April 10, 2020
Approval: 4/17/20

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 18/12-1

11:00 a.m., February 12, 2018

1. United Kingdom—2017 Article IV Consultation

Documents: SM/18/18 and Correction 1, and Supplement 1; SM/18/19, and Correction 1

Staff: Gerson, EUR; Iakova, EUR; Koeva Brooks, SPR

Length: 1 hour, 22 minutes

Executive Board Attendance

D. Lipton, Acting Chair

Executive Directors	Alternate Executive Directors
	D. Mahlinza (AE)
	H. Razafindramanana (AF)
A. Armas (AG)	
	C. Barron (AP)
A. Tombini (BR)	
Z. Jin (CC)	
	J. Dajani (CE)
N. Horsman (CO)	
	C. Just (EC)
H. de Villeroché (FF)	
S. Meyer (GR)	
S. Gokarn (IN)	
A. Leipold (IT)	
M. Kaizuka (JA)	
	M. Daïri (MD)
	W. Abdelati (MI), Temporary
	R. Doornbosch (NE)
T. Ostros (NO)	
A. Mozhin (RU)	
H. Alogeel (SA)	
J. Agung (ST)	
M. Panek (SZ)	
S. Field (UK)	
	M. Sobel (US), Temporary

T. Rumbaugh, Acting Secretary
O. Vongthieres, Summing Up Officer
M. Guerra Bradford, Board Operations Officer

Also Present
European Central Bank: K. Nikolaou, R. Rueffer. European Department: N. Arregui, J. Chen, P. Gerson, L. Gornicka, D. Iakova, R. Vega. Legal Department: H. Pham. Strategy, Policy, and Review Department: G. Minasyan, P. Koeva Brooks. Executive Director: P. Inderbinen (SZ), G. Lopetegui (AG), M. Raghani (AF). Alternate Executive Director: A. Castets (FF), P. Fachada (BR), C. Hurtado (CE), G. Johnston (AP), A. McKiernan (CO), L. Palei (RU), B. Saraiva (BR), K. Virolainen (NO). Senior Advisors to Executive Directors: H. Joshi (IN),

Y.Liu (CC), A. Machmud (ST), R. N'Sonde (AF), O. Odonye (AE), P. Pollard (US), G. Preston (AP), S. Rouai (SA), M. Sanchez (FF), C. Sassanpour (MD), F. Spadafora (IT), O. Stradal (EC). Advisors to Executive Directors: A. Arevalo Arroyo (CE), P. Braeuer (GR), X. Cai (CC), M. Chen (UK), N. Feerick (CO), T. Gade (NO), D. Hart (CO), O. Haydon (UK), T. Hemingway (UK), M. Ismail (AE), G. Kim (AP), N. Komura (JA), E. Myers (UK), B. Parkanyi (GR), L. Rauqeuqe (ST), F. Rivadeneira (BR), D. Vogel (AG), K. Lok (CC), J. Montero (CE), M. Cowie (UK).

1. UNITED KINGDOM—2017 ARTICLE IV CONSULTATION

The representative from the European Central Bank submitted the following statement:

> We would like to thank Mr. Field for his buff statement and staff for their report. We associate ourselves with the statement by Mr. Meyer and would like to further highlight a few issues.
>
> We agree with staff that the considerable uncertainty following the U.K. Brexit decision has adversely affected the current economic situation of the United Kingdom, with the macroeconomic outlook critically hinging upon the terms of the new agreement to be reached with the European Union. The staff rightly highlights the adverse economic consequences of the highly uncertain environment in the light of the ongoing Brexit negotiations across a wide range of economic outcomes—from the strong depreciation of sterling and its impact on inflation, through dampened consumption and lower-than-anticipated investment, as well as impacts on equity prices of U.K.-focused firms. Even assuming a relatively smooth and orderly exit process, growth is likely to remain moderate over the coming years. At the same time, risks to growth are tilted to the downside: Growth prospects depend heavily on the degree to which a new EU-U.K. relationship will be able to minimise the adverse effects on trade over and beyond those implied by the United Kingdom leaving the customs union and Single Market. In projecting the evolution of the U.K. economy, it may be important to more clearly distinguish between the next couple of years, which may be governed by a transition agreement, and the period following such a transition period. Some assumptions that may be plausible for the former period may be less so for the latter, for example regarding the framework governing the cross-border provision of financial services.
>
> We welcome the staff's explicit attention to the potential challenges for the U.K. financial sector from Brexit as well as the strong focus in the assessment of contingency plans in case of a disorderly Brexit. The importance of the financial sector's contribution to the U.K. economy would become even clearer if one were to include in the analysis some estimate of broader network effects, notably in Box 3. The benefits from such effects may be compromised should the City of London's long-standing status as a global hub be adversely affected by the loss of financial "passporting" rights following Brexit.

In what concerns the ECB Banking Supervision, we do not foresee any strains in supervisory capacity coming from a potential expansion of the size and complexity of the EU financial system following Brexit (paragraph 42 of the staff note). Very extensive preparatory work has already been carried out as regards incoming and outgoing credit institutions. Furthermore, the SSM is already dealing with a number of complex institutions and has the required expertise to deal also with the incoming investment banks.

We agree with staff that steady fiscal consolidation is needed, alongside a more growth-friendly composition of public finances. The recent fiscal loosening in part reflects the considerable downgrading of growth and potential growth prospects following the Referendum result, as noted by the Chancellor in his Autumn 2017 Budget. As a result, steady fiscal consolidation remains critical to set the public debt ratio on a sustainable downward path and to rebuild fiscal buffers. At the same time, the United Kingdom should intensify efforts towards achieving a more growth-friendly composition of public finances. The identification of additional revenue streams (including growth-friendly tax reforms) could support these efforts. This would increase the fiscal space for growth enhancing infrastructure investment but also to build buffers with which to tackle any near-term risks potentially associated with Brexit and as a means of helping to meet the longer-term projected rises in healthcare, long-term care and pensions.

Mr. Field submitted the following statement:

I thank staff for their cooperation and engagement on this Article IV. My authorities note staff's view that the overall policy mix is appropriate and, notwithstanding the steady growth the United Kingdom has experienced, agree with staff that they should continue to take action to ensure the economy remains resilient to ongoing domestic and external challenges.

Since the 2016 Article IV, the British people have voted to leave the EU. The economic outlook has become more uncertain, but the fundamental strengths of the U.K. economy will support growth in the long term, as the United Kingdom forges a new relationship with the EU. The government has set out policies to support the economy during this transition, prioritizing investment to improve productivity and ultimately living standards.

The government and the European Commission are in the process of negotiating the United Kingdom's departure from the EU. On 8 December 2017, both parties reached agreement in principle across the areas under consideration in the first phase of negotiations, namely: protecting the rights of EU citizens in the United Kingdom and U.K. citizens in the EU; the framework for addressing the unique circumstances in Northern Ireland; and the financial settlement. Progress was also made in achieving agreement on aspects of other separation issues and the European Council subsequently agreed to move to the second phase of negotiations related to transition and the framework for the future relationship. The PM has said that the United Kingdom will approach our future discussions with the EU with ambition and creativity, and wants a deep and special partnership that spans a new economic relationship.

Economic Context and Outlook

The U.K. economy has demonstrated its resilience over the past 18 months. Growth has remained solid, extending the period of continuous growth to 20 quarters. Employment has risen by 3 million since 2010 and is at record highs, and over the past year, higher employment has reflected rising full time work. The increase in employment has supported prosperity across the country and income inequality is at its lowest level in 30 years. The level of female employment is close to a record high at 15 million. The unemployment rate, which now stands at 4.3 percent, is at its lowest rate since 1975.

As the staff report notes, over the past year, higher inflation has weighed on household income, business investment has been affected by uncertainty, and productivity remained subdued. Productivity growth has slowed across all advanced economies since the financial crisis, but it has slowed more in the United Kingdom than elsewhere. If the United Kingdom can unlock productivity growth, there is an opportunity to increase growth, wages and living standards over the long term. In the near term, the government has pursued policies that provide support for households and businesses. Over the medium term, the government has set in train a plan to address the United Kingdom's productivity challenge, by cutting taxes to support business investment, improving skills and investing in high value infrastructure.

The staff forecasts are in line with those of the authorities. In November, the independent Office of Budget Responsibility (OBR) revised down its forecast for GDP growth in 2017 to 1.5 percent, reflecting slower-than-expected growth at the start of the year and revisions to recorded growth in 2016. Growth this year is expected to be 1.4 percent, with growth of 1.3 percent in 2019 and 1.3 percent in 2020, driven by a more cautious assumption for trend productivity. From 2020, growth is forecast to pick up and GDP growth rises to 1.6 percent at the end of the OBR's forecast horizon in 2022.

Public Finances

The government has made significant progress since 2010 in restoring the public finances to health. The deficit has been reduced by three quarters from a post war high of 9.9 percent of GDP in 2009 10 to 2.3 percent in 2016 17, its lowest level since before the financial crisis.

The staff report notes the public debt ratio remains high by international standards. The OBR forecasts debt will peak at 86.5 percent of GDP in 2017 18, its highest level for 50 years. The government agrees with staff that borrowing needs to be reduced further to maintain the United Kingdom's economic resilience, improve fiscal sustainability, and lessen the burden on future generations.

The fiscal rules approved by parliament in January 2017 commit the government to reducing the cyclically adjusted deficit to below 2 percent of GDP by 2020 21 and having debt as a share of GDP falling in 2020 21. The rules enable the government to take a balanced approach: returning the public finances to a sustainable position while helping households and businesses, supporting public services, and investing in Britain's future. These rules will also guide the United Kingdom towards a balanced budget by the middle of the next decade. The OBR forecasts that the government will meet both its fiscal targets. By 2022-23, borrowing is expected to be at its lowest level since 2001 02 and debt as a share of GDP is forecast to fall next year and in every year of the forecast.

The government welcomes recognition in the staff report that the United Kingdom continues to set international standards with respect to fiscal transparency. In July 2017, the OBR published its first 'Fiscal Risks Report' (FRR), which provides a comprehensive assessment of risks to the public finances over the medium to long term. It also illustrates the potential fiscal impact of a number of these risks materializing at the same time through a fiscal stress test based on the Bank of England's annual cyclical scenario (ACS). The publication of the FRR builds on the steps that the government has taken to improve fiscal transparency, including the creation of the OBR itself. The government's response to the FRR will be published this summer.

Monetary Policy

Following the vote to leave the EU, on 4 August 2016 the Bank of England’s Monetary Policy Committee (MPC) announced a monetary stimulus package to support economic growth and achieve a sustainable return of inflation to target. The MPC cut the Bank of England’s base interest rate from 0.5 percent to 0.25 percent, extended the quantitative easing program, and introduced a new Term Funding Scheme to enable banks to pass on the Bank Rate cut to businesses and households.

The steady erosion of slack over the subsequent year reduced the degree to which it was appropriate for the MPC to accommodate an extended period of inflation above the target. Consequently, at its November 2017 meeting, the MPC judged it appropriate to tighten modestly the stance of monetary policy in order to return inflation sustainably to target. As the staff report notes, notwithstanding this tightening, monetary policy remains accommodative and continues to provide significant support to jobs and activity. At the most recent meeting, in December, the MPC voted unanimously to maintain the current monetary stance.

Consistent with the staff assessment, the MPC remains of the view that, were the economy to follow the path expected, further modest increases in Bank Rate would be warranted over the next few years. Any future increases in Bank Rate are expected to be at a gradual pace and to a limited extent. The MPC will monitor closely the incoming evidence on the evolving economic outlook, including the impact of the increase in Bank Rate, and stands ready to respond to developments as they unfold to ensure a sustainable return of inflation to the 2 percent target.

Financial Sector Risk Overview

In its most recent decision, the Bank of England’s Financial Policy Committee (FPC) judged that, apart from those related to leaving the EU, domestic risks were at a standard level overall. In line with their published strategy, they agreed to raise the U.K. countercyclical capital buffer (CCyB) rate from 0.5 percent to 1 percent, with binding effect from 28 November 2018. The FPC will reconsider the adequacy of a 1 percent U.K. CCyB rate in light of the evolution of the overall risk environment.

The FPC has been monitoring the risks highlighted in the staff report and has already taken action, for example, to guard against a loosening of underwriting standards in the owner-occupied mortgage market and in relation to the rapid growth of consumer credit. The committee has also judged risks from global debt levels and asset valuations and risks from misconduct costs to be material.

The ACS results gave the FPC an updated indication of the risks to banks' capital from this overall risk environment. The U.K. economic shock in the scenario, in aggregate, reduces banks' capital by around 3.5 percent of their relevant U.K. risk-weighted assets. Based on a fully-phased-in capital conservation buffer of 2.5 percent, this suggests that a U.K. CCyB rate in the region of 1 percent would deliver a sufficient regulatory buffer for the banking system to absorb a domestic stress of the severity embodied in the test.

Raising Productivity

The staff identify the need for sustained policy focus on raising productivity in order to increase living standards. Average output per hour growth between 2008 and 2016 was 0.1 percent, well below its pre crisis trend of 2.1 percent in the decade before. Evidence suggests the United Kingdom should prioritise upgrading infrastructure, improving skills, helping businesses to invest, and reforming the housing and planning systems.

The government has already made significant progress in these areas and has announced reforms to go further. The National Productivity Investment Fund (NPIF), announced at Autumn Statement 2016 and extended at Autumn Budget 2017, targets investment at areas crucial for improving productivity, namely housing, R&D and infrastructure. Tax cuts will support business investment and the government is improving skills through a significant increase in apprenticeships and the introduction of "T level" qualifications, to transform technical education. Delivering high value infrastructure projects like the Mersey Gateway Bridge, the Northern Hub in Manchester and Crossrail will also support productivity.

The government's plans mean that by the end of this parliament public investment in economic infrastructure will have doubled in a decade, from £12 billion in 2012-13 to at least £24 billion in 2022-23, in real terms an increase of more than 60 percent. This includes a 50 percent increase in transport investment, funding the biggest road investment program in a generation, and the biggest rail transformation in modern times.

Productivity is a long term issue and these reforms will take time to have an impact. However, taken together, the government believes the action it is taking represents a significant step towards improving the United

Kingdom’s productivity, in order to boost wages and enhance people’s living standards.

Impact of the United Kingdom’s Decision to Leave the EU

As the staff report highlights, developments regarding the U.K.’s withdrawal from the EU and the reactions of households, businesses and asset prices remain the most significant influence on the economic outlook and a continued source of uncertainty.

The government is approaching the EU exit negotiations anticipating success. It does not want or expect to leave without a deal, but while it seeks a new partnership, it is planning for a range of outcomes, as it is the responsible thing to do. To support the preparations, nearly £700 million of additional funding has been provided to date and the 2017 Autumn Budget set aside a further £3 billion spread evenly over the next two years to ensure that the government can continue to prepare effectively for EU exit.

The authorities are also cognizant of the risks. For example, the FPC assessed the resilience of major banks to a highly unlikely combination of severe risks in its annual stress test, judging that the extent of the stress test scenario meant that it encompassed a wide range of macroeconomic risks that could be associated with leaving the EU. Furthermore, on the basis of the results of the ACS, the FPC judged that the U.K. banking system could continue to support the real economy even in the unlikely event of a disorderly exit.

