INTERNATIONAL MONETARY FUND

IMF Country Report No. 16/57

UNITED KINGDOM

February 2016

2015 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE UNITED KINGDOM

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2015 Article IV consultation with the United Kingdom, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its February 12, 2016 consideration of the staff report that concluded the Article IV consultation with the United Kingdom.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on February 12, 2016, following discussions that ended on December 11, 2015, with the officials of the United Kingdom on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on February 1, 2016.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for the United Kingdom.

The documents listed below have been or will be separately released.

Selected Issues

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FOR IMMEDIATE RELEASE
February 24, 2016

International Monetary Fund
700 19th Street, NW
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IMF Executive Board Concludes 2015 Article IV Consultation with the United Kingdom

On February 12, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the United Kingdom.

The UK economy has been growing steadily. Economic recovery has been driven by robust expansion of private domestic demand and has supported rapid job growth, with the unemployment rate falling to 5.1 percent in late 2015.

Looking forward, growth looks set to continue, averaging around 2.2 percent over the medium term. Inflation, which is currently very low (0.3 percent in January 2016), is expected to rise slowly as disinflationary effects from past commodity price falls and sterling appreciation dissipate, and as wages increase. However, this relatively benign scenario is subject to risks and is sensitive to movements in global growth, asset prices, and productivity growth, among other factors.

Policies have been directed to supporting growth, while strengthening public finances and promoting financial stability. The overall fiscal deficit has been halved since 2009, and budget plans aim for further gradual consolidation over the medium term, reaching a surplus by Fiscal Year 2019/20. Accommodative monetary policy has helped offset contractionary effects from fiscal consolidation, with the Bank of England maintaining the policy rate at 0.5 percent, given subdued inflationary pressures. At the same time, financial sector policies have overseen steady improvement in banks' capital positions while also overhauling the financial regulatory framework, laying out a comprehensive regime to support bank resolution, and directing increased attention to the nonbank financial sector. However, notwithstanding some recent deceleration in house prices and efforts to boost supply and contain housing-related risks, house price pressures remain elevated, posing continued challenges for both macroprudential and housing supply policies.

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[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.

Executive Board Assessment[2]

Executive Directors welcomed the United Kingdom's strong economic performance, which has delivered robust growth, record high employment, a significant reduction in fiscal deficits, and increased financial sector resilience. Directors noted, however, that the relatively positive outlook is subject to risks and uncertainties, including those related to the global outlook, sluggish productivity growth, a weak external position, still-high levels of household debt, and the forthcoming referendum on EU membership. They encouraged the authorities to remain vigilant to the challenges ahead and to continue their policy efforts to promote growth and further boost resilience.

Directors commended the authorities' substantial fiscal consolidation efforts thus far and supported their plans to sustain measures to achieve stronger public finances and further rebuild buffers. They highlighted the importance of further strengthening the pro-growth and pro-stability aspects of the consolidation, including by scaling back distortionary tax expenditures, reforming the property tax, and reducing the tax code's bias toward debt. Directors encouraged the authorities to explore both revenue and expenditure measures, while protecting spending in priority areas, including healthcare, education, and infrastructure. They emphasized that flexibility in the fiscal framework should be used to modify the pace of adjustment in the event of weaker demand growth.

Directors supported maintaining an accommodative monetary policy while remaining vigilant in case conditions change. They underscored that when monetary policy begins to normalize, policies should be carefully communicated to ensure a smooth lift-off. More generally, Directors agreed that a policy mix of tight fiscal and accommodative monetary policies should also assist in external rebalancing.

Directors encouraged the authorities to continue their prudent approach to financial sector regulation and supervision. They emphasized that ensuring the safety of the UK financial sector is critical for maintaining domestic and global financial stability. In this context, they encouraged continued vigilance as the regulatory environment stabilizes following a period of considerable reform and as the credit cycle matures, including by addressing emerging risks early, actively using countercyclical capital buffers, and ensuring that risks do not migrate outside of the regulatory perimeter. Directors welcomed efforts to strengthen standards for financial market conduct, encouraged close monitoring of the nonbank financial sector, and looked forward to the results of the ongoing Financial Sector Assessment Program (FSAP).

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

Directors stressed that the buoyant housing market requires ongoing efforts to contain macroprudential risks and address long-standing supply problems. They welcomed macroprudential measures introduced since mid-2014, but noted that further measures may be necessary if the reduction in high loan-to-income mortgages does not continue. Directors also encouraged the authorities to extend the Financial Policy Committee's powers of direction to the buy-to-let market to mirror those they currently have over the owner-occupied market. They noted that ongoing efforts to reduce housing supply constraints, such as changes to planning processes, have improved prospects for increasing supply but require continued attention to implementation.

Directors agreed that structural reforms should continue to complement macroeconomic policy to help sustain growth and employment. They welcomed the authorities' focus on improving productivity, particularly by alleviating infrastructure constraints, addressing skills and labor supply, and increasing housing supply.

United Kingdom: Selected Economic Indicators, 2012–17

	2012	2013	2014	2015	2016	2017
				Est.	Projections	
Real Economy						
Real GDP (change in percent)	1.2	2.2	2.9	2.2	2.2	2.2
CPI, end-period (change in percent)	2.6	2.1	0.9	0.1	1.4	2.0
Unemployment rate (percent) 1/	8.0	7.6	6.2	5.4	5.0	5.1
Public Finance (fiscal year, percent of GDP) 2/						
Public sector overall balance	-6.6	-5.7	-5.2	-4.3	-2.9	-1.6
Public sector cyclically adjusted primary balance (staff estimates) 3/	-3.2	-3.0	-3.1	-2.4	-0.9	0.4
Public sector net debt	75.8	78.0	83.4	82.8	82.4	81.2
Money and Credit (end-period, 12-month percent change)						
M4	-1.0	0.2	-1.1	0.2	...	...
Net lending to private sector	-0.2	0.9	1.5	2.0	3.0	4.0
Interest rates (percent; year average)						
Three-month interbank rate	0.8	0.5	0.5	0.6	...	...
Ten-year government bond yield	1.9	2.4	2.6	1.9	...	...
Balance of Payments (percent of GDP)						
Current account balance	-3.3	-4.5	-5.1	-4.1	-3.9	-3.5
Trade balance	-2.0	-2.0	-1.9	-1.8	-1.7	-1.7
Net exports of oil	-0.9	-0.6	-0.6	-0.3	-0.2	-0.3
Exports of goods and services (volume change in percent)	0.7	1.2	1.2	5.5	3.7	3.8
Imports of goods and services (volume change in percent)	2.9	2.8	2.4	5.9	3.5	3.5
Terms of trade (percent change)	0.8	1.7	1.1	0.7	-0.4	0.2
FDI net	-1.3	-2.4	-4.5	-2.7	-2.6	-2.2
Reserves (end of period, billions of US dollars)	105.2	108.8	109.1	130.5	...	...
Exchange Rates						
Nominal effective rate (2010=100) 4/	103.5	101.0	107.4	...	...	...
Real effective rate (2010=100) 4/ 5/	106.8	105.8	113.8	...	...	...

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

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

2/ The fiscal year begins in April. Data exclude the temporary effects of financial sector interventions. Debt stock data refer to the end of the fiscal year using centered-GDP as a denominator. There is a break in the series from 2014 on, reflecting the reclassification of housing associations as part of the public sector.

3/ In percent of potential output.

4/ Average. An increase denotes an appreciation.

5/ Based on relative consumer prices.

INTERNATIONAL MONETARY FUND

UNITED KINGDOM

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION

February 1, 2016

KEY ISSUES

Considerable progress has been achieved in the post-crisis repair of the UK economy. Private-sector indebtedness has been reduced, the financial sector regulatory framework has been overhauled, the fiscal deficit has been cut in half, and the employment rate has reached a record high. With the output gap now nearly closed, growth is expected to average near its potential rate of around 2¼ percent over the medium term, with inflation rising slowly from its current low levels to the 2 percent target by end-2017. However, this benign baseline is subject to risks, including those related to potential shocks to global growth and asset prices, still-high levels of household debt, the elevated current account deficit, and the degree to which productivity growth will recover. Uncertainty associated with the outcome of the forthcoming referendum on EU membership could also weigh on the outlook.

Continued efforts are needed to complete the post-crisis repair, promote growth, and further bolster resilience.

- In the baseline scenario, fiscal consolidation should continue as planned to rebuild buffers, with flexibility exercised in the event of shocks. Efforts should continue to make consolidation more pro-growth, including by scaling back distortionary tax expenditures, reforming property taxes, and reducing the tax code's bias toward debt.

- Monetary policy should remain on hold for now to help offset headwinds from fiscal consolidation and given currently weak inflationary pressures. This mix of tight fiscal and loose monetary policy should also help narrow the wide current account deficit.

- As the credit cycle shifts and the financial sector's new regulatory architecture sets in, maintenance of an intrusive and conservative approach to supervision and regulation will be essential to continue to mitigate risks.

- Further tightening of mortgage-related macroprudential measures may be needed if the recent reduction in high-leverage mortgages does not continue.

- Structural reform priorities include measures to ensure that growth is not hampered by constraints on housing supply, skills, labor supply, and infrastructure.

Approved By
Philip Gerson and Vivek Arora

Discussions took place in London during November 30–December 11, 2015. The staff team comprised P. Gerson (head), K. Fletcher, A. Scott, A. Bordon, M. Mrkaic, K. Shirono (all EUR), and F. Vitek (MCM). O. Ftomova and R. Vega (both EUR) supported the mission from headquarters. The Managing Director met with the Chancellor and Bank of England (BoE) Governor and held a press conference.

CONTENTS

ANNEXES

FOCUS OF THE CONSULTATION

1. **Economic growth and reforms have assisted repair of the UK economy following the global financial crisis, but challenges remain**. In recent years, the UK has experienced steady growth with low inflation. Considerable progress has been made in repairing public finances and private-sector balance sheets, and new fiscal frameworks and financial sector regulatory architecture have been adopted. Nonetheless, important challenges and vulnerabilities remain—for example, productivity growth is still well below pre-crisis levels; growth remains heavily dependent on domestic demand, with a wide current account deficit; and household debt levels and fiscal deficits are still high, despite progress in reducing them in recent years.

2. **The UK economy and financial sector also remain heavily interconnected to the rest of the world**. This is in general a source of major benefits via gains from trade, cooperation, increased ability to specialize and realize economies of scale, and diversification of risks. However, interconnectedness also implies that the UK is affected by global shocks and can also be a source of important outward spillovers.

3. **Against this background, the consultation focused on the following issues**:

- What is the current state of the economic cycle in the UK and what factors have driven recent economic developments?
- What is the outlook for growth, job creation, and inflation?
- What are the main risks and impediments to strong and steady growth?
- How can the UK's macroeconomic and financial sector policies support growth and limit risks, both for the UK economy and globally?

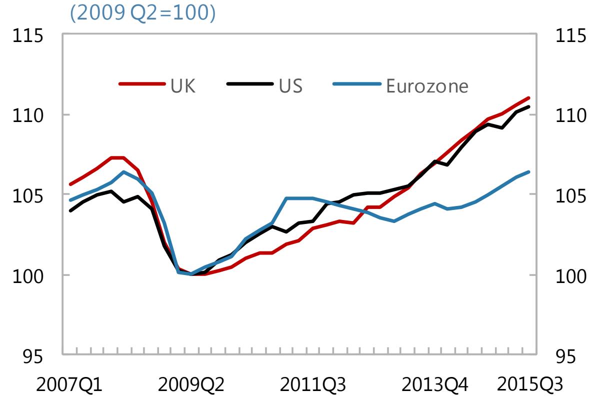
MACROECONOMIC CONTEXT

In recent years the UK has enjoyed a robust economic recovery, led by private domestic demand. With the output gap now nearly closed, growth is projected to average near its potential rate over the medium term. Inflation, which is currently just above zero, is expected to rise slowly back to 2 percent as one-off deflationary effects from lower commodity prices and sterling appreciation gradually dissipate. The large current account deficit is also projected to narrow somewhat as returns on foreign investments revert closer to historical averages. However, this relatively benign baseline scenario is subject to large global and UK-specific risks.

A. Macroeconomic Developments and Outlook

4. The UK economy continues to grow steadily. Output expanded by about 2¼ percent in 2015, following a nearly 3 percent expansion in 2014. With recent upward revisions also to growth estimates for 2011–13, the UK's post-crisis recovery path now looks similar to that of the US. The recovery has been led by private domestic demand, which has more than offset weak external demand and ongoing fiscal consolidation (Tables 1–2).

UK: Real GDP per Working Age Population
(2009 Q2=100)



Source: Haver.

5. Remaining economic slack is limited. Standard models suggest that the output gap is nearly closed, as the unemployment rate and capacity utilization have returned to pre-crisis levels (Figures 1–2).

6. Productivity growth remains low, but has recently started to tick upward.

- Productivity growth has been very weak during the recovery, averaging only 0.4 percent (annualized growth in output per hour worked) during 2010–14, well below the 2.2 percent productivity growth rate observed during the decade before the crisis.

- This productivity slowdown likely reflects a combination of factors. Some of these may be structural, given the broad-based slowdown in productivity growth across advanced economies that predates the crisis, possibly reflecting changes in the nature of technological progress, increased difficulties in measuring it, and/or changes in the pace of knowledge-based capital accumulation, among other factors. However, part of the slowdown may also be cyclical and therefore temporary, reflecting factors such as the post-crisis impairment of credit markets inhibiting the flow of investment to more productive sectors (see the companion *Selected Issues* paper).

- More recently, productivity growth has started to rise somewhat, reaching 1.3 percent (y/y) in the third quarter of 2015 (Figure 1).

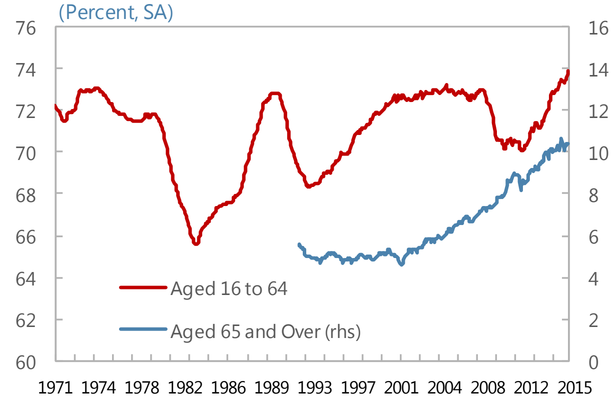
7. Looking forward, staff expects steady economic growth to continue in 2016. Lower commodity import prices, higher global growth, buoyant residential and commercial real estate prices (which should encourage investment), and ongoing monetary policy accommodation are expected to support expansion, offsetting headwinds from a moderate acceleration of fiscal consolidation (Table 3). On balance, staff projects growth in 2016 to remain around 2.2 percent.

8. Staff projects growth to average around 2.2 percent over the medium term, as well. This is based on the following assumptions:

- labor productivity growth continues its recent acceleration, eventually reaching 1.7 percent, (Table 2), but does not fully revert to pre-crisis productivity growth rates, given the possible structural factors behind lower productivity growth mentioned above; and

- employment growth slows to around 0.5 percent in the medium term; this projection assumes that (i) the population expands as projected by the Office for National Statistics (ONS), (ii) the employment rate for those age 16–64, which recently hit a record high, soon stabilizes, and (iii) the employment rate of those age 65+ continues to rise in line with the trend over the last decade, due to ongoing increases in longevity and the state pension age.

UK: Employment Rate
(Percent, SA)



Source: Haver.

9. Inflationary pressures remain subdued.

- As of December 2015, headline inflation was near a record low at 0.2 percent; core inflation was also subdued at 1.4 percent.

- Low inflation partly reflects lower import prices due to (i) the 15 percent appreciation of the NEER between Spring 2013 and end-2015 and (ii) the large drop in commodity prices since mid-2014. However, domestic drivers of inflation have also been muted, with nominal private-sector wages growing by only 2.1 percent as of November 2015 (Figure 1). Even if productivity growth remains in the range of only 1 percent, this pace of wage growth would still be consistent with underlying inflation of only around 1.1 percent.

- Consequently, markets do not expect the BoE to raise its policy rate (currently 0.5 percent) until 2017. Under this scenario, staff expects inflation to rise gradually to 2 percent by end-2017, as effects from past exchange rate appreciation and commodity price declines dissipate and assuming a gradual rise in wage growth in response to tighter labor markets.

B. External Assessment

10. The current account deficit has risen substantially in recent years, reaching 5.1 percent of GDP in 2014 (Table 6). The increase has been due almost entirely to a weaker income balance. Part of this decline could reflect structural factors, such as the UK's increasingly favorable corporate tax rates attracting more inward FDI, thereby reducing the stock of net FDI and in turn the income derived from it (see the companion *Selected Issues* paper). However, part of the decline in the income balance may also be temporary, reflecting factors such as unusually low returns on British investments abroad, possibly due to relatively subdued growth in major investment destinations such as continental Europe. Indeed, as the growth differential between the UK and other advanced economies has narrowed over the last year, the current account deficit has started to decline, reaching 4.2 percent of GDP (sa) in the first three quarters of 2015 due to an improving income balance.

11. **However, the current account was wider than justified by fundamentals in 2015, and sterling appeared overvalued**. For the full-year 2015, the current account is projected to be -4.1 percent of GDP. Adjusting for cyclical factors and temporary effects on the income balance yields an underlying cyclically adjusted balance of -2.8 percent of GDP (see Annex 1 and the companion *Selected Issues* paper). This compares to a current account norm of -0.3 percent of GDP, as estimated by the EBA model, implying a current account gap of -2.5 percent of GDP and sterling overvaluation of 11 percent. The EBA REER models provide a similar assessment, estimating overvaluation of 10–12 percent. Adding uncertainty around these estimates yields an estimated current account gap of -1.5 to -3.5 percent of GDP and REER overvaluation of 5–15 percent in 2015. Most of the estimated current account gap (1.3 percentage points) reflects the fiscal balance currently being looser than its optimal medium-term level.

UK: Estimated Exchange Rate Overvaluation under Different EBA Approaches

Approach	Overvaluation (percent)
Adjusted Current Account Regression 1/	11
REER models	11
REER Index Regression	12
REER Level Regression	10
Average	11

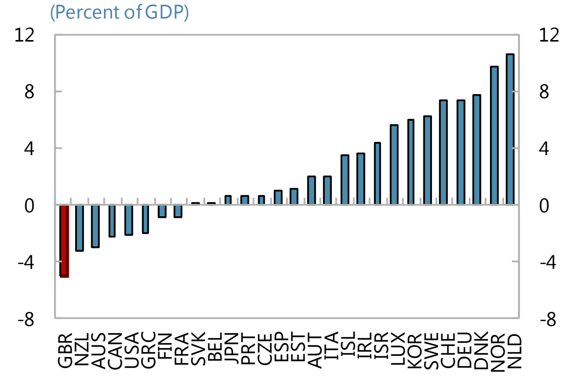
Source: IMF staff calculation.

1/ Adjusted for cyclical factors. Uses an elasticity of -0.23.

12. **Several factors mitigate risks associated with the high current account deficit**. First, financing of the deficit has shifted to somewhat more stable sources, such as FDI. Second, even if exchange rate overvaluation does unwind rapidly, the BoE's well-established inflation-targeting framework should allow it to largely look-through the one-off effects on inflation, as the BoE did during 2010–12, thereby avoiding pro-cyclical tightening. Third, the currency composition of the NIIP helps act as an automatic stabilizer, as foreign assets have a higher foreign-currency component than do foreign liabilities, such that sterling depreciation automatically improves the NIIP and income flows via valuation effects.

13. **That said, a smaller deficit would be preferable**. A large deficit may indicate underlying imbalances, such as sub-optimally low public and private saving. More generally, the sheer size of the deficit—the largest among advanced economies in 2014—and its general usefulness as an early warning indicator suggests that the deficit should not be ignored completely. For example, although recent financing has been more stable, events could change market sentiment and trigger a shift in the composition and size of financial flows. Abrupt outflows could adversely affect domestic investment, with negative outward spillovers via cross-border

UK: Current Account Balance, 2014
(Percent of GDP)



Source: WEO.

linkages with foreign investors. An accumulation of substantial external imbalances would thus be best avoided, and policies that assist external adjustment could be helpful.

C. Risks and Spillovers

14. The baseline scenario is subject to several risks. In the near term, risks to growth are somewhat tilted to the downside, taking into account also the downturn in global asset markets in early 2016. Specific risks are elaborated upon in the Risk Assessment Matrix (Annex 2) and include the following:

Globally originating risks

- *Global downturn*. Weak global growth and/or sharp declines in global asset prices would depress near-term growth in the UK. For example, simulations suggest that the Global Asset Market Disruption scenario outlined in the IMF's most recent *Global Financial Stability Report* would reduce output by 2.3 percent relative to the baseline scenario by 2017 (Annex 3).

- *China and emerging markets (EMs)*. A sharp slowdown in China and other EMs would likely have only limited effects via trade channels, as they account for only 4 and 13 percent of UK exports, respectively. However, financial sector linkages are somewhat stronger, with system-wide exposures to China and Hong Kong SAR equal to about 150 percent of system-wide CET1 in mid-2015. Nonetheless, the BoE's stress tests released in December 2015 indicate that the UK banking system's core functions can withstand a severe downturn in China and EMs along with lower growth in the euro area.

