**EXECUTIVE BOARD MEETING**

SM/18/249
Correction 1

November 8, 2018

To: Members of the Executive Board

From: The Acting Secretary

Subject: **United Kingdom—Staff Report for the 2018 Article IV Consultation**

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|---|---|
| Board Action: | The attached corrections to SM/18/249 (10/26/18) have been provided by the staff: |
| **Evident Ambiguity** | **Pages 11 (line 1), 12 (para. 20), 29** |
| **Factual Errors Not Affecting the Presentation of Staff's Analysis or Views** | **Pages 1, 2, 8, 10 (para. 16), 11 (lines 2–3), 12 (para. 21, lines 3, 5, 7, and 10; para. 22), 17, 46** |
| **Typographical Errors** | **Pages 10 (para. 18) and 12 (para. 21, line 2)** |
| Questions: | Ms. Iakova, EUR (ext. 35365)<br>Mr. Arregui, EUR (ext. 38456)<br>Mr. Chen, EUR (ext. 34746)<br>Mr. Espinoza, EUR (ext. 34831) |

INTERNATIONAL MONETARY FUND

# UNITED KINGDOM

## STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION

October 25, 2018

## KEY ISSUES

**Context and Outlook.** The United Kingdom is set to exit the European Union in March 2019. It is now in the process of negotiating its ~~future relationship with~~ withdrawal from the EU. Once an agreement is reached, there will be an implementation period through the end of 2020. Complex issues still remain to be resolved, including the future status of the land border with Ireland. Growth over the past year has been moderate. The post-referendum depreciation caused an increase in inflation, depressing private consumption. Business investment growth has been constrained by protracted uncertainty about the future trade regime and potential increases in trading costs. Nonetheless, slack in the economy is limited as weaker demand is matched by slower supply growth. Growth is expected to continue at a moderate pace, conditional on a smooth Brexit transition and some recovery in labor productivity. A key downside risk is an exit without an agreement with the EU, accompanied by disruptive asset price movements.

**Policies.** While a disorderly Brexit remains the largest risk to the economy, the UK faces a raft of issues that predate the referendum, including relatively large public debt and current account deficit, and low productivity growth. Sustained fiscal consolidation would help restore fiscal buffers and prepare public finances for the expected increase in demographic-related spending. The pace of further tightening of the monetary policy stance should be gradual and data-dependent given high uncertainty about the future macroeconomic environment. Structural reforms to boost productivity and facilitate reallocation of resources post-Brexit would help promote inclusive and sustainable growth. Continued focus on strict prudential supervision is warranted in the context of relatively easy financial conditions and Brexit-related risks. Close collaboration with the EU prudential authorities will be essential to maintain a smooth functioning of the financial system and minimize risks.

Approved By
**Philip Gerson (EUR) and ~~Petya Koeva Brooks~~Rupa Duttagupta (~~EUR~~SPR)**

Discussions took place in London during September 3–17, 2018. The staff team comprised P. Gerson (head), D. Iakova, N. Arregui, J. Chen, R. Espinoza (all EUR), and T. Gudmundsson (MCM). J. Pampolina, C. El Khoury (both LEG), L. Gornicka, O. Ftomova and R. Vega (all EUR) supported the mission from headquarters. The Managing Director met with the Chancellor and the Bank of England Governor and held a press conference at the end of the mission.

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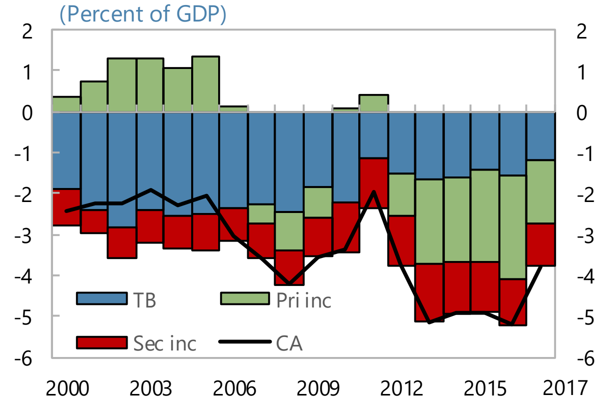
of England project growth to remain modest by historical standards. They noted that spare capacity in the economy is currently limited, and that potential supply growth in the future was likely to be lower relative to past averages, in part as a result of reduced net migration and subdued investment growth. A disorderly no-deal exit from the EU in March 2019 is the main downside risk to the outlook. Beyond Brexit, the authorities shared staff's view on the key domestic and global risks. The medium-term growth outlook would depend on the outcome of the Brexit negotiations and the recovery of productivity growth.

