

## United Kingdom—2014 Article IV Consultation Concluding Statement of the Mission

June 6, 2014

1. **The economy has rebounded strongly and growth is becoming more balanced.** Growth has accelerated since the second half of 2013, and leading indicators suggest that the recovery has momentum. Although household expenditures played the driving role in the early stages of the recovery, business investment has picked up more recently. Net exports remain subdued.

2. **Inflation has fallen rapidly.** Despite lackluster productivity growth and the recent rebound in demand, inflation has dropped to just below the Bank of England's 2 percent target, owing to the fading impact of administered price increases, lower import prices, and weak growth in wages and margins.

3. **Good macroeconomic performance is expected to persist.** Real GDP growth is projected to remain strong this year, before gradually returning to trend rates, driven by further rebalancing toward business investment and a gradual recovery in productivity. Inflation is expected to revert to target.

4. **But productivity and the housing market present risks to this outlook.**

- The durability of the recovery hinges on productivity growth, which remains well below historic norms. Accelerating productivity growth would spur investment and output, while allowing real wage increases without triggering inflation. If productivity continues to be flat, however, growth will eventually stall.

- House price inflation is particularly high in London, and is becoming more widespread. So far, there are few of the typical signs of a credit-led bubble. Nonetheless, a steady increase in the size of new mortgages compared with borrower incomes suggests that households are gradually becoming more vulnerable to income and interest rate shocks.

5. **The external environment also poses risks.** The global economy could see disruptions from the withdrawal of unconventional monetary policies in the US, shocks to growth in emerging markets and the euro area, and increased geopolitical tensions. Although the UK's direct exposure to these risks through trade and financial channels is in some cases low, the realization of any, in concert with a repricing of risk from the current unusually low levels, could depress asset prices and damage confidence.

6. **Monetary policy should stay accommodative—for now.** With inflation below target, contained cost pressures, and excess supply, monetary policy should remain on hold. Policy might, however, have to be tightened quickly if costs run ahead of productivity growth, slack is absorbed, or financial stability concerns cannot otherwise be addressed.

7. **Bank rate should be raised before reducing QE balances.** When the time comes to begin normalizing monetary conditions, raising the policy rate first is preferable to selling off assets: should changing conditions require reversing the normalization, decreasing the policy rate would likely be less disruptive than repurchasing gilts.

8. **The prospect of normalizing monetary conditions places a premium on communication.** The Bank of England has taken important steps toward greater transparency, including the introduction of "forward guidance". Going forward, it faces the challenge of reducing the risk of potential market surprises without imparting a false sense of certainty about the evolution of interest rates. Further, now that the Financial Policy Committee (FPC) also plays a key role in affecting economic conditions, the Bank faces the additional challenge of explaining the coordination of monetary and macroprudential policies.

**9. Macroprudential policies should be the first line of defense against financial risks from the housing market.** The objective of macroprudential policy is to address systemic financial risks, not house price growth. Some measures have already been taken. In particular, the Funding for Lending Scheme has been refocused towards businesses, with emphasis on SME loans, while household lending is no longer eligible for additional borrowing allowances. Underwriting standards for owner-occupier mortgages have been tightened to ensure better borrower protection. But in an environment where expectations of capital gains can quickly drive up household indebtedness—and thus systemic risk for financial institutions—more policy action is warranted.

**10. Measures must be targeted and timely.**

- Limits on the proportion of high Loan-To-Income (LTI) mortgages any lender can issue would help to contain directly the currently most pressing risks to financial stability—if such limits prove insufficient, outright caps on LTIs or Loan-To-Value ratios may need to be considered. Raising lenders' sectoral capital requirements would build additional buffers against increased exposures to the housing sector.
- Given uncertainty about the lags associated with such measures and their effectiveness, they should be introduced early and gradually, allowing the FPC to “calibrate” the measures to the risks.

**11. Help to Buy (HtB) is enabling creditworthy lower-income households to purchase homes, especially outside London and the Southeast.** The program has also played a role in unlocking mortgage credit for lower-income borrowers from other sources. If these flows increase significantly, the FPC and the Treasury may wish to consider whether HtB should be modified or even remains necessary for the full three years of the policy. And as the volume of high-LTV transactions rises, the FPC will need to evaluate if the program is contributing to financial risks.

**12. Imbalances in the housing market should be addressed through supply-side remedies.** Fundamentally, house prices are rising because demand outstrips supply. The UK has a secular problem with inadequate housing supply, associated with planning restrictions and compounded by depressed housing starts since the financial crisis. Macroprudential and monetary policies can only be temporary palliatives to an underlying problem.