UK-specific risks

- *Medium-term productivity growth*. Despite the recent pick up, productivity growth remains far below its historical average, and the degree to which it will recover over the medium term remains highly uncertain. If productivity growth is lower than expected, this would have large adverse implications for medium-term output and incomes.

- *Real estate market-related risks*. Housing and mortgage markets have decelerated somewhat over the last year, and lenders have become more resilient. Nonetheless, house-price growth continues to outpace income growth, and household leverage remains high by historical standards. A leverage-driven re-acceleration of the market would further increase households and banks' vulnerabilities to house-price, income, and interest-rate shocks. Commercial real estate prices also continue to rise rapidly, and a market correction could reduce business investment and tighten corporate credit constraints, given lower collateral values (see later sections for further details on real estate market developments).

- *Referendum on EU membership*. The government is currently renegotiating the terms of the UK's membership in the EU, seeking changes such as increased leeway to limit benefits for new immigrants and an opt-out for the UK from the objective of "ever closer union". Following these negotiations, the government plans to put membership in the EU to a referendum as early as 2016 and no later than end-2017. Quantifying how a decision to leave the EU would affect the economy is difficult, given that (i) the terms of staying in the EU are still being negotiated and (ii) the nature of post-exit relations with the EU are unknown. However, analysts have raised concerns that the exit debate could bring a period of uncertainty that could weigh on investment.

Authorities' views

15. The authorities broadly shared staff's baseline outlook and list of key risks. The authorities expected steady growth to continue over the next few years. The independent Office for Budget Responsibility (OBR) and the BoE were both slightly more optimistic than staff on the degree to which productivity would recover over the medium term, resulting in somewhat higher growth projections, though the authorities agreed that uncertainty about productivity growth remained large and was a key risk. Staff's external assessment was viewed as reasonable. However, the authorities noted that the external stock position remained relatively sound, not least because BoE analysis showed that it would still be positive if all external assets and liabilities were measured at market value.

UK: Growth and Output Gap Projections
(Percent)

	Growth		2015 Output
	2016	2020	Gap
Consensus forecast	2.3	2.3	…
Nov 2015 *Autumn Statement* (OBR)	2.4	2.3	-0.7
Nov 2015 *Inflation Report* (BoE)	2.5	…	-0.5
Staff projection	2.2	2.2	-0.2

Sources: OBR; IMF staff projections.

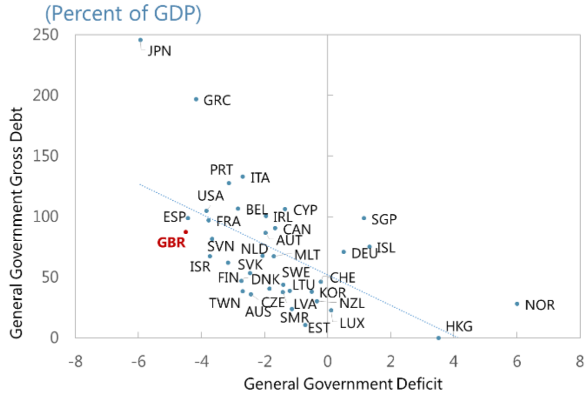
POLICIES TO PROMOTE GROWTH AND STABILITY

Significant economic adjustment and policy reforms have been achieved since the crisis, with policies since the last Article IV being largely in line with past staff advice (Annex 4). However, further efforts are needed to complete the repair process. In particular, monetary policy should remain on hold until inflationary pressures are clearer and to help offset headwinds from fiscal consolidation, which is needed to help rebuild buffers. Such a mix of tight fiscal and loose monetary should also assist external adjustment. Mortgage-related macroprudential policies may need to tighten if the recent moderation of housing-related risks does not continue, financial sector supervision and regulation should remain conservative and intrusive, and the structural reform agenda should be completed.

A. Fiscal Policy

16. The authorities have achieved substantial fiscal consolidation over the last five years. The overall deficit has been halved, falling from 10 percent of GDP in FY09/10 to 5 percent of GDP in FY14/15. Nonetheless, both

General Government Deficit and Gross Debt, 2015
(Percent of GDP)



Sources: WEO; and IMF staff projections.

the deficit and debt ratio remain high relative to those in other advanced economies. Consolidation has been achieved primarily by spending restraint (Figure 3).

17. The authorities plan to continue gradual fiscal consolidation over the medium term.

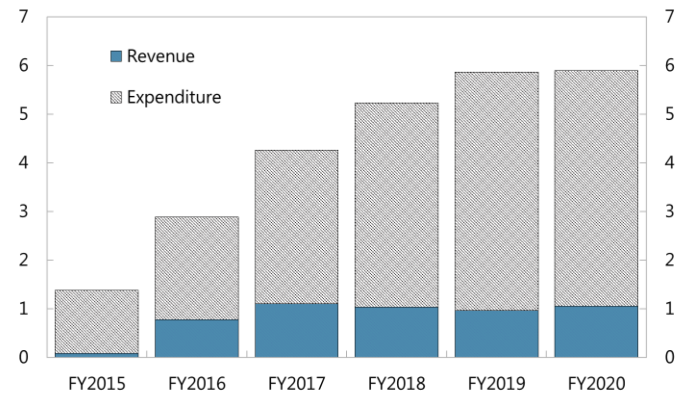
- The consolidation plan aims for gradual deficit reduction and an eventual surplus by FY19/20 (Figure 3, Table 3). As a result, the gross debt ratio is expected to decline steadily over the medium term (Annex 5).

- Consolidation will continue to rely mostly on spending restraint, especially for certain departments (e.g., Communities and Local Government). Selected priority areas will remain protected, including spending on the National Health Service, which will continue to increase every year in real terms, and foreign development assistance, which will be maintained at 0.7 percent of gross national income. Key revenue measures include changes to social insurance contributions and to dividend tax.

- Relative to the last pre-election budget (March 2015), the authorities' latest fiscal plans as announced in the 2015 Autumn Statement envisage a smoother path of deficit reduction. Consolidation is also now based somewhat less on spending cuts than previously projected, partly due to revised revenue and interest expenditure projections and new revenue measures.

UK: Changes in Primary Balance

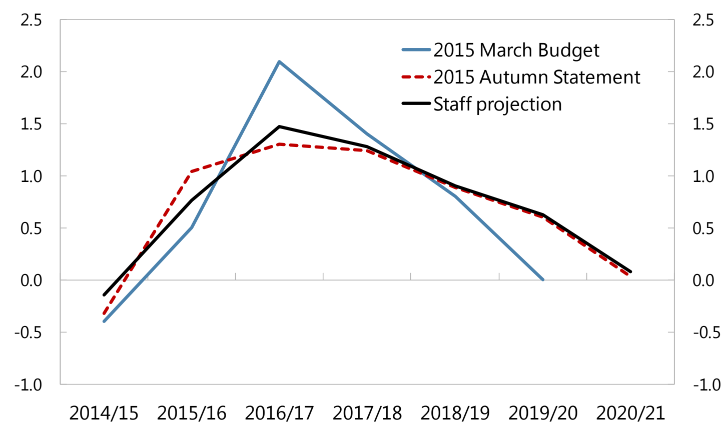
(Percent of GDP, cumulative from FY2014)



Sources: National Authorities; and IMF staff calculations.

UK: Pace of Fiscal Consolidation

(Change in cyclically adjusted primary balance, percent of GDP)



Sources: Office for Budget Responsibility; and IMF staff calculations.

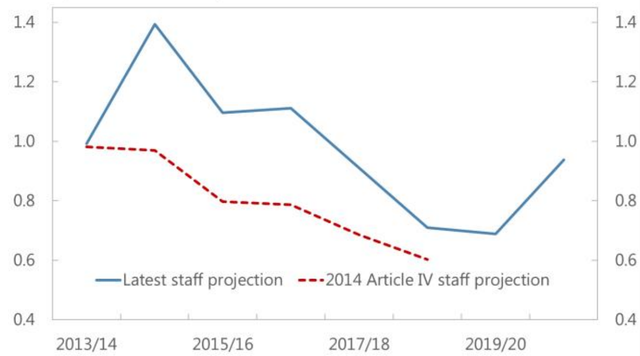
18. The consolidation path is appropriate in the baseline scenario. Continued consolidation is needed to rebuild buffers, thereby allowing more aggressive countercyclical policy during the next recession. Such an approach should yield net gains, as fiscal multipliers are likely lower now than they will be during the next recession, given that the output gap is nearly closed and that monetary policy over the next few years would likely be tighter in the absence of fiscal consolidation. The policy mix of tight fiscal and accommodative monetary policies should also support external adjustment.

19. However, automatic stabilizers should be allowed to operate freely, and the fiscal path may need to be eased if growth slows markedly. The stabilizers should operate symmetrically in response to small deviations of a cyclical nature. In the event of an extended period of sluggish demand growth—for example, if private investment is less robust than projected in the baseline—the flexibility in the fiscal framework (see below) should also be used to modify the pace of structural adjustment. In addition, the envisaged reductions in some categories of expenditure remain sizable, and the government may need to show flexibility in finding alternative fiscal measures if anticipated spending efficiency gains fail to materialize.

20. Pro-growth and pro-stability aspects of the consolidation could be further strengthened. Specific reform options along these lines include the following:

- Scaling back distortionary tax expenditures (e.g., nonstandard zero VAT rates) could improve efficiency, increase tax neutrality, and free up resources for other uses. Such uses could include higher spending on priority items such as infrastructure, given that needs in this area are still high despite recent increases in capital spending relative to previous projections. Such priority items could also be funded by phasing out the "triple-lock" for pensions, which guarantees that state pensions rise each year by the highest of CPI inflation, wage inflation, or 2.5 percent. This approach is costly, poorly targeted to those most in need, and inconsistent with international best practice, which is generally to maintain a constant real income in retirement via indexation only to the CPI.

UK: Net Acquisition of Nonfinancial Assets
(Percent of GDP)



Source: IMF staff projections.

- Property tax reform, along the lines recommended in the *Mirrlees Review*, could help reduce vulnerabilities in the housing market by easing supply constraints. For example, rebalancing taxation away from transactions and towards property values could boost mobility and encourage more efficient use of the housing stock. Reducing council tax discounts for single-occupant properties could also increase the utilization of these properties (see companion *Selected Issues* paper).

- Reducing the tax code's bias toward debt could also promote financial stability. This could be achieved by, for example, adopting an Allowance for Corporate Equity, with offsetting changes in other corporate tax parameters to ensure revenue neutrality.

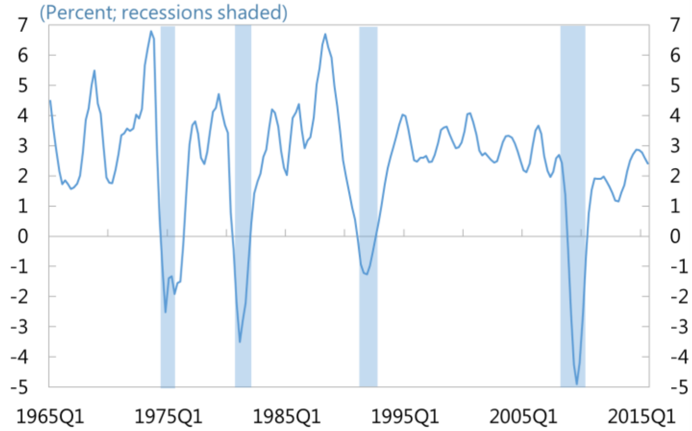
21. The fiscal framework has been revised. Consistent with the medium-term fiscal plans, the authorities have adopted a new fiscal rule requiring a budget surplus, starting in FY19/20, as long as rolling 4Q on 4Q GDP growth exceeds 1 percent. Once projected growth falls below 1 percent, the rule allows the government to run a deficit until conditions allow a return to surplus. The rule is not a strictly binding one (as, for example, if it were enshrined in a constitution), but instead effectively operates on a "comply or explain" basis, adding another degree of flexibility. The rule is supplemented by a target for public sector net debt to fall as a percent of GDP in every year to FY19/20.

22. The authorities recently announced plans to start producing a regular analysis of fiscal risks. In mid-2015, the government undertook a review of the OBR to reflect on lessons learned during its five years of existence. The review concluded that the OBR was functioning well, but made some recommendations to further strengthen its operations. One of the key recommendations was for the OBR to start preparing a new report on fiscal risks, as recommend by the IMF's Fiscal Transparency Code. The OBR plans to produce the first such report within the next two years.

Authorities' views

UK: Real GDP Growth

(Percent; recessions shaded)



Sources: ONS; Haver; and IMF staff calculations.

23. The authorities viewed their fiscal plans as helping to bolster fiscal resilience and improve public-sector efficiency. They emphasized that responsible fiscal policy should rebuild buffers to allow for the fact that the UK economy will continue to be hit by shocks in the future. They agreed with the need to maintain flexibility in the event of large shocks, but noted that the new fiscal framework covered most contingencies in this regard, as UK growth has exhibited a "bi-modal" tendency in which it has been either relatively strong (e.g., growth above 2¼ percent) or sufficiently weak that it would trigger the 1 percent escape clause (see text chart). The authorities stressed that the composition of consolidation aimed to support a competitive low-tax economic environment and prioritize efficiency gains, while continuing to provide high-quality outputs in key areas such as science, infrastructure, education, and health. In this regard, they emphasized that the pace of real cuts in departmental spending was significantly slower than in the previous parliament.

B. Monetary Policy

24. Monetary conditions remain accommodative. Current monetary policy settings—a policy rate of 0.5 percent and QE assets of £375 billion—have remained unchanged since the last Article IV consultation.

25. Monetary policy should stay on hold until inflationary pressures are clearer.

- Both headline and core inflation are well below target. Forward-looking indicators—such as inflation expectations and wage growth in excess of productivity growth—are also well-contained (Figure 1).

- While the output gap is nearly closed, continued monetary policy accommodation is likely to be needed to keep the output gap from re-opening, given the moderate acceleration of fiscal consolidation.

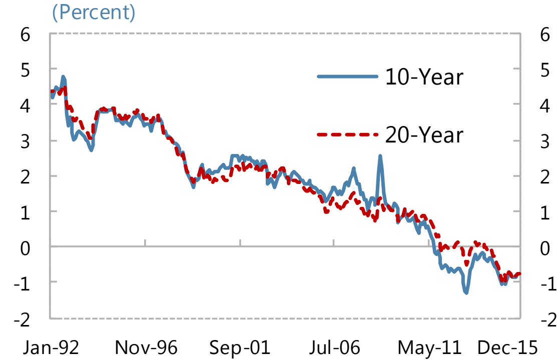
- Moreover, risks to policy errors are asymmetric, as the costs to inflation undershooting likely exceed those of overshooting due to the increased complications related to easing monetary policy when interest rates are near the effective lower bound (ELB). In this regard, some moderate overshooting of the 2 percent target may even be desirable to more firmly escape the ELB.

- Current monetary policy settings thus remain appropriate until inflationary pressures become stronger. However, policy should also stay data dependent and may need to adjust quickly if conditions change, especially if core inflation or wage growth in excess of productivity growth rises quickly.

26. The medium-term neutral real rate is likely to be lower than before the crisis. Market expectations of future interest rates, as indicated by long-term bond yields, have fallen sharply over the last two decades, likely reflecting high global savings and lower potential growth due to slower population growth, among other factors.

27. A lower neutral rate has at least two important implications.

UK: Real Yields on Government Securities 1/
(Percent)



1/ Real yields based on retail price index inflation, which tends to run somewhat higher than CPI inflation.
Source: Haver.

- First, it implies that the current policy rate may not be providing as much monetary stimulus as it may initially appear. This in turn may partly explain why inflationary pressures remain modest despite a nearly closed output gap and further underscores the case for keeping rates on hold.

- Second, a lower neutral rate implies that the odds of hitting the ELB will be higher going forward than in the past. Consequently, contingency planning for addressing ELB-related problems that may arise again over the longer run is welcome. Such planning could include, for example, ensuring that the financial sector's IT systems and legal contracts can incorporate negative interest rates, among other issues.

Authorities' views

28. Monetary policy settings were viewed as appropriate. When the MPC judges it appropriate to raise Bank Rate, careful communication will be important to ensure a smooth lift-off. The BoE reiterated that the process of normalizing monetary policy should begin with rises in Bank Rate and proceed gradually—with the neutral rate likely to remain below levels seen prior to the financial crisis—and that QE asset sales should only be considered once Bank Rate had reached a level from which it could be cut materially in the face of a negative shock.

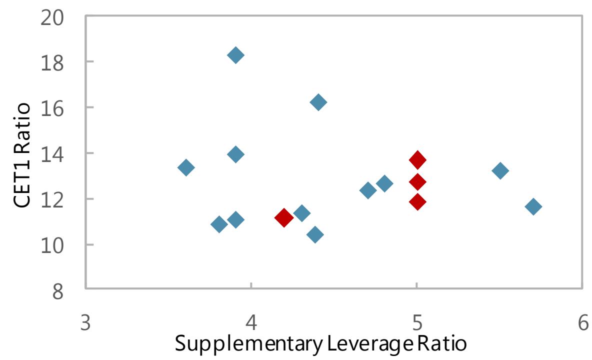
C. Financial Sector Policies

29. The UK's banking sector has become more resilient in recent years in line with tougher regulatory requirements.

- *Capital*. In preparation for the full implementation of Basel III in January 2019, UK banks have steadily strengthened their capital positions (text table). In aggregate, the ratio of common equity Tier 1 (CET1) capital to risk-weighted assets for major UK banks reached 12.0 percent in September 2015—up from 7.2 percent in 2011 and well above regulatory minima.[1] Effective January 2016, the major UK banks must also satisfy leverage ratio requirements. The aggregate Basel III leverage ratio for major banks reached 4.7 percent in September 2015, also well above regulatory minima. The capital ratios of major UK banks were also broadly in line with those of their peers in other advanced economies.

European G-SIBs: CET1 and Leverage Ratios, 2015:Q3

(Percent; selected UK banks in red 1/)



1/ UK banks include Barclays, LBG, RBS, and HSBC.
Source: SNL

Financial Soundness Indicators for Major UK Banks 1/

(Percent)

	2000-06	2011	2012	2013	2014	2015 2/
Capital adequacy						
Basel III common equity Tier 1 capital ratio	...	7.2	8.4	10.0	11.3	12.0
Simple leverage ratio	4.8	5.1	5.1	5.6	5.9	6.3
Basel III leverage ratio (2014 proposal)	...	...	...	...	4.4	4.6
Asset quality 1/						
Non-performing loans net of provisions to capital	...	16.1	13.9	9.5	5.4	...
Non-performing loans to total gross loans	...	4.0	3.6	3.1	1.8	...
Profitability						
Return on assets before tax	1.1	0.4	0.2	0.3	0.5	0.3
Price-to-book ratio	224.6	57.0	81.0	106.0	96.0	85.0
Liquidity						
Loan-to-deposit ratio	113.1	108.9	103.1	99.1	96.0	97.4
Short-term wholesale funding ratio	...	18.8	16.4	14.1	12.6	...
Average senior CDS spread	...	2.7	1.5	1.0	0.6	0.7

Sources: BoE FPC Core Indicators, IMF Financial Soundness Indicators.
1/ The coverage of banks is as defined in the BoE's December Financial Stability Report, except for asset quality indicators, for which the coverage is as defined in the IMF's Financial Soundness Indicators.
2/ 2015 latest available data.

[1] Specific regulatory minima for CET1 and leverage ratios differ across banks, depending on their systemic importance.

- *Asset quality*. Stronger capital positions have been supported by improving asset quality, with the non-performing loan ratio falling to 1.8 percent at end-2014—less than half its post-crisis peak (text table, Figure 4). Since the global financial crisis, UK banks have shifted the composition of their loan portfolios towards domestic lending and away from foreign lending and reduced their direct credit exposures to both other banks and nonbank financial institutions, lowering their interconnectedness.
- *Profitability*. Profitability, however, remains low relative to historic levels. In aggregate, UK banks currently generate a return on assets about half that prior to the global financial crisis (text table, Figure 4). In parallel, the shares of the major UK banks now trade at around their book value, about half the multiple prior to the global financial crisis. The weak profitability of UK banks in recent years has been driven by lower trading income, lower net interest income, and high misconduct costs.
- *Liquidity*. UK banks have strengthened their liquidity positions, with most major banks disclosing that they have already satisfied the full Basel III end-point liquidity coverage ratio requirement of 100 percent. Banks have also reduced their reliance on short-term wholesale funding while increasing deposits (text table, Figure 4), raising the overall stability of their funding.

30. The government still has ownership stakes in Lloyds Banking Group (LBG) and the Royal Bank of Scotland (RBS), as legacies from crisis bailouts. With a business model focused on UK mortgage lending, LBG has benefited from robust UK growth. The government plans to divest its remaining ownership stake of less than 10 percent in the near future as market conditions allow. In contrast, RBS remains in the midst of a major restructuring and deleveraging, designed to simplify its business model and make it more domestically oriented. The government plans to divest at least three-quarters of its 73 percent ownership stake gradually over the course of this parliament.

