United Kingdom—2013 Article IV Consultation Concluding Statement of the Mission

May 22, 2013

Activity appears to be improving, but a slow recovery remains likely

1. **Recent data suggest some improvement in economic and financial conditions.** Purchasing indicators, demand for vehicles, and consumer and business sentiment surveys indicate an uptick in activity. Moreover, the drag from construction and trade might prove to be less than last year. And private sector employment growth has been notably strong. Coming after disappointing growth in 2012, such promising news is encouraging.

2. **The UK is, however, still a long way from a strong and sustainable recovery.** Notwithstanding the recent uptick in activity, per capita income remains 6 percent below its pre-crisis peak, making this the weakest recovery in recent history. Of particular concern is that capital investment (as a share of GDP) is at a postwar low, and that youth unemployment is high.

3. **The prospect remains for weak growth**. Given ongoing domestic deleveraging pressures and weak external demand, activity is expected to pick up only gradually. Similar to the view of the Office for Budget Responsibility, the most likely scenario is a prolonged period in which output is below potential.

4. **Risks remain tilted to the downside.** The key risk is that persistent slow growth could permanently damage medium-term growth prospects—this could arise if private sector deleveraging is larger than expected, credit conditions fail to improve, external demand does not pick up, and the drag from fiscal consolidation is greater than anticipated. In addition, despite recent market calm, growth in the euro area is likely to be weak, and the re-emergence of market tensions cannot be ruled out, with the potential for continued spillovers to the UK from depressed exports, higher bank losses and funding costs, and reduced confidence.

Policy priorities and challenges: restoring strong and balanced growth

5. **Restoring growth momentum and rebalancing the economy is vital.** Strong growth is needed to restore incomes, ensure the sustainability of public debt, and restore bank balance sheets. For long-term prosperity and resilience against future shocks, the economy has to be diversified and not reliant on domestic consumption. These imperatives have supply as well as demand dimensions—after five years of relatively weak activity, additional measures are needed to raise long-term expectations of potential growth, while rebalancing necessitates a transformation to a high-investment and more export-oriented economy.

6. **Policy remedies to restore growth and rebalance the economy are not straightforward**. Monetary policy is at the zero bound; bank balance sheets are impaired; and public debt is rising, but the consolidation to address this is also a drag on growth. This implies the need for a coordinated multi-pronged strategy to guide the economy to greater and more balanced growth. Such a package would bring growth benefits not merely to the UK, but would also have positive spillovers to the rest of the world, especially those who trade most with the UK.

Monetary policy: maintain accommodative stance

7. **The monetary policy response has been vigorous and appropriate, with substantial easing and policy innovations.** The Bank of England has cut policy rates, made substantial purchases of gilts, and, jointly with the Treasury, introduced the Funding for Lending Scheme. The March 2013 Budget provided a new remit for monetary policy that reaffirms that the central objective of monetary policy is to meet the inflation target of 2 percent per year. It also clarifies the government's expectations of the MPC about communicating the tradeoffs between inflation and growth, explicitly permits the use of unconventional policies, and requests the Bank to explore the use of thresholds to guide policy. More recently, the FLS has been modified to encourage lending to SMEs and its term has been extended. These are welcome initiatives.

8. **The transmission of accommodative monetary policy has, however, been weak.** Credit flows remain negative overall and some retail rates—notably for unsecured lending—remain higher than before the onset of the crisis. Patterns of funding rates and spreads in lending markets, as well as surveys of lenders and borrowers, suggest that both supply and demand are important for explaining the flow of credit.

9. **Monetary policy should remain accommodative.** The continued underperformance of the economy, reflected in the persistent output gap, calls for the accommodative stance to be maintained for an extended period. Because underlying inflation pressures are expected to remain subdued, there is no immediate risk of the monetary policy framework being eroded. In addition to considering further purchases of gilts, the BoE could provide assurance to households and investors that policy rates will be kept low until the recovery reaches full momentum.

10. **The effectiveness of monetary policy would be enhanced if it were supported by other policy measures.** The effectiveness of accommodative monetary policy is dependent on the health of the banking system and the demand for credit. Hence, implementation of financial policies to strengthen banks' health and fiscal and structural measures to boost expectations about long-term incomes are necessary to give monetary policy greater traction.

Financial policy: resolve the uncertainty over banks

11. **Financial sector repair has advanced, but banks are still not restored to healthy**

functionality. On the positive side, funding is more assured and regulatory capital ratios continue to edge up. However, the share of non-performing assets across some major banks remains at elevated levels, and underlying profitability is weak. Moreover, there are concerns pertaining to lender forbearance, under-provisioning for risky assets and conduct costs, and aggressive use of risk-weights.

12. **Fixing bank balance sheets is imperative for a durable resumption in lending.** Following the Asset Quality Review, the PRA is identifying the capital shortfall that individual banks face to meet an equity capital ratio of at least 7 percent (on a fully-loaded Basel III basis) by end-2013, and any additional requirement necessary to address bank-specific risk. To achieve this without compromising credit, banks will need to focus on some combination of building capital, notably through new equity issuance, reduction of dividend payouts, restrained remuneration, and balance sheet restructuring that does not reduce net lending. Looking ahead, the system-wide stress test that the authorities are planning for 2014 should aim to cover a broad range of risks, employ sufficiently stringent scenarios, and be anchored in supervisor-approved capital plans for participating banks. Transparency over methodology, results, and bank-by-bank capital plans would significantly enhance the credibility of this exercise.