Mr. Sobel and Ms. Pollard submitted the following statement:

In some respects, the U.K. economy is doing well —the employment rate is near record highs and output is close to potential; inequality has fallen in recent years; the primary fiscal balance is expected to be zero in 2018; and, net public debt is expected to start declining. Nevertheless, the 2016 decision to exit from the European Union presents a major risk to the economy of the United Kingdom along with spillover risks not only to Europe but to the global economy. Thus, we welcome the focus of the staff report on Brexit. As staff note, the decision has already had some negative effects on the economy, as uncertainty regarding the outcome of negotiations with the European Union has dampened business investment, decreased net migration from the EU, and resulted in a depreciation of sterling.

The staff's baseline forecast for the United Kingdom is, in our view, the best-case scenario. As this is the first Article IV report for the United Kingdom, since the referendum, we would have liked to have seen an analysis of less favorable scenarios. Paragraph 11 in the report provides a glimpse of these potential effects. We appreciate the comment in Mr. Field's buff statement that while anticipating success, the authors are planning for a range of outcomes. We think a selected issues paper would have been a useful way to present a range of scenarios and pull together the results of work by both Fund staff and others on the effects on the United Kingdom as well as spillover effects. Does staff have an assessment of the effect on GDP of their baseline scenario compared to GDP under a no exit scenario? Relatedly, we would appreciate staff's assessment of the EU Exit Analysis paper which indicated a free trade type arrangement would reduce GDP by 8 percent over 15 years compared with a no exit scenario.

As the EU and the United Kingdom continue to negotiate the terms of the United Kingdom's exit, we hope that both sides will work toward an agreement that maintains as robust and open an economic and financial relationship as possible. We see this as clearly optimal for supporting financial stability and global growth. We agree with staff that Brexit presents a major challenge for the U.K. financial sector. A more fragmented European financial sector, will negatively affect not just the United Kingdom but the rest of Europe as well. Thus, we encourage all parties to work together to limit these effects.

We appreciate the authorities' commitment to respond as necessary to shocks from Brexit. In the near term, policy will need to be applied deftly to limit disruptions and spillovers. We agree with the authorities that there is some room to adjust fiscal policy to help offset any initial negative effects on the economy but that a permanent shock will require an eventual adjustment in revenues or expenditures to maintain fiscal sustainability. Policies aimed at boosting potential growth will be key to raising median incomes and supporting fiscal sustainability.

Finally, we welcome the focus in the report on net public debt and encourage other European country teams to follow the lead of the U.K. team in this regard.

Mr. Meyer submitted the following statement:

We thank staff for their report and selected issues paper in the context of the United Kingdom's Article IV consultation. We also thank Mr. Field for his buff statement that provided helpful additional insights.

Unemployment is low, employment is at record high levels and exports perform well. However, inflation is above target and private consumption and growth are slowing down. In this environment and with the added risks related to Brexit, fiscal, monetary and supervisory policies need to start building policy space, in a growth-friendly manner. Therefore, we believe that the authorities are striking the right balance with their continued fiscal consolidation and the gradual withdrawal of monetary accommodation. We broadly agree with staff's recommendations and encourage the authorities to continue structural reforms that bolster labor skills and productivity and with helping financial institutions prepare for Brexit, where we would emphasize the approach of both the U.K. and European authorities is to strive for the most mutually beneficial outcome within the politically feasible set.

Macroeconomic Developments

Brexit-related uncertainty is holding back the British economy. As staff points out, the depreciation of the British pound following the referendum and the uncertainty with regards to the future U.K.-EU economic relationship have compressed household real income, and hence consumption growth, and domestic investments. While this impact was counterbalanced by relatively buoyant exports, boosted by the currency depreciation, medium-term growth prospects are being reduced to around an annual 1½ percent, due to lagging productivity growth. Moreover, the output potential of the British economy will depend on the final outcome of the Brexit negotiations; which cannot be prejudged at this stage and could substantially differ from the economic conditions during a potential transition period. As the impact of the depreciation fades out, we broadly agree with staff on its inflation outlook moderating from 2.7 percent in 2017 and reaching the target of 2 percent in the medium term. At the same time, monetary policy has started to tighten in response to the data.

Fiscal Policies

Promoting certainty and boosting confidence in the economy via measured steps, building fiscal buffers and productivity enhancing public investment is a central task for fiscal policy at the current juncture. As government deficit fell to below 3 percent of GDP in the 2016-17 fiscal year, the United Kingdom has exited the EU's Excessive Deficit Procedure. However, an expansionary 2017 Autumn Budget and weaker growth prospects will likely reduce the pace of the consolidation. A steady fiscal consolidation remains critical to set the public debt ratio on a sustainable downward path and to rebuild fiscal buffers vis-à-vis the new fiscal mandate targets. Such buffers would be needed to meet the longer-term projected rises in healthcare, long-term care and pensions, but also to tackle any near-term risks potentially associated with Brexit. We see merit in staff's recommendation to reduce the tax systems' potential for economic distortions, though we acknowledge that these reforms would be politically contentious.

Financial Market Policies

Banks' balance sheets have been strengthened but their profitability remains low. U.K. banks are well capitalized and were assessed in the 2017 annual stress test to be resilient to a wide range of shocks. At the same time, credit growth has overall been moderate and banks' profitability remains weak, partly reflecting large misconduct charges in recent years. Consumer credit has grown quite rapidly in recent quarters with the ratio of new mortgages with high LTI ratios also increasing. In this context, we welcome the authorities' intention to strengthen underwriting standards and agree with staff that the counter-cyclical capital buffer for banks should be kept under review.

The potential impact of Brexit on the U.K.'s financial sector is highly uncertain at this stage. We welcome the staff's explicit attention to the potential challenges for the U.K. financial sector from Brexit as well as the strong focus in the assessment of contingency plans in case of a disorderly Brexit. EU supervision has carried out extensive preparatory work and is well placed to deal with the various potential outcomes of the Brexit negotiations. We also welcome the proactive attitude of the U.K. prudential supervisors in helping the financial institutions prepare for Brexit. We note, though, that the impact on the U.K. financial sector will depend on the final outcome of the Brexit negotiations and on the future evolution of the regulatory frameworks in the two jurisdictions.

Structural Policies

Investments into raising human capital, labor mobility and innovation will help raise productivity growth. We share staff's assessment in their report and selected issues paper about causes of the relatively low productivity growth and regional disparities in the United Kingdom. These include shortcomings in transport infrastructure, gaps in school graduates' basic and technical skills, modest R&D spending, and a housing shortage. We welcome the authorities comprehensive approach to addressing these issue that ranges from prioritizing capital spending, the creation of the National Productivity Investment Fund and the National Infrastructure Commission to a new industrial strategy and a new system for funding apprenticeships. At the same time, raising educational attainments among the United Kingdom's "long tail" of low-achieving pupils, improving the provision and standards of technical education and supply side reforms in the housing market with a view to raising labor mobility could also receive more attention. Such reforms should be undertaken not least in the light of demographic changes including the impact of changing immigration patterns that might result from Brexit.

Assumptions Regarding Brexit

Inevitably, uncertainty regarding the United Kingdom's exit from the EU is large, not least as negotiations are still ongoing. Therefore, more clarity about the technical assumptions on the future U.K.-EU trading arrangements and about the possible outcomes of the Article 50 negotiations would have benefited the reader in appreciating better the inescapable limits of staff's forecast and in avoiding prejudging the outcome of the Brexit process. In particular, the assumptions on the future U.K.-EU trading arrangements should realistically reflect the indivisibility of the 4 Freedoms. We appreciated Box 3 in this regard, as it clearly states that the United Kingdom's decision to leave the Single Market will mean that U.K.-based financial institutions will lose their passporting rights in the EU. We note that during a transition period cross-border provision of financial services could potentially take place. We missed such clear distinction between the assumptions made for the transition period and the final state after Brexit.

Mr. Tombini and Mr. Fachada submitted the following statement:

We thank staff for the reports and Mr. Field for his useful statement. After the initial resilience following the Brexit referendum, U.K. growth moderated somewhat in 2017. Uncertainties related to the future relationship of the United Kingdom with the European Union (EU) have been affecting business sentiment, taking a toll on investment and economic activity—and despite a strong job market. We welcome the recent progress in negotiations with the EU as indicated by Mr. Field, but time for completion of Brexit talks is fast approaching and major issues need to be agreed in the coming quarters.

The staff's baseline scenario is relatively benign. The scenario assumes that tariffs on goods traded with the EU remain at zero and U.K. firms continue to provide cross-border financial services. We agree that such scenario is realistic and desirable, but it is important that the Fund communicates that risks to the baseline are substantial and tilted to the downside, as the staff report recognizes. The Risk Assessment Matrix (RAM) clearly highlights that leaving the EU with no deal is a high likelihood/high impact risk that should be avoided. The high impact of this risk sends a strong message that even a country with solid track-record of policy implementation and strong institutions, such as the United Kingdom, would be worse-off in an environment of less integration.

The authorities appropriately eased the pace of fiscal consolidation in the aftermath of the Brexit vote. In particular, we commend the authorities for using the flexibility embedded in the U.K. fiscal framework and their decision to boost public investment to support growth. That said, we agree with staff that fiscal consolidation remains crucial to put the public debt ratio on a clear downward trend and to rebuild buffers against future shocks. In this regard, can staff quantify the potential gains of the tax measures identified in paragraph 22?

The Bank of England (BoE) has responded appropriately to the uncertainties associated with the Brexit vote. Inflation has increased, reflecting the sharp exchange rate adjustment, but medium-term inflation expectations have remained well-anchored. We agree with staff that in the event of market disruptions associated with Brexit, the BoE will need to ensure that the financial system remains sufficiently liquid, including through adjusting the countercyclical capital buffer (CCyB), as has been done in the aftermath of the Brexit. We take note that prudential supervisors are proactively helping regulated financial institutions prepare for Brexit, according to staff.

Apart from difficulties arising from the Brexit process, the United Kingdom faces similar challenges of other advanced economies. The country has been suffering from low productivity growth since the global financial crisis, and we agree with staff that raising labor productivity is crucial to achieve sustainable and more inclusive growth. The staff documents that infrastructure quality, human capital and spending on research and development in the United Kingdom rank relatively low compared to other advanced economies. Finding ways to adequately address these issues will be important to ensure a stronger recovery in the coming years.

The United Kingdom has been closing loopholes, enhancing corporate transparency and improving the AML/CFT framework. Efforts to enhance transparency of trust and company service providers (TCSPs) and information sharing with all British Overseas Territories (BOTs) and Crown Dependencies (CDs) are welcome. Our chair maintains the view that British peculiarities and systemic financial industry, with the presence of many offshore financial centers, require a closer and well-tailored surveillance exercise. We continue to call on management, staff and authorities to enhance IMF surveillance over all British jurisdictions.

Finally, as Mr. Sobel and Ms. Pollard, we welcome the focus in the report on net public debt.

Mr. de Villeroché, Mr. Castets and Ms. Sanchez submitted the following statement:

We thank staff for their informative set of reports and Mr. Field for his insightful buff statement. The ongoing process of exit from the European Union is rightly the common thread of staff’s report given that this is the first Article IV review since the referendum. We commend the authorities for responding swiftly to the current uncertain environment and adapting adequately the policy-mix. We recognize that staff task is difficult given the high level of uncertainties on both the transitory and permanent relationship between the United Kingdom and the EU and the inherent difficulties to quantify potential impacts. We associate ourselves with Mr. Meyers’s statement and would like to make the following comments for emphasis.

As a general comment, although we acknowledge the need for staff to make hypotheses in order to build their macro framework, we would have expected a more precise analysis on several aspects and would caution against too rapid or contradictory assumptions.

On the macroeconomic outlook, while some fundamentals appear solid, the slowdown observed in 2017 in the aftermath of the decision to leave the EU reinforces the need to boost potential growth. Considering the record high already reached by employment and participation, as recalled by Mr. Field in his buff statement, raising productivity appears essential. The low productivity growth in the United Kingdom, with ample regional differences, remains a puzzle and staff recommends a broad range of reforms to tackle it. We take note that structural reforms related to infrastructure and investments have been prioritized by the authorities. Going forward, increasing human capital, notably through the recent initiatives concerning education will be paramount. Measures to tackle shortages of housing supply should also continue to be developed.

We also thank staff for their SIP on the different drivers of U.K. wage growth. This chapter illustrates the relevance of a broadened and country-tailored definition of labor market slack, notably to take into account the impact of self-employed workers in U.K.'s case. We also note that staff analysis confirms the significant cross-border spillovers of labor market conditions and that the slack in the EU has an impact on wage growth in the United Kingdom.

More generally, considering the uncertainties constraining investment and the rise of low productivity employment, productivity growth could be lower than envisaged by staff in the future.

In view of the share of the financial sector in the U.K. economy, the prospects for this sector are of particular importance for the macroeconomic projections. To be relevant and useful to the British authorities in the first place, staff analysis must be carefully crafted and communicated given the current high level of uncertainty. In this regard, we would have expected staff to have a more consistent assessment of the future EU-U.K. relationships in the financial sector field (the baseline scenario and in particular the assumption, in paragraph 6, of a continued possibility to provide financial services on a cross-border basis is not aligned with the factual description of box 3). Moreover, we do not share staff assessment of the consequences of the Brexit for the European financial system as a whole (paragraph 42). This assessment is not documented and the complex issues touched upon deserve more careful considerations in our view. In future Article IV, we strongly encourage staff to refrain from such rapid formulations, or at least to have them thoroughly discussed with the EU authorities prior to the presentation to the Board.

Lastly, the strengthening of the British banking sector is a welcome development considering the existing risks factors, that could hinder banks profitability as noted by the BOE in its extreme stress tests. We commend the authorities for the prudent adaptation of the capital requirements.

On fiscal policy, we support staff advice to pursue the reduction of the deficit in a gradual and growth-friendly manner. With output losses weighing on the fiscal trajectory, we also agree that reforms should be more on the revenue side. However, we wonder to what extent the implementation of such reforms is realistic notably considering the opposition to higher social contribution for self-employed, the engagement of the government to not increase the VAT and the withdrawal of the suppression of pensions' indexation.

In addition, we commend the British authorities for anticipating on the potential fiscal costs of the exit of the EU, as mentioned in Mr Field's buff statement. We understand that it is difficult for staff to assess the impact of leaving the EU on the British budget at this stage. Nonetheless, we would appreciate more information on the technical aspects of the transition period regarding financial flows between the government and the European Commission and the magnitude of these flows. Also, it would be useful to have an estimate of the costs of the capacities that need to be rebuilt at the national level.

Mr. Jin, Ms. Liu and Ms. Cai submitted the following statement:

We thank staff for a well-written report and Mr. Field for the helpful buff statement. While growth has moderated, the U.K. economy is fundamentally sound with robust net exports, relatively low inflation, record low unemployment rate, closed output gap, and resilient banking sector. We broadly agree with the thrust of the staff's appraisal and would limit our comments to the following.

Further fiscal consolidation would be helpful to curtail the public debt ratio and rebuild buffers against future shocks. We welcome the authorities' new fiscal framework and encourage the authorities to continue implementing growth-friendly tax reforms. Given that by 2020, most categories of public spending as a ratio to GDP will be at or below their levels prior to the crisis, we concur with staff that revenues measures are needed in the next phase of fiscal consolidation.

The gradual withdrawal of monetary stimulus should go hand-in-hand with prudent financial supervision. The recent increase in the countercyclical capital buffer was appropriate. We encourage the authorities to closely monitor the consumer credit developments and conduct system-wide liquidity stress test in a future exploratory scenario. Continued close cross-border regulatory and supervisory cooperation would be essential to assess and manage risks in a more fragmented European financial system.

We encourage the authorities to further implement structural reforms to raise productivity. We welcome the establishment of the National Productivity Investment Fund, targeting investments in transportation, housing, digital, and R&D. Sustained efforts are still needed, including boosting housing supply and increasing human capital.