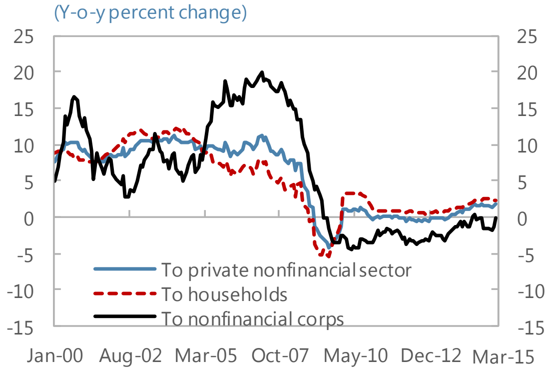
31. The banking sector's resilience to shocks is now regularly assessed by stress tests.

- The 2015 stress test scenario featured a deep global macroeconomic downturn accompanied by an abrupt tightening of financial conditions, concentrated in China and the Euro Area. The test also incorporated severe but plausible future misconduct costs. The results, released in December 2015, indicate that all seven major UK banks—which collectively account for over 80 percent of domestic bank credit provision to the domestic economy—have the capacity to maintain lending under such a scenario, given their capital plans, including actions taken in 2015 (e.g., Standard Chartered announced in November 2015 that it planned to raise $5.1 billion in shares and cut 15,000 jobs).

- Beginning in 2016, the BoE plans to conduct two banking sector stress tests per year, combining an annual cyclical scenario—the severity of which will vary with the financial cycle—with a biennial exploratory scenario designed to probe resilience to other risks in between the biennial European Banking Authority stress tests. Going forward, the integration of systemically important nonbank financial institutions, such as central counterparties (CCPs), into the stress-testing framework should be a priority.

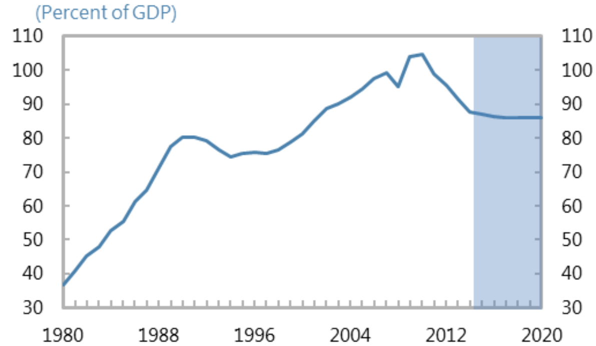
32. Balance sheet repair has helped shift aggregate bank credit growth back into slightly positive territory, supporting economic activity. Going forward, bank credit growth is expected to converge gradually toward nominal GDP growth rates, now that the bank credit-to-GDP ratio has returned near pre-boom levels (i.e., circa 2000).

UK: Lending Growth 1/
(Y-o-y percent change)



Source: Haver.
1/ Lending by monetary financial institutions.

UK: Outstanding Credit to Households and NFCs 1/
(Percent of GDP)



Source: Bank of England.
1/ Lending by monetary financial institutions.

33. As the credit cycle shifts and the new regulatory architecture sets in, continuation of an intrusive and conservative approach to supervision and regulation will be essential. UK financial sector stability is essential not only for domestic macro-stability, but also to avoid adverse outward spillovers to the rest of the world, given the UK's role as a global financial center. Priorities for reducing risks include the following:

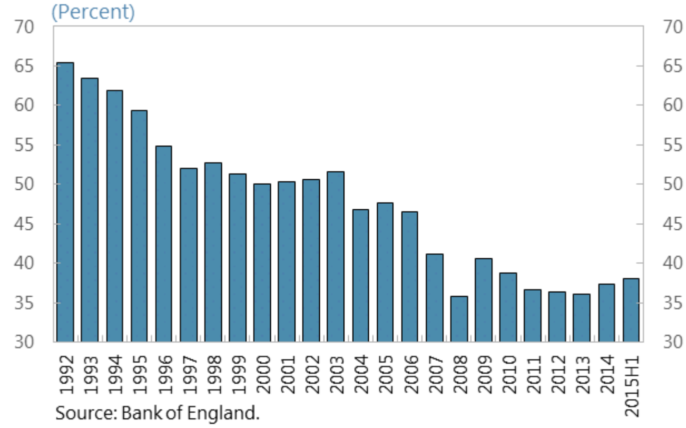
- *Addressing emerging risks early*. Given its central coordinating role in maintaining financial stability, the Financial Policy Committee (FPC) needs to continue scanning the horizon for emerging systemic risks, while taking action in concert with the Prudential Regulation Authority and the Financial Conduct Authority to remove or reduce them. In this context, the authorities should, in addition to their ongoing monitoring of large financial institutions, continue to monitor systemic risk arising from small and medium-sized financial institutions—which tend to have correlated business models—through robust thematic microprudential supervision. Also, the authorities' recent efforts to push banks to bolster resilience to cyber attacks are welcome.

- *Countercyclical capital buffer (CCB)*. As the incipient financial cycle upturn in the UK gains momentum, the FPC should raise the CCB from its current level of 0 percent and continue raising it as warranted by credit conditions. While this is unlikely to significantly moderate the financial cycle, it will enhance the resilience of the banking sector in line with the level of systemic risk it faces. In this regard, the FPC indicated in November 2015 that a hike in the near future was likely, though any initial increase in the CCB would likely be at least partly offset by reductions in existing buffers, such that the first CCB hikes would probably not add to total capital requirements for individual banks, but rather increase the transparency of the nature of these buffers.

- *Risk weights*. Supervisors should also continue to carefully scrutinize risk weights in banks' internal models, including to ensure that they are not overly pro-cyclical. Although the leverage ratio requirement helps mitigate risks associated with internal models, heavy reliance on the leverage ratio as the binding capital adequacy constraint could incentivize banks to adopt excessively risky lending behavior. In this context, recently announced plans by the Basel Committee—in which the UK plays an important role—to complete work to address the problem of excessive variability in risk weights by end-2016 are welcome. Should the authorities identify immediate risks, the imposition of sectoral risk-weight floors and heightened risk-weight disclosure requirements should also be considered.

UK: Average Risk Weights

(Percent)



Source: Bank of England.

34. A comprehensive set of arrangements to support bank resolution is being established. The UK regulatory framework includes three main elements relevant to resolution:

- *Ring-fencing*. Effective January 2019, the major UK banks will be required to ring-fence their core retail operations, insulating them from risks arising in their investment banking arms. The Prudential Regulation Authority plans to complete its consultation process and publish final ring-fencing rules well before January 2019, to give banks sufficient time to implement them.

- *Total loss-absorbing capacity (TLAC)*. The Financial Stability Board recently finalized a TLAC standard for global systemically-important banks (G-SIBs)—of which the UK is the home jurisdiction for four—designed to ensure that they have sufficient equity plus eligible liabilities to absorb losses and be recapitalized in resolution. Consistent with the EU's Bank Recovery and Resolution Directive, the BoE plans to impose a minimum requirement for own funds and eligible liabilities (MREL) on all UK banks that will apply as of January 2019 for G-SIBs and January 2020 for other banks. For UK G-SIBs, MREL will be set so as to implement the FSB's TLAC standard.

- *Resolution planning*. The BoE conducts resolution planning for all UK banks, which will be required to remove any substantive barriers identified to implementing the BoE's preferred resolution strategy. Discussions are also ongoing with other jurisdictions on the issue of clarifying modalities for cross-border resolution.

These complementary requirements aim to mitigate the too-big-to-fail problem by (i) reducing the likelihood of a systemic banking crisis by subjecting the major banks to greater market discipline through their funding costs and (ii) reducing the macroeconomic costs of a major bank failure by facilitating orderly resolution while insulating taxpayers from losses.

35. It will be equally important to continue closely monitoring risks in nonbanks.

- Nonbank financial institutions now account for nearly 50 percent of UK financial sector assets, up from less than 40 percent prior to the global financial crisis. This expansion has been concentrated among broker-dealers, pension funds, and investment funds. The resilience of broker-dealers continues to improve, with their leverage ratios having roughly doubled since the global financial crisis. Nevertheless, it is important that the FPC continue to assess the adequacy of the regulatory perimeter to guard against the migration of financial stability risks outside of it.

- Another priority is to ensure that UK insurers are resilient to the low interest-rate environment. Although insurers' assets and liabilities have well-matched durations, the low interest-rate environment has steadily eroded their investment income as maturing assets have been reinvested in lower-yielding securities. Nevertheless, UK insurers are sufficiently capitalized to withstand the stresses specified by Solvency II, which came into force in January 2016.

- The ongoing FSAP, which is due to be completed in mid-2016, will be an opportunity to further assess the adequacy of steps taken to reduce risks in nonbanks, as well as to review broader changes (e.g., the liquidity framework) to the financial sector framework since the last FSAP in 2011.

36. The reform of ethics and conduct in the financial sector is ongoing. Financial institutions in the UK have been charged substantial misconduct costs, and the restoration of public trust in the ethical underpinnings of the financial sector remains elusive. The UK authorities are strengthening incentives for financial institutions to provide financial services in an ethical manner, in part by pushing accountability for misconduct down to the individual level, including via new measures such as the Senior Managers Regime, which increases the responsibility of managers for misconduct that occurs on their watch. Applying effective, proportionate, and dissuasive sanctions for misconduct, including for AML/CFT violations, should enhance compliance and promote financial integrity. The authorities' efforts to promote global standards for the ethical provision of financial services are welcome.

Authorities' Views

37. Post-crisis reforms were viewed as having bolstered financial sector resilience, though challenges remain. The FPC judged that, on a system-wide basis, significant further capital-raising was unlikely to be required. As a result, it foresees the sector transitioning to a more neutral phase of the cycle in which credit growth is more able to support sustainable growth. At the same time, newer risks, such as those related to cyber-security and expansion of the nonbank financial sector, were gaining prominence and warranted close attention. On mortgage risk weights, the BoE agreed that in some cases these were too pro-cyclical, but emphasized that leverage ratio requirements, stress testing, and hypothetical portfolio exercises provided mitigating backstops, as did measures under Pillar II of the Basel framework.

D. Real Estate Markets and Related Macroprudential Policies

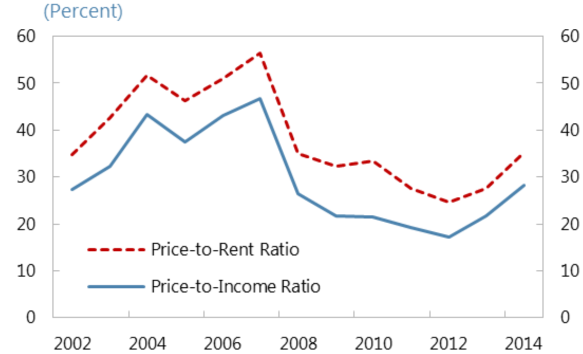
38. Housing markets have decelerated somewhat since mid-2014, but significant pressures remain.

- House-price growth has eased from 12 percent (y/y) in mid-2014 to around 8 percent in late 2015. The percentage of new mortgages with high loan-to-value or high loan-to-income ratios has also declined (Figure 5). This moderate deceleration of housing and mortgage markets may partly reflect policy actions, including tougher mortgage lending requirements (the FCA's Mortgage Market Review) and an FPC restriction that no more than 15 percent of a lender's new mortgages be at or above a loan-to-income ratio of 4.5. Though the latter restriction was not binding for the vast majority of lenders, it may have had a signaling effect that prompted them to reduce high loan-to-income mortgages.[2]

- Despite the recent slowdown, house prices are still rising faster than incomes. Consequently, the average price-to-income ratio is climbing back toward its pre-crisis peak and has exceeded it in London (Figure 5).

UK: House Price Metrics 1/

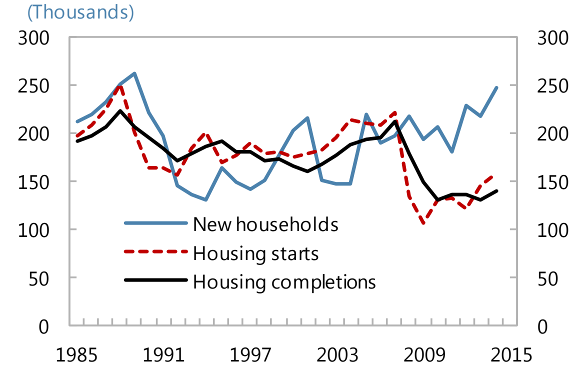
(Percent)



Sources: OECD; and IMF staff calculations.
1/ Percentage deviations of the price-to-income and price-to-rent ratio s from their long-run historical averages (calculated from 1987Q1).

UK: Household Formation vs. Housing Construction

(Thousands)



Source: Haver.

39. Persistent upward pressure on house prices partly reflects supply constraints. Restrictive planning regulations have long constrained supply, such that even the house-price boom of the early 2000s was not accompanied by the type of building surge seen in other countries such as Ireland and Spain. In addition, the crisis-induced shock to the construction industry has further constrained supply since 2008. Large builders consolidated and reduced employment, including of skilled workers, who are difficult to re-hire quickly. Several smaller builders exited the market, and some remaining ones have seen their financing conditions worsen. Together, these factors have helped prevent housing completions from keeping pace with new household formation since 2008. The rapid rise in house prices in recent years without an accompanying surge in net mortgage lending (Figure 5) further points to supply constraints as an important driver of the increase in prices.

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[2] Banks account for over 90 percent of mortgage lending.

40. High house prices result in some households taking on high leverage, posing financial stability risks. Despite recent declines, the percentage of new mortgages at high LTI ratios remains well above pre-boom (i.e., circa 2000) levels, as does the aggregate household debt-to-income ratio, which has stopped declining and is higher than in most other G7 countries. Such high leverage significantly exposes households and banks to interest-rate, income, and house-price shocks.

41. Further macroprudential tightening may thus be needed if the reduction in high-leverage mortgages does not continue.

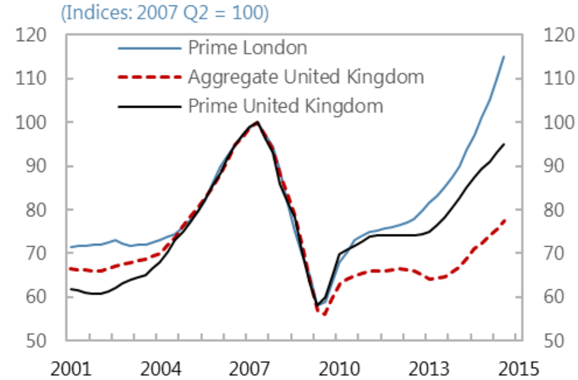
- If needed, such tightening could take the form of tighter LTI and/or LTV limits on new mortgages. Priority should also be given to the consolidation of household-level credit data so as to allow a shift from LTI limits to debt-to-income limits, which cannot be evaded by taking out multiple loans.

- In addition, the authorities should extend the FPC's powers of direction to the buy-to-let market, which has accounted for about one-third of gross mortgage growth since 2012 and is dominated by small-scale landlords (owning three properties or less), to avoid biasing the market toward this segment. The powers of direction should mirror those the FPC currently has over the owner-occupied market. Somewhat looser restrictions could be considered for borrowing for new construction to avoid unintentionally restricting supply.

42. Other policies also affect housing demand. The authorities should continue to monitor the Help to Buy program and consider if it needs to be adjusted to avoid adding to demand for existing houses. In addition, continuing to carefully monitor beneficial ownership of legal entities and arrangements holding real estate is crucial for effectively implementing AML/CFT controls.

43. Ongoing efforts to address supply constraints remain essential. Increased housing supply will support near-term growth, reduce the need for excessive household leverage, and promote social cohesion by lessening wealth inequality, as rising house prices have been a key contributor to the latter in the UK. The government has undertaken a number of welcome initiatives to boost housing supply in recent years, such as improving incentives for local governments to approve new construction. The authorities should remain vigilant against local-level resistance to effective implementation of these initiatives—otherwise the risks associated with an approval process perceived by many to be slow and unpredictable will remain. The authorities should continue efforts to mobilize unused publicly-owned lands for construction and explore ways in which property tax reform could ease supply constraints (see fiscal section above).

UK: Commercial Real Estate Prices
(Indices: 2007 Q2 = 100)



Sources: MSCI; and Bank of England.

44. Commercial real estate (CRE), with its rapidly growing prices, warrants close monitoring. The CRE market has been buoyant, with annual price growth exceeding 10 percent as of mid-2015. Domestic banks have reduced their commercial real estate exposure, but international investors and nonbanks have picked up the slack. CRE is particularly sensitive to swings in sentiment about economic prospects. Since many firms rely on CRE as collateral to support their borrowing, a fall in prices could tighten corporate credit constraints, reducing business investment and economic activity. Such an event could also have negative outward spillovers via the sector's cross-border financial linkages.

Authorities' Views

45. **The authorities will continue to monitor real estate-related financial stability risks closely, including household debt levels and also buy-to-let lending**. In the second half of 2015, the government introduced a suite of measures, such as reduced interest-deductibility for buy-to-let mortgages and higher transaction taxes on buy-to-let purchases. The FPC are closely monitoring the impact of these reforms on the housing market and have indicated that they are ready to take further macroprudential action if necessary. After the mission, the government also announced a consultation on providing the BoE with powers of direction over buy-to-let lending. At the same time, the authorities emphasized that supply-side constraints were the main force behind high house prices and reiterated that much had already been done, including significant reforms to the planning system, and they remained committed to going further.

E. Structural Reforms

46. **Structural reforms are an important complement to other macroeconomic policies.** UK goods and labor markets are relatively competitive, with few major barriers to entry. Nevertheless, structural reforms could help boost potential growth, thereby also raising real interest rates and reducing ELB-related problems. Structural reforms will also increase competitiveness, assisting external adjustment, and help address regional disparities.

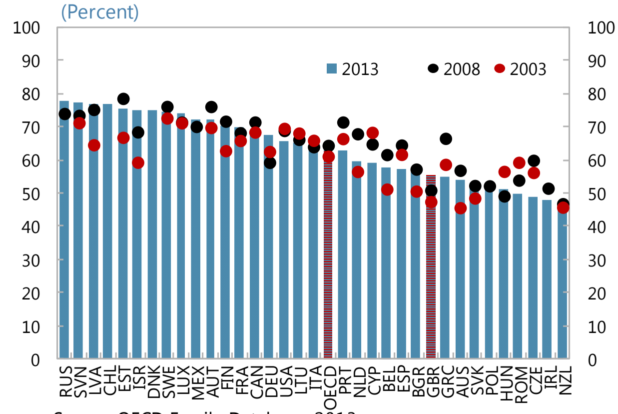
47. **Reform priorities include infrastructure, skills, and labor supply:**

- *Infrastructure:* Domestic regional development and external trade are notably held back by transport bottlenecks. Increased spending on infrastructure and an enhanced focus on decentralization are therefore welcome. An important innovation is the recent formation of a nonpartisan National Infrastructure Commission that is mandated to lay out long-term plans for northern connectivity, London transport, and energy policy. This could usefully depoliticize infrastructure planning and make infrastructure externalities more predictable for UK firms.

- *Education:* Increasing signs of tightness in the market for skilled labor highlight the need for ongoing investment in skills—only four-fifths of those aged 15–19 are enrolled in education, below the OECD average. Further expansion of vocational training would help reduce double-digit youth unemployment and make growth more inclusive. To this end, recent support for apprenticeship programs is welcome.

- *Labor force participation* is high overall but, despite recent improvement, remains below the OECD average for single women with children. Recent changes to childcare and to benefit conditionality could increase participation.

Employment Rate for Single Parent Women 1/
(Percent)



Source: OECD Family Database, 2013.
1/ 15-64 years old with at least one dependent child, 0-14.

48. Housing supply measures are an important complement to conventional structural reforms. The shift in economic output to services and an increasingly digital economy is likely to continue; this may be accompanied by increasing agglomeration effects as knowledge-based jobs are concentrated in major metropolitan areas. Hence, housing supply reforms are crucial to support a well-functioning flow of potential employees for such jobs and to ensure that workers in critical support services—health, education, policing, and emergency services—are not squeezed out of metropolitan areas. To this end, the development of commercially-managed rental accommodation may be increasingly important. As discussed earlier in the section on real estate markets, key policy measures in this area include continuing efforts to reform planning regulations and improve incentives for local governments to approve new construction.

Authorities' Views

49. The authorities agreed with the mission's attention to infrastructure, education, and labor participation issues. The current National Infrastructure Plan identified transportation and connectivity as crucial for long-term development. In addition, the newly-formed National Infrastructure Commission would take evidence and independently make recommendations for the National Infrastructure Delivery Plan in early 2016. Skills and human capital were key components of the productivity plan, published in 2015, to close the productivity gap between the UK and its peers. Labor participation was at its highest level in almost 25 years; although female labor participation was lower than the OECD average, the rate had been increasing in recent years, and childcare benefits had been adjusted in the Autumn Statement to support those on low incomes.

STAFF APPRAISAL

50. The UK's recent economic performance has been strong, and considerable progress has been achieved in addressing underlying vulnerabilities. Growth has been robust, the unemployment rate has fallen substantially, employment has reached an historic high, the fiscal deficit has been reduced, and financial sector resilience has increased.

51. Steady growth looks likely to continue over the next few years, and inflation should gradually return to target. Staff expects labor productivity to slowly improve, while lower commodity import prices, higher global growth, and ongoing monetary policy accommodation would support growth and offset moderate fiscal consolidation. Inflation is expected to revert to target gradually, as effects from commodity price falls and sterling appreciation dissipate and wages increase.

