

United Kingdom: 2006 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for United Kingdom

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

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on December 18, 2006, with the officials of United Kingdom on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on February 13, 2007. 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 February 28, 2007 discussion of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for United Kingdom.

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

Selected Issues Paper

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INTERNATIONAL MONETARY FUND

UNITED KINGDOM

Staff Report for the 2006 Article IV Consultation

Prepared by Staff Representatives for the 2006 Consultation with United Kingdom

Approved by Michael Deppler and Adrienne Cheasty

February 13, 2007

Executive Summary

Background and outlook: The pickup in GDP growth in 2006 continues a decade-long record of strong and steady macroeconomic performance. Recent and planned economic policies, in a supportive international environment, are well-suited to sustaining these strengths. GDP growth in 2007-08 is expected to remain steady and in line with potential, while CPI inflation is projected to return to target over the coming year. Although sterling could be slightly overvalued, the external current account is sustainable. Notwithstanding the strong and steady outlook, risks are not insignificant, especially from the housing market and the global economy.

Challenge: The United Kingdom has absorbed domestic and global shocks well, thanks to the economy's flexibility and the strong positioning of macroeconomic and financial policies. Ensuring that policies can continue to contribute to resilience remains a challenge. In particular, fiscal stabilizers must have ample space to operate, monetary policy must anchor inflation expectations, and financial policies must bolster the financial sector's strength.

Authorities' views: The authorities see their policy frameworks as providing a strong platform for the economic stability they believe is essential to prosperity. Spending restraint is planned to underpin fiscal consolidation. Interest rates are seen as well-positioned to respond to shocks. Efforts are underway to strengthen the resilience of the financial system by improving stress-testing and enhancing cross-country cooperation.

Staff views: Convergence between the authorities' and the staff's views is high. Planned fiscal consolidation should halt the increase in public debt, and staff emphasizes the desirability of holding the fiscal deficit down after this adjustment so as to increase scope for fiscal stabilizers. For monetary policy, taming the energy-price-related increase in inflation remains a challenge. Efforts to promote financial system resilience are welcome.

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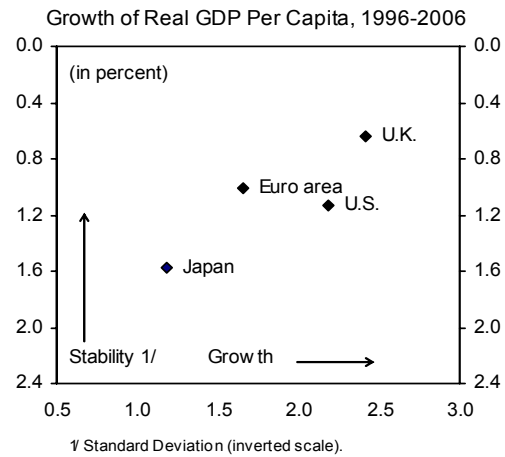
I. INTRODUCTION

1. Recent developments reflect a continuation of a decade-long record of strong and steady macroeconomic performance.

During 1996–2005, the growth of real GDP per capita was higher and less volatile than in any other G7 country. Unemployment and inflation were low and stable, and the current account deficit was moderate.

2. Recent and planned macroeconomic policies, in a broadly supportive international environment, are well-suited to sustaining these strengths (Box 1).

Wide-ranging structural reforms over the past two-and-a-half decades have increased the economy's openness and flexibility, paving the way for reaping important benefits from globalization. Macroeconomic policies have contributed to growth and stability, encouraging households and businesses to plan for the long term and positioning the economy well to respond to shocks.



Box 1. Surveillance and Policies¹

Fiscal policy: Fiscal adjustment in 2005 was in line with the Fund's views on the need to narrow the fiscal deficit and stabilize net public debt. The authorities and the Fund share the view that the rules-based fiscal framework has constrained discretion and allowed automatic stabilizers to operate. Consistent with Fund recommendations, the authorities have broadened the scope of independent audit of the budget assumptions.

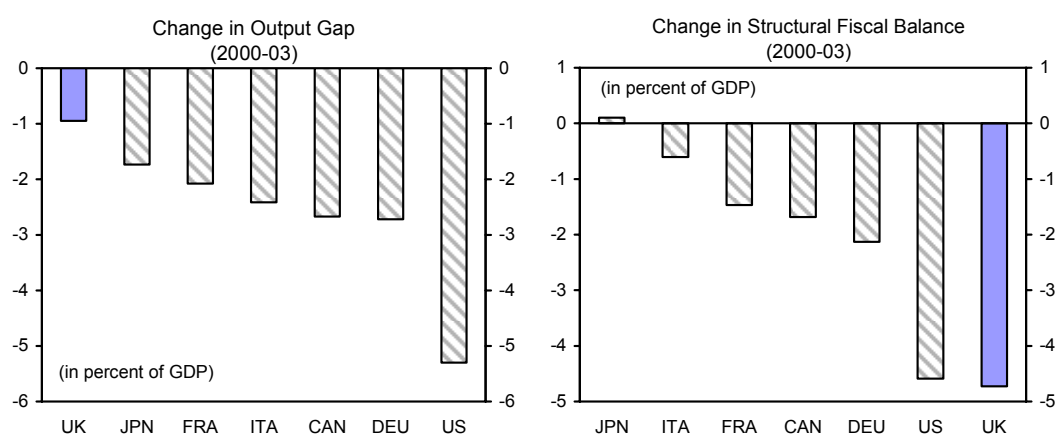
Monetary policy: The Fund has praised the inflation targeting framework for its overall design and consistently strong implementation.

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

Pension system: The government has proposed pension reform, supported by the Fund, that will help ensure both adequate saving for retirement and fiscal sustainability.

¹The latest Public Information Notice is available at <http://www.imf.org/external/np/sec/pn/2006/pn0624.htm>

3. **While the economic outlook is favorable, a crystallization of risks could threaten macroeconomic stability, so managing shocks will remain a challenge.** Given the economy's openness, global shocks influence the United Kingdom quickly and strongly. Some shocks have had and continue to have positive effects, including the rapid growth of productivity in emerging Asia, immigration, and the increased demand for financial services. Other shocks, such as the global downturn of 2000–03 and the increase in oil prices during 2004–06, were managed with good policy responses. For example, the shallowness of the UK growth slowdown during last global downturn reflected in part the most aggressive fiscal expansion of any G7 country, alongside a reduction in interest rates and a sharp increase in house prices.



4. **In light of the high convergence between the authorities' and staff views on the outlook and policies, this report focuses on the capacity of macroeconomic policies to respond to shocks.**¹ Although openness and flexibility are important shock absorbers, the positioning of policies is also key. In this vein, the fiscal framework has constrained discretion, but there is a question whether over time margins for fiscal stabilizers under prudent rules should be increased. Regarding monetary policy, a question is whether globalization shocks could weaken the link between economic slack and inflation or distort

¹ A staff team comprising Ms. Schadler (head), Mr. Morsink, Mr. Hunt, Ms. Honjo, Ms. Iakova (all EUR), and Ms. Ong (MCM), joined by Mr. Scholar and Ms. Robinson (OED), visited London during December 7–18, 2006. The mission met with the Chancellor of the Exchequer, the Governor of the Bank of England, the Chairman of the Financial Services Authority, and other senior government officials, as well as representatives from research institutes, labor and business organizations, and financial organizations. Basic data about the UK economy are in Annex I. The United Kingdom has accepted the obligations of Article VIII and maintains an exchange system free of restrictions on the making of payments and transfers on current international transactions (Annex II). Data provision is adequate for surveillance (Annex III). This report does not cover trade policy, ODA, or AML/CFT as they are not currently considered macro-relevant in the United Kingdom. The United Kingdom is scheduled to be assessed for AML/CFT compliance by the FATF in June 2007.

perceptions of potential. The financial sector, despite its strong performance, could be affected by shocks in international financial markets, especially given London's role as a global financial center. This report first covers recent developments and the outlook, then provides staff's analysis of the positioning of macroeconomic and financial policies, before turning to the authorities' views and the staff appraisal.

II. 2006—BALANCED RECOVERY PUSHING CLOSE TO CAPACITY CONSTRAINTS

5. **Domestic demand alongside strong exports drove a pick up in GDP growth during 2006** (Figure 1, Tables 1 and 2). The mild downturn in 2005 reflected the United Kingdom's advanced cyclical position, the abrupt deceleration of house prices, and the sharp increase in oil prices. The pick-up in 2006 was anticipated, though it came slightly more quickly than expected. Business investment was supported by high net rates of return, in part due to the low cost of capital. Residential investment was boosted by a surprisingly strong acceleration of house prices. The upturn in private consumption was based on robust employment growth, steady wage growth, and rising household wealth, including housing wealth. The recovery in the euro area boosted export growth.

6. **Most economic indicators suggest little economic slack as of end-2006.** Staff's production-function-based estimate suggests that the output gap at end-2006 was close to zero. In addition, measures of capacity utilization have risen over the past year and are now above their historical averages. The unemployment rate, however, increased through mid-2006. The dampening effect on labor demand from higher energy prices and the surge in new entrants to the labor force appear to have been key factors. Both should be temporary. Productivity growth rebounded in line with output growth, consistent with a decline in labor hoarding.

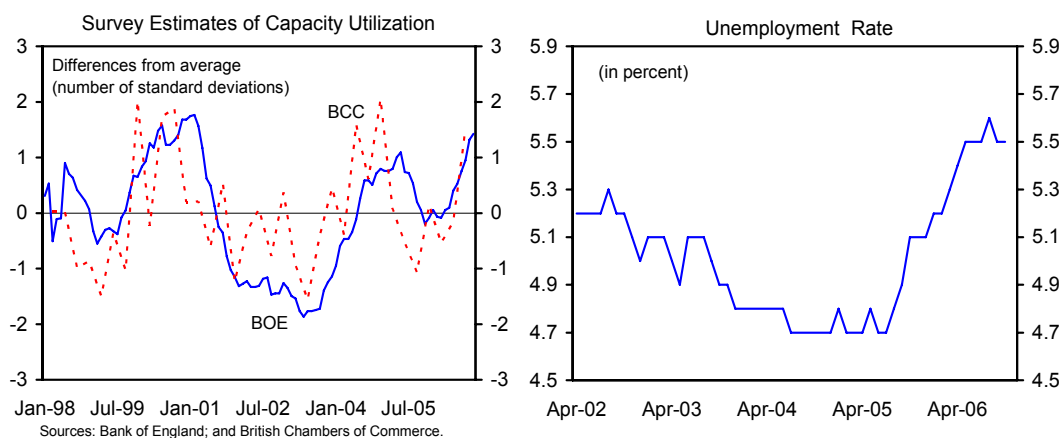
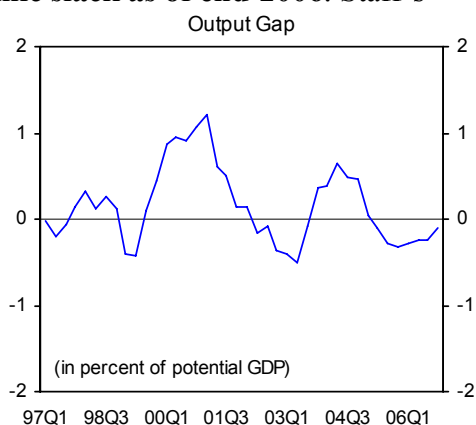
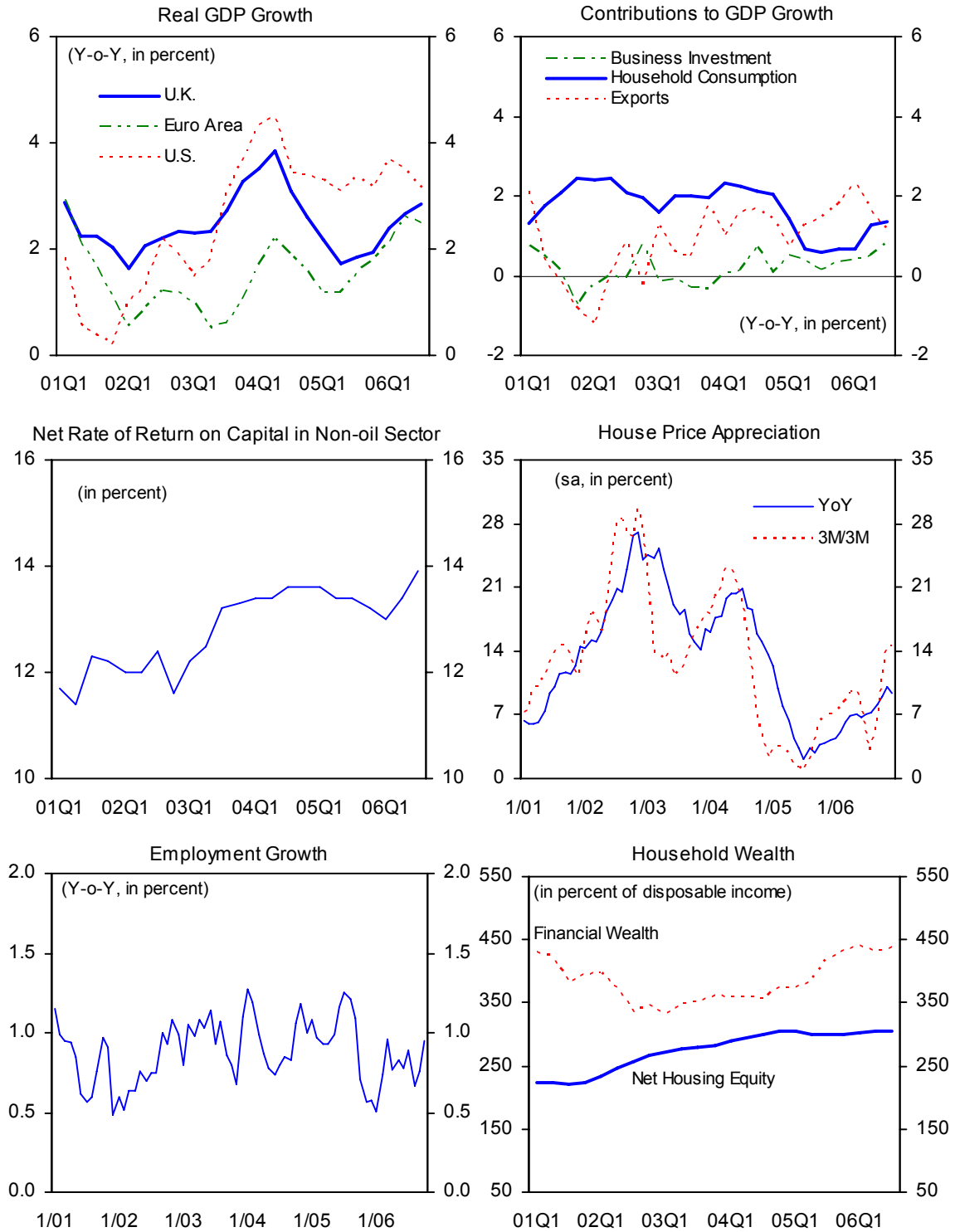
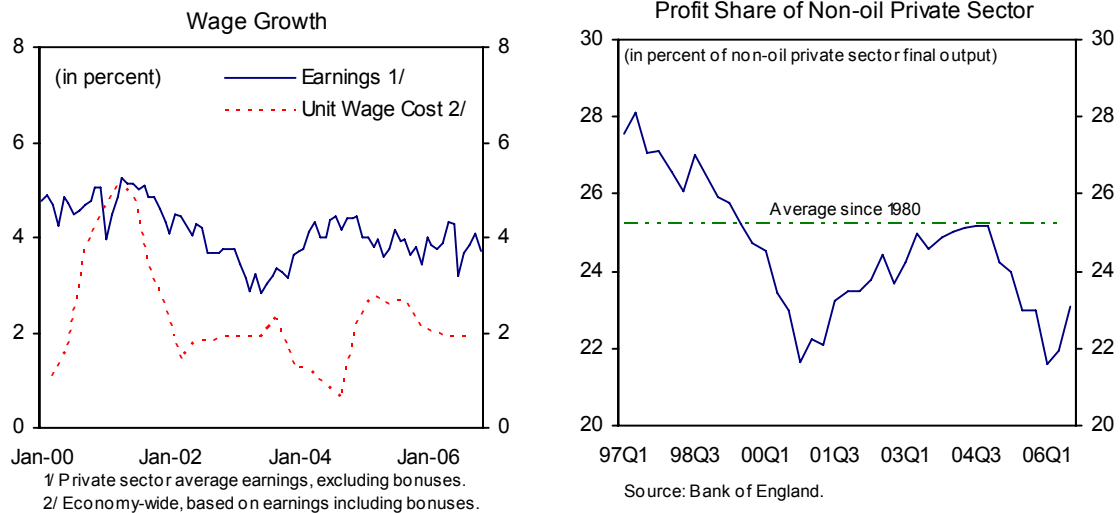