We think staff's analysis on the implications of Brexit might fall short of expectation. We appreciate it if staff could elaborate more on the implications of Brexit for different sectors, such as manufacturing and financial sectors. Which cities or countries could benefit from the possible relocation of some financial operations? Overall, what are the costs and benefits of Brexit for the United Kingdom?

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. Ostros and Mr. Gade submitted the following statement:

Economic growth in the United Kingdom has been dampened by the decision to exit from the European Union, although the economic effect was mitigated by an accommodative policy response, weakening of the sterling, and stronger demand from its main trading partners. Looking towards the immediate future, the uncertainty of negotiations in the transition period will continue to weigh on the economy. Beyond the transition period, hopefully the U.K. and the EU will agree on a loss-minimizing outcome within the politically feasible options, and the negative long-term effects of Brexit mitigated. The staff report adds an important international perspective on the process and potential end-states. But even more importantly, it also looks beyond Brexit, and provides important analysis and recommendations on more structural measures to lift productivity growth in the U.K. economy, which long-term growth perspectives will materially depend upon. We thank staff for their reports and Mr. Field for his buff statement. We associate ourselves with Mr. Meyer's gray, and generally concur with the thrust of staff's appraisal, while adding the following for emphasis.

While it is clear that in the near term, the uncertainty surrounding the Brexit negotiations will be the main risk factor for the U.K. economy, staff highlight important structural issues to strengthen the long-term growth perspectives. We welcome staff's analysis and recommendations as an important contribution to deal with low productivity growth. We think the focus on productivity growth is particularly important given the uncertainty related to the future flow of foreign workers in labor supply of the U.K. economy, including labor supply from the EU. The U.K. has benefitted significantly from inflow of foreign workers, not least because of their high employment rates and even higher educational attainment than the native-born population. The selected issues paper provides an interesting analysis of the various drivers impacting productivity growth and regional differences. On the set of staff's recommendations, we encourage particular attention to staff's recommendations on human capital and education. In this context, further attention to the potential effects of Brexit on the U.K. labor market could have been further elaborated in the report.

On the process of Brexit, assumptions, and potential end-states, the report makes an important contribution, but could have been more detailed on various scenarios of end-states. The Fund as an international institution is an important contributor to the global understanding of the implications of Brexit, the process, and the risks. However, the report makes a relatively descriptive contribution in this respect, and we would have preferred if the report could have detailed and quantified some of the risk scenarios surrounding staff's baseline assumption. This also means that the report could have been more explicit on the costs of a potentially disorderly Brexit, and while the report does address contingency plans, the recommendations of the report remain fairly descriptive and general. We appreciate staff pointing out their assessment of potential regulatory spill-overs were parts of the U.K. financial services industry to relocate to the EU. EU supervision has carried out extensive preparatory work and is well placed to deal with the various potential end-states. We look forward to the euro area Article IV and euro area/EU FSAP detailing and discussing any concerns.

Finally, we appreciate the attention to the external sector vulnerabilities, and see some of the key mitigating policy responses, such as gradual fiscal consolidation and a credible medium-term framework, important to mitigate these vulnerabilities. The current account deficit is primarily explained by a deficit on the income account and on the goods trade balance. We take note of staff's assessment of the composition of the NIIP and valuation effects from sterling weakening as a mitigating risk factor, and its assessment of the likelihood of an improved income account. However, given the sizable current account deficit, and the large role of financial services exports to lower the deficit, the uncertainty surrounding the financial services export component could have deserved further attention in the main part of the report.

Mr. Alogeel and Mr. Rouai submitted the following statement:

We thank staff for a comprehensive set of reports and Mr. Field for his helpful buff statement. While the U.K. economy continues to perform relatively well, with record employment, the outlook is subject to a number of significant risks, mostly centered on the Brexit and the impact of current negotiations about the terms of the exit on trade flows and costs, financial sector services, and how households and business would adjust to the new environment. In this regard, we note that uncertainties about the Brexit outcome are already affecting growth, business investment, the exchange rate, and inflation and we encourage the authorities to remain vigilant.

Against this background, we welcome the section on Contingency Plans detailing policies that need to be implemented in case of a breakdown of negotiations leading to a disorderly Brexit and we welcome the authorities' indication that they are prepared to respond to a wide range of shocks. While we appreciate the focus of the policy discussions on the Brexit and the impact of an U.K.-EU agreement, we missed an analysis of the status and prospects of the United Kingdom's trading relationship with non-EU economies and we would appreciate staff elaborations on any recent development. In this context, we noted from paragraph 9 that staff considers that new trading arrangements with these countries could affect positively the level of potential output in the United Kingdom. Since such agreements would take time to finalize, could staff elaborate on the cost for the United Kingdom of reverting to WTO rules?

On monetary policy, we noted from the February 8, 2018 Bank of England's Monetary Policy Committee (MPC) communiqué, that based on the recent Inflation Report projections "monetary policy would need to be tightened somewhat earlier and by a somewhat greater extent over the forecast period than anticipated at the time of the November Report, in order to return inflation sustainably to the target." We consider this indication as consistent with staff's view in paragraph 28 that "a more accelerated pace of interest rate increases would be warranted if inflation expectations become unmoored or domestic cost pressures increase faster than expected." Could staff clarify our understanding that this indeed is the case?

We welcome the authorities' efforts to ease the pace of fiscal consolidation and introduce greater flexibility in the fiscal framework in the aftermath of the Brexit vote. We also welcome their commitment to boost public investment in infrastructure to support growth. We agree with staff on the need to set public debt on a downward path and to rebuild buffers against future shocks. Here, we take note of the authorities' intention to continue to rely on expenditure restraint to reduce deficits in the near term, while being open to adjustment of revenues in case of large negative output shocks.

Finally, we note that the cycle of recent Article IV consultations with the United Kingdom since 2015 has been irregular and we encourage staff to adhere to the 12-month cycle.

With these comments, we wish the authorities all the success.

Mr. Dajani and Mr. Montero submitted the following statement:

We thank staff for its reports and Mr. Field for his informative buff statement. We associate ourselves with Mr. Meyer’s statement and would like to add the following comments for emphasis.

Economic activity moderated in 2017 on the back of falling household real incomes driven by the sterling depreciation and subdued business investment due to Brexit-related uncertainty. Despite this slowdown in growth, employment continued to rise and economic slack seems very limited. Going forward, the outlook for the U.K. economy is highly uncertain, as it depends on how Brexit unfolds, about which there is not enough information yet.

We share staff’s view that sustained fiscal consolidation is critical to rebuilding buffers against future shocks, meeting increases in age-related spending and helping reduce external imbalances. Moreover, we agree with staff that under current circumstances, additional revenue measures may be needed to help balance the budget, as spending restraint accounted for the bulk of deficit reduction since the crisis and the risk of affecting the quality of public services is present. We see merit in the tax reforms suggested by staff, which can also help reduce economic distortions and thus increase potential growth.

We are concerned by the high levels of inequality in the United Kingdom, as well as by the low intergenerational mobility. Brexit can have relevant distributional consequences at a moment in which there is not enough fiscal space to minimize the disruptions caused by the reallocation of firms and displaced workers. To address this concern, it is important to prioritize those policies aiming at enhancing human capital; particularly for those at the lower tail of the skills distribution.

We concur with staff on the need to focus the structural reform effort on increasing productivity as the key to rising living standards and making growth more inclusive. This is vital in a context where the exit from the EU is likely to depress trend productivity going forward. We broadly share staff's recommendations for structural measures.

We welcome the additional measures adopted by the authorities to enhance the transparency of companies and trusts. We concur with staff in that it is important to strengthen the engagement with Crown Dependencies and British Overseas Territories on the exchange of information on these entities, in particular on trusts, to help ensure consistent enforcement and compliance and, thus, achieve an effective ALM/CFT supervision.

We wish the British authorities the best in their future undertakings.

Mr. Gokarn and Mr. Joshi submitted the following statement:

We thank staff for the set of informative papers and Mr. Field for the useful buff statement

The United Kingdom is passing through challenging times given rising anxieties about the outcomes of changed economic and financial relationships with the EU post the Brexit transition. The impact of the referendum of mid-2016 has depressed business investment and household consumption with sharp depreciation of the exchange rate and the spike in inflationary pressure becoming evident in 2017. Despite the broad-based recovery in global economy, the prognosis for the United Kingdom's growth is somewhat subdued at this juncture. The United Kingdom's GDP growth has moderated to 1.8 percent since the beginning of 2017 from 1.9 percent in 2016 and is expected to decelerate further. Unemployment too could rise as firms adjust their businesses to the possibility of a restricted trade system post-Brexit. We believe that staff's baseline projection of 1.5 percent over the medium term based on the most benign assumption of free trade with EU counterparts is optimistic given the continuing lack of clarity about Brexit trade-offs being weighed within the United Kingdom and EU. Although sometime away, we see merit in the staff views about the negative effects of a disorderly exit. Downside risks stemming from low productivity and future financial tightening could further complicate economic prospects in the United Kingdom going forward.

Although the new fiscal framework aims to reduce the cyclically adjusted deficit to two percent by 2020-21, rising spending pressures due to demographic changes and low productivity will continue to strain fiscal management. Growth friendly reforms aimed at rationalizing various direct and indirect taxes can achieve efficiency in revenue mobilization and fiscal resilience. The re-design of the pension system in line with international best practices is needed to manage pension outgoes over the long haul. These measures, coupled with appropriate spending controls, will serve to consolidate the fiscal position and ensure a downward trajectory of debt. Rebuilding buffers would insulate the economy against unanticipated macroeconomic shocks. We welcome the authorities' commitment to a credible reduction in deficits including the publication of Fiscal Risks Report (FRR) and the review of expenditure efficiency gains in the Spending Review. While the temporary use of fiscal space in contingent situations is reasonable, does staff consider the fiscal headroom of £ 15 billion available with the authorities in 2020-21 sufficient to mitigate permanent output shocks in the event of 'no-deal' Brexit?

Rising inflation pressures in 2017, due partly to wage increases, may warrant containment of monetary accommodation for a sustainable return to the inflation target of 2 percent. We however, find merit in staff opinion that the withdrawal of stimulus would need to be appropriately calibrated against the compression of demand that would ensue from the implementation of the fiscal consolidation program going forward. Nonetheless, we support the view that the monetary policy stance should have the ability to provide sufficient liquidity while responding appropriately to evolving inflationary conditions. Inflation and growth trade-offs under a scenario of breakdown of Brexit negotiations could create complexity—and monetary policy will have to play a balancing role. Could staff comment on the hierarchy of fiscal and monetary policies that is best suited to managing the economic consequences in the likely event of hard Brexit?

The CA deficit is assessed by staff as wider than justified by fundamentals. Even as the RER valuation is considered tentative, a large depreciation may occur in a scenario of increasing uncertainties about the United Kingdom's future trade relationships.

The risk of Brexit in the face of the ongoing financial cycle requires that the financial system is carefully managed—especially with an eye on rising credit concentration and underlying risks. This would require not only strengthening banks' capital endowments but also reducing operational costs to enhance profitability. At the same time, stringent supervisory oversight on risk weights applied by banks is required to avoid slippages in underwriting standards. System-wide stress tests and cross-border cooperation on regulatory and supervisory areas would enable meaningful assessment of risks and vulnerabilities despite the authorities' consideration that the United Kingdom's banking system would remain resilient even in the event of hard

Brexit. Such proactive policies are vital for preventing the disruption in the continuity of outstanding cross-border financial contracts as well as information sharing agreements with EU countries. Could staff inform about the progress made by the authorities so far in harmonizing EU financial regulation with the U.K. law?

The economic stress of low productivity is worrisome, and is a key impediment to achieving sustainable growth. We encourage the authorities to address the wide regional disparities in productivity by way of policy actions to incentivize investments, innovations and international competition. Moreover, decentralization of governance, improved implementation and institutional framework of infrastructure projects, strengthening transport, developing human capital, easing housing supply through better planning, among others, would help to raise national level productivity, employment and support economic growth. We welcome the authorities' commitment on supporting productivity growth by incentivizing private investments, skilling and increasing spending on high-value infrastructure. In the financial system, the adoption of 2017 Money Laundering Regulation and overseeing AML/CFT supervisors of trust and company service providers [TCSPs] would strengthen corporate transparency, investor confidence and prevent financial crimes.

We wish the authorities the very best in future endeavors.

Mr. Armas and Mr. Lischinsky submitted the following statement:

We thank the staff for the set of reports, in particular the selected issues, and Mr. Field for his helpful buff statement.

Real GDP growth is on a downward trend since the 2014 GDP growth rate picked up to 3.1 percent. The staff projections for 2017 and 2018 are 1.8 and 1.6 percent respectively, closer to potential output, and inflation rate is currently above the target for transitory reason (sharp exchange rate depreciation). We would like to highlight that the unemployment rate is at the lowest it has been in 42 years, at 4.3 percent in 20173Q, female employment is close to a record high, and exports of goods and services are projected to increase by 6.1 percent in 2017. However, negotiating its exit from the EU is now the most important task facing the U.K. authorities to diminish uncertainty about potential GDP growth. We concur with the staff that the higher any new barriers to the cross-border flow of services, goods and workers, and also capital, the more negative the impact would be on the country. In view of the Brexit consequences mentioned in paragraph 7 of the staff report and lower labor force and employment growth due to a sharp decline in net migration from the EU, has the potential output been recalculated?

U.K. Fiscal policy is more flexible since the last Article IV, and the fiscal consolidation speed was mitigated. Although debt and fiscal deficits are smaller than in other AEs, such as the United States and France, it is important to consider reducing them, due to the highly sensitive fiscal position with regards to macroeconomic shocks. In the same vein, rebuilding buffers would protect against future shocks and reduce the current account deficit. The staff's comments would be appreciated.

In July 2017, the OBR published the first Fiscal Risk Report, setting a high benchmark with regards to fiscal transparency, while at the same time drawing attention to a broad variety of risks to be assessed and, if needed, addressed. Risk analysis, policy and procedure evaluations, stress tests and debt sustainability analysis, must become good practices to be adopted by the membership's public administrations. To reduce demographic spending pressures, the staff proposes to remove the "triple lock" guarantee on state pensions. Would the staff explain the simulations made to reach this conclusion?

Monetary policy remains accommodative, although the BoE has started to slow down some extraordinary stimulus and the policy rate was increased by 25 basis points in November 2017. Inflation, at around 3 percent at the end of 2017, reflects the depreciation of the currency pushed by import and energy prices and it is expected to take a downward path when these pressures diminish. On the other hand, the authorities observed that to bring inflation to the target, future interest rate increases will be gradual and limited, while the historic low level of unemployment could intensify pressure to increase wages and help bring inflation to target. The Term Funding Scheme, introduced in 2016 to strengthen the pass-through from the policy rate to lending rates, is to be discontinued this month. Has this policy fulfilled its objective? The staff response would be appreciated.

The U.K. financial system is resilient and capitalized but not overly profitable. The major U.K. banks are well capitalized and satisfy the Basel III requirements. Annual stress tests carried out in 2017 by the BoE reveal that the banking system is resilient to shocks. Nevertheless, profitability remains low due to low investment banking returns and past misconduct charges. This implies needed cuts to operating costs. Furthermore, Brexit means further challenges to the sector, mainly depending on the agreement with the EU on financial services, particularly on derivative and insurance contracts. The authorities are committed to implementing strong prudential regulatory and supervisory frameworks. We see in the table on page 17 of the staff report, Financial Soundness Indicators for Major U.K. Banks, that there are no figures for 2017 on non-performing loans (NPLs). Does the decreasing trend for NPLs continue in 2017? The staff's comments would be appreciated.