# EXTERNAL ASSESSMENT

**11. The current account balance has narrowed significantly but the deficit still exceeds its average historical values.** The current account deficit shrank to 3.~~9~~7 percent of GDP in 2017 (Figure 5). The improvement in trade and primary income balances was driven by the post-referendum currency depreciation and a stronger global economy, which boosted UK exports and returns on the UK's foreign currency-denominated assets. From a savings perspective, the improvement reflects significant increases in savings by the government and private corporations, only partly offset by net dissaving by the household sector. From a financing perspective, the share of debt inflows—which may be more vulnerable to refinancing risks—has increased. The current account deficit is projected to narrow further to about 3 percent over the medium term as import growth decelerates in line with subdued domestic demand.

**Current Account Balance**

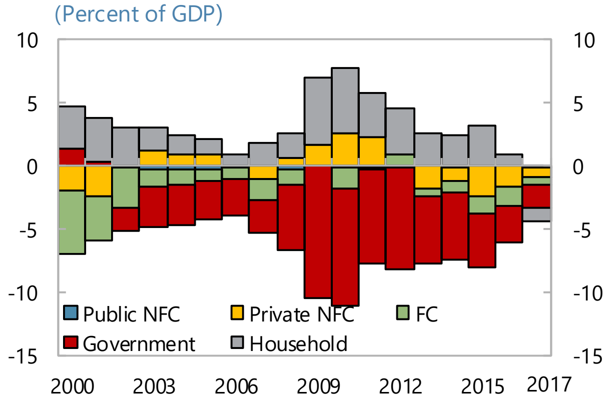
(Percent of GDP)




Sources: Haver Analytics; and IMF staff calculations.

**Saving - Investment Balance, by Sectors**

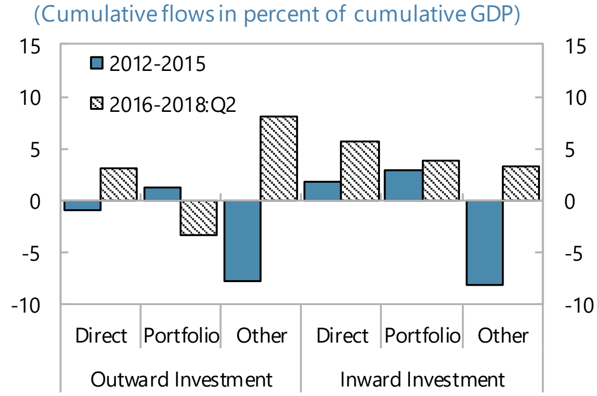
(Percent of GDP)




Sources: Haver Analytics; and IMF staff calculations.

**Capital Flows**

(Cumulative flows in percent of cumulative GDP)




Sources: Haver Analytics; and IMF staff calculations.

degree of uncertainty about the future macroeconomic environment. Structural policies should continue to focus on raising competitiveness and potential growth over the medium term. Brexit will lead to important shifts in the structure of the UK economy, and policies could facilitate the transition. In doing so, however, measures should seek to support workers and not particular jobs or sectors. In the financial sector, continued prudent oversight would be necessary to ensure resilience to risks and to prevent a relaxation of credit standards. Across the full policy-making spectrum, it is important to have in place contingency plans to maintain economic and financial stability in case of a disorderly exit from the EU.

**16. The UK government has taken a number of steps to prepare for the administrative and legislative changes that Brexit will require.** Parliament ~~is in the process of transposing~~ has passed legislation converting into UK law the legislative framework currently encompassed in EU laws. The government has guaranteed EU program funding committed to projects in the UK before the end of 2020 and is working to ensure that the UK maintains access to critical items like medicines. A budgetary allocation of £3 billion has been established to help fund the costs of Brexit preparation, and thousands of civil servants have been hired to help shoulder the workload. The government has begun publishing technical notices setting out information to allow private stakeholders to understand what they would need to do in a no deal scenario, so they can make informed plans and preparations. The government has also committed to providing temporary permissions for EU financial institutions to continue to operate in the UK to provide continuity at the moment of departure from the EU.