Figure 1. United Kingdom: Economic Growth



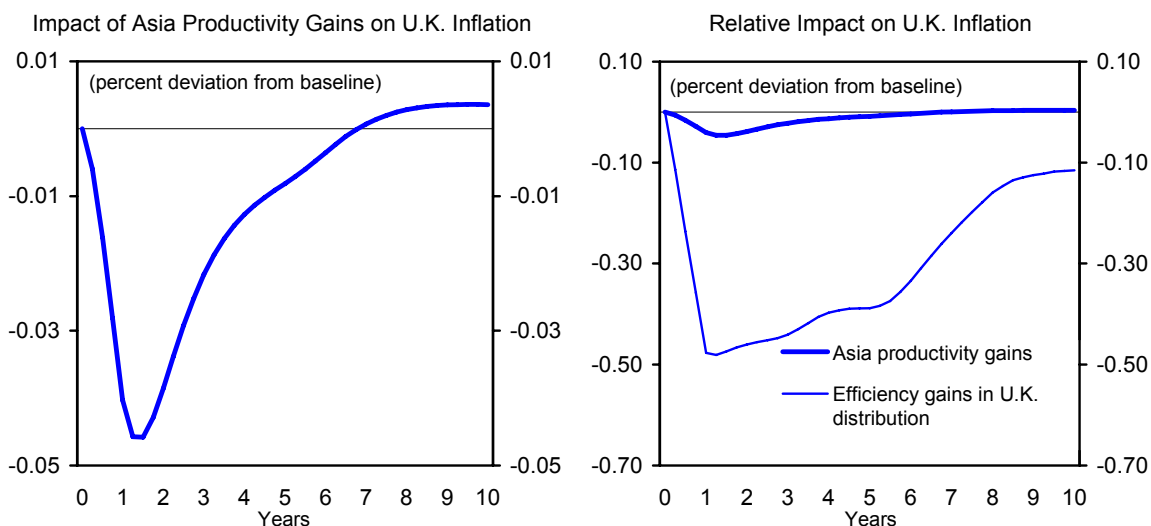
7. **Wage growth has been steady, but profit margins in the non-energy sector have fallen.** Over the past year, the increases in both actual private sector earnings and pay settlements have been stable. The deceleration in unit wage costs has been mainly due to the procyclicality of productivity growth. However, in the non-energy sector, with subdued output price inflation, the share of profits in output declined from mid-2004 to mid-2006, reflecting sharp increases in contributions to company pension plans and input costs. As these factors wane, the profit share should rise.



8. **In light of the pick up in GDP growth and concerns about second-round effects of cost pressures, the Bank of England (BOE) began raising the policy interest rate in mid-2006.** Following a decade of low core inflation due in part to globalization and efficiency gains (**Box 2**), inflation rose above target in May 2006, reflecting primarily higher energy prices (pass-through to utilities prices continued through late 2006). But core inflation (ex-energy and food) increased too, as the decline in core goods prices subsided and services price inflation picked up. Owing to concerns about rising costs, The real policy rate has increased back to its 2004 level. Given projected nominal GDP growth of about 5½ percent over the medium term, a policy interest rate of 5¼ percent is broadly neutral.

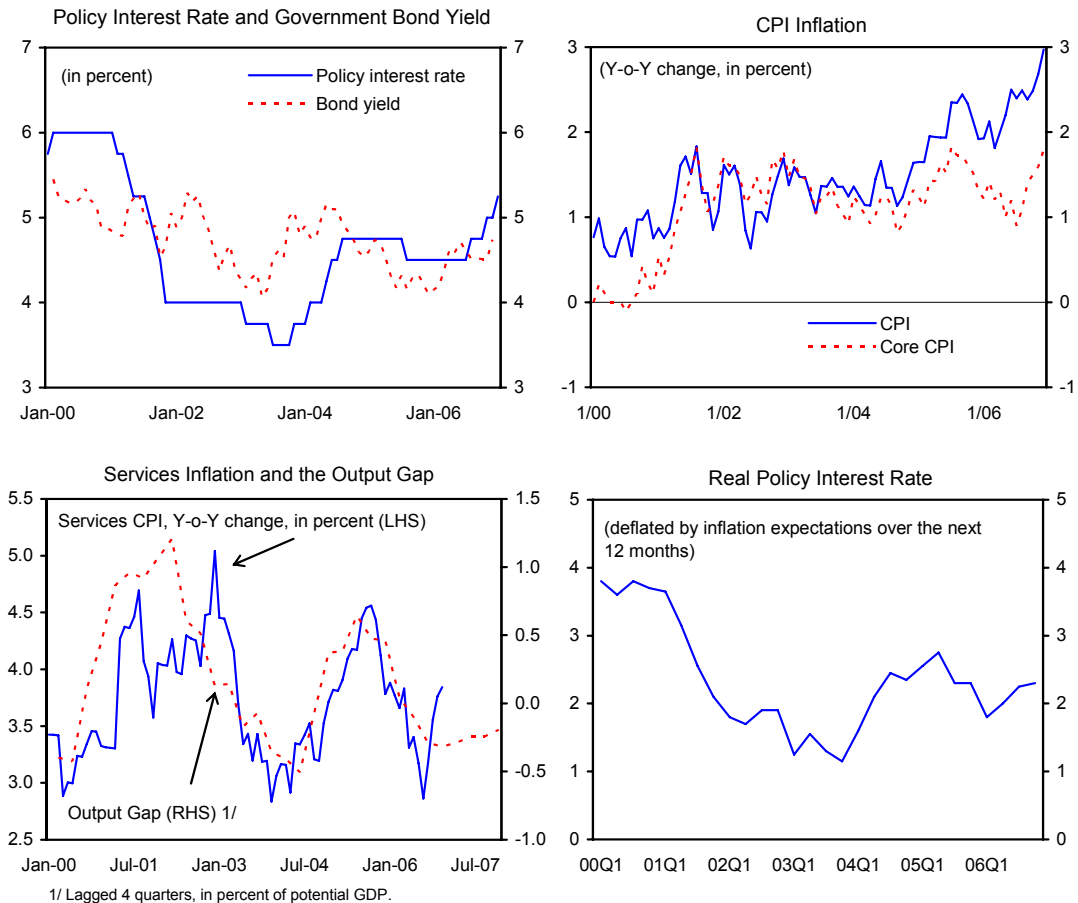
Box 2. Globalization, Efficiency Gains, and Inflation

Subdued core inflation in industrial countries over the past decade is often attributed to rapid growth in emerging Asia (which has dampened the prices of imported manufactured goods) or efficiency gains (notably in the distribution sector). In the United Kingdom, efficiency gains in the distribution sector reflect mergers and acquisitions, as well as the growth of “big box” style retailing (“Tescoization”).

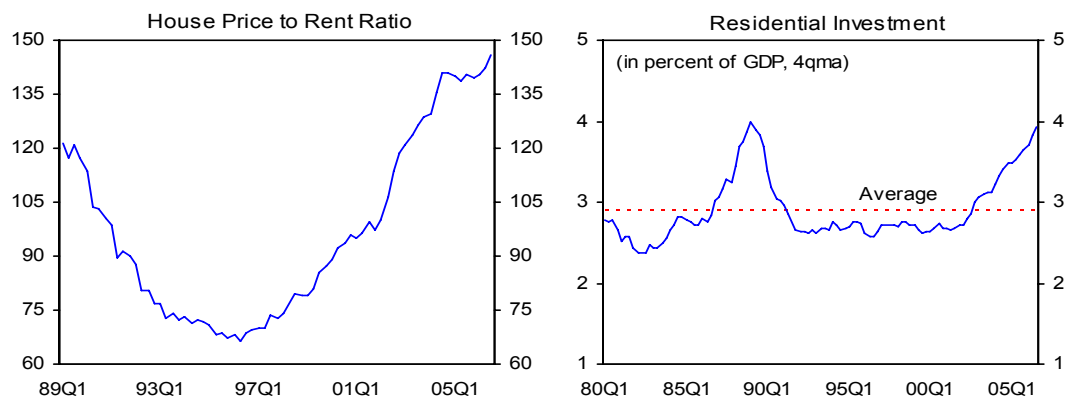


Staff analysis, using the Fund’s Global Economy Model, suggests that rapid growth in Asia has had a larger dampening effect on the relative price of goods in the United Kingdom than in the United States or the euro area, but that the impact on UK core inflation is much smaller than that of efficiency gains in the UK distribution sector.¹ The Asia effect is bigger in the United Kingdom for two reasons. First, since imports from Asia constitute a larger *share* of UK absorption, the direct effect on goods prices is larger. Second, from Asia’s perspective, the required increase in the *volume* of imports from the UK needed to equilibrate the current account is smaller than that from the US or the euro area, so the depreciation of sterling against emerging Asia currencies is smaller than that of the US dollar or the euro.

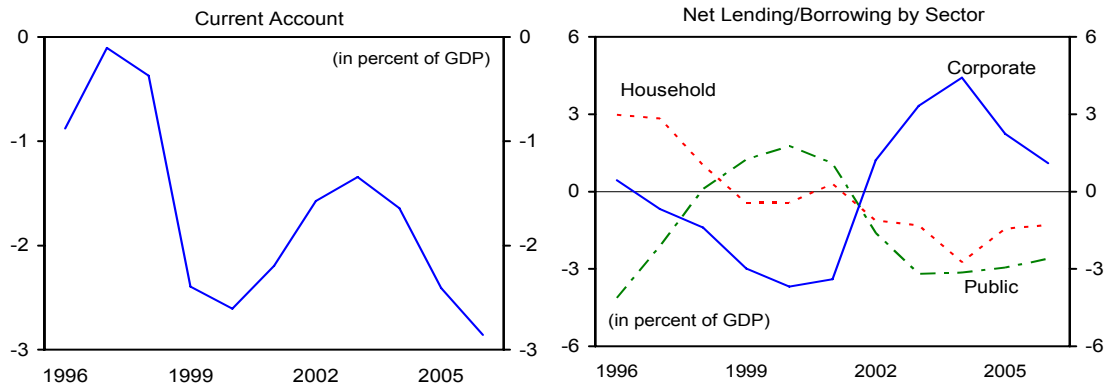
¹/ Benjamin Hunt, “U.K. Inflation and Relative Prices over the Last Decade: How Important Was Globalization?” in *United Kingdom—Selected Issues*.



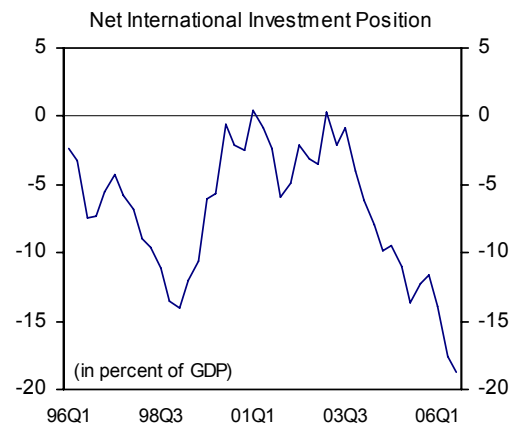
9. **House price growth increased during 2006, and house prices are likely overvalued.** Following the stabilization of house prices in 2005, house price appreciation picked up again in 2006, reflecting in part the combination of a decline in 2-year bond yields and the growth of fixed-rate mortgages, which are priced off 2-year bond yields. As a result, the ratios of house prices to average earnings and rents, which were already at historical highs, increased further. However, estimates of house price overvaluation are subject to great uncertainty, not least because of the difficulty of incorporating supply constraints. Such constraints appear to have loosened somewhat in recent years, as the share of residential investment in GDP has grown substantially.



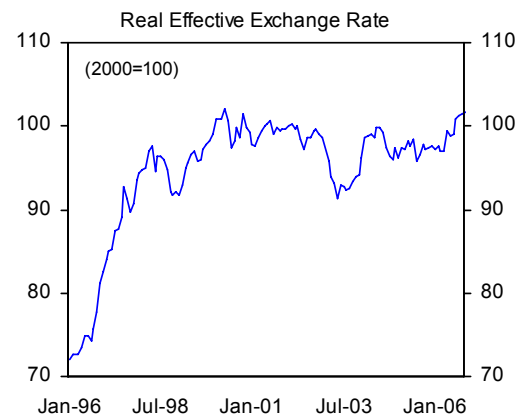
10. **Although the current account deficit and the international investment position deteriorated in 2006, neither is a significant vulnerability.** The current account deficit widened in 2006 to 3 percent of GDP, roughly the same as it was in 2000. Between 2000–06,



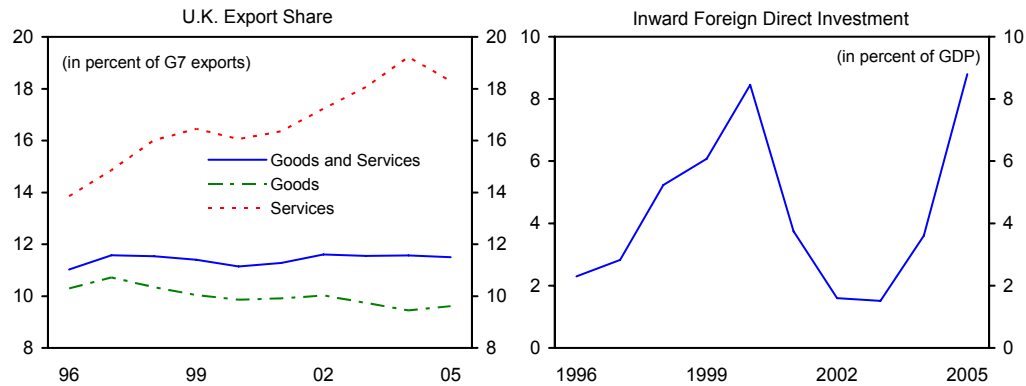
a considerable increase in the trade deficit was matched by an increase in net investment income (Table 3). Over the past decade, the current account balance worsened, reflecting a gradual deterioration in the household and the public sector saving-investment imbalances only partially offset by an improvement in the corporate savings-investment imbalance. The decline in the net international investment position (IIP) in recent years is due primarily to sterling appreciation against the US dollar (Appendix II). Notwithstanding the negative IIP, net investment income is projected to remain in substantial surplus, as the United Kingdom earns more on its external assets (especially foreign direct investment) than it pays on its liabilities (mostly sterling-denominated debt).