The U.K. economy is faced with structural issues, especially at the regional level, such as low productivity, inequality, and low potential growth. We note that the authorities are tackling these challenges. A National Productivity Investment Fund was created, as well as the National Infrastructure Commission to assess long-term priorities and to promote infrastructure and housing. Efforts are underway to improve labor market policies and skill enhancement through apprenticeships and technical education. At the same time, industrial strategies are being developed, governance decentralization is in progress and corporate transparency is being encouraged.

With these comments, we wish the United Kingdom and its people the best in their future endeavors.

Mr. Beblawi and Ms. Abdelati submitted the following statement:

We thank staff for a well-written set of papers that outline the challenges facing the United Kingdom since the mid-2016 referendum. U.K. growth has moderated and is expected to remain subdued in the near term. Risks are tilted to the downside risks due to uncertainty surrounding Brexit. We thank Mr. Field for his buff statement that provided helpful additional insights.

We concur with staff that policies need to focus on maintaining macroeconomic and financial stability and boosting productivity growth, which has been very low for ten years. We broadly support staff recommendations. The gradual withdrawal of monetary stimulus should be carried out at a gradual pace, with due regard to data developments. With respect to fiscal policy, it is important to continue with fiscal consolidation to rebuild buffers and maintain investor confidence, and the emphasis should be on pro-growth spending and tax reforms. We welcome the new fiscal framework, which targets a balanced budget by the mid-2020 and a net borrowing ceiling that exceeds the current medium-term deficit projections by nearly 1 percent of GDP, which provides room for policy flexibility to support growth if needed. The commitment to spending on public investment is consistent with the aim of improving competitiveness and productivity of the economy.

Early agreement on a process of transition would help reduce uncertainty facing firms and households. The report highlights the adverse economic impacts since the Brexit vote including the sharp sterling depreciation, higher inflation, and depressed private consumption. Business investment has also been constrained. Like other Directors, we are interested in staff ‘s assessment of a comparison of the effect on GDP of the baseline scenario compared to a no exit scenario. An agreement that minimizes barriers to cross-border flow of goods, workers and services would be most supportive of growth. Prolonged uncertainty would be especially detrimental. We take note of the authorities’ contingency planning and preparedness for a wide range of shocks.

As noted in the report, the financial sector, which has a prominent role in the U.K. economy may be particularly affected in the absence of an agreement that allows continued trade in financial services. This is further complicated by the absence of a timeline and contours of a possible agreement. We appreciate staff’s elaboration of these challenges. One step in the right direction is that the authorities have identified the two key issues that would be difficult for financial firms to address unilaterally and could best be handled through bilateral agreements between the United Kingdom and the EU. We agree that it will be essential to maintain close cross-border supervisory and regulatory cooperation to reduce financial stability risks, especially in the context of Brexit-related challenges. Careful supervision and regulation must also be maintained to limit excessive risk-taking in the context of relatively easy financial conditions and prevent relaxation of credit standards.

With limited scope for labor force growth, raising worker productivity is important and will greatly depend on the shape of the new agreement with the EU on trade, investment and migration. We take note of the broad agreement between staff and the authorities on the key structural reform priorities, and the initiatives in place to support skills and innovation.

Mr. Leipold and Mr. Spadafora submitted the following statement:

We thank staff for an informative set of reports and Mr. Field for his candid buff statement. We associate ourselves with Mr. Meyer’s statement, in particular with the emphasis on an approach, by both the United Kingdom and European authorities, which strives for the most mutually beneficial outcome, within the politically feasible. We broadly agree with staff's recommendations, with the following additional comments.

Uncertainty on the terms of a new economic arrangement with the European Union is taking a toll on the U.K. economy. Growth moderated in 2017, business investment suffered and the higher inflation resulting from sterling's substantial depreciation ate away at household real income, resulting in consumption growth at half the rate of 2016. On the positive side, net exports remained robust and unemployment declined to record-lows.

The authorities face uncommon challenges as Brexit will require all-encompassing adjustments, at present not fully identifiable. In the near term, a measured approach—consisting of steady fiscal consolidation and a gradual withdrawal of monetary accommodation—strikes the right balance to build policy space and reconstitute fiscal buffers in a growth-friendly manner. The stance will need to remain agile, marked by adequate policy responses to dispel the risk of a "No-EU mediocre" of sustained lower growth for the U.K. economy in the longer term.

We welcome the emphasis placed on the challenges posed by low productivity growth and regional disparities. As recognized in Mr. Field's buff statement, while productivity growth has slowed in all advanced economies since the financial crisis, the slowdown in the United Kingdom has been more marked than elsewhere. Looking ahead, productivity also risks being adversely impacted by a more difficult post-Brexit trading environment and the potential effects on the quality and quantity of labor supply from lower net immigration. Against this background, the authorities' multi-pronged approach to raising productivity is well-placed, including importantly increased public investment in infrastructure. Scope for further public investment should arise from a more growth-friendly composition of public finances. More broadly, an overarching goal of structural reforms to raise productivity should be that of facilitating the reallocation of production factors. To this end, the measures highlighted by staff go in the right direction. It appears particularly important to improve housing supply so as to inter alia foster labor mobility in the face of lower net immigration.

We agree with staff that achieving the government's fiscal targets will be challenging given very limited scope for further cuts on the expenditure side and age-related spending increases. Besides, several Brexit-driven developments raise risks to public finances in the medium term and may require offsetting revenue increases in order to achieve the objective of a balanced budget by the mid-2020s.

Under the baseline scenario, growth is expected to remain moderate and inflation is returning gradually to target in the medium term. In the circumstances, we agree with staff that the withdrawal of policy stimulus should continue at a gradual pace. Given the environment of uncommonly high uncertainty, we also agree with staff that flexibility in policy-making and clear communication are of the essence.

The financial sector is at the forefront of facing the impact of Brexit—an impact that is highly uncertain at this time. In the authorities' assessment, U.K. banks are well-capitalized and appear resilient to large macroeconomic shock; like most of their peers, they face a structural decline in profitability. We welcome the staff's efforts to illustrate and advise on the challenges at hand. While some passages of the staff report may be subject to misinterpretations of realistic outcomes, we would focus on the clear statement in Box 3 whereby "exit from the Single Market would imply that U.K.-based institutions lose their passporting rights." In welcoming the proactive efforts of U.K. supervisors, we would also emphasize that—as stated in Mr. Meyer's Gray—EU supervision has also carried out extensive preparatory work and is well placed to deal with the various potential outcomes of the Brexit negotiations. Finally, we note that the pervasive uncertainty seems not to have affected consumer credit, whose rapid growth may signal a loosening of credit standards. The staff's comments on the recent measures adopted by the authorities are welcome.

Ms. Erbenova, Mr. Just and Mr. Stradal submitted the following statement:

We thank staff for a comprehensive set of reports and Mr. Field for his informative buff statement. We broadly concur with the staff appraisal, but we feel that the analysis could have been more risk-based and focused on spillovers, in particular, more attention should have been devoted to the more immediate financial sector risks, as well as their propagation channels related to the potential outcomes of the Brexit negotiations. We associate ourselves with Mr. Meyer's statement and add the following comments.

The United Kingdom's economic growth outlook is underwhelming in the context of the accelerating global economic recovery, as the fundamental uncertainty of the post-EU arrangements weighs on business investments, as well as consumer sentiment. Brexit has brought into sharper focus long-standing structural economic challenges and we appreciate staff's analysis in that respect. The monetary policy is appropriately accommodative in this uncertain environment and tightening should proceed at a measured pace, as the inflation gradually returns to the target once the effects of the sterling's depreciation dissipate. It will be important to strike the right balance and pursue the necessary fiscal consolidation without derailing the fragile growth or undermining the prospects for potential growth by reducing spending on education or infrastructure much further. Do the debt sustainability projections include the disbursements under the financial settlement with the EU?

We appreciate the difficulty of staff's task how to do analytical justice to this truly unprecedented situation. As a myriad outcomes of the Brexit negotiations is possible, a focus on the tail risk of a disorderly Brexit might have been advisable. The role of surveillance under such circumstances should be a thorough description of the consequences in case the negotiation process goes wrong, as well as a quantification of the risk scenarios around staff's baseline to inform recommendations on contingency planning. For instance, the topics for the selected issues papers, while relevant, informative, and well-written, would be applicable to any other advanced economy. The United Kingdom is unique in that it faces, together with the European partners, a series of very consequential decisions in negotiating its way out of the European Union. The staff report is interspersed with acknowledgments of different risks, but the economic narrative often describes a win-win resolution of the contentious issues between the two parties. While we would emphasize the approach of both the U.K. and European authorities is to strive for the most beneficial within the politically feasible set, the emphasis of staff's analysis on relatively benign outcomes is at odds with the Risk Assessment Matrix, which lists leaving the EU with no deal as the number one risk, with high relative likelihood and high expected impact.

This pertains particularly to the financial sector developments given the key role that the City of London plays in the global financial architecture and the ensuing spillovers into the EU economies but importantly, also beyond. As we witnessed during the Global Financial Crisis, the accelerators were often relatively unknown corners of the financial markets "plumbing." It would have been useful to have a close look at the interplay between the extra regulatory and capital constraints generated by a range of Brexit outcomes across the asset and derivatives markets that would provide a clearer picture, as the Report only mentions transitional financial stability risks and risks of asset market corrections. Could staff elaborate what are the most salient issues in the cross-border swaps, futures, and repo markets, and the possible migration from U.K.-based central counterparties which constitute these risks, as well as whether these themes will be taken up in the Spillover Report and other multilateral surveillance products? Having said that, we fully agree with staff that this is not an exclusive task for the U.K. authorities, but close, cross-border regulatory and supervisory cooperation with the EU will be indispensable for identifying and managing risks during the transition period.

Ms. Horsman, Ms. McKiernan and Mr. Hart submitted the following statement:

We thank staff for their analysis and Mr. Field for his buff. The U.K. economy has shown a degree of resiliency since the last Article IV, and the supportive macroeconomic policy response by U.K. policymakers deserves credit. But the economy's modest growth and mediocre outlook contrasts sharply with the cyclical upswing underway among the United Kingdom's major economic partners. Uncertainties related to the United Kingdom's departure from the EU will likely weigh on the growth outlook for some time. Moreover, the outcome of Brexit negotiations matter for the United Kingdom, the EU, and global economy. As discussions continue, we encourage all parties to work towards a new relationship that is open, integrated, and mutually beneficial.

In this context, we agree with staff's recommendation to focus on stability in the near term, and on boosting productivity and inclusive growth over the longer term. The staff and the authorities are broadly aligned regarding the challenges facing the U.K. economy, but the range of possible Brexit-related outcomes makes offering specific advice more difficult. How Brexit will unfold, and whether and how the outcome impacts financial markets and the real economy, remains highly uncertain. Looking ahead, we encourage staff to dig deeper into the possible spillover channels to/from the United Kingdom. This could better inform advice related to the development of contingency measures, particularly if the baseline scenario—already leaning in a positive direction—proves to be too optimistic.

That said, monetary policy and financial supervision appear appropriately calibrated for the current conjuncture. Inflation expectations are well-anchored and we agree that any withdrawal of monetary stimulus should be gradual and data-driven. Similarly, there has been good progress on the 2016 FSAP's key recommendations, and financial sector stress tests indicate that bank balance sheets are largely resilient to shocks. We welcome the collaboration between the United Kingdom's prudential regulators and financial institutions on developing contingency measures. Also, the stated commitments by U.K. regulators to maintain high standards of prudential and conduct regulation post-EU exit are welcome. We echo the authorities' view that continued cross-border regulatory and supervisory cooperation is essential to preserving hard-won financial stability gains.

We welcome that the revised fiscal framework eases the pace of fiscal consolidation while still building buffers for future shocks. Future spending pressures (e.g., related to pensions and health) and Brexit uncertainties suggest that the authorities should consider further revenue-enhancing measures alongside the efficiencies identified in the Spending Review. However, staff have provided very prescriptive tax policy measures, which are hard to assess without further context. Additionally, the dispersed nature of the Fund's institutional views on various tax matters complicates such a judgement.

We encourage the authorities to expand their focus on boosting potential output and inclusive growth. The U.K. authorities clearly recognize the challenge of low productivity growth (which has averaged close to zero post-crisis). Demographic dynamics (aging population, lower immigration) and uncertainty over future trade relations represent further headwinds. We welcome their efforts to strengthen quality national infrastructure, increase R&D spending, support innovation, and expand technical education and apprenticeships. Of course, there is always more that can be done. We encourage the authorities to consider further measures to address regional housing constraints (e.g., ease urban planning restrictions), adapt policies to support the growing share of self-employed workers, and consider adjustments to immigration policy to offset demographic pressures

Finally, we found it puzzling that cyber risks were mentioned in the Risk Assessment Matrix but did not feature in the policy discussions. We recognize that AIV reports face constraints on their length, but if cyber risks are important enough to be included in the RAM—and we accept that they are—some discussion of the related policy advice should feature in the main body of the report. The staff's comments would be welcome.

Mr. Kaizuka and Mr. Komura submitted the following statement:

We thank staff for the comprehensive reports and Mr. Field for their informative statement. The U.K. economy has exhibited its resilience. While its economic activity moderated in 2017, a broad set of indicators, including the headline unemployment rate and broader measures of underemployment in the selected issues, illustrate that the economic slack is limited. At the same time, the United Kingdom appears to have some challenges. As in other advanced economies, productivity growth and wage growth remain subdued since the GFC. More importantly, the United Kingdom has been in the process of Brexit. Following the June 2016 Brexit referendum, the sharp depreciation of sterling pushed up CPI, compressing household real income and consumption. Looking ahead, there remain many tasks to be accomplished and therefore uncertainties in the process of negotiation of Brexit. In this context, we would like to make following comments.

Fiscal Policy

Continued fiscal consolidation is critical to put public debt on a downward path and rebuild fiscal buffers to potential Brexit-related shocks. We welcome that the authorities have made significant progress since 2010 in fiscal consolidation. The fiscal deficit has decreased from 9.9 percent of GDP in 2009-2010 to 2.3 percent in 2016-2017. In the near and medium term, the new fiscal framework appropriately aims to reduce the cyclically-adjusted deficit to below 2 percent and balance the budget by the mid-2020s to ensure fiscal sustainability and build fiscal buffers while securing spending in prioritized area, such as health, education, and infrastructure. In the long run, population aging will put pressure on public finances. In this regard, we encourage the authorities to further discuss the desired size in public sector in the future and necessary measures, especially on health-related expenditure and tax system, and intensively communicate with citizens about those topics because these topics may take long time to obtain wide-understanding and agreement.

Contingency Plans

It is important to keep reviewing contingency plans following developments of the negotiations of Brexit. We agree with staff that policies should be geared toward supporting macroeconomic stability and financial stability under a tail risk scenario, a disorderly exit from EU. We also positively note that the authorities have proceeded with preparation to respond wide range of Brexit-related shocks. Going forward, since there remain uncertainties in the process of negotiation, staff and the authorities should review and refine their contingency plans under a tail risk scenario, even it is unlikely, following developments of the negotiations of Brexit. Furthermore, we also encourage staff, together with other department, to explore potential spillovers and necessary policy actions under such scenario to help countries which have strong relationship with the United Kingdom to prepare their own contingency plans. The negotiations and related works should be proceeded with close consultation with all the relevant parties including foreign entities which would be directly affected so that they could make necessary preparation on timely manner.