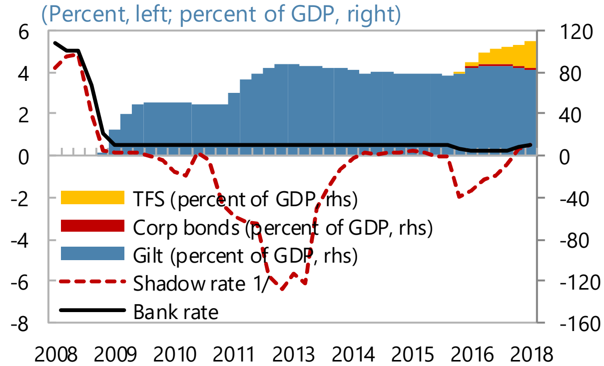
**17. Nevertheless, the range of remaining issues to prepare for Brexit is large, underscoring the importance of securing an implementation period.** The UK will have to bolster human, physical, and IT resources in customs and other services, and establish domestic agencies to operate in place of EU ones. In addition, the government will need to renegotiate the hundreds of bilateral and multilateral international agreements to which it is now party via its EU membership. Many of the required tasks cannot be initiated until there is greater clarity on the future trade relationship with the EU. There are, accordingly, risks of serious disruptions without an implementation period in place. Irrespective of the shape of the new economic relationship post Brexit, continued close cooperation between the UK and the EU authorities in different policy areas would be mutually beneficial.

## A. Monetary Policy

**18. Monetary policy remains accommodative, despite a cumulative 50 basis point increase in ~~the~~ Bank ~~r~~Rate over the last 12 months.** The Bank of England raised the policy rate by 25 basis point to 0.75 percent in August, citing limited slack in the economy as unemployment rates fell to historical lows, productivity performance remained lackluster,

**Monetary Instruments**

(Percent, left; percent of GDP, right)

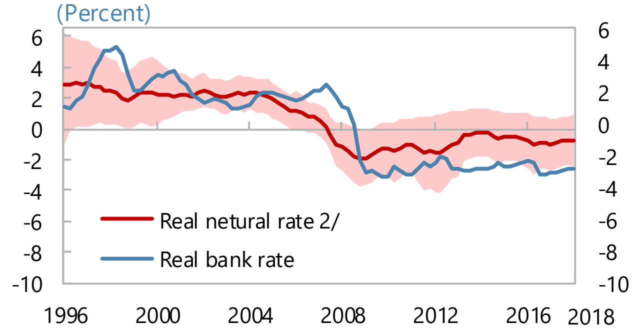



Sources: Haver Analytics; and IMF staff calculations.
1/ Based on Krippner (2011-2015).

and net migration flows slowed down. The nominal policy rate is still below the Fund staff's estimated neutral rate of about 1½ percent.[4] The Monetary Policy Committee (MPC) also voted to ~~continue to re-invest maturing~~ maintain the stock of gilts and corporate bonds on the Bank's~~its~~ balance sheet. A Term Funding Scheme for banks was closed at the end of February 2018 (a total of £127 billion was drawn and banks must repay the funds within four years).

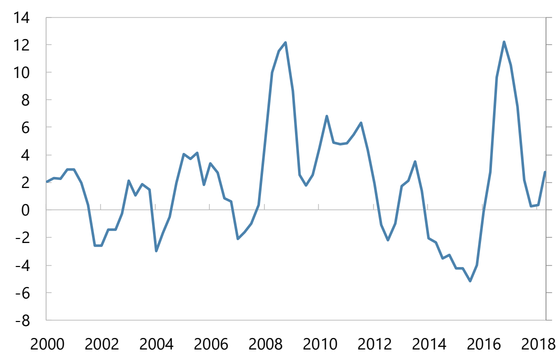
**19. While import price pressures are easing, domestic labor costs are on the rise.** Import price inflation has declined in recent months as the impact of past sterling depreciation on prices is fading. At the same time, the unemployment rate is historically low despite a record high labor force participation rate. Private sector pay growth has strengthened in the context of a tight labor market, while productivity growth remains modest. Unit labor costs increased by about 2½ percent yoy in the first half of 2018 and are projected to remain relatively high in the near term, which would push up domestic cost pressures further. High energy prices are expected to keep headline inflation above 2 percent for the rest of 2018, with a gradual convergence to target projected next year.

