

**United Kingdom: 2008 Article IV Consultation—Staff Supplement; 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 2008 Article IV consultation with the United Kingdom, the following documents have been released and are included in this package:

- A staff supplement of July 25, 2008, updating information on recent developments.
- The staff report for the 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 23, 2008, with the officials of the United Kingdom on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 7, 2008. 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 July 30, 2008 discussion of the staff report that concluded the Article IV consultation.
- A statement by the Executive Director for the United Kingdom.

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INTERNATIONAL MONETARY FUND

UNITED KINGDOM

**Staff Report**

Prepared by Staff Representatives for the 2008 Consultation with the United Kingdom

**Supplementary Information**

Approved by Alessandro Leipold and Tessa van der Willigen

July 25, 2008

1. This supplement reflects new information since the staff report was issued, notably regarding the macroeconomic outlook and the authorities' public consultation on the financial stability framework. The update does not change the thrust of the staff appraisal, but it sharpens some of the specifics on the stance of macroeconomic policies.

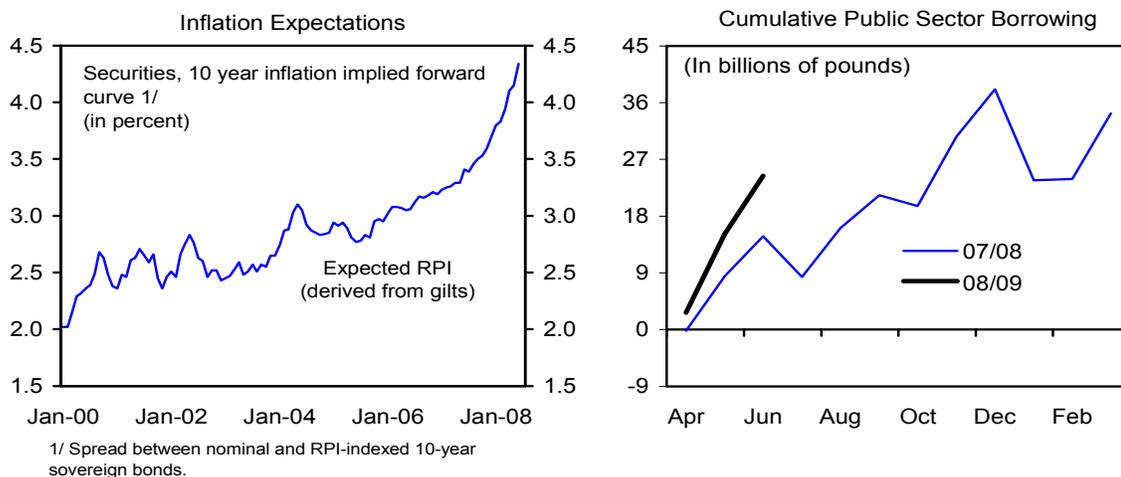
**I. OUTLOOK FOR 2008 AND 2009**

*Recent developments*

2. A spate of negative data releases suggest that the risks highlighted in the staff report are materializing, notably with headline inflation and inflation expectations rising alongside weakening activity:

- Headline inflation was 3.8 percent in June, higher than anticipated, driven by food and fuel price increases. Alongside, long-run inflation expectations implicit in yield differentials between indexed and non-indexed gilts rose above 4 percent.
- Demand and activity show signs of weakening. Despite healthy credit flows outside of housing, business investment plummeted alongside residential investment in the first quarter, with consumer demand—reflected in retail sales—following suit in June. In this context, production fell sharply, declining by ½ percent in the three months through May, with energy dropping most sharply. Indices of Purchasing Managers Intentions in manufacturing, services, and construction dipped to some of the lowest values on record, with business and consumer confidence indicators deteriorating alongside. And the Bank of England's second quarter Credit Conditions Survey pointed to further tightening in bank lending conditions.

- The housing market has also weakened markedly. House prices (the Halifax measure) fell 2½ percent in June alone, resulting in a cumulative 9 percent decline since December 2007, considerably faster than during the housing contraction of the early 1990s. Alongside, mortgage approvals fell to the lowest levels in two decades, and mortgage rates rose: in June, the average quoted rate on the two-year fixed rate mortgage with 75 percent LTV was 50 basis points up on December, despite a 75 basis points cut in the bank rate in the same period.
- Export volumes remained subdued, despite the support from sterling depreciation, as external demand has weakened.
- Economic growth slowed further to 0.8 percent in the second quarter on a seasonally adjusted annualized basis. Data on the expenditure side are not yet available.
- In this context, public borrowing in the first quarter of fiscal year 2008 (which started in April) was well above levels for the same period last year, and labor market conditions are starting to turn. Unemployment has edged up, and vacancies are falling, even though nominal wage growth remains contained. Despite recent declines in sterling money market spreads, efforts by banks to raise capital have proved difficult, with underwriters set to retain significant portions of the stock offered.

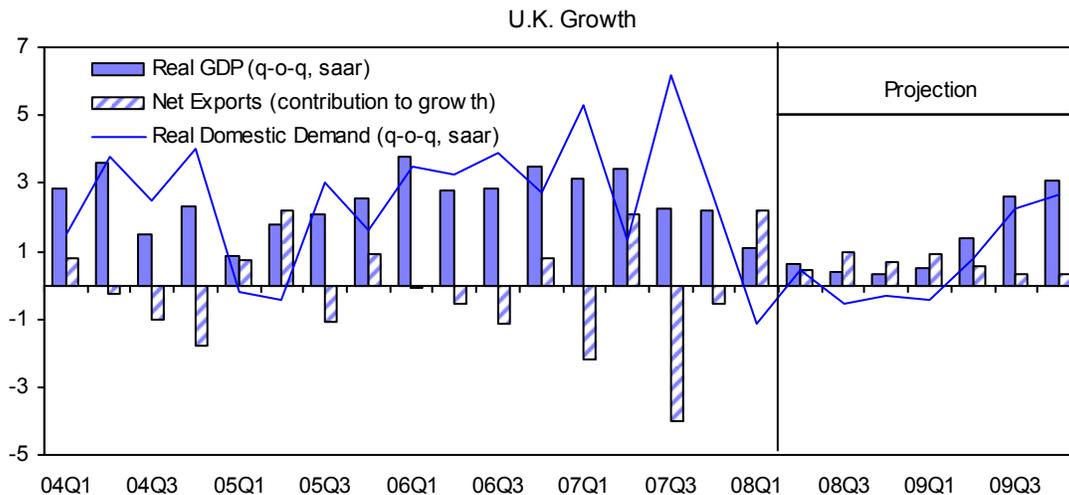


3. With the domestic economy slowing sharply and external demand set to remain weak, the risk of adverse feedback loops—between house prices, credit conditions, labor markets, and domestic demand—has increased.

#### ***Revised staff projections 2008-09***

4. Accordingly, staff now project a growth rate of 1.4 percent for 2008 as a whole, falling to 1.1 percent in 2009.

5. In particular, with fixed investment and business confidence projected to remain weak, the outlook for the labor market and consumer demand steadily declines. This compounds and prolongs broader economic weakness, and increases housing and financial sector strains that feed back to activity. The contribution of net exports remains positive, especially in 2009 as export markets are projected to recover. Accordingly, the slowdown is projected to reach its trough around the turn of the year, with the uptick starting in the second quarter of 2009 and gathering pace over the remainder of the year. These dynamics imply that year-on-year growth declines to 0.6 percent in the fourth quarter of 2008, before recovering to 1.9 percent a year later. These projections are broadly in line with consensus.



6. CPI inflation is also expected to be higher than anticipated in the staff report, peaking at close to 5 percent, and averaging 3.8 percent in 2008. It is still expected to return to target by 2010, given wage moderation and a stronger disinflationary impetus from activity.

### ***Implications for policy stance and frameworks***

7. Both the sustainable investment fiscal rule and the inflation target are set to be exceeded for protracted periods. On announced policies, the fiscal deficit is now projected to hover around 3½ percent of GDP in fiscal years 2008 and 2009, with net debt breaching and remaining above the 40 percent ceiling from 2009 onwards (Text Table 1).<sup>1</sup> There is speculation that a revision of the fiscal rule may be announced with the autumn Pre-Budget Report. On the inflation side, even if global food and fuel prices fall back somewhat and second-round effects are contained, the CPI is expected to remain above target until the end of 2009. These fiscal and inflation outcomes would be aggravated by any policy slippage.

<sup>1</sup> These projections exclude prospective level adjustments to national accounts estimates from revised measures of value added from financial intermediation services (see ¶53 in staff report).

**Text Table 1: Fiscal Balances and Public Debt 1/**

(In percent of GDP)

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
<b>Overall balance</b>						
Budget 2008	-2.6	-2.9	-2.5	-2.0	-1.6	-1.3
Staff	-2.5	-3.5	-3.6	-2.9	-2.3	-1.6
<b>Cyclically-adjusted overall balance</b>						
Budget 2008	-2.7	-2.7	-2.2	-1.7	-1.4	-1.2
Staff	-2.6	-2.8	-2.3	-1.8	-1.5	-1.3
<b>Net public debt</b>						
Budget 2008	37.1	38.5	39.4	39.8	39.7	39.3
Staff	36.9	39.1	41.3	42.4	42.8	42.6

Sources: Budget 2008 and staff projections.

1/ Staff projections are based on the change in the cyclically-adjusted overall balance in the authorities' budget 2008 projections, with the staff's growth and potential output projections.

Official estimates are based on official projections of growth and potential output.

8. Notwithstanding concerns with output prospects, the case for strengthened policies remains. Long-run inflation expectations have risen further. If the inflation anchor loses its moorings, the management of immediate macroeconomic challenges will become even more difficult and the burden on monetary policy will rise, likely impeding net exports, rebalancing, and eventual recovery. Moreover, the cost of subsequently restoring credibility will be high.

9. Accordingly, on fiscal policy, the planned medium-term fiscal consolidation—namely the cumulative structural adjustment of 1 percent of GDP in 2009 and 2010—should be regarded as a minimum. It would take an adjustment averaging  $\frac{3}{4}$  of a percentage point of GDP per year from 2009 to 2012 to set debt on a path to return under the ceiling by 2012; frontloading, to the extent possible, would underpin the credibility of that path. In any event, and in addition, any slippage from the cyclically adjusted balance objectives for 2008 announced in the March budget should be made up in 2009.

10. In this context, any revision of the fiscal rules should support the credibility of the recommended fiscal stance. The 40 percent net debt ceiling should be retained, notably through adoption of a clear and short horizon to bring debt back under the ceiling following a breach. Given the premium on fiscal credibility, accountability should be emphasized over flexibility in any redesign of the rules. This adds to the case made in the staff report to emphasize nominal expenditure ceilings.

11. On the monetary side, the focus will need to remain on stemming second-round effects. Although overt signs of these so far are few, risks remain elevated, especially given indicators of long-run inflation expectations and the sharp rises in prices of highly visible consumer goods. In light of these considerations, staff do not see scope to ease now. But given output trends and still elevated money market spreads, nor is there a clear case for an immediate increase in the bank rate. Instead, holding the bank rate steady in these circumstances provides a measure of tightening. Further out, in the event that data are unclear regarding the outlook for both inflation and output, inflation concerns should remain the top priority in weighing the policy response to conflicting indicators.

## II. FINANCIAL STABILITY FRAMEWORK

12. In July 2008, the tripartite authorities issued two further consultation documents on financial stability reform.<sup>2</sup> Building on an earlier discussion document issued in January 2008 and discussed in the staff report (¶62), the two recent releases take the debate forward in a number of areas, highlighting where proposals have developed through the consultation process, but still seeking further views on a number of key questions. There is now substantial detail on the proposed special resolution regime, including draft legal language (see staff report ¶63-66). Key issues in the present documents include:

- The proposed special resolution regime will give the authorities a number of options to support the orderly resolution of a failing bank, including transferring part or all of the bank to either a private sector third party or a publicly-controlled bridge bank and a new bank insolvency regime. The power to trigger the regime will lie with the FSA alone, and the Bank of England will be responsible for administering institutions once they are put in the special resolution process. In addition, decisions regarding the use of public funds require Treasury approval. Proposed triggers for the special resolution regime are envisaged to be both qualitative and quantitative, including that a bank is deemed to fail or is likely to fail to meet its “threshold conditions”—such as adequacy of resources and adherence to suitability standards for management.
- For deposit insurance, the compensation limit awaits further consultation, but is expected to be £50,000. The authorities are committed to ensuring that depositors have prompt access to their deposits (at least a portion of their insured funds within seven days, with the balance a few days later). Although pre-funding is not proposed at present, the authorities will retain the option to do so in the future. Instead, the

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<sup>2</sup> *Financial Stability and Depositor Protection: Further Consultation* (released July 1, 2008), and *Financial Stability and Depositor Protection: Special Resolution Regime* (released July 22, 2008), [http://www.hm-treasury.gov.uk/documents/financial\\_services/fin\\_stability/financial\\_stability\\_depositor.cfm](http://www.hm-treasury.gov.uk/documents/financial_services/fin_stability/financial_stability_depositor.cfm). A video conference with Treasury staff was held on July 21 to discuss these documents.

deposit insurance scheme will borrow from the public sector, to be repaid by future levies on the industry and proceeds from asset sales from the failed bank.

- To strengthen the tripartite arrangements, the Bank of England will be granted statutory responsibility for financial stability. The aim is to create a Financial Stability Committee within the Court of the Bank, comprising senior representatives from within and experts from outside to oversee the Bank of England's financial stability functions, including actions under the special resolution regime.
- On information and disclosure, legislation will facilitate the FSA collection and sharing of supervisory information with the Bank of England and the Treasury as needed for financial stability. Although the Bank of England can request information, the FSA will remain the sole data collection entity. The FSA will consult further on the extent of new information that banks need to provide to demonstrate that they are meeting the regulatory thresholds for authorization on an ongoing basis.

13. There are also a number of steps in the direction of reduced transparency of Bank of England liquidity operations. In particular, the authorities are considering ending the requirement for the Bank of England to release a weekly balance sheet, and allowing banks in receipt of official liquidity support to delay disclosure. These proposed actions follow the decision that the Bank of England not release information on use of the Special Liquidity Scheme for at least six months (staff report ¶29).

14. The staff agrees with the thrust of the proposals as set out in the two consultative documents, with the following observations:

- Clarity of Bank of England authority and ability to act in the administration of the special resolution regime is essential. As prefunding of the deposit insurance scheme is not envisaged in the immediate future, recourse to public financing to effect a bank resolution appears likely. As this requires Treasury authorization, the Bank of England's authority in the administration of the special resolution regime is circumscribed, with implications for accountability, speed, and effectiveness. Substantial prefunding for deposit insurance, to commence as soon as conditions allow, could help ameliorate these difficulties.
- Transparency in financial markets more broadly could be bolstered. In this regard, the FSA's collection of additional information for stability purposes (including that needed by the Bank of England) and to ensure that banks meet regulatory thresholds is welcome. But further consideration could usefully be given to increased disclosure of such information to strengthen market discipline in regard to bank adherence to regulatory requirements.

INTERNATIONAL MONETARY FUND

UNITED KINGDOM

**Staff Report for the 2008 Article IV Consultation**

Prepared by the European Department

Approved by Alessandro Leipold and G. Russell Kincaid

July 7, 2008

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**Counterparts:** The mission met with the Chancellor of the Exchequer, the Governor of the Bank of England, the Chairman of the Financial Services Authority, and senior officials in these institutions. In addition, the mission met with parliamentarians, opinion-makers, representatives of trade union and business associations, and a wide range of financial institutions.

**Exchange System:** The U.K. maintains an exchange system free of restrictions on payments and transfers for current international transactions, except for those notified to the Fund in accordance with Decision No. 144-(52/51).

## I. STAFF APPRAISAL AND SUMMARY

### *The United Kingdom faces several challenges to continued strong economic performance*

1. For over a decade, the United Kingdom has sustained low inflation and rapid economic growth—an exceptional achievement. This is the fruit of strong policies and policy frameworks. These now face new tests from the ongoing global shocks to financial markets and energy and commodity prices.

2. Challenges were evident, however, even before recent global shocks ([¶16-¶24](#)). Imbalances had emerged in recent years—inflation, overheating in housing markets, low domestic saving rates, high current account deficits, and sustained declines in the international investment position. The monetary tightening cycle from mid-2006 responded to the immediate inflation risks and began to cool the housing market. But medium-term inflation expectations—which had been rising for some time—remained elevated, and the real effective appreciation of sterling compounded underlying external imbalances. Alongside, although net public debt remains low, fiscal policy was not tight enough to maintain headroom under the sustainable investment and golden rules.

### *A moderate slowdown is underway, and will help*

3. Growth is set to slow below trend during 2008 and 2009. This will help attenuate inflationary and external pressures in the near term, albeit at the expense of further erosion of headroom relative to the fiscal rules. In the staff's central projection, the slowdown this year will be followed by a gradual rebound that gathers pace during 2009. Specifically, year-on-year growth is projected to decline to 1¼ percent in the fourth quarter of 2008 before recovering to 2¼ percent a year later. Shocks to commodity prices and sterling depreciation are set to keep CPI inflation above target well into 2009, even in the absence of second-round nominal wage pressure. But with improved competitiveness and slower growth, the current account deficit is expected to narrow in the near term (see [¶25-¶38](#)). These forecasts reflect the underlying resilience of the economy, and the view that risks of a pronounced credit squeeze are becoming less threatening following various actions, including introduction of the Special Liquidity Scheme (SLS) and capital raising initiatives by banks.

### *But risks of a sharper downturn remain, and imbalances may reemerge*

4. Uncertainty focuses on the impact of ongoing dislocation in global financial markets, associated spillovers across markets, the ongoing correction in the U.K. housing market, terms of trade shocks, and possible adverse feedback loops (see [¶39-¶40](#)). And adjustments in the policy mix to support external relative to domestic demand over the medium term would provide insurance against imbalances reemerging when output eventually returns to trend. The recent global shocks have increased the importance of this shift.

***Sustained balanced growth requires a three-pronged strategy***

5. Given the outlook and risks, a package of complimentary policies is needed: an underlying fiscal stance that supports rebalancing over the medium term, a monetary stance that remains focused on the inflation target, and actions to forestall further financial sector shocks.

***First, an appropriate fiscal stance for 2009 and beyond***

6. Budget consolidation would help rebalance demand away from domestic in favor of external (see ¶41-¶42). Absent a marked worsening in near-term growth prospects, the commitment made in the 2008 budget to tighten fiscal policy by ½ percentage point of GDP in cyclically-adjusted terms in both 2009 and 2010 should not waver<sup>1</sup>. In addition, any slippage from the neutral fiscal stance for 2008 that was anticipated in the budget should also be corrected. And if the medium-term outlook for the current account deteriorates, additional structural fiscal consolidation may be needed for 2009 and beyond. Early announcement of any such revisions to budget commitments would allow their prompt reflection in monetary policy decisions.

***Second, monetary policy should aim to keep second-round effects in check***

7. Adjustments to the monetary stance must weigh the upside risks to inflation against the potential disinflationary effect from downside risks to output. Given the outlook for these factors, the current halt in monetary policy easing is appropriate. Risks on both sides appear balanced. Unexpected output weakness or wage deceleration could justify a further reduction in the bank rate, and a tighter fiscal policy would provide room. But signs that wage restraint or inflation expectations are slipping may warrant a rate increase to send a strong signal.

8. In this connection, continued moderation in nominal earnings growth will be essential. If secured in the face of large relative price changes, monetary easing and associated sterling depreciation may reduce risks to output, the external balance, and employment without compromising the nominal anchor. If not, monetary flexibility to address these concerns will be diminished (see ¶43-¶45). The risks to nominal wages appear balanced. So far, nominal remuneration has held steady, encouraged by the flexibility of labor market institutions and public sector pay restraint. But key wage settlements remain outstanding, and tolerance for ongoing low real earnings growth is uncertain with continued tight labor markets.

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<sup>1</sup> The fiscal year runs from April to March.

***Third, stabilizing financial markets***

9. Efforts to stabilize financial markets will not only reduce lagged effects on credit flows from past strains, but will also reduce remaining risks and support more efficient pricing of risk in future. The steps outlined in the Bank of England’s Financial Stability Report form a good basis for action in this regard. The SLS addresses liquidity tail risks while guarding against moral hazard, and has already contributed to an easing in money market pressure. In difficult market conditions, banks can further boost confidence in their resilience through information disclosure and raising capital, as some are already doing (see ¶46-¶47).

***Alongside, reforms to policy frameworks are needed***

10. The U.K.’s policy frameworks have been the foundation of strong policy macroeconomic performance over the past decade, but these frameworks are being tested by current economic conditions. Selected reforms would help maintain confidence in medium-term prospects.

***The inflation targeting regime remains appropriate as is***

11. The inflation targeting regime faces its most difficult test to date, but should remain unaltered. Adjusting the inflation target, its definition, or the remit of the Bank of England to include output objectives, as suggested by some outside commentators, would be a serious mistake. Such steps would risk unanchoring nominal wage settlements without changing the fundamental challenges facing the economy (see ¶48).

***The fiscal sustainable investment rule also remains appropriate***

12. Margin for error under the fiscal rules has been all but eliminated, and a breach of the debt ceiling is likely as early as 2009, but key elements of the fiscal framework should be retained. Specifically, the commitment to maintain net public debt below 40 percent of GDP in each and every year remains appropriate. It constrains fiscal discretion within boundaries set by long-term considerations and also underpins the credibility of the inflation targeting regime. If public debt—net of stock adjustments—were to breach 40 percent of GDP, concrete plans to bring it back under the ceiling on a sustained basis should be announced promptly. Further, to improve the operation of the framework and support automatic stabilizers over the medium term, it will be important to develop procedures to manage headroom under the ceiling (see ¶49-¶53).

***But the fiscal framework could be strengthened***

13. In particular, building on the success of the recent Comprehensive Spending Review in slowing the pace of expenditure growth, consideration should be given to reversing the relative status of the golden rule and the medium-term spending limits. An expenditure rule

would be transparent, reduce risk of expenditure drift, and strengthen fiscal resistance to unanticipated inflation (see ¶54-¶55).

***And significant reforms to the financial stability framework are needed***

14. The framework of tripartite co-operation among the Bank of England, Financial Services Authority (FSA) and Treasury remains appropriate. However, in light of the lessons learned during the financial market turmoil since mid-2007, the authorities have identified areas in which the tripartite and broader financial stability framework can be strengthened, including crisis management.

15. In taking these matters forward, focus is required in a number of areas to strengthen market and supervisory discipline on financial institutions (see ¶56-¶66). These include improved disclosure by financial institutions, and further elaboration of the regime of remedial measures to be applied by supervisors against weak institutions crossing various thresholds. Alongside, the aim of early intervention in distressed institutions under the proposed special resolution regime is appropriate and should be supported by specifying the criteria for its application. Although discretion will remain essential, the presumption that the regime would be triggered when the criteria are met strikes an appropriate balance between regulatory forbearance and unnecessary actions. And finally, even with the steps outlined above, financial stability will require strengthening the capacity of all implementing institutions, including better coordination within the tripartite arrangements and provision of a formal legal basis for the Bank of England's role in financial stability.

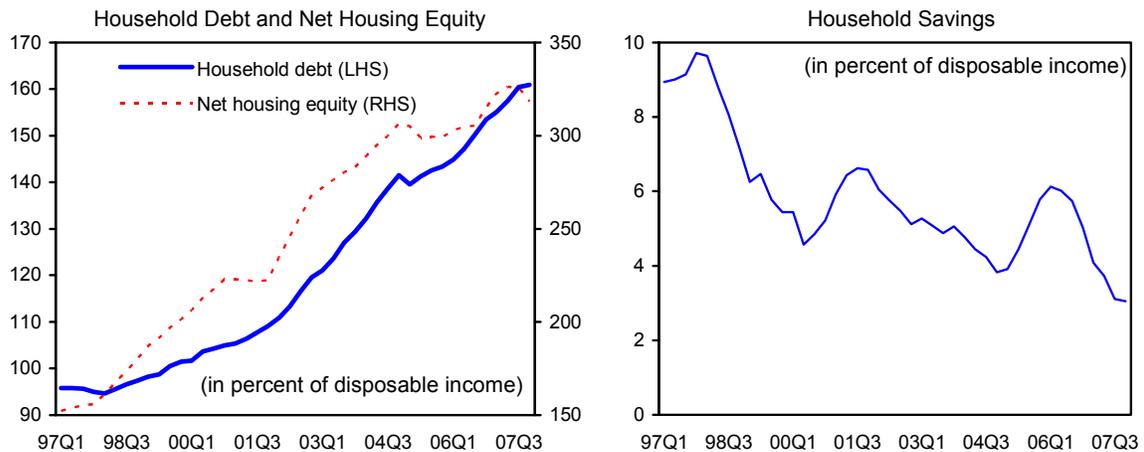
*It is proposed to hold the next Article IV consultation on the regular 12-month cycle.*

## II. THE CONTEXT—IMBALANCES AND POLICY RESPONSES 2005–07

*The origins of the large external deficits lie in buoyant domestic demand, with falling domestic savings accompanying rising investment ratios*

16. After a mild slowdown in 2005, activity rose 3 percent a year in 2006 and 2007 (Table 1 and Figure 1).

- Consumer spending was supported by robust labor market conditions—strong employment, steady real wage growth, and a surge in immigrant labor from EU accession countries after 2004 (Figure 2). Compressed global credit market spreads, loosening credit conditions, soaring household debt, and the decade-long housing boom provided additional fuel (Figure 3). In this context, household savings rates declined to 3½ percent of disposable income in 2007 from some 10 percent a decade earlier.
- The low cost of capital, high corporate profitability, and capital spending to match the increased labor supply boosted investment, while residential investment responded to the strong housing market.
- Alongside, the fiscal deficit remained high, especially for the peak of the cycle, and headroom under the fiscal rules was eroded.



***With reduced slack in the economy, inflation rose, a monetary tightening cycle began, and large current account deficits emerged***

17. The bank rate rose five times from mid-2006 to mid-2007 by a cumulative 125 basis points to 5¾ percent, and sterling appreciated (Figure 4). In this context, the housing market began to cool, with turnover dropping from early 2007.

18. Nonetheless, increased commodity and core (and notably services) prices pushed the CPI up, breaching 3 percent in March 2007—requiring the first explanatory letter from the Governor to the Chancellor under the U.K.’s inflation targeting setup.

19. In 2006–07, notwithstanding favorable export market growth, the balance of trade deteriorated, with the services balance not quite offsetting this (Table 2, Text Table 1). This deterioration was compounded by a sharp fall in the income balance following earlier sizeable FDI inflows. The widening current account deficit was accompanied by an appreciation of the CPI-based real effective exchange rate of almost 10 percent from 2006 through mid-2007 (Text Box 1 and Figure 5).

**Text Table 1. External Balances**  
(Percent of GDP)

Data revisions in 2007 showed a significantly weaker net income position than earlier estimated. In particular, with earlier data unrevised, the income balance for 2006 was lowered by some 0.8 percentage points of GDP, indicating a significant deterioration in the external deficit from 2005. The income balance for the first half of 2007 was lowered by considerably more.

	2004	2005	2006	2007
Balance in:				
Goods	-5.1	-5.6	-5.9	-6.5
Services	2.2	2.0	2.4	2.8
Income	2.2	2.0	0.6	0.4
Transfers	-0.9	-1.0	-0.9	-1.0
Current account	-1.6	-2.5	-3.9	-4.3

### Box 1. Exchange Rate Assessment and Sustainability

In recent years, sterling appreciated significantly beyond norms in real terms (Text figure 1). Alongside, the external current account balance and the net IIP position have both deteriorated (see Annex 1). Only half of the weakening in the current account deficit since 2003 reflects increased domestic fixed investment. And reflecting the external deficit and valuation changes, the IIP declined from a deficit of 4 percent of GDP in 2003 to a deficit of 25 percent of GDP in 2007 (Table 2, and Table 4). Staff econometric projections suggest that the IIP will remain on a deteriorating path. Since August 2007, the real effective exchange rate has depreciated by more than 10 percent, reflecting not only cuts in the bank rate (¶17) but likely also a reassessment of U.K. risk and views about the sustainable real value of sterling in the wake of global financial turmoil.

