GDP)

	2000	2001	2002	2003	2004	2005Q3
Assets	311	315	298	318	338	386
Direct investment abroad	64	61	59	60	57	59
Portfolio investment abroad	95	94	81	85	94	104
Other investment abroad	150	158	156	171	185	222
Reserve assets	3	3	2	2	2	2
Liabilities	315	322	303	324	350	404
Direct investment in the UK	33	36	32	32	33	39
Portfolio investment in the UK	105	96	85	95	101	113
Other investment in the UK	178	190	186	197	217	252
Net investment position	-4	-7	-5	-6	-12	-18
Direct investment	31	24	27	28	24	19
Portfolio investment	-10	-2	-5	-10	-7	-9
Other investment	-28	-32	-29	-26	-32	-30
Reserve assets	3	3	2	2	2	2
Monetary Financial Institutions	-7	-9	-13	-14	-16	-14
Other Sectors	6	5	11	12	8	3
Public Sector	-3	-3	-2	-3	-4	-6
Memorandum Items:						
Change in the net investment position		-3.6	2.6	-1.3	-6.6	-5.6
o/w Valuation change		-1.6	3.4	1.3	-5.3	-4.0
Current account balance		-2.2	-1.6	-1.4	-2.0	-2.0

Source: Office on National Statistics.
1/ Data correspond to the end of the indicated period. They are expressed as a percent of the cumulated GDP of the four quarters ending on that date.

