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IMF Executive Board Concludes 2011 Article IV Consultation with the United Kingdom

On July 27, 2011 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the United Kingdom.[1] This consultation included a Financial System Stability Assessment (FSSA) under the IMF's Financial Sector Assessment Program, which analyzes financial sector health and associated policies. It also included discussion of the first UK Spillover Report, which analyzes spillovers emanating from UK policies to the rest of the world and is being conducted this year for five systemic economies.

Background

Economic growth has recently been sluggish and inflation has been high in the UK, though both indicators are projected to improve gradually over time. Recent increases in indirect taxes and commodity prices will keep headline inflation well above 4 percent during 2011. However, it should return near the 2 percent target by end-2012 as these transitory factors dissipate and as significant spare capacity keeps underlying inflation in check. Growth, which has also been adversely affected by spiking commodity prices, is expected to gradually accelerate from around 1½ percent in 2011 to 2½ percent in the medium term, as low interest rates and global growth support expansion led by net exports and investment. Nonetheless, there are large risks around this central scenario,

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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. 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.

including from uncertainties surrounding turmoil in parts of the euro area, headwinds from fiscal consolidation, volatile commodity prices, and the housing market.

A wide-ranging policy program has been put in place to aid the post-crisis repair of the UK economy. The agenda includes restoring confidence in public finances, moving to a safer financial sector, and rebalancing the economy away from public and private consumption and toward more sustainable sources of growth (net exports and investment). As part of this program, the government has undertaken institutional reform to address weaknesses in the policymaking framework. These reforms include moving the microprudential regulator under the Bank of England (BoE), establishing a Financial Policy Committee (FPC) to oversee macroprudential policy, and creating an independent Office for Budget Responsibility (OBR) aimed at strengthening the credibility of fiscal analysis and forecasts.

The government has made progress on its medium-term fiscal consolidation plan, which is a central component of its overall macroeconomic strategy. The cyclically adjusted primary balance (as a percent of potential GDP) is estimated to have improved by about 2 percentage points in FY10/11. Going forward, the pace of adjustment is projected to ease slightly and become increasingly reliant on spending restraint.

The BoE has maintained an accommodative monetary policy stance, with the Bank Rate at 0.5 percent and the stock of outstanding asset purchases at £200 billion. This stance reflects the BoE’s forecast that inflation will return to target over the forecast horizon, taking into account disinflationary forces from fiscal consolidation.

Meanwhile, banks have strengthened their balance sheets and reduced funding vulnerabilities over the last year, with all major banks ahead of schedule in their transition to Basel III rules. Nonetheless, the recovery process is not yet complete. Despite recent progress, funding risks remain a key vulnerability, as highlighted by the FSSA.

Executive Board Assessment

Executive Directors welcomed progress made in repairing the UK economy, including a lower fiscal deficit, higher bank capital, and expanded employment. Nonetheless, they noted that the combination of low growth and above-target headline inflation poses policy challenges.

Directors considered the current mix of accommodative monetary and tight fiscal policy to be appropriate. They noted that such a mix will help keep real interest rates low and sterling competitive, thereby assisting public and private balance sheet repair while rebalancing growth toward investment and net exports. This rebalancing is necessary if robust growth is to be achieved at the same time that private and public consumption are eased to more sustainable levels.

Directors noted that the growth outlook is subject to considerable uncertainties. They agreed that policies may need to adjust in the event of a change in macroeconomic conditions. In particular, if growth and inflation surprise on the upside, monetary tightening would need to accelerate. Conversely, mounting evidence that weak demand is likely to cause the economy to stall and enter a period of prolonged low growth would call for looser macroeconomic policies.

Directors stressed the importance of accelerating structural reforms to promote long-term fiscal sustainability and bolster the growth potential, along the lines outlined in the authorities' Growth Review. In this regard, they welcomed the creation of a permanent Office for Budget Responsibility and supported the reform of the pension system.

Directors noted that efforts to strengthen the resilience of the financial sector have yielded improvements as bank capital levels have improved significantly and all major banks passed the recent EU stress-tests. They considered, however, that the sector remains vulnerable to risks relating to their funding model and their asset quality.

Directors concurred with the findings of the FSSA and called for implementing its recommendations, including improving the standards for the public disclosure of financial data. In this context, they welcomed the establishment of the FPC, whose explicit mandate for macroprudential oversight should help reduce systemic risk.