Quantification of the degree of overvaluation is complicated by uncertainties over the prospects for net income following the recent large data revisions. If the deterioration in the net income position is assumed to be temporary, as seems likely, the staff's assessment—supported by evidence from the suite of CGER methodologies—is that sterling has moved closer to its equilibrium real value following its recent depreciation, but that it remains somewhat on the strong side. 1/

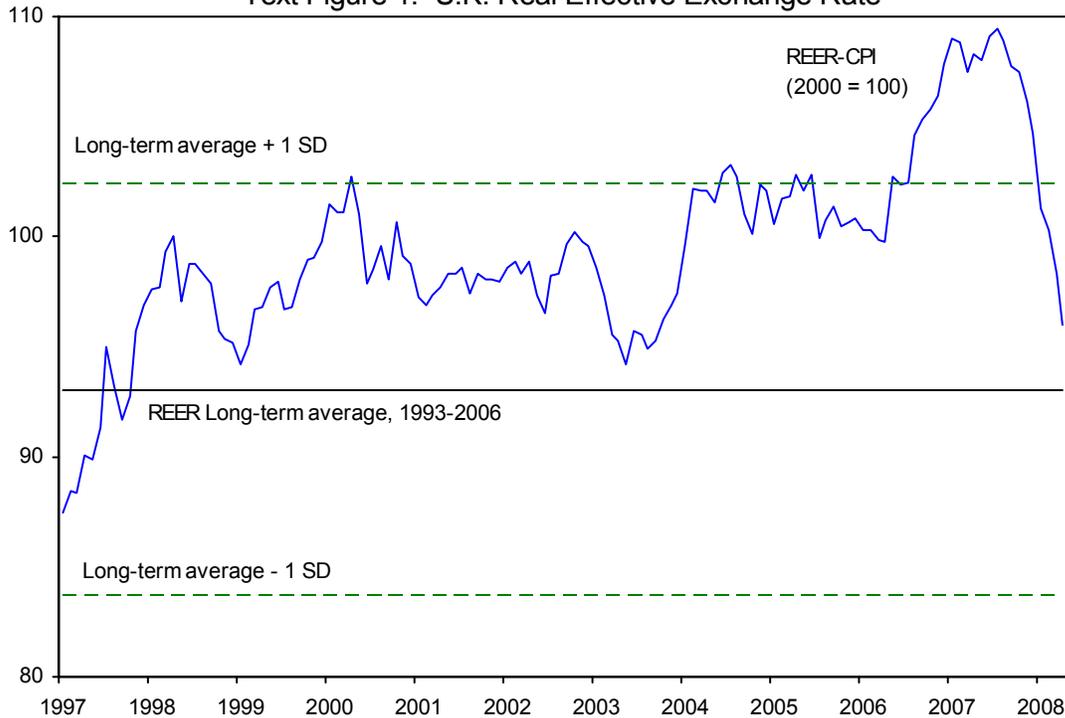
#### CGER–Sterling Overvaluation (in percent)

Macro Balance	6
Equilibrium RER	7
External Sustainability	11
<b>Overall</b>	<b>5-10</b>

These calculations are based on average exchange rates in May 2008.

Given open access to international capital markets, policy and data transparency, and the flexible exchange rate regime, risks of a destabilizing depreciation are low.

Text Figure 1. U.K. Real Effective Exchange Rate



1/ For details of CGER methodologies, see *Exchange Rate Assessments: CGER Methodologies*, IMF Occasional Paper 261, 2008.

20. By the eve of the financial market turmoil from August 2007, apart from the housing market, the broader slowdown that the Bank of England had sought to stem inflation had yet to occur. And external trends underscored the need for that slowdown to be accompanied by a rebalancing—with net external demand replacing domestic demand.

***The context for the necessary macroeconomic adjustments became more difficult after August 2007***

21. The U.K. was hit by two new shocks: the disruptions to global financial markets from August 2007 onwards, and sharp increases in food and fuel prices that started last year but intensified in recent months. These shocks raised uncertainties about export market and output growth prospects, disrupted money markets, compounded the ongoing correction in the domestic housing market, and increased inflation risks on both sides.

22. Policy faces several new challenges in this context. On the monetary side, the determination of the appropriate stance became more complicated, and the transmission mechanism became subject to repeated shocks as the financial market turmoil played out. On the fiscal side, it became increasingly difficult to reconcile full use of the automatic stabilizers with adherence to the fiscal rules. And on the financial stability side, the run on Northern Rock highlighted weaknesses in the framework, including the maintenance of adequate capital, bank resolution procedures and deposit insurance (see Annex 2).

***That said, the turmoil may have temporarily lowered the external current account deficit and sterling overvaluation, with modest effects on output so far***

23. Partly in anticipation of output weakness and its associated disinflationary impact, bank rate reductions were advanced. They have been lowered by 75bp in three steps and, until recently, markets were pricing in further rate cuts through 2008. In addition, despite continued dividend payments by U.K. banks in the fourth quarter of 2007, outflows from foreign-owned banks on the current account declined as the value of derivative positions was marked down in the wake of global credit tensions. This strengthened the current account deficit—which fell from 5½ percent of GDP in the third quarter to 2½ percent in the fourth—taking the annual deficit to 4¼ percent of GDP in 2007.

24. So far in 2008, activity—especially consumption—has surprised on the upside. In particular, preliminary national accounts data show that personal consumption strengthened in the first quarter, even as the housing market cooled and global demand began to soften. In addition, the labor market remains tight, with unemployment having edged up only slightly to 5.3 percent primarily because of fast labor supply growth. Nevertheless, wage and non-food non-fuel consumer prices remained subdued, with the rise in CPI inflation from 2.1 percent in December to 3.3 percent in May accounted for by large increases in the prices of food and energy rather than excess demand. While tax collections are below budget projections for the year through May, these data are highly volatile and it is too early to identify clear patterns.

### III. NEAR-TERM OUTLOOK AND RISKS

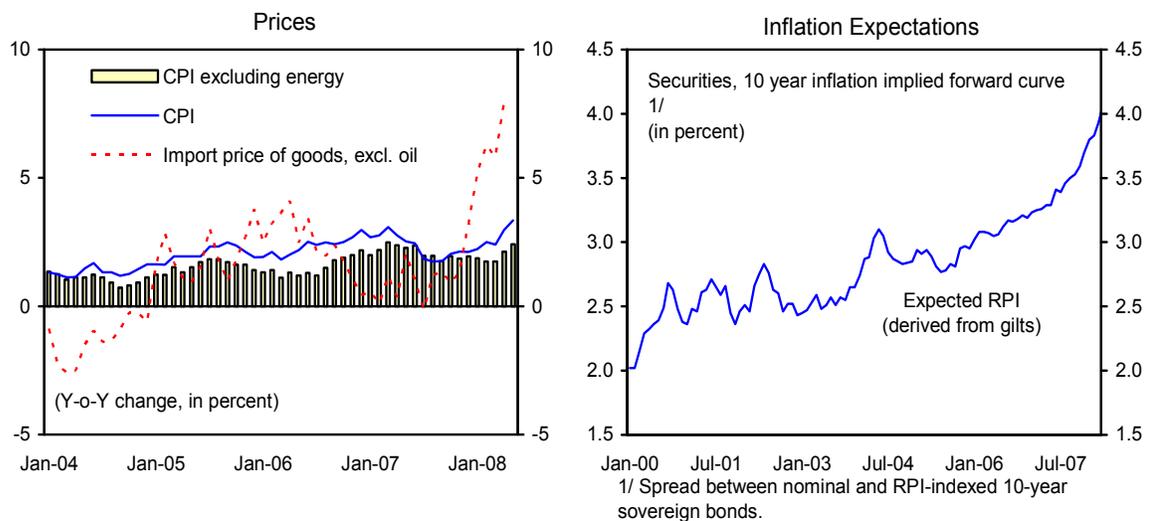
#### A. Factors Affecting the Outlook

##### *Prospects for economic activity in the U.K. have dimmed*

25. Notwithstanding developments early in 2008, the slowdown now forecast for the U.S. and the euro area in 2008-09, and ongoing strains in domestic credit markets, will all impose a toll on the U.K.. The severity of the impact depends significantly on the credibility of the inflation anchor, and hence the scope to offset weakening activity with monetary policy action consistent with the inflation target. Signs now are that—although the period of financial sector turmoil is not over—the overall impact of developments in banking markets may be less cause for concern than earlier thought. But even so, long-term trend growth may be somewhat lowered by the repricing of credit risk now underway.

##### *Inflationary pressures have risen*

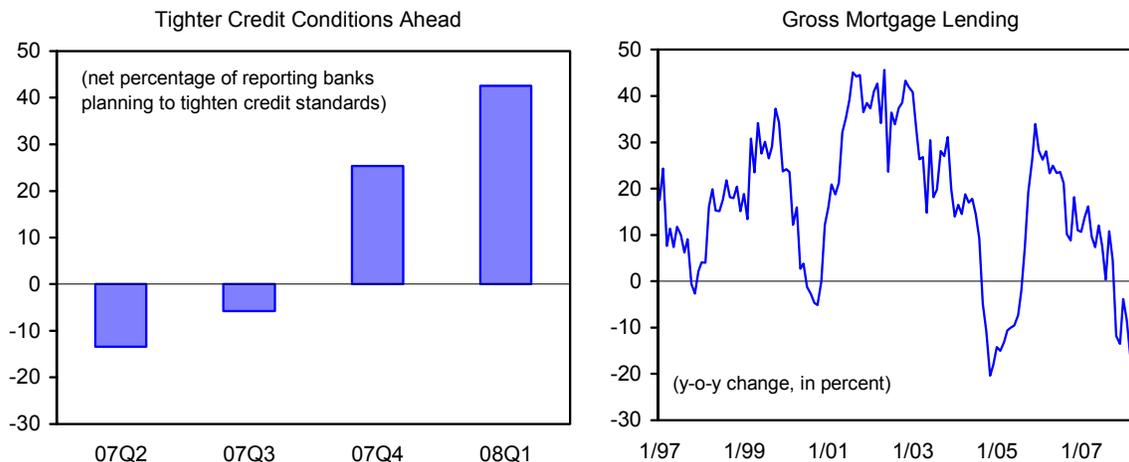
26. Headline CPI, PPI, import, and input prices all signal pressures (Figure 4). Indeed, with the PPI rising at much higher rates than the CPI, there is likely pent-up inflationary pressure in compressed manufacturing and retail margins that has yet to work through. In this light, the food and fuel price shocks and prospective domestic energy price adjustments all set the stage for a series of elevated CPI outturns—and associated need for several explanatory letters from the Governor to the Chancellor. This prospect remains even if global energy prices remain roughly unchanged from where they now are. The associated risks are underscored by direct surveys of household inflation expectations and evidence from indexed vis-à-vis non-indexed gilt spreads.



***Mortgage credit has slowed, and involuntary lending may be obscuring a broader slowdown***

27. Since August 2007, survey evidence of lenders' quarter-ahead intentions have indicated that tighter credit standards were in prospect, suggesting a restriction in credit growth (see Annex 3). Loan-to-value ratios have fallen and the number of mortgage products has declined, together with a sharp increase in quoted mortgage rates for new borrowers in recent months. Accordingly, the seasonally-adjusted quarterly growth of secured net lending—four-fifths of the stock of lending to households—has dropped from an annualized average of 10 percent in the second quarter of 2007 to 6½ percent in May 2008.

28. Annualized growth of unsecured lending (including credit cards) flows has risen (from 6 to 8 percent) from the second quarter of 2007 to May 2008. Lending to private non-financial corporations has slowed, but various shocks to the series complicate interpretation. In both cases, the current pace of lending may reflect agreements predating the ongoing financial sector strains—on credit cards and credit lines for households and firms respectively. Anecdotal evidence suggests that new voluntary credit extension has slowed.



Source: Bank of England and AllianceBernstein.

***Official liquidity support and capital raising efforts by banks have helped, but market strains remain***

29. As part of efforts to support orderly functioning of money markets, the Bank of England announced a Special Liquidity Scheme swapping T-bills for assets including mortgage-backed securities. Despite the potential scale of the scheme—an initial take up of around US\$100 billion was expected—the swap structure, including haircuts, ensures that credit risk remain with banks, while the fees and restriction to legacy assets on banks' balance sheets at end-07 guard against moral hazard. The scheme represents a further extension of adjustments to the Bank of England's money market operations, which since August 2007 have extended collateral, and amounts offered at auctions of 3-month maturity. A particular feature of the SLS is non-transparency—usage will not be announced until after

closure of the drawdown window (at least six months)—aimed to overcome the “stigma” impeding use of other liquidity facilities. The aim was to buttress the liquidity of, and so confidence in, the banking system. Market commentators suggest this has been instrumental in reducing money market spreads. Nevertheless, as in euro and U.S. dollar markets, sterling spreads remain high.

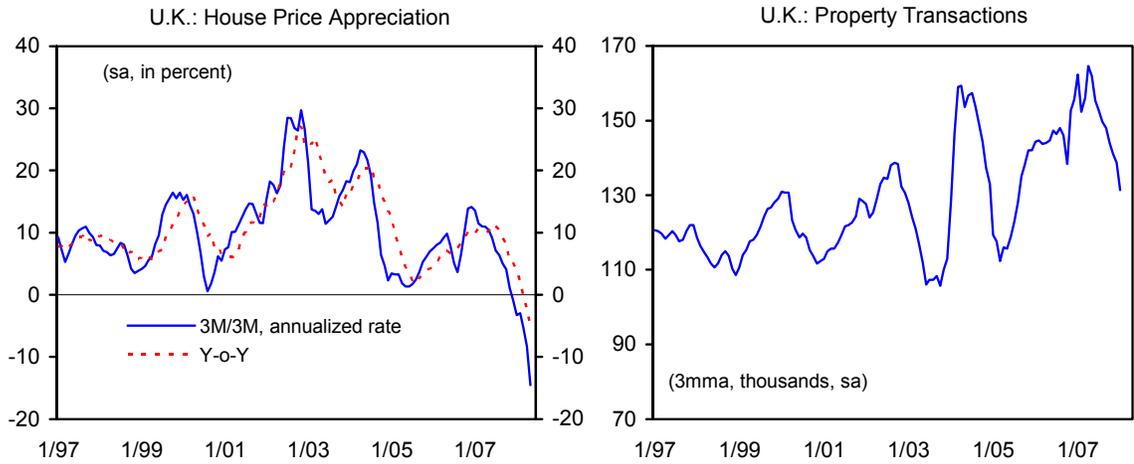
30. Continued money market strains partly reflect ongoing concerns with counterparty risk, notably regarding adequacy of banks’ capital. Following subprime-related writedowns by the five big banks of £4.4 billion so far, staff estimates suggest that further writedowns of about £6 billion are to come (Annex 3). These would lower the total (Basel I) capital ratio of the five largest banks from 12.1 percent at end-2007 to 11.8 percent, with potential losses on other bank assets, including those on the weak domestic commercial property market, compounding these effects. Within these aggregates, mortgage lenders funded by residential mortgage-backed security (RMBS) issuance are under particular strain and share price valuations of two of the large global banks are being marked down heavily due to low levels of capital amidst the prospect for further writedowns and continued market turbulence.

31. In response, various initiatives are under way to raise capital. Four large banks have announced such plans since April. Widening spreads between bank deposit and lending rates have encouraged equity issue, particularly for largely deposit-funded institutions, but difficulties have still been encountered. In particular, underwriters may have to take up some of the stock, and if so, prospects for subsequent equity issues may be impaired (Figure 6).

32. Furthermore, even when credit supply conditions improve, risk premia in financial markets are likely to remain elevated compared to the unsustainably low levels prevailing prior to the August 2007 crisis.

***House prices are falling rapidly, with further declines likely***

33. After turnover began to fall from early 2007, nominal house prices on some measures have fallen some 8 percent since their autumn 2007 peak. With credit constraints and stretched affordability, further falls are likely. In particular, U.K. households typically maintain a relatively constant ratio of cash outflows of principal and interest on mortgages as a share of their monthly incomes. As this ratio has been elevated in recent years, it may be expected to revert to mean. Simulations for this process, based on staff assumptions on mortgage interest rates and household income growth, indicate that the “normal” cash flow burden can be retained with moderate nominal house price declines (induced by contracting demand) over a time frame typical of past corrections (Text Table 2). The results appear relatively robust to alternative macro assumptions, but are more sensitive to the assumed pace of correction, which could be faster than in the past or could overshoot previous norms. The central scenario assumes a cumulative decline in house prices of about 15 percent over two years rather than a precipitous correction. Some market indicators—including forward contracts on house price indices—suggest a cumulative fall of 20-25 percent by 2011



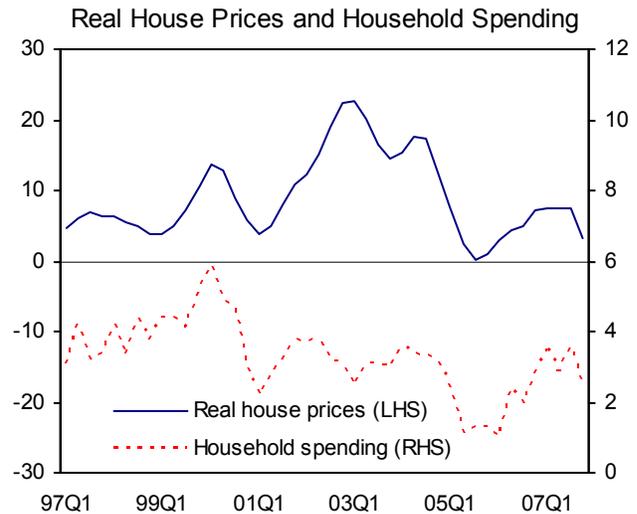
**Text Table 2. Affordability Adjustment (e.o.p.; in percent)**

	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>
Mortgage rate	6.0	6.0	6.0	6.0
Income change (oya)	---	4.0	4.0	5.0
1. Central Case				
Cash flow burden	24	21	19	18
House price change (oya)	---	-8	-6	0
2. One year correction				
Cash flow burden	24	18	18	18
House price change (oya)	---	-21	+4	+5

***The impact of housing corrections on activity may depend on developments in the broader economy***

34. The impact of such house price declines on growth is expected to be contained, as long as other aspects of the U.K. economic environment remain broadly unchanged. This assessment reflects staff work on the direct links between house prices and consumption—finding a modest link, but one greater than other researchers have suggested.<sup>2</sup> In addition, there is range of market analysts’ views concerning the effect of house price declines on banks’ capital, with some judging resilience to be considerable and others noting that housing market developments could lead to further negative rating actions for U.K. banks.

The substantial cushion of equity in housing built up over the past housing boom, and—relative to the early 1990s—the low share of outstanding mortgages contracted at the crest of the market are reassuring. But if house price declines are accompanied by a deterioration in the labor market or a significant rise in mortgage rates—due to the bank rate, rising spreads, or as teaser rates expire—there would be a significant effect on mortgage delinquencies, feeding back into impaired bank capital and new credit extension.<sup>3</sup>



The substantial cushion of equity in housing built up over the past housing boom, and—relative to the early 1990s—the low share of outstanding mortgages contracted at the crest of the market are reassuring. But if house price declines are accompanied by a deterioration in the labor market or a significant rise in mortgage rates—due to the bank rate, rising spreads, or as teaser rates expire—there would be a significant effect on mortgage delinquencies, feeding back into impaired bank capital and new credit extension.<sup>3</sup>

***And medium- term trend growth may have fallen moderately***

35. Following the widespread repricing of risk, corporates may face greater difficulty securing external finance for productive investment (including R&D) and entry into new businesses. This would likely lead to softer growth in capital stock and factor productivity. Moreover, net inflows of immigrant workers—an important source of economic growth recently—may slow with activity and sterling weakening.

<sup>2</sup> See Dora Iakova, 2006, “The Link Between Private Consumption and the Housing Market,” Selected Issues, pp 27-40, IMF Country Report No. 06/87, <http://www.imf.org/external/pubs/cat/longres.cfm?sk=18986.0>.

<sup>3</sup> The Bank of England’s April 2008 Financial Stability Report judges the “level of likelihood of risk” associated with U.K. household debt (which is primarily mortgages) to be “low”, and the possible impact on financial stability to be “medium-low”.

## B. Outlook in the Central Scenario

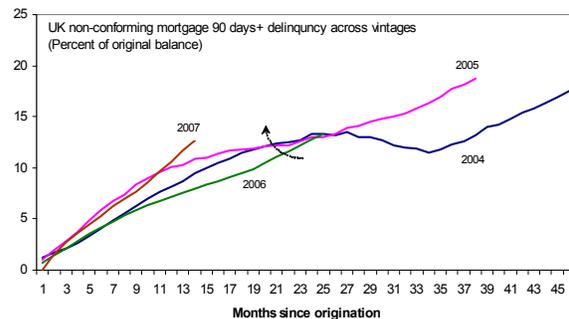
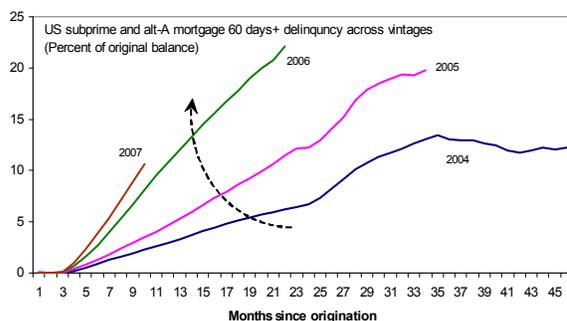
### *Taking the above factors into account, staff project a moderate slowdown*

36. Economic momentum eases in 2008 as constrained real household income growth due to higher consumer prices and prospective weaker employment growth, together with a deceleration in lending, curbs consumption (Table 3). Residential investment is assumed to fall sharply and business investment also weakens significantly. On the supply side, activity in the financial services and property-related sectors are particularly hard hit. These factors will be compounded by the projected slowdown in the U.S. and the euro area and its spillover to the U.K. But the impact of these shocks is offset by the underlying resilience of the U.K. economy, the boost to net trade from sterling depreciation, the operation of automatic stabilizers envisaged in the 2008 budget, and the recent monetary loosening. And, although the U.K. and the U.S. face somewhat similar shocks, there are also notable differences that distinguish the near-term outlook for the two countries (Box 2).

### Box 2. United Kingdom and United States Compared

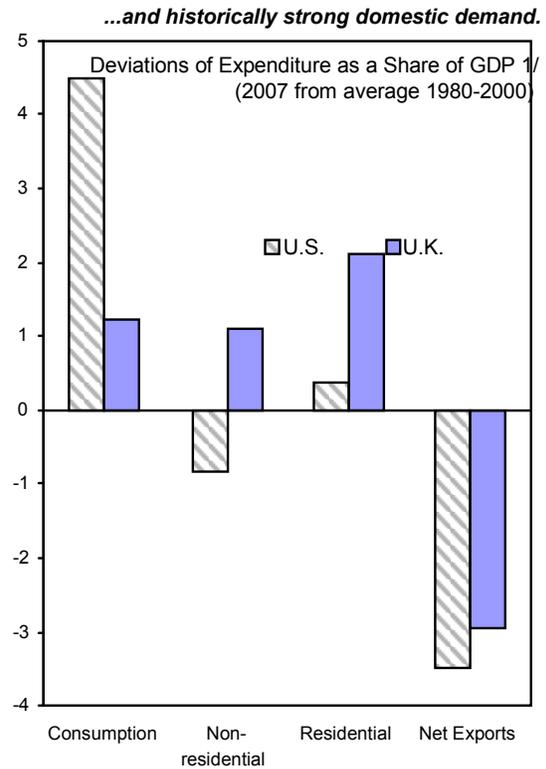
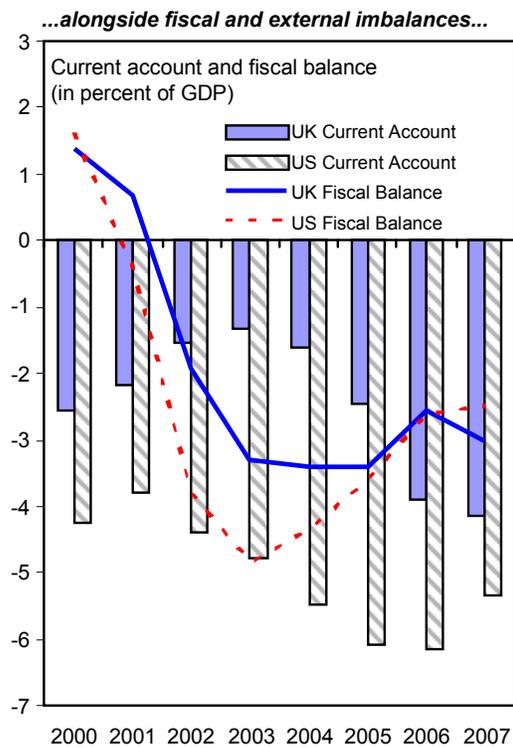
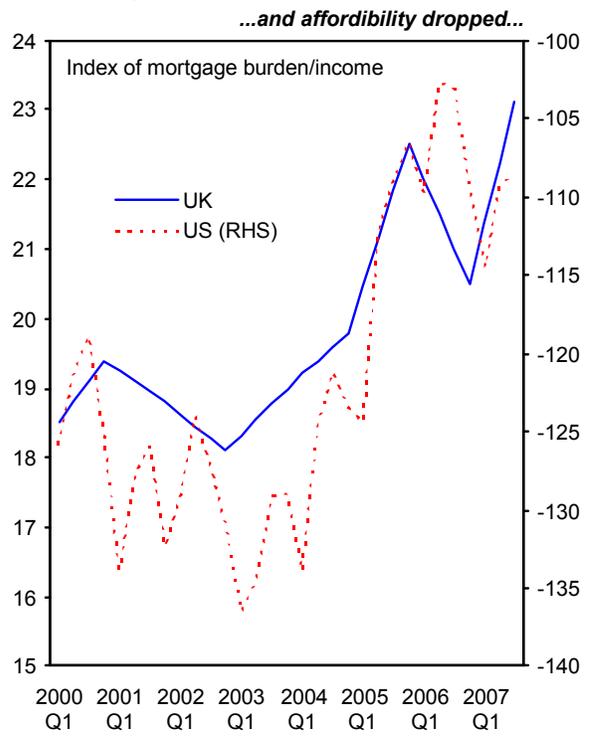
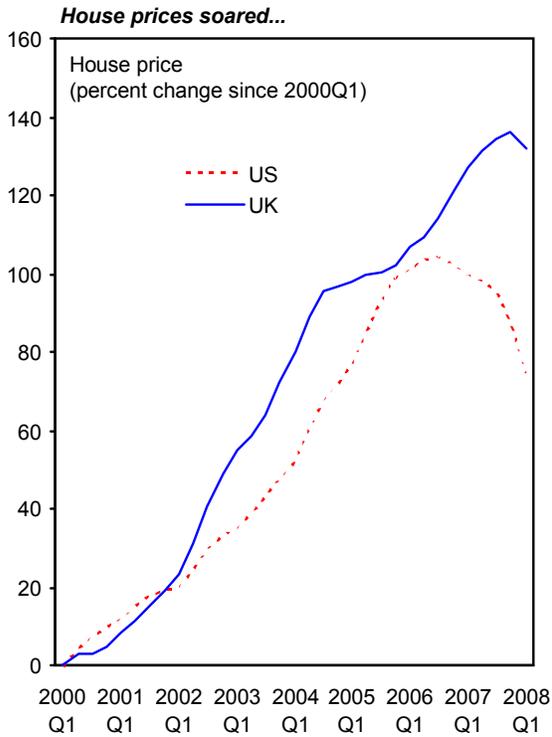
**The apparent macroeconomic similarities between the U.K. and U.S. could suggest that a similar slowdown is likely in the U.K.** Credit and housing booms, hitherto strong currencies, high household indebtedness and low savings rates, and external imbalances are shared characteristics. Indeed, with external adjustment underway in the U.S., U.K. adjustment may be even more challenging given consequent slowing export market growth.