Table A3. United Kingdom: Indicators of External and Financial Vulnerability
(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003	2004	2005	Latest availal as of:
External indicators								
Exports (annual percentage change, in U.S. dollars) 1/	1.3	4.6	-3.0	5.0	11.8	16.7	7.7	Sep-05
Imports (annual percentage change, in U.S. dollars) 1/	4.2	5.3	-0.6	6.5	11.3	19.1	9.5	Sep-05
Terms of trade (annual percentage change)	0.6	-0.8	-0.7	2.8	1.1	0.0		
Current account balance	-2.7	-2.6	-2.2	-1.6	-1.4	-2.0	-2.0	Sep-05
Capital and financial account balance	-2.5	-1.6	-2.1	-0.8	-2.7	-1.5	0.3	Sep-05
Of which : Foreign direct investment (net)	-7.7	-7.8	-0.4	-1.7	-1.9	-0.9	5.0	Sep-05
Portfolio investment (net)	10.2	10.4	-3.9	4.8	5.4	-4.7	-3.1	Sep-05
Other investment (net)	-0.1	-0.7	5.9	-2.4	-1.1	6.9	-0.2	Sep-05
Net errors and omissions	0.2	1.0	0.2	0.7	-1.3	0.5		
Official reserves (in billions of U.S. dollars, end of period) 2/	42.2	48.1	39.4	42.5	46.1	49.4	46.8	Sep-05
Central bank net foreign assets (in billions of U.S. dollars)	-1.9	-1.7	2.2	1.2	0.6	-1.9	-6.1	Sep-05
Foreign assets of banking institutions (in billions of U.S. dollars)	1819	2106	2209	2500	3074	3764	4096	Sep-05
Foreign liabilities of banking institutions (in billions of U.S. dollars)	1803	2094	2237	2591	3162	3896	4161	Sep-05
Exchange rate against U.S. dollar (period average)	1.62	1.52	1.44	1.50	1.63	1.83	1.82	
Financial markets indicators								
Public sector net debt 13/	37.1	32.0	30.1	31.4	32.8	34.7	36.6	
3-month T-bill yield	5.0	5.8	4.8	3.9	3.6	4.4	4.6	
3-month T-bill yield (real) 3/	3.6	2.6	3.1	0.9	1.0	1.2	1.9	Nov-05
Change in stock market index (percent, end of period)	21.2	-8.0	-15.4	-25.0	16.6	9.2	18.1	
Spread of 3-month T-bill vs. the U.S. (percentage points)	0.0	-0.2	2.1	2.7	3.0	2.5	0.4	
Credit indicators 4/								
M4 lending (exc. effect of securitisations and loan transfers)	9.0	12.4	8.8	10.4	11.5	12.6	11.4	Nov-05
Total lending to individuals								
Secured on dwellings	8.2	8.2	10.0	13.3	15.0	12.9	10.3	Nov-05
Consumer credit	14.6	12.5	14.0	15.4	13.5	14.1	9.8	Nov-05
o/w Credit card	20.7	21.1	17.2	18.7	21.0	21.7	12.5	Nov-05
M4 lending to private non financial corporations	5.4	12.4	7.5	6.9	6.8	7.1	18.7	Nov-05
Lending to construction sector	1.0	1.2	1.4	1.4	1.4	1.5	1.7	Sep-05
Lending to real estate sector	5.0	6.0	7.2	8.3	9.1	10.0	11.4	Sep-05
Interest rate on personal loans 5/	15.4	15.7	15.9	15.0	12.8	14.3	14.0	
Interest rate on fixed rate mortgages 5/	7.1	6.5	5.7	5.3	5.7	5.5	5.2	
Interest rate on time deposits 5/	4.2	4.4	2.6	2.5	2.1	3.1	2.9	
Financial sector risk indicators 6/								
Total loans to assets (percent)	82.5	82.0	82.1	83.1	83.4	83.1	83.1	Sep-05
Total loans to deposits (percent)	93.5	92.9	92.2	93.8	93.6	83.1	92.2	Sep-05
Foreign exchange loans (in US$bn)	1443.5	1698.5	1,789.1	2059.5	2599.3	3165.3	3413.0	Sep-05
Net foreign exchange loan (in US$bn)	-255.2	-296.5	-368.3	-640.4	-796.9	-959.5	-983.5	Sep-05
Share of foreign exchange loans in total lending (percent)	39.2	41.4	41.8	41.3	42.7	43.0	44.7	Sep-05
Deposits in foreign exchange (in US$bn)	1698.7	1995.0	2,157.4	2699.9	3396.2	4124.8	4396.4	Sep-05
Share of foreign deposits in total deposits (percent)	54.9	57.3	57.8	57.9	56.1	57.3	58.6	Sep-05
Share of foreign denominated liabilities in total liabilities (percent)	48.5	52.4	52.5	52.8	54.3	54.7	56.2	Sep-05
Share of real estate sector in private credit (percent) 7/	48.6	46.9	47.5	48.8	49.4	48.7	48.1	Sep-05
Share of real estate sector in loans to non financial private corporations (percent) 7/	0.0	27.9	32.1	35.4	39.4	43.1	39.6	Sep-05
Share of non-performing loans in total loans (percent) 7/ 8/ 9/	3.0	2.5	2.6	2.6	2.5	1.9		Sep-05
Share of non-performing loans in total assets sector (%)	2.1	1.7	1.7	1.7	1.8	1.3		Sep-05
Regulatory capital to risk-weighted assets 8/ 10/	14.0	13.0	13.2	13.1	13.0	12.7		Sep-05
Return on Equities	16.2	13.5	7.7	6.1	8.6	10.9		Sep-05
Return on Assets (before taxes) 8/ 11/	1.0	0.9	0.5	0.4	0.6	0.7		Sep-05

Source: National Statistics; Bank of England; FSA and IMF, International Financial Statistics.

1/ Exports and imports of trade in goods and services at current prices
2/ Including gold, national valuation.
3/ Calculated as 3-month T-bill over actual 12-month RPI inflation in Dec of relevant year.
4/ Twelve-month growth rates.
5/ Weighted averages for banks and building societies.
6/ Building societies and insurance companies are excluded from this sample. 'Deposits' includes currency, deposits and money market instruments.
7/ The figures for non-performing loans represent the gross value of loans against which specific provisions have been made.
8/ Includes mortgage banks.
9/ NPL's to Total Loans calculated using prospective methodology that will be used for the Financial Soundness Indicator (FSI) of the same name.
10/ Capital to RWA calculated using prospective methodology that will be used for the Financial Soundness Indicator (FSI) of the same name.
11/ Return on Assets calculated using prospective methodology that will be used for the Financial Soundness Indicator (FSI) of the same name.
12/ Return (pre-tax profit) accrues throughout the year, so will be expected to be a lower in June than at end-year.
13/ Fiscal Year Basis