13. **A clear strategy is needed for the two government-intervened banks, with a view to returning them to private ownership**. Together, RBS and LBG account for two-fifths of the stock of UK net private sector lending. The banks have made progress in repairing their balance sheets and improving profitability. But challenges remain, as evident by the recent failure to divest surplus business lines, and the still-low market-to-book value for RBS. The approaching completion of the banks' original EC-approved restructuring plans provides an opportunity to elaborate a clear way forward. Any strategy should seek to return the banks to private hands in a way that maximizes the value for taxpayers, strengthens confidence and competition in the sector, and minimizes outward spillovers. In this context, if a sovereign backstop is required to meet a capital shortfall, it should be provided, as this would have a high multiplier.

Fiscal policy: bring forward growth initiatives while preserving the fiscal framework

14. **The commitment to a medium-term plan has earned the government credibility.** Reducing the large structural fiscal deficit over the medium term is essential. To this end, the government set out in the June 2010 Budget a plan for discretionary deficit reduction measures of about £130 billion from FY 2010/11 to FY 2015/16. The government has since implemented more than a half of those discretionary measures.

15. While adhering to the medium-term framework, the government has shown welcome flexibility in its fiscal program. The government has accommodated a slowdown in the pace of structural consolidation, notably in the context of weakening potential growth; allowed automatic stabilizers to operate freely; and public sector net debt is forecast to fall in

2017-18, two years later than set out in the Supplementary Debt Target. Furthermore, several measures to support growth have been introduced, such as increases in personal tax allowances and reductions to corporate tax rates. The government has also used its balance sheet to provide support through the use of guarantees.

16. But planned fiscal tightening will be a drag on growth. Discretionary measures for this fiscal year amount to £10 billion. These will pose headwinds to growth, as expected, coming on top of domestic deleveraging and a weak external outlook, notably at a time when resources in the economy are underutilized.

17. **Judgments about fiscal policy need to balance debt sustainability with growth concerns.** The combination of continuing weak growth and high debt presents a dilemma: further fiscal consolidation will weaken output, with the risk of a permanent loss to productive capacity, while debt will accumulate unless there is consolidation. Given the tepid recovery, policy should capitalize on the nascent signs of momentum to bolster growth, notably by pursuing measures that address supply-side constraints and also provide near-term support for the economy. In the current context in which labor is underutilized and funding costs are cheap, the net returns from such measures are likely to be particularly favorable.

18. **Within the context of the medium-term fiscal framework, several growth-enhancing initiatives could be considered now to offset the drag from consolidation and bolster the recovery.**

- Bringing forward planned capital investment where possible, which would help catalyze private investment and spur much-needed growth. Alongside this, well-designed public guarantees could be used to facilitate private investment.

- Further modifying the composition of consolidation to boost growth. This could include growth-friendly measures, such as reducing marginal effective corporate tax rates to bring investment forward, and introducing tax allowances for raising equity. To offset the budgetary impact of these measures over the medium term, the government could undertake a reform of property taxes and consider broadening the VAT base.

- The 2013 Budget announced a new scheme, Help To Buy, aimed at boosting activity in the housing market. This measure may temporarily help boost confidence in the housing market, but there is a risk that, in the absence of an adequate supply response, the result would ultimately be mostly house price increases that would work against the aim of boosting access to housing. To mitigate this risk and engineer a supply response, the government should consider fiscal disincentives for holding land without development.

19. **Government investment in supply-side measures to boost growth will enhance rather than damage credibility.** The UK has a strong commitment to medium-term fiscal consolidation, an Office for Budget Responsibility that has rapidly established its credibility, and long-duration debt. Raising growth expectations will do more for reassuring debt sustainability, while also helping restore banks to good health. And although supply measures are often thought to have only long-run benefits, they could bring immediate reassurance to purchasers of UK debt.

Structural policies: the essential pillar for long-term rebalancing and prosperity

20. **Structural reforms are essential to aid rebalancing to a dynamic, balanced, and robust economy.** A number of initiatives identified by the LSE Growth Commission, the Heseltine Review, and the government should be pursued with greater vigor:

- Retraining opportunities, including vocational training, should be provided to currently low-skilled workers to enable them transition to high valued-added, high wage work. Immigration policy should be reformed, with an aim to improve the economy's skills and competitiveness.

- Investment in infrastructure, notably in transport and energy, could be supported by streamlining the planning application process and removing regulatory uncertainty. To accelerate the implementation of infrastructure projects, more authority over planning decisions should be devolved to local authorities, with financial incentives provided through greater revenue sharing.

- Reduced concentration in the banking sector would better serve the needs of UK firms and households, especially given few alternative sources of funds for start-ups and smaller enterprises.

Financial regulation: clarity and consistency

21. **Transition to the new "twin peaks" regulatory and supervisory structure has been well managed, but challenges remain.** Going forward, it will be important to ensure greater coordination between the FPC and the newly-established PRA, especially in the context of forthcoming stress tests planned through 2014 and beyond. This will help alleviate regulatory uncertainty. Moreover, ensuring the operational independence and adequate resourcing of the PRA will be critical to support the intensive and intrusive supervision of the UK's globally-systemic financial sector, including to minimize the risk of adverse spillovers.

22. **There is scope to expand the FPC's toolkit.** To help ensure financial stability, the FPC should have additional powers to limit loan-to-value and loan-to-income ratios, as higher capital requirements alone might be insufficient to restrain property bubbles. Separately, given that the UK is home to several large globally-active banks, it would be important to internalize spillover effects, positive or negative, that result from applying macroprudential tools to enhance the financial system's resilience.

23. **Structural banking reform measures will have to be coordinated internationally and address gaps.** The effectiveness of the authorities' planned (electrified) ring fence atop price-based regulations to address systemic risk will depend in part on progress at an international level toward robust cross-border supervisory and bank resolution frameworks. Structural reform measures seek to address the "too important to fail" issue, but, in addition, due regard needs to be paid to concerns about regulatory arbitrage, including the risk of significant activity migration to more lightly-regulated shadow banks and non-banks.