11. **Despite the gradual increase in the current account deficit, competitiveness is broadly appropriate.** The real effective exchange rate has been less volatile than those of other major currencies over the past five years. The UK share of exports of goods and services in G7 exports has been steady, with an increase in the services share offset by a decline in the goods share. Inward foreign direct investment (as a share of GDP) has risen in recent years to exceed the level recorded at the peak of the equity price boom in 2000. Some of the staff's multilaterally-consistent measures of equilibrium exchange rates

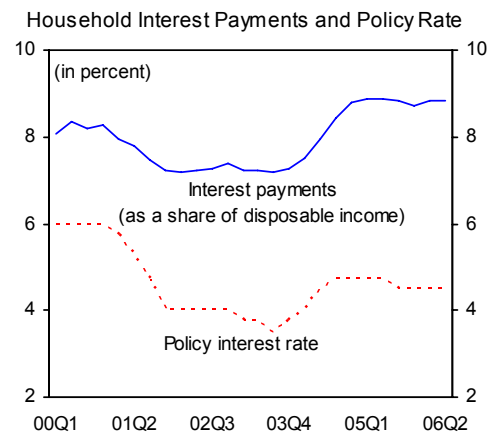


suggest that sterling is slightly overvalued, though well within the bounds of uncertainty surrounding the methodologies.²



III. STRONG AND STEADY OUTLOOK

12. **In 2007–08, growth is projected to be broadly in line with potential, with inflation falling to target and the current account deficit stabilizing** (Table 4). The increase in net immigration—especially from new EU member states—will boost growth potential (**Box 3**). At the same time, the growth of domestic demand should remain steady as positive influences (continued robust employment growth and steady wage growth) are broadly matched by the dampening effect of recent increases in the policy interest rate.³ Given the appreciation of the real effective exchange rate over the past year and a slight easing of growth in major export markets (primarily reflecting the slowdown in the United States), the current account deficit is expected to widen further in 2007 and then remain steady. With the appreciation of the exchange rate and the decline in energy prices, CPI inflation is projected to return to target by late-2007. In 2009 and beyond, there are no obvious reasons for the macroeconomic outlook to change.



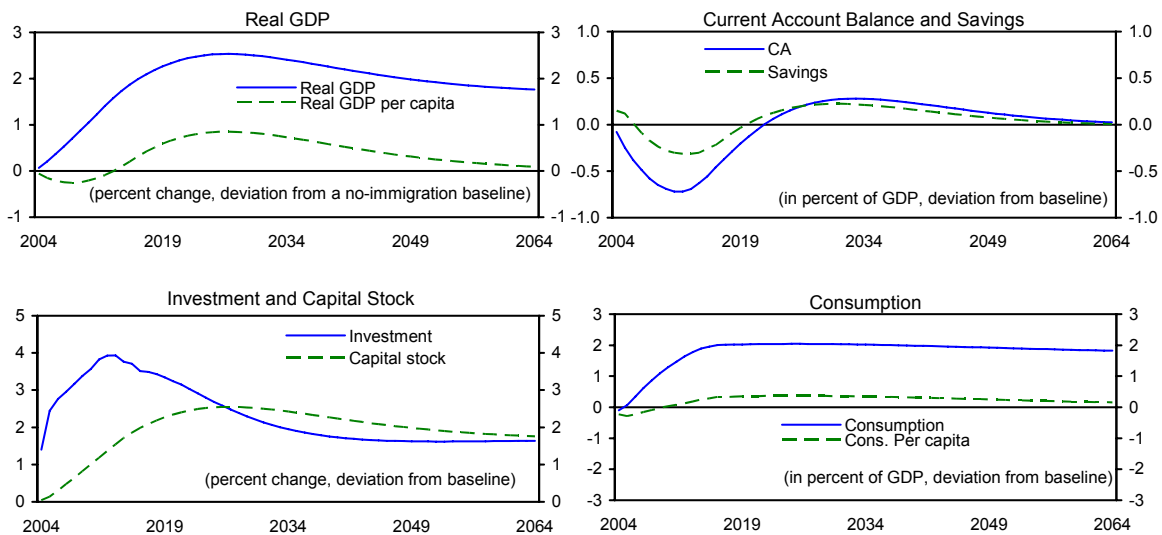
² For background on methodology, see IMF policy paper, *Methodology for CGER Exchange Rate Assessments*, 2006, available at www.imf.org/external/np/pp/eng/2006/110806.pdf.

³ The interest sensitivity of aggregate demand in the United Kingdom is similar to that in the United States and the euro area, though consumption is more sensitive in the UK and the US. See Keiko Honjo, "The Interest Sensitivity of UK Demand," IMF Country Report No. 04/55, March 2004.

Box 3. The Macroeconomic Impact of Immigration

How is the surge in immigration to the United Kingdom from Central Europe following the accession of new EU members in May 2004 affecting potential output, the current account balance, and other key macroeconomic variables?¹ Although the precise number of immigrants is uncertain, the labor force survey estimates that the number of accession country nationals increased by about 185,000 (about ½ percent of the labor force) in the two years since accession. The vast majority of these immigrants are less than 30 years old and virtually all are employed.

Staff analysis, using a dynamic overlapping generations model, indicates that the medium- and long-term (through 2050) macroeconomic effects of a long-lived immigration shock should be favorable.² After about 10 years, the impact on real GDP per capita is positive, as the immigrants accumulate experience and become more productive. The current account balance deteriorates for about 20 years, reflecting both a lower saving rate (as young immigrants consume and remit more than the average worker) and a higher investment rate (to equip the new workers with capital).



1/ Starting in 2007, workers from the newest members—Bulgaria and Romania—will be admitted in some sectors, subject to tight quantity restrictions.

2/ Dora Iakova, “The Macroeconomic Effects of Immigration in the U.K.” in *United Kingdom—Selected Issues*.

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

	2004	2005	2006	2007	2008	2009-12 Average
Real GDP	3.3	1.9	2.7	2.9	2.7	2.7
Domestic demand	3.8	1.9	2.8	3.0	2.8	2.7
Net exports 1/	-0.6	0.0	-0.3	-0.2	-0.2	-0.1
Current account balance 2/	-1.6	-2.4	-2.9	-3.1	-3.2	-3.3
Gross national saving 2/	15.1	14.8	15.0	15.4	15.7	16.0
Private	16.0	15.8	14.9	14.9	14.8	14.8
Corporate	11.1	10.5	9.5	9.4	9.4	9.3
Household	4.9	5.2	5.5	5.4	5.4	5.4
Public	-0.9	-1.0	0.0	0.5	0.8	1.2
Gross domestic investment 2/	16.5	17.2	17.9	18.5	18.8	19.3
CPI inflation	1.3	2.1	2.3	2.3	2.0	2.0
Output gap	0.5	-0.2	-0.2	0.0	0.0	0.0
Unemployment rate 3/	4.8	4.8	5.4	5.3	5.1	4.9

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

1/ Contribution to the growth of GDP.

2/ In percent of GDP.

3/ In percent of labor force; based on Labor Force Survey.

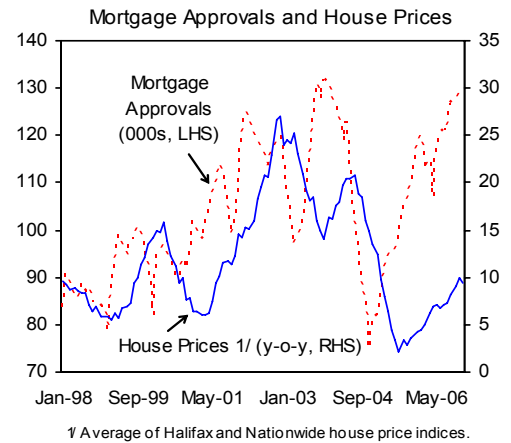
13. **Prospects for the longer term are also good, particularly as population aging will not be as severe as elsewhere and the recent pension reform proposal lessens concerns about the adequacy of private saving for retirement.** With a less generous state pension system than in other G7 countries, government projections show that—to keep net public debt below 40 percent of GDP—the required improvement in the primary balance as a share of GDP is only about ½ percentage point *per decade* starting in the 2030s. Staff analysis points to the large uncertainties surrounding these long-term projections, especially for health care spending.⁴ Uncertainties about the adequacy of saving for retirement will, however, be reduced by three key elements of the pension reform proposal: shifting the indexation of the flat-rate state pension from prices to average earnings (to reduce the spread of means-testing); introducing a national, defined-contribution scheme with automatic enrolment and low operating costs; and raising the state retirement age in line with rising life expectancy.⁵ The reform would address the existing disincentives to private saving for retirement and preserve fiscal sustainability, as the savings from the rise in the state retirement age would largely offset the cost of indexing pension payments to earnings.

⁴ See Keiko Honjo, “Long-Term Health Care Costs: Will They Make the Budget Sick?” IMF Country Report No. 06/87, March 2006.

⁵ United Kingdom: 2005 Article IV Consultation—Staff Report, IMF Country Report No. 06/86, March 2006.

14. **Notwithstanding the strong and steady outlook, risks are not insignificant:**

- Immigration may expand the economy's productive capacity more quickly than is currently envisaged. The large wage differentials between Western and Central Europe suggest that migratory flows may remain substantial for several years, though it is difficult to predict the precise allocation of these immigrants across countries in Western Europe.
- In the short term, forward-looking indicators of housing market activity suggest that house price growth is likely to remain elevated. In light of estimates that house prices are already overvalued, this would increase the subsequent risk of an abrupt downward adjustment. The current strength of household balance sheets reflects in part high house prices.
- External risks are low-probability but potentially high-impact, particularly as the global financial center could transmit shocks to the domestic economy. Higher global interest rates could trigger a reassessment of asset valuations, including UK house prices. Slower global growth would dampen external demand for UK goods and services. A disorderly adjustment of the US dollar could put upward pressure on sterling, leading to a widening of the UK current account deficit and a worsening of the IIP, ultimately producing considerable exchange rate volatility.

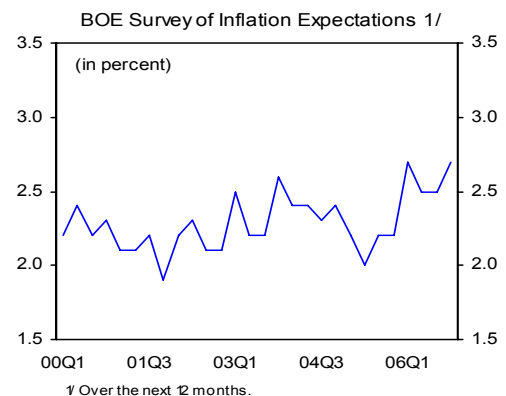


15. **Such risks present a challenge for macroeconomic and financial sector policies.**

Policymakers face not only low-probability, high-impact risks, but also more immediate questions of how policies should respond to changes in the environment from immigration and globalization. The Bank of England faces the challenge of assessing how these influences affect inflation and how monetary policy should respond to them. Fiscal policy needs to ensure that both the fiscal rules and the underlying debt position permit appropriate countercyclical behavior. Financial sector policies need to keep supervision and crisis management tuned to changing risks.

IV. CHALLENGES IN ANCHORING INFLATION EXPECTATIONS

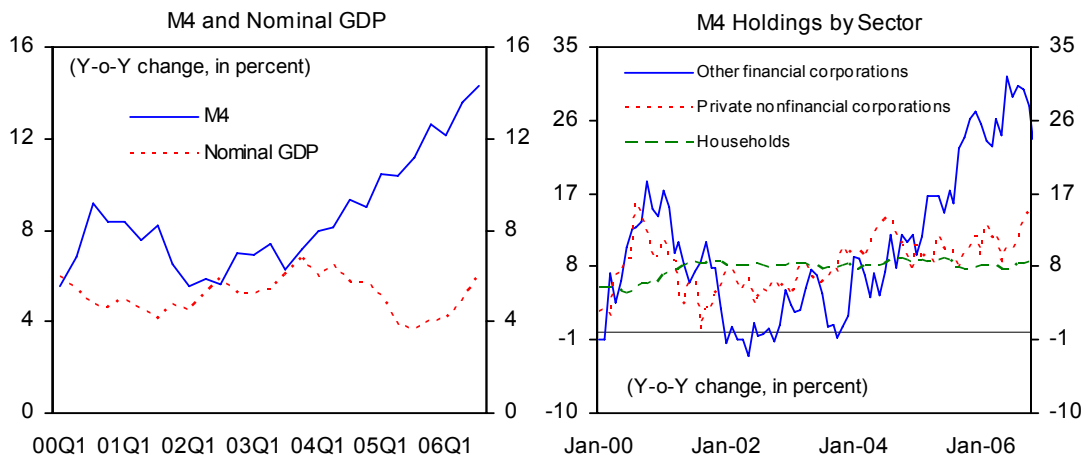
16. **With CPI inflation having been above target since May 2006, inflation expectations could become less well anchored.** The longer headline inflation persists above target, the greater the risk of a shift toward higher inflation expectations. The BOE's



survey measure of the public's inflation expectations is now at its highest level in several years.

17. **This heightens concerns that higher-than-target inflation could be embedded in upcoming pay deals.** The inflation forecast assumes that private sector wage growth remains stable, reflecting in part continued slack in the labor market. However, with energy and other input prices now expected to be permanently higher than they were a couple years ago, a temporary slowing in real wage growth to rebuild margins of non-energy producing firms is inevitable. For this to happen without a secondary burst of inflation, nominal wage restraint in upcoming pay deals (many are concluded during the first quarter of the year) is essential. The recent interest rate increases send a strong signal on this score and further increases would be needed if wage restraint were not to continue.

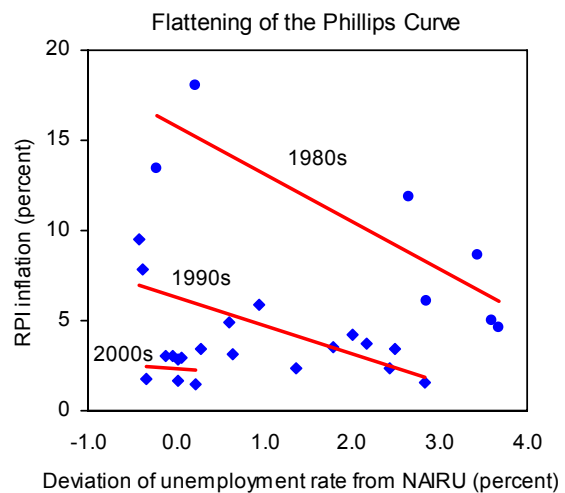
18. **Recent rapid broad money growth has raised concerns but is difficult to interpret.** M4 growth increased sharply over the past year, driven largely by deposits held by nonbank financial companies (known as other financial corporations or OFCs). To the extent that these money balances are eventually used (for example, by pension funds) to purchase other assets, this build-up in liquidity could be associated with upward pressures on demand and subsequently inflation. However, these money balances could also partly reflect financial innovation. For example, pension funds and insurance companies are holding more deposits to finance derivative payments. Moreover, evidence suggests that the link between broad money growth and inflation in the United Kingdom in the short- to medium-term is weak.⁶ On balance, staff do not view recent broad money growth as a major concern, though careful monitoring is appropriate.