**Although a flat path for GDP as forecast for the U.S. cannot be ruled out, there are also notable differences that could mitigate such an outcome.** Specifically, partly reflecting tighter loan standards and monetary policy (and so less extreme introductory “teaser” rates), mortgage delinquency patterns are more favorable than in the U.S. Subprime loans constitute about 6 percent of the total mortgage market in the U.K. compared to 13 percent in the U.S. And in contrast to the U.S. where credit quality has declined notably in recent years, credit standards in the U.K. appear to have been relatively stable (see charts below). Thus, the abrupt creditor retreat from the large low-quality segment of the U.S. credit market is unlikely to be repeated in the U.K. Furthermore, residential investment peaked at a lower level relative to GDP (3½ percent versus 6 percent), and the relative openness of the U.K. economy allows the exchange rate to play a larger cushioning role. On this basis, the U.K. slows down in the central scenario, but not as sharply as the U.S., despite the more accommodative monetary stance in the U.S.



**Box 2. United Kingdom and United States Compared (cont'd)**

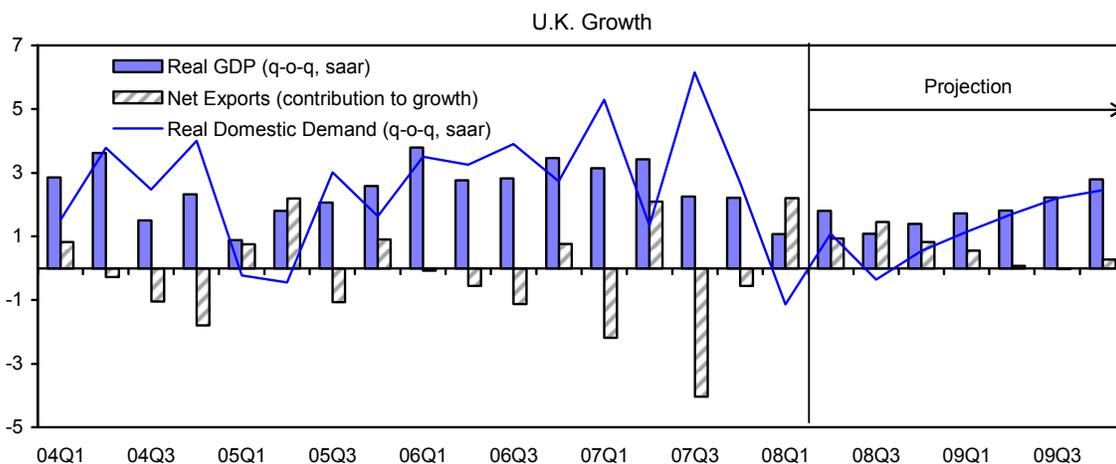
**U.S. and U.K. Compared**



37. Overall growth slows to 1¾ percent in 2008 and 2009, opening up some slack (Text Table 3). Though economic activity accelerates from the trough in end-2008, it remains below potential in 2009. With revival of external demand and lagged pass-through of the earlier sterling depreciation, net trade contributes further in 2009. The output gap starts narrowing in 2010.

	2008	2009
Consensus (July 2008)	1.5	1.1
Five forecasters with best record	1.5	1.2
HMT (March 2008 Budget)	1¾ - 2¼	2¼ - 2¾
BoE (May Inflation Report)	1.9	1.6
Staff <sup>1/</sup>	1.4	1.1
Q4/Q4	0.6	1.9

1/ Staff forecasts are updated in the staff supplement.



38. Inflation is expected to remain above target through 2008 and 2009. Although food and fuel prices remain elevated, continued wage moderation and a lack of second-round effects alongside the disinflationary impetus from slower growth should foster a return to target by 2010.

### C. Risks to the Outlook

***Risks to the central case projections are broadly balanced, but downside risks warrant particularly close attention***

39. The downside risks include a major credit squeeze or dramatic house price corrections, with both risks being relatively low-probability but high-impact events.

- The contraction in wholesale funding for institutions and the protracted investor caution in respect of default and liquidity risk underscore the fragility of confidence. Even if the specter of an outright failure of another medium-size or larger institution is avoided, aggregate credit supply could nonetheless drop sharply. The risk of adverse feedback loops—from curtailed credit to asset (including commercial property) price falls, to a capital squeeze in banks, to curtailed credit supply—is real. And if another institution does fail, then the broader impact could be severe if the authorities prove unable to ring fence the problem.
- One source of adverse feedback loops could be a dramatic fall in house prices. If they were to drop a cumulative 30 percent in 2008 and 2009, with other aspects of the international and U.K. environment remaining as in the base case, the growth impact could be contained to within ½-1 percentage point of the baseline in 2008–09. This robustness reflects the previously mentioned econometric evidence (¶39) and also the stability of recent U.K. mortgage underwriting standards and the creditor-friendly bankruptcy arrangements.<sup>4</sup> But outcomes could turn out to be considerably worse if the house price collapse occurs alongside other (unrelated) negative shocks to output and employment.<sup>5</sup>
- These downside risks to activity could be aggravated by inflation, which could curtail the scope for offsetting monetary policy action. If high food and energy prices unsettle inflation expectations and nominal wage discipline, notwithstanding weaknesses in activity, monetary policy flexibility will be lost.

40. Against this, upside risks come in various forms, but, in contrast to those on the downside, they are moderate-probability low-impact events.

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<sup>4</sup> Fitch estimates that in a “severe” stress scenario widespread rating downgrades would be seen for 2006-2007 vintage RMBS (when house price appreciation was more muted), but earlier vintage transactions should hold up reasonably well.

<sup>5</sup> In the early 1990s, nominal house prices fell nearly 30 percent (20 percent in real terms) from peak to trough. Alongside, annual growth fell to 0.8, -1.4, 0.2 and 2.3 percent in the four years to 1993. However, this was in the context of a major stabilization effort, rising unemployment, and a change in the monetary and exchange rate regime.

- Mortgage lending aside, aggregate credit supply could, as it has done since August 2007, remain resilient. The banking system could ride out the storm of losses and liquidity constraints by postponing dividends, capital raising efforts, widened banking spreads, and the support of various official initiatives. Even with wholesale-funded institutions contracting, there are signs that banks with strong retail funding may step into the gap in the market, thereby supporting aggregate credit supply. And with corporate savings historically high, internal funding by firms could replace faltering external credit, with the inter-firm credit market potentially replacing, at least partially, intermediation through troubled banks.
- Furthermore, even to the extent that aggregate credit supply shocks occur, the underlying resilience of the economy—the fruit of two decades of substantive reform—could more effectively offset the associated output and employment costs than is assumed in the central case.
- And as part of this, wage growth and hence inflation risk may remain contained (Text Table 4), reflecting the liberalization of U.K. product and labor markets, increased openness to migratory labor flows, and the underlying credibility of the U.K. inflation targeting framework. If so, monetary policy flexibility will be retained with attendant benefits for activity.

<b>Text Table 4: Private Sector Earnings 1/</b> (y-o-y change, in percent)							
	Averages			2008			
	1998-06	2007 H1	2007 H2	Jan.	Feb.	Mar.	Apr.
(1) Regular pay	4.2	3.7	3.7	3.7	3.8	n.a.	n.a.
(2) Pay settlements 2/	3.3	3.4	3.6	3.7	3.7	3.6	4.6
(1) - (2) Pay drift 3/	0.8	0.3	0.1	0.0	0.1	n.a.	n.a.
(3) Total average earnings	4.3	4.2	4.1	4.0	3.7	n.a.	n.a.
(4) Excluding Bonus	4.1	3.7	3.8	3.6	3.9	3.9	3.7
(3) - (1) Bonus contribution 3/	0.2	0.5	0.3	0.3	-0.1	n.a.	n.a.

Source: Bank of England, *Inflation Report*, May 2008.

1/ Based on the monthly average earnings index. Three-month average measures.

2/ Average of private sector settlements over the past twelve months.

3/ Percentage points.

## IV. IMPLICATIONS FOR MACROECONOMIC AND FINANCIAL SECTOR POLICIES

### A. Fiscal Policy

#### *Budget consolidation will be essential to rebalance demand, and adhere to the debt rule<sup>6</sup>*

41. The 2008 budget anticipates a neutral fiscal stance. It assumes below-trend growth of  $1\frac{3}{4}$ – $2\frac{1}{4}$  percent, with the headline fiscal deficit increasing to 2.9 percent of GDP, avoiding a procyclical tightening. Medium-term objectives imply a cumulative structural adjustment of  $1\frac{1}{2}$  percent of GDP by 2012, with two-thirds of the adjustment in 2009 and 2010 (Table 5 and Text Table 5). In this context, net public debt remains just below the authorities' ceiling of 40 percent of GDP (excluding debt associated with the nationalization of Northern Rock), and external imbalances remain large once the downturn in 2008-09 passes. Staff, however, project weaker-than-budgeted balances in 2008—specifically, a deficit of 3.3 percent of GDP—and over the medium term.<sup>7</sup> This largely reflects lower growth projections and lower revenue buoyancy from the financial sector. In this context, even if the planned fiscal adjustment in cyclically-adjusted terms is implemented as planned, the debt ceiling would be breached as early as 2009. And if output continues to evolve thereafter as staff project, debt would not return below the ceiling on announced fiscal policies, abstracting from debt-stock adjustments and prospective revisions to national accounts data (See ¶59).

**Text Table 5: Fiscal Balances and Public Debt**

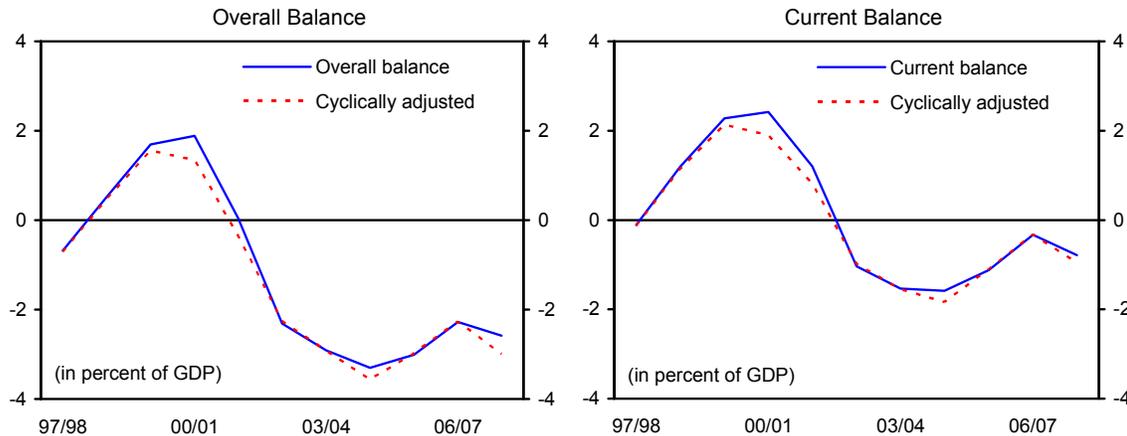
(In percent of GDP)

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
<b>Overall balance</b>						
Budget 2008	-2.6	-2.9	-2.5	-2.0	-1.6	-1.3
Staff	-2.6	-3.3	-3.2	-2.6	-2.1	-1.6
<b>Cyclically-adjusted overall balance</b>						
Budget 2008	-2.7	-2.7	-2.2	-1.7	-1.4	-1.2
Staff	-3.0	-2.9	-2.4	-1.9	-1.6	-1.5
<b>Net public debt</b>						
Budget 2008	37.1	38.5	39.4	39.8	39.7	39.3
Staff	37.3	39.2	40.9	41.7	42.1	42.0

Sources: Budget 2008 and staff projections.

<sup>6</sup> Specifics of the fiscal rules and possible reforms are discussed in Section V.A below.

<sup>7</sup> An excessive deficit procedure has already been initiated by the European Commission.



42. With underlying external imbalances still large, the terms of trade shocks enduring, and concern with output risks giving way to concern with inflation risks, strong fiscal consolidation is warranted over the near- to medium term. For 2008, following tax changes announced in May, some structural slippage has already occurred on the revenue side. Any slippage due to discretionary policy action in the projected 2008 outturn should be corrected in the 2009 budget. More generally, with growth projected to return to trend during the course of 2009, and the likely breach of the debt rule, the planned cumulative structural adjustment of 1 percent of GDP in 2009 and 2010 should be regarded as a minimum. And if nominal wage discipline slips or if the medium-term outlook for the current account deteriorates relative to official projections, additional fiscal adjustment may be needed to secure external and domestic stability.

## B. Monetary Policy

***Monetary policy should remain firmly focused on price stability by preventing second-round effects of cost pressures***

43. With CPI inflation, which has been above target for some time, set to rise even further and remain high in the near term, there is a risk that businesses and consumers will expect inflation to be persistently above 2 percent. Tight monetary policy and subdued growth will be required to prevent elevated inflation expectations from getting embedded into wages and prices.

44. Given the planned fiscal stance, the challenge for the monetary authorities is to balance the upside risks to inflation against the potential disinflationary effect from downside risks to output. In the staff's central scenario, the broad strategy should be to allow slack to develop in the economy to reduce upside risks to price stability and return inflation to its target level in about two years, consistent with the flexibility in the inflation targeting framework to respond to shocks. House price declines should affect the policy rate only if

they reduce demand more than anticipated. This scenario incorporates the modest tightening of the monetary stance implied by holding the bank rate constant, given the increase in money market spreads and the link between many financial contracts and 3-month LIBOR. At the same time, financial sector stabilization initiatives have reduced downside risks to output from that source, diminishing the case for a further relaxation on that account.

45. Accordingly, the current halt in monetary policy easing is appropriate, and the next move in the bank rate needs to be assessed in light of the evolving outlook for inflation. Risks on both sides appear balanced. On the one hand, there may be room for additional policy easing if there is evidence of reinforcement of disinflationary factors, such as unexpected output weakness or deceleration of nominal wages. A tighter fiscal policy than anticipated would also provide room for easing. On the other hand, should signs emerge that wage restraint will not continue, or that medium-term inflation expectations rise further, an increase in the bank rate may be necessary to send a strong signal on this score.

### **C. Financial Sector Policies**

#### ***Initiatives to strengthen bank capital remain critical***

46. In light of continued illiquidity in money markets and perceived vulnerabilities of banks' balance sheets, steps are needed to restore confidence and ease pressures. Several initiatives are underway, as outlined in the Bank of England's April 2008 Financial Stability Report. For example, the Bank of England is reviewing its money market operations with a view to introducing a new permanent facility that learns from the experience of the SLS. In addition, steps are underway to improve the pricing of risk and strengthen risk management as envisaged in the recent report of the Financial Stability Forum, alongside greater regulatory emphasis on liquidity risk management, stress testing, and contingency funding. A critical additional element is the need for banks to raise capital to signal their ability to withstand potential shocks.

47. Although U.K. banks are reporting regulatory capital ratios above required levels, markets remain skeptical about bank robustness. Generally, concerns focus on declines in net income due to higher interest expenses from money market funding, weakness in the mortgage market, and accounting losses due to falling reference prices (particularly for sub-prime exposures). But in addition, even where losses have been announced and capital raised, there are concerns that these adjustments focus on banks' trading books, with prospective losses from credit impairment yet to be addressed. In this context, the markets appear to be downplaying risk-based and internal capital measures in favor of simpler (but more transparent) equity measures such as an equity to asset ratio, with greater importance given to core (i.e. nonhybrid) equity. For those banks less able to bolster capital by recourse to new equity issues, options to postpone dividends, sell assets, and other such broader capital-raising initiatives may be necessary.

## V. POLICY FRAMEWORKS

### *The U.K.'s policy frameworks are under pressure*

48. As noted above, although the inflation-targeting regime is confronted by difficult circumstances, its essential structure remains sound. But the fiscal and financial stability frameworks need reform.

#### A. Fiscal Rules

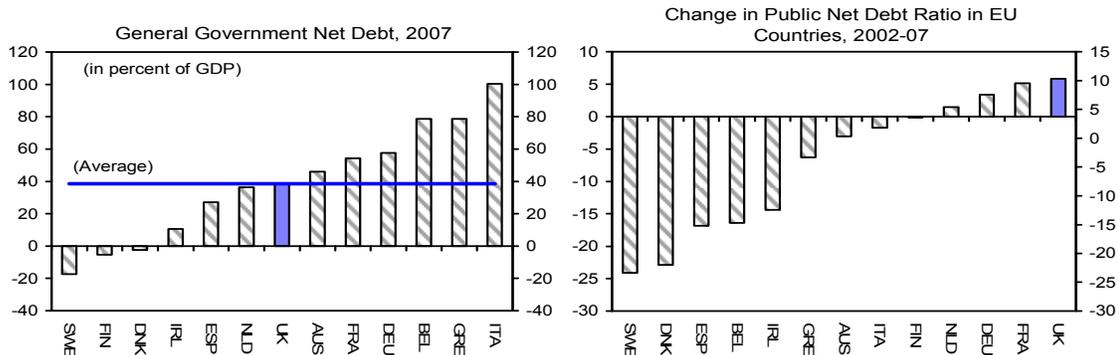
### *The rules-based fiscal framework aims to improve credibility and transparency*

49. The framework comprises two rules, together with periodically issued medium-term spending objectives:

- A sustainable investment rule. For the current cycle, this is expressed as a commitment to maintain net public debt below 40 percent of GDP and, since 2003, to observe this limit in every year.
- A golden rule, measured by the cumulative current balance since the beginning of the cycle, as a percent of GDP.
- Compliance with the two rules is supported by comprehensive spending reviews which set departmental spending limits three years ahead.

### *Like inflation-targeting, this is a framework of constrained discretion*

50. Although medium-term sustainability is emphasized, discretion is considerable in several dimensions—annual budget balances can swing substantially, revenue and expenditure ratios are unanchored as long as they move together, the headroom to be maintained against the rules and the treatment of debt stock adjustments are undefined, and the authorities largely self assess compliance. And public debt remains low compared to other EU advanced economies, even though its continued rise in recent years goes counter to the reductions achieved by most of these countries.



***However, some use of this discretion has created difficulties***

51. In particular, despite output close to potential over the entire decade, headroom under the debt rule has been steadily eroded (see Annex 4). Expenditure has tended to exceed the multi-year projections, even when the latter anticipated significant increases. Recent revisions to external data underscore the toll the associated high deficits—in the context of buoyant private demand—took on the external balance. And in light of the uncertainties surrounding the cyclical position of the economy, the authorities have not yet established an end point for the cycle that began in 1997, complicating assessment of adherence to the fiscal rules.

***The debt rule should be maintained, but other adjustments to the rules to constrain discretion may be appropriate***

52. The net debt ceiling underpins the medium-term and sustainability focus of the current framework, which reflects aging and other factors (Figure 7). In this light, any softening of the ceiling—even a reversion to casting it “over the cycle”—would be inappropriate, especially at the current juncture because of elevated inflation expectations, current account developments, terms of trade losses, and the difficulty of establishing the credibility of a higher ceiling or an alternative framework.

53. Indeed, a stronger medium-term fiscal path than that implied by the authorities’ plan would support the necessary shift from domestic to external demand and help secure headroom under this cap to accommodate stabilizers in future. Further, any leeway arising from prospective upward revisions to official estimates of GDP, such as those expected from revised estimates for financial sector value added, would best be applied to headroom under the debt ceiling, not to a relaxation of the recommended fiscal stance. If, however, the ceiling is breached in coming years, as appears likely, prompt announcement of plans to bring it back under the ceiling on a sustained basis and create the necessary buffers over the medium term to allow automatic stabilizers to operate will be critical.

***The status of the spending guidelines should be raised***

54. The net debt rule needs the support of other elements of the fiscal framework. In that regard, nominal spending caps are simple and transparent, facilitate multi-year expenditure planning, constrain upward expenditure drift directly, allow automatic stabilizers to operate on the revenue side, and strengthen fiscal resistance to inflation. Binding three-year global current expenditure ceilings could be set on a rolling basis—building on the system of three-year departmental expenditure limits as well as steps towards multi-year public service nominal pay awards—so that each new budget would introduce a further year, with limited scope for revision.

55. Cyclically-sensitive items such as unemployment benefits could be excluded if a contingency reserve to accommodate cyclical spending proves infeasible. Concern to secure investment spending could be reflected in adoption of a multi-year floor on investment. Medium-term policy on the revenue ratio would be implicit in the expenditure and debt targets. Adherence to the golden rule could still be monitored—much as nominal spending relative to target is now—but it would no longer play a primary role in the fiscal framework. Such a shift in emphasis would also reflect the success of broader policy frameworks, which have underpinned reduced economic volatility thereby diminishing the need to define fiscal or other rules “across the cycle.”

## **B. Financial Stability Framework**

### ***The post-August 2007 global liquidity turmoil highlighted weaknesses in the financial stability framework.***

56. The design of the U.K. financial stability framework reflects several core principles. The “caveat emptor” approach implies that—consumer protection aside—investors large and small are expected to play a role in providing discipline to institutions, a principle reflected, among other things, in limited and partial deposit insurance cover. Relatedly, banks should be allowed to fail (as reflected in a series of closures in recent decades), subject to systemic concerns. Furthermore, supervision within the U.K. should operate on a consolidated rather than line-of-business basis to reflect and facilitate increased integration of financial firms. And cross-border supervisory matters are handled in a variety of frameworks, sometimes in an ad hoc manner reflecting individual firms’ circumstances. And finally, clearly demarcated responsibilities are assigned to the tripartite bodies—the Financial Services Authority (FSA), the Bank of England, and the Treasury.

57. Following the global freeze on liquidity since August 2007, these core principles have been questioned, notably in a series of thorough and transparent official reviews. The consequent official proposals for reform aim to correct shortfalls while retaining the core principles of the financial stability framework, and they go in the right direction.

### ***The review of supervision of Northern Rock catalogues multiple failings, but endorses the supervisory framework***

58. Deficiencies highlighted in the supervision of Northern Rock include insufficient resources devoted to the case, management and staff turnover, training, flow of information, and inadequate proactiveness—all undermining FSA decision-making in that case.

59. In learning lessons from this review, two issues are key. First, linkages between the aggregate market risk factors highlighted in the authorities’ various “Stability Reports” did not translate into specific supervisory follow-up, neither for Northern Rock nor for other cases. Second, despite multiple risk management failings in many financial institutions, it appears to have required the trigger of an overt crisis to generate close supervisory follow-up.

The FSA has acknowledged the need for more formal links between risk identification and follow-up in respect of individual institutions and more assertive supervisory action when a problem is uncovered in an institution.

***Liquidity regulation remains a critical challenge***

60. An FSA discussion document sets out initial considerations for reform. These include: reemphasis on the responsibility of bank boards and management in liquidity risk management, enhanced use of stress tests by regulators, introduction of quantitative liquidity requirements, and further buffers of highly liquid assets to ensure survival under stress. As noted in the Bank of England Financial Stability Report, stress tests alone are insufficient and should be integrated with well-developed contingency funding plans.

61. In taking these matters forward, two issues are key. First, although the Northern Rock crisis was triggered by illiquidity, solvency concerns led to loss of depositor confidence. Regulators need to consider capital and liquidity requirements jointly. Second, the role of strengthened disclosure to markets in forestalling liquidity difficulties can be developed in various dimensions, including greater regulatory reporting to investors and markets. These matters are being considered in a number of international fora and progress is underway in the U.K. as part of the adoption of Basel II.

***Establishment of a special framework for bank resolution, along with other key reforms, are also under preparation***

62. Key proposals, outlined in the tripartite consultation paper<sup>8</sup>, include:

- A special regime aimed at the orderly resolution of failing banks prior to formal insolvency. Actions on a failing bank would be based on regulatory triggers based on quantitative and qualitative criteria.
- Increased coverage of deposit insurance aimed at raising compensation limits, facilitating compensation of depositors within one week of a bank closing, and improved arrangements for funding the deposit insurance scheme.
- Strengthening the tripartite arrangements for financial stability among the government, the Bank of England, and the FSA, with particular focus on strengthening the communication with the public and providing a statutory basis for the Bank of England's role in maintaining financial stability.

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<sup>8</sup> *Financial Stability and Depositor Protection: Strengthening the Framework*, January 2008. [http://www.hm-treasury.gov.uk/documents/financial\\_services/financial\\_stability\\_framework.cfm](http://www.hm-treasury.gov.uk/documents/financial_services/financial_stability_framework.cfm). Follow-up consultation papers will be assessed in a supplement to this staff report.

- Effective cooperation across borders, with a view to improving the coordination of approaches to international financial stability issues, introducing an early warning system on global financial risks, and improving cross-border crisis management. This will include initiatives at both the EU and global level to ensure satisfactory crisis management procedures.

***The proposals are sound but will require development in various areas***

63. The special resolution regime provides the authorities a key extra tool to pre-empt outright bank failure and to manage it, reducing the burden on other elements of the financial stability framework to address these matters. Determination of the basis on which the regime is triggered has to set an appropriate balance between addressing regulatory forbearance and unnecessary actions. Although the variety of possible circumstances rules out the possibility of an exhaustive ex ante definition of trigger conditions, unconstrained discretion may weaken the effectiveness and legitimacy of the regime. Accordingly, an approach whereby the regime is presumed to be triggered when specified thresholds are crossed but where it may be triggered in advance of those thresholds, would be appropriate. But however triggered, the legal basis for actions under the regime needs to be secure in a broad range of contexts if the special resolution regime is to play its pivotal role in the new financial stability framework.

64. In similar vein, and in light of the internal FSA review of its supervision of Northern Rock, it may be appropriate to elaborate further the actions presumed to be taken once institutions cross specified thresholds. This could involve simply strengthening the FSA internal information system—automatically informing senior management when thresholds are crossed. Or it could go further, to establish in appropriate cases more concrete supervisory actions that are “presumed” to be taken in such cases. In this context, balances have to be struck between accommodation of unique circumstances and forbearance.

65. There appears also to be scope to strengthen further the data available to markets on individual firms and the information-sharing arrangements between the tripartite authorities. Although listed firms have extensive disclosure requirements—including for significant developments between formal audited reports—greater, more frequent, and more standardized reporting to markets of financial information of the banking system and individual banks could address information asymmetries which arise, notably in fast-moving crisis episodes. In addition, it is key that all tripartite authorities are appropriately informed to fulfill their assigned roles. In this light, proposals to give the Bank of England a legal basis for its financial stability functions and to establish a Financial Stability Committee to assist in these matters have merit.

66. Finally, the policy responses to the Northern Rock run and related turmoil in financial markets have signaled a fundamental shift in policy on bank stability. In particular, the extension of public guarantees to banks, provision of liquidity by the Bank of England to

markets, and proposed reforms to deposit insurance have all signaled that the “caveat emptor” principle will not be applied as extensively as hitherto. As this principle was a key counterpart to the U.K.’s “principle based” regulatory philosophy, the post-Northern Rock de facto diminution of market discipline may require corresponding shifts in the nature of supervision. The proposals on bank resolution are one element of that shift. Other steps may be needed in this context along with a more transparent rules-based approach that promotes early intervention and assurance that the relevant authorities are provided with access to sufficient resources.

## VI. AUTHORITIES’ VIEWS

67. There was broad agreement with the staff on the major macroeconomic concerns facing the U.K. and that strong policy frameworks and macroeconomic outcomes have situated the U.K. well to face the twin shocks of financial market turmoil and commodity price rises. There were, however, some divergences in views on the short-term outlook and on the appropriate adjustments to fiscal policy and policy frameworks.