52. However, this relatively benign baseline is subject to risks. These include uncertainties related to global growth, the degree to which productivity growth will recover, and the outcome of the referendum on EU membership, as well as risks related to still-high levels of household debt, elevated commercial and residential real estate markets, and a current account deficit that is wider than justified by fundamentals. Risks related to the latter are mitigated by a naturally-hedged international investment position and a well-entrenched inflation-targeting regime that should help monetary policies look through any one-off price-level shocks. Nonetheless, the current account deficit is strikingly large, and confidence shocks could reduce external capital flows into the UK, adversely affecting growth.

53. Given the outlook and these challenges, the current policy mix is broadly appropriate. Steady and measured fiscal consolidation is warranted to restore healthier public finances and rebuild buffers; supportive monetary policy will make this task easier, while also assisting external rebalancing. Recent macroprudential policy measures have somewhat reduced housing-related risks, and ongoing financial sector policies should help promote financial sector stability.

54. The planned pace of fiscal consolidation is justified under the baseline scenario. The planned path of deficit reduction over the medium term is notably smoother than foreseen at the time of the 2014 Article IV consultation. In addition, revised revenue and interest expenditure projections and new revenue measures allow deficit reduction to be based less on expenditure consolidation than originally projected. Efforts to safeguard priority items such as foreign development assistance are also commendable. Nonetheless, the envisaged reductions in some categories of expenditure remain sizable, and the government may need to show flexibility in finding alternative fiscal measures if anticipated spending efficiency gains fail to materialize. More neutrality in the tax system—such as by scaling back distortionary tax expenditures, reforming property taxes, and reducing the corporate tax code's bias toward debt—and could help promote efficiency and stability.

55. The transparency of the new fiscal rule—with a focus on headline balances and a simple and well-defined escape clause in the event of very low growth—is welcome. The "comply or explain" nature of the rule, which requires the Chancellor to explain to parliament any deviation from the rule but does not mandate any specific sanctions, adds another appropriate level of flexibility. Plans to undertake regular analyses of fiscal risks should further bolster the fiscal framework.

56. Monetary policy should stay on hold until inflationary pressures are clearer. Although low inflation mostly reflects temporary external factors, indicators of domestic-driven inflation are also muted. Moreover, risks of policy errors are asymmetric—when the policy rate is close to its lower bound, the costs of inflation undershooting exceed those of overshooting. And the policy rate associated with a neutral monetary stance is likely lower than what historical averages would suggest, implying that the current policy rate is less stimulative than it first appears.

57. The authorities should continue to take a prudent and intrusive approach to financial sector regulation and supervision. The soundness of the banking sector has improved notably since the crisis, and stress tests indicate its resilience to shocks. But finance is an inherently risky business, and the financial sector in the UK is very large. Ensuring the safety of the UK financial sector is not only a domestic concern, but is also critical to maintaining global financial stability. It will be important to maintain vigilance as the regulatory environment settles, including by addressing emerging risks early, actively using the countercyclical capital buffer, and continuing close scrutiny of risk weights in banks' internal models. Given its rising importance, the nonbank financial sector should be monitored closely, including to ensure that risks do not migrate outside of the regulatory perimeter and that insurers remain resilient in the low interest-rate environment.

58. Financial market conduct and culture remain concerns. In this regard, the UK authorities' efforts to promote (i) stronger standards domestically via measures such as the Senior Managers Regime and (ii) a set of global standards for ethical behavior in the financial system are important contributions to the global public good of well-functioning financial markets. Strong follow-through and implementation of these initiatives will be key.

59. The housing market requires ongoing efforts to contain macroprudential risks and address long-standing supply problems. Macroprudential measures introduced by the FPC since mid-2014 have eased but not eliminated risks to household finances. Further macroprudential measures may therefore be necessary if the reduction in high-leverage mortgages does not continue. The authorities should also extend the FPC's powers of direction to the buy-to-let market to mirror those they currently have over the owner-occupied market. In addition, the authorities should continue to monitor the parameters of the Help to Buy program and consider if they need to be adjusted. Continued efforts to reduce housing supply constraints are equally important; changes to planning processes have improved the prospects for increasing supply, but require ongoing attention to implementation.

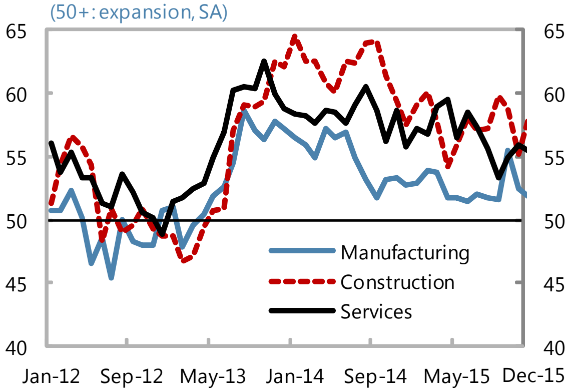
60. Continued structural reforms are necessary to complement the macroeconomic policy mix and sustain growth and employment. In addition to important supply measures for the housing market and strong implementation of reforms of the financial sector architecture—sectors that are particularly important for the UK economy—measures are needed to ensure that growth is not hampered by constraints on skills, labor supply, and infrastructure.

61. It is recommended that the next Article IV consultation take place within the next 12 months. A mandatory financial stability assessment is also expected to be conducted in time for the 2016 Article IV consultation, in line with the five-year cycle for members or members' territories with financial sectors that are determined to be systemically important pursuant to Decision No. 15495-(13/111), adopted December 6, 2013.

Figure 1. United Kingdom: Recent Macroeconomic Developments

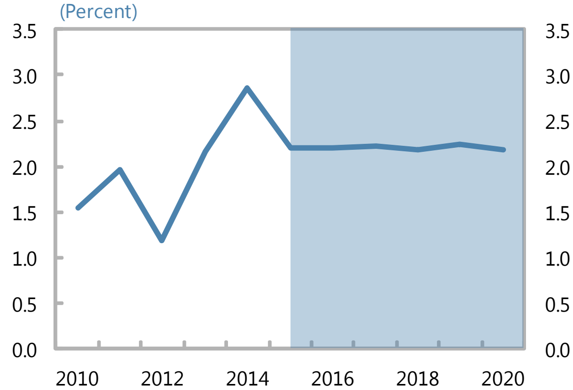
Leading indicators suggest continued growth....

PMI
(50+: expansion, SA)



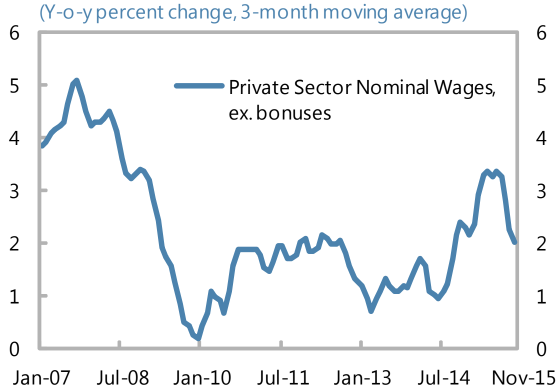
...with staff projecting growth to stabilize near the trend rate.

Real GDP Growth
(Percent)



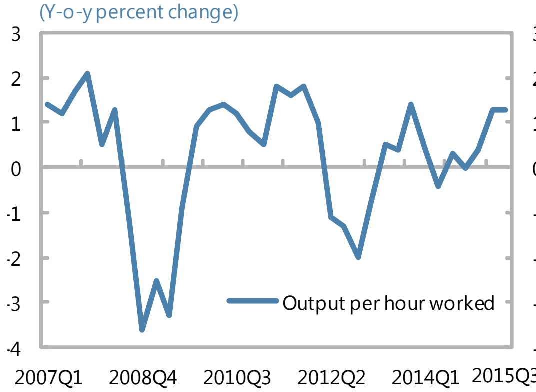
Wage growth has recently surprised on the downside....

Nominal Wage Growth
(Y-o-y percent change, 3-month moving average)



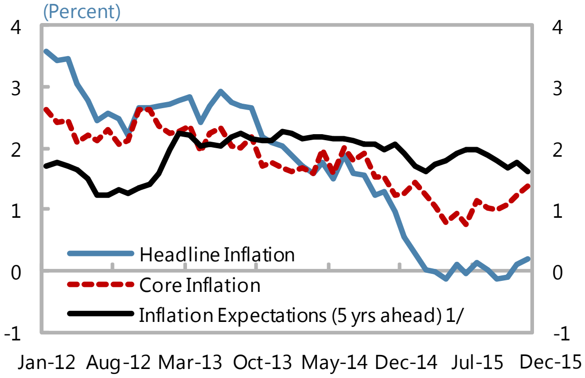
...while productivity growth has ticked upward...

Labor Productivity
(Y-o-y percent change)



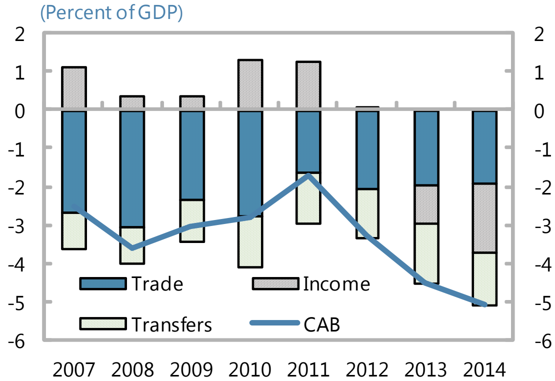
...helping to keep core inflation and inflation expectations remain well-contained.

Inflation and Inflation Expectations
(Percent)



The current account widened further in 2014, mainly due to lower investment income.

Current Account Balance
(Percent of GDP)

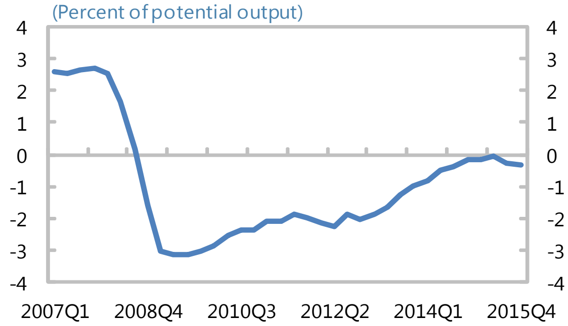


Sources: Haver; ONS; World Economic Outlook; Bank of England; and IMF staff calculations.
1/ Implied forward CPI inflation rate, 5 years ahead on inflation-indexed bonds, assuming RPI inflation exceeds CPI inflation by 1 percentage point.

Figure 2. United Kingdom: Indicators of Spare Capacity

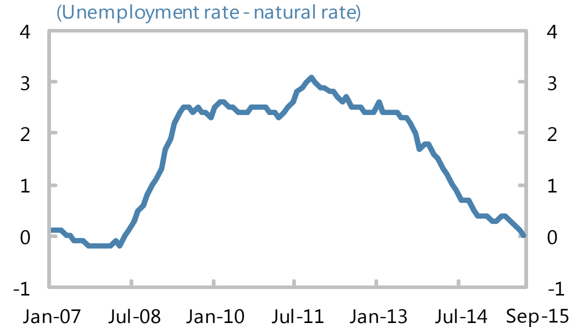
The output gap is nearly closed based on standard models ...

Output Gap 1/
(Percent of potential output)



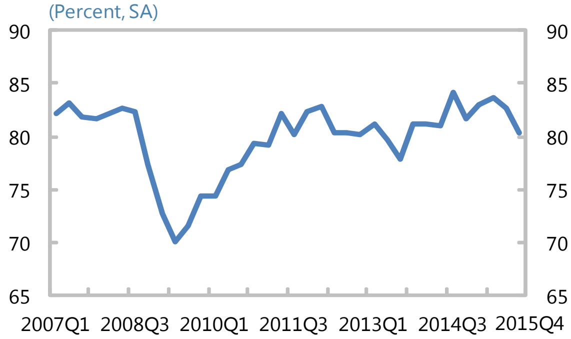
... as is the unemployment gap.

Unemployment Gap 2/
(Unemployment rate - natural rate)



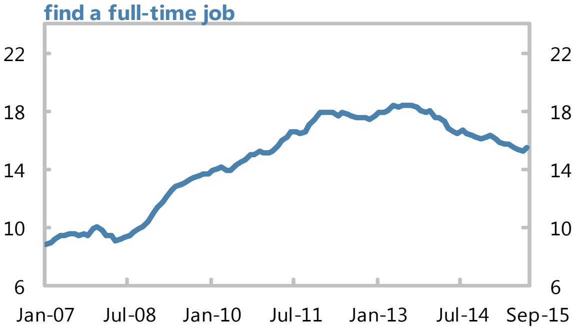
Similarly, capacity utilization is back to pre-crisis levels.

Capacity Utilization 3/
(Percent, SA)



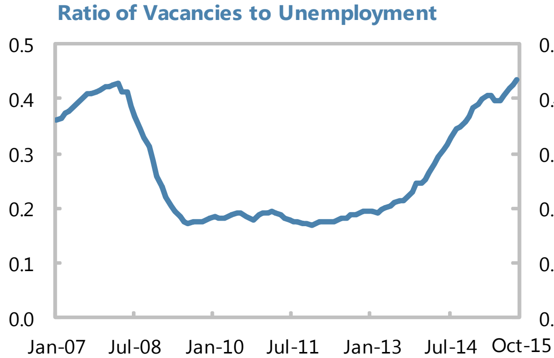
However, there could still be some slight slack from underemployment of part-time workers.

Percent of part-time workers that could not find a full-time job



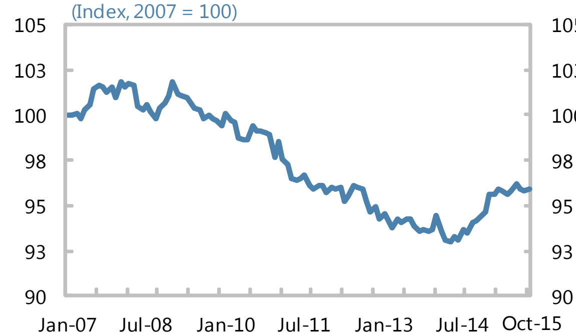
But the ratio of vacancies to unemployment is also back to pre-crisis levels ...

Ratio of Vacancies to Unemployment



...helping to halt the post-crisis decline in real earnings.

Real Earnings
(Index, 2007 = 100)

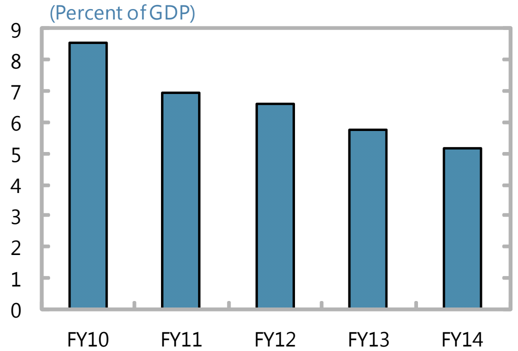


Sources: European Commission; Haver; ONS; and IMF staff calculations.
1/ IMF staff estimate.
2/ IMF staff estimate.
3/ European Commission.

Figure 3. United Kingdom: Fiscal Developments

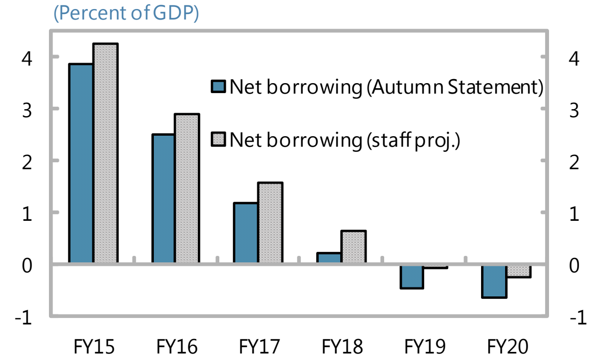
Fiscal consolidation continued in FY14, with the deficit down significantly from 5 years ago .

Public Sector Net Borrowing
(Percent of GDP)



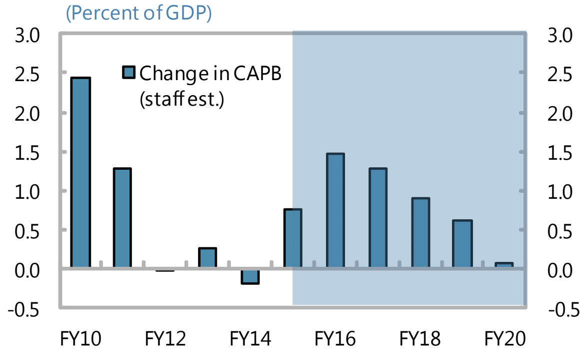
The Autumn Statement 2015 envisages further consolidation and a small surplus by FY19.

2015 Fiscal Consolidation Plan
(Percent of GDP)



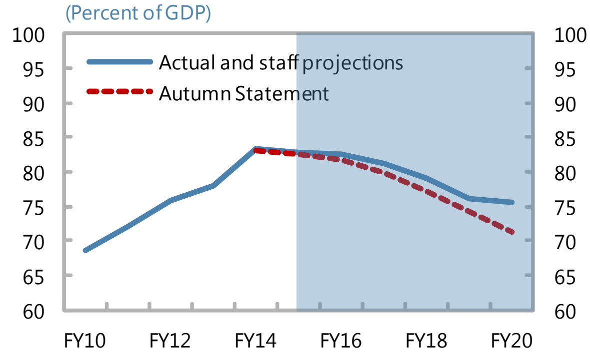
The pace of consolidation is projected to increase somewhat in FY15.

Fiscal Stance
(Percent of GDP)



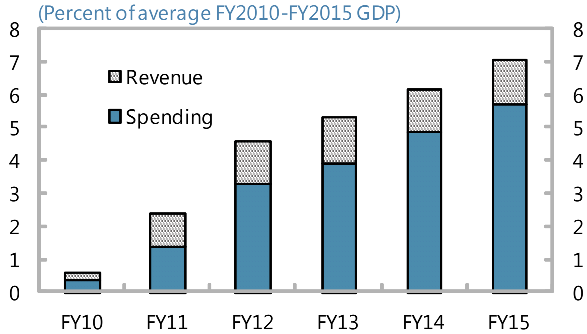
Net public debt is projected to start declining this year and will be reduced further in the medium term.

Net Public Sector Debt
(Percent of GDP)



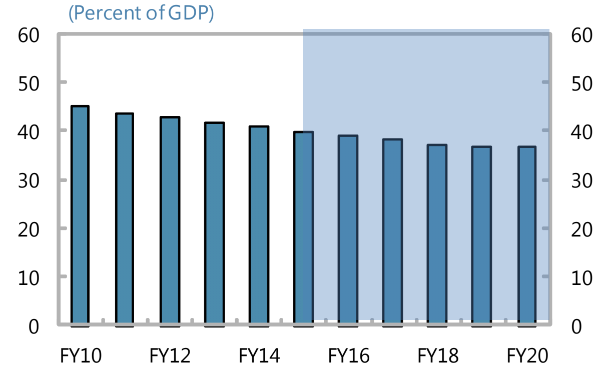
The consolidation so far has been mainly driven by expenditure measures.

Public Sector Discretionary Consolidation Plan
(Percent of average FY2010-FY2015 GDP)



The Autumn Statement entails more tax measures, but spending cuts in some categories remain sizable.

Public Sector Spending
(Percent of GDP)

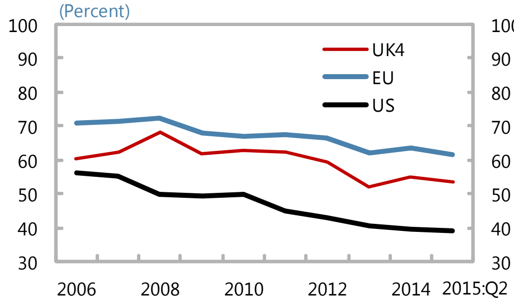


Sources: National authorities; and IMF staff projections.

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

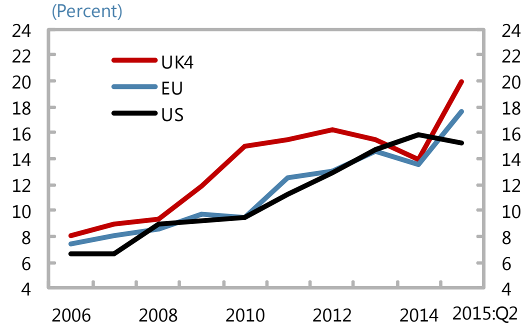
EU, UK, and US banks have reduced reliance on wholesale funding...

Share of Wholesale Funding in Liabilities
(Percent)



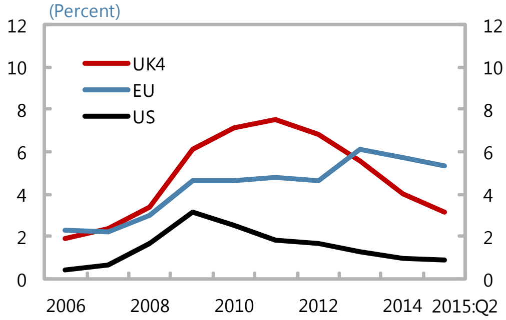
...and raised the share of liquid assets.