Statement by Tom Scholar, Executive Director for the United Kingdom
March 1, 2006

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

Economic prospects

Growth was below trend in 2005 at 1.8 percent, in the face of rising oil prices, weak demand in the euro area and the necessary slowing of the housing market and consumer spending. Nevertheless the UK was among the fastest growing European economies and continues to enjoy an unprecedented period of economic stability, with 54 consecutive quarters of growth, the longest unbroken expansion on record. The economic fundamentals remain sound: CPI inflation at 1.9 percent, short term interest rates at 4.5 percent, and employment at record levels of 75 percent. Growth is forecast (in the 2005 Pre-Budget Report) to increase to 2 to 2½ percent in 2006, and 2 ¾ to 3 ¼ percent in 2007, with inflation at or close to target. As staff note, there are risks: my authorities remain vigilant to these and agree with staff on the need for cautious macroeconomic polices, to which they are fully committed.

Monetary and fiscal policy

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

- Fiscal policy set according to two fiscal rules:
    - the golden rule—over the cycle, the Government will borrow only to invest;
    - the sustainable investment rule—over the cycle, public sector net debt will be held at a stable and prudent level, defined as 40 percent or less;
- Monetary policy set by the Bank of England's Monetary Policy Committee to meet a symmetric inflation target.

My authorities agree with staff that the fiscal and monetary policy frameworks have served the UK well, anchoring expectations and delivering long-term stability.

Fiscal policy will, as usual, be set in the Budget. The latest official projections show a gradual reduction in the deficit to 1½ percent of GDP, with an average annual surplus on the current budget over the cycle, and net debt stabilising at 38 percent of GDP. My authorities are therefore meeting the fiscal rules.

Staff project a slightly higher medium-term deficit (2 percent), reflecting a different view of the output gap. My authorities believe that recent average earnings and labour market data point to considerable spare capacity in the economy. On prospects for the public finances, they expect the recent strength in monthly receipts to be sustained through 2006/07, and corporation tax to return to its long-term average. In any case they view the difference of view expressed by staff as modest, and well within the normal margins of error on medium-term fiscal projections.

Staff recognise that the fiscal rules have constrained discretion, as intended, and that they provide a means of protecting investment spending and guarding against pro-cyclical fiscal policy. But they suggest replacing a rule defined over the cycle (and which allows the automatic stabilizers to operate) with one requiring the current budget to be in balance three years ahead. My authorities believe this could introduce a risk of pro-cyclicality, given the typical pattern of economic cycles, and recall the unsuccessful experience with such a rule during the 1980s.

Staff suggest extending the scope of NAO audit. My authorities keep this constantly under review, and last year extended it to include the dating of the economic cycle (where, as staff note, the NAO endorsed the Treasury methodology as reasonable and concluded that the change would not reduce the extent of caution in the fiscal projections). There is also extensive external scrutiny of the government's assessment of the output gap and the cyclical position of the economy.

On pensions, my authorities believe that the UK system is better placed than most to confront future demographic challenges. Nevertheless there are issues to be addressed, and the Pensions Commission's report and the Treasury's Long Term Public Finances Report provide useful analytical material for doing so. My authorities will provide their response to the Pensions Commission's proposals in the coming months.