**Monetary Policy Stance 1/**
(Percent)



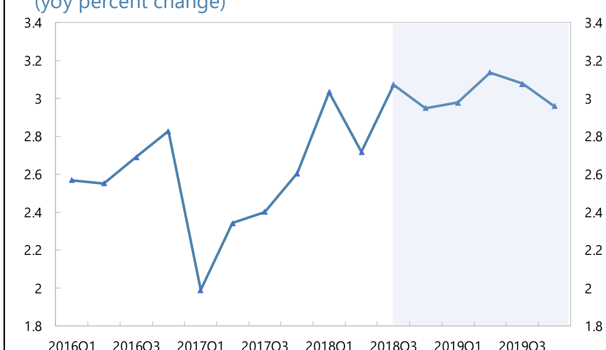

Source: IMF staff calculations.
1/ Real rates are calculated using market based inflation expectations.
2/ Based on Pescatori and Turunen (2015).

**Import Price Inflation**
(yoy percent change)




Sources: Haver.

**Estimated Nominal Wage Growth**
(yoy percent change)




Sources: ONS and IMF staff calculations.

**20. A modest further tightening of monetary policy over the next two years would likely be needed to ensure that inflation converges sustainably to the target.** Domestic inflation is expected to continue to firm as labor supply remains constrained by falling migration and wage growth exceeds productivity growth. If excess demand pressures persist after domestic inflation has reached a level consistent with the 2-percent target, further gradual tightening of monetary policy

[4] Staff estimates are from a model based on Pescatori and Turunen (2015).

would be needed to help keep inflation close to the target and inflation expectations anchored. However, policymakers should stand ready to respond flexibly to data developments in an environment of greater-than-usual uncertainty about the outlook. If negative surprises related to the Brexit negotiations depress domestic demand (relative to supply) further, accommodative conditions should be maintained for longer. Transparent and timely communication will remain important to guide market expectations.