Liquid Assets/Total Assets
(Percent)



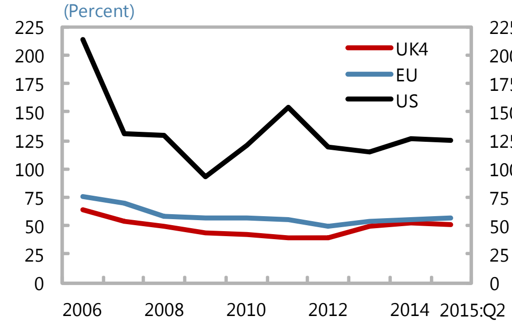
The UK's nonperforming asset ratio has been cut in half relative to its post-crisis peak.

NPA-to-Total Loans 1/
(Percent)



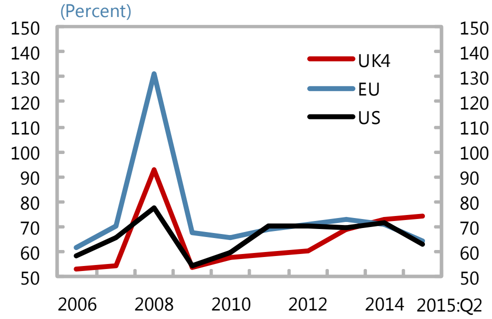
The UK's NPL coverage ratio is similar to that of EU banks.

Reserves for Loan Loss-to-NPA 1/
(Percent)



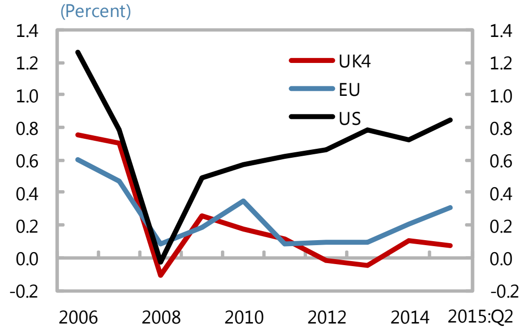
But non-interest expense/income ratios for UK banks have risen given the drag from conduct/restructuring costs.

Efficiency Ratio
(Percent)



This has continued to weigh on profitability.

Return on Assets
(Percent)

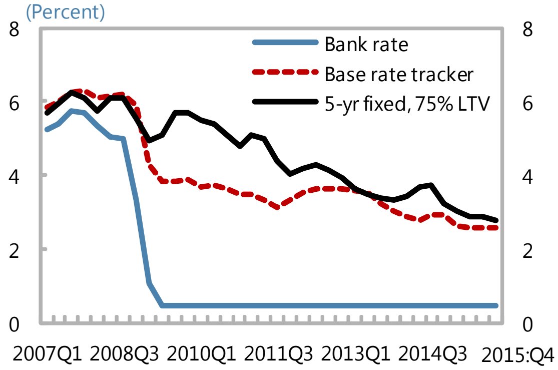


Sources: Bloomberg.; and IMF staff calculations.
Note: Ratios shown are not adjusted for accounting differences across regions (such as GAAP for US vs. IFRS for UK). UK refers to the average for HSBC, Barclays, RBS and LBG. EU and US indicators are weighted averages (by total assets) of the following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

Figure 5. United Kingdom: Housing Market Developments

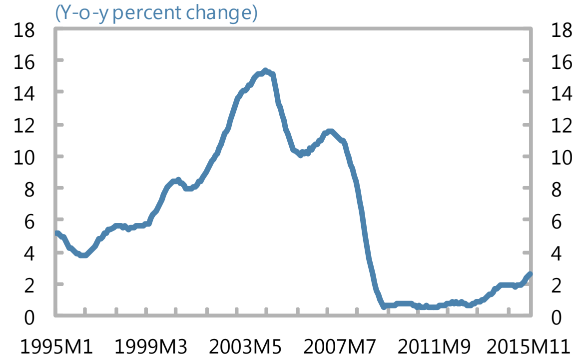
Mortgage rates continue to fall.

Interest Rates
(Percent)



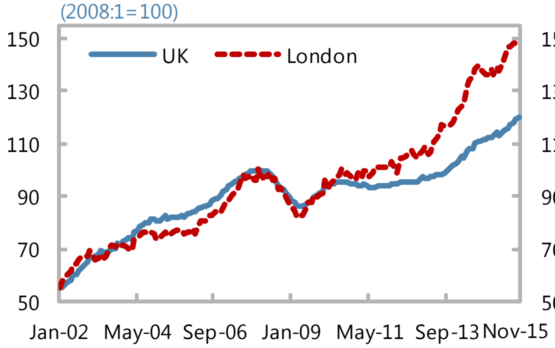
But net mortgage growth remains well below pre-crisis levels.

MFI Mortgages
(Y-o-y percent change)



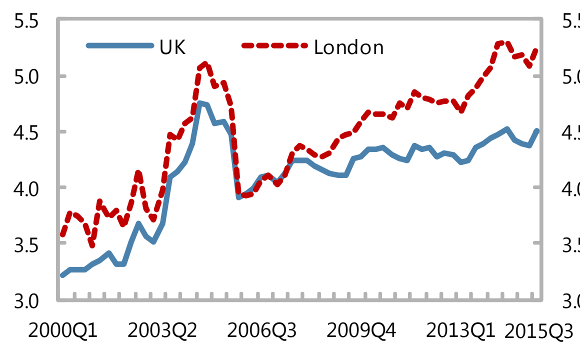
House prices continue to rise...

House Prices
(2008:1=100)



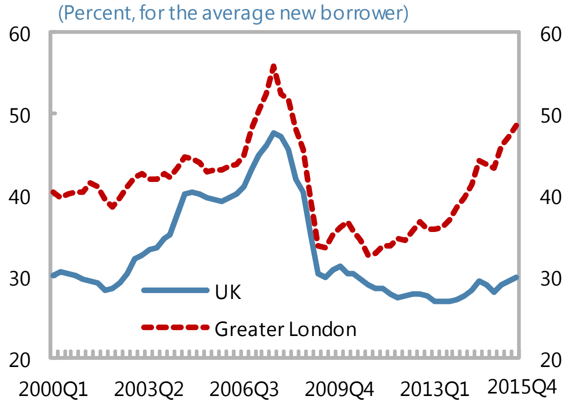
...outpacing income growth, raising affordability concerns...

Price-to-Income Ratios



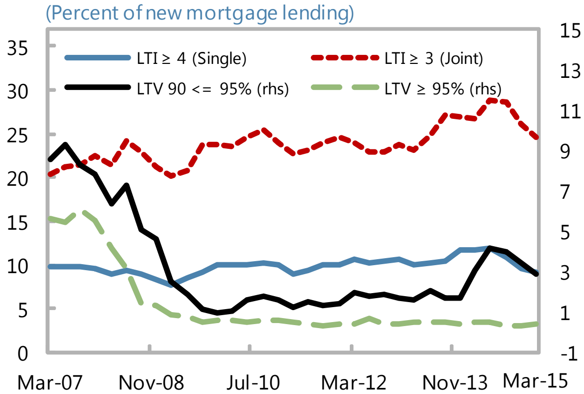
...though this is partly mitigated by low interest rates.

Mortgage Payment/Earnings
(Percent, for the average new borrower)



The percentage of new lending at high LTIs has dipped since mid-2014, but is still at historically high levels.

Loan-to-Income Ratios
(Percent of new mortgage lending)



Sources: Haver; and IMF staff calculations.

Table 1. United Kingdom: Selected Economic Indicators, 2012–17

	2012	2013	2014	2015	2016	2017
				Projections		
Real Economy (change in percent)						
Real GDP	1.2	2.2	2.9	2.2	2.2	2.2
Private final domestic demand	2.1	2.3	3.4	3.2	2.8	2.6
CPI, end-period	2.6	2.1	0.9	0.1	1.4	2.0
Unemployment rate (in percent) 1/	8.0	7.6	6.2	5.4	5.0	5.1
Gross national saving (percent of GDP)	12.9	12.1	12.3	13.2	14.0	14.6
Gross domestic investment (percent of GDP)	16.2	16.6	17.4	17.4	17.9	18.1
Public Finance (fiscal year, percent of GDP) 2/						
Public sector overall balance	-6.6	-5.7	-5.2	-4.3	-2.9	-1.6
Public sector cyclically adjusted primary balance (staff estimates) 3/	-3.2	-3.0	-3.1	-2.4	-0.9	0.4
Public sector net debt	75.8	78.0	83.4	82.8	82.4	81.2
Money and Credit (end-period, 12-month percent change)						
M4	-1.0	0.2	-1.1	...	...	...
Net lending to private sector	-0.2	0.9	1.5	2.0	3.0	4.0
Interest rates (percent; year average)						
Three-month interbank rate	0.8	0.5	0.5	0.6	...	...
Ten-year government bond yield	1.9	2.4	2.6	1.9	...	...
Balance of Payments (percent of GDP)						
Current account balance	-3.3	-4.5	-5.1	-4.1	-3.9	-3.5
Trade balance	-2.0	-2.0	-1.9	-1.8	-1.7	-1.7
Net exports of oil	-0.9	-0.6	-0.6	-0.3	-0.2	-0.3
Exports of goods and services (volume change in percent)	0.7	1.2	1.2	5.5	3.7	3.8
Imports of goods and services (volume change in percent)	2.9	2.8	2.4	5.9	3.5	3.5
Terms of trade (percent change)	0.8	1.7	1.1	0.7	-0.4	0.2
FDI net	-1.3	-2.4	-4.5	-2.7	-2.6	-2.2
Reserves (end of period, billions of US dollars)	105.2	108.8	109.1	...	...	...
Fund Position (as of November 30, 2015)						
Holdings of currency (in percent of quota)						88.6
Holdings of SDRs (in percent of allocation)						95.5
Quota (in millions of SDRs)						10,738.5
Exchange Rates						
Exchange rate regime						Floating
Bilateral rate (December 14, 2015)						US$1 = £0.6616
Nominal effective rate (2010=100) 4/	103.5	101.0	107.4	...	...	...
Real effective rate (2010=100) 4/ 5/	106.8	105.8	113.8	...	...	...

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

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

2/ The fiscal year begins in April. Data exclude the temporary effects of financial sector interventions. Debt stock data refers to the end of the fiscal year using centered-GDP as a denominator. There is a break in the series from 2014 on, reflecting the reclassification of housing associations as part of the public sector.

3/ In percent of potential output.

4/ Average. An increase denotes an appreciation.

5/ Based on relative consumer prices.

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

(Percentage change, unless otherwise indicated)

	2012	2013	2014	2015	2016	2017	2018	2019
				Projections				
Real GDP	1.2	2.2	2.9	2.2	2.2	2.2	2.2	2.2
Real domestic demand	2.3	2.6	3.2	2.2	2.2	2.2	2.1	2.2
Private consumption	1.8	1.9	2.5	2.8	2.4	2.3	2.2	2.2
Government consumption	1.8	0.5	2.5	1.7	0.9	0.6	0.5	0.5
Fixed investment	1.5	2.6	7.3	4.5	3.9	3.7	3.5	4.0
Public	-6.8	-5.1	5.8	2.4	-0.6	0.4	-1.6	1.9
Residential	-2.9	5.7	11.7	2.0	2.5	3.1	4.0	4.0
Business	5.1	2.3	4.7	6.7	5.7	5.0	5.0	5.0
Stocks 1/	0.4	0.7	0.2	-0.6	-0.2	0.0	0.0	0.0
External balance 1/	-0.7	-0.5	-0.4	-0.3	-0.1	0.0	0.0	0.0
Exports of Goods and Services	0.7	1.2	1.2	5.5	3.7	3.8	3.9	3.9
Imports of Goods and Services	2.9	2.8	2.4	5.9	3.5	3.5	3.5	3.6
Current account 2/	-3.3	-4.5	-5.1	-4.1	-3.9	-3.5	-3.3	-3.0
CPI Inflation, period average	2.8	2.6	1.5	0.0	1.1	2.0	2.0	2.0
CPI Inflation, end period	2.6	2.1	0.9	0.1	1.4	2.0	2.0	2.0
Output gap 3/	-2.1	-1.4	-0.5	-0.2	-0.1	0.0	0.0	0.0
Potential output	1.3	1.5	1.8	2.0	2.1	2.1	2.2	2.2
Employment and productivity								
Employment	1.1	1.2	2.3	1.2	0.7	0.6	0.5	0.5
Unemployment rate 4/	8.0	7.6	6.2	5.4	5.0	5.1	5.2	5.3
Productivity 5/	0.1	1.0	0.6	1.0	1.5	1.6	1.7	1.7
Memorandum items:								
Private final domestic demand	2.1	2.3	3.4	3.2	2.8	2.6	2.6	2.6
Household saving rate 6/	8.8	6.3	5.4	4.6	4.7	4.6	4.2	4.1
Private saving rate	17.4	14.9	15.0	14.4	14.0	13.4	13.0	12.9
Credit to the private sector	-0.2	0.9	1.5	2.0	3.0	4.0	4.2	4.3

Sources: Office for National Statistics; and IMF staff estimates.
1/ Contribution to the growth of GDP.
2/ In percent of GDP.
3/ In percent of potential GDP.
4/ In percent of labor force, period average; based on the Labor Force Survey.
5/ Whole economy, per worker.
6/ In percent of total household available resources.

Table 3. United Kingdom: Public Sector Operations, 2010/11–19/20 1/

(Percent of GDP; unless otherwise indicated)

	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
						2015 Autumn Statement				
Revenue	36.4	36.5	35.9	35.6	35.8	35.8	36.5	36.9	36.9	36.9
Taxes	27.5	27.6	26.9	26.8	26.7	26.9	27.2	27.5	27.5	27.5
Social contributions	6.2	6.2	6.2	6.1	6.0	6.0	6.4	6.5	6.5	6.5
Other revenue	2.6	2.6	2.8	2.7	3.0	2.9	2.9	2.9	3.0	3.0
Of which: Interest income	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.4	0.4	0.5
Expenditure	44.9	43.5	42.5	41.4	40.9	39.7	39.1	38.1	37.2	36.5
Expense	43.3	42.3	41.1	40.3	39.6	38.6	38.0	37.2	36.4	35.8
Consumption of fixed capital	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Interest	2.6	2.6	2.2	2.1	2.0	2.0	2.2	2.3	2.4	2.4
Others	38.7	37.7	36.8	36.2	35.6	34.5	33.7	32.8	32.0	31.3
Net acquisition of nonfinancial assets	1.6	1.1	1.4	1.0	1.3	1.1	1.1	0.9	0.7	0.7
Gross operating balance	-6.9	-5.9	-5.2	-4.7	-3.9	-2.8	-1.4	-0.3	0.5	1.1
Net lending/borrowing (overall balance)	-8.6	-7.0	-6.6	-5.7	-5.2	-3.9	-2.5	-1.2	-0.2	0.5
Current balance 2/	-6.0	-5.1	-5.1	-4.2	-3.1	-2.1	-0.7	0.4	1.2	1.9
Primary balance	-6.4	-4.8	-4.7	-4.0	-3.5	-2.2	-0.6	0.7	1.7	2.3
Cyclically adjusted overall balance	-6.5	-5.1	-4.6	-4.2	-4.4	-3.4	-2.3	-1.1	-0.2	0.5
Cyclically adjusted current balance 2/	-4.0	-3.2	-3.1	-2.6	-2.4	-1.6	-0.5	0.5	1.2	1.9
Cyclically adjusted primary balance (CAPB)	-4.3	-2.9	-2.7	-2.4	-2.7	-1.7	-0.5	0.8	1.7	2.3
General government gross debt 3/	77.0	82.6	84.7	86.6	87.5	87.1	86.5	84.8	82.2	79.2
Public sector net debt 4/	68.7	72.1	75.8	78.0	83.1	82.5	81.7	79.9	77.3	74.3
Output gap (percent of potential) 5/	-2.6	-2.8	-2.9	-2.0	-0.8	-0.7	-0.3	-0.1	0.0	0.0
Real GDP growth (percent)	1.9	1.8	1.2	2.5	2.9	2.2	2.5	2.4	2.4	2.3
Nominal GDP (in billions of pounds)	1575.4	1628.9	1677.9	1755.9	1829.0	1903.0	1980.0	2065.0	2157.0	2251.0
Potential GDP growth (percent)	1.2	2.0	1.3	1.6	1.8	2.1	2.1	2.2	2.3	2.3
						Staff projections				
Revenue	36.4	36.5	35.9	35.6	35.7	35.8	36.5	36.9	36.9	36.9
Taxes	27.5	27.6	26.9	26.8	26.7	26.9	27.2	27.5	27.5	27.4
Social contributions	6.2	6.2	6.2	6.1	6.0	6.0	6.4	6.4	6.4	6.5
Other revenue	2.6	2.6	2.8	2.7	3.0	3.0	2.9	3.0	3.0	3.0
Of which: Interest income	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.4	0.5	0.5
Expenditure	44.9	43.5	42.5	41.4	40.9	40.1	39.4	38.5	37.6	36.9
Expense	43.3	42.3	41.1	40.3	39.5	39.0	38.3	37.6	36.9	36.2
Consumption of fixed capital	2.1	2.1	2.1	2.1	2.0	2.1	2.1	2.1	2.1	2.1
Interest	2.6	2.6	2.2	2.1	2.0	2.1	2.2	2.3	2.4	2.4
Other	38.7	37.7	36.8	36.2	35.5	34.8	33.9	33.1	32.3	31.7
Net acquisition of nonfinancial assets	1.6	1.1	1.4	1.0	1.4	1.1	1.1	0.9	0.7	0.7
Gross operating balance	-6.9	-5.9	-5.2	-4.7	-3.8	-3.2	-1.8	-0.7	0.1	0.7
Net lending/borrowing (overall balance)	-8.6	-7.0	-6.6	-5.7	-5.2	-4.3	-2.9	-1.6	-0.7	0.1
Current balance 2/	-6.0	-5.1	-5.1	-4.2	-3.1	-2.5	-1.1	0.0	0.8	1.5
Primary balance	-6.4	-4.8	-4.7	-4.0	-3.5	-2.6	-1.0	0.4	1.3	1.9
Cyclically adjusted overall balance	-6.8	-5.5	-5.2	-4.8	-4.8	-4.1	-2.8	-1.6	-0.7	0.0
Cyclically adjusted current balance 2/	-4.3	-3.6	-3.6	-3.2	-2.7	-2.3	-1.0	0.1	0.8	1.5
Cyclically adjusted primary balance (CAPB)	-4.6	-3.3	-3.3	-3.0	-3.1	-2.4	-0.9	0.4	1.3	1.9
CAPB (percent of potential GDP)	-4.5	-3.2	-3.2	-3.0	-3.1	-2.4	-0.9	0.4	1.3	1.9
General government gross debt 3/	77.0	82.6	84.7	86.6	87.4	87.5	87.0	85.5	83.2	80.4
Public sector net debt 4/	68.7	72.1	75.8	78.0	83.4	82.8	82.4	81.2	79.0	76.2
Output gap (percent of potential)	-2.3	-2.0	-2.0	-1.2	-0.3	-0.2	-0.1	0.0	0.0	0.0
Real GDP growth (percent)	1.9	1.8	1.2	2.5	2.8	2.1	2.2	2.2	2.2	2.2
Nominal GDP (in billions of pounds)	1575.4	1628.9	1677.9	1755.9	1831.9	1884.1	1962.9	2044.8	2133.0	2226.1
Potential GDP growth (percent)	1.2	1.5	1.1	1.6	1.9	2.1	2.1	2.1	2.2	2.2

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

1/ Excludes the temporary effects of financial sector interventions, as well as the one-off effect on public sector net investment in 2012/13 of transferring assets from the Royal Mail Pension Plan to the public sector, unless otherwise noted. The data reflect the reclassification of housing associations as part of the public sector starting from 2014/15.

2/ Includes depreciation.

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

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

Table 4. United Kingdom: General Government Operations, 2008–14

(Percent of GDP)

	2008	2009	2010	2011	2012	2013	2014
Revenue	41.5	38.8	39.1	39.2	38.4	39.2	38.2
Taxes	29.4	26.6	27.4	27.8	27.1	27.0	26.6
Social contributions	8.1	8.1	8.0	7.9	7.9	7.8	7.6
Other	4.0	4.1	3.7	3.5	3.5	4.5	4.0
Expense	46.6	49.6	48.8	46.9	46.8	44.9	43.9
Expense	44.9	47.8	47.2	45.6	45.7	44.0	42.9
Compensation of employees	10.6	11.2	11.1	10.6	10.3	9.6	9.5
Use of goods and services	11.6	12.6	12.1	11.5	11.4	11.3	11.1
Consumption of fixed capital	1.4	1.5	1.5	1.6	1.6	1.6	1.6
Interest	2.2	1.9	2.9	3.2	2.9	2.9	2.7
Subsidies	0.6	0.6	0.6	0.5	0.5	0.5	0.6
Social benefits	12.9	14.7	14.6	14.5	14.8	14.5	14.1
Other	5.6	5.3	4.4	3.8	4.2	3.6	3.3
Net acquisition of nonfinancial assets	1.6	1.8	1.6	1.3	1.1	0.9	1.0
Consumption of fixed capital	-1.4	-1.5	-1.5	-1.6	-1.6	-1.6	-1.6
Gross operating balance	-2.0	-7.4	-6.5	-4.8	-5.7	-3.2	-3.1
Net operating balance	-3.4	-9.0	-8.1	-6.4	-7.3	-4.7	-4.7
Net lending/borrowing (overall balance)	-5.1	-10.8	-9.7	-7.7	-8.3	-5.7	-5.7
Net financial transactions	-5.6	-10.3	-10.1	-7.6	-8.1	-5.8	-5.6
Net Acquisition of Financial assets	4.5	3.7	0.2	0.7	0.7	-1.3	0.7
Currency and deposits	0.8	0.2	-0.8	0.7	0.2	0.3	0.4
Securities other than shares	0.3	-0.5	0.4	0.5	0.1	-0.2	0.3
Loans	1.5	0.8	0.6	-0.2	0.3	0.1	0.3
Shares and other equity	0.6	2.4	0.0	-0.1	0.1	-1.7	-0.5
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts receivable	1.3	0.2	0.1	-0.3	0.0	0.2	0.1
Monetary gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Incurrence of Liabilities	10.2	14.1	10.2	8.2	8.8	4.5	6.3
Currency and deposits	1.3	0.5	-0.3	0.5	-0.2	-0.4	1.0
Securities other than shares	7.4	14.8	10.5	8.0	6.6	4.6	4.8
Loans	0.6	-2.0	-0.1	-0.1	0.1	0.0	0.1
Shares and other equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Insurance technical reserves	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts receivable	0.8	0.1	0.0	-0.3	2.2	0.2	0.3

Source: IMF's International Finance Statistics.