My authorities welcome the FSAP Follow-Up Report in the Selected Issues papers. This is well-focused, concentrating on what the UK authorities have been doing to implement the recommendations in the 2002 FSAP, and providing an assessment of current risks to the UK financial sector outlook. As a general policy matter it will be interesting to see whether this new approach will strengthen follow-up on FSAP findings in Article IV reports across the membership.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 05/24
FOR IMMEDIATE RELEASE
March 3, 2006

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

IMF Executive Board Concludes 2005 Article IV Consultation with the United Kingdom

On March 1, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the United Kingdom.[1]

Background

Macroeconomic stability remains remarkable, due in part to confidence-enhancing policy frameworks and generally sound implementation. With economic activity above potential in 2004, some easing of real GDP growth and rise of inflation in 2005 were expected. In the event, the slowdown in growth and rise in inflation were sharper than envisaged. The growth slowdown was driven mainly by a fall in private consumption growth, reflecting the cooling of the housing market, previous monetary policy tightening, and rising personal income tax revenues. Employment growth remained surprisingly rapid, owing in part to strong immigration and increased labor force participation by older people. CPI inflation peaked at 2½ percent in September, reflecting the earlier testing of supply constraints and the sharp increase in energy prices.

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

The simultaneous slowdown in aggregate demand and the large rise in energy prices presented monetary policy with conflicting signals. Higher energy prices produced an increase in the overall price level and a risk of second-round effects on inflation. A further consideration was the strength of immigration, especially from new EU members, which may have boosted labor supply relative to demand for goods and services. The only change in the policy interest rate in 2005 was a ¼ percentage point cut to 4½ percent in August.

Over much of the past decade, fiscal policy managed to contain—even reduce—debt while playing a useful countercyclical role. However, the sharp increase in government spending on public infrastructure and public services that began in FY2000/01 continued in FY2003/04 and FY2004/05. The result, as growth picked up, was procyclical stimulus, a growing deficit, and a rising debt ratio. In FY2004/05, the overall public sector deficit was 3¼ percent of GDP and end-year net debt amounted to almost 35 percent of GDP.

The banking system is strong, though the possible reversal of low global interest rates poses a risk. Ratings agencies continue to rank the U.K. banking system as one of the strongest among G7 countries. However, over the medium term, increasing leverage and the continuing search for yield represent downside risks. These risks, while global, are particularly relevant for the U.K. given the size and openness of its financial sector.

A longer-term question is whether private saving is adequate to support an aging population in the context of a frugal state pension system. Long-term fiscal sustainability in the U.K. is helped by less severe population aging and a less generous state pension system than in other G7 countries. However, if the working generation does not save enough for retirement, future governments may be forced to increase state pensions. There is evidence that a portion of the population is not saving enough to meet likely expectations of retirement income.

Executive Board Assessment

Executive Directors welcomed the U.K. economy's remarkable performance that has lasted more than a decade, and has been marked by continued economic expansion, falling unemployment, and sustained low inflation. Directors attributed this success to sound policies implemented by strong institutions and underpinned by monetary, fiscal, financial, and structural policy frameworks that have increasingly instilled confidence in the authorities' conduct of macroeconomic policies. Developments in 2005 put these policy frameworks to the test, with a slowdown in real GDP growth and a rise in inflation that were the sharpest in a decade, reflecting the economy's advanced cyclical position, the abrupt deceleration in house prices, and the sharp rise in oil prices. Monetary policy faced difficult choices, while fiscal policy needed adjustment in order to meet the authorities' fiscal rules.

Prospects for the U.K. economy going forward are favorable, with growth expected to pick up in 2006-2007 on the strength of private consumption, and inflation remaining stable around the target. Directors observed that the current account deficit and the negative international investment position are not major concerns, and that there is no clear evidence of overvaluation of the exchange rate. At the same time, Directors noted that important uncertainties and risks surround the outlook, to which the authorities will need to remain vigilant. These include the degree of overvaluation of house prices; the impact of high energy prices on potential output; the potential effects of immigration on aggregate supply and demand; and—on the external side—the risk that a disorderly unwinding of global imbalances could affect the value of sterling.

Directors agreed that monetary policy decisions remain delicately balanced. The cut in the policy interest rate last August appropriately acknowledged the downside risks to demand, while maintaining the rate in a neutral range. Looking ahead, Directors concurred that policy rate decisions should be focused in the very near term on averting second-round effects of the energy price increases and—following the pay rounds to be concluded in early 2006—on ensuring that the recovery of demand remains on track to close the output gap.