Directors agreed with the conclusions of the spillover report that the UK's potential for spillovers is concentrated in the financial sector. They stressed that, given its central position, the stability and efficiency of the UK financial sector is a global public good, requiring that financial supervision and regulation be strengthened and held to the highest standards. International cooperation between regulatory agencies in ensuring effective cross-border resolution arrangements, group-wide liquidity management, information sharing, and jurisdictional reciprocity will be essential for the UK to fulfill its potential to support global financial stability.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2011 Article IV Consultation with the United Kingdom is also available.

United Kingdom: Selected Economic and Social Indicators, 2007–12

	2007	2008	2009	2010	2011 Proj.	2012 Proj.
Real Economy						
Real GDP (change in percent)	2.7	-0.1	-4.9	1.4	1.5	2.3
Domestic demand (change in percent)	3.1	-0.7	-5.5	2.7	-0.1	1.4
CPI (change in percent, period average)	2.3	3.6	2.1	3.3	4.5	2.6
Unemployment rate (in percent) 1/	5.4	5.6	7.5	7.9	7.7	7.6
Gross national saving (percent of GDP)	15.6	15.0	11.8	11.8	11.5	12.5
Gross domestic investment (percent of GDP)	18.2	16.6	13.5	15.0	14.0	14.5
Public Finance 2/						
General government balance	-2.7	-6.7	-11.3	-9.8	-7.9	-6.3
Public sector balance	-2.4	-6.7	-11.1	-9.7	-8.0	-6.4
Cyclically adjusted balance (staff estimates)	-3.1	-6.7	-9.1	-7.7	-6.2	-4.7
Public sector net debt	36.6	43.3	52.8	59.8	65.7	69.3
Money and Credit (end-period, 12-month percent change) 3/						
M4	12.8	15.5	6.7	-1.4	-0.2	...
Net lending to the private sector	10.8	4.9	0.6	-0.4	0.1	...
Interest rates (year average) 4/						
Three-month interbank rate	6.0	5.8	1.2	0.7	0.8	...
Ten-year government bond yield	5.0	4.7	3.6	3.6	3.7	...
Balance of Payments						
Trade balance (percent of GDP)	-3.1	-2.6	-2.1	-3.4	-2.0	-1.3
Current account balance (percent of GDP)	-2.6	-1.6	-1.7	-3.2	-2.6	-1.9
Exports (percent of GDP)	26.6	29.3	28.0	29.4	30.6	30.4
Export volume (change in percent)	-2.6	1.0	-10.1	5.2	7.5	5.5
Imports (percent of GDP)	29.7	31.9	30.1	32.8	32.6	31.7
Import volume (change in percent)	-0.8	-1.2	-11.9	8.8	1.6	2.4
Reserves (end of period, billions of US dollars)	57.9	53.9	66.4	78.8	91.2	...
Fund Position (as of June 30, 2011)						
Holdings of currency (percent of quota)						69.2
Holdings of SDRs (percent of allocation)						92.1
Quota (millions of SDRs)						10,738.5
Exchange Rates						
Exchange rate regime						Floating
Bilateral rate (June 30, 2011)					US$1 =	£0.6228
Nominal effective rate (2005=100) 3/ 5/	102.3	89.3	78.8	79.3	79.1	...
Real effective rate (2005=100) 3/ 5/ 6/	102.3	89.3	80.4	82.2	83.0	...
Social Indicators (reference year):						

Income per capita (in US dollars, 2009) : 35,165; Income distribution (ratio of income received by top and bottom quintiles, 2009): 5.2
Life expectancy at birth (2009): 78.1 (male) and 82.1 (female); Automobile ownership (2009): 459 per thousand;
CO2 emissions (ton per capita, 2007): 8.84; Population density (2009) 256 inhabitants per sq. km.;
Poverty rate (at-risk-of-poverty rate after social transfers, 2009): 17 percent.

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

1/ ILO unemployment; based on Labor Force Survey data.
2/ Fiscal data refer to the fiscal year, which begins in April. For example, fiscal balance data for 2005 refers to FY2005/06. Debt stock data refer to the end of the fiscal year using centered-GDP as a denominator. Data exclude the temporary effects of financial sector interventions.
3/ 2011: actual data through May.
4/ 2011: actual data through June.
5/ Average. An increase denotes an appreciation.
6/ Based on relative consumer prices.

