United Kingdom - 2015 Article IV Consultation Concluding Statement of the Mission

December 11, 2015

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

Outlook and Risks

1. The UK's recent economic performance has been strong, and considerable progress has been achieved in addressing underlying vulnerabilities. Growth has exceeded that of the other major advanced economies, the unemployment rate has fallen substantially, employment has reached an historic high, the fiscal deficit has been reduced, and financial sector resilience has increased.

2. Steady growth looks likely to continue over the next few years, and inflation should gradually return to target. After a period of robust private domestic demand-driven growth, matched by steady increases in employment, the economy now looks to be running near capacity. Investment has contributed to domestic demand growth, and recent increases in productivity give cause for cautious optimism about growth in real incomes. As labor market slack is used up, the mission expects growth to slow slightly in 2016 and to average around 2¼ percent over the medium term. Inflation is expected to revert to target gradually, as effects from commodity price falls and sterling appreciation dissipate and wages increase.

3. There are, however, a number of risks to this broadly positive outlook. In particular, domestic and external imbalances persist, and while there are often mitigating factors that offset some of the associated risks, these imbalances remain, in an absolute sense, large:

• House price growth has eased somewhat over the past year, but remains high. The absence of an associated boom in net mortgage lending helps contain financial risks associated with high house prices. In addition, thanks in part to policy initiatives, lenders are more resilient. There are also encouraging signs that the share of households borrowing at high loan-to-income multiples has come down. Nonetheless, after initial declines, the household debt-to-income ratio has stabilized at a high level despite steady output growth, leaving some households vulnerable to income and interest rate shocks.

• The current account deficit is similarly not a result of funding a household credit boom, but nonetheless is strikingly large. Notwithstanding a flexible exchange rate and independent monetary policy, confidence shocks could reduce external capital flows into the UK, which could adversely affect growth.

• The 2014/15 fiscal deficit stood at nearly 5 percent of GDP, with general government gross debt reaching 87 percent of GDP, despite steady progress in reducing fiscal imbalances. While the UK continues to benefit from record low interest rates, maintaining deficits and debts at these levels would constrain the space to respond proactively to future large negative growth shocks.

• In addition, there are other uncertainties that may affect the outlook. For example, the presumed recovery of productivity growth to nearer its historical average rate, which is essential to ensure that the growth of output and incomes remains solid, may fail to materialize. In addition, uncertainty associated with the outcome of the planned referendum on EU membership could weigh on the outlook.

Addressing these vulnerabilities will require continued prudent and intrusive supervision of the financial sector, continued implementation of financial regulatory reforms, further reductions of fiscal imbalances (which in combination with accommodative monetary policy will also contribute to an improved current account), and structural reforms to boost productivity.

Macroeconomic Policies

4. The fiscal framework has been revised. A new fiscal rule specifies a surplus to be maintained in “normal” times, replacing the rolling cyclical mandate. The transparency of the new 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.

5. The Autumn Statement appropriately targets steady declines in the deficit and the achievement of a small surplus by 2019/20. Notably, the envisaged path of deficit reduction over the medium term is 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, at about half the rate under the previous parliament for total departmental spending. This has permitted continued preferential treatment of spending on the National Health Service, foreign development assistance, and other priority areas and smaller-than-expected cuts in remaining areas of the budget. The planned pace of deficit reduction is appropriate under the baseline, but, should growth slow unexpectedly, automatic stabilizers should continue to be allowed to operate freely. In the event of an extended period of sluggish demand growth, the flexibility in the fiscal framework should 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 efficiency gains fail to materialize.

6. More neutrality in the tax system could help promote efficiency and stability.

• Scaling back distortionary tax expenditures (e.g. nonstandard zero VAT rates) could free up resources for other uses, including higher spending on priority items such as infrastructure.

• 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 facilitate more efficient use of the housing stock. Reducing council tax discounts for single-occupant properties could also increase the utilization of these properties.

• Reducing the tax code's bias toward debt, possibly by adopting an Allowance for Corporate Equity with offsetting changes in other corporate tax parameters, could also promote financial stability.