Financial Sector

Brexit-related risks should be closely examined. The financial sector plays a significant role in the U.K. economy. The financial services account for 7 percent of gross value added, and their export amounted to 2 ¾ percent of GDP. We note that bank profitability remains subdued after the GFC. Could staff comment the background of the low profitability and outlook of profitability in the future? We take note that Brexit presents major challenges in the financial sector. In this regard, we welcome that U.K. prudential supervisors proactively helping the financial sector to prepare for Brexit by asking it to develop contingency plan, and from a review of the plans, identifying key issues the authorities to should tackle with.

Structural Reform and Regional Disparities

Raising productivity is critical to improve living standards. At the same time, the authorities need to make more citizens, especially low-skilled, to be able to share fruits from economic growth. Productivity growth has been stagnated in the United Kingdom. Since real wages are basically determined by productivity, a wide range of measures, including improvement of education and training, and increase in R&D investment, will be warranted in the United Kingdom to improve living standards. Furthermore, there are large and long-standing disparities of productivity across regions, which may have facilitated "Leave vote" in the referendum. Key drivers of reginal disparities are difference in human capital and agglomeration effects according to the selected issues. While highly productive areas, London and the South East, would continue to enjoy agglomeration effects and lead innovation in the United Kingdom, the authorities should remove impediments for more citizens outside those areas to be able to improve their living standards. In this regard, skyrocketed housing prices in productive areas would decline in-migration there, contributing to lower reginal convergence. In particular, because housing is likely an inferior good within an area (Ganong and Shoag (2017)), low-skilled workers are disproportionally affected by expensive housing prices and would lose opportunities to work in productive areas. We therefore encourage the authorities to make every effort to restore housing affordability of the productive areas. In this regard, we would like to hear staff's long-run policy advice, especially supply side measures, in detail. Other than housing sector, there may be a need for governmental support to certain segments of industries including SMEs which may be severely affected by the Brexit. Are there any possible measures to be adopted in this regard?

Mr. Panek and Ms. Andresen submitted the following statement:

We welcome the robust performance of the U.K. economy in face of the substantial challenges posed by Brexit, but the outlook is subject to significant risks. The initial Brexit-related shock was less pronounced than widely feared. Growth has remained fairly solid and employment is at record highs. Sterling depreciation following the Brexit referendum supported the export industry. At the same time, it had a moderating effect on consumption. Uncertainties about the ongoing exit negotiation process and post-Brexit implications for consumers, investors, firms and the financial sector remain high and weigh considerably on growth prospects. In this regard, a clearer distinction between staff's assumptions for the transition period and post-Brexit period would have been helpful. In addition, as Brexit is likely to have an important impact on migration, we would welcome a detailed analysis of changes in migration patterns and implications for labor markets in future reports by staff.

The prudent monetary policy stance is appropriate at the current juncture. A reduction of monetary stimulus is warranted given the above-target inflation. At the same time, we support the gradual approach envisaged by the authorities in light of the current uncertainties. Given the expectations of a moderating inflation due to abating import price pressures, the BoE has sufficient scope to respond flexibly to changing conditions. A faster tightening would be warranted should price pressures persist and push inflation further above the target.

We support the authorities' commitment to continue fiscal consolidation and rebuild fiscal buffers. Given the considerable uncertainties to the outlook, some flexibility in the United Kingdom's fiscal stance is appropriate in order to increase public investment and thereby support potential growth. At the same time, we see merit in the longer-term goal of setting the public debt ratio on a downward path and build buffers to counter future shocks. To reach this target in a growth-friendly manner, increasing the revenue base by implementing tax reforms seems advisable. In particular, we encourage the authorities to reduce tax distortions by eliminating VAT exemptions, aligning tax treatment between employment categories, and reducing the tax code's bias towards debt.

A focus on structural reforms to raise productivity growth is key going forward. We welcome the authorities' commitment to prioritize investment to improve productivity, as outlined in the buff statement. As staff rightly points out, low productivity growth in many regions is a longstanding issue in the

United Kingdom. In this regard, further efforts are needed for improvements in human capital, innovation, and infrastructure, as pointed out by staff. Supporting vocational and technical training would be particularly helpful in increasing skilled labor.

The financial sector is resilient overall but Brexit-related uncertainties present major challenges. We welcome the overall good condition of the financial sector in the United Kingdom. Banks' balance sheets appear generally healthy and the authorities have made good progress in strengthening the regulatory framework. As of now, relatively few financial firms have decided to leave the United Kingdom in response to the Brexit referendum. However, depending on how the outlook evolves for economic and institutional conditions and cross-border market access, relocation decisions could increase. Continuous efforts to reduce related uncertainties as well as a close and constructive cross-border regulatory and supervisory cooperation are therefore necessary.

Mr. Sembene and Mr. N'Sonde submitted the following statement:

We thank staff for a set of well-written papers of United Kingdom (UK), and Mr. Field for his informative buff statement.

The U.K. economy has thus far withstood the adverse developments following the Brexit referendum, including a sharp depreciation of the Sterling, weak business investment growth, and growth slowdown in 2017. The authorities are commendably pursuing macroeconomic policies aimed at sustaining activity—including a broadly accommodative monetary policy and a growth-friendly fiscal policy —and preparing a new economic relationship with the European Union (EU).

We share the view that the nature of the Brexit agreement will likely have implications for the United Kingdom's economic prospects. To address the negative impact of uncertainties stemming from Brexit, we encourage both sides—EU and the United Kingdom—to promptly reach an agreement. On the policy front, fiscal consolidation should be pursued over the near-term, including through continued implementation of ongoing measures to contain spending and boost revenue, put debt on a declining path, and overcome infrastructure bottlenecks. Monetary policy should be normalized progressively in a way that supports activity while supervision and regulation should be strengthened to contain financial excesses. We welcome the authorities' continued efforts to monitor financial stability risks, including through heightened cross-border cooperation in regulation and supervision.

The authorities should also tackle structural impediments to long-term growth, notably lower total factor productivity growth and labor force.

The staff forecast that annual growth will hover around 1.5 percent in the next two years, predicated on favorable assumptions regarding the outcome of negotiations between the EU and the United Kingdom in the trade, financial sector, and other areas. However, we note that risks are mostly tilted to the downside. In particular, we would be interested in staff's assessment of the growth effect of a tail-risk scenario. Such scenario may include protracted negotiations on Brexit—which would exacerbate uncertainty—or a Brexit that results in non-zero tariffs and increased non-tariff barriers on trade with the EU. Sectors such as manufacturing, agriculture and tourism—which incidentally seem to rely on immigrant labor force—could be significantly affected under such a scenario, with an impact on overall growth.

On fiscal policy, structural developments (population aging, productivity growth) argue in favor of adopting revenue measures to meet the objective of balanced budget over the medium-term. The wide-ranging tax reforms recommended by staff—covering VAT rates, the tax code's bias, the orientation of property and labor taxations—should help meet this goal while reducing economic distortions. We invite staff to further elaborate on the authorities' view on these recommendations. On a different front, we welcome the authorities' intention to develop proposals to put in place a more sustainable care and support system for the aging population.

We note that the banking sector remains resilient to house price and income shocks. Nevertheless, the authorities should closely monitor household debt developments and banks' liquidity. Supervisors should stand ready to take additional measures to enhance bank-specific capital buffers and strengthen the oversight of non-bank financial institutions. Given the significant implications of Brexit for the financial sector, we welcome the actions taken by U.K. prudential supervisors to help financial institutions prepare for it, notably through contingency plans to address outstanding cross-border over-the-counter derivative and insurance contracts as well as continued cross-border sharing of data.

On the structural front, efforts should be pursued to reduce income inequality and regional disparities and foster intergenerational income mobility. We agree with the avenues proposed by staff in the areas of housing supply, infrastructure, innovation, human capital and skills, labor market, and devolution to subnational governments, and we commend the authorities for the initiatives already taken. That said, we would appreciate staff's comments on the scope for introducing more progressivity in the tax system with a view to reducing inequality. Finally, we commend the U.K. authorities for setting high standards on corporate transparency, and encourage them to enforce these standards on companies operating in developing countries which generally face weak oversight capacities.

With these remarks, we wish the authorities of the United Kingdom success in their endeavors.

Mr. Mahlinza and Mr. Ismail submitted the following statement:

We thank staff for their informative set of reports and Mr. Field for his insightful buff statement.

The United Kingdom (UK) economy has moderated despite substantial monetary stimulus and robust growth of trading partners. Uncertainty around the new economic relationship with the European Union (EU), post Brexit, continues to weigh on investment growth, exchange rates, and household real income and consumption. The positive progress made on the first phase of the Brexit negotiations is commendable. We therefore urge the authorities to step up efforts towards reaching timely agreements on the transition period and other outstanding issues to mitigate adverse spill-overs associated with a disorderly exit. We broadly agree with the thrust of the staff's appraisal and provide the following comments for emphasis.

Steady fiscal consolidation is key to placing public debt on a downward trajectory, building fiscal buffers, and restoring external balance. In this context, we encourage the authorities to mobilize additional revenues through tax reform measures aimed to reduce the tax code's bias towards debt; achieve a more equal treatment of employees, self-employed and corporations; curtail distortionary tax expenditures; and rebalance property taxation towards values. These reforms are critical for creating fiscal space needed for scaling up pro-growth spending and mitigating the adverse impact of demographic changes. We also see merit in eliminating the "triple lock" guarantee on state pensions aimed at curbing demographic-related spending and strengthening fiscal sustainability. That said, we commend the authorities for setting international standards with respect to fiscal transparency and encourage them to implement the remaining Fiscal Transparency Evaluation's (FTE) recommendations.

Accommodative monetary policy has supported the economy well. Going forward, the authorities should stand ready to alter the monetary policy stance in line with data developments. In the event of continued improvements in the labor market and above target inflation, a gradual unwinding of the monetary policy stimulus may be necessary. We also concur with staff that, in light of the elevated uncertainties, the withdrawal of the monetary policy stimulus should initially be transmitted through interest rate hikes given the effective and well-established transmission mechanism.

Although the financial sector remains broadly sound and resilient, vulnerabilities in the corporate bond and real estate markets should be closely monitored. In this context, while the low counter-cyclical capital buffer (CCyB) has been supportive of credit growth, the Financial Policy Committee's (FPC) decision to raise the CCyB is considered appropriate in light of the United Kingdom's position with respect to the financial cycle and rapid growth of consumer credit. Relatedly, further measures including targeted capital buffer increases, sectoral capital requirements, and strengthening non-bank financial institutions supervision should be adopted, if rapid consumer credit growth persist. We also urge the authorities to closely monitor capital market developments and liquidity conditions, while strengthening cross-border supervisory cooperation to address vulnerabilities in the financial system, post Brexit.

Raising productivity is critical for supporting inclusive growth and mitigating negative spill-overs from exiting the EU. In this regard, we welcome the creation of the National Productivity Investment Fund (NPIF) targeting investments in transport, housing, digital and R&D. At the same time, we encourage the authorities to scale up efforts towards human capital development to eliminate the skills gap and job mismatches, while supporting innovation and research. We also underscore the importance of addressing housing bottlenecks across all regions. Finally, we note that staff estimates that a moderate increase in non-tariff costs would reduce EU output by about ¼ percent in the long run. Could staff comment on the possible impact on the U.K. economy of an increase in non-tariff costs, particularly on the financial services sector.

Mr. Mozhin and Mr. Palei submitted the following statement:

Since the previous Article IV consultation almost two years ago the British people voted to leave the European Union. This major event has not just regional, but global implications, and it remains one of the key sources of uncertainty in global economic outlook. Throughout the report staff repeatedly called the disorderly exit from the EU a "tail risk." However, the Risk Assessment Matrix assigns "leaving the EU with no deal" a very high probability of between 30 and 50 percent. We note that several Executive Directors representing the Fund's major shareholders also warned against complacency and questioned whether the baseline scenario in the report was sufficiently realistic. We would appreciate staff's clarification of their definition of "tail risks" in their assessment of the likelihood of a disorderly Brexit. While we understand political sensitivity of the language in the report, we believe that staff should be as realistic as possible under the highly fluid circumstances.

At this stage, we see the British economy as successfully dealing with transition from the EU membership. As Mr. Field reminded us in his well-balanced buff statement, the employment is at a historically high level, while the rate of unemployment is very low. Over the past decade since the beginning of the Global Financial Crisis persistent swings in the exchange rate demonstrated the resilience of the economy to very large and prolonged shocks. In their report staff highlighted stabilizing effects of international trade and valuation of the NIIP. We find the scenario of sudden changes in capital flows, let alone the damaging attack on the currency, to be highly unlikely, if at all possible. We recall that already in 2010 such a scenario was a popular subject of debates between prominent economists when they discussed the costs and benefits of fiscal austerity in the U.K. during the initial stages of the euro area crisis. We believe that the outcome of this debate should be encouraging for the British authorities.

Given our views on the resilience of the British economy, we welcome the authorities' decisions to slow down and slightly delay fiscal adjustment. Despite the still rising public debt and the prospects of additional expenditures related to Brexit, the new fiscal goals appear to be prudent. The recent advances in fiscal transparency with the technical assistance provided by the Fund and the independent opinion of the Fiscal Responsibility Council provide additional assurances in this area. We agree with staff that a budget neutral adjustment in the VAT taxation accompanied by additional pro-growth fiscal measures would be an appropriate response to current challenges.

In the monetary area, we welcome the agreement between the Bank of England and staff on the policies ahead. We find the authorities' hands-on approach to stress-testing and their close dialogue with systemically important financial institutions to be the necessary preparation for a variety of risks.

We note that the British authorities have recently started to pay more attention to AML/CFT strategy and already took significant steps to address long-standing challenges in this area. We strongly encourage them to accelerate changes in the supervision of trust company service providers, as well as to significantly upgrade the level of engagement with Crown Dependencies and British Overseas Territories. The approach taken by the U.K. authorities in this area will have major spillovers across the global economy. Lack of progress in this area could undermine other countries' efforts to improve governance and transparency.

In the structural area, staff described the authorities' various initiatives aimed at increasing unusually low productivity in the British economy. We would be interested in more details on the authorities' embrace of industrial policy. While staff warned against any attempts to pick up losers and winners among the sectors and geographic areas, we would be interested to hear more about the safeguards established by the authorities to prevent slippages in this complex area of government activities. It would be useful to compare the British authorities' approach with that of the authorities in Ireland in the aftermath of the financial crisis.

The staff listed several priorities in the structural area, including more government investment in infrastructure, more active labor market interventions, and educational reforms. Given that the Fund has limited expertise in these areas, in the future it would be useful to collaborate more closely with other international institutions and, perhaps, provide an overview of the existing studies in one of the chapters in the SIP.

Mr. Agung and Mr. Machmud submitted the following statement:

We thank staff for their comprehensive report and Mr. Field for his informative buff statement.

The U.K. economy has showed stable macroeconomic conditions following the June 2016 Brexit referendum, underpinned by appropriate macroeconomic policy mix. These stable conditions are reflected in favorable financing conditions, eased monetary conditions, contained fiscal deficit, moderated growth, and somewhat higher-than targeted inflation. Sterling depreciation and uncertainty on the future trade regime with EU have contributed to moderated growth and higher inflation. Looking ahead, risks and uncertainties remain elevated, particularly stemming from potential breakdown of the negotiation and disorderly exit from the EU that might hamper the United Kingdom's medium-term growth. Given the uncertainties, we encourage staff to do an exit scenario analysis on the U.K. economy. We agree with staff's recommendation that the policies should focus on maintaining macroeconomic and financial stability, and enhancing productivity growth to support growth in medium and long run. We broadly concur with the thrust of the staff appraisal and offer the following comments.