Table 5. United Kingdom: General Government Stock Positions, 2008–14
(Percent of GDP)

	2008	2009	2010	2011	2012	2013	2014
Net worth	...	...	...	...	...	...	...
Nonfinancial assets	...	...	...	...	...	...	...
Net financial worth	-40.8	-50.4	-54.8	-70.2	-72.4	-70.7	-82.4
Financial assets	25.0	28.9	35.8	33.9	35.4	32.7	32.2
Currency and deposits	4.1	4.4	4.1	4.7	4.7	4.6	4.5
Securities other than shares	2.7	2.0	3.0	3.3	3.2	2.8	3.0
Loans	3.8	4.7	9.5	9.0	9.0	8.6	8.5
Shares and other equity	9.6	11.8	12.7	11.1	12.8	11.3	11.0
Insurance technical reserves	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives	-0.2	0.0	0.1	0.2	0.2	0.2	0.1
Other accounts receivable	4.5	4.8	5.0	4.4	4.3	4.2	4.1
Monetary gold and SDRs	0.4	1.1	1.2	1.2	1.2	0.9	0.9
Liabilities	65.8	79.3	90.6	104.2	107.8	103.3	114.7
Currency and deposits	8.0	8.6	8.2	8.4	8.0	7.3	7.9
Securities other than shares	44.6	59.2	72.6	86.0	88.9	85.6	96.2
Loans	4.0	1.9	1.7	1.7	1.6	1.6	1.6
Shares and other equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Insurance technical reserves	6.6	6.2	4.8	5.2	4.4	3.6	3.1
Financial derivatives	0.0	0.0	0.2	0.2	0.1	0.1	0.1
Other accounts payable	2.5	2.6	2.5	2.0	4.2	4.5	5.2

Source: IMF's International Finance Statistics.

Table 6. United Kingdom: Balance of Payments, 2012–19
(Percent of GDP)

	2012	2013	2014	2015	2016	2017	2018	2019
				Projections				
Current account	-3.3	-4.5	-5.1	-4.1	-3.9	-3.5	-3.3	-3.0
Balance on goods and services	-2.0	-2.0	-1.9	-1.8	-1.7	-1.7	-1.5	-1.4
Trade in goods	-6.4	-6.6	-6.8	-6.3	-6.2	-6.3	-6.2	-6.2
Exports	18.3	17.7	16.2	15.9	15.2	15.5	15.8	16.0
Imports	-24.7	-24.3	-22.9	-22.2	-21.5	-21.8	-22.0	-22.2
Trade in services	4.4	4.7	4.9	4.6	4.5	4.6	4.7	4.8
Exports	11.9	12.4	12.1	11.5	11.1	11.4	11.5	11.7
Imports	-7.5	-7.7	-7.2	-6.9	-6.7	-6.8	-6.8	-6.9
Primary income balance	0.1	-1.0	-1.8	-1.0	-0.8	-0.5	-0.4	-0.2
Secondary income balance	-1.3	-1.5	-1.4	-1.4	-1.4	-1.4	-1.4	-1.4
Capital and financial account	-2.7	-4.0	-5.6	-4.2	-4.0	-3.6	-3.4	-3.1
Capital account	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account	-2.7	-4.0	-5.6	-4.2	-3.9	-3.6	-3.3	-3.0
Direct investment	-1.3	-2.4	-4.5	-2.7	-2.6	-2.2	-2.1	-2.1
Abroad	0.5	-1.1	-2.9	-0.7	-0.5	0.0	0.2	0.3
Domestic	1.8	1.4	1.6	2.0	2.1	2.2	2.3	2.4
Portfolio investment	12.8	-2.9	-6.3	0.5	0.5	0.5	0.5	0.5
Financial derivatives	-1.8	0.8	-0.8	-0.6	-0.4	-0.5	-0.3	-0.4
Other investment	-12.8	0.3	5.7	-1.7	-1.8	-1.7	-1.8	-1.3
Change in reserve assets	0.5	0.3	0.4	0.3	0.3	0.3	0.3	0.3
Net errors and omissions	0.6	0.5	-0.4	0.0	0.0	0.0	0.0	0.0

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

Table 7. United Kingdom: Net Investment Position, 2012–19
(Percent of GDP)

	2012	2013	2014	2015	2016	2017	2018	2019
				Projections				
Net investment position	-20.9	-14.1	-23.7	-27.3	-30.2	-32.5	-34.5	-36.1
Assets	632.3	558.2	560.9	559.4	555.0	551.4	549.8	549.2
Liabilities	653.1	572.3	584.7	586.7	585.2	583.9	584.3	585.3
Net direct investment	6.3	3.1	-8.1	-10.6	-12.8	-14.5	-16.0	-17.4
Direct investment abroad	81.0	73.1	67.5	65.0	62.0	59.4	57.2	55.2
Direct investment in the UK	74.6	69.9	75.7	75.6	74.8	73.9	73.3	72.6
Net Portfolio investment	-10.9	-2.1	-4.2	-3.6	-3.0	-2.3	-1.8	-1.2
Portfolio investment abroad	141.0	140.8	140.1	141.2	141.0	140.7	140.9	141.2
Portfolio investment in the UK	151.9	142.9	144.4	144.8	144.0	143.1	142.6	142.3
Net financial derivatives	1.7	2.7	1.2	0.6	0.2	-0.3	-0.6	-1.0
Assets	183.8	139.7	155.7	155.7	155.7	155.7	155.7	155.7
Liabilities	182.1	137.0	154.4	155.0	155.5	156.0	156.2	156.6
Net other investment	-21.6	-21.4	-16.3	-17.6	-18.7	-19.6	-20.6	-21.0
Other investment abroad	222.9	201.0	193.9	193.6	192.2	191.3	191.6	192.7
Other investment in the UK	244.5	222.4	210.2	211.2	210.9	210.9	212.2	213.7
Reserve assets	3.7	3.5	3.7	4.0	4.1	4.3	4.4	4.5
Memorandum items:								
Change in the net investment position	-13.6	6.0	-10.3	-4.2	-3.9	-3.6	-3.3	-3.0
Current account balance	-3.3	-4.5	-5.1	-4.1	-3.9	-3.5	-3.3	-3.0

Source: Office for National Statistics.

1/ Data correspond to the end of the indicated period, expressed as a percent of the cumulated GDP of the four preceding quarters. No valuation effects are assumed in the projections.

Annex 1. External Sector Assessment

	United Kingdom	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. The net international investment position (NIIP) stood at -24 percent of GDP in 2014. The revised series shows a declining external position from 2011. Staff projections for the current account and GDP suggest that the official NIIP to GDP ratio would stabilize at around -30 to -45 percent of GDP by 2021, though the importance of uncertain valuation effects implies significant uncertainty to these estimates. Gross assets and liabilities are more than 500 percent of GDP, reflecting the international activities of large financial institutions. **Assessment**. The NIIP and sustainability issues are not yet a concern. But fluctuations in the underlying gross positions are a source of external vulnerability to the extent that they could lead to large changes in the net position.	**Overall Assessment**: *The external position in 2015 is weaker than implied by medium-term fundamentals and desirable policy settings.* External deficits reflect insufficient public and private saving rates. **Potential policy responses**: Sustaining a strong and durable recovery in the UK requires rebalancing away from public support toward private-sector led demand, along with greater reliance on external demand. The current fiscal consolidation plan implemented within a medium-term framework and an accommodative monetary policy stance contribute to the goal of external rebalancing. Further structural reforms focused on broadening the skill base and investing in public infrastructure will boost productivity, improving the competitiveness of the economy.
Current account	**Background**. During the recovery from the crisis, the current account (CA) balance deteriorated from -3 to -5 percent of GDP. The decline in the CA balance is accounted for primarily by a lower income balance, reflecting a fall in earnings on the UK's foreign direct investment abroad, notably earnings on investment exposed to the euro area. The trade balance has been stable at around -2 percent of GDP, despite a 9½ percent real exchange rate depreciation between 2007 and 2014. In the first three quarters of 2015, the current account balance improved to -4.2 percent of GDP, helped by the recent oil price drop and an improvement in the income balance. Household and non-financial sector saving-investment balances have declined, more than offsetting the slight improvement in the general government balance. **Assessment**. The EBA CA regression approach estimates a CA gap of around -3.5 percent of GDP for 2015. However, the recent deterioration in the income balance is not expected to be all permanent, suggesting a smaller underlying CA deficit and smaller CA gap than implied by the EBA model. Taking this and other factors (such as the CA gaps implied by the REER regressions discussed below) into account, staff assesses the 2015 cyclically-adjusted CA balance to be 1.5 to 3.5 percent of GDP weaker than the current account norm.	
Real exchange rate	**Background**. For 2014 as a whole, the average REER was 8 percent more appreciated than for 2013. As of November 2015, the REER has strengthened by 10 percent from its average level in 2014. This appreciation may reflect the UK's relatively strong domestic demand and differences in interest rates (both current and prospective) between the UK and many advanced economies. **Assessment**. For 2015, the EBA exchange rate assessment implied by the EBA CA regression model (adjusted by staff for estimates of temporary effects on the income balance) indicates an overvaluation of 11 percent. The EBA REER regressions estimate an overvaluation of 10 percent (REER Level model) and 12 percent (REER Index model). Staff assesses the 2015 REER as 5–15 percent above the level consistent with fundamentals and desirable policy settings; this assessment is informed by and consistent with the staff's CA assessment.	
Capital and financial accounts: flows and policy measures	**Background**. Given the UK's role as an international financial center, portfolio investment and financial derivatives are the key components of the financial account. **Assessment**. Large fluctuations in capital flows are inherent to financial transactions in countries with a large financial services sector. This volatility is a potential source of vulnerability.	
FX intervention and reserves level	**Background**. The pound has the status of a global reserve currency. **Assessment**. Reserves held by the UK are typically low relative to standard metrics, and the currency is free floating.	

Annex 2. Risk Assessment Matrix[1]

Source of Risks and Relative Likelihood	Expected Impact of Risk	Policy Recommendation if Risk Occurs
Medium **Tighter or more volatile global financial conditions:** • **Sharp asset price decline and decompression of credit spreads** as investors reassess underlying risk and respond to unanticipated changes in growth and financial fundamentals in large economies, Fed policy rate path, and increases in U.S. term premia, with poor market liquidity amplifying volatility (short-term).	**High** • Tightened financial conditions and market discontinuity. • Depressed investment, consumption, and GDP growth due to increased uncertainty. • Sharp reduction in asset and house prices (including from reduced demand from foreigners), suppressing aggregate demand.	• Continue with accommodative monetary policy—including, if necessary, rate cuts and restarting QE—to offset market volatility. • Allow automatic fiscal stabilizers to operate; ease fiscal path if growth slows sharply. • Continue to allow liquidity policies to be a backstop against market volatility.
Low-Medium / Medium / High-Medium **Sharper-than-expected global growth slowdown:** • **Significant China slowdown**, triggered by corporate distress that propagates through shadow banks, precipitating deleveraging, uncertainty and capital outflows. Weak domestic demand further suppresses commodity prices, roils global financial markets, and reduces global growth (**low** in short-term, **medium** thereafter) • **Significant slowdown in other large EMs/frontier**	**Medium-High** • Slowdown in GDP growth. • Persistently low real interest rates complicating the operation of monetary policy due to effective lower bound problems. • Widening of the current account deficit. • A China slowdown's effects via trade may be limited, as China accounts for	• Continue with accommodative monetary policy for longer to support demand. If further support is needed, cut the policy rate to at least zero, followed, if necessary, by restarting QE. • Allow automatic fiscal stabilizers to operate; ease

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

economies. Turning of the credit cycle and fallout from excess household and corporate leverage (incl. in FX) as investors withdraw from EM corporate debt, generating disorderly deleveraging, with potential spillbacks to advanced economies (**medium** in short-term) • **Structurally weak growth in key advanced and emerging economies.** Weak demand and persistently low inflation from a failure to fully address crisis legacies and undertake structural reforms, leading to low medium-term growth and persisting financial imbalances in the Euro area and Japan (**high** likelihood). Easy global financial conditions coming o an end and insufficient reform progress undermine medium-term growth in emerging markets and suppress commodity prices (**medium** likelihood).	only 3½ percent of UK exports. Financial sector linkages are somewhat stronger. However, the BoE's stress tests released in December 2015 indicate that the UK banking system's core functions can withstand a severe downturn in China and EMs along with lower growth in the euro area.	fiscal path if growth slows sharply. • Implement structural policies to boost investment, productivity and competitiveness. • Continue to allow liquidity policies to be a backstop against market volatility.
High **Persistently lower energy prices,** triggered by supply factors reversing only gradually.	**Low** • Lower energy prices may boost disposable income and consumption, but weigh on investment in the energy sector. • Headline inflation may be lower for longer.	• If persistently low energy prices produce second-round effects that depress medium-term inflation expectations and core price-setting behavior, monetary policy may need to be accommodative for longer.
Medium **Disruptions to trade and capital flows:** • The government is currently renegotiating the terms of its membership in the EU. Following these negotiations, a referendum on EU membership is planned by end-2017, which could lead to an exit from the EU.	**Medium-High** • Quantifying how a decision to leave the EU would affect the economy is difficult, given that (i) the terms of staying in the EU are still being negotiated and (ii) the nature of post-exit relations with the EU are unknown. However, analysts have raised concerns that the exit debate could bring a period of uncertainty that could weigh on investment.	• Re-double efforts to secure benefits of economic cooperation and trade. • Continue to allow liquidity policies to be a backstop against market volatility.

Medium **Protracted period of stagnant productivity:** • The incipient recovery in productivity growth halts, followed by further protracted stagnation.	High • Increase in unit labor costs, causing inflation to rise faster than expected. • Loss of competitiveness. • Slowdown of GDP growth.	• Accelerate the implementation of productivity-enhancing structural reforms. • Tighten monetary policy if earnings increase ahead of productivity.
Medium **Financial stability risks arising from the housing market:** • A rapid rise in house price-to-income ratios driven by increased leverage would raise the vulnerability of banks and households to adverse shocks to house prices, income, and interest rates.	High • Increased household leverage. • Rapid growth of mortgage credit. • Higher exposure of the financial system to the housing market.	• Tighten macroprudential policy by using new macroprudential tools (DTI and LTV limits). • Tighten parameters of Help-to-Buy by restricting the qualification criteria.
Medium **The current account deficit does not decline over the medium term:** • Yields on foreign investments could remain depressed, hampering adjustment of the net income balance, and external adjustment arising from the policy mix of tight fiscal and loose monetary might not be adequate to offset this.	Low • A build-up of large external imbalances would raise risks of abrupt capital outflows that could reduce business investment and economic activity. • Large external imbalances also raise risks of a sharp currency depreciation that yields a burst of inflation. However, this risk is mitigated by the BoE’s inflation-targeting framework and by well-anchored inflation expectations, which should allow the BoE to mostly look through the inflationary effects of a one-off depreciation. • Aggregate balance sheet effects of sterling depreciation should also be positive, but dislocations could occur in specific sectors/institutions.	• If the current account fails to adjust, re-double efforts to boost productivity through structural reforms and raise saving via the fiscal and monetary mix (i.e., further tighten fiscal policy; this would allow looser monetary policy, thereby facilitating adjustment of sterling overvaluation and external imbalances).

Annex 3. The Global Asset Market Disruption Scenario: Effects on the United Kingdom

This annex documents the effects on the United Kingdom of the Global Asset Market Disruption scenario in Chapter 1 of the Fall 2015 Global Financial Stability Report. This global downside risk scenario is simulated using the Global Macrofinancial Model documented in Vitek (2015).[1]

Under the Global Asset Market Disruption scenario, the realization of financial stability risks delays or stalls monetary normalization in the systemic advanced economies. It assumes an abrupt decompression of asset risk premia relative to the baseline amplified by low secondary market liquidity in all of the systemic advanced economies as financial risk-taking unwinds, interacted with the reemergence of financial stress in the Euro Area periphery. It also assumes credit cycle downturns in all emerging economies to varying degrees, together with a disorderly deleveraging in China, represented by additional increases in the default rate on bank loans to nonfinancial corporates. Finally, it assumes suppressed economic risk-taking worldwide, represented by additional confidence-driven private domestic-demand decreases. These specific assumptions are show in Table 1.

Scenario Assumptions

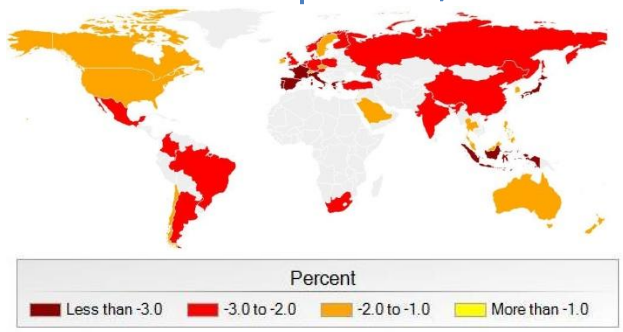
Layer 1: Tightening of financial conditions in systemic economies, 2016	
Long-term government bond yield; Duration risk premium shocks	
Euro Area periphery	+100 basis points
Euro Area core	+25 basis points
Japan, United Kingdom, United States	+50 basis points
Real equity price; Equity risk premium shocks	
China, Euro Area, Japan, United Kingdom, United States	−20 percent
Money market interest rate spread; Credit risk premium shocks	
China	+100 basis points
Euro Area, Japan, United Kingdom, United States	+25 basis points
Layer 2: Credit cycle downturns in emerging economies, 2016 - 2017	
Loan default rate; Loan default shocks	+0.1 to +4.5 percentage points
Layer 3: Suppressed economic risk taking worldwide, 2016 - 2017	
Private investment; Investment demand shocks	−0.500 percent
Private consumption; Consumption demand shocks	−0.125 percent

Note: All scenario assumptions are expressed as deviations from baseline. The Euro Area periphery consists of Greece, Ireland, Italy, Portugal, and Spain. The Euro Area core consists of Austria, Belgium, Finland, France, Germany, and the Netherlands.

[1] Vitek, F. (2015), Macrofinancial analysis in the world economy: A panel dynamic stochastic general equilibrium approach, *International Monetary Fund Working Paper*, 227.

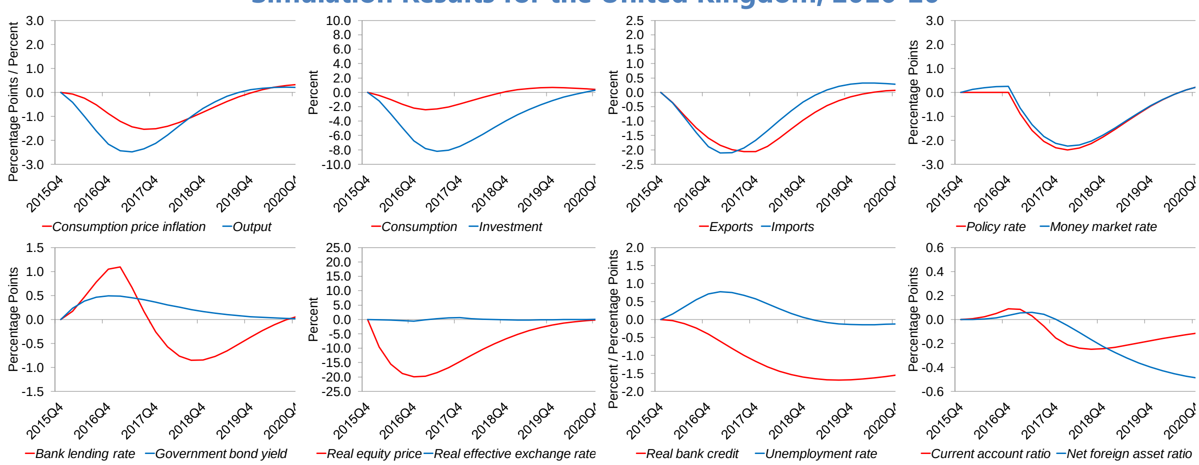
The Global Asset Market Disruption scenario generates a wide range of macroeconomic impacts worldwide. Reflecting lower financial and economic risk-taking, output contracts by 2.6 percent in the systemic advanced economies, by 1.6 percent in other advanced economies, by 2.6 percent in China, and by 2.4 percent in other emerging economies, relative to the baseline by 2017. This wide variation in output losses across economies reflects differences in shocks, exposures, vulnerabilities, and policy space. In aggregate, world output contracts by 2.4 percent by 2017, while energy and nonenergy commodity prices fall by 22.9 and 11.9 percent, respectively.