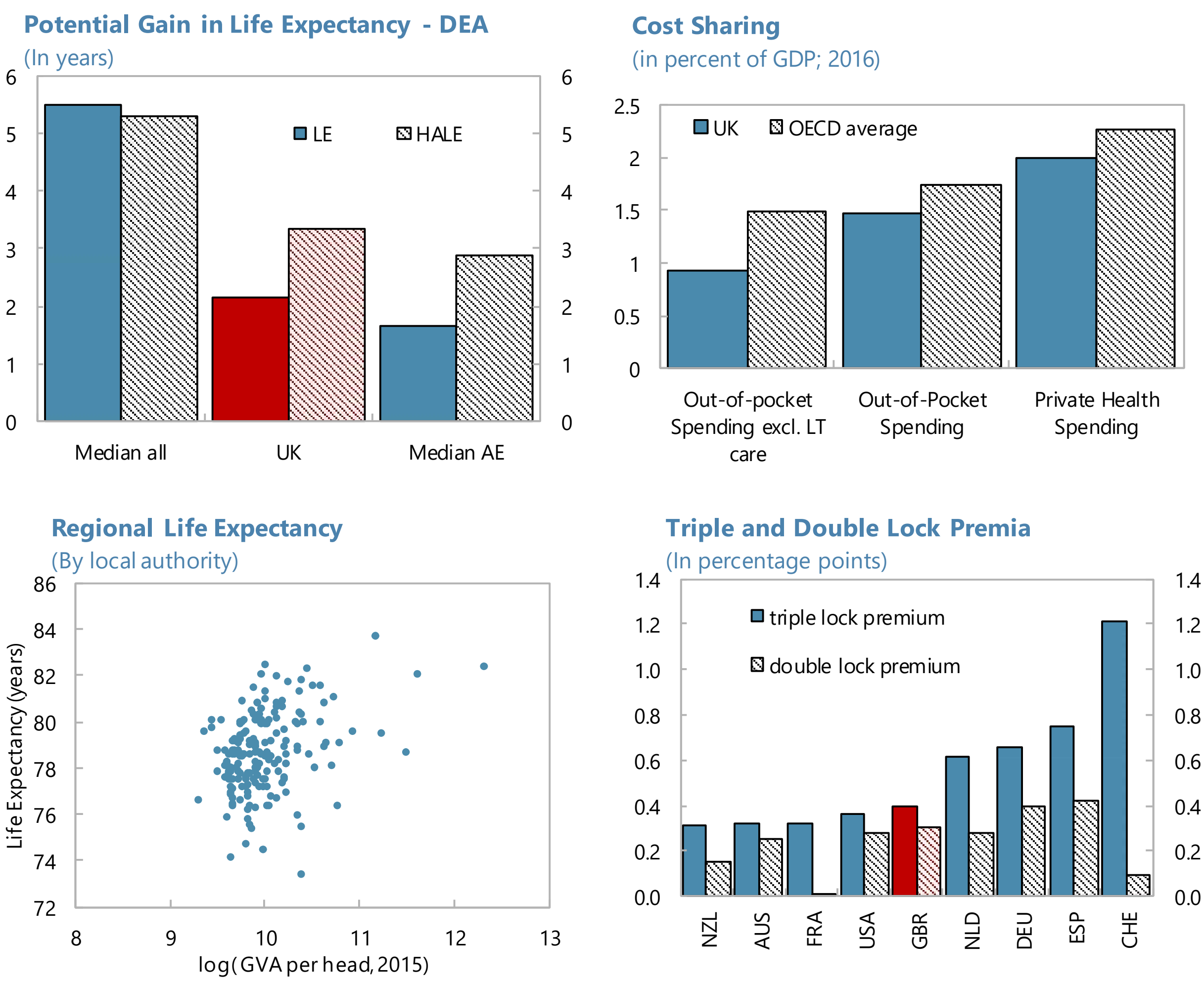
**21. The Bank of England's strategy for reducing its balance sheet in the future is appropriate.** The Bank intends to continue to use ~~the~~ Bank Rate as the main policy instrument. The MPC announced that it ~~will start~~ does not intend to start reducing the stock of purchased assets until ~~Bank balance sheet once the~~ Bank Rate reaches around 1.5 percent, a level from which it could be cut materially if needed to react to shocks.[5] Staff agreed with this strategy. There was also an agreement that ~~once this threshold is reached~~ when it becomes appropriate, the Bank should start reducing its balance sheet in a gradual and predictable manner. In a recently published paper, the Bank ~~announced~~ confirmed that it expects to continue to use a floor system to control short-term interest rates, meeting fully banks' demand for reserves at the Bank Rate. This system implies that in the long run the size of the central bank balance sheet will depend on the demand for reserves and would likely be higher than pre-crisis due in part to changes in liquidity regulations. Staff and authorities agreed ~~noted~~ that asset sales may have to be coordinated with the UK debt management office to minimize the impact on market liquidity conditions. The Bank will need to monitor short term money markets to determine the equilibrium value of the balance sheet. A clear communication of the Bank's approach to asset sales and the indicators that it will use to determine the end-point for normalization would help guide the market.

**22. The ~~revised~~ new Bank of England capital framework should reinforce the Bank's independence and policy credibility.** The new arrangements establish a rules-based framework to define the Bank's capital needs and its income distribution policy. The framework provides adequate financial resources to ensure the Bank's independence and back its monetary policy and financial stability mandates.

***Authorities' Views***

**23. The authorities reiterated that future increases in the Bank Rate are likely to be gradual and limited.** The authorities expect that domestic cost pressures will keep rising as labor market pressures feed into higher wages. They noted that there were signs of rising wage pressures, such as strong pay growth for recently hired workers. They also noted that the effect of Brexit on monetary policy is difficult to predict since exit could be accompanied by significant supply shocks whose impact could dominate those of lower demand. They agreed that the balance sheet should be reduced in a predictable and well-communicated manner.

[5] The lowering of this threshold from 2 to 1.5 percent was justified by an updated assessment of the effective zero lower bound for the policy rate. With new facilities such as the Term Funding Scheme, commercial banks can get funding at the Bank Rate.




Sources: Eurostat, Haver Analytics; OBR FSR 2017; OECD; ONS; WDI database; WHO database; and IMF staff calculations.
Note: LE= Life expectancy; HALE = Health-adjusted life expectancy. Potential gain in LE/HALE is computed using Data Envelope Analysis (DEA). Private health spending includes voluntary schemes and out of pocket expenditures on health. Double-lock premium estimated as the average difference between the maximum of earnings growth and CPI inflation, and earnings indexation, over the period 1990-2016. Triple and double lock premia are computed for illustrative purposes and do not denote the formal method of pension indexation in different countries.