⁶ Luca Benati, "Long-Run Evidence on Money Growth and Inflation," Bank of England Quarterly Bulletin, Autumn 2005.

19. **Turning to global risks, a key challenge for the BOE is judging when the deflationary impact of rapid productivity growth in emerging Asia will wane.** Looking back, subdued core inflation has been due in part to falling prices of imported manufactured goods and efficiency gains in the distribution sector. Looking forward, two risks stand out. First, the pace of productivity growth in Asia or the UK distribution sector may slow. Second, even if these underlying trends persist, their dampening effects on UK inflation will eventually diminish, because households learn about them and incorporate them into their expected wealth. This will tend to boost aggregate demand. Rising prices of non-energy imported goods suggest that the effect of the Asia productivity shock is already waning and that the level of the policy interest rate needed to secure the inflation target may be shifting up.

20. **Another risk from globalization is that the influence of monetary policy on inflation diminishes.** Increased trade makes goods prices in any given country less sensitive to domestic demand pressures, while increased cross-border labor mobility makes wages less sensitive to the domestic labor market. Both developments weaken the link between domestic economic slack and domestic inflation. One implication is that the BOE needs to worry less about temporary imbalances between demand and supply. Another, however, is that deviations of inflation from target are likely to become more persistent. Thus, if wage growth were to increase, then the BOE would need to keep monetary policy tight for longer to bring inflation back to target (**Box 4**).



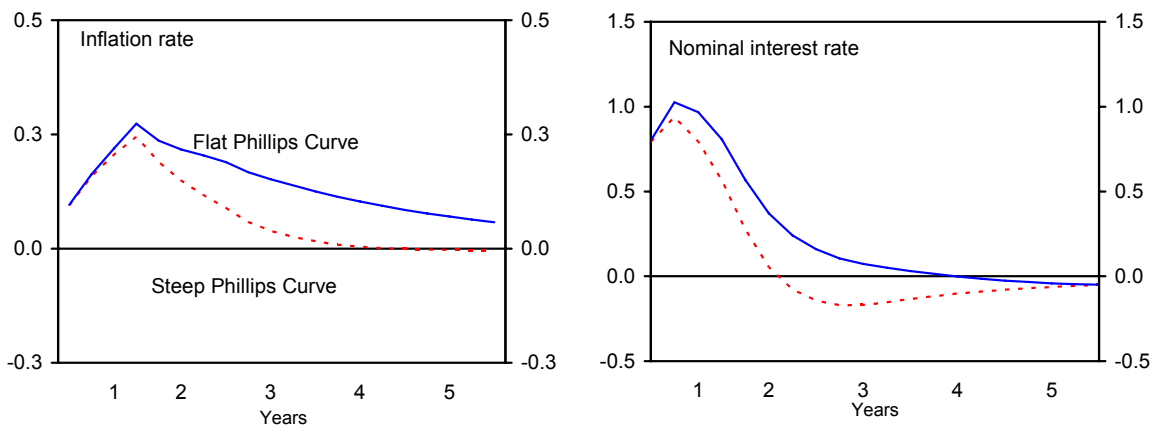
21. **Altogether, with interest rates now within a broadly neutral range, monetary policy is well-positioned to respond in either direction to unexpected developments.** If inflation expectations do not moderate or signs of wage pressures were to emerge, additional tightening would be desirable. In this event, interest rates may need to be held higher for some period. Conversely, if global growth were to slow more sharply than currently envisaged or the UK housing market were to weaken substantially, interest rate cuts should be considered. Moreover, any decision would need to be conditioned on new evidence of the effect of immigration on the potential output. But the scope for interest rate adjustments to adequately address large shocks appears ample.

Box 4. Globalization and Monetary Policymaking

Globalization is widely seen as contributing to a flattening of the Phillips curve (the link between inflation and measures of economic slack) in the United Kingdom and other industrial countries over the past decade. Using a small macroeconomic model, staff analysis finds that a flatter Phillips curve has three main implications:¹

- First, macroeconomic volatility increases. With the weaker link between inflation and economic slack, higher output variability is needed to achieve a given level of inflation variability.
- Second, a central bank that cares about inflation and (even a small amount) about deviations of output from potential should respond relatively less to deviations of inflation from target in deciding monetary policy stance. This is because the deviation of output from potential needed to bring inflation to target quickly is much higher when the Phillips curve is flatter.
- Third, even though the central bank's response to a given deviation of inflation from target is attenuated, interest rates would need to stay higher for longer after a positive shock to inflation, since deviations of inflation from target are more persistent. Conversely, the cumulative interest rate movement would be smaller after a demand shock.

Impulse Responses to an Inflation Shock
(percentage point deviation from baseline)

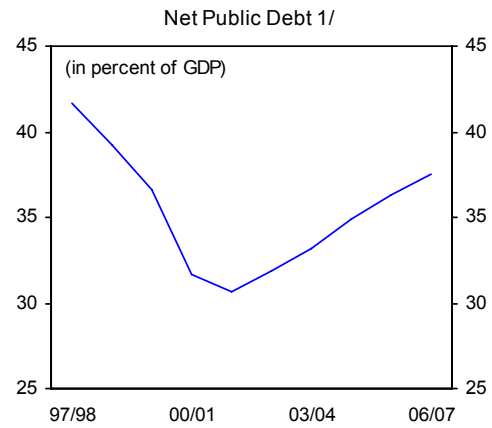


^{1/} Dora Iakova, "Flattening of the Phillips Curve: Implications for Monetary Policy" in *United Kingdom—Selected Issues*.

V. PROTECTING COUNTER-CYCLICALITY IN FISCAL POLICY

22. **A substantial fiscal expansion in 2001–04 led to a sharp deterioration in the fiscal balance and rising net public debt**

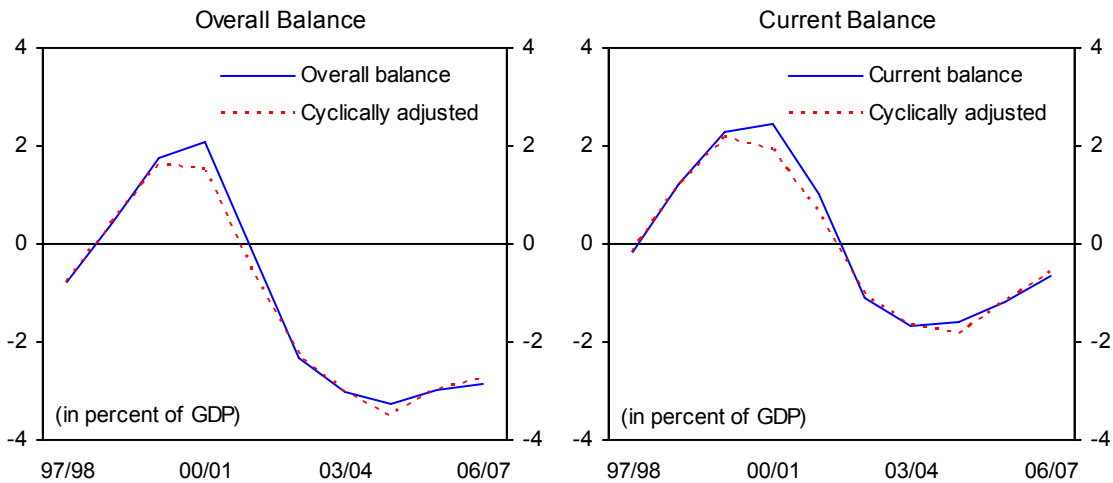
(Table 5). During this period, the government undertook a significant expansion in spending to increase public services. While this increase provided beneficial countercyclical stimulus during 2001–02, it continued in the stronger macroeconomic environment of 2003-04.



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

23. **A reversal of the deficit started in FY2005/06, but much remains to be done to return the fiscal position to one with ample space for fiscal stabilizers.**⁷

In FY2005/06, the cyclically-adjusted overall balance relative to GDP improved by ½ percentage point, primarily due to windfall energy-price-related revenues and higher revenues from the booming financial sector. In FY2006/07, receipts and expenditures during the first nine months of the year point to some further improvement in the cyclically-adjusted overall deficit, reflecting buoyant personal and corporation income tax revenue (in turn due to the continued strength of the financial sector) and the higher tax rate on North Sea firms.



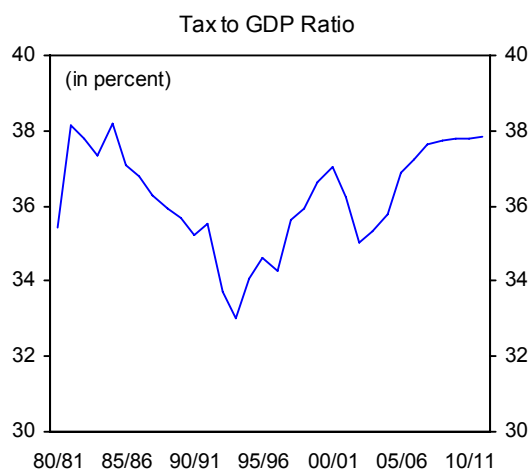
⁷ The fiscal year runs from April to March.

Fiscal Balances and Public Debt
(In percent of GDP)

	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
						Proj.		
Overall balance								
PBR	-3.3	-3.0	-2.8	-2.3	-1.9	-1.7	-1.5	-1.3
Staff	-3.3	-3.0	-2.9	-2.5	-2.2	-2.0	-1.8	-1.6
Cyclically-adjusted overall balance								
PBR	-3.2	-2.8	-2.6	-2.2	-1.9	-1.7	-1.5	-1.3
Staff	-3.5	-3.0	-2.8	-2.5	-2.2	-2.0	-1.8	-1.6
Current balance								
PBR	-1.6	-1.2	-0.6	-0.1	0.3	0.5	0.6	0.8
Staff	-1.6	-1.2	-0.6	-0.4	-0.1	0.1	0.3	0.6
Cyclically-adjusted current balance								
PBR	-1.6	-1.0	-0.4	-0.1	0.3	0.5	0.6	0.8
Staff	-1.8	-1.2	-0.6	-0.4	-0.1	0.1	0.3	0.6
Output gap								
PBR	0.1	-0.4	-0.2	0.0	0.0	0.0	0.0	0.0
Staff	0.4	-0.2	-0.2	0.0	0.0	0.0	0.0	0.0
Net public debt								
PBR	35.6	36.4	37.5	38.2	38.6	38.7	38.7	38.5
Staff	34.9	36.3	37.5	38.3	38.9	39.3	39.5	39.6

Sources: December 2006 Pre-Budget Report, and staff projections.

24. **The authorities plan further adjustment over the medium term so as to return the current balance to surplus, relying primarily on spending restraint to do so.** The December 2006 *Pre-Budget Report* presented a plan to lower the ratio of current spending to GDP by $\frac{3}{4}$ percentage points by FY2011/12. Capital spending as a share of GDP is expected to remain stable, in line with the OECD recommendation to redress decades of under-investment in public, especially transport, infrastructure. Appropriately, the *Pre-Budget Report* shifted away from previous plans to rely on higher revenue for the needed adjustment. The tax-to-GDP ratio is back to about its level in the second half of the 1980s, reflecting a combination of buoyancy and measures. After a small further rise in FY2007/08, the ratio is projected to remain roughly stable over the medium term, as fiscal drag is offset by a modest decline in the VAT base.



25. **Recent actions have strengthened the credibility of the commitment to spending restraint, but the Comprehensive Spending Review (due by mid-2007) will be the critical test.** Key actions have been settlements with selected ministries (covering about 10 percent of discretionary spending) for 2008–10—with the Home Office (one of the largest ministries) for no real growth, with some smaller ministries (including the Department for Work and Pensions, HM Revenue and Customs, and the Treasury itself) for declines of 5 percent per year in real terms. Looking ahead, the objective is to achieve savings of at least 3 percent per year across central and local government, with administrative budgets across ministries reduced by at least 5 percent in real terms per year. While wage bargaining with public sector employees is conducted on a ministry-by-ministry basis, the Treasury has responsibility for approving government submissions to the pay review bodies. In 2006, the average pay increase in the public sector was 2½ percent, the lowest in a decade. The plan is to ensure that wage increases are affordable and consistent with the 2 percent inflation target over the medium term.

26. **Once the adjustments in the Comprehensive Spending Review are in place, fiscal policy should ensure that net public debt remains below 40 percent of GDP, a limit that has served the economy well.**⁸ On staff projections, net public debt will rise to just below 40 percent of GDP in the medium term. Countercyclical fiscal policy in the event of an adverse shock would then push net public debt over 40 percent of GDP. For example, staff analysis suggests that a sharp drop in house prices could lead to a slowdown in economic growth that would increase net public debt relative to GDP by about 3 percentage points.⁹ This would be consistent with holding debt below 40 percent of GDP “over the cycle.” However, staff would favor keeping the deficit at 1½ percent of GDP, which would gradually reduce the debt ratio, creating sufficient room for automatic stabilizers to work while maintaining debt below 40 percent of GDP “at all times.” The “at all times” formulation would provide a clearer measure of fiscal performance.

27. **More generally, the fiscal framework has broadly contributed to stability.** In particular, the fiscal rules—the debt rule and the golden rule (which requires current balance or better over the cycle)—have helped to constrain discretion and protect investment. Nevertheless, the definition of the golden rule as applying “over the cycle” has two widely-discussed drawbacks: the uncertainty surrounding the dating of the cycle and the risk of procyclicality in the event of asymmetric cycles. Possibilities for redressing them while

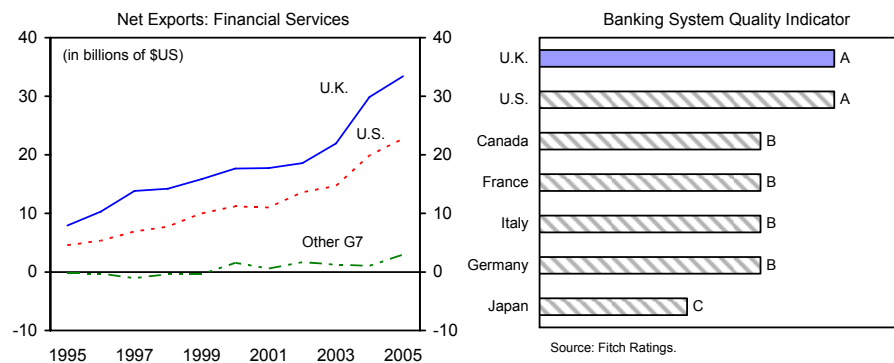
⁸ The debt rule specifies that net public debt should be held over the cycle at a stable and prudent level, which the Treasury has defined as 40 percent of GDP. In 2003, the government committed to keeping net debt under this ceiling at all times until the end of the current cycle (which is widely seen as imminent), when the default option would be to revert to 40 percent of GDP over the cycle.

⁹ See Ben Hunt, “How Should Policymakers Respond to a Decline in House Prices?” in IMF Country Report No. 05/81, March 2005.

preserving constraint on discretion exist, but it is not clear whether the cost of changing the rule outweighs the benefit.¹⁰ Separately, the credibility of the fiscal framework would be served by increasing the role of the National Audit Office in auditing certain assumptions underlying the fiscal projections. Since 1997, the government has invited the NAO, which is independent of the government and reports directly to Parliament, to audit some general macroeconomic assumptions and some specific assumptions (such as the effective VAT rate), so as to enhance the transparency of the Budget forecast. Broader NAO audit of key fiscal assumptions would further enhance fiscal transparency.