Directors noted that the structural fiscal deficit in the current fiscal year is on track to narrow substantially, reflecting windfall revenues from higher energy prices and strong personal income and corporate tax revenues, especially from the booming financial sector.
They underscored the importance of full implementation of the authorities' plans to reduce the deficit further, including through the announced rise in the tax rate on North Sea oil and gas company profits, and restraint in the growth of current expenditure from FY2008/09. Directors agreed with the view that these measures should be sufficient to stabilize net debt. At the same time, they noted the uncertainties surrounding the estimates of the output gap, and the associated risk of the authorities' fiscal projections being somewhat more optimistic than warranted.

Directors observed that the envisaged expenditure restraint will involve difficult decisions and require careful planning, given the small share of discretionary spending in total spending and the authorities' intention to maintain the share of capital spending in GDP. They stressed the need to target the least productive expenditures, and looked forward to specific recommendations from the Comprehensive Spending Review, due for completion in mid-2007.

Directors agreed that the U.K fiscal framework is at the forefront of international best practice, particularly in terms of clarity and transparency. They observed that one particular strength of the framework is its use of independent audit of key assumptions and conventions underlying the fiscal projections. They welcomed the expansion of the role of the National Audit Office (NAO) over the past year and the authorities' intention to keep this issue under review. Several Directors saw merit in further broadening the scope of the NAO audit.

Directors agreed that the fiscal rules have played an important role in constraining discretion and disciplining fiscal policy. However, many Directors saw room for improving the credibility of the framework further in light of the unusually muted cyclical behavior of the economy and concerns regarding the redating of the economic cycle, although a number of Directors noted that the framework continues to serve the United Kingdom well. Directors noted the suggestion that, once current balance is regained, the authorities consider adopting a more forward-looking formulation that requires fiscal policy to be positioned to attain current balance in a set number of years. To bolster credibility, this could be accompanied by an independent audit of assumptions concerning the economy's cyclical position. A number of Directors, however, expressed reservations about these proposals.

Directors commended the supervisory authorities for skillfully meeting the challenge of overseeing a global financial center, and in particular for staying abreast of financial innovations in an environment marked by concerns about possible global underpricing of risk. They agreed that the banking system is well-capitalized and cost-efficient, and hence is well-positioned to absorb potential losses from financial market disturbances. Directors noted that specific risks—including exposures to commercial property, a possible loosening of corporate lending standards, and the growth of sub-prime lending—appear to be manageable. The rapid growth of credit risk transfer instruments, while providing important diversification benefits, has also created new risks. Directors therefore welcomed the authorities' efforts to publicize these risks and to address the transactions backlog. Going forward, it will be important to ensure that the development of market infrastructure and of financial institutions' risk management systems keeps pace with these innovations. Directors encouraged the authorities to continue to strengthen market surveillance and encourage market initiatives to improve disclosure, while paying due attention to the costs and benefits of new regulatory burdens.
They welcomed the FSAP follow-up report and the impressive progress in implementing the 2002 FSAP recommendations.

Directors noted with concern the evidence that a portion of the population is not saving enough to meet retirement income expectations, and underlined the importance of strengthening incentives for private saving. They welcomed the findings and recommendations of the independent Pensions Commission as a key first step in developing a consensus on the extent of the problem and measures to address it. Directors recognized that increasing the generosity of the currently frugal state pension system would come at the cost of other public expenditures, and ensuring that the trade-offs are accurately and circumspectly considered will be critical.

Directors noted that the flexible and dynamic labor market is one of the U.K. economy's key strengths. They commended the policy of allowing new members of the EU full access to the labor market, which has relieved specific skill shortages and helped mitigate inflationary pressures. Directors considered that the authorities' strategy to stimulate productivity growth is appropriate, including the current emphasis on reducing the regulatory burden and improving the skills base. They welcomed the authorities' aspiration to increase the already high employment rate further, including through innovative measures to help incapacity benefit recipients find work.