We commend the authorities’ commitment to adopt steady fiscal consolidation to reduce public debt and rebuild fiscal buffers against future macroeconomic shocks. We note that the consolidation commitment has lowered fiscal deficit and public debt ratio, which in turn would help maintaining investor confidence and lower the current account deficit. To support potential growth, we welcome the authorities’ effort to prioritize spending on infrastructure, health, science, and education, while reducing current spending. In addition to the current spending restraint, we concur with staff that additional revenue measures, particularly growth-friendly tax reforms, are needed to balance the budget in the medium term. This is particularly important given the potential rise in demographic-related spending, given the United Kingdom’s aging population problem. In this respect, we would like to invite staff to provide further explanation on the authorities’ plan to adopt staff’s proposed tax reforms. With regard to fiscal transparency, we note positively that the U.K. authorities continue to set international standard by publishing OBR’s first fiscal risk report that provide comprehensive assessment on the vulnerability of public finance to various risks.

Regarding monetary policy, we welcome the authorities’ intention to withdraw monetary stimulus gradually to achieve inflation target. We applaud Bank of England (BoE) for increasing the policy rate and unwinding monetary stimulus last year as slack in labor market diminished and inflation exceeded the target. In view of planned fiscal consolidation and the unfavorable impact of Brexit related uncertainties on domestic demand, the withdrawal of monetary stimulus should be proceeded gradually. We take positive note of the authorities’s commitment to stand ready to adjust monetary policy flexibly in response to changes in the economic activity and inflation outlook.

On financial sector, we welcome the authorities’ strong commitment to maintain robust prudential regulatory and supervisory standards notwithstanding of the post-Brexit arrangement for financial services trade. Following 2016 Brexit referendum, we take positive note that financial and non-financial corporate balance sheets have strengthened. Major banks are well-capitalized and liquid, while debt ratio in non-financial corporation declined. More importantly, the U.K. banking system is resilient to deep recessions in the United Kingdom and global economies, large house price declines, and a rise in unemployment, as demonstrated by recent BoE’s stress tests. We take positive note of BoE’s Financial Policy Committee latest decisions to increase countercyclical capital buffer and guard against loosening of underwriting standards in the owner-occupied mortgage market to mitigate the adverse effect on rapid growth of consumer credit.

In the case of disorderly Brexit scenario, we support staff's recommendation that polices should be directed to support macroeconomic and financial stability. BoE should provide adequate liquidity in the financial system given unfavorable market response with sharp decline in asset prices. In the meantime, fiscal policy could be eased temporarily to support the economy and the counter cyclical capital buffer could be lowered to permit banks to keep providing credit to the economy.

Boosting productivity is vital to enhance living standards and provide more inclusive growth. Given relatively weak productivity in the United Kingdom, we note staff's recommendation for the authorities to further pursue structural reforms to support growth, improve competitiveness, and help reduce inequality. In this respect, we commend the authorities' efforts to raise productivity by prioritizing infrastructure spending, providing new system for funding apprenticeship, and reforming technical education to improve student's skills and facilitate job matching. Regarding the recommendation on structural reforms, could staff provide further explanation on the sequencing and prioritization of their recommended structural reforms?

Ms. Barron and Ms. Preston submitted the following statement:

We thank staff for an informative set of papers, analysis made more challenging given the uncertainty arising from the United Kingdom's vote to leave the EU. We also thank Mr. Field for his helpful buff statement that clearly articulates the authorities' thoughtful approach to the challenges ahead.

The focus of staff's assessment is rightly on the importance of remaining open to trade, investment and immigration as this is the first Article IV assessment since the United Kingdom's decision to withdraw from the EU. We support staff calls to seek to negotiate a position that minimizes barriers to the cross-border flow of services, goods and workers. We agree that the U.K. government's ability to secure favorable future trading relationships is critical for the future growth and prosperity for the economy. We encourage authorities to maintain commitment to a cooperative multilateral trading framework and to promote openness over protectionism. In this regard we take note of Mr. Field's buff statement that the U.K. authorities are seeking a "a deep and special partnership with the EU that spans a new economic relationship."

Baseline projections for growth are around 1.5 percent over the next two years based on the perhaps slightly optimistic assumptions that the EU and the United Kingdom make smooth progress in negotiations, leading to a broad free trade agreement, that is implemented smoothly, with tariffs on goods remaining at zero. We share staff's assessment that productivity growth will be the primary determinant of U.K. living standards in the long run. Productivity growth since the crisis has been very weak in the United Kingdom, similar to other advanced economies. Noting that staff's medium-term forecast for GDP growth is almost entirely supported by productivity growth we note the significant downside risks if sufficient progress is not made. We appreciate authorities' full recognition of this risk with Mr. Field acknowledging that if the United Kingdom can unlock productivity growth, there is an opportunity to increase growth, wages and living standards over the long term.

Maintaining openness is a clear policy priority, but on its own is not sufficient to underpin productivity and potential growth. The process of negotiating exit from the EU has the potential to be all consuming for the U.K. Government. We note staff's observation that the list of tasks remaining to be accomplished is very long. There may therefore be insufficient capacity in the short to medium term to progress important structural reforms that are needed to drive growth over the longer term. In this regard we would have appreciated more concrete recommendations for generating productivity growth within the U.K. context.

Continued fiscal consolidation is necessary to put public debt on a downward path. Significant progress has been made to bring the deficit from 9.9 percent of GDP in 2009-10 to 2.3 percent in 2016-17. We note positively, Mr. Field's statement that the government agrees that borrowing needs to be reduced further to maintain the United Kingdom's economic resilience, improve fiscal sustainability, and lessen the burden on future generations.

Mr. Doornbosch and Mr. Clicq submitted the following statement:

We thank staff for their report and availability for further clarifications ahead of the Board meeting. We also thank Mr. Field for his helpful buff statement. Brexit-related uncertainty is weighing on economic growth, especially on investments. The significant decline in greenfield FDI inflows in the United Kingdom in 2017 is notable. The authorities' commitment to continued deficit reduction should lower the elevated current account deficit further and help maintain investor confidence and create potential of automatic stabilizers. Brexit raises important long-term challenges for the

U.K. economy. Irrespective of the outcome of the agreement with the EU, growth is likely to remain moderate over the coming years. Also, productivity growth may experience further downward pressure from Brexit. Increasing investments in R&D (which is low from an OECD perspective) and infrastructure will be needed to achieve higher growth potential. We associate ourselves with the detailed statement of Mr. Meyer and add the following observation.

The U.K. macroeconomic outlook depends on the terms of the new agreement to be reached with the EU. We agree that a positive outcome of the ongoing negotiations between the United Kingdom and the EU is in the best interest of all parties. We assume that therefore staff has taken a rather optimistic view in its baseline scenario. As the RAM highlights that both the risk and impact of "leaving the EU with no deal" is high, the staff report would have benefited from assessing a range of outcomes and the effects on the U.K. economy and potential spillovers on its main trading partners. The staff's comments would be welcome on the range of outcomes.

To help the reader better understand the staff's assessment of the economic outlook and risks, it would also be advisable to detail in an annex to the report the model(s), assumptions and scenarios used by staff to quantify the Brexit assumptions.

Mr. Daïri and Mr. Sassanpour submitted the following statement:

We thank staff for well-written report and SIP, and Mr. Field for his insightful and candid buff statement. We agree with the thrust of the staff appraisal and limit our comments to few key issues.

Despite the high degree of uncertainty associated with Brexit negotiations over the past 18 months, the U.K. economy has kept its growth momentum and made significant gains in employment and inclusiveness, thanks to its inherent inertia and strong fundamentals. The negative impact on output from dampened private consumption and business investment due to Brexit uncertainties and the related sharp effect on currency and inflation, have been offset by gains in external competitiveness and a stronger EU growth. Still, productivity growth has not recovered since the financial crisis, and economic growth is expected to be anemic in the coming years even under an orderly exit scenario. The major downside risk to the outlook is unfavorable arrangements with the EU or a disorderly exit. The U.K. government is approaching the Brexit negotiations anticipating success, but at the same time is preparing for less benign outcomes. The staff report has elaborated on the impact of Brexit on other EU members, and we would appreciate staff assessment of potential impact on the 60 countries with which the EU has preferential trade agreements, in particular in Sub-Saharan Africa and South and East Mediterranean.

The adverse impact of uncertainties on investment and output has been contained so far by balanced and supportive policies. Monetary policy—despite recent tightening—has remained appropriately accommodative, and the pace of fiscal consolidation has moderated without undermining the medium term balanced budget targets or the downward debt ratio trajectory. Going forward, and as Brexit negotiations take shape, adequate policy mix and flexibility are critical in keeping the balance between the dual objectives of maintaining growth and employment momentum, and building sufficient fiscal buffers to protect against unfavorable Brexit outcomes and other external shocks. Monetary policy, in particular, requires greater fine-tuning: with the closing of the output gap and with inflation hovering above the BoE's target as the depreciation impact dissipates, withdrawal of the stimulus would be warranted, but its pace would need to be adjusted by the degree of flexibility offered by the fiscal buffer. Fiscal policy would also have to adjust to the final Brexit impact (and any permanent impact on output) while accommodating a host of spending pressures related to old age, infrastructural renewal, and labor skill upgrade that go beyond Brexit.

Raising economic growth above its modest path and, in the process, elevating living standards and reducing income disparities, require a major boost to productivity, a point also stressed by staff and Mr. Field. We are encouraged by the multi-pronged government efforts to upgrade infrastructure, housing, R&D and human capital. House prices—while subject to great regional differences—have stabilized recently, but a greater supply effort is needed to meet the rising demand in urban areas and improve affordability and labor mobility. As in many other AEs, wage growth is lagging employment gains. Net migration has shaped the labor force and the wage dynamics in the United Kingdom over the past two decades and is likely to remain a key contributor if the labor inflow is not curtailed to any significant degree in the aftermath of the Brexit outcome.

Financial stability risks crucially hinge on Brexit outcomes, but the depth of the U.K. financial sector and its traditionally strong regulatory and supervisory framework provide considerable comfort. We also welcome the proactive policy of the U.K. supervisory authorities to help financial institutions prepare for Brexit and the efforts of the EU authorities to stand ready for various potential Brexit outcomes. The major U.K. banks are well capitalized and, according to the BoE's 2017 stress tests, can withstand even a disorderly exit.

With these comments, we wish the U.K. authorities all the success in this transition period.

The representative from the European Department (Mr. Gerson) made the following statement:[1]

I wanted to update Directors on the February inflation report, which the Bank of England published late last week, and in particular, the revised growth forecast and the implications for monetary policy.

The Bank of England has now forecast growth of 1.8 percent in both 2018 and 2019, and 1.7 percent in 2020. These are upgrades of 0.1 to 0.2 percentage points annually over that three-year period. The revised forecast from the Bank of England put the staff's forecast firmly in the middle between the Bank of England numbers and the numbers produced by the Office for Budget Responsibility, which the Treasury uses to forecast the budget.

Market commentators seized on some of the language in the inflation report, in particular the statement from the Monetary Policy Committee that monetary policy tightening might occur somewhat earlier and to a somewhat greater extent than had been expected in November; and there has been a significant amount of commentary in the newspapers saying that the Bank of England has now adopted a more hawkish tone. I wanted to put that in context and discuss what the Monetary Policy Committee is talking about for interest rate policy and how that compares to the staff's advice.

In the November inflation report, markets had forecasted two small interest rate increases over the next three years. Since the publication of the February report, markets are now looking at three interest rate increases over the next three years. The difference between how markets interpreted what the Bank of England was saying in November and what the Bank of England is saying now is minimal. We are talking about the potential for one more rate increase over the next three years, with the first of those increases perhaps coming slightly earlier than before. In the staff's view, this is entirely consistent with the position that we had taken in the staff report that the pace of monetary policy tightening should remain gradual over the next few years.

[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

Although the Bank of England has increased its forecast and is now about 2 percentage points per year more optimistic than the staff's forecast, in terms of the implications for monetary policy, we do not see what the Monetary Policy Committee is saying as implying a significant difference from the advice the staff had given in the staff report.

Mr. Meyer made the following statement:

We thank the staff for the report and Mr. Field for his buff statement. The economic situation in the United Kingdom is dominated by the uncertainty surrounding the Brexit negotiations. While the economic situation is strong in some respects—unemployment is low, employment is at a record high, and exports performed well—the Brexit-related uncertainty is holding back the British economy as the depreciation of the British pound following the referendum and the uncertainty of the future EU-U.K. economic relationship has driven up inflation and slowed private consumption and growth. In this regard, we would like to emphasize that both the United Kingdom and the European Union authorities are striving to reach the most mutually beneficial and politically feasible outcome for their future relationship.

Overall, we believe that the U.K. authorities are striking the right balance between their continued fiscal consolidation and the gradual withdrawal of monetary accommodations. We agree that withdrawal of monetary accommodations would still be gradual, and we agree that this is not a material change in that regard. Given the economic environment and the Brexit-related uncertainties, now is the time to start building policy space in fiscal and monetary policy and on supervisory policies.

Like other Directors, for example Mr. Kaizuka and Ms. Barron, we welcome the progress made in fiscal consolidation and would like to point out that continued fiscal consolidation remains critical to put public debt on a firm downward trajectory and rebuild fiscal buffers.

Looking at financial markets, we take positive note that the bank balance sheets have been strengthened and banks are well capitalized. Profitability, however, remains low. The potential impact of Brexit on the United Kingdom's financial sector is highly uncertain and will depend on the final outcome of the Brexit negotiations and the future evolution of regulatory frameworks in the United Kingdom and the EU. We welcome the proactive attitude that U.K. supervisors are taking to help financial institutions prepare for Brexit.

We were surprised that the staff addressed recommendations also to EU supervisory authorities in the context of the U.K. Article IV consultations. I would like to take the opportunity to reassure the U.K. mission team that EU supervisors have carried out extensive preparatory work and are well placed to deal with the various potential outcomes of the Brexit negotiations. We stand ready to share this information with the euro area team as well.

Like many other chairs, we would have appreciated having more clarity about the technical assumptions on the future U.K.-EU trading arrangements and about the possible transitional arrangements. We are well aware that there is a high degree of uncertainty surrounding these issues and that the staff has to make certain assumptions in order to make the forecast. However, with such a high amount of uncertainty surrounding the Brexit negotiations, there are inevitable limits to the reliability of forecasts. A better knowledge of the assumptions would have helped us to better understand these limits. For instance, we felt that the staff's baseline assumption that most financial services would continue to be provided on a cross-border basis beyond the transition period was inconsistent with the U.K. authorities' declared intention to leave the single market and customs unions.

With this, I wish our U.K. friends all the best to bolster the fundamental strength of the U.K. economy and to achieve—as Mr. Field put it himself—a deep and special partnership with the EU that spans a new economic relationship.

Mr. Dajani made the following statement:

We thank the staff for the Article IV report, and Mr. Field for an informative buff statement. We issued a gray statement in which we associated ourselves with Mr. Meyer's statement, so I will raise a few additional issues.

We concur with the staff that the economy is doing well, that the output gap is about to be closed; and yet there are macroeconomic challenges that need to be addressed, especially because consumption and investment have taken a hit, which is probably related to the uncertainty stemming from the Brexit process. We would like to focus on three aspects that are important for the U.K. authorities to continue working on. The first is to sustain fiscal efforts; second, to tackle the issue of inequality, especially intergenerational mobility; and third, the issue of structural reforms. These aspects will be specifically relevant in the context of Brexit and the negotiations which are currently taking place.