VI. FINANCIAL STABILITY: RISK OF GLOBAL SHOCKS

28. **The financial sector is thriving.** Net exports of financial services have risen steadily over the past decade and increased sharply in recent years. Ratings agencies rank the highly profitable UK banking system as one of the strongest in the world. Robust economic growth, a benign interest rate environment, and a buoyant housing market have supported mortgage credit quality, though high-risk mortgage lending and bad debts on unsecured personal lending are increasing.¹¹ High net rates of return have underpinned strong corporate credit quality and low levels of insolvencies. The health of the banking system reflects



improved risk management, geographical diversification, and growth of new business activities. In particular, financial innovation has allowed banks to transfer some of the risk that they traditionally held on their own balance sheets. In turn, the ongoing shift from negotiated, bilateral banking finance to arms-length finance through asset markets has facilitated consumption smoothing (September 2006 WEO). Bank regulation and supervision have responded well to these developments. At the same time, the life insurance industry has returned to a more stable outlook, following several years of weakness. The introduction of a risk-based approach to determining capital adequacy has helped to increase awareness by insurers of the risks associated with the products they offer.

¹⁰ Staff analysis suggests that changing the operational target of the golden rule from current balance or better “over the cycle” to aiming for current balance or better at a rolling horizon would reduce macroeconomic volatility but increase the volatility of public debt. See Keiko Honjo, “The Golden Rule and the Economic Cycle,” in *United Kingdom—Selected Issues*.

¹¹ Unsecured personal lending represents less than 20 percent of total personal lending. In response to rising bad debts, banks have tightened their lending criteria.

29. **Linkages between the UK financial system and financial systems in other countries are growing.** Specifically, linkages between the main UK and non-UK banks are strong and getting stronger. For example, in the London interbank market, the main UK banks' exposures to the main foreign-owned banks amount to almost two-thirds of Tier 1 capital. Banks' activities have also become increasingly intertwined with other parts of the financial sector and the broader economy. These growing linkages are both a strength and a vulnerability. They allow the impact of bad shocks to be more broadly dispersed (risk transfer) and thus more easily absorbed by individual institutions and the system as a whole. However, they also potentially allow the impact to be spread around the global financial system more widely and rapidly (**Box 5**).

30. **Given these growing cross-country linkages, global risks are particularly important to the UK financial system, more for their potential severity than for their likelihood of being realized.** If global interest rates rise, unusually low risk premia reverse, or major currencies move sharply, credit and market risks in the UK financial system could be realized. Extended balance sheets in the domestic nonfinancial sector are a vulnerability. Leverage, especially among commercial property companies and arising from leveraged buyouts, has grown rapidly.¹² Household debt has also increased rapidly, mostly reflecting mortgage lending.¹³ Financial institutions' own balance sheets also contain vulnerabilities. Exposures to risky and potentially illiquid instruments are rising, including structured credit products, emerging market assets, commodities, and commercial property. At the same time, reliance on wholesale funding is increasing, as reflected in the gap between customer lending and customer funding through deposits. This raises liquidity risks, as wholesale funding may be more difficult and costly to roll over during times of heightened stress.

¹² Commercial property prices have been rising quickly and could be overvalued. An FSA survey of banks' leveraged buyout activity suggests that these exposures are relatively concentrated and increasingly complex, though banks are also increasingly distributing the debt they underwrite.

¹³ The average loan-to-value ratio on banks' stock of mortgages is about 50 percent, though some aggressive lenders are posting LTVs on new loans of up to 125 percent. In addition, concerns about sub-prime mortgage lending and unsecured lending are increasing, especially given the sharp rise in personal insolvencies.

Box 5. Linkages Between Major International Banks

Staff analysis of extreme changes (“exceedances”) in distance-to-default measures in a group of major internationally-active banks yields two key results.¹ First, the transmission of shocks appears to be more important among UK banks than between UK and non-UK banks. Second, over the past few years, the transmission of shocks between UK and non-UK banks has been rising. These results suggest that, while the national focus of financial supervisory authorities has been appropriate until now, improving international cooperation in financial crisis prevention and management is becoming more important.

Significant Coexceedances, 2000-2006 (in percent of total bank transmission channels)			Change in Significant Coexceedances, 2000-03 to 2003-06 (in percentage points)		
Transmission to:			Transmission to:		
	U.K. banks	Other banks		U.K. banks	Other banks
<u>Initial shock to:</u>			<u>Initial shock to:</u>		
U.K. banks	67	9	U.K. banks	0	9
Other banks	4	13	Other banks	2	2

Source: IMF staff calculations.

1/ Jorge Chan-Lau, Srobona Mitra, Li Lian Ong, “Transmission of Shocks in the International Banking System and Implications for London as a Global Financial Center” in *United Kingdom—Selected Issues*.

31. **Risks to the UK financial system are thoroughly and systematically reviewed in reports by the BOE and the FSA.** The FSA’s *Financial Risk Outlook* highlights the key risks present in the operating environment for firms and consumers. The BOE has revamped its *Financial Stability Report* to provide a clearer, forward-looking synthesis of the most important systemic risks. The new report provides an explicit and transparent assessment of risks, including assessments of likelihood and expected impact. It also includes a chapter on the work being done to mitigate risks.

32. **The authorities are taking action to further improve the resilience of the financial system to possible shocks.** The Financial Services Authority (FSA) has reviewed the stress-testing practices of UK financial firms as part of a campaign to identify and encourage best practices. The BOE is working with the private sector to further improve understanding of the impact of interconnections between firms on risks to the financial system. The Treasury, BOE, and FSA are planning to further improve procedures and information sharing for helping deal with financial or business continuity problems. Given the growing cross-country linkages between financial systems, the authorities are planning to enhance international crisis prevention and management arrangements both within the EU

and with other countries. In all these activities, the authorities are committed to moving further towards a principles-based approach to regulation.¹⁴

VII. CONVERGENCE OF THE AUTHORITIES' AND STAFF VIEWS IS HIGH

33. **The authorities see existing policy frameworks as providing a strong platform for the economic stability they believe is essential to prosperity.** The global economy is in the midst of radical transformation with far-reaching and fundamental changes in technology, production, and trading patterns. Stability puts households and firms in a strong position to seize opportunities and respond to challenges in the evolving global environment. Policy frameworks introduced over the past decade for fiscal policy, monetary policy, and financial stability have delivered stability and will continue to do so in the future.

34. **The authorities project a favorable economic outlook.** The Treasury, the BOE, and Fund staff have similar assessments of prospects for GDP growth and the external position in 2007–08 and beyond. Indeed, even views of the current degree of economic slack—which in the past have diverged—are now similar. The only minor difference is that, while staff tend to view house prices as overvalued, Treasury officials see risks in the housing market as balanced, noting that constraints on housing supply have boosted house prices.

35. **Members of the BOE's Monetary Policy Committee (MPC) see inflation moderating to target and interest rates as well-positioned to respond to shocks.** Nevertheless, there is debate about near- and medium-term influences on inflation. Most MPC members remain concerned that higher-than-target current inflation could affect expectations and thereby forthcoming pay settlements. Others are more sanguine about pay settlements, pointing for example to the moderating influence of immigration. In light of the fall in the profit share in the non-energy sector, MPC members observe that firms may be forced to rebuild profits by raising output prices. Some point to rapid broad money growth as an upside risk to inflation, but others feel it is difficult to interpret the high contribution from money holdings by Other Financial Corporations. From a more medium-term perspective, MPC members are concerned about the implications of a flatter Phillips curve for monetary policy. The debate centers on the best way to keep inflation close to target and inflation expectations anchored, without creating excessive output volatility.

36. **The Treasury is committed to spending restraint as the underpinning for fiscal consolidation.** The tightness of already-announced settlements with some ministries provide evidence of the government's determination to deliver the projected slowdown in spending. Plans for the remaining ministries will be announced by mid-2007. The Treasury's monthly

¹⁴ Principles-based regulation allows firms to decide how best to achieve required outcomes.

monitoring of ministries' actual spending will ensure that tight expenditure ceilings are met. On revenue, with the convergence of views on the current degree of economic slack, the Treasury's and staff's projections are similar, though the Treasury envisages slightly more revenue gain on announced policies. Regarding the debt rule, the Treasury is committed to the 40 percent of GDP limit, but has not yet decided whether—after the end of the current economic cycle—this will apply at all times or just over the cycle.

37. **The authorities consider that financial sector prospects are strong and are taking action to further improve resilience.** The UK banking system is in rude health, taking in stride the financial market correction in May-June 2006 and the tightening of monetary conditions in the second half of the year. Looking ahead, the authorities see prospects as favorable but risks as underpriced. One of their key concerns is rising correlations across countries and markets, which is partly attributable to similar strategies (for trading, risk management, and stress testing) across financial institutions. London's role as a global financial center raises the risk of cross-border transmission of shocks, but it also yields benefits in terms of greater liquidity, which improves the financial system's ability to absorb shocks. Regarding financial regulation, the FSA is determined to further develop the principles-based approach and underlines the importance of subjecting proposed regulations to a thorough cost-benefit analysis.

VIII. STAFF APPRAISAL

38. **Macroeconomic performance in the United Kingdom remains impressive.** The growth of investment, productivity, and output has rebounded from a softer 2005. Although increases in inflation and the current account deficit must be watched as possible signs of capacity constraints, net immigration is likely to spur capacity growth in line with demand. The value of sterling may slightly exceed equilibrium but by a small enough margin not to be a concern. Moreover, policy frameworks are guiding policies in ways that are responsive to the requirements for sustained strong growth, low inflation, a stable value for sterling, and continuing growth of London as a global financial center with sound institutions. The near- and medium-term outlook is for continued strong and stable growth with a return of inflation to target. Given this favorable macroeconomic outlook, financial sector prospects are strong.

39. **Openness and flexibility position the United Kingdom to continue to benefit from the opportunities of globalization and to absorb shocks.** The recent rapid growth of the world economy has boosted demand for exports, especially of financial services, and allowed the United Kingdom to source goods from the lowest cost global producers. The combination of benign global financial conditions and openness to capital flows has contributed to record levels of foreign direct investment inflows, while allowing the United Kingdom to earn substantial net investment income. Admission of workers from most new EU member states has boosted the flow of immigrants and helped fill skills gaps. Openness may also increase exposure to downside global risks. And, although the flexibility of an open economy helps smooth the absorption of global shocks, macroeconomic and financial

policies also have a role. In this vein, understanding the influences of globalization and ensuring adequate cushions to respond to adverse shocks are crucial.

40. **Monetary policy is well-positioned to respond to shocks, though taming the energy-price-related increase in inflation remains a challenge.** With diminishing economic slack and possibly rising inflation expectations, incentives are weakening for a timely adjustment in real wages to permanently higher energy prices. The tightening of monetary policy since August 2006 has therefore been appropriate to help ensure that inflation returns to target. For the immediate future, continuing to communicate the importance of wage restraint will help minimize the need for additional increases in interest rates. Depending on evolving prospects for wage growth, some further tightening of monetary policy may be required. More broadly, the BOE's efforts to disentangle the influences of globalization on inflation and monetary policy, and to communicate them to the public and financial markets, are appropriate.

41. **Turning to fiscal policy, building the cushions needed to respond to adverse shocks should be a priority.** This is especially important as financial-sector and housing-related revenues may be temporarily high. Over the next few years, reducing the overall fiscal deficit to 1½ percent of GDP will be essential to halt the increase in the ratio of net debt to GDP below 40 percent. Beyond that, maintaining the deficit below 1½ percent of GDP would build the cushion required for automatic stabilizers to operate in a downturn without allowing debt to exceed 40 percent of GDP, a limit that has served the economy well. Current plans to focus this consolidation on spending restraint are appropriate, given that further increases in tax rates would risk adversely affecting incentives to work and invest. This will require disciplined choices in the forthcoming Comprehensive Spending Review. Regarding the long term, the proposed pension reform appropriately addresses the challenges to the pension system without jeopardizing fiscal sustainability.

42. **The fiscal framework is supporting the improvement in public finances.** Continuing commitment to the framework during the prospective period of strong growth will help ensure that good times are indeed used to reduce the underlying fiscal deficit. As experience grows, further steps to strengthen the framework may be desirable, though with due regard to the cost of changes. One area where change would clearly enhance confidence in the fiscal projections is broadening the reach of NAO audit.

43. **Lastly, on the financial sector, which is in a position of strength, the authorities are appropriately promoting the system's resilience.** The key financial sector vulnerabilities are low-probability events with potentially severe consequences. In addressing these risks, the authorities are right to insist on balancing the costs and benefits of regulation. Plans to further enhance stress-testing and international crisis prevention and management arrangements are welcome.

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

Table 1. United Kingdom: Selected Economic and Social Indicators

	2002	2003	2004	2005	2006	2007	2008
					Est.	Proj.	Proj.
Real Economy (change in percent)							
Real GDP	2.1	2.7	3.3	1.9	2.7	2.9	2.7
Domestic demand	3.2	2.7	3.8	1.9	2.8	3.0	2.8
CPI	1.2	1.4	1.3	2.1	2.3	2.3	2.0
Unemployment rate (in percent) 1/	5.2	5.0	4.8	4.8	5.4	5.3	5.1
Gross national saving (percent of GDP)	15.2	15.1	15.3	14.8	15.0	15.4	15.7
Gross domestic investment (percent of GDP)	16.8	16.5	16.9	17.2	17.9	18.5	18.8
Public Finance (fiscal year, percent of GDP) 2/							
General government balance	-2.1	-3.0	-3.2	-2.8	-2.5	-2.1	-1.8
Public sector balance	-2.3	-3.0	-3.3	-3.0	-2.9	-2.5	-2.2
Cyclically adjusted balance (staff estimates)	-2.3	-3.0	-3.5	-3.0	-2.8	-2.5	-2.2
Public sector net debt	31.9	33.2	34.9	36.3	37.5	38.3	38.9
FX-denominated public debt (percent of gross debt)	0.4	0.4	0.3	0.3	...	...	...
Money and Credit (end-period, 12-month percent change)							
M4	7.3	7.3	9.0	12.8	12.8	...	...
Consumer Credit	14.9	11.4	11.9	9.6	7.0	...	...
Interest rates (percent; year average)							
Three-month interbank rate	4.0	3.7	4.6	4.7	4.8	...	...
Ten-year government bond yield	4.8	4.5	4.9	4.4	4.5	...	...
Balance of Payments (percent of GDP)							
Current account balance	-1.6	-1.3	-1.6	-2.4	-2.9	-3.1	-3.2
Trade balance	-2.9	-2.7	-3.0	-3.7	-4.3	-4.3	-4.4
Net exports of oil	0.5	0.3	0.1	-0.2	-0.3	-0.4	-0.5
Exports of goods and services (volume change in percent)	1.0	1.7	4.9	7.9	10.5	-2.5	5.3
Imports of goods and services (volume change in percent)	4.8	2.0	6.6	7.0	10.5	-1.8	5.3
Terms of trade (percent change)	2.5	1.1	0.4	-2.8	-1.3	-0.5	-0.2
FDI net	-1.7	-2.2	-1.0	4.7	...	...	...
Reserves (end of period, in billion of US dollars)	42.5	46.1	49.4	46.2	51.8	...	...
Fund Position (as of December 31, 2006)							
Holdings of currency (in percent of quota)							91.3
Holdings of SDRs (in percent of allocation)							13.8
Quota (in millions of SDRs)							10,738.5
Exchange Rates							
Exchange rate regime							Floating
Bilateral rate (January 31, 2007)							US\$ = £0.51088
Nominal effective rate (2000=100) 3/	99.4	95.8	100.5	99.3	99.9	...	...
Real effective rate (2000=100) 3/ 4/	98.7	96.0	101.8	101.3	...	...	...
Social Indicators (reference year):							
Income per capita (in US dollars, 2004) : 36,419; Income distribution (ratio of income received by top and bottom quintiles, 2001): 4.9;							
Life expectancy at birth (2003): 76.2 (male) and 80.7 (female); Automobile ownership (2001): 438 per thousand;							
CO2 emissions (ton per capita, 2002): 9.06; Population density (2002) 244 inhabitants per sq. km.;							
Poverty rate (share of the population below the established risk-of-poverty line, 2003): 18%.							