68. The twin shocks will lower growth and raise inflation. But relative to the Bank of England, the Treasury felt the impact on activity would be somewhat more muted and shorter-lived, notably in respect of the credit shock. Both underscored that consumption growth would likely be moderated by continued slow growth in real take home pay, and both noted the benefits of sterling’s depreciation on net exports. The Special Liquidity Scheme and capital raising efforts by banks were cited as contributing to increased confidence in financial markets.

69. The ongoing housing market correction is regarded as contributing to the broader rebalancing of the economy. And even if prices were to fall further and faster than anticipated, the impact on consumption growth is considered likely to remain muted as consumption responds more to household income than to asset price developments.

70. The fiscal authorities welcomed the staff endorsement of the Budget judgment for 2008, but felt that the case for greater adjustment than planned in 2009 to address discretionary policy slippage or external weakness had to be balanced against short-term output stabilization concerns. Thus, they remained committed to adhere to the debt and golden fiscal rules, which provide for some flexibility in this regard. The next assessment of fiscal objectives and planned discretionary measures, taking into account the broad sweep of developments, would take place in the context of the next pre-Budget report, and subsequently in the 2009 Budget. The authorities also remain committed to the medium-term expenditure targets laid out in the Comprehensive Spending Review, as well as public sector pay restraint through multi-year agreements, which they saw as contributing to overall wage restraint in the economy.

71. On inflation, the Monetary Policy Committee reflects a range of views of the risks. Some members focus on concerns about second round effects and impairment to credibility

of the inflation targeting framework as a result of a prospective significant deviation from target more prolonged than in the recent past, but others emphasize muted labor market responses and concerns with the disinflationary impact of credit-crunch effects on output. Most recently, the balance of views has favored holding Bank Rate constant, pending further clarification of the relative weight to be given to the two risks. Following the May 2008 CPI data, the Governor's letter to the Chancellor noted that inflation is likely to rise above 4 percent in the second half of 2008 and remain markedly above target well into 2009, and that the MPC is aiming to return inflation to target within its normal forecast horizon of around two years.

72. Turning to the external accounts, the authorities emphasized a number of concerns with the reliability of the data. In particular, trade data have been distorted by VAT-related fraud, the income accounts have indicated significant shocks which have been difficult to interpret, and the IIP accounts have various measurement difficulties, including measuring FDI at book rather than market value. Although the negative trends indicated in recent years were broadly correct, the precise numbers were not reliable. Subject to that qualification, the authorities agreed that external trends had become more of a concern in recent years and remained under review. In that light, they noted that the recent depreciation of sterling had lowered it back into the range for the real effective rate in which it had traded over the past decade or so, and that competitiveness against the euro area—a key trading partner—was stronger.

73. On the policy frameworks, the authorities agreed that changes to the Bank of England's inflation-targeting mandate would be counterproductive. On the sustainable debt rule, they reaffirmed their commitment to adhere to it, but also underscored that fiscal stabilizers should be allowed to operate. In light of the premium on flexibility over the cycle and the protection of investment, they also regarded the golden rule as more appropriate than the suggested nominal spending ceilings, even if the latter are rooted in the three year comprehensive spending review.

74. On the financial stability framework, the authorities agreed that the tripartite framework was fundamentally the right one, and that the ongoing reform work was to enhance the operation of this framework and the tools available to the authorities in maintaining financial stability. As to the detail, the authorities preferred to retain considerable discretion in the execution of supervisory practices, including in regard to application of the trigger in the proposed SRR. The variety of circumstances and the difficulty of specifying appropriate thresholds in advance appeared to rule out "hard" thresholds. That said, additional flows of management information triggered automatically as institutions crossed thresholds could help. Treasury officials were also confident that a firm legal basis for actions under the special resolution regime would be obtained once the framework goes into effect.

75. On transparency for individual financial firms, the authorities noted that practices will be upgraded in line with Pillar 3 of the Basle II accords, and emphasized the distinction between more data and more information. The burden on firms of collecting the former could only be justified if users were better informed, rather than “blinded” by the quantity of additional information. Although there was likely some benefit from greater frequency of formal reporting to markets, listed firms were already obliged to report “significant” developments even between regular reports, and unless all such data issues were audited, some confusion could arise from the different status of data issued.

Table 1: United Kingdom: Selected Economic and Social Indicators

	2002	2003	2004	2005	2006	2007	2008	2009
							Proj.	Proj.
<b>Real Economy</b> (change in percent)								
Real GDP	2.1	2.8	3.3	1.8	2.9	3.1	1.8	1.7
Domestic demand	3.1	2.8	3.8	1.6	2.8	3.8	1.3	1.2
CPI	1.3	1.4	1.3	2.1	2.3	2.3	3.7	3.1
Unemployment rate (in percent) 1/	5.2	5.0	4.8	4.8	5.4	5.4	5.5	5.7
Gross national saving (percent of GDP)	15.8	15.7	15.9	15.0	14.1	14.4	13.3	13.3
Gross domestic investment (percent of GDP)	17.4	17.1	17.5	17.5	18.0	18.7	17.5	17.1
<b>Public Finance</b> (fiscal year, percent of GDP) 2/								
General government balance	-2.5	-3.2	-3.5	-3.1	-2.6	-2.8	-2.9	-3.4
Public sector balance	-2.3	-2.9	-3.3	-3.0	-2.3	-2.6	-3.3	-3.2
Cyclically adjusted balance (staff estimates)	-2.3	-2.9	-3.6	-3.0	-2.3	-3.0	-2.9	-2.4
Public sector net debt	31.5	32.8	34.6	36.0	36.7	37.3	39.2	40.9
FX-denominated public debt (percent of gross debt)	0.4	0.4	0.3	0.3	0.3	0.3	...	...
<b>Money and Credit</b> (end-period, 12-month percent change)								
M4	7.3	7.3	9.0	12.9	12.5	12.5	...	...
Consumer Credit	14.9	11.5	11.9	9.5	7.4	6.4	...	...
<b>Interest rates</b> (percent; year average)								
Three-month interbank rate	4.0	4.0	4.8	4.6	5.3	6.4	...	...
Ten-year government bond yield	4.8	4.5	4.9	4.4	4.5	5.0	...	...
<b>Balance of Payments</b> (percent of GDP)								
Current account balance	-1.6	-1.3	-1.6	-2.5	-3.9	-4.3	-4.2	-3.9
Trade balance	-2.9	-2.6	-3.0	-3.6	-3.6	-3.7	-3.6	-3.2
Net exports of oil	0.5	0.3	0.1	-0.2	-0.3	-0.3	-0.3	-0.2
Exports of goods and services (volume change in percent)	1.0	1.7	4.9	8.2	10.7	-5.1	1.2	2.5
Imports of goods and services (volume change in percent)	4.8	2.0	6.6	7.1	9.8	-2.4	-0.5	0.4
Terms of trade (percent change)	2.5	1.1	0.4	-2.5	0.0	1.4	-0.7	-0.7
FDI net	-1.7	-2.2	-1.0	4.4	2.6	...	...	...
Reserves (end of period, in billion of US dollars)	42.5	46.1	49.4	46.2	51.8	57.2	59.3	...
<b>Fund Position</b> (as of May 31, 2008)								
Holdings of currency (in percent of quota)								92.2
Holdings of SDRs (in percent of allocation)								12.4
Quota (in millions of SDRs)								10,738.5
<b>Exchange Rates</b>								
Exchange rate regime								Floating
Bilateral rate (June 24, 2008)								US\$ = £0.5073
Nominal effective rate (2005=100) 3/	99.4	96.5	101.2	100.0	100.8	103.1	...	...
Real effective rate (2005=100) 3/ 4/	98.7	94.8	100.5	100.0	101.8	106.5	...	...
<b>Social Indicators</b> (reference year):								
<b>Income per capita</b> (in US dollars, 2006) : 39,889; <b>Income distribution</b> (ratio of income received by top and bottom quintiles, 2006): 5.4;								
<b>Life expectancy at birth</b> (2005): 77.1 (male) and 81.1 (female); <b>Automobile ownership</b> (2004): 463 per thousand;								
<b>CO2 emissions</b> (ton per capita, 2005): 9.26; <b>Population density</b> (2004) 250 inhabitants per sq. km.;								
<b>Poverty rate</b> (share of the population below the established risk-of-poverty line, 2005): 18%.								

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

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

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

3/ Average. An increase denotes an appreciation.

4/ Based on consumer price data.

Table 2. United Kingdom: Balance of Payments  
(Percent of GDP)

	2004	2005	2006	2007	2008 Proj.	2009 Proj.	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.
<b>Current account</b>	-1.6	-2.5	-3.9	-4.3	-4.2	-3.9	-3.6	-3.6	-3.5	-3.3
Trade balance	-3.0	-3.6	-3.6	-3.7	-3.6	-3.2	-3.1	-3.0	-2.9	-2.8
Trade in goods	-5.1	-5.6	-5.9	-6.5	-6.3	-6.0	-5.9	-5.8	-5.7	-5.6
Exports	16.1	17.1	18.7	16.0	17.5	17.4	17.2	17.2	17.3	17.3
Imports	21.3	22.7	24.6	22.5	23.8	23.4	23.1	23.0	23.0	22.9
Trade in services	2.2	2.0	2.4	2.8	2.7	2.8	2.8	2.8	2.8	2.8
Exports	9.1	9.3	9.8	10.1	10.4	10.3	10.3	10.3	10.2	10.2
Imports	6.9	7.3	7.4	7.3	7.7	7.5	7.5	7.5	7.4	7.4
Income balance	2.2	2.0	0.6	0.4	0.5	0.4	0.5	0.5	0.5	0.6
Current transfers	-0.9	-1.0	-0.9	-1.0	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
<b>Capital and financial account</b>	0.7	2.9	3.5	4.3	...	...	...	...	...	...
<i>Of which:</i>										
Direct investment	-1.0	4.4	2.6	3.2	...	...	...	...	...	...
Portfolio investment	-4.5	-2.4	-3.1	-2.5	...	...	...	...	...	...
Other investment	6.0	0.8	4.0	3.6	...	...	...	...	...	...

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

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

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Real GDP	3.3	1.8	2.9	3.1	1.8	1.7	2.9	2.9	2.8	2.7
Real domestic demand	3.8	1.6	2.8	3.8	1.3	1.2	2.8	3.0	2.7	2.6
Private consumption	3.4	1.5	2.0	3.2	2.4	1.3	2.9	2.8	2.6	2.6
Government consumption	3.2	2.7	1.7	1.9	2.3	2.6	2.6	2.6	2.5	2.4
Fixed investment	5.9	1.5	7.6	6.0	-0.8	-1.1	3.0	4.0	3.2	2.8
Public 1/	8.3	8.3	8.2	2.0	11.4	3.2	2.0	2.0	2.0	1.2
Residential	9.9	1.6	7.9	4.0	-6.4	-1.2	2.4	3.2	2.7	2.6
Business 1/	2.4	3.0	7.1	8.3	-0.5	-1.8	3.3	4.5	3.5	3.2
Stocks 2/	0.1	-0.1	-0.1	0.4	-0.6	0.0	0.0	0.0	0.0	0.0
External balance 2/	-0.6	0.0	0.0	-0.7	0.5	0.6	0.0	-0.1	0.0	0.0
Exports of Goods and Services	4.9	8.2	10.7	-5.1	1.2	2.5	5.4	5.4	5.2	5.2
Imports of Goods and Services	6.6	7.1	9.8	-2.4	-0.5	0.4	5.0	5.4	4.9	4.8
Exports of Goods and Services (ex. fraud) 3/	5.6	5.4	7.5	0.9	1.6	2.5	5.4	5.4	5.2	5.2
Imports of Goods and Services (ex. fraud) 3/	7.3	4.6	6.9	3.2	-0.2	0.4	5.0	5.4	4.9	4.8
Current account 4/	-1.6	-2.5	-3.9	-4.3	-4.2	-3.9	-3.6	-3.6	-3.5	-3.3
CPI Inflation	1.3	2.1	2.3	2.3	3.7	3.1	2.0	2.0	2.0	2.0
Output gap 7/	0.5	-0.2	0.0	0.4	-0.5	-1.4	-1.0	-0.6	-0.3	-0.1
Employment and productivity										
Employment	1.1	1.0	0.9	0.7	0.7	0.1	1.0	0.8	0.7	0.6
Unemployment rate 5/	4.8	4.8	5.4	5.4	5.5	5.7	5.3	5.1	5.0	5.0
Productivity 6/	2.4	0.9	2.2	2.1	1.2	1.7	1.8	2.1	2.1	2.0

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

1/ Public investment and business investment in 2005 and 2006 exclude the transfer of nuclear reactors.

2/ Contribution to the growth of GDP.

3/ These numbers exclude VAT-related fraudulent activity.

4/ In percent of GDP.

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

6/ Whole economy, per worker.

7/ In percent of potential GDP.

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

	2000	2001	2002	2003	2004	2005	2006	2007
Assets	311	314	298	316	334	393	407	470
Direct investment abroad	65	61	60	62	58	57	56	62
Portfolio investment abroad	94	93	80	84	92	111	123	132
Other investment abroad	149	157	155	169	182	222	226	274
Reserve assets	3	3	2	2	2	2	2	2
Liabilities	313	320	301	320	344	408	433	495
Direct investment in the UK	32	36	32	32	32	40	44	49
Portfolio investment in the UK	104	96	85	94	99	116	130	138
Other investment in the UK	177	188	184	195	212	252	258	309
Net investment position	-2	-6	-3	-4	-9	-14	-26	-25
Direct investment	32	25	28	30	26	17	12	13
Portfolio investment	-10	-2	-5	-10	-7	-4	-8	-6
Other investment	-28	-32	-29	-26	-30	-29	-32	-35
Reserve assets	3	3	2	2	2	2	2	2
Monetary Financial Institutions	-7	-9	-13	-14	-16	-13	-10	-16
Other Sectors	7	6	12	14	12	4	-8	0
Public Sector	-3	-3	-2	-3	-5	-7	-8	-9
<i>Memorandum Items:</i>								
Change in the net investment position		-3.3	2.4	-0.5	-5.4	-5.1	-11.9	1.0
o/w Valuation change		-1.6	3.1	1.3	-4.9	-2.4	-8.5	5.2
Current account balance		-2.2	-1.6	-1.3	-1.6	-2.5	-3.9	-4.3

Source: Office on National Statistics.

Table 5. United Kingdom: Public Sector Budgetary Projections 1/  
(Percent of GDP and percent of potential GDP)

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
<b>Budget 2008 projections</b>							
Total revenue	39.3	39.2	39.1	39.3	39.7	39.8	39.9
Current revenue	39.2	39.1	39.0	39.2	39.6	39.7	39.8
Primary revenue	38.7	38.6	38.6	38.8	39.2	39.3	39.3
Tax revenue	36.9	36.8	36.8	36.3	36.6	36.8	36.9
Non-tax revenue	1.8	1.8	1.8	2.4	2.5	2.4	2.4
Interest revenue	0.5	0.6	0.5	0.5	0.5	0.5	0.5
Capital revenue	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Total expenditure	41.6	41.8	42.0	41.8	41.8	41.4	41.2
Current expenditure	38.3	38.4	38.4	38.2	38.1	37.8	37.5
Primary expenditure	36.1	36.2	36.3	36.1	36.0	35.7	35.4
Interest payments	2.2	2.2	2.1	2.1	2.1	2.1	2.1
Capital expenditure	3.3	3.4	3.6	3.6	3.6	3.6	3.6
Depreciation	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Current balance 2/	-0.3	-0.6	-0.7	-0.3	0.2	0.6	0.9
Overall balance	-2.3	-2.6	-2.9	-2.5	-2.0	-1.6	-1.3
Net debt 3/	36.6	37.1	38.5	39.4	39.8	39.7	39.3
<i>Cyclically adjusted 1/</i>							
Current balance 2/	-0.2	-0.7	-0.5	0.0	0.6	0.8	1.0
Overall balance	-2.2	-2.7	-2.7	-2.2	-1.7	-1.4	-1.2
Output gap	0.0	0.3	-0.5	-0.4	-0.3	-0.1	0.0
Deflator growth	2.8	3.3	3.0	2.8	2.8	2.8	2.8
Real GDP growth	3.0	3.0	1.8	2.5	2.5	2.5	2.5
<b>Staff projections</b>							
Total revenue	39.4	39.2	38.7	38.6	39.2	39.3	39.6
Current revenue	39.3	39.1	38.6	38.5	39.1	39.2	39.5
Primary revenue	38.8	38.6	38.1	38.1	38.6	38.8	39.0
Tax revenue	37.0	36.8	36.3	35.7	36.0	36.3	36.6
Non-tax revenue	1.8	1.8	1.8	2.4	2.6	2.4	2.4
Interest revenue	0.5	0.6	0.5	0.5	0.5	0.5	0.5
Capital revenue	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Total expenditure	41.7	41.8	42.0	41.9	41.8	41.4	41.2
Current expenditure	38.3	38.4	38.5	38.2	38.1	37.8	37.6
Primary expenditure	36.2	36.2	36.3	36.1	36.0	35.7	35.4
Interest payments	2.2	2.2	2.1	2.1	2.1	2.1	2.1
Capital expenditure	3.3	3.4	3.6	3.6	3.6	3.6	3.6
Depreciation	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Current balance 2/	-0.3	-0.8	-1.1	-1.0	-0.4	0.1	0.6
Overall balance	-2.3	-2.6	-3.3	-3.2	-2.6	-2.1	-1.6
Net debt 3/	36.7	37.3	39.2	40.9	41.7	42.1	42.0
<i>Cyclically adjusted 1/</i>							
Current balance 2/	-0.3	-1.0	-0.7	-0.2	0.4	0.6	0.8
Overall balance	-2.3	-3.0	-2.9	-2.4	-1.9	-1.6	-1.5
Output gap	0.1	0.3	-0.9	-1.4	-0.9	-0.5	-0.1
Deflator growth	2.7	3.1	2.9	2.5	2.6	2.3	2.3
Real GDP growth	3.0	2.9	1.4	2.1	3.0	2.9	2.9

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

1/ Staff projections are based on the change in the cyclically-adjusted overall balance in the authorities' budget 2008 projections, but with the staff's growth and potential output projections. Official estimates are based on official projections of growth and potential output.

2/ Including depreciation.

3/ End of fiscal year using centered-GDP as the denominator; excluding Northern Rock.