Statement by Alex Gibbs, Executive Director for the United Kingdom
July 27, 2011

We thank staff for a very good and comprehensive set of documents based on a number of productive staff missions in the first half of 2011. The reports appropriately capture the views of my authorities and reflect the fact that, for the most part, they agreed with the staff analysis and recommendations.

Outlook and recent economic developments

The 2011 Article IV mission took place just over six months after the 2010 Board discussion. Since then, temporary factors have clouded assessment of the state of the UK economy. The growth numbers have been choppy, with a contraction of 0.5 percent in 2010Q4 reversed by growth of 0.5 percent in 2011Q1. However, as the staff report notes, other economic indicators - including employment data, growth in tax revenues and manufacturing performance - have been suggestive of a stronger recovery.

The weakness in the growth figures relative to forecast largely reflects the impact of transitory factors, including rising energy prices, supply chain disruptions and weather related shocks. The latest forecast from the Office for Budget Responsibility (OBR) projects a sustained recovery, with 1.7 percent growth in 2011 continuing to strengthen before peaking at 2.9 percent in 2013. This is consistent with rebalancing from private consumption and government spending to net trade and investment. The latest survey data indicates that corporate investment intentions remain strong.

On the inflation outlook, while headline inflation is currently at around 4¼ percent, reflecting the increase in VAT, higher energy and import prices, and some rebuilding of companies' margins, core inflation excluding indirect tax rises is just over 1 percent. Inflation is likely to fall back through 2012 and into 2013 as the temporary impact of those factors wanes and some downward pressure from spare capacity persists. Medium-term inflation expectations remain contained and continue to be consistent with meeting the inflation target.

Fiscal Policy

In their last Article IV report, staff supported the UK Government's commitment to fiscal consolidation and its ambitious medium-term targets for adjustment, which themselves were consistent with staff advice in previous Article IV consultations.

The 2011 Article IV report highlights that fiscal consolidation is still essential to reduce fiscal risks and achieve a more sustainable budgetary position. My authorities welcome the staff conclusion that the current path of fiscal consolidation remains appropriate in their central case. Since the consolidation path was announced, yields on UK sovereign debt have fallen significantly and remain below the levels at the onset of the euro-area sovereign debt crisis. Retaining fiscal credibility is essential to maintain this improvement in market confidence.

As staff's very thorough analysis shows, risks still remain, both to the upside and the downside. The economy is still some distance from the risk scenarios set out in the report but the UK authorities are continuing to monitor developments closely. If risks do materialize, the policy response will need to be calibrated to the nature and cause of the particular shock. However, the successful implementation of the Government's fiscal consolidation plan is the key to maintaining confidence in debt sustainability and will continue to be a prerequisite in any scenario.

Implementation is now fully underway. Consistent with previous staff advice, the plan is tilted clearly to expenditure-based measures: of a total consolidation of £126 billion a year by 2015-16, £95 billion comes through spending cuts and £30 billion through taxation. The Government has delivered the £6.2 billion of savings announced in May 2010 and has implemented departmental budgets and the reforms to welfare and public service pensions that were outlined in the October 2010 Spending Review. Where necessary, legislation has now been introduced to Parliament. Mindful of the need to sustain commitment to implementing spending measures over a period of years, my authorities have established a Public Expenditure Cabinet Committee to oversee departments' performance. On the revenue side, the Government has put in place the planned 2011-12 tax reforms, including the increase in the standard rate of VAT to 20 percent.

Nevertheless, my authorities remain committed to protecting Overseas Development Assistance from the expenditure cuts, and their spending plans provide for achieving the ODA target of 0.7 percent of GDP.

My authorities welcome the staff advice on further structural reforms that could help address longer-term fiscal pressures and support medium-term growth. Measures have already been taken. For example, the rise in the State Pension Age (SPA) from 65 to 66 has already been brought forward to 2020 from 2026. My authorities have committed to bring forward proposals to manage future increases in the SPA more automatically, as staff propose. Since the Article IV mission, the OBR has published its first Fiscal Sustainability Report, which looks at these issues in detail.

A key focus of the structural reform effort is to ensure sustainable growth, and to that end a Growth Review, launched in November 2010, has identified a programme of structural reforms to boost competitiveness and improve the business environment. The focus is on reforms to the tax system, measures to encourage investment and rebalancing towards exports and action to improve education and skills. Implementation is underway, with 16 of 182 proposed measures already implemented and major milestones passed in 92 others. The second phase of the Growth Review was launched in June and will report in the autumn.