Sources: National Statistics; HM Treasury; Bank of England; 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: Quarterly Growth Rates and Contribution to Growth

	2006				2007				2008			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
				Prj. Annual				Prj. Annual				Prj. Annual
Real GDP	2.9	3.0	2.8	3.3	2.7	2.8	2.8	2.8	2.7	2.7	2.7	2.7
Domestic demand	3.2	3.2	2.7	3.3	2.8	3.0	3.0	3.0	2.7	2.7	2.7	2.7
Private consumption	1.3	3.6	1.6	3.2	1.9	2.7	2.6	2.6	2.7	2.7	2.7	2.7
Government consumption	0.7	2.4	3.1	2.3	2.3	2.2	2.4	2.4	2.6	2.6	2.6	2.6
Gross fixed investment	8.3	2.0	7.6	6.6	5.7	6.8	5.6	5.5	2.6	2.6	2.7	2.7
Public investment	62.6	-36.8	10.1	0.0	7.4	19.3	18.3	18.3	-5.1	-5.1	-5.1	-5.1
Residential investment	5.5	24.6	1.9	4.9	8.3	3.6	3.2	3.2	3.2	3.2	3.2	3.2
Business investment	8.8	8.3	13.2	8.2	6.8	5.7	4.3	4.1	3.9	3.9	3.9	3.9
Foreign Balance	-0.3	-0.2	0.0	0.1	-0.2	-0.2	-0.2	-0.2	0.0	0.0	0.0	0.0
Exports of goods and services	42.9	14.3	-40.6	-0.4	10.5	5.6	5.6	5.5	5.2	5.1	5.0	5.1
Imports of goods and services	41.6	14.2	-37.0	-2.1	10.5	6.1	6.1	6.0	4.8	5.0	4.8	4.8

Sources: Office for National Statistics; and staff estimates.

Table 3. United Kingdom: Balance of Payments

	2004	2005	2006	2007	2008	2009	2010	2011	2012
			Proj.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Current account	-19.3	-29.5	-37.1	-41.7	-45.7	-49.5	-52.9	-54.8	-57.8
Trade balance	-35.0	-45.4	-55.8	-59.2	-63.6	-67.5	-70.1	-73.0	-76.9
Trade in goods	-60.9	-68.8	-83.1	-87.3	-92.6	-98.7	-103.9	-109.1	-114.4
Exports	190.9	211.6	241.8	226.8	242.4	252.3	264.2	277.8	292.4
Imports	251.8	280.4	325.0	314.2	335.0	351.1	368.1	386.8	406.9
Trade in services	25.9	23.4	27.3	28.1	29.0	31.2	33.8	36.1	37.5
Exports	107.8	111.7	120.2	124.9	130.6	137.4	144.6	151.8	158.4
Imports	81.9	88.3	92.9	96.8	101.6	106.2	110.8	115.7	120.9
Income balance	26.6	27.2	28.7	29.5	30.8	31.9	32.1	33.8	35.4
Current transfers	-10.9	-12.1	-11.1	-12.0	-12.9	-13.8	-14.8	-15.6	-16.4
Central government	-8.3	-9.5	-9.4	-10.2	-11.0	-11.9	-12.7	-13.4	-14.1
Other sectors	-2.6	-2.6	-1.6	-1.8	-1.9	-2.0	-2.1	-2.2	-2.3
Capital account	2.1	2.6	...	...	...	...	...	...	...
Financial account	5.6	30.7	...	...	...	...	...	...	...
Direct investment	-11.4	57.8	...	...	...	...	...	...	...
Portfolio investment	-53.6	-41.2	...	...	...	...	...	...	...
Other investment	70.9	14.8	...	...	...	...	...	...	...
Reserve assets	-0.2	-0.7	...	...	...	...	...	...	...
Net errors and omissions	11.6	-3.9	...	...	...	...	...	...	...
Current account	-1.6	-2.4	-2.9	-3.1	-3.2	-3.3	-3.3	-3.3	-3.3
Trade balance	-3.0	-3.7	-4.3	-4.3	-4.4	-4.5	-4.4	-4.3	-4.4
Trade in goods	-5.2	-5.6	-6.5	-6.4	-6.4	-6.5	-6.5	-6.5	-6.5
Exports	16.2	17.3	18.8	16.6	16.8	16.6	16.5	16.5	16.6
Imports	21.4	22.9	25.2	23.0	23.3	23.2	23.0	23.0	23.1
Trade in services	2.2	1.9	2.1	2.1	2.0	2.1	2.1	2.1	2.1
Exports	9.2	9.1	9.3	9.2	9.1	9.1	9.0	9.0	9.0
Imports	7.0	7.2	7.2	7.1	7.1	7.0	6.9	6.9	6.9
Income balance	2.3	2.2	2.2	2.2	2.1	2.1	2.0	2.0	2.0
Current transfers	-0.9	-1.0	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9
Capital and financial account	0.7	2.7	...	...	...	...	...	...	...
<i>Of which:</i>									
Direct investment	-1.0	4.7	...	...	...	...	...	...	...
Portfolio investment	-4.6	-3.4	...	...	...	...	...	...	...
Other investment	6.0	1.2	...	...	...	...	...	...	...

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

Table 4. United Kingdom: Medium-Term Scenario
(Percentage change, unless otherwise indicated)

	2004	2005	2006	2007	2008	2009	2010	2011	2012
Real GDP	3.3	1.9	2.7	2.9	2.7	2.7	2.7	2.7	2.7
Real domestic demand	3.8	1.9	2.8	3.0	2.8	2.7	2.7	2.7	2.7
Private consumption	3.4	1.4	1.9	2.7	2.7	2.7	2.7	2.7	2.7
Government consumption	3.2	3.1	2.3	2.4	2.5	2.6	2.6	2.6	2.6
Fixed investment	6.0	3.4	5.7	6.1	3.7	3.2	2.7	2.6	2.5
Public 1/	8.3	14.8	7.4	9.5	3.0	2.0	2.0	2.0	2.0
Residential	9.9	2.2	8.3	4.7	3.2	2.9	2.6	2.6	2.6
Business 1/	2.3	3.5	6.8	6.6	4.0	3.5	2.9	2.6	2.6
Stocks 2/	0.1	-0.1	0.2	-0.1	0.0	0.0	0.0	0.0	0.0
External balance 2/	-0.6	0.0	-0.3	-0.2	-0.2	-0.2	-0.1	-0.1	-0.1
Exports of Goods and Services	4.9	7.9	10.5	-2.5	5.3	5.1	5.0	5.0	5.1
Imports of Goods and Services	6.6	7.0	10.5	-1.8	5.3	5.0	4.9	4.9	4.9
Exports of Goods and Services (ex. fraud) 3/	5.6	5.1	5.9	5.4	5.3	5.1	5.0	5.0	5.1
Imports of Goods and Services (ex. fraud) 3/	7.3	4.5	6.4	5.3	5.3	5.0	4.9	4.9	4.9
Current account 4/	-1.6	-2.4	-2.9	-3.1	-3.2	-3.3	-3.3	-3.3	-3.3
CPI Inflation	1.3	2.1	2.3	2.3	2.0	2.0	2.0	2.0	2.0
Output gap	0.5	-0.2	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Employment and productivity									
Employment	1.0	0.9	0.8	0.7	0.6	0.5	0.5	0.5	0.5
Unemployment rate 5/	4.8	4.8	5.4	5.3	5.1	5.0	4.9	4.9	4.9
Productivity 6/	2.5	1.1	2.1	2.1	2.1	2.2	2.1	2.1	2.1

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.

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

(Percent of GDP and percent of potential GDP)

	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
PBR 2006 projections								
Total revenue	38.0	39.3	39.8	40.3	40.5	40.5	40.5	40.5
Current revenue	37.9	39.2	39.7	40.2	40.4	40.4	40.4	40.4
Primary revenue	37.5	38.7	39.3	39.8	40.0	40.0	39.9	40.0
Tax revenue	35.8	36.91	37.3	37.8	38.1	38.1	38.1	38.1
Non-tax revenue	1.7	1.8	2.0	1.9	1.9	1.9	1.8	1.9
Interest revenue	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.4
Capital revenue	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Total expenditure	41.3	42.3	42.6	42.6	42.4	42.2	42.0	41.8
Current expenditure	38.2	39.1	38.9	38.9	38.8	38.6	38.4	38.2
Primary expenditure	36.2	36.9	36.8	36.8	36.7	36.5	36.3	36.1
Interest payments	2.1	2.2	2.2	2.1	2.1	2.1	2.1	2.1
Capital expenditure	3.1	3.3	3.7	3.6	3.6	3.7	3.7	3.6
Depreciation	1.3	1.3	1.3	1.3	1.4	1.4	1.4	1.3
Current balance 2/	-1.6	-1.2	-0.6	-0.1	0.3	0.5	0.6	0.8
Overall balance	-3.3	-3.0	-2.8	-2.3	-1.9	-1.7	-1.5	-1.3
Net debt 3/	34.9	36.4	37.5	38.2	38.6	38.7	38.7	38.5
<i>Cyclically adjusted 4/</i>								
Current balance 2/	-1.6	-1.0	-0.4	-0.1	0.3	0.5	0.6	0.8
Overall balance	-3.2	-2.8	-2.6	-2.2	-1.9	-1.7	-1.5	-1.3
Output gap	0.0	-0.4	-0.2	0.0	0.0	0.0	0.0	0.0
Deflator growth	2.8	1.9	2.7	2.7	2.7	2.7	2.7	2.7
Real GDP growth	2.9	1.9	2.8	2.8	2.4	2.4	2.4	2.4
Staff projections								
Total revenue	38.0	39.3	39.7	40.1	40.2	40.2	40.2	40.2
Current revenue	37.9	39.2	39.6	40.0	40.1	40.1	40.1	40.1
Primary revenue	37.5	38.7	39.2	39.5	39.6	39.7	39.7	39.7
Tax revenue	35.8	36.9	37.2	37.6	37.8	37.8	37.8	37.8
Non-tax revenue	1.7	1.8	2.0	1.9	1.9	1.9	1.9	1.9
Interest revenue	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.4
Capital revenue	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Total expenditure	41.3	42.3	42.6	42.6	42.4	42.3	42.1	41.8
Current expenditure	38.2	39.0	38.9	39.0	38.8	38.6	38.4	38.2
Primary expenditure	36.2	36.9	36.7	36.8	36.6	36.4	36.2	36.1
Interest payments	2.1	2.1	2.2	2.2	2.2	2.2	2.2	2.2
Capital expenditure	3.1	3.2	3.7	3.6	3.6	3.6	3.7	3.6
Depreciation	1.3	1.3	1.3	1.3	1.4	1.4	1.4	1.3
Current balance 2/	-1.6	-1.2	-0.6	-0.4	-0.1	0.1	0.3	0.6
Overall balance	-3.3	-3.0	-2.9	-2.5	-2.2	-2.0	-1.8	-1.6
Net debt 3/	34.9	36.3	37.5	38.3	38.9	39.3	39.5	39.6
<i>Cyclically adjusted 4/</i>								
Current balance 2/	-1.8	-1.2	-0.6	-0.4	-0.1	0.1	0.3	0.6
Overall balance	-3.5	-3.0	-2.8	-2.5	-2.2	-2.0	-1.8	-1.6
Output gap	0.4	-0.2	-0.2	0.0	0.0	0.0	0.0	0.0
Deflator growth	2.8	1.9	2.7	2.8	2.7	2.6	2.7	2.3
Real GDP growth	2.9	1.9	2.9	2.8	2.7	2.7	2.6	2.7

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

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

2/ Including depreciation.

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

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

Appendix I. United Kingdom: Sustainability Exercises

Fiscal sustainability

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

In the *baseline scenario*, which assumes that no policy action is taken, the net public debt-to-GDP ratio¹ grows from 38.8 percent of GDP in 2006 to about 41 percent of GDP in 2011, given the staff projection that the primary balance turns to small surplus by 2011 (Figure A1 and Table A1). This rise in the public debt ratio is unlikely to create debt management problems, given that it is relatively slow and from a level that is one of the lowest among industrial countries. The stabilization of the public debt ratio would require the primary balance to remain at 0.1 percent of GDP.

In the *alternative scenarios*, the evolution of the public debt-to-GDP ratio is generally similar to that in the baseline. Only Scenario A1 shows a decline in the debt ratio, reflecting the assumption (consistent with the historical average) that the primary balance is in surplus. Scenario A2 indicates a somewhat larger increase in the debt ratio, consistent with the assumption of constant primary balance in 2006–11.

In the *bound test scenarios*, the debt ratio stays below 50 percent of GDP in most cases. The worst deterioration—to 51 percent of GDP—occurs under the assumption that contingent liabilities amounting to 10 percent of GDP materialize in 2007.

External sustainability

External sustainability does not appear to be an issue in the United Kingdom (Table A2). The UK's role as an international financial center implies large gross external assets and liabilities (gross external liabilities in 2005 were about 400 percent of GDP, compared to about 100 percent of GDP in the United States). The impact of revaluations on the net external position has been greater than that of financial flows in all but two years since 1990 (valuation changes have been dominated by currency effects). Cross-border mergers and acquisitions can also have a sizable impact on the net external position. As a result, one standard deviation for both net portfolio investment and net foreign direct investment (calculated over the last ten years) is about 10 percentage points of GDP.