**13. New initiatives to spur house building are welcome, but political consensus for further reform is needed.** The government has introduced major changes to the planning system to create incentives for local councils to increase available land for housing development, and there are some signs of recovery in housing construction. Nonetheless, key inefficiencies remain. These include: unnecessary constraints on brownfield and greenfield developments; tax policies that discourage the most economically-efficient use of property; and underdeveloped rental markets with relatively short lease terms.

**14. While adhering to the medium-term framework, the government has shown welcome flexibility in its fiscal program.** Despite allowing automatic stabilizers to operate fully in response to slower-than-expected growth, the deficit has been nearly halved since 2009. The government has also reoriented expenditures from current to capital to support longer-term growth.

**15. The planned fiscal adjustment this year is appropriate.** The ½ percentage point of GDP reduction in the cyclically-adjusted primary balance in FY2014/15 addresses the need to strengthen the public finances without putting an undue drag on growth.

**16. Over the medium term, fiscal policy should continue to aim to put debt on a firmly declining path while supporting long-term growth and safeguarding social needs.** Consolidation efforts should strike an appropriate balance between expenditure and revenue measures, carefully considering issues of equity and efficiency.

- Efforts to enhance efficiency have already lowered spending; in searching for further efficiency gains, the government should prioritize the delivery of quality health and education services, as well as infrastructure. Means testing for social benefits could be used more widely, to reduce

spending while ensuring that basic needs continue to be met. Entitlement reforms could both yield budgetary savings and improve labor supply incentives.

- Revenue measures could include reducing tax expenditures (such as VAT zero-ratings) and greater reliance on Pigouvian taxes (including those on carbon and congestion).
- Recent efforts by the government to analyze and document the distributional impact of the consolidation are welcome. In planning and implementing its medium-term plans, the government should continue to undertake and publicize this type of analysis to allow for an informed public discussion.

**17. The Bank of England's 2013 capital-building exercise has helped boost banks' health and ability to lend.** Major UK banks' common equity tier 1 ratios on a fully-loaded Basel-III basis now exceed 9 percent. Liquidity indicators have also improved, with a further reduction in wholesale funding. Market valuations have therefore risen, while bank borrowing costs have declined.

**18. However, the outlook for profitability is mixed, and fresh risks are emerging.** Profitability for some major banks is weighed down by a longer-than-expected drag from conduct-related and restructuring costs and by headwinds to investment banking returns. Moreover, as described above, new domestic and external risks have surfaced.

**19. The 2014 stress tests will offer a timely assessment of major banks' vulnerabilities to these risks.** The European Banking Authority's adverse scenario and the UK-specific scenario helpfully complement each other, and should enable a robust assessment of banks' resilience. The success of the stress tests rests on maintaining the improved coordination between macro- and micro-prudential authorities; clear communication about capital definitions, hurdle rates and any required capital actions by banks (including with regard to capital planning frameworks); and sufficiently-disaggregated disclosure of results.

**20. The authorities have laid out plans that could see the concurrent stress testing framework extended in the medium term to systemic entities beyond the major UK banks, which would better identify risks in the system.** In addition, there are broader efforts aimed at strengthening the monitoring of risks in the shadow banking system. These efforts are critical, given the size of local and global shadow banking activity routed through the UK and the associated risk of outward financial spillovers. They are also particularly relevant in the current context of a global underpricing of risk and a build-up of vulnerabilities outside the banking system.

**21. The new regulatory architecture is proving effective.** The new structure of the FPC, the Prudential Regulation Authority (PRA) and the Financial Conduct Authority has functioned relatively smoothly over the last year. Looking ahead, maintaining strong coordination across bodies and ensuring coherent communication will be vital to avoiding regulatory uncertainty. Separately, given the Bank of England's significantly expanded mandate, it would be important to maintain strong and effective oversight arrangements.

**22. Reforms to the Bank of England's Sterling Monetary Framework will strengthen buffers against shocks.** Stronger liquidity backstops should allow solvent UK banks to ride out temporary funding stresses. However, easier access to the backstops could increase banks' appetite for risk-taking, unless supervision is commensurately strengthened. This consideration should also guide any decision to offer backstops to systemic nonbanks.

**23. Measures to address the problem of Too-Important-To-Fail institutions are advancing, but are not yet complete.** The ring-fencing of banks' retail operations, new bail-in and other resolution powers for the Bank of England, and the development of resolution strategies and plans for systemically important banks all constitute important reforms. As the authorities have acknowledged, completing the task requires a clear strategy for systemic entities outside the ring fence and maintaining positive momentum on cross-border cooperation on resolution of global banks (including international agreement on gone-concern loss-absorbing capacity). The authorities should also ensure that an appropriately-stringent leverage ratio is in place to add to the

robustness of the regulatory capital framework. This entire agenda must be implemented in a way that ensures international consistency of national reforms, and guards against regulatory arbitrage.