Figure 1. Real Developments, 2004-07

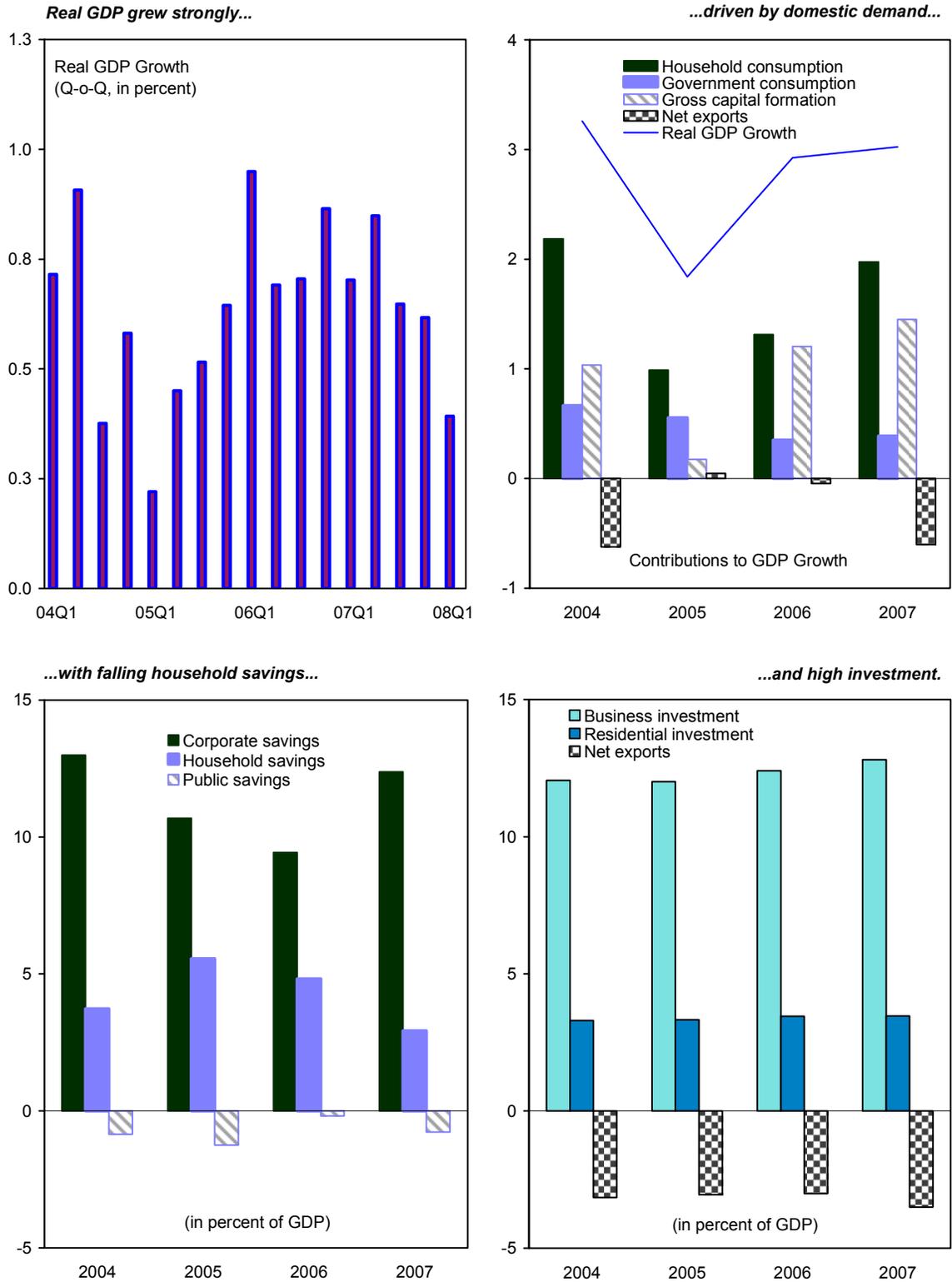


Figure 2. Labor Market Developments, 2004-07

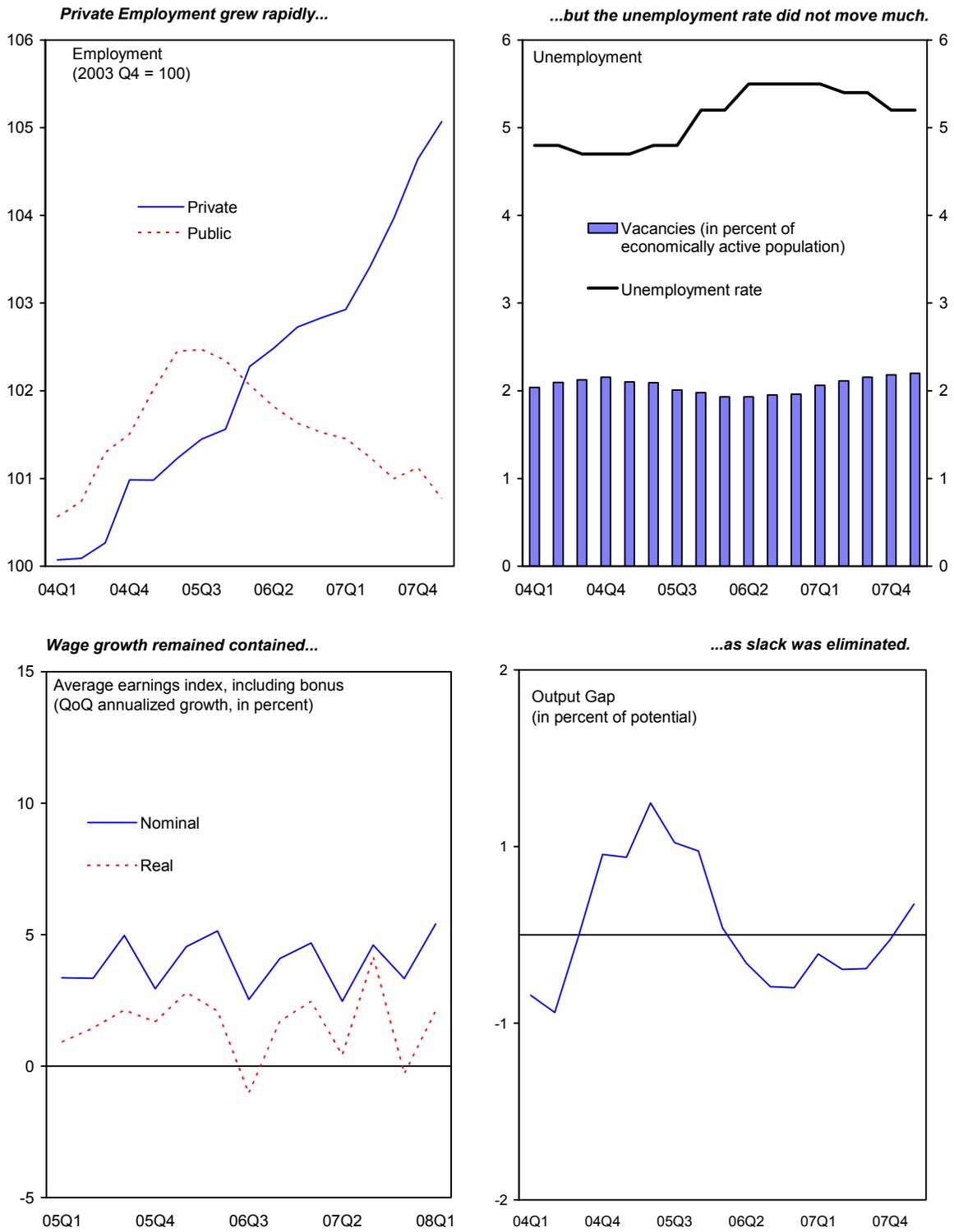


Figure 3. Credit Developments, 2004-08

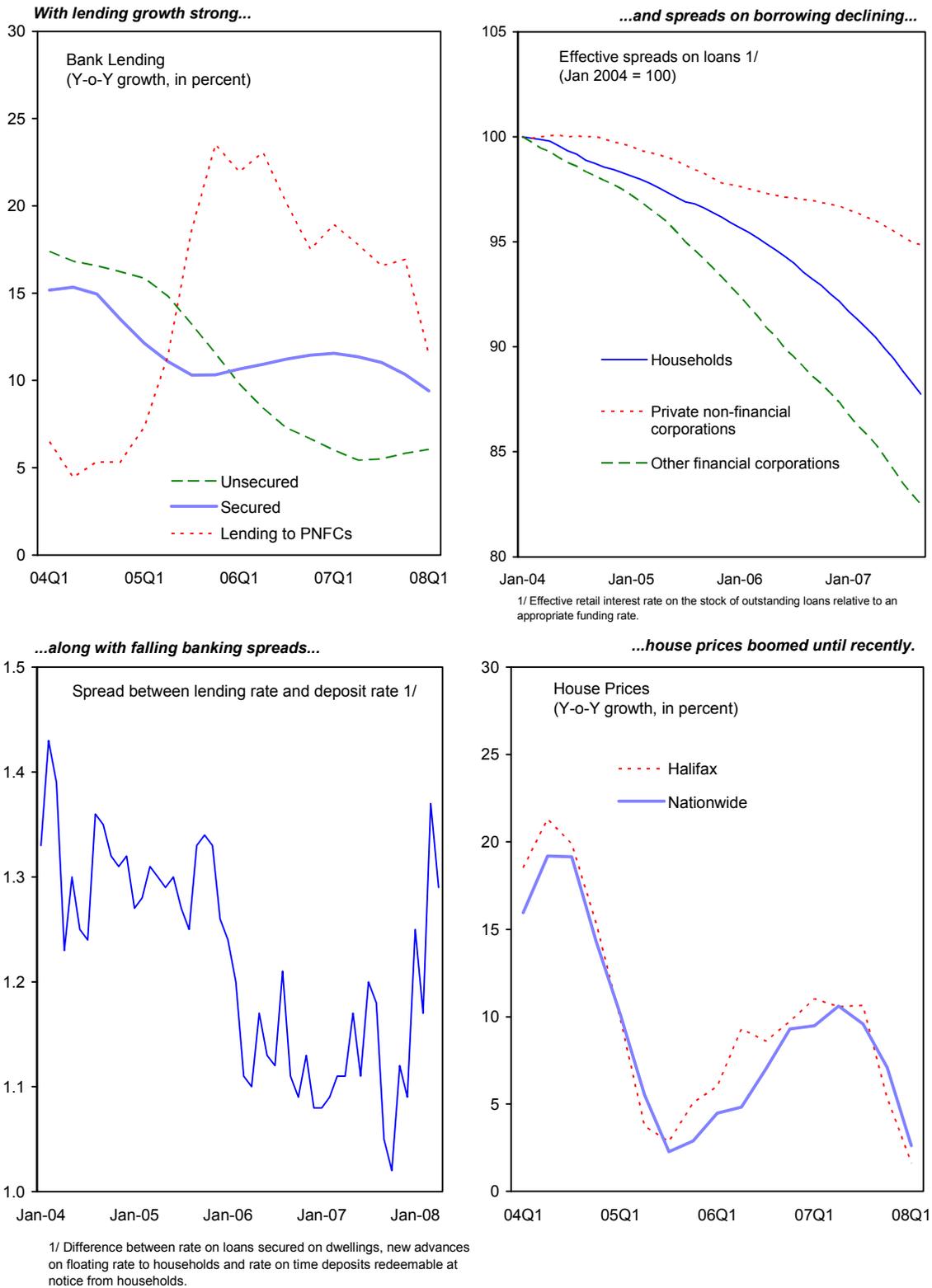


Figure 4. Monetary Policy and Inflation

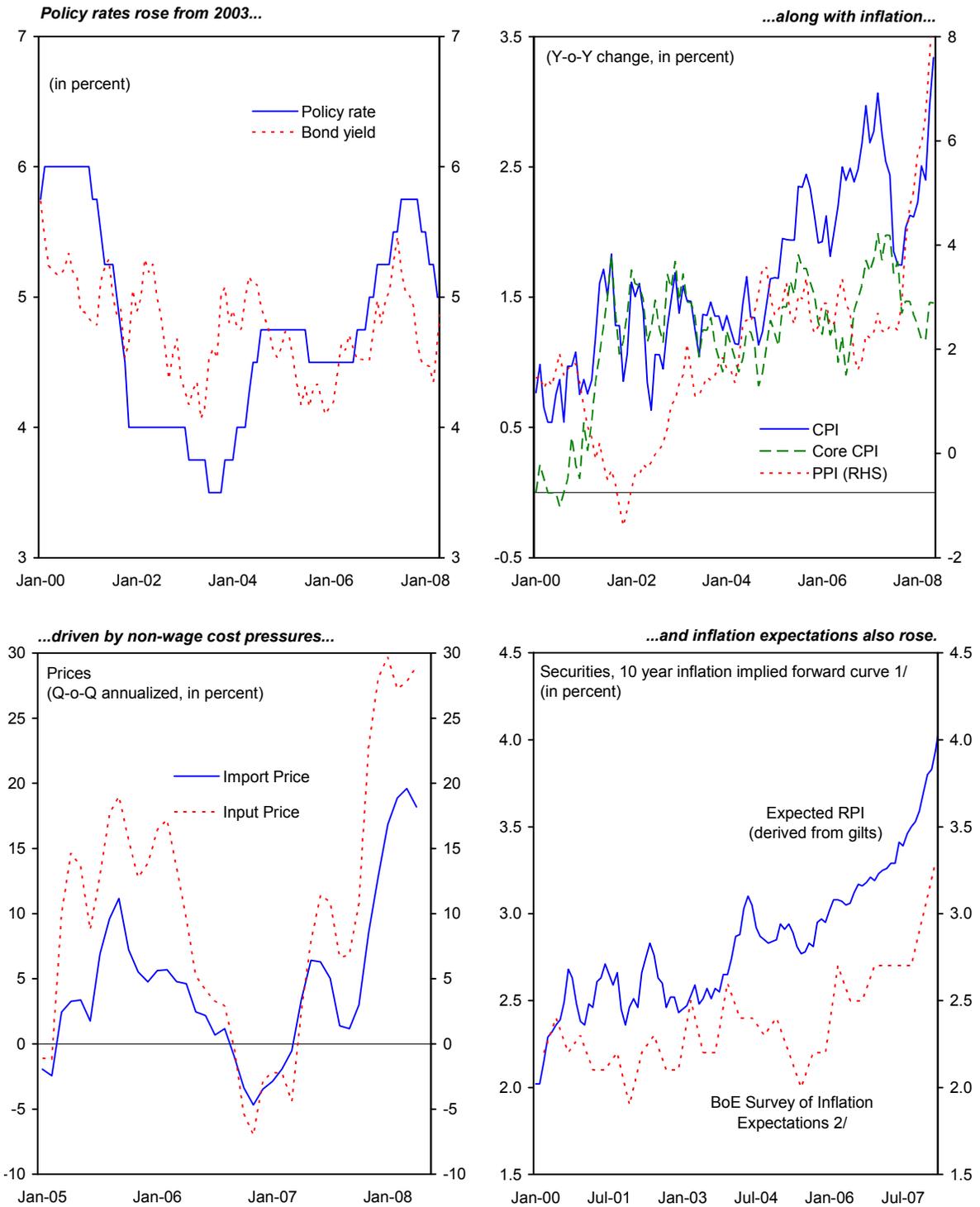


Figure 5. Competitiveness, 1999-2008

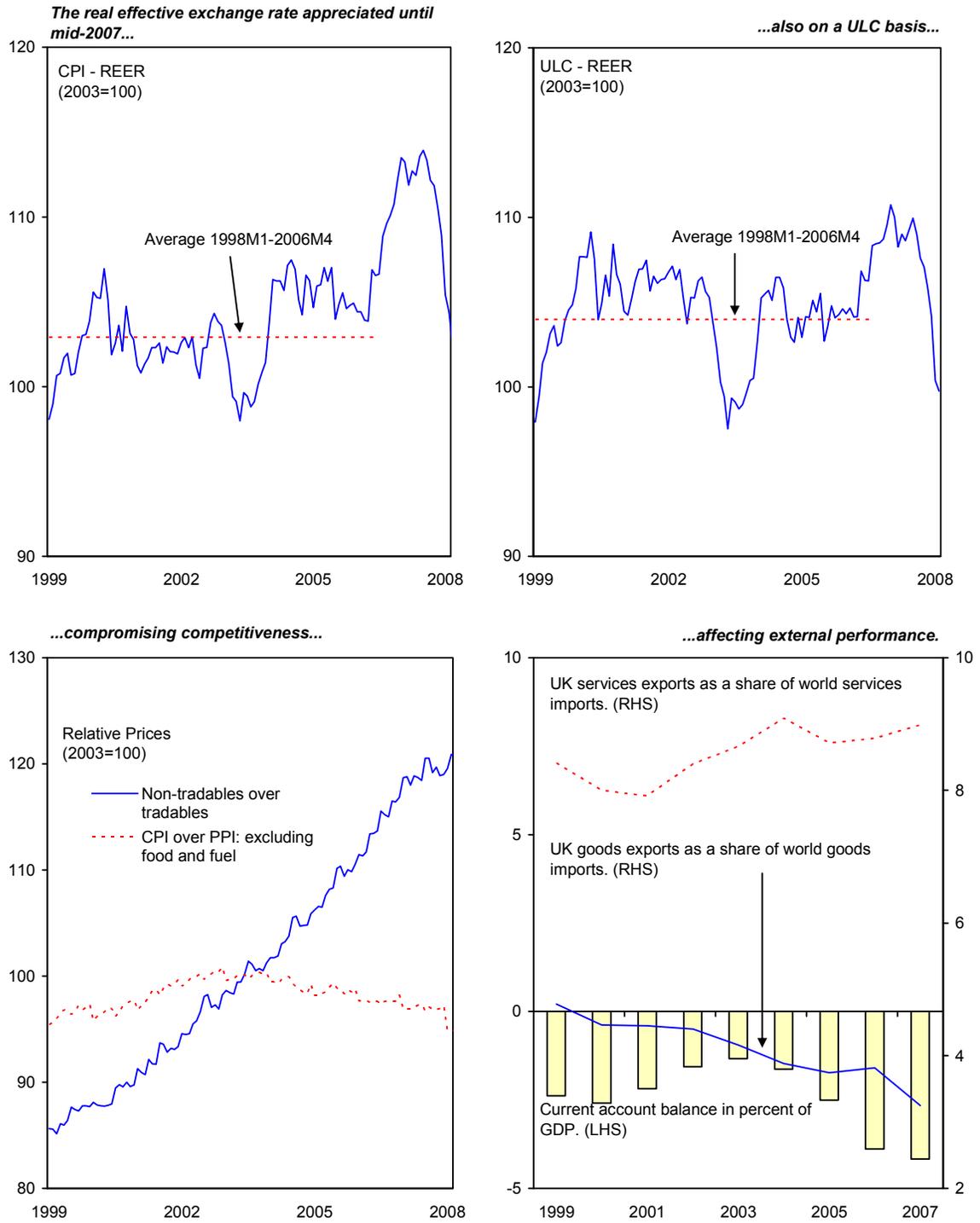


Figure 6. Recent Financial Market Developments

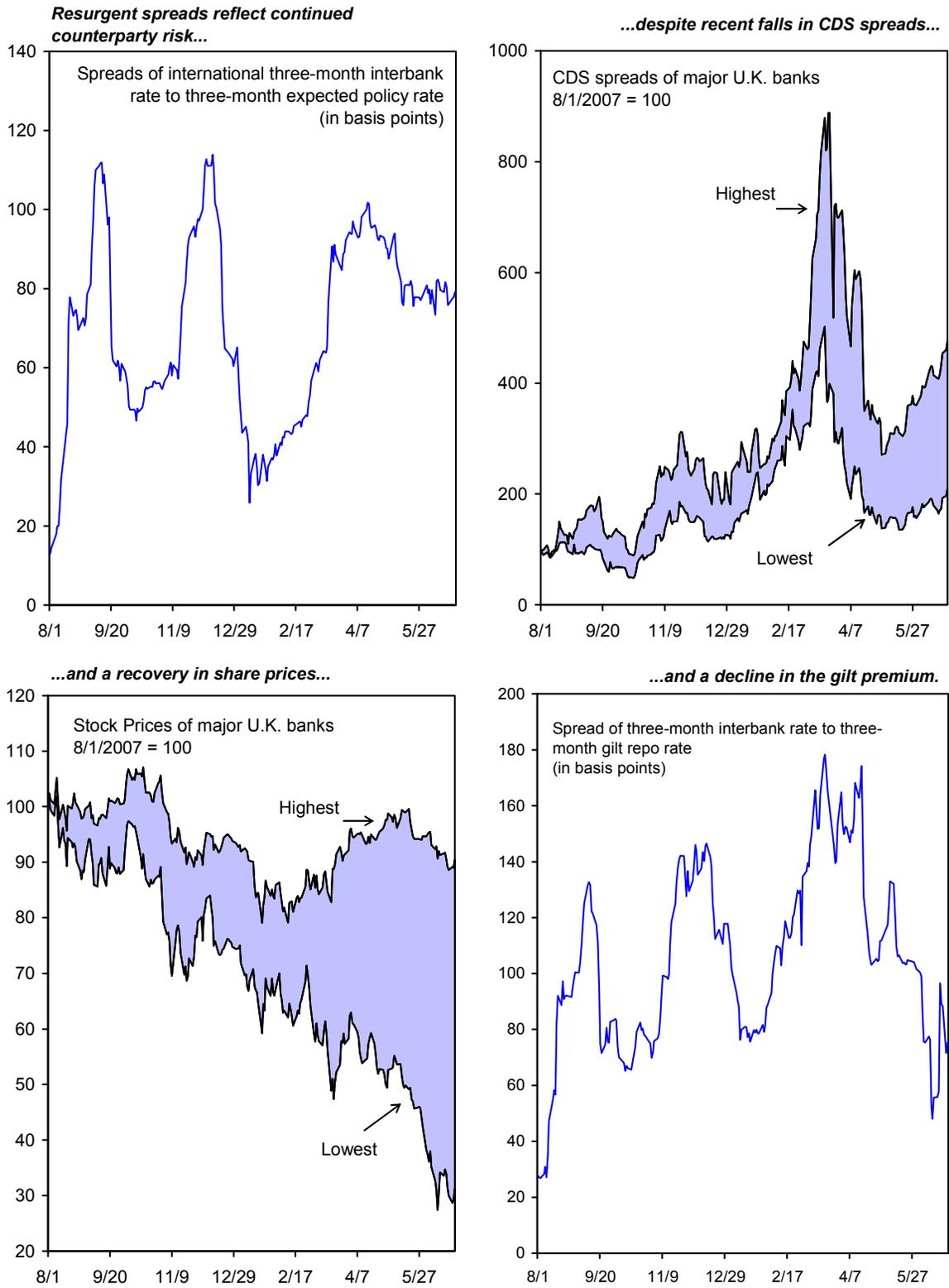
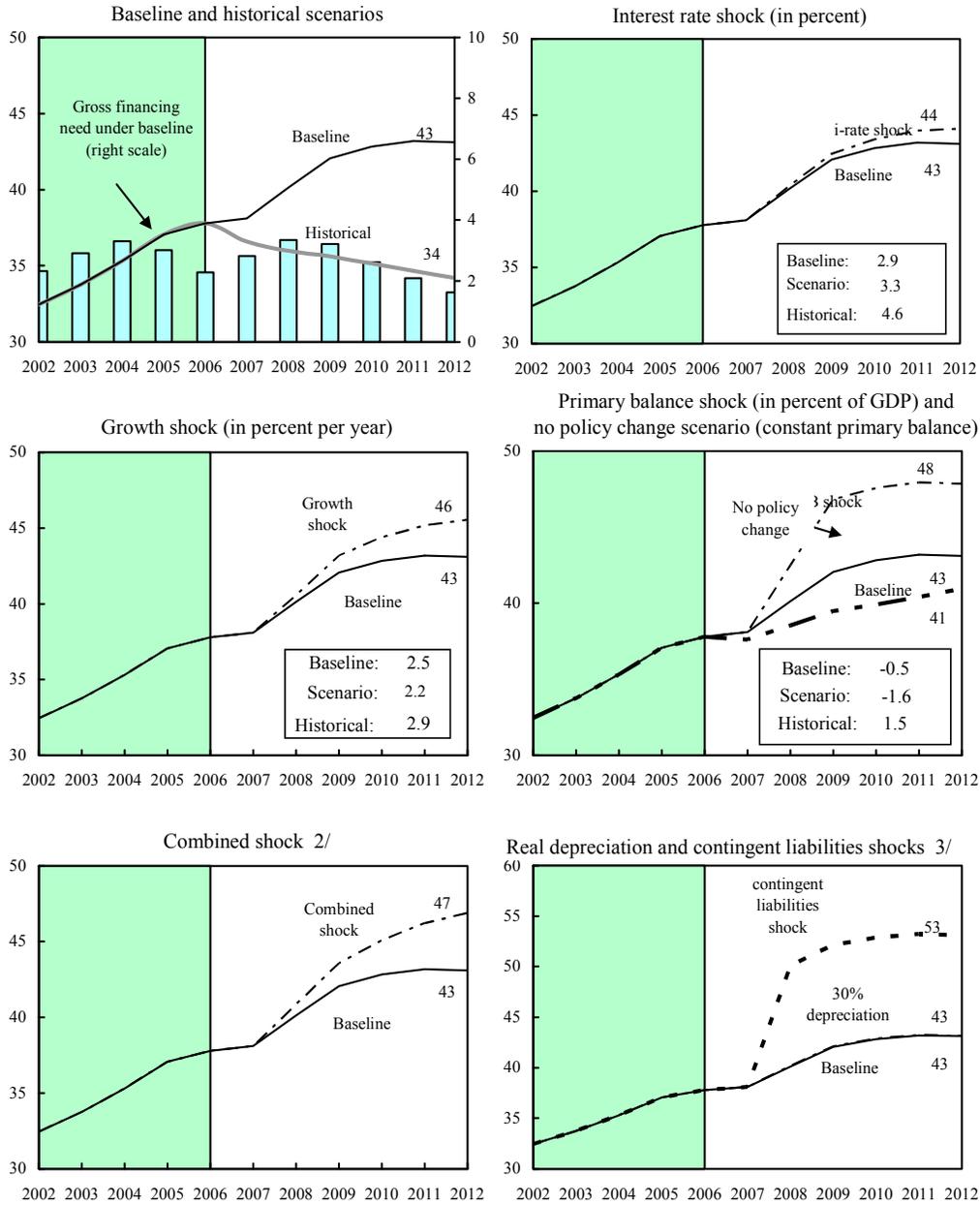


Figure 7. Public Debt Sustainability: Bound Tests 1/  
(Public debt in percent of GDP)



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.

Definition of net public debt ratio in this exercise differs from official and staff projections, which use centered GDP as the denominator.

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

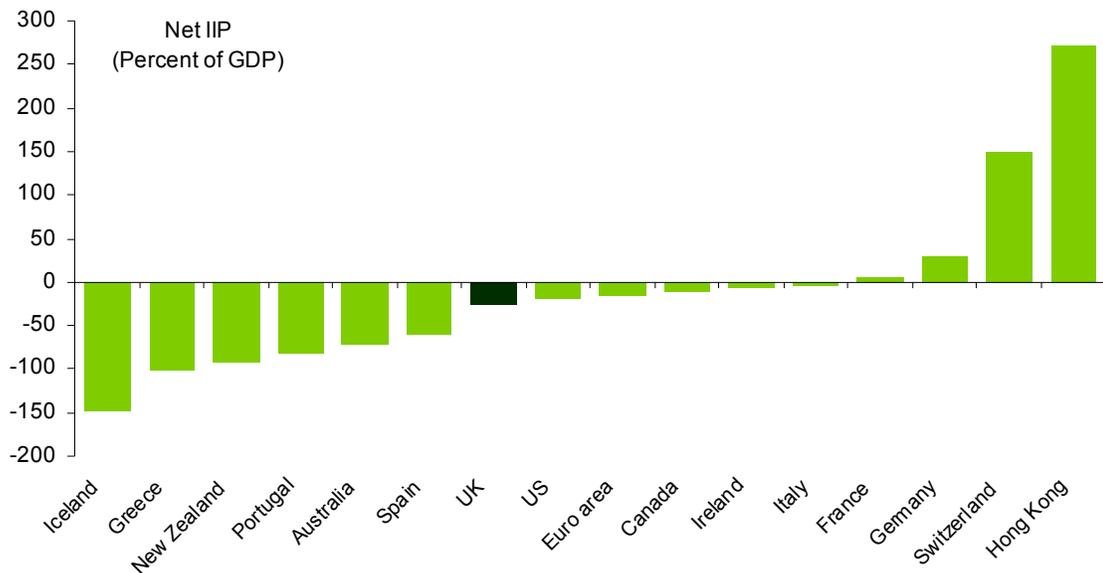
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2007, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

ANNEX I—EXTERNAL SUSTAINABILITY<sup>9</sup>

*The underlying trend in the U.K.'s external balance has worsened in recent years, raising concerns about sustainability. Staff projections suggest that the current account deficit remains above equilibrium and the net asset position continues to erode in the medium term. Although risks of a disrupting external correction are low, the projected weakness in the outlook underscores the need for rebalancing activity toward net trade to ensure sustained external stability.*

**Recent developments**

The U.K.'s net external liabilities are modest by international standards. At a deficit of 25 percent of GDP, the U.K.'s net International Investment Position is comparable to other advanced economies. The net debt position in part reflects the U.K.'s strong fundamentals, such as favorable demographics and a high trend growth relative to its major trading partners.

***The U.K.'s net IIP is comparable to other advanced economies;<sup>10</sup>***

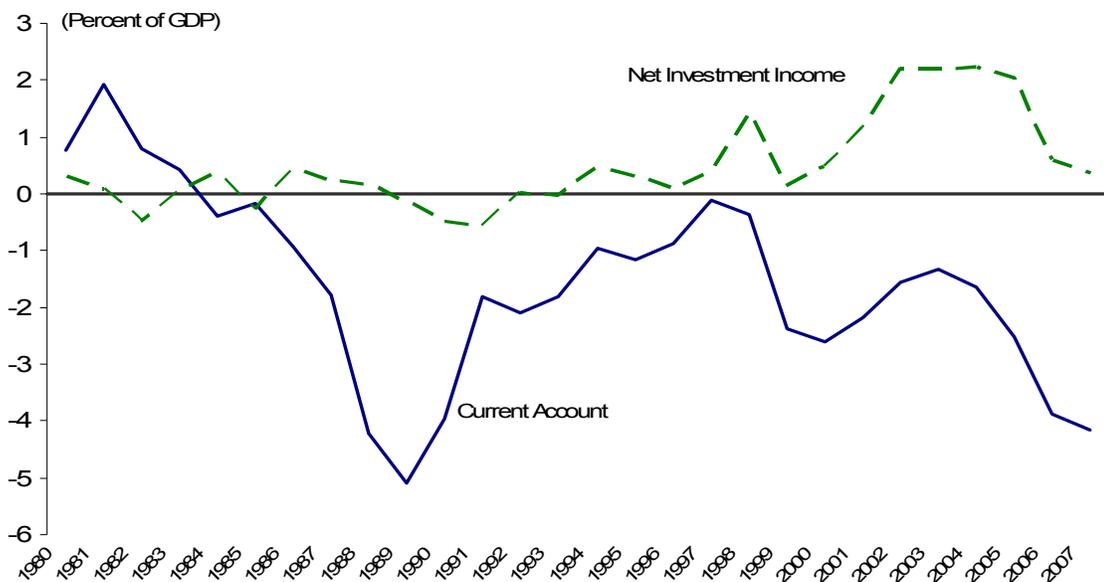
Note: Data refer to 2007 for the U.K., Iceland, Greece, New Zealand, Australia, the euro area, Canada, and Switzerland, and to 2006 for the others.

<sup>9</sup> Prepared by MK Tang (EUR).

<sup>10</sup> Some of the economies in the comparison group, like the U.K., have large gross exposures.

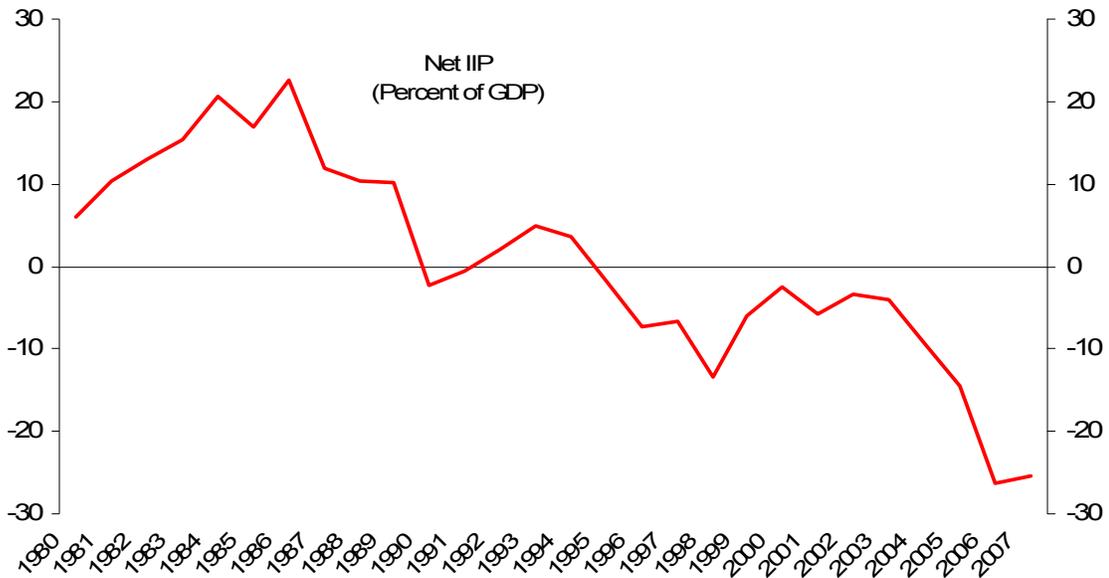
The U.K.'s external balance, however, has deteriorated substantially in recent years amid strong sterling appreciation. Although net investment income provided an exceptionally strong boost to the current account in 2002-05, the underlying trade deficits were widening. Prior to the second half of 2007, it might be argued that the strong income flows indicated a permanent rise in U.K. residents' income and, hence, justified the weakening in net exports. This hypothesis, however, was undermined by subsequent data revisions, which revealed that net income fell sharply in 2006-07 to only about ½ percent of GDP. Indeed, if it were not for the large write-offs by foreign banks at end-2007 in light of the financial turmoil, the current account deficit in 2007 would have likely reached 5 percent of GDP—a level not seen since the eve of the notable current account adjustment episode in 1990-97.

*but the current account has deteriorated in recent years...*



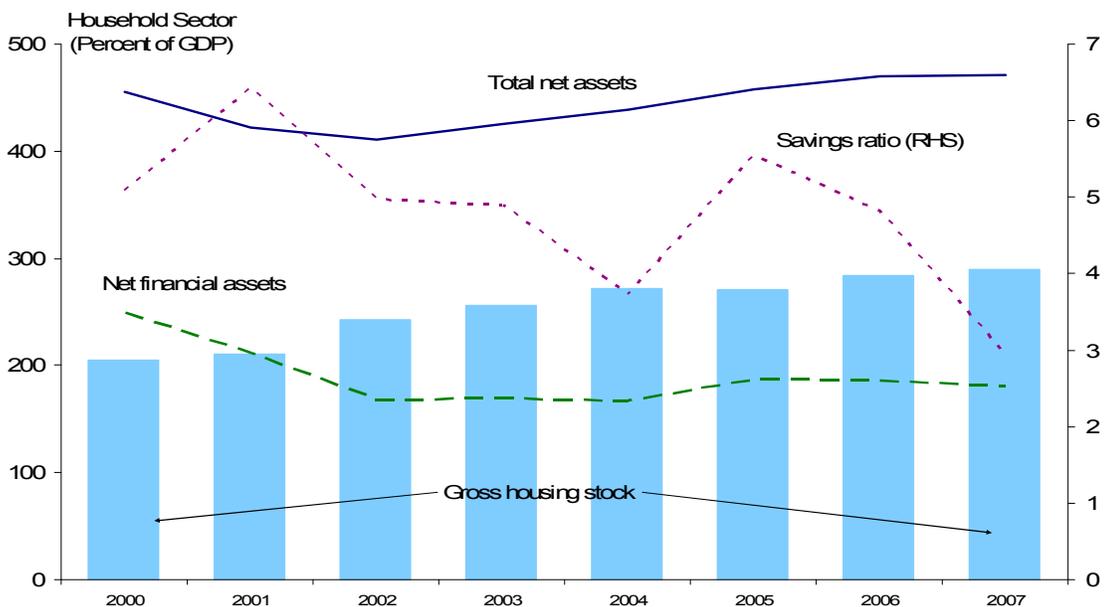
The net IIP has worsened alongside. Although measurement issues may qualify inferences drawn from the observed level of net assets, the consistent downward trend since 2003 points to a significant erosion of the U.K.'s underlying external position. During 2003-07, the U.K.'s net liabilities more than quintupled, rising from 4 to 25 percent of GDP.