On this point, we would like to echo what many Directors have said, including Mr. Meyer—namely, that we would have liked more clarity on the assumptions that have been adopted or used to create the scenarios. On the one hand, we do not see a clear differentiation between the transitional period and the end period, or where we believe the negotiations will end. I know this is a complex issue, but we would have liked a clearer differentiation.

Second, we would have liked more realistic scenarios. This is a specific area where more could have been done. As Mr. Meyer, Mr. Sobel, and other Directors have mentioned, the scenarios that were used look more like a best-case scenario than a baseline scenario. Assuming that tariffs will be zero, for instance, or thinking that the financial passport will be easily adopted for all British financial services firms, seems unrealistic and probably not coherent given the context of the negotiations.

We wish the U.K. authorities all the best, and once again we thank the staff for an interesting report.

Mr. Kaizuka made the following statement:

I appreciate the staff's comprehensive paper and also the informative buff statement by Mr. Field. At this point of the discussion, I do not have anything to add, but I would like to raise three points.

I congratulate the staff and the U.K. authorities for the first Article IV report after the referendum. There is an uncertain situation amid the Brexit negotiations, and I have sympathy for the staff. This is difficult work. I encourage the staff and the authorities to update the Board on a continuous basis—for example, during the discussions on the World Economic Outlook (WEO) or the discussion of the regional outlook—about the current status of the U.K. economy and the progress of the Brexit negotiations.

Since many of the private entities, including financial institutions, are keen to learn about the status of the negotiations, I hope that the process is transparent and the information is made available to all the relevant parties in the course of the negotiations.

Second, due to Brexit, the United Kingdom may have more flexibility to negotiate new trade and investment arrangements with non-EU member countries. I encourage the United Kingdom to facilitate and promote an open, free, fair, and rules-based trade and investment regime in the forthcoming negotiation with the new parties, either bilaterally, regionally, or multilaterally.

Lastly, I appreciate the staff's analysis on the productivity in the region. Raising productivity in the so-called left-behind regions is key. This is a longstanding issue. This is one of the reasons why the Brexit vote took place. It is important to discover how to raise productivity, especially in those left-behind regions. I am encouraged by Mr. Field's buff statement in this respect. Japan is also facing longstanding stagnation of the regional economy, so Japan and the United Kingdom may have some common elements of the agenda ahead of us; and we appreciate the future opportunity to compare progress and share information about how we can tackle those longstanding issues.

Mr. Leipold made the following statement:

We also issued a gray statement and associate ourselves with Mr. Meyer's gray statement. We would like to make a few points—one is a comment that we did not make in our gray statement, and then we have a few observations about the staff scenarios and the monetary policy stance following last week's inflation report.

The comment we did not make in the gray statement but that merits recognition concerns fiscal transparency. We need to recognize the United Kingdom's strong record in setting standards and best practices in this area, and it is a record that dates back a long time. When I was following these issues closely as a staff member, the United Kingdom was a path breaker in the transparent recording of contingent liabilities in general, reporting public-private partnerships (PPPs) in reports on tax expenditures. Now there is the Office for Budget Responsibility's first fiscal risks report, which uses so-called fiscal stress tests. There would be some merit in the staff writing a paper reviewing these practices as examples for other countries as good or even best practices. Fund surveillance is, after all, about spreading such practices across the membership.

Second, I understand some of the critiques of the staff's scenarios. Given the possible outcomes of the Brexit saga, it may be a bit harsh to be overly critical of the staff when it comes to understanding of the scenarios. I share some of the points made, but I would cut them some slack. Having said that, I tend to agree with those Directors who thought that the staff may in the end be erring on the side of sanguinity. We note that the correction that was issued on Friday continued in this rosy direction, because the risk assessment matrix downgrades the probability of the risk that there will be no deal. The staff may have been cautious not to be labeled as part of the fear brigade, and I understand they do not want to be in that camp. But the result could turn out to be, as Mr. Sobel put it in his gray statement, that the baseline scenario may be a best-case scenario. The recommendations of the last few days from the U.K. and EU negotiators are hardly encouraging, and the Brexit clock keeps ticking.

On the monetary policy stance, I thank the staff for the clarification they have provided in the Board and also bilaterally. I understand and accept that perhaps overly hawkish readings of the monetary policy—of the inflation report that was issued on Thursday—may be wrong, but I think that analysts, the press, and the markets grabbed onto the phrase that monetary policy needs to be tightened somewhat earlier and by a somewhat greater extent as indicating a change in direction. I am happy to be comforted, but if one compares this to the November report, perhaps we are talking about two rather than three rate increases over three years, with a potential difference in timing of just a few months.

All that seems to go in the direction that we support, which is that in the current environment, any interest rate increases should be gradual and limited compared to the last cycle. But perhaps the communication was not as clear as one would have liked, and it created some market confusion in this region.

Mr. Ostros made the following statement:

I thank the staff for the papers, and I thank Mr. Field for his buff statement. I would like to highlight one part of the economy that would deserve even more attention, and that is the labor market developments.

Figure 3 gives us some insights into a labor market that has a very low unemployment rate, and I would like to commend the authorities for reaching that situation in a tough environment, with rising vacancy rates, low productivity rates, and a marked decrease in net work-related migration. There is no doubt the that United Kingdom has benefited immensely from migration in all parts of the labor market, from basic services to high-end, high value-added sectors. From Box 1, we also learn that migrants to the United Kingdom have employment rates that are at least as high as the native-born population and have higher average educational attainment than the native-born population.

> The baseline scenario does not include unfortunate Brexit effects on migration flows. It incorporated some trends into the prognosis, but not negative supply shocks from Brexit effects. Could the staff reflect on the likely effects from the negative supply shock on the labor market considering that in the short run there are already rising vacancy rates, but also considering the medium-term effects on the productivity level if the United Kingdom is to lose its supply inflow of well-educated labor in the coming years.
>
> Since the 2016 selected issues paper on a disorderly Brexit did not include negative supply effects on migration either, could there be scope for digging deeper into this issue, because these migration issues are of general interest in many countries, and there is a similar debate and policy discussion on migration effects. That could be a worthwhile contribution.

Ms. Horsman noted that the Fund had an important role to play in highlighting the economic implications of Brexit. She remarked that the staff had provided good economic analysis, although more discussion on a broader range of possible outcomes would have also been useful. She noted that the outcome of the Brexit negotiations would have global implications due to the importance of the U.K. economy and possible spillovers. She hoped for a successful outcome that benefited all parties and maintained support for an open and inclusive multilateral system.

Mr. Sobel made the following statement:

> I would like to make two points and then drill down on a third. First, as Mr. Leipold mentioned, in comparing the staff's baseline Brexit scenario with other data points, the staff's baseline struck us as overly sanguine. Furthermore, we felt the downside case was only lightly touched upon and should have featured more prominently in the paper.
>
> Second, the U.K. Article IV report uses net debt not gross debt. I presume this is because the authorities use net debt, and admittedly the two figures are similar for the United Kingdom; but regardless, we have long raised the net versus gross debt issue in many European Article IV papers, especially in northern European cases where net debt was either very low or in surplus. The staff then explained the net number away, so I remain at a loss about how the European Department approaches such a basic issue as gross versus net debt.
>
> Third, with regard to the United Kingdom, the EU, and the financial sector, picking up on Ms. Horsman's remarks, London is an enormous global financial hub. The financial arrangements made between the United Kingdom

and EU are not just a Brexit negotiation issue; they are a global financial stability issue affecting us all. Mr. Meyer and the EURIMF gray statement happily observes that Box 3, “clearly states the United Kingdom’s decision to leave the single market will mean the U.K.-based financial institutions will lose their passporting rights in the EU,” but Box 3 does not say “will lose.” Instead, it says “would imply such a loss.” On the face of it, should the United Kingdom leave the EU, then logically it would not have passporting rights into the EU. But on second thought, the logic may not be so clear. It depends upon the nature of cross-border supervisory and regulatory arrangements. If country X’s supervisory and regulatory framework is highly similar to and as rigorous, if not more rigorous, than country or union Z’s, and there is good regulatory supervisory cooperation, why cannot there be deference? Indeed, for many years Brussels and continental European colleagues called upon the United States to grant unconditional deference to the EU.

The United States and EU have long reached equivalence agreements based on detailed and lengthy reviews of whether both sides achieve similar high-quality outcomes on the basis of robust application of international principles and standards. In the case of central counterparty resolutions, after several years, we reached a deal on substituted compliance, so London is a major clearer of dollar interest rate swaps and euros. Because of Brexit, should location requirements be required to pull euro swaps trading into the euro area? Even if good for business and continental financial centers, would this make the world safer? Should the United States do likewise for dollar interest rate swap trading? I thought the staff began to give us the start of a helpful answer in its response to question 20.

Similarly, if the EU adopts new equivalence arrangements with London, which are different than those with the United States or Switzerland or Singapore, would those deals have to be renegotiated? Furthermore, what if an asset manager is domiciled and regulated in an EU country, but the managers are based in London or New York because the markets are there? Should the managers be forced to move to the continent? Would they need to move all of their global transactions or just the European ones?

We welcome Box 3, but it is largely descriptive. It does not present fulsome and clear views. I am not sure that the U.K. Article IV report would be the place to do so. I began posing these very same questions about a year ago. In November, I raised many of them anew. I know that there is a euro Financial Sector Assessment Program (FSAP) underway for the summer, but I see these as highly consequential global issues that have enormous ramifications for international financial stability, regulatory and supervisory cooperation, and for whether global markets are fragmented.

The United Kingdom voted on Brexit in June 2016. The United Kingdom invoked Article 50 almost a year ago. Every day the *Financial Times* has a story on Brexit and the U.K.-EU financial sector discussions. I do not mean to be critical, but the Fund tells us it is at the center of excellence on global financial stability, yet the Fund remains quite silent on these issues. The horse has left the barn ages ago. The Fund's voice is still in the stable.

Mr. Armas made the following statement:

Our chair issued a gray statement, so I will just add a few remarks. Macroeconomic policy has been successful in helping the United Kingdom face recessionary pressures coming from the uncertainty created in 2016 by the Brexit referendum.

Looking forward, reducing the debt and the fiscal deficit should allow the authorities to rebuild fiscal space so as to face the possible shocks that Brexit could still produce, and at the same time reduce the current account deficit. We already know that last year's fiscal deficit was the lowest since the crisis, but this effort must be made due to the highly sensitive fiscal position with regard to macroeconomic shocks. As the output gap has already closed after six or seven years, and with low levels of underemployment, structural policies are key to enhance GDP growth. In that regard, I would like to emphasize the potential GDP growth from international trade. International trade is a key driver of long-run economic growth, so the approach to that matter is crucial not only for the United Kingdom and Europe, but also the rest of the global economy, as Mr. Sobel and Ms. Horsman mentioned.

Negotiating this exit from the EU is now the most important task facing the U.K. authorities. We hope that the uncertainty about Brexit will soon come to an end and an agreement can be reached with the EU. The lowest barriers to the cross-border flow of capital services, goods, and workers will have the most positive impact on the country and the rest of the global economy.

Furthermore, Brexit represents a further challenge to a financial sector mainly depending on the agreement with the EU on financial services, particularly on derivatives and insurance contracts.

Second, it is important to renew all free trade agreements already signed by the EU with third countries after leaving the customs union and the single market.

The third point is to initiate conversation directly with other countries to reach new free trade agreements. The Article IV report and the selected issues paper have provided interesting findings regarding the labor market and disparity in the United Kingdom. Following the Article IV paper and Mr. Field's buff statement, we commend the authorities for their efforts to deal with the structural issues, especially at the regional level, such as low productivity, inequality, and low potential growth, while at the same time dealing with governance decentralization and corporate transparency.

Mr. Just made the following statement:

We thank the staff for the reports, the written responses to technical questions, as well as comments in the Board, and I thank Mr. Field for his eloquent buff statement.

This Article IV consultation was never going to be an easy one. In some sense, the approach chosen by the staff is right. The 2016 report covered scenarios of how Brexit could impact the U.K. economy. This consultation's focus on structural reforms is a logical continuation. Brexit is accentuating the legacies of the industrialization which started in the 1970s. The problem of low labor productivity needs to be addressed with urgency so that the United Kingdom will be able to deal with the Brexit shock and address the long-term fiscal and demographic challenges.

Still, we have the feeling, like many others, that in this staff report, the balance between long-term risks and short-term risks which pertain to the difficult Brexit negotiations have shifted too much toward the long-term. We are fully cognizant of the daunting task the staff faced in writing this report, as the modalities of the negotiations and results are numerous, the uncertainties extreme, and the issues sensitive.

However, we fully share Mr. Myers' oral remarks on the baseline and assumptions in this regard, as well as Mr. Leipold's comments on the risk assessment matrix.

Therefore, in the forthcoming public communication, it is necessary for the staff and management to address possible concerns that the current report downplays some of the risks, even though a smooth process is in the best interests of all negotiating parties. However, the final outcome could still look very different. The financial sector is a case in point, and we share the gist of Mr. Sobel's intervention on the financial sector.

There is a mindset of regulatory and legal uncertainty facing the derivatives market, insurance contracts, and asset management products that go beyond the issue of central clearing. In the answer to our technical question, the staff points out that some of them will be covered in more detail in the forthcoming euro area FSAP. However, given the timeline of the Brexit negotiations, it may be far too late for the Fund to weigh in with its expertise on the financial sector.

The city of London is probably the most important financial center in the current global financial market infrastructure. Enhanced spillovers could potentially be significant and affect more parties than the EU.

Mr. de Villeroché made the following statement:

I would like to associate myself with the Mr. Meyer's written and oral remarks. I would like to make a few comments for emphasis.

First, with regard to the outlook and the macroeconomic policies, we would like to commend the authorities for how they have managed in an uncertain and difficult environment, and how they adapted the policy mix since the referendum. The fiscal consolidation path will be gradually pursued, and the monetary stance remains adequately accommodative, while the Bank of England has announced its intention to adapt the course of the ongoing normalization depending on inflation. We encourage the authorities to keep adapting flexibly to the current uncertain environment, and overall they have performed well.

On the report, we found the attention dedicated to the question of productivity in the United Kingdom interesting. We believe it is a long-term challenge. It is true in the United Kingdom and other countries as well. This focus is relevant since addressing the persistent low level of productivity growth through educational reforms and regional policy is of high importance to ensure higher growth in the future to align productivity with wage dynamics in the long run.

We have some reservations about the report, especially the lack of the clarity about the assumptions taken under Brexit. We believe it is important to be cautious and realistic. I am not saying it is easy to make assumptions. I am saying that once one chooses one way forward in terms of assumptions, one has to be consistent with what it implies. We have some questions about the consistency of saying that it is likely that the United Kingdom will leave the single market and the customs unions, while saying that an agreement with the EU will allow firms to continue to provide more financial services on a cross-border basis. We do not believe it is a completely realistic scenario.

Like Mr. Sobel, we believe there is a way forward with a wide variety of agreements, especially equivalences. But if we take the example of the relationship between the EU and the United States in terms of equivalences, it is an interesting one. However, it has been limited in scope so far and in terms of past discretions on debt between the EU and the United States on a potential trade agreement. One of the main questions was whether we should include financial services in the scope of those discussions. Today it is not possible for an EU firm, just as it is not possible for a U.S. firm, to provide direct lending to customers on a cost accounting basis, and the range of services and the freedom to provide services are limited as well. Most of the banks have to establish subsidiaries and adequately supervise the subsidiaries on both side of the Atlantic.