## C. Financial Sector Policies

### Brexit Implications for the Financial System

**31. The UK financial industry will be significantly affected by Brexit.** Banking activities, including mortgages, cross-border banking, and deposit taking, will be most affected by the loss of passport rights. The asset management industry may see a smaller impact as its activities could benefit from existing ~~equivalence~~third-country frameworks, although approvals will have to be granted (GFSR, October 2018). Typically, free trade agreements do not cover services. Staff's assumption in the baseline is that non-tariff costs for services will rise to half of the estimated non-tariff trade costs surpasses the level consistent with the 2-percent target, further gradual tightening of monetary policy would be warranted. However, if negative economic shocks depress domestic demand relative to supply, accommodative conditions should be maintained. The reduction in the Bank of England's balance sheet should commence once the policy rate has reached a level from which it can be cut materially in the event of a demand slowdown.

**54. Steady fiscal consolidation remains critical to comply with the government's fiscal framework, build buffers against future shocks, and help reduce the current account deficit.** The recently-announced increase in public health spending should be financed from new revenue sources and/or offsetting spending cuts elsewhere in the budget. Brexit-related effects would add to the rising strain on public finances related to population aging. To mitigate age-related spending increases, the authorities should explore opportunities for further efficiency gains in health care provision and eliminate the "triple lock" on public pensions. Absent a fundamental rethinking of the size and role of the public sector, revenue measures would need to occupy a more prominent place in deficit reduction efforts going forward.

**55. A continued prudent approach to supervision is crucial in a context of relatively easy financing conditions and heightened risks related to Brexit.** Household and corporate leverage have started to edge up, although they remain below pre-crisis levels. Consumer credit continues to rise faster than income, despite recent tightening of underwriting standards. Further policy action may be needed if high rates of growth persist, including additional increases in bank-specific capital buffers and steps to enhance the oversight of nonbank financial institutions. Regulatory and supervisory cooperation between UK and EU authorities will be crucial to maintaining the integrity of cross-border financial transactions after Brexit. As suggested in the recent Euro Area FSAP, the EU and UK authorities should work together to ensure legal continuity in insurance and derivative contracts and proper data sharing to avoid cliff-edge effects. Continued commitment to high regulatory standards is essential to preserve hard-won financial stability gains.

**56. In a disorderly no-deal Brexit scenario, policies should seek to safeguard macroeconomic and financial stability.** In the event of financial market disruption accompanied by sharp declines in asset prices, the Bank of England would need to ensure that the financial system has adequate liquidity. The fiscal framework provides flexibility to support the economy, for example through bringing forward infrastructure spending. However, the space to respond could narrow if the shock were to significantly raise interest rates on public debt. Any easing of fiscal policy should be targeted and embedded in a credible medium-term fiscal consolidation plan. A permanent shock to output would require an eventual adjustment of revenues or spending.

**57. Further sustained policy efforts are needed to support productivity and make growth more inclusive.** The plan to increase public infrastructure investment over the medium term is welcome. Continued focus on policies to increase human capital is also critical. Improving economic opportunities for women by facilitating flexible work arrangements and closing the gender pay gap would promote growth and equity. Brexit will lead to important shifts in the structure of the UK economy and policies could play a role in facilitating the transition. Policies should seek to support