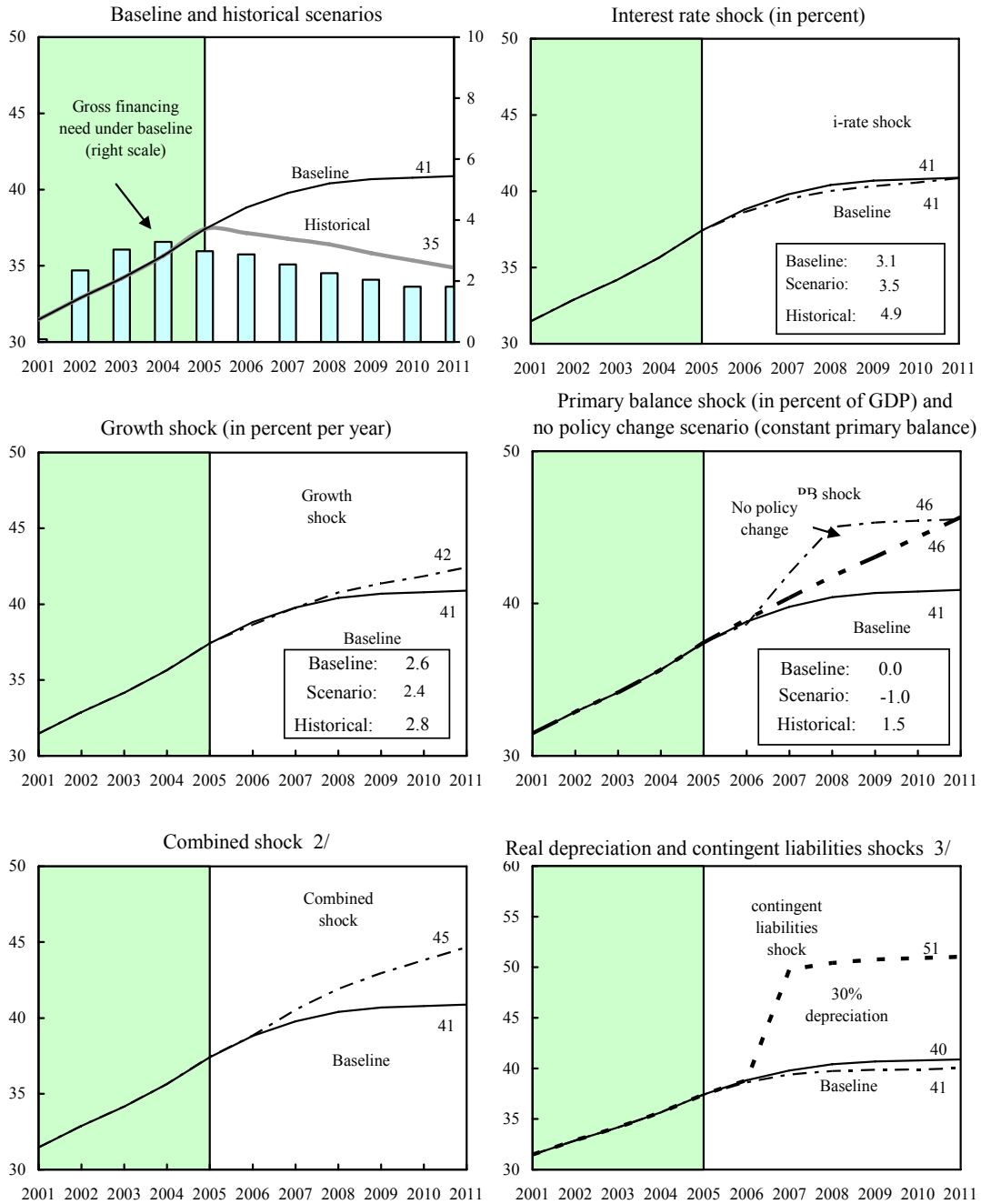
¹ The definition of the debt ratio in this exercise differs from that shown in official and staff projections. The latter uses centered-GDP as the denominator.

The composition of the international investment position (IIP) has allowed the UK to earn positive investment income despite having a sizable negative net external position. The UK has a large positive net position in FDI, which has a high rate of return; and a large negative position in bonds and bank deposits, on which the return (in this case, the interest rate on net liabilities) is low. The return on FDI may be overstated due to measurement problems: it is difficult to value the stock of FDI on a current basis. Using the book value as a proxy could understate the size of UK's net FDI position and therefore overstate the return. The ability of the UK to generate a positive return on negative net external assets has mitigated the effect of the widening trade deficit on the current account. This may help explain the relative stability of the REER over the past few years.

London's growing role as an international financial center increases the risk of transmission of global shocks to the domestic economy through the financial sector. However, empirical evidence suggests that the transmission of shocks among the main UK banks is still much more important than that between the main UK and non-UK banks.² In addition, the breadth and depth of the financial sector improves its ability to absorb shocks.

² Li Lian Ong, "Transmission of Shocks in the International Banking System and Implications for London as a Global Financial Center," Selected Issues Paper.

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



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

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

2/ Permanent 1 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).

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

	2000	2001	2002	2003	2004	2005	2006Q3
Assets	313	316	300	318	337	398	410
Direct investment abroad	65	62	61	62	59	61	60
Portfolio investment abroad	95	94	80	84	93	112	115
Other investment abroad	150	158	156	170	183	222	233
Reserve assets	3	3	2	2	2	2	2
Liabilities	315	322	303	322	346	410	429
Direct investment in the UK	33	36	32	32	33	41	45
Portfolio investment in the UK	105	96	85	94	100	115	122
Other investment in the UK	178	190	186	196	213	254	262
Net investment position	-3	-6	-3	-4	-9	-12	-19
Direct investment	32	25	28	30	26	21	15
Portfolio investment	-10	-2	-5	-10	-7	-3	-6
Other investment	-28	-32	-30	-26	-30	-31	-29
Reserve assets	3	3	2	2	2	2	2
Monetary Financial Institutions	-7	-9	-13	-14	-16	-13	-12
Other Sectors	7	6	12	14	12	8	1
Public Sector	-3	-3	-2	-3	-5	-7	-7
<i>Memorandum Items:</i>							
Change in the net investment position		-3.4	2.4	-0.5	-5.5	-2.3	-7.0
o/w Valuation change		-1.6	3.1	1.3	-5.0	0.2	-4.1
Current account balance		-2.2	-1.6	-1.3	-1.6	-2.4	-2.9

Source: Office on National Statistics.

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

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

	2000	2001	2002	2003	2004	2005	2006	as of:
External indicators								
Exports (annual percentage change, in U.S. dollars) 1/	4.6	-3.1	5.5	12.4	17.3	8.4	2.9	Sept, 06
Imports (annual percentage change, in U.S. dollars) 1/	5.3	-0.7	6.8	11.5	18.8	10.3	3.4	Sept, 06
Terms of trade (annual percentage change)	-2.1	-0.7	2.4	2.6	0.8	-0.2	0.2	June, 06
Current account balance	-2.6	-2.2	-1.6	-1.3	-1.6	-2.4	-3.1	Sept, 06
Capital and financial account balance	1.5	1.9	0.8	2.0	0.7	2.7	2.9	Sept, 06
<i>Of which</i> : Foreign direct investment (net)	-7.9	-0.5	-1.7	-2.2	-1.0	4.7	2.3	Sept, 06
Portfolio investment (net)	10.4	-3.9	4.8	5.3	-4.6	-3.4	0.6	Sept, 06
Other investment (net)	-0.9	5.0	-2.5	-0.9	6.7	1.4	0.9	Sept, 06
Net errors and omissions	1.1	0.3	0.8	-0.6	1.0	-0.3	0.1	Sept, 06
Official reserves (in billions of U.S. dollars, end of period) 2/	48.1	39.4	42.5	46.1	49.7	48.1	51.4	Sept, 06
Central bank net foreign assets (in billions of U.S. dollars)	-1.7	2.2	1.2	0.6	-2.0	-3.2	-4.9	Sept, 06
Foreign assets of banking institutions (in billions of U.S. dollars)	2106.2	2208.9	2499.6	3074.0	3763.6	4105.1	4950.3	Sept, 06
Foreign liabilities of banking institutions (in billions of U.S. dollars)	2094.4	2236.6	2590.8	3162.2	3895.6	4115.0	4929.5	Sept, 06
Exchange rate against U.S. dollar (period average)	1.52	1.44	1.50	1.63	1.83	1.82	1.84	
Financial markets indicators								
Public sector net debt 12/	33.0	31.8	32.7	33.5	35.5	37.3	38.1	Dec, 06
3-month T-bill yield	5.8	4.8	3.9	3.6	4.4	4.6	4.6	Dec, 06
3-month T-bill yield (real) 3/	2.6	3.1	0.9	1.0	1.2	2.2	0.6	Dec, 06
Change in stock market index FTSE All shares (percent, end of period)	-8.0	-15.4	-25.0	16.6	9.2	18.1	13.2	Dec, 06
Spread of 3-month T-bill vs. the U.S. (percentage points)	-0.2	2.1	2.7	3.0	2.5	0.4	0.3	Dec, 06
Credit indicators 4/								
M4 lending (exc. effect of securitisations and loan transfers)	12.4	8.9	10.4	11.7	12.7	12.2	15.0	Dec, 06
Total lending to individuals								
Secured on dwellings	8.2	10.0	13.3	15.0	12.9	10.4	11.5	Dec, 06
Consumer credit	13.4	14.7	15.9	14.0	14.4	10.1	6.2	Dec, 06
o/w Credit card	21.1	17.2	18.7	21.1	21.2	11.5	4.0	Dec, 06
M4 lending to private non financial corporations	12.4	7.5	6.9	6.7	7.1	17.8	18.9	Dec, 06
Lending to construction sector	26.4	16.5	10.1	5.1	14.5	9.7	12.3	Sept, 06
Lending to real estate sector	27.6	25.3	21.8	15.6	16.1	18.3	16.6	Sept, 06
Interest rate on personal loans 5/	15.4	15.7	15.9	15.0	12.8	14.3	14.2	Dec, 06
Interest rate on fixed rate mortgages 5/	7.1	6.5	5.7	5.3	5.7	5.5	5.2	Dec, 06
Interest rate on time deposits 5/	4.2	4.4	2.6	2.5	2.1	3.1	2.9	Dec, 06
Financial sector risk indicators 6/								
Total loans to assets (percent)	82.0	82.1	83.1	83.4	83.2	82.6	82.3	Sept, 06
Total loans to deposits (percent)	92.9	92.2	93.8	93.6	92.5	91.7	91.9	Sept, 06
Foreign exchange loans (in US\$bn)	1698.5	1789.1	2059.5	2599.3	3165.5	3391.1	4065.2	Sept, 06
Share of foreign exchange loans in total lending (percent)	41.4	41.8	41.3	42.7	43.0	44.3	44.3	Sept, 06
Deposits in foreign exchange (in US\$bn)	1995.0	2157.4	2699.9	3396.2	4126.4	4424.9	5307.9	Sept, 06
Share of foreign deposits in total deposits (percent)	57.3	57.8	57.9	56.1	57.3	58.4	57.9	Sept, 06
Share of foreign denominated liabilities in total liabilities (percent)	52.4	52.5	52.8	54.3	54.7	56.5	56.5	Sept, 06
Share of real estate sector in private credit (percent) 7/	46.9	47.5	48.8	49.4	48.7	48.0	47.1	Sept, 06
Share of real estate sector in loans to non financial private corporations (percent) 7/	27.9	32.1	35.4	39.4	43.1	42.0	41.8	Sept, 06
Share of non-performing loans in total loans (percent) 7/ 8/ 9	2.5	2.6	2.6	2.5	1.9	1.0	...	Dec, 05
Regulatory capital to risk-weighted assets 8/ 10/ 12	13.0	13.2	13.1	13.0	12.7	12.8	...	Dec, 05
Return on Equities	13.5	7.7	6.1	8.6	10.9	11.8	...	Dec, 05
Return on assets (before taxes) 8/ 11/ 13	0.9	0.5	0.4	0.6	0.7	0.8	...	Dec, 05

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

1/ Exports and imports of trade in goods and services at current prices

2/ Including gold, national valuation.

3/ Calculated as 3-month T-bill over actual 12-month RPI inflation in Dec of relevant year.

4/ Twelve-month growth rates.

5/ Weighted averages for banks and building societies.

6/ Building societies and insurance companies are excluded from this sample. 'Deposits' includes currency, deposits and money market instruments.

7/ The figures for non-performing loans represent the gross value of loans against which specific provisions have been made.

8/ Includes mortgage banks.

9/ NPL's to Total Loans calculated using prospective methodology that will be used for the Financial Soundness Indicator (FSI) of the same name.

10/ Capital to RWA calculated using prospective methodology that will be used for the Financial Soundness Indicator (FSI) of the same name.

11/ Return on Assets calculated using prospective methodology that will be used for the Financial Soundness Indicator (FSI) of the same name.

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

UNITED KINGDOM—ANNEXES TO THE 2006 ARTICLE IV CONSULTATION STAFF REPORT

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Annex I. United Kingdom: Basic Data

Demographic and other data:

Area	94,247 square miles (244,100 sq. km.)
Population (mid 2005)	60.2
Infant mortality (per 1,000 live births, 2004)	5.1
GDP per capita (2005)	SDR 24,439

Composition of GDP in 2005, at current prices	In billions of Pounds		Distribution in Percent			
Private consumption	791.3		64.7			
Public consumption	269.0		22.0			
Total investment (including stockbuilding)	206.6		16.9			
Total domestic demand	1267.0		103.6			
Exports of goods and services	325.9		26.7			
Imports of goods and services	370.5		30.3			
GDP at market prices	1222.4		100			
Selected economic data	2002	2003	2004	2005	2006 Proj.	2007 Proj.
Output and unemployment:	(Annual percentage change)					
Real GDP (at market prices)	2.1	2.7	3.3	1.9	2.7	2.8
Industrial production (excluding construction)	-1.9	-0.3	0.8	-1.8	...	...
Unemployment (in percent)	5.2	5.0	4.7	4.8	5.4	5.2
Earnings and prices:	 					
Average earnings in manufacturing	3.5	3.6	3.7	4.3	4.8	5.5
CPI inflation (average)	1.2	1.4	1.3	2.1	2.3	2.3
Money and interest rates:	 					
M0 (end of period)	6.4	7.4	5.7	4.7	6.2	...
M4 (end of period)	7.3	7.3	9.0	12.8	13.0	...
3-month Interbank rate	4.0	3.7	4.6	4.7	4.8	...
10-year government bond yield	4.8	4.5	4.9	4.4	4.5	...
	(In billions of pounds sterling)					
Fiscal accounts (In percent of GDP): 1/	 					
General government balance	-2.1	-3.0	-3.2	-2.8	-2.5	-2.1
Public sector balance	-2.3	-3.0	-3.3	-3.0	-2.9	-2.5
Public sector net debt	31.9	33.2	34.9	36.3	37.5	38.3
Balance of payments (4 quarters moving sum):	 					
Current account balance	-16.5	-14.9	0.0	-29.5	-36.8	-42.1
(In percent of GDP)	-1.6	-1.3	-1.6	-2.4	-2.9	-3.1
Trade balance	-30.9	-29.4	77.6	-44.6	-54.4	-59.6
Exports	276.5	285.4	77.6	325.9	365.8	355.9
Imports	307.4	314.8	0.0	370.5	420.2	415.5
Direct investment (net)	-18.3	-24.1	-11.4	57.8	...	...
Portfolio investment (net)	50.0	59.0	-53.6	-41.2	...	...
Reserve assets	0.5	1.6	-0.2	-0.7	...	...

Source: National Statistics; HM Treasury; Eurostat; and IMF staff estimates.

1/ Fiscal year beginning April 1.

Annex II. United Kingdom: Fund Relations
(As of December 31, 2006)

I.	Membership Status:	Joined 12/27/1945; Article VIII	
II.	General Resources Account:	SDR Million	% Quota
	Quota	10,738.50	100.00
	Fund holdings of currency	9,798.97	91.25
	Reserve position in Fund	939.63	8.75
III.	SDR Department:	SDR Million	% Allocation
	Net cumulative allocation	1,913.07	100.00
	Holdings	263.03	13.75
	Designation Plan	0.00	
IV.	Outstanding Purchases and Loans:	None	
V.	Financial Arrangements:	None	
VI.	Projected Obligations to Fund:	None	
VII.	Exchange Rate Arrangement:		

The U.K. authorities maintain a floating regime. As of January 31, 2007 the exchange rate for sterling was \$1.97. In accordance with UN resolutions and EU restrictive measures, the United Kingdom applies targeted financial sanctions under legislation relating to Al-Qaeda and Taliban, and individuals, groups, and organizations associated with terrorism; and certain persons associated with: the former Government of Iraq, the former Government of Liberia, the current Government of Burma (aka Myanmar), the former Government of the Republic of Yugoslavia and International Criminal Tribunal Indictées, the current Government of Zimbabwe, the current government of Belarus, the current government of North Korea; the current government of Iran and persons considered to be a threat to peace and reconciliation in Sudan, Cote d'Ivoire, and Democratic Republic of Congo; and persons considered by the UN to have been involved in the assassination of former Lebanese Prime Minister Rafik Hariri. These restrictions have been notified to the Fund under Decision 144-(52/51).