Directors praised the United Kingdom for its leadership role in promoting trade liberalization, especially of agricultural trade. They also commended the government for the recent and planned increases in overseas development assistance.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2005 Article IV consultation with the United Kingdom is also available.

United Kingdom: Selected Economic and Social Indicators

	2001	2002	2003	2004	2005 Est.	2006 Proj.
Real Economy						
Real GDP (change in percent)	2.2	2.0	2.5	3.2	1.8	2.5
Domestic demand (change in percent)	2.8	3.2	2.7	3.8	1.7	2.4
CPI	1.2	1.3	1.4	1.3	2.1	1.9
Unemployment rate (in percent) 1/	5.1	5.2	5.0	4.8	4.8	4.8
Gross national saving (percent of GDP)	15.0	15.2	14.8	14.9	14.7	15.1
Gross domestic investment (percent of GDP)	17.2	16.7	16.3	16.9	17.0	17.4
Public Finance 2/						
General government balance	0.0	-2.1	-3.1	-3.3	-2.9	-2.8
Public sector balance	0.0	-2.3	-3.1	-3.3	-3.0	-2.9
Cyclically adjusted balance	-0.5	-2.3	-3.1	-3.6	-2.9	-2.7
Public sector net debt	30.1	31.4	32.8	34.7	36.4	37.8
M0	7.6	6.4	7.4	5.7	5.0	...
M4	6.7	7.0	7.2	8.8	12.6	...
Consumer Credit	12.6	14.0	10.6	11.2	8.5	...
Interest rates (year average)						
Three-month interbank rate	4.9	4.0	3.7	4.6	4.7	...
Ten-year government bond yield	4.9	4.8	4.5	4.9	4.4	...
Balance of Payments						
Trade balance (in percent of GDP)	-2.7	-3.0	-2.8	-3.3	-4.0	-3.9
Current account balance (in percent of GDP)	-2.2	-1.6	-1.4	-2.0	-2.3	-2.3
Exports (percent of GDP)	27.4	26.2	25.5	25.2	25.7	26.1
Export volume (change in percent)	2.9	0.2	1.2	4.6	4.7	5.5
Imports (percent of GDP)	30.1	29.2	28.3	28.6	29.7	30.0
Import volume (change in percent)	4.8	4.5	1.8	6.7	4.3	4.8
Net exports of oil (in billions of U.S. dollars)	8.0	8.6	6.7	3.1	-0.5	...
Reserves (end of period, in billion of US dollars)	40.4	42.8	46.0	49.7	...	...
Fund Position (as of December 31, 2004)						
Holdings of currency (in percent of quota)						84.8
Holdings of SDRs (in percent of allocation)						10.5
Quota (in millions of SDRs)						10,738.5
Exchange Rates						
Exchange rate regime						Floating
Bilateral rate (December 31, 2004)						US$ = £0.5664
Nominal effective rate (1995=100) 5/	98.6	99.3	94.6	98.7	97.3	...
Real effective rate (1995=100) 5/ 6/	98.3	98.9	95.4	100.8	100.2	...

Social Indicators (reference year):
Income per capita (in US dollars, 2004) : 36,419; Income distribution (ratio of income received by top and bottom quintiles, 2001): 4.9; Life expectancy at birth (2003): 76.2 (male) and 80.7 (female); Automobile ownership (2001): 420 per thousand;
CO_2 emissions (ton per capita, 2002): 9.06; Population density(2002) 244 inhabitants per sq. km.; Poverty rate (share of the population below the established risk-of-poverty line, 2003): 18%

Sources: National Statistics; HM Treasury; Bank of England; International Financial Statistics; INS; World Development Indicators; and IMF staff estimates.
1/ ILO unemployment; based on Labor Force Survey data.
2/ The fiscal year begins in April. For example, fiscal balance data for 2002 refers to FY2002/03. Debt stock data refers to the fiscal year using centered-GDP as a denominator.
3/ Average. An increase denotes an appreciation.
4/ Based on Consumer Price data.
5/ As of November 2005.