*and the external position has weakened...*



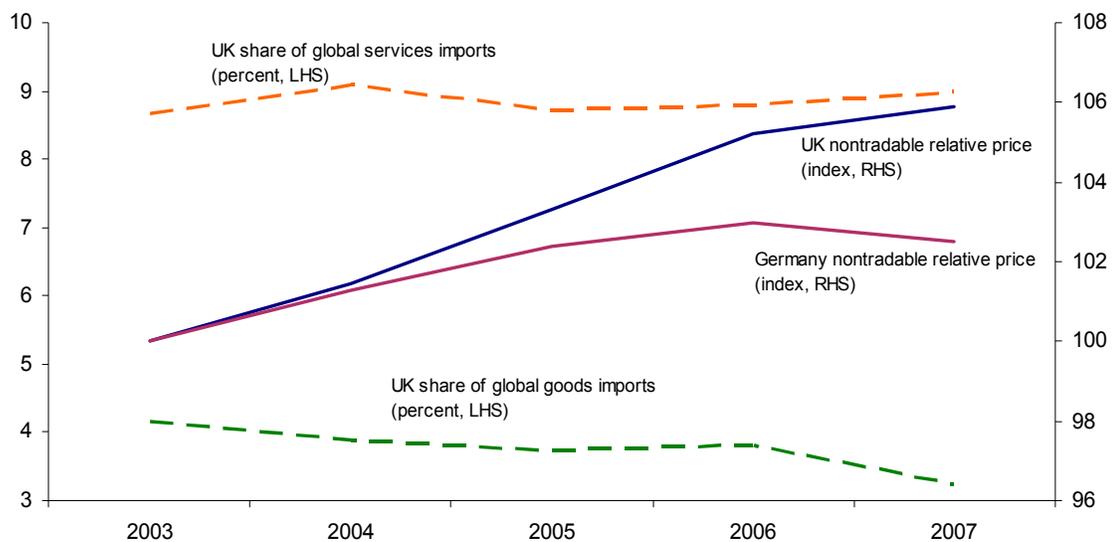
The external deterioration largely reflected the change in domestic savings behavior. More than half of the rise in external deficits since 2003 has been attributed to the decline in the household savings ratio, which occurred even though households' net financial wealth remained stagnant. A decrease in precautionary saving motive following a prolonged period of economic stability was likely an important factor, but the decline in savings might have been driven more by the rapid rise in house values.

*...as households saved less amid the housing cycle upturn.*



The U.K.'s competitiveness has weakened. Relative nontradable prices have risen, dampening export performance. The U.K. share of global goods imports has fallen while the services counterpart has remained flat. In what may be a worrying sign for the future trend, the U.K.—like some other advanced economies—has been losing trade business with such dynamic regions as Asia and oil exporters, which will likely continue to be increasingly driving global demand. Even after netting out intra-Asia trade, data show that developing Asia has reduced the share of its imports from the U.K. from 3.7 percent in 1997 to 2.2 percent in 2006, a reduction of 40 percent. Oil exporters have also lowered their share of spending on U.K. imports by a similar amount. Part of the deterioration has been driven by the strength of sterling. Notwithstanding the substantial depreciation in recent months, as of May 2008 the U.K.'s REER is still 5–10 percent above its equilibrium level, according to a variety of methodologies.<sup>11</sup>

*The U.K. has consequently lost competitiveness...*



<sup>11</sup> See “Exchange Rate Assessments: CGER Methodologies,” *IMF Occasional Paper* 261, 2008, for details.

*...and trade business with dynamic regions.*

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	Percentage change b/w 2006 and 1997
<i>Developing Asia's imports from (percent of developing Asia's total imports)--excluding trade among developing Asia</i>											
<b>UK</b>	3.7	3.7	3.5	3.2	3.2	2.9	2.5	2.4	2.3	2.2	<b>-41</b>
US	22.3	23.2	22.3	20.7	20.1	19.0	17.2	16.2	15.1	14.8	<b>-34</b>
Germany	6.2	6.5	5.8	5.4	6.2	6.6	7.1	6.7	6.2	6.4	<b>3</b>
EU	22.8	23.5	21.3	19.4	21.5	21.0	20.8	19.9	18.8	19.2	<b>-16</b>
Non-Asia Developing Co.	16.6	15.0	17.4	18.9	19.7	19.0	20.5	22.1	24.6	26.4	<b>59</b>
<i>Oil exporters' imports from (as a percentage of oil exporters' total imports)</i>											
<b>UK</b>	6.1	5.9	5.5	4.9	5.0	4.9	4.6	4.3	5.0	3.5	<b>-43</b>
US	15.0	14.9	12.9	12.8	11.8	10.3	9.2	8.4	9.7	9.5	<b>-37</b>
Germany	6.9	7.5	6.9	6.4	7.0	7.9	7.5	7.0	6.7	6.0	<b>-12</b>
EU	31.6	33.5	32.6	30.5	31.2	32.4	32.8	32.4	31.3	27.2	<b>-14</b>
Developing Co.	34.5	34.8	39.7	40.1	40.8	41.5	43.2	46.8	48.3	52.9	<b>53</b>

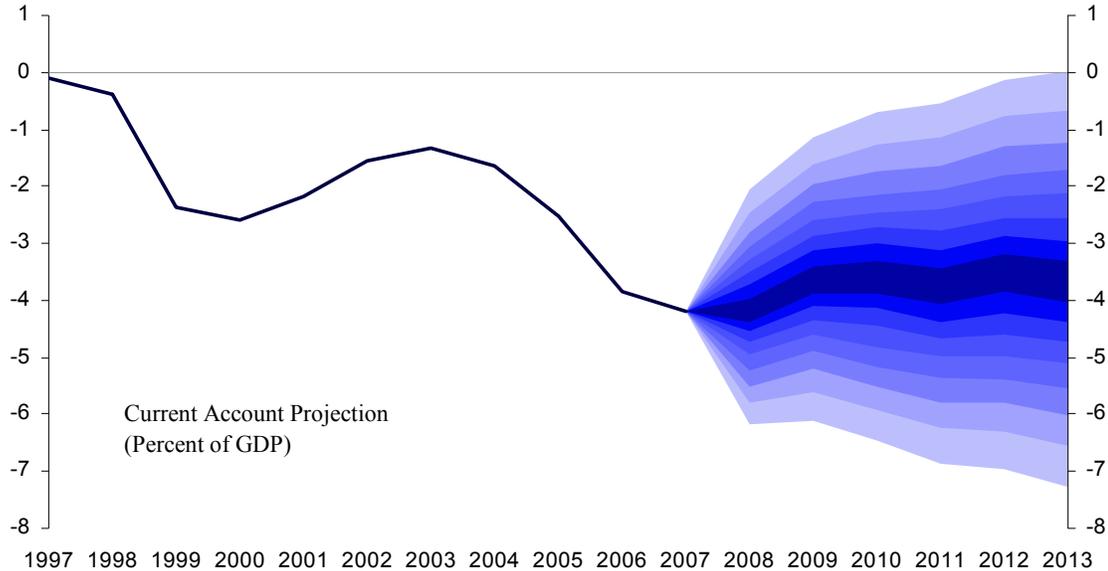
## **Outlook**

To facilitate risk assessment, staff projections of the U.K.'s current account and net IIP are portrayed in fan charts. This approach allows a comprehensive presentation of the degree of uncertainty behind the central projections and of the balance of risks around them. The econometric methodology used in creating the fan charts exploits both low-frequency cross-country and higher-frequency U.K.-specific time-series data. First, we estimate in panel regressions the behaviors of the current account and valuation change of the IIP as a function of global growth, the economy's own growth, nominal and real exchange rates, lagged IIP, and individual country fixed effects.<sup>12</sup> Second, we estimate with a vector autoregressive (VAR) model the statistical interdependence among the variables key to the U.K.'s external sector and, accordingly, simulate constellations of shocks, which are then fed into the panel estimations to generate our projections.<sup>13</sup>

The current account deficit is projected to stabilize at 3–4 percent of GDP. In the central projection, the deficit remains at around 4 percent of GDP in 2008, as the expected pickup in net trade is offset by unfavorable terms-of-trade movement. Thereafter, the current account is projected to improve slightly before flattening. Risks around the baseline are roughly balanced. According to the projection, there is a high probability—about 70 percent—that by 2013 the external deficit would remain above the level assessed to be the equilibrium for the U.K. (about 2 percent of GDP) using CGER methodology.

<sup>12</sup> Statistical tests suggest that the probabilistic distributions of the U.K.-specific error terms in the panel regressions are similar to those for the other countries—an indication that the regressions are not mis-specified.

<sup>13</sup> To more completely preserve the statistical properties suggested by the time-series data, the probabilistic distributions of the simulated data are captured in non-parametric manner (by using kernel density estimation). Alternatively depicting the risks with two-piece normal distributions yields similar results.

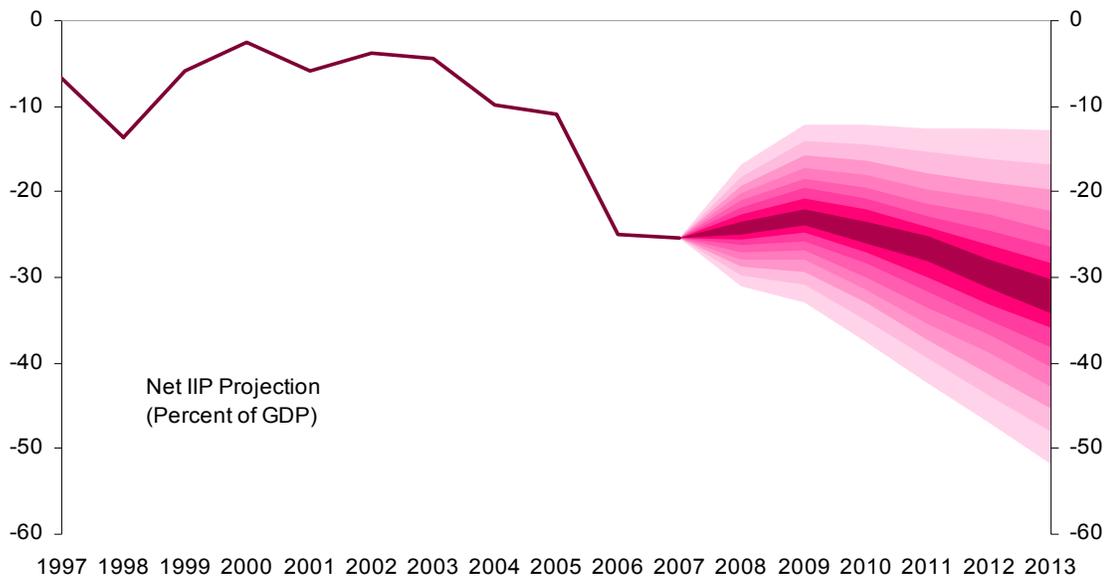
*With the current account projected to remain in significant deficit...*

Note: The darkest area represents the 10 percent confidence interval around the central projection. The band expands out in 10 percent increments, with the lightest area representing the 80 percent confidence interval.

The net IIP is projected to be on a downward trajectory in the medium term. The U.K.'s external position is forecast to strengthen modestly in 2008–09, largely reflecting favorable valuation changes as sterling weakens.<sup>14</sup> Beyond 2009, however, the net IIP is projected to shift to a deteriorating trend, as the effect of valuation change dissipates and the current account remains in deficit. With upside risks approximately balanced against downside risks, the projection suggests that the U.K.'s net IIP is likely to worsen modestly in the medium term.

<sup>14</sup> The effect of sterling depreciation on the net IIP is attenuated by the fact that a large portion of the U.K.'s liabilities are denominated in foreign currency. Whitaker (2006) estimates that about 60 percent of the U.K.'s liabilities and 95 percent of its assets are foreign currency denominated. To illustrate, suppose for simplicity that half of the foreign currency denominated assets and liabilities are linked to the euro, and the other half to the U.S. dollar. Given that the U.K.'s assets and liabilities each amount to around 450 percent of GDP, the sterling depreciation in the first half of 2008 (by about 7 percent against the euro, and 1 percent against the U.S. dollar) would then imply a positive valuation change of roughly 6 percent of GDP.

*...the net IIP will likely keep trending downward.*



Note: The darkest area represents the 10 percent confidence interval around the central projection. The band expands out in 10 percent increments, with the lightest area representing the 80 percent confidence interval.

A main source of uncertainty behind the projections is the strength of sterling going forward. The recent sterling depreciation could only be partly explained by the movement in interest rate differentials. As the Bank of England's May *Inflation Report* points out, the other driving forces likely include an increase in the risk premium associated with sterling assets and a reassessment by market participants of sterling's sustainable value; but the relative importance of these factors and, thus, the persistence of the downward pressure on the currency is not entirely clear. Looking ahead, the extent to which there are sustained shifts in U.K. residents' savings tendencies and in the relative attractiveness of U.K. assets would be among the key determinants of sterling's medium-term strength.

### **Assessment**

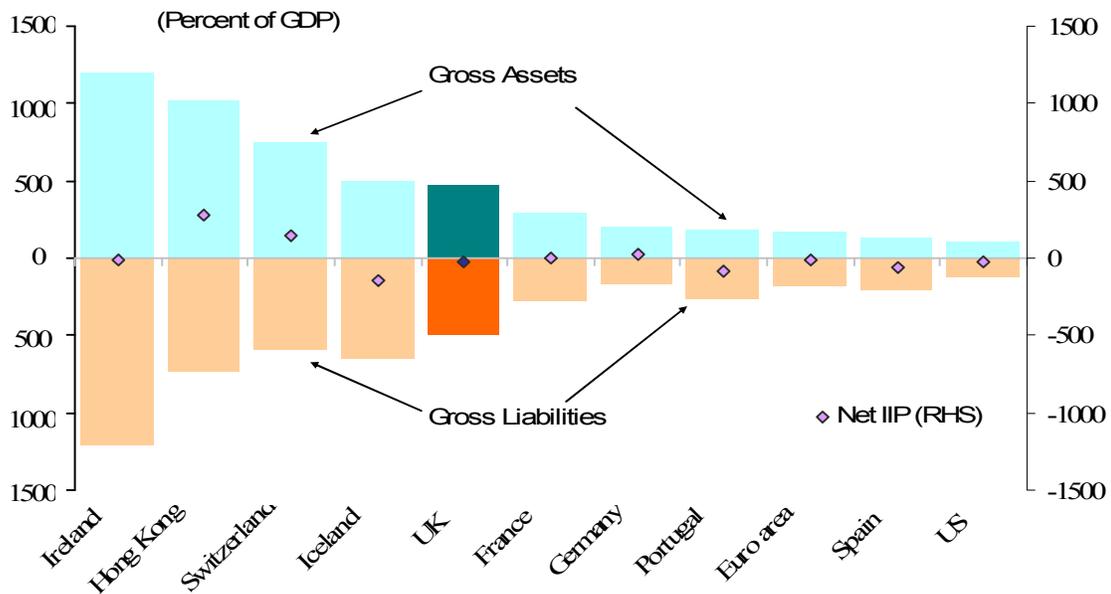
At present, the U.K. faces little threat to external stability. Its net external liabilities—though already modest—might have been overstated in the official data. As previous analyses (e.g., Nickell, 2006; and Whitaker, 2006) point out,<sup>15</sup> official statistics—with FDI generally measured at book rather than market value—might have considerably underestimated the

<sup>15</sup> Nickell, Stephen, 2006, "The U.K. Current Account and All That," *Bank of England Quarterly Bulletin 2006Q2*, pp. 231-9; Whitaker, Simon, 2006, "The U.K. International Investment Position," *Bank of England Quarterly Bulletin 2006Q3*, pp. 290-6.

U.K.'s FDI assets and the related valuation changes, and hence, the overall net external position. Moreover, the U.K. possesses a robust economic infrastructure—e.g., free access to international capital markets, a high degree of data and policy transparency, and a flexible exchange rate regime—that supports efficient pricing of sterling assets and further diminishes risks of a destabilizing external correction.

Nevertheless, the projected weakening of the U.K.'s external position raises concerns about medium-term vulnerability. Although it does not pose major risks, the recent substantial sterling depreciation underscores the fact that shocks can trigger a considerable repricing of the currency. Sustained buildups in net liabilities—as projected—would amplify risks of deep and abrupt exchange rate revaluations, thus leaving the economy increasingly susceptible to shocks. This vulnerability is further compounded by risks to the U.K.'s external position from asymmetric valuation changes; these changes can be highly significant, given the large and growing gross size of the U.K.'s external assets and liabilities (now over four times GDP).

***The outside gross position implies risks to net IIP from valuation changes.***



Note: Data refer to 2007 for the U.K., Switzerland, Iceland and the euro area, and to 2006 for the others.

In this light, a continued commitment to structural fiscal consolidation is important. There is a case for the government to take measures to offset distortions that may result in undersaving by the private sector. In particular, strengthening public-sector savings would bring an important marginal contribution to the U.K.'s savings dynamics. Further, by reducing the burden on monetary policy, tighter fiscal policy would facilitate rebalancing activity toward external demand.

**ANNEX II—NORTHERN ROCK: ANATOMY OF A BANK FAILURE<sup>16</sup>**

*Arising from the global financial turbulence last summer, Northern Rock—a medium-sized U.K. mortgage lender heavily reliant on wholesale funding—was forced to seek lender-of-last-resort assistance from the Bank of England. A subsequent retail run was only stopped with government guarantee arrangements for deposits. A private sector solution on acceptable terms was not identified, so the bank was taken into temporary public ownership. The lessons learned from these events underscored the need for financial sector reform. This annex provides a brief account of the timeline of events surrounding the failure of Northern Rock and the authorities' self-assessment of the lessons.*

***Prelude to a Crisis***

Northern Rock was a former building society that, having demutualized in 1997, began to expand rapidly. By the end of 2006, its assets had grown sixfold to £101 billion. This expansion was aided by the increasing reliance on wholesale funding, comprising about three-quarters of total funding, with over 40 percent alone in residential mortgage-backed securities. Only a quarter of funding came from deposits, down from nearly two-thirds in 1997. By 2006, Northern Rock had captured 7 percent of the U.K. mortgage market.

Its expansion continued through the first half of 2007, when its assets increased by almost £11 billion, and it accounted for almost 10 percent of gross mortgage lending in the U.K. On June 29, the FSA granted Northern Rock a Basel II waiver, allowing it to provide more of its own estimates of risk components. As a result, the risk weighting for residential mortgages fell from 50 percent to around 15 percent, boosting capital ratios. The company also reviewed its dividend policy and proposed an increase in its interim dividend of 30 percent to shareholders.

***Bank Run and Policy Response***

Beginning in August 2007, concerns about exposure to U.S. subprime mortgage assets led wholesale markets to seize up. Northern Rock came under pressure, as it was able to find only limited liquidity in wholesale markets. During August and early September, the tripartite authorities discussed a number of options to deal with Northern Rock's liquidity problems, including sale of assets, takeover by other financial institutions, and a lender-of-last-resort support facility from the Bank of England.

Northern Rock ultimately sought liquidity support from the Bank of England. The intention of the company was to make a trading statement on September 17, in which it would refer to

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<sup>16</sup> Prepared by Anthony Annett (EUR).

the facility, but rumors and media reports on September 13 prompted the company to bring forward the announcement to September 14. Any lending under the facility would be against appropriate collateral (principally RMBSs and mortgage assets) and at an interest rate premium, on the premise that Northern Rock's problems related only to liquidity. The FSA judged that Northern Rock was solvent and exceeded its minimum capital requirement, and had a good quality loan book.

A retail run, the first significant run since 1878, began after the announcement of the facility. Northern Rock faced heavy withdrawals, and its share price halved. Although most withdrawals were made through the internet, phone, or mail, lines forming outside some branches were the most visible sign of the run. The run was aggravated by two key weaknesses in the bank resolution framework. First, the industry-funded compensation scheme for eligible depositors guaranteed the first £2,000 of deposits in full, and 90 percent of the next £33,000. If it had been necessary to call on this scheme, reimbursement would have been a lengthy process, possibly taking up to six months. Second, putting Northern Rock into administration risked causing deposits to be frozen, with a lengthy process before payout. The run was stopped only when the Chancellor, on September 17, announced arrangements to guarantee all existing deposits in Northern Rock, "during the current instability in the financial markets." The guarantee arrangements were intended to supplement, not replace, the general deposit insurance scheme.

Over the next few months, the authorities undertook further actions. On October 1, the FSA extended deposit protection for all banks to the entirety of the first £35,000 of loss, eliminating co-insurance. On October 9, the guarantee arrangements for Northern Rock were extended to encompass new retail deposits in return for a fee. Also on this date, the Bank of England announced an additional facility for Northern Rock. Given its differences from the Bank facilities of September 14, the Treasury indemnified the Bank of England for this facility. The facility was uncommitted but with no specific borrowing limit. It would incur a premium rate of interest, with the premium element rolled up and subordinated.

On December 5, the European Commission declared that while the original lender-of-last resort facility did not constitute state aid, all the additional facilities and the deposit guarantee arrangements did, but approved it as rescue aid under the rescue and restructuring guidelines. To preserve Northern Rock's credit ratings in respect of certain wholesale obligations, the Treasury, on December 18, extended the guarantee arrangements to a wider range of wholesale products, including all unsubordinated and uncollateralized wholesale borrowings as well as payment obligations under any uncollateralized derivative transactions. Northern Rock paid a fee for this further guarantee. The guarantee arrangements now applied to most of the liabilities on its balance sheet. By December 31, 2007, Northern Rock had borrowed £26.9 billion. The earlier decision to pay a dividend was rescinded on September 25.

On November 16, the chief executive resigned. In the loan documentation, Northern Rock gave the Bank of England representations and undertakings consistent with the Bank of England being Northern Rock's largest lender, including agreement that Northern Rock would refrain from paying any dividends without the prior written consent of the Bank of England. A stabilization plan was agreed with the tripartite authorities.

### ***Seeking a Buyer***

During this period, Northern Rock searched for a private buyer. The Treasury made clear that potential buyers should not assume that the Bank of England facilities would be available after a sale or their expiry in February 2008. On November 19, the Chancellor declared that the government's approach would continue to be governed by three core goals: guarding the interest of taxpayers, protecting depositors, and maintaining financial stability.

On November 26, Northern Rock decided to take forward discussions "on an accelerated basis" with a consortium led by the Virgin Group, although it also agreed to undertake discussions with Olivant on December 13. On December 21, Northern Rock agreed to hold an emergency shareholders' meeting in the following month, reflecting calls from two of the largest shareholders to restrict the authority of the Board in terms of selling assets or issuing new equity above certain limits without specific consent from shareholders. But when the meeting took place on January 15, shareholders rejected those proposals.

On January 21, the Treasury on behalf of the tripartite authorities announced a new financing structure that could be made available to Northern Rock and other interested parties, for a possible private-sector solution for the entire company. In essence, Northern Rock would issue new bonds, backed by mortgage assets, and use the proceeds to repay its debt to the Bank of England. The government would guarantee these bonds, in return for a fee. The new owners would provide Northern Rock with new equity and would manage the company. The loan facility would be extended until March 17, by which time a restructuring plan would have to be submitted to the European Commission under EU state aid rules. The Chancellor made clear that if no private sector proposal was forthcoming on terms that were consistent with the authorities' stated objectives, the government would bring forward legislation to take Northern Rock into temporary public ownership. Bidders were given a deadline of February 4. The share price rose by 46 percent on the day of the announcement. Two offers were submitted, one from Virgin and one from Northern Rock's own board.

### ***Temporary Public Ownership***

Both offers were rejected by the government as they were considered not to meet the authorities' objectives, in particular that of protecting the taxpayer. On February 17, 2008, the Chancellor announced that Northern Rock would be taken into temporary public ownership, to be run at arms length from the government, and on a commercial basis with

due regard to fair competition. Compensation for former shareholders would be determined by an independent valuer.

Even before the temporary nationalization, the Office of National Statistics ruled that Northern Rock should be treated as part of the public sector, adding about £100 billion to public sector net debt (measured as liabilities minus short-term assets), raising debt above the 40 percent of GDP ceiling under the government's sustainable investment rule. On the grounds that they are temporarily in the public sector and backed by financial assets, however, the government announced that Northern Rock liabilities would be excluded from the definition of debt used to report performance against the sustainable investment rule. In the 2008 budget, the government decided to transfer Northern Rock's loan facilities from the Bank of England to the Treasury. On June 18, the government announced that this transfer would take place over the summer of 2008, and would be accomplished by issuing £19.3 billion of government bonds in fiscal year 2008/09.

While it remains in public ownership, Northern Rock's key objectives are to repay its loan from the authorities, release the Treasury guarantee arrangements, and facilitate a smooth return to private ownership. The plan is to fully clear the loans by the end of 2010 and have the guarantee lifted by the end of 2011. To facilitate this, Northern Rock intends to reduce its balance sheet from £107 billion to about £50 billion by the end of 2011, primarily by encouraging customers to transfer mortgages to other lenders when they come off fixed or discounted rate loans and withdrawing from non-core lending facilities. In June 2008, Northern Rock agreed with Lloyds TSB that some Northern Rock customers would be offered the option of applying for a mortgage from Lloyds TSB when their current fixed-rate deal matured.

Northern Rock also intends to increase the proportion of retail deposits to about 50 percent of funding by 2012 (compared to 15–20 percent in 2008). And although it plans to conduct some new mortgage lending (about £5 billion a year), this will be offered predominantly to high-credit quality customers. Other aspects of the strategy include closing non-core business lines, reducing operating costs by about 20 percent by reducing staff by around a third over three years, and strengthening risk management. Safeguards will also be in place to avoid competitive distortions while receiving state aid, including not sustaining market leadership in any product category, maintaining market share below historic levels and submitting to regular monitoring.

Meanwhile, the European Commission continues to investigate the compatibility of the restructuring with the state aid rules, and a number of Northern Rock former shareholders have commenced judicial review proceedings regarding the basis on which compensation is to be assessed.

### ***Looking Back: Authorities' Self-Assessment***

Reviews by the parliamentary Treasury Select Committee and the FSA concluded that the directors of Northern Rock were the principal authors of the difficulties faced by the company since August 2007, but also pointed to regulatory failure.<sup>17</sup>

In its internal audit, the FSA signaled a number of failures in the supervision of Northern Rock in the two years or so preceding the crisis. First, it was classified among the 11 percent of the most significant high-impact firms—supervised either by the FSA's Major Retail Groups Division (MRGD) or the Wholesale Investment Bank Department—with supervisory periods spanning 36 months, lengthened at the previous formal risk assessment (“ARROW panel”) in February 2006. Despite being regarded as a high-impact bank, another assessment was not due until 2009. Second, it was the only entity within this same set of most significant high-impact firms not to have a risk mitigation program in place. Third, supervision after the ARROW panel was inadequate, with only one “Close and Continuous” supervision set of meetings in its aftermath (in April 2007). This was far below average. Fourth, Northern Rock was originally supervised in a group that dealt primarily with insurance companies, and moved through three heads of departments between the start of 2005 and the run in 2007 (one of only two high-impact firms in MRGD in this position). The Treasury Select Committee also blamed lax regulation and noted that the rapid expansion should have raised alarm bells, as should have the continuous decline in the share price since February 2007—especially sharp after a profits warning in June 2007.

The Treasury Select Committee raised some broader issues relating to the tripartite framework. Its report endorsed the system in principle, but pointed to some issues that contributed to the run on Northern Rock, including inadequate information exchange between the different authorities, an unclear leadership structure, and the lack of an effective communication strategy during this crisis. It also criticized the tripartite authorities for not following through with sufficient vigor on the results of war games conducted in 2005 that identified key weaknesses in the legislative frameworks for failing banks, even though they had agreed in 2006 that urgent action was needed. The parliamentary committee also argued that the regime for liquidity regulation was flawed.

The tripartite authorities initiated a consultation process on January 30 setting out the authorities' proposed actions to strengthen the financial system. This process continues.

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<sup>17</sup> In addition to the official post-mortems, others have examined the case of Northern Rock: see, for example, Willem Buiters, 2008, “Lessons from the North Atlantic Financial Crisis,” mimeo, London School of Economics.