Simulated output effects, 2017



Under the Global Asset Market Disruption scenario, the United Kingdom experiences a medium macroeconomic impact. Output contracts by 2.3 percent relative to the baseline by 2017, while consumption price inflation falls by 1.4 percentage points, and the unemployment rate rises by 0.7 percentage points. However, net effects on the current account balance would be modest.

Simulation Results for the United Kingdom, 2016-20



Note: All simulation results are expressed as deviations from baseline. A real effective exchange rate increase represents a currency depreciation in real effective terms.

Annex 4. Authorities' Response to Past IMF Policy Recommendations

IMF 2014 Article IV Recommendations	Authorities' Responses
Fiscal Policy	
Fiscal tightening for FY14/15 is appropriate. Given the need to put debt on a downward path, the government's objective of eliminating the overall deficit by FY18/19 is also appropriate.	The cyclically-adjusted primary balance was broadly unchanged in FY14/15, but fiscal tightening is budgeted for FY15/16 and subsequent years. The deficit is expected to reach a small surplus in FY19/20, which will put debt on a firmly downward path.
Both revenue and expenditure items should be explored to meet the medium-term fiscal objectives. Consolidation efforts should carefully consider issues of equity and efficiency.	Revised revenue and interest expenditure projections and new revenue measures allow deficit reduction to be based less on expenditure consolidation than originally projected.
Any new fiscal framework should have clearly defined operating targets that can be directly controlled by policymakers and are closely linked to debt and its sustainability (such as overall deficits), while allowing for flexibility to deal with unexpected shocks.	The new fiscal rule is transparent and simple. It specifies a surplus in "normal" times, focuses on the overall balance, and includes a well-defined escape clause in the event of very low growth.
Monetary Policy	
Monetary policy should stay accommodative.	The MPC has maintained an accommodative monetary policy stance, keeping the policy rate and stock of QE assets unchanged.
Housing Market	
Prudential, rather than monetary policy tightening, tools should be the first line of defense against financial risks from the housing market.	The FPC has been granted powers of direction over LTV and DTI limits in respect of mortgages on owner-occupied properties. The Treasury is consulting on granting similar powers for the buy-to-let sector.
Supply-side measures are crucial to safeguard affordability and mitigate financial risks.	Planning regulations have been changed to accelerate new developments. However, the July 2015 Budget imposes 1 percent annual rent reductions in the social rented sector, which the OBR assesses is likely to reduce affordable housebuilding.
Help to Buy should be regularly assessed.	HMT monitoring shows Help to Buy accounts for a small percentage of overall mortgage transactions, mostly outside of London, and predominantly at values well below the national average. Mortgage guarantee loans have been restricted to 4.5 times borrowers' income, in line with FPC LTI limits.

Financial Sector Policies	
Further capital effort will likely be needed over the medium term.	The major G-SIBs have increased CET1 ratios and are now broadly in line with peers.
The multi-pronged approach to a more robust regulatory capital framework is appropriate but the authorities will need to communicate clearly and early their regulatory expectations to alleviate uncertainty.	The FPC announced in December 2015 its capital requirements framework. In particular, the FPC judged the appropriate aggregate Tier 1 equity requirement for the banking system to be 11 percent at this time and viewed that, on a system-wide basis, significant further capital-raising is unlikely to be required. In addition, the FPC announced that it intends to make active use of the time-varying countercyclical capital buffer (currently set at 0).
Broadening the institutional perimeter of the stress tests and strengthening supervision beyond the major banks would be important.	The BoE wants to conduct system-wide stress tests that would broaden their coverage to include investment funds and other major nonbank financial institutions. On supervision, the BoE is engaged in efforts to develop a CRE debt database to address CRE-related vulnerabilities.
Structural Financial Reforms	
Stronger liquidity backstops will provide a buffer against shocks, but supervision should be strengthened commensurately to address a potential increase in risk-taking.	The BoE has revised its liquidity insurance framework to cover a broader range of key financial institutions and markets, against a wider range of collateral and for longer maturities. The BoE regulates all recipients of liquidity insurance.
Reforms to address the problem of Too-Important-To-Fail institutions should be completed. The agenda should ensure international consistency of national reforms and guard against regulatory arbitrage.	A comprehensive bank resolution regime has been designed and will be in place by 2020 combining ring-fencing, TLAC, and resolution planning requirements.
Supply-side Policies	
Infrastructure. A further expansion in public investment in infrastructure projects, within the medium-term fiscal framework, along with the implementation of well-designed guarantee schemes, could provide the necessary infrastructure to address capacity constraints.	The Autumn Statement increased the government's infrastructure spending plans by £20 billion in this parliament compared to the last parliament.
Education. A further expansion in vocational training and apprenticeship programs could provide the needed skills for the young.	The new government announced an apprenticeship levy to finance apprenticeships. The program aims to encourage more employers to hire apprentices with the cost borne by large employers.

Annex 5. Debt Sustainability Analysis[1]

The level of public sector debt remains high, but the authorities' fiscal consolidation efforts in recent years are starting to have an effect on the debt level. Public sector gross debt is projected to have stabilized in FY14/15 at about 87 percent of GDP, and staff forecasts that it will decline to 80 percent of GDP by FY20. Fiscal consolidation will need to continue in the medium term to ensure the debt ratio stays on a downward path and to rebuild buffers over time. All debt profile vulnerabilities are below early warning benchmarks, but the projected debt trajectory is susceptible to various shocks, especially a negative real GDP growth shock.

Baseline and Realism of Projections

- **Macroeconomic assumptions.** Real GDP in FY15/16 is projected to grow by 2.1 percent, supported by robust private domestic demand. In subsequent years, growth is projected to stay around 2.2 percent. Inflation is projected to gradually rise closer to 2 percent in the medium term. Short-term interest rates are projected to start rising from FY16/17, gradually increasing by a total of 140 basis points by FY20/21.

- **Fiscal adjustment.** The authorities aim to eliminate the overall budget deficit by FY19/20. In staff's baseline projections, the primary balance strengthens over the medium term from a deficit of 2.6 percent of GDP in FY15/16 to a surplus of 2 percent of GDP in FY20/21.

- **Heat map and debt profile vulnerabilities.** Risks from the debt level are deemed high by DSA standards, as the level of debt exceeds the benchmark of 85 percent of GDP under the baseline and stress scenarios. However, gross financing needs—estimated at around 12 percent of GDP in FY14/15—remain comfortably below the benchmark of 20 percent of GDP, and all debt profile vulnerability indicators are below early warning thresholds.[2] Interest rates and CDS spreads also suggest that markets view debt vulnerabilities as low.

- **Realism of baseline assumptions.** The median forecast errors for real GDP growth and inflation (actual minus projection) during FY06/07–FY14/15 are -0.6 percent and -0.2 percent, respectively, suggesting a slight upward bias in staff's past projections. The median forecast error for the primary balance is 0.4 percent of GDP, suggesting that staff projections have been slightly pessimistic. The cross-country experience suggests that the envisaged CAPB adjustment of 3.5 percentage points of GDP in FY15/16–FY17/18 appears to be slightly ambitious. However, given the authorities' commitment to fiscal consolidation, the path appears credible provided that output continues to grow in line with the baseline projections.

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[1] The data are presented on fiscal year (April-March) basis with ratios calculated using fiscal year GDP (not centered-fiscal year GDP). Public debt series include housing associations starting from FY14/15.

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

Shocks and Stress Tests

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

- **Growth shock.** In this scenario, real output growth rates are lowered by one standard deviation in FY16/17 and FY17/18. The primary balance improves much more slowly than in the baseline, reaching a surplus of 0.1 percent of GDP only in FY20/21. Under these assumptions, the debt-to-GDP ratio rises to 93 percent of GDP by FY17/18 and declines only gradually thereafter. Gross financing needs rise slightly to about 13 percent of GDP by FY17/18 and stays above 12 percent through FY20/21.

- **Primary balance shock.** This scenario assumes that fiscal consolidation stalls between FY15/16 and FY16/17, with no change in the primary balance. The debt-to GDP ratio rises slightly to 88.5 percent of GDP in FY16/17 and falls thereafter to 82 percent of GDP by FY20/21, about 4 percentage points of GDP higher than the baseline. Gross financing needs also rise to 12 percent of GDP by FY17/18.

- **Interest rate shock.** In this scenario, a 200 basis points increase in interest rates is assumed from FY16/17 on. The effective interest rate edges up to 3.7 percent by FY20/21, but only ½ percentage points higher than the baseline. The impacts on debt and gross financing needs are expected to be mild.

- **Combined macro-fiscal scenario.** This scenario aggregates shocks to real growth, the interest rate, and the primary balance. Under these assumptions, the debt-to-GDP ratio reaches close to 94 percent of GDP in FY17/18 and declines only gradually to 93 percent of GDP by FY20/21. Gross financing needs would rise to 13 percent by FY20/21.

- **Contingent fiscal shock.** This scenario assumes, hypothetically, that a banking crisis leads to one-time bail out of the financial sector, raising non-interest expenditure by 3 percent of banking sector assets in FY16/17. Real GDP is also reduced by one standard deviation for two years. Under this hypothetical scenario, the debt-to-GDP ratio would rise to 102 percent of GDP in FY17/18, and gross financing needs would exceed 20 percent of GDP at their peak.

- **Stagnant growth and low inflation scenario.** This scenario assumes that real growth would slow and remain stagnant while inflation also stays well below the inflation target throughout the projection period. This event could be triggered by globally weak demand and persistently low inflation in advanced economies. With subdued growth rates, revenue growth would lack buoyancy, and the revenue-to-GDP ratio would fall short of that in the baseline by one percentage point of GDP. Debt would not be put on a clear downward path, with the debt ratio staying above the FY14/15 level. Gross financing needs would hover around 11 percent of GDP.

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

(In percent of GDP unless otherwise indicated)[1/]

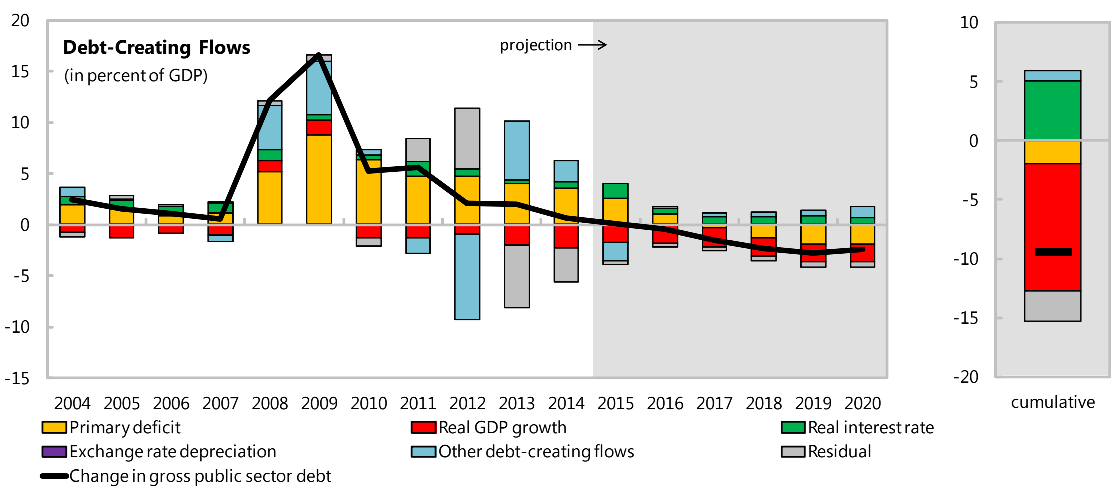
Debt, Economic and Market Indicators [2/]

	Actual			Projections					
	2004-2012 [3/]	2013	2014	2015	2016	2017	2018	2019	2020
Nominal gross public debt	59.9	86.8	87.4	87.4	87.0	85.5	83.2	80.4	77.9
Public gross financing needs	9.6	12.7	11.8	11.0	10.2	9.9	8.5	8.8	8.2
Real GDP growth (in percent)	1.1	2.5	2.8	2.1	2.2	2.2	2.2	2.2	2.2
Inflation (GDP deflator, in percent)	2.6	2.1	1.5	0.7	1.9	1.9	2.1	2.1	2.3
Nominal GDP growth (in percent)	3.8	4.7	4.3	2.8	4.2	4.2	4.3	4.4	4.5
Effective interest rate (in percent) [4/]	4.4	2.6	2.4	2.4	2.7	2.9	3.0	3.2	3.2

As of December 18, 2015		
Sovereign Spreads		
EMBIG (bp) 3/		128
5Y CDS (bp)		19
Ratings	Foreign	Local
Moody's	Aa1	Aa1
S&Ps	AAA	AAA
Fitch	AA+	AA+

Contribution to Changes in Public Debt

	Actual			Projections							
	2004-2012	2013	2014	2015	2016	2017	2018	2019	2020	cumulative	debt-stabilizing
Change in gross public sector debt	5.2	2.0	0.6	0.1	-0.5	-1.5	-2.3	-2.8	-2.5	-9.4	primary
Identified debt-creating flows	4.3	8.1	3.9	0.4	-0.1	-1.1	-1.8	-2.3	-1.9	-6.8	balance [9/]
Primary deficit	3.9	4.0	3.5	2.6	1.0	-0.4	-1.3	-1.9	-2.0	-2.0	0.1
Primary (noninterest) revenue and grants	36.4	35.4	35.5	35.6	36.3	36.6	36.5	36.4	36.6	217.9	
Primary (noninterest) expenditure	40.3	39.4	39.0	38.1	37.2	36.2	35.2	34.5	34.6	215.9	
Automatic debt dynamics [5/]	0.3	-1.7	-1.6	-0.4	-1.3	-1.1	-1.1	-0.9	-1.0	-5.7	
Interest rate/growth differential [6/]	0.3	-1.7	-1.6	-0.4	-1.3	-1.1	-1.1	-0.9	-1.0	-5.7	
Of which: real interest rate	0.9	0.4	0.7	1.4	0.6	0.7	0.7	0.8	0.7	5.0	
Of which: real GDP growth	-0.6	-2.0	-2.3	-1.8	-1.9	-1.8	-1.8	-1.8	-1.7	-10.7	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.1	5.8	2.0	-1.8	0.1	0.4	0.5	0.6	1.1	0.9	
Cash adjustments incl. privatization(-)	0.1	5.8	2.0	-1.8	0.1	0.4	0.5	0.6	1.1	0.9	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	1.0	-6.2	-3.3	-0.3	-0.3	-0.4	-0.5	-0.5	-0.6	-2.6	



Source: IMF staff.

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

2/ Public sector is defined as consolidated public sector.

3/ Based on available data.

4/ Long-term bond spread over German bonds.

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

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

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

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

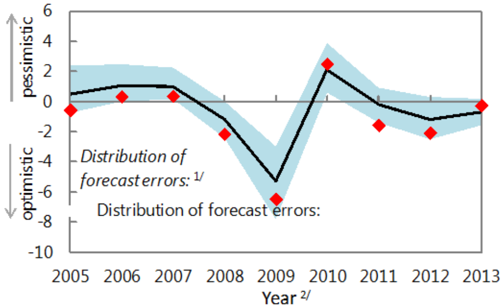
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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

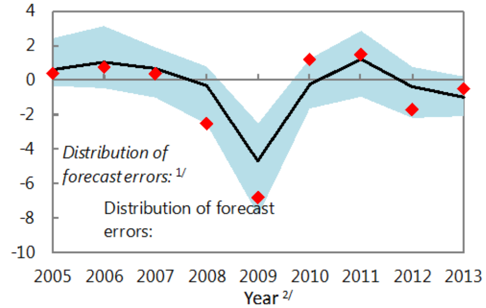
United Kingdom Public DSA—Realism of Baseline Assumptions

Forecast Track Record, versus surveillance countries

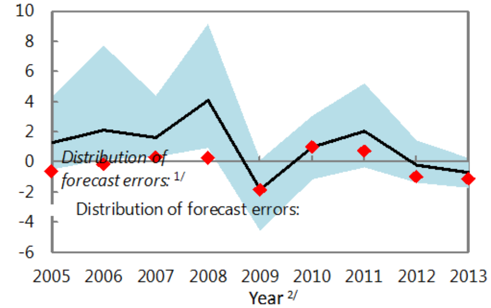
Real GDP Growth
(in percent, actual-projection)
United Kingdom median forecast error, 2005-2013: -0.58
Has a percentile rank of: 33%



Primary Balance
(in percent of GDP, actual-projection)
United Kingdom median forecast error, 2005-2013: 0.38
Has a percentile rank of: 71%

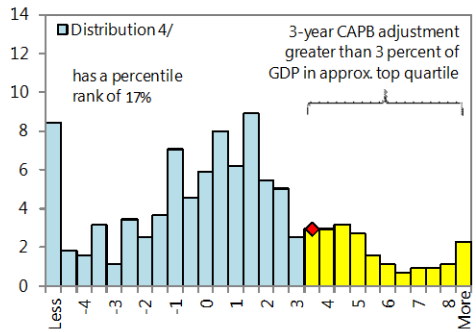


Inflation (Deflator)
(in percent, actual-projection)
United Kingdom median forecast error, 2005-2013: -0.17
Has a percentile rank of: 21%

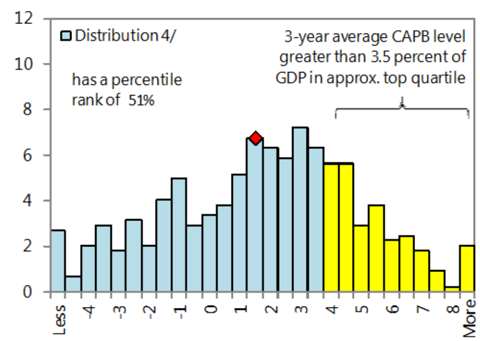


Assessing the Realism of Projected Fiscal Adjustment

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

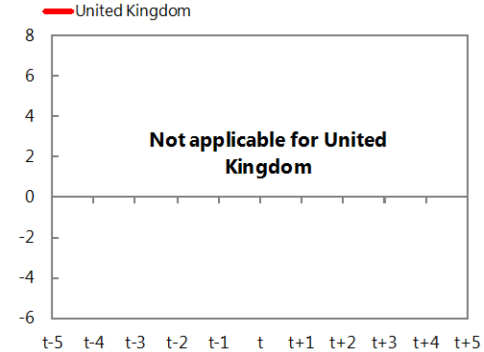


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Boom-Bust Analysis 3/

Real GDP growth
(in percent)



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

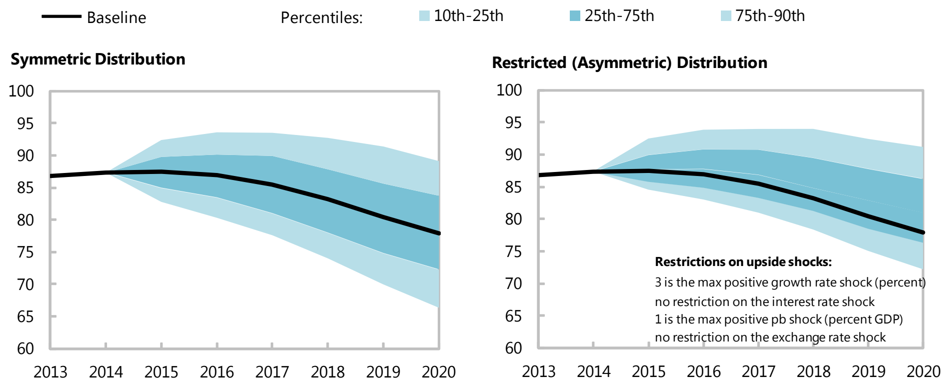
United Kingdom Public DSA Risk Assessment

Heat Map

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

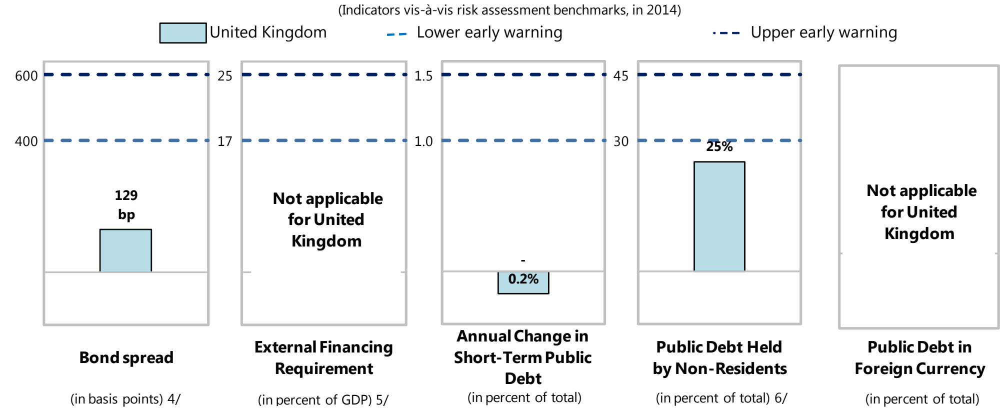
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2014)



Source: IMF staff.