7. Monetary policy should stay on hold until inflationary pressures are clearer. Headline inflation remains well below target, and core inflation is subdued. The mission sees a strong case for the Bank of England to maintain the policy rate at 0.5 percent and the stock of QE assets at £375 billion until signs of stronger inflationary pressures emerge:

• Although low inflation mostly reflects temporary external factors, indicators of domestic-driven inflation are also muted. In particular, wage growth in excess of productivity growth remains below 2 percent, suggesting no immediate threat to inflation.

• The 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.

• In addition, the policy rate associated with a neutral monetary stance is lower than what historical averages would suggest, owing to factors such as relatively high global saving. This implies that the current policy rate is less stimulative than it first appears.

Financial Sector Policies

8. The authorities should continue to take a prudent and intrusive approach to financial sector regulation and supervision. 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. The soundness of the banking sector has improved notably since the crisis, and stress tests indicate its resilience to shocks. The recent Financial Stability Report clarifies further steps to strengthen regulation, notably the intention of the Financial Policy Committee (FPC) to use actively the time-varying countercyclical capital buffer. It will be important to maintain vigilance as the regulatory environment settles. This includes continuing to take a prudent approach to reviewing dividend payouts and being proactive in challenging risk weights in banks' internal models through processes such as stress testing.

9. Financial market conduct and culture remain concerns. Substantial conduct and litigation charges have been issued, and a return of public confidence in the ethical underpinnings of the financial system remains a ways off. The authorities have increased incentives for firms to clearly define individual responsibilities, making it easier to find and discipline individuals responsible for

misconduct. Cultural changes are just as important as defining "hard" legal boundaries—to this end, the UK authorities' efforts to promote a set of global standards for ethical behavior in the financial system are welcome.

The Housing Market and Macroprudential Policies

10. New macroprudential measures have eased but not eliminated risks to household finances. Affordability tests for prospective borrowers and limits on new mortgages with very high loan-to-income multiples have played a role in slowing house price growth, and the proportion of households with higher loan-to-income ratios has also fallen. Nonetheless, prices are still rising much faster than incomes. Properties bought for letting have accounted for over a third of gross mortgage growth; this market is dominated by small-scale landlords that could be relatively exposed if expected returns are not realized. Developments in this market following changes announced in the Budget and Autumn Statement will be monitored closely by the FPC. Commercial real estate has also been buoyant; experience suggests that this market is particularly sensitive to swings in sentiment about economic prospects. Since many firms rely on commercial real estate as collateral to support their borrowing, a fall in prices could tighten corporate credit constraints, reducing business investment and economic activity.

11. Further macroprudential measures may be necessary. Tightened LTI limits or use of loan-to-value caps might be needed if shares of higher-leverage mortgages do not continue to fall. Priority should also be given to the consolidation of household-level credit data so as to allow an eventual shift from LTI limits to debt-to-income limits, as these are more comprehensive and hence more difficult to evade. The authorities should 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.

12. Continued efforts to reduce housing supply constraints are equally important. House price pressures are fundamentally due to limits on supply. Increased housing supply is not just necessary to meet demand but is also important to lessen wealth inequality. Changes to planning processes have improved the prospects for increasing supply, but without effective implementation the risks associated with an approval process perceived by many to be slow and unpredictable will remain.

Structural Reforms

13. Structural reforms are necessary to sustain gains in growth and employment. 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 to 19 are enrolled in education, which is below the OECD average—and regional development and trade are held back by transport bottlenecks. Increased spending on infrastructure, an enhanced focus on decentralization that could improve allocation, and support for apprenticeship programs are welcome; further expansion of vocational training could reduce double-digit youth unemployment and make growth more inclusive. Labor force participation is high overall but, despite recent rapid improvement, remains below the OECD average for single women with children. Recent changes to childcare and to benefit conditionality could increase participation.

The mission thanks the authorities and representatives from the private sector and academic institutions for open and productive discussions.