**ANNEX III—CREDIT MARKETS: CURRENT CONDITIONS, CREDIT CHANNELS, AND  
OUTLOOK<sup>18</sup>**

*Credit conditions for U.K. households and firms have tightened since late 2007, amid turmoil in global money markets. This annex describes current conditions in the market for credit and assesses the risk of a capital credit crunch and its potential real sector implications based on historical experience and estimates of bank losses. Overall, the analysis indicates that U.K. credit markets are likely to undergo a period of modest contraction, particularly in the market for mortgage loans, while banks rebuild capital positions. Underlying this forecast is a view that risks of a credit squeeze have become less threatening following various actions, including the introduction of the Special Liquidity Scheme and capital raising initiatives by some banks, but that conditions nevertheless remain tight as previous strains persist.*

Credit conditions have tightened since late 2007, particularly for residential mortgages. Survey results from the Bank of England's Credit Conditions Survey indicate that the supply of credit has decreased sharply since mid-2007 (Figure 1)<sup>19</sup>. This deterioration in credit supply has been accompanied by tighter credit standards and increased spreads. Demand for credit, on the other hand, has held up relatively well, particularly for secured credit to households.

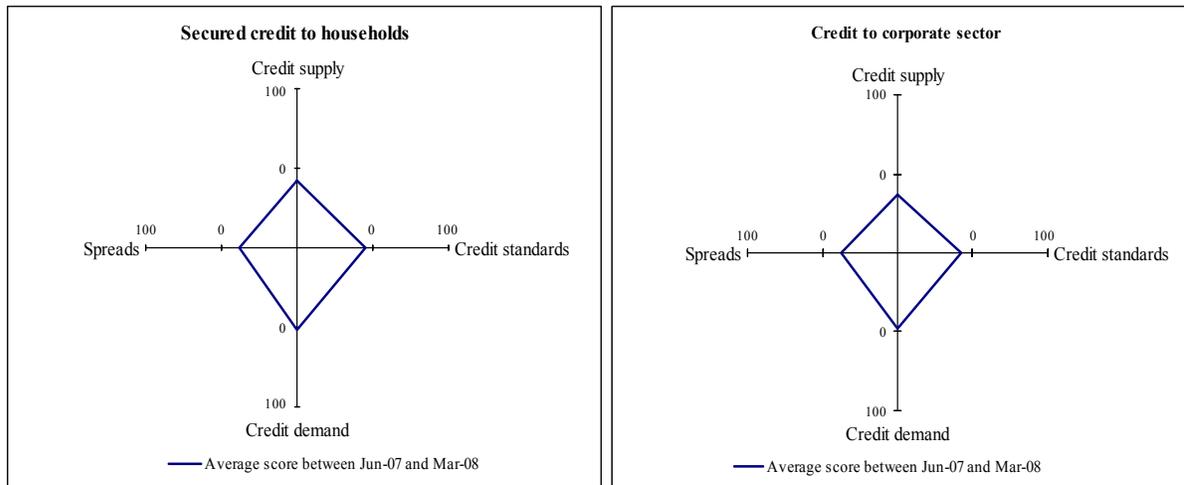
Thus far, the deterioration of credit conditions has not led to a sharp contraction in overall lending, though credit growth has slowed. The 12-month growth rate in net lending to individuals has slowed to 8 percent in May 2008, down from 10 percent in October 2007. Growth rates have fallen in particular for lending secured on dwellings. The number of mortgages approved for house purchases fell to 58,000 in April 2008, nearly half the number a year earlier.

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<sup>18</sup> Prepared by Luc Laeven (RES).

<sup>19</sup> The figures report net percentage balances for households and corporate separately. Household figures refer to secured credit. Corporate figures refer to credit to medium and large public non-financial companies. For households, "credit standards" is computed as the average of responses to (a) How have overall secured lending spreads changed? (b) How have fees on secured lending changed? (c) How have maximum loan to value ratios changed? and (d) How have maximum loan to income ratios changed? For corporates, "credit standards" is computed as the average of responses to (a) How have spreads on loans changed? (b) How have fees/commissions on loans changed? (c) How have collateral requirements for loans changed? (d) How have maximum credit lines changed? and (e) How have loan covenants changed?

Figure 1. Tightening of Credit Conditions 1/



1/ Average scores across all quarterly surveys between June 2007 and March 2008. Positive (negative) scores denote improvement (deterioration) in credit conditions; scores range from -100 to +100. Source: Bank of England Credit Conditions Survey.

The deterioration of credit conditions has been accompanied by tighter interbank market conditions. The interbank market has been under pressure, with spreads of 3-month interbank rates over 3-month expected policy rates increasing to almost 100 basis points in March 2008, after having come down from a previous high in November 2007. Interbank spreads remain high in part as a result of continued fear of counterparty risk due to banks' exposures to distressed mortgage-backed securities, though spreads for sterling interbank rates have largely converged to those for dollars and euros following the introduction of the Special Liquidity Scheme. The increasing interbank spreads raise the cost of funding for banks, many of which are highly dependent on wholesale markets for their funding. Ultimately, this cost is likely to be passed on to the banks' borrowers.

Credit conditions are expected to remain tight as turmoil in the global market for mortgage backed securities has reduced banks' capital positions. Subprime related writedowns by the five largest U.K. banks are expected to total about £10.5 billion (Table 2) given further deterioration in market prices of mortgage-backed securities during the first quarter of 2008. Although total expected writedowns are a substantial fraction of equity capital for some banks, banks are relatively well capitalized such that banks are able to absorb these losses without the risk of significant capital impairment. The (Basel I) capital ratio of the five largest banks would fall from 12.1 percent at end-2007 to 11.8 percent as a result of these writedowns.

Table 2. Subprime writedowns and their impact on capital of large banks

Five largest banks	Reported writedowns as of end-2007 (in £bn)	Expected writedowns in 1Q08 (in £bn) 1/	Total expected writedowns (in £bn) 1/	Total expected writedowns (% of shareholder equity)	Total capital ratio at year-end 2007 (%) 2/	Total capital ratio after total expected writedowns (%) 2/	Tier 1 capital ratio after total expected writedowns 2/
Total 3/	4.36	6.11	10.47	5.7	12.1	11.8	7.7

1/ Staff calculations based on current market prices of ABX indexes, market portfolio of issued MBSs, and writedowns reported by banks. Losses on CDOs and MBSs are assumed to be the same. Assumes that banks' holdings of CDOs and MBSs in each credit rating class are in proportion to overall market of RMBS issuances in past 3 years. Market prices on ABX contracts as of March 12, 2008 are applied to holdings of CDOs and MBSs to infer expected losses on CDOs and MBSs. Total expected loss rates on CDOs and MBSs are assumed to be 34.0 percent for CDOs and MBSs (in line with the estimate in the Bank of England's April 2008 Financial Stability Report), while expected losses on U.S. subprime mortgages is assumed to equal 17 percent, based on current delinquency rates of U.S. subprime mortgages.

2/ Capital ratios computed according to Basel I guidelines, assuming losses are absorbed by capital and are not compensated by profits from other banking activities.

3/ The five largest banks are HSBC, Barclays, RBS, HBOS, and Lloyds TSB.

The negative shock to bank capital has increased the risk of a credit squeeze, though recent actions on the part of authorities and banks mitigate this risk. Given that banks are highly levered, the deterioration in banks' capital positions could have significant implications for the supply of credit, especially if banks choose to deleverage to preserve capital ratios rather than raise new capital. If banks deleverage to maintain capital ratios at levels prior to the fallout from the subprime crisis, the contraction in customer loans to U.K. residents is estimated to total up to 4 percent of total customer loans (Table 3). If the U.S. subprime crisis spreads to other assets classes (such as U.S. prime real estate, leveraged loans, or credit card debt) or if U.K. house prices continue to decline and mortgage delinquency rates increase sharply, the shock to banks' capital and private sector credit would be more severe. However, the risks of a credit squeeze have become less threatening following various actions, including the introduction of the SLS and capital raising initiatives by some banks. During the first six months of 2008, one of the five largest U.K. banks has raised a total of £12 billion through a successfully completed rights issue and two other large banks have announced capital issues of £4 billion and £4.5 billion, respectively. These efforts do not preclude that additional capital may be needed should the risk of further negative shocks to bank capital, such as those arising from a decline in U.K. house prices, materialize.

Table 3. Credit contraction assuming banks deleverage to maintain capital ratios

	Target	Subprime- related	Shrinkage of total	Shrinkage of total	Shrinkage	Share of	Shrinkage of	Shrinkage of
Five largest banks	leverage ratio (%) 1/	writedowns (£ bn) 2/	assets (%) of total assets) 3/	assets (£ bn) 3/	of loans (£ bn) 4/	U.K. residents (%) 5/	loans to U.K. residents (£ bn) 5/	loans to U.K. residents (%) of total) 5/
Total 6/	29.0	10.47	5.7	301.9	111.0	53.0	50.1	4.1

1/ Target leverage ratio is defined as total assets over shareholders' equity at year-end 2007.

2/ See Table 2.

3/ Calculation follows the approach in Greenlaw, D., J. Hatzius, A. Kashyap, and H. Shin (2008), "Leveraged Losses: Lessons from the Mortgage Market Meltdown", mimeo, University of Chicago and Princeton University. Assumes that subprime-related writedowns are absorbed by banks' capital and that banks target a leverage ratio equal to the level at year-end 2007.

4/ Assumes that banks reduce loans and assets by maintaining constant loan-to-asset ratios as of year-end 2007.

5/ Loans to U.K. residents exclude loans to U.K. public sector and financial institutions.

6/ Five largest banks include: HSBC, Barclays, RBS, HBOS, and Lloyds TSB.

Regression analysis using bank-level data shows a strong association between bank capital and credit growth, lending support to the notion that bank capital impairment could impact the supply of credit. Empirical analysis shows that credit growth is responsive to changes in bank capital positions (Box 1). A one standard deviation decrease in capital-to-asset ratios would result in a decline in credit growth to total assets of about 0.2 (a substantial effect compared to the standard deviation of this ratio of about 0.3). The effect is particularly pronounced during previous episodes of credit crunch, defined as years during which the ratio of private credit to GDP declines. During such episodes, a one standard deviation decrease in capital-to-asset ratios results in a decline in credit growth to total assets of about 0.4, or twice the effect during periods of no credit crunch. The effect is also stronger for small banks, and for banks dependent on wholesale funding. Overall, these regressions lend support to the notion that capital impairment could cause a contraction of credit, especially by banks that are small and dependent on wholesale funding.

### Box 1. Existence of credit channel in the U.K.

To estimate the relationship between bank capital and loan growth, the following regression specification is estimated:

$$\Delta L_{i,t}/A_{i,t-1} = \alpha_i + \alpha_t + \beta (K/A)_{i,t-1} + \varepsilon_{it}$$

where  $i$  denotes bank  $i$ ,  $t$  denotes year  $t$ ,  $\Delta L_{i,t}$  denotes the difference between total loans at the end of year  $t$  and total loans at the end of year  $t-1$  (in real terms),  $A_{i,t-1}$  denotes total assets at the beginning of the year,  $(K/A)_{i,t-1}$  denotes the beginning of year capital-to-asset ratio, and  $\varepsilon_{it}$  denotes the error term with the usual properties. This regression specification builds on work by Bernanke, N. and C. Lown (1991), "The Credit Crunch", *Brookings Papers on Economic Activity*, 205-239; and Peek, J. and E. Rosengren (1995), "The Capital Crunch: Neither a Borrower nor a Lender Be", *Journal of Money, Credit and Banking* 27, 625-638.

Table. Bank capital and loan growth

Dependent variable: $\Delta L_t/A_{t-1}$	(1)	(2)	(3)	(4)	(5)	(6)
	All banks	IV	Credit crunch	Small	Wholesale	Wholesale and small
$(K/A)_{t-1}$	1.038* (0.526)	0.955*** (0.313)	2.828 (2.361)	1.323* (0.707)	1.403 (0.929)	2.039* (1.141)
Observations	1071	887	157	796	564	350
Number of banks	174	174	100	144	112	81
R-squared	0.08	--	0.18	0.10	0.11	0.18

Notes: Dependent variable is  $\Delta L/(A)_{t-1}$ , with  $\Delta L$  the annual change in total loans and  $(A)_{t-1}$  total assets at the beginning of the year (both in real terms).  $(K/A)_{t-1}$  denotes the beginning of year capital-to-asset ratio. Bank-level data from Bankscope. Sample consists of bank holding companies, commercial banks, and savings banks with at least three years of data on loan growth. Sample period is 1989 to 2006. Regressions are estimated using OLS, except regression (2) which is estimated using instrumental variables with  $(K/A)_{t-2}$  as instrument for  $(K/A)_{t-1}$ . Regressions include bank and year fixed effects (not reported). Sample in regression (3) is limited to "credit crunch" years, corresponding to the years 1991 through 1994 and 1998, during which the ratio of private credit to GDP declined compared to the previous year. Regression (4) limits the sample to small banks, defined as banks with total assets below the 75<sup>th</sup> percentile of assets across banks. Regression (5) limits the sample to banks that depend on wholesale funding, defined as banks with a ratio of non-customer deposit funding to total funding above the median across banks. Regression (6) limits the sample to banks that are both small and dependent on wholesale funding. White's robust errors are reported in parentheses. \* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1%.

Regression analysis using firm-level data shows a close association between financial factors and inventory investment, particularly during episodes of credit crunch, suggesting that a capital impairment-inflicted credit squeeze is likely to have real effects. Empirical analysis shows that inventory investment (the most cyclical component of firm investment) depends strongly on financial factors, such as the ratio of liquid assets to total assets, suggesting that many firms are financially constrained (Box 2). The effect is more pronounced during

### Box 2. Real effects of credit crunch

To estimate the relationship between liquidity shocks and firm investment, the following regression specification is estimated:

$$\Delta \text{LOG}(\text{INV})_{i,t} = \alpha_i + \alpha_t + \beta_1 \text{LOG}(\text{INV}_{i,t}/\text{SALES}_{i,t-1}) + \beta_2 \text{LOG}(\text{SALES})_{i,t-1} + \beta_3 \text{LOG}(\text{SALES})_{i,t-2} + \beta_4 \text{LIQ}_{i,t-1} + \varepsilon_{it}$$

where  $i$  denotes firm  $i$ ,  $t$  denotes year  $t$ ,  $\Delta \text{LOG}(\text{INV})_{i,t}$  denotes the log difference between inventories at the end of year  $t$  and inventories at the end of year  $t-1$  (in real terms),  $\text{SALES}$  denotes total sales,  $\text{LIQ}$  denotes the ratio of cash and short-term investments to total assets, and  $\varepsilon_{it}$  denotes the error term with the usual properties. This regression specification builds on work by Kashyap, A., O. Lamont, and J. Stein (1994), "Credit Conditions and the Cyclical Behavior of Inventories", *Quarterly Journal of Economics* 109, 565-592.

Table. Real effect of liquidity shocks and credit crunches on firms' inventory investment

<i>Dependent variable: <math>\Delta \text{LOG}(\text{INV})</math></i>	(1)	(2)	(3)	(4)	(5)
	All firms	No credit crunch	Credit crunch	No credit crunch, IV	Credit crunch, IV
LOG(INV/SALES)	-0.486*** (0.061)	-0.583*** (0.066)	-0.463*** (0.091)	-0.590*** (0.029)	-0.466*** (0.050)
$\Delta \text{LOG}(\text{SALES})$	0.879*** (0.051)	0.936*** (0.055)	0.761*** (0.114)	0.940*** (0.032)	0.760*** (0.062)
$\Delta \text{LOG}(\text{SALES})_{t-1}$	-0.054** (0.027)	-0.057* (0.031)	-0.042 (0.058)	-0.062** (0.026)	-0.043 (0.031)
LIQ	0.401*** (0.100)	0.302*** (0.099)	0.754*** (0.181)	0.195 (0.228)	0.697** (0.326)
Observations	2177	1517	660	1517	660
R-squared	0.48	0.53	0.39	0.21	0.19
Number of firms	301	290	212	290	212

Notes: Dependent variable is  $\Delta \text{LOG}(\text{INV})$ , where  $\text{INV}$  denotes firm-level inventories.  $\text{SALES}$  denotes firm sales.  $\text{LIQ}$  denotes the ratio of cash and short-term investments to total assets at the beginning of the year. Regressions include a constant and year and firm-fixed effects (not reported). Regressions (1) to (3) are estimated using OLS and adjust standard errors for clustering at the firm level. Regressions (4) and (5) are estimated using instrumental variables, with the one-period lag of  $\text{LIQ}$  as instrument for  $\text{LIQ}$ . Regressions (3) and (5) limit the sample to "credit crunch" years, corresponding to the years 1991 through 1994 and 1998, during which the ratio of private credit to GDP declined compared to the previous year, while regressions (2) and (4) limit the sample to the remaining years with no "credit crunch". Sample period is 1988 to 2006. Data are from Compustat Global. Sample includes U.K. manufacturing firms only. White's robust errors reported in parentheses. \* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1%.

episodes of credit crunch (years during which the ratio of private credit to GDP declined), suggesting that credit crunches have real effects. For example, a one standard deviation decrease in liquidity reduces inventory investment by 8 percentage points during credit crunches compared to 4 percentage points during periods without credit crunch. Similar regression analysis using a larger sample that also includes nonlisted firms shows that the link between financial factors and inventory investment is particularly pronounced for small and young firms.

Overall, U.K. credit markets are likely to undergo a period of modest contraction, particularly in the market for mortgage loans, while banks rebuild capital positions. Underlying this forecast is a view that risks of a credit squeeze have become less threatening following various actions, including the introduction of the Special Liquidity Scheme and capital raising initiatives by some banks, but that conditions nevertheless remain tight as previous strains persist. The magnitude of credit contraction will depend on a number of factors, including the extent to which:

- Banks choose to deleverage their balance sheets to maintain strong capital ratios.
- Global U.K. banks choose to disproportionately reduce credit exposure in the U.K..
- Delinquencies in U.K. mortgage markets increase.
- Prices of mortgage-backed securities fall further or rebound in the near term.
- Bank that are highly dependent on wholesale funding can attract customer deposits.
- Banks can attract new capital to strengthen capital buffers.

#### ANNEX IV—PERFORMANCE UNDER THE FISCAL FRAMEWORK, 1997-2007<sup>20</sup>

*Although the U.K. fiscal framework is rules based, it deliberately provides for aspects of discretion. On the whole, the framework has served the U.K. well, partly reflecting appropriate use of scope for discretion. Nonetheless, the dwindling headroom under the two fiscal rules over the past few years following the build-up of large cushions during the early period reflects discretionary choices that now significantly limit the room for maneuver. This annex discusses these issues in more detail, and provides the background for the policy recommendations outlined in the main report.*

#### ***The framework***

The U.K. fiscal framework was inaugurated in 1997 and comprised:

- A *Code for Fiscal Stability*, laying out the basic principles of fiscal management, including transparency in objectives and implementation, stability, and fairness, including across generations. It also instructs the National Audit Office to audit key assumptions.
- Accordingly, the short- and medium-term objectives of fiscal policy are laid out in each budget document. Fundamentally, the aim is to allow unfettered operation of automatic stabilizers, consistent with sound public finances on a medium-term basis and intergenerational equity.
- To support these objectives, the government relies on two formal fiscal rules. First, a sustainable investment rule strives to keep net public debt below a “stable and prudent level” as a percent of GDP over the cycle. This was defined as 40 percent, and—from 2003 onwards—the government committed to respecting that limit in each and every year of that cycle. Second, a golden rule over the cycle is designed to ensure that the government only borrows for investment purposes. Compliance is measured by the average annual surplus on the current balance since the beginning of the cycle, as a percent of GDP. These rules are supported by three-year nominal expenditure ceilings on Departmental Expenditure Limits.<sup>21</sup>

<sup>20</sup> Prepared by Anthony Annett (EUR).

<sup>21</sup> Departmental Expenditure Limits are firm three-year limits for departments’ expenditure programs.

***Large cushions emerged during the early years***

Between 1997–2001, strong economic growth boosted revenue, while spending was held in check by strict spending limits. Higher-than-anticipated proceeds from auctioning 3G mobile phone licenses—amounting to nearly 2½ percent of GDP—provided further headroom against the sustainable investment rule. As a result, net debt fell to just over 30 percent of GDP by 2000/01, down more than 10 percentage points since the inauguration of the framework, while the average current account surplus between 1998/99 and 2000/01 was 2 percent of GDP. Both developments created substantial headroom for policy flexibility in subsequent years.

***Headroom for policy flexibility was fully used***

Discretionary spending increases and unanticipated revenue weakness led to a rapid fiscal turnaround after 2001, helping to smooth the path of the economy. A calculated increase in government spending coincided with a sharp and protracted decline in revenue, fallout from the bursting of the technology bubble at the turn of the decade.

Resulting from specific policy decisions, the current expenditure ratio increased for six consecutive years, rising by 3¾ percentage points of GDP by 2005/06. Annual average nominal spending growth peaked at 8 percent a year during 2002–05, up from 3 percent during the government’s first term. Increases in the current expenditure ratio consistently exceeded budget plans over this period, as the authorities opted to spend more on government priorities. Concomitantly, net investment rose from about ½ percent of GDP in 2000/01 to almost 2 percent five years later.

After higher-than-expected revenues when the economy was operating above trend, the revenue loss related to the turn-of-the-century stock market decline was consistently underestimated in terms of both depth and persistence. Revenue buoyancy proved especially difficult to gauge at this time, reflecting compositional tax-base effects from financial sector profitability and the uncertain impact of asset price boom-bust cycles on revenue. As a result, forecast errors were significant, although they became smaller over time. In 2002/03, for instance, revenue fell by almost 1½ percentage points of GDP, while the budget and pre-budget reports projected a decline one third as large. Similarly, the subsequent rebound in the following year was a ¼ percent of GDP, much less than the anticipated 1 percent. Only in 2005/06 did revenue rebound significantly.

Fiscal outturns deteriorated accordingly. Between 2000/01–2004/05, the actual and cyclically-adjusted balances worsened by 5 percentage points of GDP, with the bulk of the deterioration (4 percentage points) concentrated in the first two years. The overall budget deficit peaked at 3.3 percent of GDP in 2004/05, due largely to changes in the current budget. Each successive budget and pre-budget report over this period projected a relatively rapid

return to current surplus, but the forecasts were not borne out. Approaching the limits under the fiscal framework, the average current balance dipped toward zero as the cycle that had begun when the framework was inaugurated approached its end in 2006/07. Alongside, debt climbed above 36 percent of GDP in 2006/07, exceeding the Budget 2002 forecast by 5½ percentage points of GDP.

The authorities reacted to eroding margins on a number of fronts. First, they curbed the growth of expenditure, especially in the 2004 spending review that set limits for the following three years; nominal spending growth fell below 5 percent in 2006/07. Second, an earlier tendency toward tax cuts was reversed, with Budget 2002 in particular heralding a revenue-raising strategy by increasing social security contributions (amounting to about ¾ percent of GDP). But further revenue measures proved modest.

### *Assessing performance*

The fiscal framework has served the U.K. well, and its objectives have largely been met. The sustainable investment rule appropriately anchors fiscal policy in medium-term considerations, reinforces the anti-inflationary credentials of the policy frameworks, supports sustainability, and creates fiscal space for dealing with longer-term spending pressures, such as those resulting from population aging. The golden rule was consistent with aims to shift the pattern of expenditure toward public investment and with intergenerational equity. And in contrast with earlier experience, fiscal policy proved countercyclical.

The framework was designed to allow discretion in a number of dimensions, and that discretion has been used. But in five such dimensions, the use of that discretion—and therefore the appropriateness of the framework which accommodated it—may be questioned. In this regard, expenditure growth and management of headroom against the rules raise particular concern:

- *Large swings in annual budget balances.* The framework includes a fair degree of latitude in this regard, contingent on available headroom. In general, use of this latitude was not excessive, with the possible exception of the period 2001-03, when spending rose in line with policy objectives.
- *Expenditure and revenue are unanchored as long as they move together.* As the framework is based on fiscal balance and debt aggregates, there is nothing preventing large increases in expenditure that are financed by revenue. And indeed, as a result of policy decisions, expenditure trended upwards. To further complicate matters, the projected revenue increase that should have financed this boost in spending did not materialize—at least not for a number of years.
- *The headroom against the rules is undefined.* The debt rule is set as a ceiling rather than a target. Within this framework, there is no guidance on the underlying

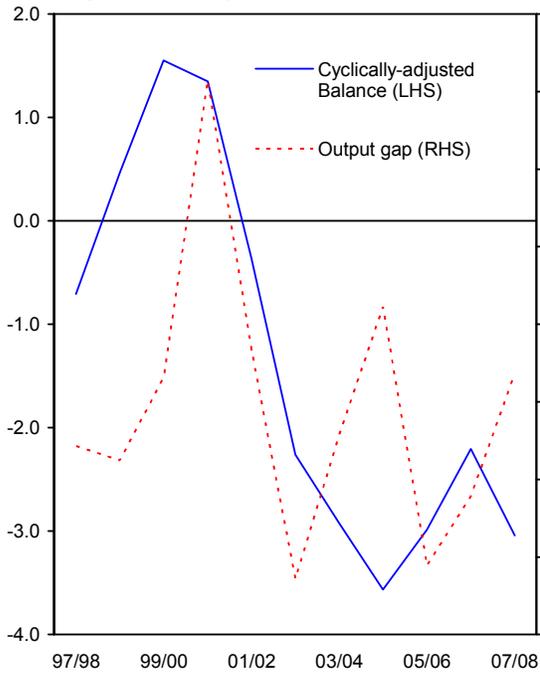
level of net debt needed to ensure that respecting the ceiling does not conflict with the unhindered operation of automatic stabilizers. And while the backward-looking nature of the golden rule fosters ex post accountability, it is not always fully congruent with the forward-looking character of fiscal framework, underpinned by clear policy objectives.

- *The treatment of debt stock adjustments is undefined.* To maximize transparency, a debt rule should spell out exactly what is captured and what is excluded, especially in the context of stock adjustments.<sup>22</sup> Further issues may arise in this context with the treatment of liabilities from the Private Finance Initiative.
- *Self-compliance and ability to change the rules in mid-game.* Any fiscal rules will face credibility problems if it is perceived that the authorities can “change the goalposts” instead of policy when tested. In practice, this has not been a significant problem, and the fiscal rules have been in place for over a decade. The addition of two prior years to the then-current economic cycle in 2005—following revisions made to the national accounts by the Office of National Statistics and approved by the National Audit Office—had the effect of “buying back” some cushion under the golden rule. Although this had little effect on compliance with the rules, even this limited adjustment has been sufficient for many to challenge the credibility of the broader framework.

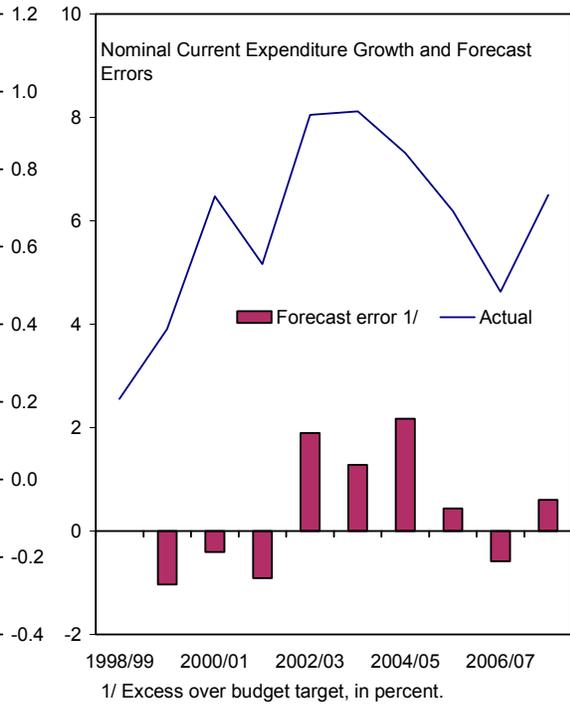
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<sup>22</sup> There was a good case for excluding Northern Rock liabilities from the definition of net debt under the sustainable investment rule (see Annex II), but the terms of such exclusions should be spelled out as much as possible in advance. The same holds true for the receipts from auctioning mobile phone licenses.