VIII. Article IV Consultation:

Discussions for the 2005 Article IV consultation were conducted in London during December 8–19, 2005. The Staff Report (IMF Country Report No. 06/86) was considered by the Executive Board on March 1, 2006 (EBM/06/20).

IX. FSAP

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

X.	Technical Assistance:	None
XI.	Resident Representative:	None

Annex III. United Kingdom: Statistical Issues

The United Kingdom maintains high standards in the provision of economic data which are adequate for surveillance purposes. The authorities publish a full range of economic and financial data including electronically and have subscribed to the Special Data Dissemination Standard (SDDS). The U.K. shifted to ESA95 in September 1997. More recently, the authorities have implemented a number of important methodological changes to the national accounts dataset, most of which were related to the adoption of ESA95. In 2003 the authorities introduced further revisions reflecting a shift to annual chain-linking, corrections for import fraud, and revisions in some volatile construction data. The authorities have indicated plans to report monetary and financial statistics to STA (using *Standardized Report Forms*) for publication in the *International Financial Statistics (IFS) Supplement*, beginning early 2007.

Table of Common Indicators Required for Surveillance
(As of January 19, 2007)

	Date of latest observation	Date received	Frequency of Data ⁶	Frequency of Reporting ⁶	Frequency of Publication ⁶
Exchange Rates	1/19/07	1/19/07	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	Nov 2006	Dec 2006	M	M	M
Reserve/Base Money	Nov 2006	Dec 2006	M	M	M
Broad Money	Nov 2006	Dec 2006	M	M	M
Central Bank Balance Sheet	Dec 2006	Dec 2006	M	M	M
Consolidated Balance Sheet of the Banking System	Nov 2006	Dec 2006	M	M	M
Interest Rates ²	1/19/07	Jan 2007	D	D	D
Consumer Price Index	Dec 2006	Jan 2007	M	M	M
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	Nov 2006	Dec 2006	M	M	M
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	Nov 2006	Dec 2006	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	Nov 2006	Dec 2006	M	M	M
External Current Account Balance	Q3 2006	Jan 2007	Q	Q	Q
Exports and Imports of Goods and Services	Nov 2006	Oct 2006	M	M	M
GDP/GNP	Q3 2006	Dec 2006	Q	Q	Q
Gross External Debt	Q3 2006	Dec 2006	Q	Q	Q

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

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

³Foreign, domestic bank, and domestic nonbank financing.

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

⁵Including currency and maturity composition.

⁶Daily (D), weekly (W), monthly (M), quarterly (Q), annually (A), irregular (I), and not available (NA)

**Statement by Mr. Tom Scholar, Executive Director for United Kingdom
February 28, 2007**

My authorities value their annual consultation with staff and will carefully consider their comments. There is a broad level of agreement on most aspects of economic policy.

The economic fundamentals in the UK remain sound. Growth was at trend (2.7 percent) in 2006 and is forecast in the 2006 Pre-Budget Report at 2 ³/₄ - 3 ¹/₄ percent in 2007, and 2 ¹/₂ - 3 percent in 2008. CPI inflation rose to 3 per cent at the end of the year, reflecting higher energy and import prices, but is expected to return to its 2 percent target by the end of 2007. Employment remains at record levels of 74.5 percent. As staff report, there are risks, both upside and downside: my authorities remain vigilant to these and agree with staff on the need for cautious macroeconomic policies, to which they are fully committed.

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

- fiscal policy set according to two fiscal rules:
 - The golden rule – over the cycle, the Government will borrow only to invest and not to fund current spending;
 - The sustainable investment rule – over the cycle, public sector net debt will be held at a stable and prudent level, defined as 40 percent of GDP or less;
- Monetary policy set by the Bank of England's Monetary Policy Committee to meet a symmetric inflation target.

My authorities agree with staff that the macroeconomic policy framework has served the UK well, guiding policies and anchoring expectations to deliver long-term stability.

My authorities concur with staff that monetary policy is well-positioned, but that continued vigilance is needed to ensure that inflation returns to target. The current monetary policy framework gives the Monetary Policy Committee flexibility to adapt its analysis in the light of events and new data, while maintaining a focus on the inflation target and thus anchoring inflation expectations. The present policy framework should have the capacity to withstand more turbulent times, should they materialise.

Fiscal policy will, as usual, be set in the budget. My authorities' plans will reduce the deficit over the medium term. The latest official projections show a gradual reduction to 1.3 percent of GDP, with an average annual surplus on the current budget over the cycle, and net debt stabilising at 38.5 per cent. My authorities are therefore meeting the fiscal rules. As staff note, my authorities have already taken a number of steps to restrain spending growth and

deliver medium-term fiscal consolidation by committing to, for the period 2008-09 to 2010-11:

- a series of early departmental spending settlements at or below the rate of inflation;
- cross-government value for money savings of at least 3 percent per annum;
- a 5 per cent annual real reduction in administration budgets across departments; and
- ensuring public sector pay settlements are affordable and consistent with the 2 percent inflation target.

Full departmental spending allocations for this period will be announced later this year following the conclusion of the Comprehensive Spending Review.

As staff note, the fiscal framework has performed well, constraining discretion and protecting public investment, and allowing fiscal policy to respond to shocks such as the global slowdown in 2001- 2002. With a decade of experience the framework is very well established, and my authorities believe that stability in the framework has strengthened its credibility. Defining the rules over the cycle has been central to this. As staff note, the authorities have broadened the scope of independent audit by the National Audit Office of key budget assumptions. Last year the National Audit Office approved the methodology for dating the economic cycle; this year they are auditing five assumptions, including tax compliance, the VAT gap, and tobacco receipts.

On the financial sector, there is, as noted in the staff report, a high degree of convergence between the views of staff and the authorities. The Bank of England's relaunched Financial Stability Report provides a forward-looking analysis of the systemic risks to the UK economy as well as efforts to mitigate these risks. The authorities are working with the private sector to improve stress testing, including understanding the links between firms. International efforts to coordinate crisis prevention and management are vital and the UK is working towards improving these mechanisms.



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
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DEPARTMENT

Public Information Notice (PIN) No. 07/28
FOR IMMEDIATE RELEASE
March 5, 2007

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

IMF Executive Board Concludes 2006 Article IV Consultation with the United Kingdom

On February 28, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the United Kingdom.¹

Background

Macroeconomic performance in the United Kingdom remains impressive. After softer growth in 2005, the acceleration in GDP in 2006 was broadly based. Business investment was boosted by high net rates of return; residential investment by a pickup in house price appreciation; private consumption by robust employment growth, steady wage growth, and rising household wealth; and exports by the recovery in the euro area. Most indicators suggest little economic slack as of end-2006. CPI inflation rose above the 2 percent target in May 2006, mostly due to higher energy prices, and reached 3 percent in December. Although the current account deficit and the international investment position deteriorated in 2006, neither is a significant vulnerability and competitiveness is broadly appropriate.

In light of diminishing spare capacity, concerns about second-round effects of cost pressures, and rapid broad money growth, the Bank of England began raising the policy interest rate in mid-2006. The policy rate was raised on three occasions to 5¼ percent in January 2007. Given projected nominal GDP growth of about 5½ percent over the medium term, the current policy interest rate is broadly neutral.

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

A substantial fiscal expansion in 2001-04 led to a sharp deterioration in the fiscal balance and rising net public debt. A reversal of the deficit started in 2005-06, with the cyclically-adjusted overall balance relative to GDP estimated to have improved by $\frac{3}{4}$ percentage points over two years. This reflected primarily higher financial sector-related revenues, windfall energy-price-related revenues, and a higher tax rate on North Sea firms. The growth rate of current spending in 2006 is estimated to have been in line with nominal GDP growth.

The financial sector continues to thrive and linkages with financial systems in other countries continue to grow. Net exports of financial services have risen steadily over the past decade and increased sharply in recent years. Ratings agencies rank the highly profitable banking system as one of the strongest in the world. Linkages between the main UK and non-UK banks are getting stronger. Bank regulation and supervision have responded well to these developments. The life insurance industry has returned to a more stable outlook.

Executive Board Assessment

The Executive Directors welcomed the economy's continued impressive performance, which they attributed in part to policy frameworks that guide policies in ways that are responsive to the requirements for sustained strong growth, low inflation, a stable value for sterling, and continuing growth of London as a global financial center with sound institutions.

With the rebound in growth in 2006, Directors considered that increases in inflation and the current account deficit need to be watched as possible signs of capacity constraints, though going forward net immigration is likely to support capacity growth in line with demand. The near- and medium-term outlook is for continued strong and stable growth with a return of inflation to target. A number of Directors considered, however, that vulnerabilities, including those associated with high housing prices, warrant vigilance.

Directors agreed that openness and flexibility position the United Kingdom to continue to benefit from the opportunities of globalization and to absorb shocks. The recent rapid growth of the world economy has boosted demand for exports, especially of financial services. The combination of benign global financial conditions and openness to capital flows has contributed to record levels of foreign direct investment inflows. Admission of workers from most new EU member states has boosted the flow of immigrants and helped fill skills gaps. Openness may also increase exposure to downside global risks. And, although the flexibility of an open economy helps smooth the absorption of global shocks, macroeconomic and financial policies also have a role. In this vein, understanding the influences of globalization and ensuring adequate cushions for policies to respond to adverse shocks are crucial.

Directors noted that monetary policy is well-positioned to respond to shocks, though taming the energy-price-related increase in inflation remains a challenge. They agreed that the exchange rate may be slightly overvalued, though well within the bounds of uncertainty associated with such estimates, and in any case by a small enough margin not to be a concern. With diminishing economic slack and possibly rising inflation expectations, incentives are weakening

for a timely adjustment in real wages to permanently higher energy prices. The tightening of monetary policy since August 2006 has therefore been appropriate to help ensure that inflation returns to target. For the immediate future, continuing to communicate the importance of wage restraint will help minimize the need for additional increases in interest rates. Depending on evolving prospects for wage growth, some further tightening of monetary policy may be required. More broadly, the Bank of England's efforts to disentangle the influences of globalization on inflation and monetary policy, and to communicate them to the public and financial markets, are appropriate.

Directors welcomed the government's plans for fiscal consolidation. Given the favorable medium-term outlook and the possibility that financial-sector and housing-related revenues may be temporarily high, Directors agreed that building the fiscal cushions needed to respond to adverse shocks should be a priority. Over the next few years, reducing the overall fiscal deficit will be essential to halt the increase in the ratio of net debt to GDP. Beyond that, maintaining a low deficit would build the cushion required for automatic stabilizers to operate in a downturn without allowing debt to exceed 40 percent of GDP, a limit that has served the economy well. The plan to focus this consolidation on spending restraint is appropriate, given that further increases in tax rates would risk adversely affecting incentives to work and invest. This will require disciplined choices in the forthcoming Comprehensive Spending Review. Regarding the long term, the proposed pension reform appropriately addresses the challenges to the pension system without jeopardizing fiscal sustainability.

Directors commended the fiscal framework for supporting the improvement in public finances. Continuing commitment to the framework during the prospective period of strong growth will help ensure that good times are indeed used to reduce the underlying fiscal deficit. As experience grows, further steps to strengthen the framework may be desirable, though with due regard to the cost of changes. One area where change would enhance confidence in the fiscal projections is broadening the reach of the National Audit Office audit of key fiscal assumptions.

Directors praised the financial authorities' efforts to further enhance the resilience of the financial system. With the financial sector in a strong position, the key vulnerabilities are to low-probability events with potentially severe consequences. In addressing these risks, the authorities are right to insist on balancing the costs and benefits of regulation. Plans to further enhance stress-testing and international crisis prevention and management arrangements are welcome.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The [staff report](#) (use the free [Adobe Acrobat Reader](#) to view this pdf file) for the 2006 Article IV Consultation with United Kingdom is also available.

United Kingdom: Selected Economic and Social Indicators

	2002	2003	2004	2005	2006 Est.	2007 Proj.
Real Economy						
Real GDP (change in percent)	2.1	2.7	3.3	1.9	2.7	2.9
Domestic demand (change in percent)	3.2	2.7	3.8	1.9	2.8	3.0
CPI	1.2	1.4	1.3	2.1	2.3	2.3
Unemployment rate (in percent) 1/	5.2	5.0	4.8	4.8	5.4	5.3
Gross national saving (percent of GDP)	15.2	15.1	15.3	14.8	15.0	15.4
Gross domestic investment (percent of GDP)	16.8	16.5	16.9	17.2	17.9	18.5
Public Finance 2/						
General government balance	-2.1	-3.0	-3.2	-2.8	-2.5	-2.1
Public sector balance	-2.3	-3.0	-3.3	-3.0	-2.9	-2.5
Cyclically adjusted balance (staff estimates)	-2.3	-3.0	-3.5	-3.0	-2.8	-2.5
Public sector net debt	31.9	33.2	34.9	36.3	37.5	38.3
Money and Credit (end-period, 12-month percent change)						
M0	6.4	7.4	5.7	4.7	6.2	...
M4	7.3	7.3	9.0	12.8	12.8	...
Consumer Credit	14.9	11.4	11.9	9.6	7.0	...
Interest rates (year average)						
Three-month interbank rate	4.0	3.7	4.6	4.7	4.8	...
Ten-year government bond yield	4.8	4.5	4.9	4.4	4.5	...
Balance of Payments						
Trade balance (in percent of GDP)	-2.9	-2.7	-3.0	-3.7	-4.3	-4.3
Current account balance (in percent of GDP)	-1.6	-1.3	-1.6	-2.4	-2.9	-3.1
Exports (percent of GDP)	26.4	25.7	25.4	26.4	28.1	25.8
Export volume (change in percent)	1.0	1.7	4.9	7.9	10.5	-2.5
Imports (percent of GDP)	29.3	28.4	28.4	30.1	32.4	30.1
Import volume (change in percent)	4.8	2.0	6.6	7.0	10.5	-1.8
Net exports of oil (in billions of US dollars)	7.7	5.5	1.6	-4.0	-7.2	...
Reserves (end of period, in billion of US dollars)	42.5	46.1	49.4	46.2	51.8	...
Fund Position (as of December 31, 2006)						
Holdings of currency (in percent of quota)						91.3
Holdings of SDRs (in percent of allocation)						13.8
Quota (in millions of SDRs)						10,738.5
Exchange Rates						
Exchange rate regime						Floating
Bilateral rate (January 31, 2007)						US\$ = £0.51088
Nominal effective rate (2000=100) 3/	99.4	95.8	100.5	99.3	99.9	...
Real effective rate (2000=100) 3/ 4/	98.7	96.0	101.8	101.3	...	...

Social Indicators (reference year):

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

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

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

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

3/ Average. An increase denotes an appreciation.

4/ Based on Consumer Price data.