# Annex I. External Sector Assessment

| | United Kingdom | Overall Assessment |
|---|---|---|
| **Foreign asset and liability position and trajectory** | **Background.** The net international investment position (NIIP) declined from -2.4 percent of GDP in 2016 to -8.~~1~~ 6 percent of GDP in 2017. Over the past five years, the NIIP has strengthened by 20.4 percentage points, reflecting a negative CA contribution (-22.4pp) more than offset by valuation and growth effects (37.9pp and 4.8 pp respectively).[1/] Staff projects the NIIP to weaken over the medium term, although the importance of and uncertainty around valuation effects cast significant doubt around these estimates.<br>**Assessment**. The sustainability of NIIP is not a concern. Since 2000, valuation gains have offset around a third of the effect of current account flows on the IIP. In addition, UK's external assets have a higher foreign-currency component than its external liabilities, so the NIIP improves with sterling depreciation. However, fluctuations in the underlying gross positions are a potential source of vulnerability (excluding derivatives, gross assets and gross liabilities exceed 400 percent of GDP). | **Overall Assessment**:<br>*The external position in 2017 was weaker than implied by medium-term fundamentals and desirable policy settings, and preliminary data suggest the assessment will be broadly unchanged for 2018.*<br><br>Although improving, the current account deficit remained high in 2017, reflecting low public and private savings. Over the medium term, the deficit is set to narrow helped by ongoing fiscal consolidation, the effect of the real depreciation, and an improving primary income balance as UK growth underperforms that of its trade partners.<br>The uncertainty around this assessment is significant, reflecting both possible measurement uncertainty, as well as uncertainty about the future trade arrangement with the EU and its possible effect on growth and trade flows.<br><br>**Potential policy responses**:<br>The current fiscal consolidation plan implemented within a medium-term framework will appropriately continue to support the external rebalancing. Further |
| **Current account**<br><br>CA Assessment 2017 | **Background.** The CA balance improved to -3.9 percent of GDP in 2017 (from -5.2 percent in 2016) and is expected to further improve to -3.5 percent of GDP in 2018, remaining significantly below its average historical values. The wider CA deficits since the global financial crisis reflect mostly weaker income balance, due in part to lower earnings on the UK's foreign direct investment abroad (especially in the euro area). By contrast, the trade balance has been broadly stable at around -1.6 percent of GDP through 2016, and increased to -1.~~3~~ 1 percent in 2017, supported by strong growth in trading partners and a weaker sterling. It is expected to remain broadly stable in 2018, at -1.0 percent of GDP. The CA improvement in 2017 was also driven by an improvement in net income flows (0.9 percent of GDP), helped by the positive valuation effect from sterling depreciation which increase the sterling value of income inflows denominated in foreign currency.<br>From a savings-investment perspective, the CA dynamics during 2017 reflect an improvement in gross national savings, but the CA deficit reflects a still elevated general government deficit (1.8 percent of GDP in 2017) and low private sector savings.<br>**Assessment.** The EBA CA model estimates a CA gap of -4.8 percent of GDP for 2017 (a cyclically-adjusted CA balance of -3.8 percent of GDP compared with a CA norm of 1 percent of GDP). However, the cyclically-adjusted CA could be understated due to measurement biases associated with large NIIP valuation effects.[2/] Looking ahead, the recovery of global growth relative to UK growth should translate into higher net income inflows over time. Uncertainty around the CA gap estimation is high, as evident from the results under different methodologies, partly reflecting measurement uncertainties (large and volatile NIIP valuation changes, and other unidentified stock-flow adjustments). Overall, staff assesses the 2017 cyclically-adjusted CA balance to be 1 to 5 percent of GDP weaker than the CA norm, with a mid-point of 3 percent of GDP. This range takes into account the uncertainty in the assessment due to the Brexit negotiation process, possible measurement and modeling issues, the REER assessment below and the External Sustainability (ES) approach.[3/ 4/]<br>Actual CA: -3.9 \| Cycl. Adj. CA: -3.8 \| EBA CA Norm: 1.0 \| EBA CA Gap: -4.8 \| Staff Adj.: -1.8 \| Staff CA Gap: -3.0 | |
| **Real exchange rate** | **Background.** Sterling depreciated by 10 percent in 2016 in real effective terms relative to its average level in 2015 and by additional five percent from 2016 to 2017. The depreciation may reflect in part an unwinding of past overvaluation, and in part market expectations of more restrictive access to the EU market in the future. As of August 2018 the REER is unchanged relative to its 2017 average.<br>**Assessment.** EBA REER level and index approaches suggest a gap of -9.3 and -10.0 percent, respectively, for 2017. In comparison to previous years, the REER assessment is subject to a greater margin of uncertainty due to uncertainty about the UK's new trading relationship with the EU and its effects on the equilibrium level of REER. Overall, staff assesses the REER to be between 0 and 15 percent above the level consistent with fundamentals and desirable policy settings. This range is broadly anchored on the CA assessment. The weaker sterling and strong trading partner growth are expected to support further CA deficit narrowing in the near term. | |