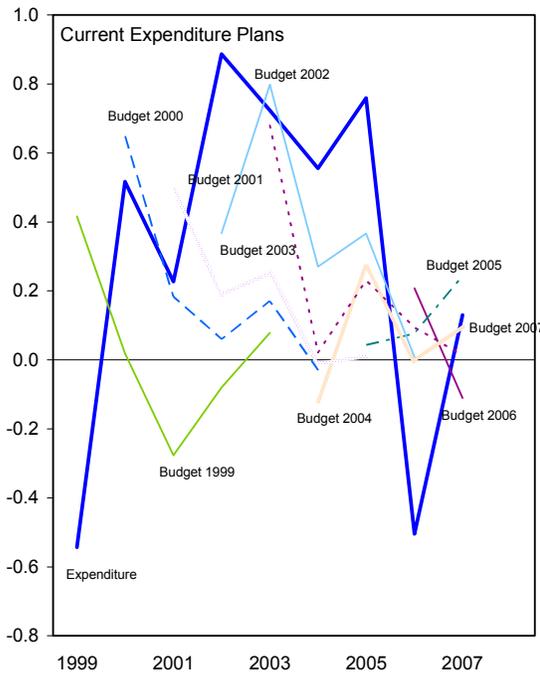
**Fiscal policy was not procyclical...**



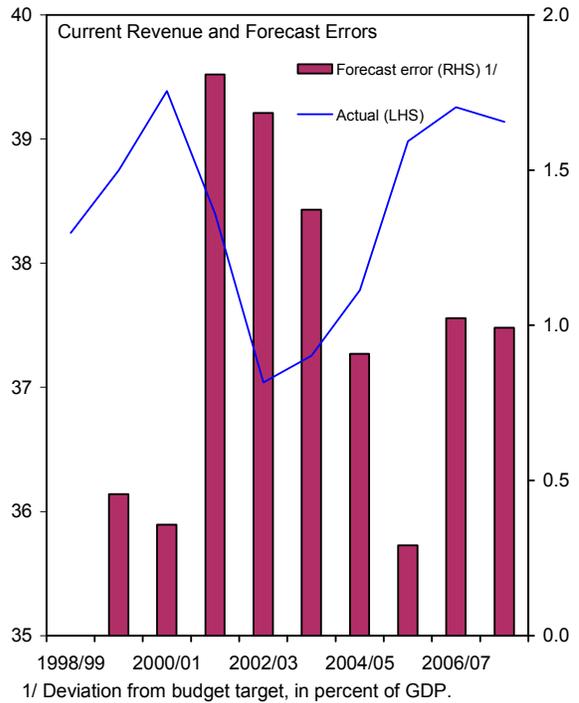
**...spending growth was robust...**



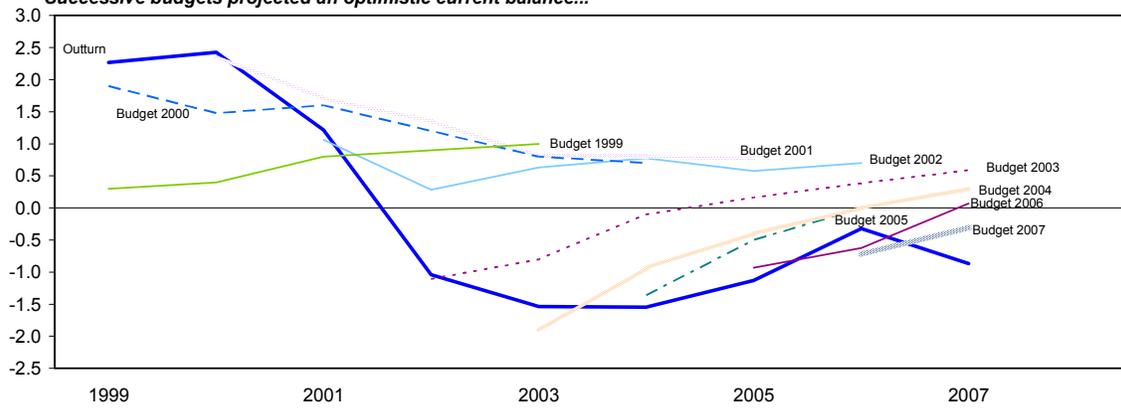
**...and consistently exceeded budget plans...**



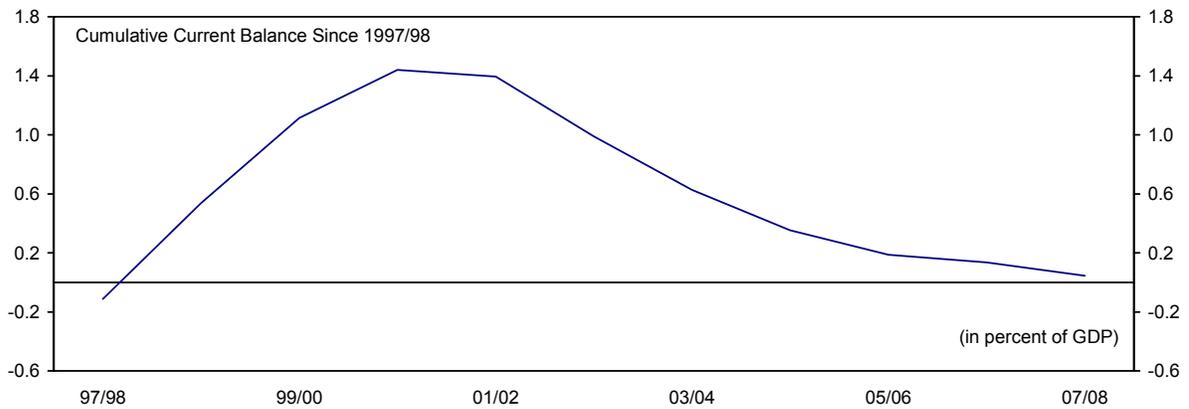
**...while revenue projections proved optimistic.**



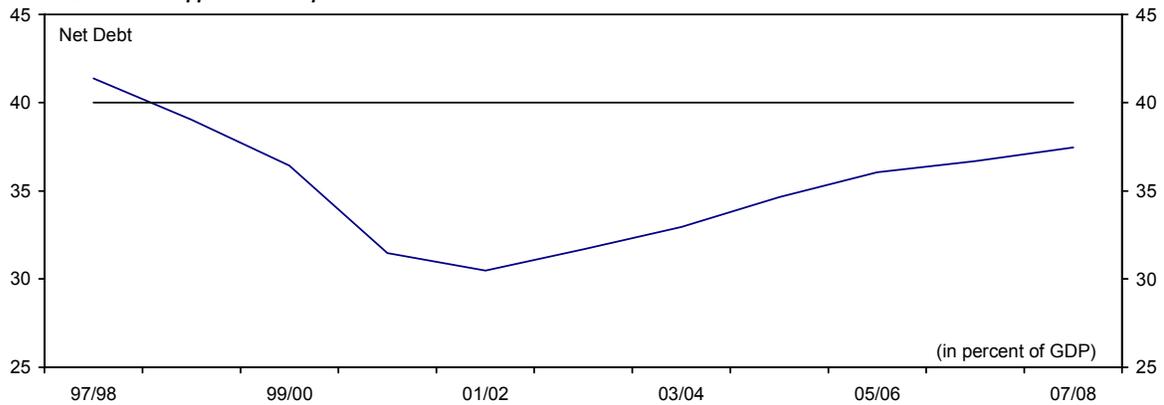
**Successive budgets projected an optimistic current balance...**



**...margins were eroded under the golden rule...**



**...and net debt approached 40 percent.**





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## **IMF Executive Board Concludes 2008 Article IV Consultation with the United Kingdom**

On July 30, 2008 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the United Kingdom.<sup>1</sup>

### **Background**

Economic growth was above trend in 2006 and 2007. In terms of expenditure, the expansion was largely driven by private consumption, on the heels of strong employment, steady real wage and living standards growth, and a surge in immigration. Compressed global credit market spreads, loosening credit conditions and a resulting expansion of household debt, alongside the decade-long housing boom provided additional fuel. Concurrently, investment was boosted by a low cost of capital and high corporate profitability. And notwithstanding favorable export market growth, the current account deficit reached 4¼ percent by 2007, a 3 percentage point worsening since 2003. The real effective exchange rate also appreciated by about 10 percent from 2006 through mid-2007.

With slack diminishing, inflation began to rise, prompting the initiation of a tightening cycle by the Bank of England. Still, rising commodity and services prices led CPI inflation to rise above 3 percent in March 2007, requiring the first explanatory open letter from the governor to the chancellor since the inauguration of the regime a decade earlier. During this period, the fiscal deficit remained high, with a structural tightening in 2005 reversed in 2006.

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

In the second half of 2007, the U.K. faced two new international shocks—the disruption to global financial markets and the sharp acceleration of the upward trend in world food and fuel prices. The combined effects of these shocks raised uncertainty, increased inflation risks on both sides, and compounded the ongoing correction in the domestic housing market. A run on Northern Rock, a medium-sized mortgage lender, raised the specter of financial stability weakness feeding through to the real sector.

Reflecting the disinflationary impact of expected output weakness, the monetary tightening cycle ended and the Bank of England lowered the bank rate by a cumulative 75 basis points (to 5 percent) in three steps from December 2007. The 2008 budget set a neutral fiscal stance, allowing full operation of automatic stabilizers. Since August 2007, the real effective exchange rate has depreciated by more than 10 percent, in line with monetary loosening, but also reflecting a reassessment of U.K. risk. And aided by lower outflows from foreign owned banks, the current account deficit fell toward the end of 2007.

So far in 2008, evidence points to a sharp slowing in activity alongside high inflation. Second quarter growth was weak, forward looking indicators are gloomy, sterling money market spreads remain elevated, unemployment has edged up, and house prices are falling rapidly. Accordingly, real GDP growth is projected to be 1.4 percent in 2008, falling to 1.1 percent in 2009. Inflation rose to 3.8 percent in June, on account of food and fuel price developments. And while there is scant evidence of second-round effects, as wages remain subdued, indicators of long-run inflation expectations have risen further.

### **Executive Board Assessment**

Executive Directors agreed with the thrust of the staff appraisal. They observed that, following a decade of sustained strong economic performance, including stable economic growth and low inflation, the UK economy is now facing several concomitant shocks. The strong policy frameworks and structural reforms that have underpinned this remarkable performance will be tested by lower growth, higher inflation from food and fuel price increases, ongoing strains in financial markets, rapid housing price reversals, and medium-term external imbalances. The financial sector strains have also triggered a broad-based effort to reform the financial stability framework.

In this difficult context, Directors noted that the authorities' inflation target of 2 percent will be exceeded for an extended period. In addition, the public net debt ceiling of 40 percent of GDP is likely to be breached. Rising long-term inflation expectations have added to the importance for fiscal and monetary policies to play their part in safeguarding the credibility of the nominal framework.

Directors welcomed the commitment made in the 2008 budget to tighten fiscal policy in the coming two years. Directors saw no room for slippages in the current fiscal year. A number of Directors recommended a stronger-than-planned fiscal stance for 2009 and beyond to support medium-term fiscal sustainability and help build headroom for full operation of automatic

stabilizers. A stronger fiscal stance would also help address external imbalances. Some Directors favored a somewhat more gradual adjustment as planned given short-term output concerns.

Directors generally considered that any revision to the fiscal framework should enhance its credibility. They recommended that the net public debt ceiling of 40 percent of GDP be retained. Should it be breached, they called for concrete and frontloaded plans to bring debt back below the ceiling. Some Directors argued that the elevation of the status of nominal expenditure ceilings within the current fiscal framework would enhance its credibility. Some Directors suggested that any revision of the fiscal rules should strengthen consistency with the Stability and Growth Pact.

Directors agreed that monetary policy has been appropriately focused on stemming second-round effects from the food and fuel terms of trade shocks. Given the outlook for inflation and the stance of fiscal policy, Directors saw little scope for monetary easing at present. Directors considered that the current inflation-targeting framework contains sufficient flexibility in the target horizon and definition to accommodate the ongoing terms of trade shocks.

Directors noted that sterling has moved towards its equilibrium value, but remains on the strong side. This could adversely affect export growth, and underscores the case for improving the mix of policies to rebalance demand toward the external sector. Some Directors also stressed the need to enhance productivity.

Directors welcomed the ongoing efforts to stabilize financial markets, including the introduction of the Special Liquidity Scheme. They noted that further capital-raising and information disclosure initiatives by financial institutions would boost confidence in the financial system. With regard to the financial stability framework, Directors praised the thoroughness of efforts to diagnose and resolve the problems illuminated by recent market tension. They welcomed the close tripartite cooperation among the Bank of England, the Financial Services Authority, and the Treasury, and the openness of the consultation process. This process has correctly highlighted the need for a special bank resolution regime, a statutory role of the Bank of England in the financial stability framework, and strengthened operations of the Financial Services Authority. In addition, Directors agreed that success of the special resolution regime will require full clarity and accountability within the tripartite structure.

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### United Kingdom: Selected Economic and Social Indicators

	2003	2004	2005	2006	2007	2008 Proj.
<b>Real Economy</b>						
Real GDP (change in percent)	2.8	3.3	1.8	2.9	3.1	1.4
Domestic demand (change in percent)	2.8	3.8	1.6	2.8	3.8	1.1
CPI	1.4	1.3	2.1	2.3	2.3	3.8
Unemployment rate (in percent) 1/	5.0	4.8	4.8	5.4	5.4	5.5
Gross national saving (percent of GDP)	15.7	15.9	15.0	14.1	14.4	13.0
Gross domestic investment (percent of GDP)	17.1	17.5	17.5	18.0	18.7	17.4
<b>Public Finance 2/</b>						
General government balance	-3.2	-3.5	-3.1	-2.6	-2.8	-2.9
Public sector balance	-2.9	-3.3	-3.0	-2.3	-2.6	-3.3
Cyclically adjusted balance (staff estimates)	-2.9	-3.6	-3.0	-2.3	-3.0	-2.9
Public sector net debt	32.8	34.6	36.0	36.7	37.3	39.2
<b>Money and Credit (end-period, 12-month percent change)</b>						
M4	7.3	9.0	12.9	12.5	12.5	...
Consumer Credit	11.5	11.9	9.5	7.4	6.4	...
<b>Interest rates (year average)</b>						
Three-month interbank rate	4.0	4.8	4.6	5.3	6.4	...
Ten-year government bond yield	4.5	4.9	4.4	4.5	5.0	...
<b>Balance of Payments</b>						
Trade balance (in percent of GDP)	-2.6	-3.0	-3.6	-3.6	-3.7	-3.7
Current account balance (in percent of GDP)	-1.3	-1.6	-2.5	-3.9	-4.3	-4.3
Exports (percent of GDP)	25.5	25.2	26.5	28.4	26.1	27.8
Export volume (change in percent)	1.7	4.9	8.2	10.7	-5.1	0.5
Imports (percent of GDP)	28.2	28.2	30.1	32.0	29.8	31.6
Import volume (change in percent)	2.0	6.6	7.1	9.8	-2.4	-0.5
Net exports of oil (in billions of US dollars)	5.5	1.6	-4.0	-6.3	-7.9	...
Reserves (end of period, in billion of US dollars)	46.1	49.4	46.2	51.8	57.2	...
<b>Fund Position (as of May 31, 2008)</b>						
Holdings of currency (in percent of quota)						92.2
Holdings of SDRs (in percent of allocation)						12.4
Quota (in millions of SDRs)						10,738.5
<b>Exchange Rates</b>						
Exchange rate regime						Floating US\$ = £0.5024
Bilateral rate (July 25, 2008)						...
Nominal effective rate (2000=100) 3/	96.5	101.2	100.0	100.8	103.1	...
Real effective rate (2000=100) 3/ 4/	94.8	100.5	100.0	101.8	106.5	...

**Social Indicators (reference year):**

Income per capita (in US dollars, 2006) : 39,889; Income distribution (ratio of income received by top and bottom quintiles, 2006): 5.4;

Life expectancy at birth (2005): 77.1 (male) and 81.1 (female); Automobile ownership (2004): 463 per thousand;

CO2 emissions (ton per capita, 2005): 9.26; Population density (2004) 250 inhabitants per sq. km.;

Poverty rate (share of the population below the established risk-of-poverty line, 2005): 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.

**Statement by Mr. Alex Gibbs, Executive Director for the United Kingdom  
July 30, 2008**

**Outlook and recent developments**

The UK economy faces significant global challenges. There is evidence that, following extensive structural reforms and the development of strong macroeconomic frameworks, it has become more resilient in recent years. This, together with a long period of stability, provides a platform from which to manage the severe adverse shocks it is facing. But my authorities are highly alert to the risks and strongly committed to maintaining sound policies and strengthening policy frameworks where appropriate. In this context my authorities have proposed reforms to the financial stability framework.

Since the last IMF Article IV report, published in March 2007, the UK has recorded GDP growth of 3% in 2007. However, growth in advanced economies is slowing in 2008. Whereas all forecasting judgements are subject to uncertainty, the Treasury's Budget forecast was made in March against a backdrop of considerable uncertainty relating to the duration, intensity and effects of the ongoing disruption in financial markets. Specifically, credit conditions were assumed to ease during the second half of 2008 and normalise by mid-2009. Contingent on our assumptions for credit conditions, and in the absence of any further shocks, the Budget forecast was for quarterly growth to pick up in the second half of 2008, with year-on-year growth rates picking up in 2009. The Treasury will update its forecasts in the Pre Budget Report in the Autumn, as normal. In the latest Treasury-compiled Comparison of Independent Forecasts, published in July, forecasts of GDP growth averaged 1.6 per cent in 2008 and 1.3 per cent in 2009.

There are clear downside risks to growth should credit conditions deteriorate further, or for longer, than assumed, constraining consumer spending and business investment by more than forecast. Furthermore, continued cost pressures from rises in global agricultural commodity and energy prices are helping to push up headline inflation, impacting negatively on households' real incomes. Weaker real household disposable income growth would likely further constrain consumer spending.

Global cost pressures temporarily raised inflation above 3 percent in March 2007, but inflation returned close to target from mid-2007, averaging 2.3 per cent in 2007/08. Following an increase to 3.3% in May 2008, the Governor of the Bank of England wrote to the Chancellor of the Exchequer on 16<sup>th</sup> June 2008 on behalf of the Monetary Policy Committee, as required by the MPC's remit. In his letter, the Governor stated:

“Inflation has risen sharply this year, from 2.1% in December to 3.3% in May. That rise can be accounted for by large and, until recently, unanticipated increases in the prices of food, fuel, gas and electricity. These components alone account for 1.1 percentage points of the 1.2 percentage points increase in the CPI inflation rate since last December”.

After rising 10% in the year to July 2007, house prices have now shown some falls and the housing market is experiencing significant challenges as a result of the disruption in the international financial markets. With the securitisation markets effectively closed, mortgage approvals are now down over 60% compared to a year ago and mortgages, particularly for those with small deposits, are increasingly difficult to find. House-builders are also experiencing difficult business conditions after years of favourable conditions. However, demand underpinning the housing market is still strong and is likely to remain so as our population ages and grows and more people live alone; this will support house prices in the long-term.

My authorities agree with the IMF assessment that the UK faces little threat to external stability, but they will continue to monitor the external balance closely. The current account deficit in 2005 was around 2½ per cent of GDP. Since 2005 investment has risen strongly, by nearly 2 percentage points of GDP, while gross national savings has fallen by a similar amount. This left the current account deficit at around 5 per cent of GDP in the third quarter of 2007. The deficit has since fallen to 2.4 per cent of GDP. Although most of this improvement is due to the value of derivative positions of American and European owned investment banks in the UK being marked down following turmoil in financial markets, the underlying current account deficit is forecast to fall as investment and savings rebalance.

The continued turbulent conditions in global financial markets are posing challenges for the financial sector in the UK, as they are around the world. Actions taken by central banks to ease liquidity concerns, along with action taken by financial institutions to raise additional capital, will improve the resilience of the financial system to shocks. However, prospects for the UK and world economy are subject to considerable uncertainties relating to the present adverse shocks from ongoing disruption in financial markets and rising global commodity prices.

### **Policy frameworks**

We welcome staff’s assessment that sustained low inflation and rapid economic growth over the last decade has been achieved thanks to strong policies and policy frameworks.

### **Fiscal**

The UK Government’s fiscal policy objectives are:

- over the medium term, to ensure sound public finances and that spending and taxation impact fairly within and between generations; and
- over the short term, to support monetary policy and, in particular, to allow the

automatic stabilisers to help smooth the path of the economy

As noted by staff, the Government's two fiscal rules, designed to implement these objectives, have served the economy well. Discipline imposed on the public finances through the framework has seen debt cut over the economic cycle which began in 1997-98 from 43.3 per cent of GDP at the end of 1996-97 to 36.6 per cent in 2006-07. Budget 2008 also forecasts that net investment, protected by the fiscal framework, will grow as a share of GDP to rates not seen since 1979-80, helping to address the historic underinvestment in infrastructure.

The UK's 2008 Budget set out a path for fiscal policy that provides support to the economy in the short term, while taking action to maintain sound public finances in the medium term. My authorities welcome the staff's assessment that "the 2008 budget judgment was appropriate, as was its commitment to fiscal tightening over the next few years." This judgement was in line with the Government's fiscal policy objectives, and the design and implementation of the fiscal framework is based on these objectives. My authorities wish to stress their firm commitment to ensuring that public finances remain sustainable in the long-term. As part of this, a comprehensive assessment of long-term fiscal sustainability was published alongside Budget 2008.

The staff report makes an interesting contribution to the ongoing debate about the role and design of fiscal frameworks, building on the constructive discussions that the team had with my authorities during the mission. My authorities' utmost priority is to continue to ensure that the fiscal framework supports the overarching fiscal policy objectives described above.

## **Monetary**

The UK Monetary Policy Framework seeks to ensure low and stable inflation as an essential precondition for achieving the Government's central objective of high and stable levels of growth and employment.

The framework is based on four principles:

- Clear and precise objectives – the primary objective of monetary policy is to deliver price stability;
- Full operational independence for the MPC in setting interest rates to meet the Government's inflation target;
- Openness, transparency and accountability, which are enhanced through, for example, the publication of MPC member's voting records, prompt publication of the minutes of monthly MPC meetings, and the open letter system; and
- Credibility and flexibility—the MPC has discretion to decide how and when to react to events, within the constraint of the inflation target.

Since its introduction in 1997, the monetary policy framework has successfully delivered a long sustained period of low and stable inflation. The Government fully supports the

Monetary Policy Committee of the Bank of England in the difficult decisions it is facing.

In previous years staff has praised the inflation-targeting framework for its overall design and consistently strong implementation and we welcome the conclusion of this year's report that it should remain unaltered.

In setting the Bank Rate, the MPC has been aiming, as always, to bring UK CPI inflation back to the 2% target in the medium term. In recent months, the Committee has been balancing two major risks to the inflation outlook. On the upside, there is a risk that rising CPI inflation will lift medium-term inflation expectations and thereby lead to a more prolonged period of above-target inflation. On the downside, the risk is that weaker incomes and tighter credit will lead to a sharper and more prolonged downturn in the economy that would pull inflation below the target further out. Both risks have become more pronounced since the Bank of England's *May Inflation Report* was published. The MPC judges that some measure of spare capacity will be required to reduce the risk of medium-term inflation expectations rising; the question is what level of Bank Rate is consistent with the appropriate slowing in growth. As usual, the Committee will decide month by month on the basis of the latest data.

## **Financial**

My authorities believe that the UK has strong fundamental arrangements in place for financial stability. The framework, with a principles- and risk-based regulatory regime, with the Financial Services Authority (FSA) as single regulator at its centre is right, though it has been tested over recent months, and shortcomings in its execution have been identified and are being addressed by the FSA. The FSA has outlined a comprehensive supervisory enhancement programme to ensure that its supervision is effective across all the organisations that the FSA regulates. In response to market developments since last August, the FSA has intensified its engagement with individual banks. My authorities are committed to strengthening the existing overall framework with its clear roles and responsibilities for the Treasury, the FSA and the Bank of England, and with a Standing Committee of the three authorities to ensure proper communication and coordination.

As part of this process, my authorities propose to provide the Bank of England with a new statutory objective for financial stability and new policy tools to ensure it can fully deliver against this new objective. Reforms are also proposed to extend the range of tools available to the authorities in the rare situations where a bank is judged to be failing, including a special resolution regime. Changes are also being proposed to the operation of the UK's deposit compensation scheme to ensure customers fully understand, and have confidence in, the arrangements which will deliver swift and adequate compensation should a bank fail. These proposals continue to be subject to further public consultation and refinement with a view to starting implementation this year including through legislative reform<sup>1</sup>. The UK Authorities acknowledge the staff report's conclusion that the proposed reforms are sound.

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<sup>1</sup> *Financial stability and depositor protection: further consultation* (July 2008)

As the financial market risks are global in nature it is key that there is adequate response at the global level – including the implementation of the recommendations of the FSF which the UK strongly supports. We also support efforts to enhance the IMF's early warning capabilities to improve awareness of risks to the global financial system and responses to mitigate these risks through joint FSF-IMF work reporting to the IMFC.

The Bank of England has responded to strains in money and financing markets by using the flexibility built into its money market operating framework. Since August 2007, the Bank has provided 61% more reserves to banks, in line with an increase in the voluntary targets set by banks at the start of each monthly maintenance period for the reserves they hold on account at the Bank. In addition to this, the Bank has used other tools in its published framework.

First, in September 2007 and March 2008 in response to heightened pressures in short-term money markets, it offered to supply additional reserves, above the amount required to meet the targets set by banks. Subsequent to each operation, short-term market rates traded closer to Bank Rate. In order to accommodate that additional supply (and subsequently to provide banks with extra flexibility to manage their day-to-day liquidity), the Bank of England has widened the ranges around banks' reserves targets within which reserves are remunerated. The Bank has also increased the ceilings on the reserves targets individual institutions can choose. In addition, the Bank increased the size of its scheduled long-term repo operations held in December and January, lending more at three months against a wider range of high-quality collateral, including AAA residential mortgage-backed securities and covered bonds. These operations were offered again at their maturity in March and April and again in June and July. The Bank has also provided reserves through drawings by Northern Rock on the liquidity facility available to it.

In April 2008, the Bank announced and implemented a Special Liquidity Scheme, to allow banks to swap temporarily their high-quality, but currently illiquid, mortgage-backed and other securities for UK Treasury bills. The scheme's aim is to improve the liquidity position of, and hence confidence in, the UK banking system.

The SLS has three main features:

1. The asset swaps will be for long terms. Each swap will be for a period of one year and may be renewed for a total of up to three years.
2. The risk of losses on the securities remains with the banks.
3. It is designed to provide financing for legacy illiquid assets existing at the end of 2007.

In addition, a number of UK banks have been active in raising significant amounts of new capital in the market to strengthen their solvency ratios.

### **Looking ahead**

My authorities are grateful to staff for a wide ranging consultation which addressed some very pertinent issues. The opportunity to engage with staff on the forecast and to test forecast

judgments at such a challenging time was valuable. The extra focus on the external balance in the mission, consistent with the 2007 Decision on Bilateral Surveillance, was welcome and provided useful insights to both sides. We welcome staff's endorsement of the budget judgement and the UK's fiscal stance, and of the overall approach to reforms designed to promote financial stability. My authorities believe that strong policy frameworks and extensive structural reforms, which support openness, promote flexible markets, and liberalise the economy leave the UK economy well placed to withstand economic shocks. However my authorities certainly do not underestimate the severity of the shocks or the uncertainty around their duration and impact. As global shocks require global responses, my authorities strongly support the work of the IMF with all its membership to address financial instability, and the impact of high food and oil prices.