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

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

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

Lower and upper risk-assessment benchmarks are:

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

4/ Long-term bond spread over German bonds, an average over the last 3 months, 19-Sep-15 through 18-Dec-15.

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

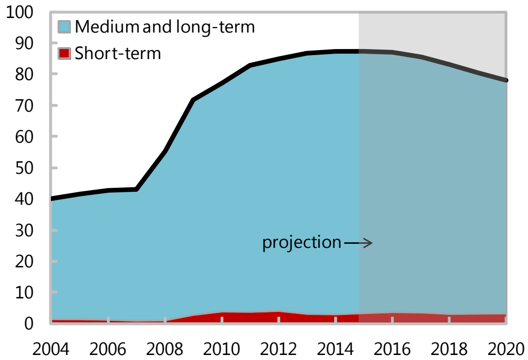
6/ Overseas holding of gilts.

United Kingdom Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

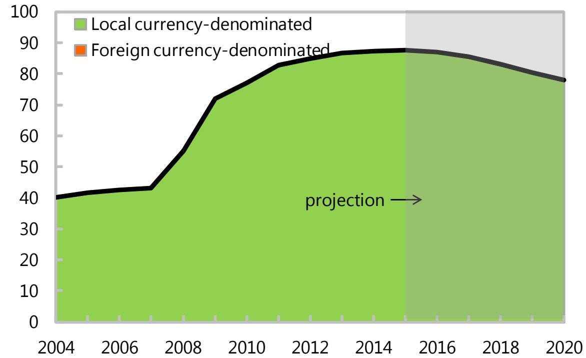
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

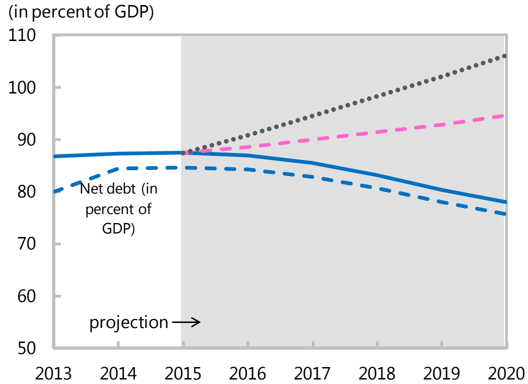


Alternative Scenarios

Baseline   Historical   Constant Primary Balance

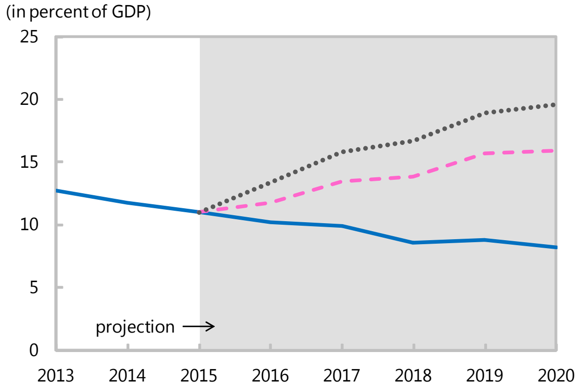
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

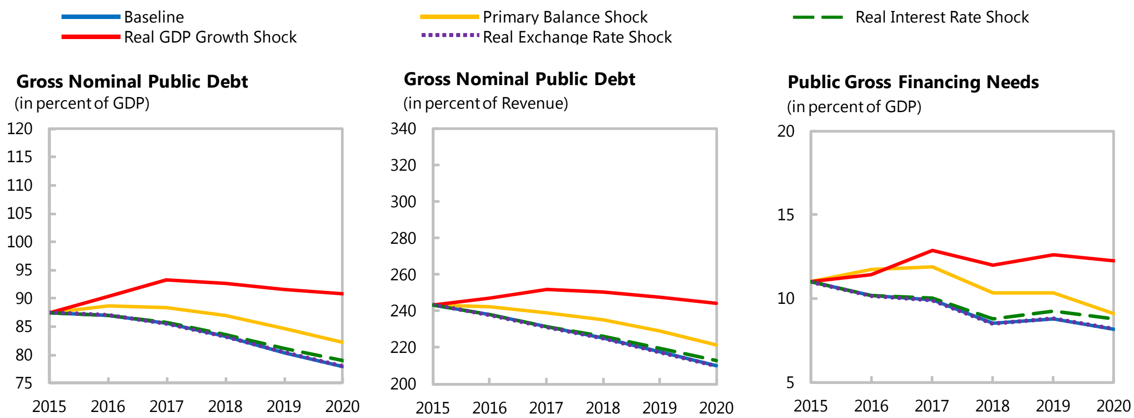
Baseline Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	2.1	2.2	2.2	2.2	2.2	2.2
Inflation	0.7	1.9	1.9	2.1	2.1	2.3
Primary Balance	-2.6	-1.0	0.4	1.3	1.9	2.0
Effective interest rate	2.4	2.7	2.9	3.0	3.2	3.2
Constant Primary Balance Scenario						
Real GDP growth	2.1	2.2	2.2	2.2	2.2	2.2
Inflation	0.7	1.9	1.9	2.1	2.1	2.3
Primary Balance	-2.6	-2.6	-2.6	-2.6	-2.6	-2.6
Effective interest rate	2.4	2.7	2.8	2.9	3.0	3.0

Historical Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	2.1	1.3	1.3	1.3	1.3	1.3
Inflation	0.7	1.9	1.9	2.1	2.1	2.3
Primary Balance	-2.6	-4.1	-4.1	-4.1	-4.1	-4.1
Effective interest rate	2.4	2.7	2.8	3.0	3.1	3.2

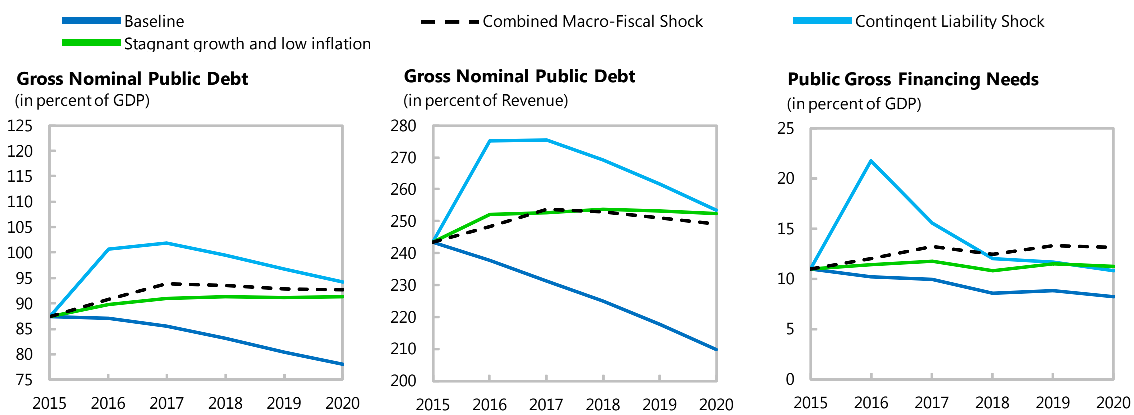
Source: IMF staff.

United Kingdom Public DSA—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

Primary Balance Shock	2015	2016	2017	2018	2019	2020
Real GDP growth	2.1	2.2	2.2	2.2	2.2	2.2
Inflation	0.7	1.9	1.9	2.1	2.1	2.3
Primary balance	-2.6	-2.6	-1.0	0.4	1.3	1.9
Effective interest rate	2.4	2.7	2.8	3.0	3.1	3.2
Real Interest Rate Shock						
Real GDP growth	2.1	2.2	2.2	2.2	2.2	2.2
Inflation	0.7	1.9	1.9	2.1	2.1	2.3
Primary balance	-2.6	-1.0	0.4	1.3	1.9	2.0
Effective interest rate	2.4	2.7	3.0	3.3	3.6	3.7
Combined Shock						
Real GDP growth	2.1	0.1	0.1	2.2	2.2	2.2
Inflation	0.7	1.4	1.4	2.1	2.1	2.3
Primary balance	-2.6	-2.6	-1.6	-0.6	0.0	0.1
Effective interest rate	2.4	2.7	3.0	3.3	3.6	3.7
Stagnant growth and low inflation						
Real GDP growth	2.1	1.2	1.2	1.2	1.2	1.2
Inflation	0.7	0.9	0.9	1.1	1.1	1.3
Primary balance	-2.6	-2.0	-0.6	0.3	0.9	1.0
Effective interest rate	2.4	2.7	2.8	3.0	3.1	3.2

Real GDP Growth Shock	2015	2016	2017	2018	2019	2020
Real GDP growth	2.1	0.1	0.1	2.2	2.2	2.2
Inflation	0.7	1.4	1.4	2.1	2.1	2.3
Primary balance	-2.6	-2.0	-1.6	-0.6	0.0	0.1
Effective interest rate	2.4	2.7	2.8	3.0	3.1	3.1
Real Exchange Rate Shock						
Real GDP growth	2.1	2.2	2.2	2.2	2.2	2.2
Inflation	0.7	1.9	1.9	2.1	2.1	2.3
Primary balance	-2.6	-1.0	0.4	1.3	1.9	2.0
Effective interest rate	2.4	2.7	2.9	3.0	3.2	3.2
Contingent Liability Shock						
Real GDP growth	2.1	0.1	0.1	2.2	2.2	2.2
Inflation	0.7	1.4	1.4	2.1	2.1	2.3
Primary balance	-2.6	-12.3	0.4	1.3	1.9	2.0
Effective interest rate	2.4	2.7	3.1	3.2	3.3	3.4

Source: IMF staff.

INTERNATIONAL MONETARY FUND

UNITED KINGDOM

February 1, 2016

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By | European Department

CONTENTS

FUND RELATIONS

(Data as of December 31, 2015)

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

General Resources Account

	SDR Million	Percent Quota
Quota	10,738.50	100.00
Fund holdings of currency	9,510.93	88.57
Reserve position in Fund	1,227.68	11.43
New arrangement to borrow	1,801.24	

SDR Department

	SDR Millions	Percent Allocation
Net cumulative allocations	10,134.20	100.00
Holdings	9552.89	94.26

Outstanding Purchases and Loans: None

Financial Arrangements: None

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

	Forthcoming				
	2016	2017	2018	2019	2020
Principal					
Charges/Interest	0.46	0.46	0.46	0.46	0.46
Total	0.46	0.46	0.46	0.46	0.46

Exchange Rate Arrangement:

The UK authorities maintain a free floating regime.

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

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

Article IV Consultation:

The last Article IV consultation was concluded on July 23, 2014. The UK is on the standard 12 –month consultation cycle.

FSAP

The FSAP update was completed at the time of the 2011 Article IV Consultation. A mandatory financial stability assessment is also expected to be conducted in time for the 2016 Article IV consultation, in line with the five-year cycle for members or members' territories with financial sectors that are determined to be systemically important pursuant to Decision No. 15495-(13/111), adopted December 6, 2013.

Technical Assistance: None

Resident Representatives: None

STATISTICAL ISSUES

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

The UK government has commissioned a review of the UK's current and future statistical needs and the capacity to meet those needs, prompted by increasing difficulty in measuring output and productivity and a perception that official data could be improved. An interim report, published in December 2015, found that conventional statistical measures and methods are increasingly challenged as the UK economy becomes more service oriented, as businesses operate more across national borders, as digitization of economic activities increases, and the boundaries between market and home production become more blurred. These issues are relevant to a number of advanced and transition economies. The interim report recommends a number of specific steps, such as greater integration of data sources and use of administrative data, addressing shortcomings to national accounts and flow of funds measures, and improvements to UK trade, construction, and CPI statistics. Staff welcomes these recommendations. The final report will be published by the March 2016 Budget.

Table of Common Indicators Required for Surveillance
(As of January 15, 2016)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	Same day	Same day	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	December 2015	1/6/2016	M	M	M
Reserve/Base Money	December 2015	1/6/2016	W	M	M
Broad Money	November 2015	1/4/2016	M	M	M
Central Bank Balance Sheet	November 2015	1/4/2016	W	W	W
Consolidated Balance Sheet of the Banking System	November 2015	1/4/2016	M	M	M
Interest Rates[2]	Same day	Same day	D	D	D
Consumer Price Index	November 2015	12/15/2015	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q3 2015	12/22/2015	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	November 2015	12/22/2015	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	November 2015	12/22/2015	M	M	M
External Current Account Balance	Q3 2015	12/23/2015	Q	Q	Q
International Investment Position	Q3 2015	12/23/2015	Q	Q	Q
Exports and Imports of Goods and Services	November 2015	1/8/2016	M	M	M
GDP/GNP	Q3 2015	12/23/2015	Q	Q	Q
Gross External Debt	Q3 2015	12/23/2015	Q	Q	Q

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

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

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

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

[5] Including currency and maturity composition.

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

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

Statement by Mr. Stephen Field, Executive Director for the United Kingdom
February 12, 2016

I thank staff for a very productive mission and thorough Article IV report. My authorities broadly agree with the staff analysis, note that staff considers the overall policy mix is appropriate and, notwithstanding the steady growth the UK has experienced, agree with staff that they should continue to take action to ensure the economy remains resilient to ongoing domestic and external challenges.

Economic Outlook

As staff notes, the UK's recent economic performance has been strong and considerable progress has been made in addressing underlying vulnerabilities. Growth has been robust, unemployment has fallen substantially, employment has reached a historic high, the fiscal deficit has been reduced and financial sector resilience has increased.

The economy continues to perform strongly with the recovery becoming more broadly entrenched. Even with the weaker global picture, staff expects growth to remain steady at 2.2 per cent this year and next. A tighter labour market and rising productivity growth is expected to support real incomes and consumption while business investment is forecast to grow at 7.4 per cent this year. The employment picture also continues to be positive, with unemployment falling from a peak of 8.4 per cent in 2011 to close to 5 per cent and the highest employment rate in the UK's history.

Recent falls in oil and other commodity prices and weaker than anticipated wage growth (due in part to lower realised inflation) are contributing to a slower recovery in CPI inflation. The scale of the recent commodity price falls means that CPI inflation is likely to remain below 1 per cent until the end of the year, but it is expected to exceed the 2 per cent target slightly at the two year point, as drags from external factors unwind and domestic cost pressures build. Core inflation has picked up since the middle of last year and is now around its pre-crisis average, at 1.4 per cent in the latest data, and the Monetary Policy Committee (MPC) judges that inflation expectations remain well anchored.

Risks to the outlook

Against this broadly positive economic outlook, we welcome staff analysis of a number of key risks and challenges. These include global risks, from lower global growth and a slowdown in emerging economies, and domestic risks, arising from the housing market and lower than expected productivity growth.

Staff has also provided a helpful external assessment, supported by new analysis, of the current account deficit, which in recent years has been large by historical and international standards, and currently stands at 3.7 per cent of GDP. As the staff report notes, however, some of the weakness in the external position is expected to be temporary and should unwind as partner economies strengthen. Moreover, the nature of the capital flows financing the deficit does not suggest a particular vulnerability (in addition to its size), and the external balance sheet has become more resilient to shocks.

In a world where the global risks are increasing it remains of the utmost importance that the Government continues to work through its plan to build resilience and better prepare the UK for whatever lies ahead both externally and domestically. The Government's strategy for doing so is built on four key pillars of: monetary activism; deficit reduction; structural reforms; and reforms to strengthen the resilience of the financial sector.

Monetary activism

Monetary policy continues to play an important role in supporting economic activity. Since the global financial crisis, the MPC has reduced and held Bank Rate at its historically low level of 0.5 per cent and purchased a stock of assets amounting to £375 billion. The MPC continues to make clear that given the likely persistence of the headwinds weighing on the economy, when Bank Rate does begin to rise, it is expected to do so only gradually and to a level lower than in recent cycles. The actual path that Bank Rate will follow over the next few years will depend on the economic circumstances.

Macroprudential policies and the housing market

The Financial Policy Committee (FPC) has been created with a remit to identify risks to financial stability and has already taken action to mitigate risks emanating from the housing market, traditionally a source of vulnerability for the UK economy, and a focus of the 2014 Article IV. In June 2014, the FPC judged that household indebtedness did not pose an imminent threat to stability, but that it was prudent to introduce two policies to insure against the risk of a marked loosening in underwriting standards and a further significant rise in the number of highly indebted households. House price growth subsequently eased somewhat, but with household debt to income still at high levels the FPC has judged that the insurance provided by the June 2014 Recommendations remains warranted.

The FPC is now looking at buy-to-let mortgages, where lending has continued to grow. In the year to 2015 Q3, the stock of buy-to-let lending rose by 10 per cent, compared to just 0.4 percent for lending to owner-occupiers. Assessed against relevant affordability metrics, buy-to-let borrowers appear more vulnerable to an unexpected rise in interest rates or a fall in income. The FPC is alert to financial stability risks arising from growth in buy-to-let mortgage lending and has made clear that it stands ready to take action if necessary to protect and enhance financial stability. Tax changes to the buy-to-let market announced last year are also expected to dampen demand from buy-to-let investors, although over time some of this may be offset by increased demand from existing and potential owner-occupiers.

The long term answer to the country's housing problems is to build more homes and in the Budget and Autumn Statement the Chancellor announced a doubling of the housing budget to over £2 billion per year. As a result the UK is embarking on the biggest home-building programme by any government since the 1970s. Further reforms to the planning system have also been announced to improve supply, and public and commercial land is being released for house-building.

Deficit reduction

Another key risk identified by staff is the high levels of public borrowing and debt. Reducing the deficit has been central to the Government's strategy since 2010, when it was set to be 11.1 per cent of national income, a peacetime record. This year it is set to fall to close to a third of that, 3.9 per cent, but at over £70 billion this year, borrowing is still far too high. The UK currently has the second largest fiscal deficit in the G7 as a share of national income, alongside its large current account deficit.

The recent Spending Review sets out spending plans that will see the deficit and debt fall every year, and we are expected to reach a surplus by the end of the Parliament. The deficit reduction plan is based on simple rules set out in the new Charter for Budget Responsibility, which commits the Government to reducing the debt to GDP ratio in each and every year of this Parliament, to reaching a surplus in the year 2019-20, and to maintaining that surplus in 'normal times' in order to rebuild buffers. Within the new framework, the surplus rule will be suspended if the economy is hit by a significant negative shock, defined as real GDP growth of less than 1 per cent on a rolling 4 quarter-on-4 quarter basis. This provides flexibility to allow the automatic stabilisers to operate freely when needed.

In line with the IMF's Fiscal Transparency Code, the new Charter also requires the Office for Budget Responsibility to produce a fiscal risks statement setting out the main risks to the public finances, including macroeconomic risks and specific fiscal risks. This will be produced at least once every 2 years, and the OBR plans to produce the first such report within the next two years.

Structural reform

Productivity continues to be a challenge for the UK, with output per hour still 15 per cent below its pre-crisis trend. In 2015, the government published a plan for strengthening productivity growth over the next decade, setting out a number of concrete policy measures. These are designed to encourage long-term investment in economic capital (including infrastructure, skills and knowledge) and promote a more dynamic economy that encourages innovation and helps resources flow to their most productive use. The government is also committed to boosting productivity by investing in human capital. A new Apprenticeship Levy was announced in the summer Budget of 2015 that will come into effect in April 2017, and the government has committed to an additional 3 million apprenticeships in England by 2020.

At the end of 2015, the government set up the National Infrastructure Commission to determine Britain's infrastructure priorities and hold governments to account for their delivery. The Commission will produce a report at the start of each five-year Parliament, offering recommendations for priority infrastructure projects. At the Spending Review the Government also committed £100 billion of spending by 2020 for new roads, rail, flood defences and other vital projects.

Reform of the Financial System

The resilience of the banking system had continued to strengthen in recent years, reflecting the introduction of higher regulatory requirements. The aggregate Tier 1 capital position of major UK banks was 13 per cent of risk-weighted assets in September 2015. In its most recent stress test, the Bank of England assessed the resilience of the banking sector to a deterioration in global financial market conditions and the macroeconomic environment, including in emerging market economies. The stress-test results and banks' capital plans, taken together, indicate that the banking system would have the capacity to maintain its core functions, notably lending capacity, in a stress scenario.

The FPC has judged that the appropriate equity requirement for the banking system was broadly in line with internationally agreed Basel III requirements, which would be fully phased in by 2019, and has clarified that it is therefore not seeking further structural increases in capital requirements for the system as a whole. The FPC has also announced its intention to make active use of the time-varying countercyclical capital buffer that will apply to banks' UK exposures, and is actively considering the appropriate setting.

The Fair and Effective Markets Review was established in June 2014, to conduct a comprehensive and forward-looking assessment of the way wholesale financial markets operate, help to restore trust in those markets in the wake of a number of recent high profile abuses and influence the international debate on trading practices. In June 2015, the review published its final report and the recommendations are currently being taken forward.

Looking ahead staff is currently undertaking the UK's Financial Sector Assessment Program that is expected to come to the Board in July 2016.

EU membership

As staff highlight in the report, the UK is currently seeking reforms to address the concerns of the British people over its membership of the European Union. A date for a referendum will be set as soon as the Prime Minister gets a substantial agreement for reform in the EU, and will be at the latest by the end of 2017. We welcome the Managing Director's commitment to look at this issue in more detail in the 2016 Article IV.