I do not know what the future relationship will be between the United Kingdom and the EU regarding this precedent of using equivalences, but I do not think it will be completely neutral for the scope of services that will be provided across the Channel. Certainly, a transitional agreement will be different from the definitive agreement. It is hard to speculate, but some consistency on the assumptions is needed.

Second, we believe there is a pending issue which remains unaddressed in the report, which is the fiscal implication of Brexit. It is still early days. It is hard to make any assumptions. However, it is important macroeconomically, although we believe that the United Kingdom has ample fiscal space to absorb the shock. In the future, we would like to better understand the direct impact of ending contributions to the EU budget; what will be the possible cost of Brexit for EU institutions, and what will be the cost of building domestic capacities and policies for the United Kingdom. There could be some overlap between these different costs. We believe the country has fiscal space, but a better understanding of this would have been helpful.

Mr. Tombini agreed with other Directors that Brexit was an issue with global, and potentially systemic, implications, particularly given London's central role as a major financial center. He supported further involvement by the Fund to help reduce uncertainty amid the dynamic and fluid negotiating process. He also supported more frequent reports to the Board on Brexit negotiations.

Mr. Daïri made the following statement:

> I thank the staff for the excellent paper and Mr. Field for his candid statement. I commend the authorities for handling this difficult transition with pragmatism while keeping hopeful that the exit would be, if not smooth, at least not disorderly.
>
> I would like to come back to the point made by Mr. Leipold on the correction of the staff's assessment of the risk of a disorderly exit from high to low. This is quite a change. Usually when there is a need for a correction, we generally move one notch. In this case, it is two notches. I am not disputing the correction which I find appropriate, but I am not sure it is consistent with the way the Fund has accepted corrections so far. Sometimes when an assessment is only 10 or 20 percent right, the staff maintains that it is still correct and rejects requests for correction or deletion based on the Transparency Policy. I am not sure this is an issue of transparency. Maybe the staff came to the conclusion that the risk assessment matrix was not consistent with the other developments in the report. But I would appreciate the same willingness to correct what is not 100 percent right in other cases as well. I remember a case where two opposite assessments were made in the same document, and when the authorities mentioned it and asked for correction, the staff preferred to maintain the most damaging assessment and delete the favorable one. We are all in favor of transparency and correcting what is not right, but it should be done in an evenhanded manner while giving the authorities the chance to express their views.
>
> My second point is indirectly related to this issue. If the staff considers that the risk of disorderly exit is low, what are the implications in assessing the risks for the global economy? Does this mean that it is no longer a risk? In light of this new assessment for the U.K. economy, I would appreciate some clarification on ho staff assesses the risk of exiting without an agreement. An exit without an agreement may not necessarily be disorderly. It can be orderly. The United Kingdom and the EU have sufficient instruments and experience to know what should be done in such a situation. But what would that mean to the global economy? Would we still see exit without an agreement as a risk to the global economy or just as a tail risk, as the staff has set out?

Mr. Jin made the following statement:

> The United Kingdom is an important player in the world economy given its important role in high-end financial services and high-end manufacturing. I am a bit disappointed with this Article IV report because it has not given us a clear view on the potential impact of Brexit on the global economy or the U.K. or EU economies. I hope that the United Kingdom will continue its tradition of openness and engage in constructive negotiations with the EU to keep a high level of free trade, while enjoying a higher degree of freedom to explore opportunities with many other countries, including my own country.
>
> Our economies are highly complementary, and there is great potential for the United Kingdom and China and many other emerging market economies to reach high-level free trade agreements, which will include not only the goods trade but also financial services, which is the advantage that the United Kingdom has enjoyed.

The representative from the European Department (Mr. Gerson), in response to questions and comments from Executive Directors, made the following statement:

> I thank Directors for their comments and questions. I will respond to most of the questions, and my colleague, Ms. Koeva Brooks, will respond to the specific question about the correction.
>
> There were a number of questions about the staff's baseline assumptions, the realism of those assumptions, the absence of alternative scenarios; and I want to start by reminding Directors that the 2016 selected issues paper was devoted exclusively to analysis of the implication of Brexit for the U.K. economy and the global economy. In particular, we considered the likely implications of two different scenarios: the first, a soft Brexit with a European Economic Area (EEA)-type arrangement that would be similar to the rules governing Norway now; and the second, a different scenario that looks at a World Trade Organization (WTO) scenario where the talks do not lead to an agreement and the United Kingdom goes to the WTO overall for its trading. Those scenarios have aged quite well, which partly reflects the fact that not much has transpired since the issuance of that selected issues paper in terms of reaching agreements on what the long-run relationship is likely to be. There have been relatively few additional studies that have come out in the last several months. The studies that look at scenarios like the ones the staff considered in the selected issues paper tend to come out with results that are fairly similar.

In terms of bookending the assessment with the softest of Brexits and the hardest of Brexits, those scenarios were considered in the 2016 selected issues paper. The baseline scenario that the staff uses for this Article IV report falls somewhere in the middle between those two bookends. We responded to requests about the specifics of the assumptions in our written responses, so I will just go through those, although they are covered in more detail in the written answers.

As we note in the staff report itself, we assumed that the U.K. and EU authorities reach a broad free trade agreement and that the negotiations go smoothly, leading to an outcome that does not lead to a significant market disturbance. To put some meat on that assumption, we assume that non-tariff costs increase by about 7 or 8 percent as a result of the agreement, which we see as being the midpoint between a customs union such as what pertains now, which would be a zero increase in non-tariff costs, and a possible increase on the order of 15 to 16 percent. Again, we see this as a medium scenario.

On financial services, we assume that net exports of financial services to the EU decline by about 40 percent. When we refer to most financial services in the staff report, we are talking about 60 percent—so a 40 percent decline. This assumption is broadly consistent with the statement in the November 2017 European Central Bank (ECB) financial stability report that some services can continue to be provided from the United Kingdom, some will be provided from EU-domiciled entities instead, and some of the entities currently providing financial services out of the United Kingdom will relocate to the EU27 to continue serving their EU27 clients.

The ECB itself has assumed that there will be some mix of services, some migrating to the EU, some remaining in the United Kingdom. For our purposes, we assume that 60 percent remain; but this is an assumption, and it is subject to what comes out of the negotiations. As we go forward, we will continue looking at those assumptions and modifying as need be.

There was a broader question about the treatment of and assumptions about the financial sector in the staff report, particularly some of the statements that we make about supervisory arrangements. It is true that there are comments in the staff report about the implications of financial supervision outside the United Kingdom as well. In these, we largely pick up the language that was used in the 2017 euro area Article IV report, which notes that with Europe’s largest financial market leaving the single market, numerous activities could be transferred to the EU27, and oversight and regulatory capacity should be strengthened concordantly.

The coverage is also consistent with some of the language in the April 2017 Global Financial Stability Report (GFSR) box on Brexit, which noted that the greater complexity of financial firms will impose additional burdens on local regulators and that a share of U.K.-based derivatives activity may need to relocate, possibly forfeiting some economies of scale. There are clearly important implications and spillovers from what happens in the U.K. financial sector to the rest of the world. We touch on those in the staff report. The primary vehicle for those recommendations will clearly be the Fund's work on the euro area and the GFSR. As Directors have noted, there is an FSAP coming up for the euro area. In addition, the GFSRs are published regularly, so these are issues that we will continue to focus on, but I wanted to make clear where some of the staff report's recommendations about spillovers are coming from.

In terms of the realism of the assumptions and the extent to which the staff scenario may be optimistic or pessimistic, I would point again to the information that I gave at the outset of the meeting about the new Bank of England forecast in its inflation report that shows growth averaging about 1.8 percent over the next three years. That puts the staff's projections for the next three years firmly in the middle between the Bank of England's forecast of about 1.8 percent and the projections from the Office for Budget Responsibility. In terms of headline numbers, the staff is in the middle of those sets of forecasts, and it is very close to the consensus forecast of about 1.5 percent over the next few years.

These are all based on assumptions. As Directors have noted, what we assume now may not be realized, but this will be subject to negotiation. We will have many opportunities to redo these forecasts as the negotiations continue.

There was a question about the staff's assumptions on the impact of labor market developments, and it is the case that the staff's assumptions assume a continuation of current trends in the labor market. In particular, they are based on estimates of the working-age population produced by the U.K. Office of National Statistics. We do assume some decline in net inward migration by about one-third between now and 2023, to about 165,000 individuals a year, from close to 250,000 last year. This decline mostly reflects recent immigration trends. It is not an assumption about what will come out of the negotiations themselves.

As a benchmark to help think about this issue, there has been some discussion in the U.K. press about bringing net immigration down to about

100,000 individuals annually by 2023. If that were to occur, we would see output as being about three-quarters of a percentage point lower than in the baseline assumption. About two-thirds of that decline would come from the direct impact of just having fewer people in the United Kingdom and in the labor market.

Immigrants to the United Kingdom tend to have a higher participation rate and higher human capital levels, so there is a disproportionate impact on output from reduced immigration. The remaining one-third would come from the productivity impact, again reflecting both the higher human capital of migrants to the United Kingdom and the fact that with reduced immigration, it would be more difficult for firms to match precisely their labor force to the skills that they need.

There was a question about the net fiscal costs to the budget of the United Kingdom leaving the EU. We need to separate two costs in answering that question. There is the question related to the impact that lower growth would have on the budget, then there are more direct costs associated with leaving the EU, which would include things like the need to replicate some of the services that are currently being provided by the EU locally within the United Kingdom.

The U.K. authorities have set aside an initial allocation in the budget of about £3 million to cover those costs. Our baseline assumption follows the assumption of the Office for Budget Responsibility, which is that we assume that whatever gains the U.K. budget would realize from lower transfers to the EU are fully offset by whatever additional costs the country would face in picking up the activities that are now provided by the EU. On a net basis, we assume that the only budgetary impact at this point comes from lower growth. Clearly, as we have a better idea of what will come out of the negotiations, we will be in a better position to pin down more precisely what some of those costs are. When we have had conversations with the U.K. authorities on this, they have noted that there is a difference between transitional costs—the costs that would be associated with, for example, training additional customs officers to handle the increased burden that might come under a new customs arrangement—and the costs following that transition period, when it is simply a matter of paying the salaries of those customs agents. There is a short-term cost associated with the transition and a longer-term cost; and as we have a better idea of what comes out of these negotiations, we hope to have a better handle on what those costs would be and what the net impact on the budget would be.

The representative from the Strategy, Policy, and Review Department (Ms. Koeva Brooks), in response to questions and comments from Executive Directors, made the following statement:

> There was a question about the application of the Transparency Policy in the case of the correction. In this case, the risk assessment matrix now has a corrected label for the risk that the United Kingdom will leave the EU with no deal. That risk has been changed from high to low. This is fully consistent with the Transparency Policy, which is applied in an evenhanded manner across countries, across reports.
>
> The original label of high risk was an error, and that error was inconsistent with the staff's assessment of this scenario as a tail risk, which is also what is elaborated in the staff appraisal. Within the Transparency Policy, there is a category called factual errors affecting the presentation of staff analysis or views; and in this case, the correction was made under that category.

Mr. de Villeroché made the following statement:

> I thank the staff for these helpful clarifications and for the written answers. In the future, it will be better to have more conservative assumptions, or to have more details on the figures underlying the assumptions.
>
> In my initial reading of the report, and especially of paragraph 6, when the staff writes "most" financial services, I understand that as meaning almost all financial services will continue on a cross-border basis. However, this is not consistent with what I now understand about the baseline scenario, where net financial services exports to the EU will fall by 40 percent. I do not believe the report is very enlightening; and for outside readers, it would be hard to guess the underlying assumptions and what they imply.
>
> I would have preferred a more detailed scenario that encompasses all the difficulties, that acknowledges that it is a bet on the future of the negotiations. I hope there will be a better outcome than this scenario; but at least it will be more transparent and easier to understand what the Fund is assessing today.

Mr. Dajani made the following statement:

> We thank the staff for a complete set of answers, both written and oral. Coming back to the realism of the scenarios, it is important to clarify that

some of the criticisms are not related so much to the projections but rather to the assumptions of the scenarios. On this point, I would like to read two phrases from the written responses to technical questions, which literally say that the scenario assumes a new free trade deal with zero trade tariffs and moderate increases in non-trade tariffs, which the staff valued at about 7 to 8 percent. In addition, the current trading agreement with known and new economies seems to remain unchanged over the forecasting horizon. The written response states that with respect to the financial sector, some financial services will be provided on a cross-border basis.

What we were trying to explain is that this looks like a best-case scenario. If this is a baseline, it would be interesting to know what is the best-case scenario. That is the point that I believe Mr. de Villeroché has been trying to make, which is that we would have liked to have more scenarios that were quantitatively better specified so that we could better understand the different options.

Mr. Meyer made the following statement:

I second other Directors' sentiments on those issues. We discussed with the staff whether it would be possible to make some clarifications, especially with regard to paragraph 6 and paragraph 42. We argued it exactly the same way as Mr. de Villeroché. If one reads it, it is obvious that this is ambiguous because there is more information given. It would have been helpful to clarify was meant by the word "most," what was meant by the point on "a cross-border basis;" that this could be passporting; this could be equivalence agreements. Unfortunately we learned that it was not possible due to the Transparency Policy. This is not acceptable. My view is that it is ambiguous, and it is unfortunate that it has not changed.

The same holds true for paragraph 42. In all the documents, the staff highlights the point about preparing for the future relationship. There is a challenge for the supervisory capacity of European authorities in that they need to do something to prepare for that future relationship—and this is what Europeans are doing. The way it is first presented is ambiguous because it could indicate that the Europeans are not up to that task. It is quite unfortunate that the Transparency Policy does not allow the staff to clarify those elements. It would have been quite important.

Mr. Sobel made the following statement:

I had a somewhat unrelated minor issue, but I want to make sure the historical record is correct, at least from my standpoint. I listened with interest to Mr. de Villeroché. I heard him say that the United States opposed including financial services in the Transatlantic Trade and Investment Partnership discussions, and I just wanted to say that is not correct.

We always assumed there would be a financial services chapter when we were discussing that actively in Brussels. What we opposed was including financial regulatory issues in a trade agreement, as these are best handled among financial regulators with the appropriate expertise in long-established international fora for regulatory matters, such as the Basel Committee and the like.

Mr. Field made the following concluding statement:

This year's report is an excellent example of the kind of robust surveillance that we argue for in the United Kingdom. It focuses on the big issues and the risks facing the U.K. economy. The last time this Board discussed the United Kingdom was in June 2016, and I noted that some of the issues in that report on the housing market, fiscal vulnerabilities, low productivity, and the current account deficit, had been covered in previous Article IV reports. I also noted at the time that whatever the outcome of the referendum vote, I expected them to be covered in future surveillance. Inevitably, and I believe appropriately, there has been a significant amount of discussion and analysis of Brexit since the referendum, both at the Fund and at home; and a huge amount of government time and political attention is being devoted to the negotiations and the process of withdrawing from the EU. But given the likely duration of that process, it is right that the team retains its focus on some of these longstanding issues too.

Whatever one's views on the potential impacts of Brexit on the U.K. economy, it is clear that over the long term, it is the United Kingdom's productivity performance that will determine the living standards of its people; and therefore I welcome the focus on that issue in this year's Article IV report.

Turning to the discussion in the Board and in the gray statements, there has been some debate about the appropriateness of the team's assumptions. Mr. Gerson set out clearly why the staff has made its judgments. I do not think I need to add to that. What I would do is echo what Mr. Leipold said, that we need to cut them some slack. There is clearly great uncertainty about the outcome, and that makes forecasting a difficult process.

The scenarios that were presented in the 2016 Article IV report still stand, and people can refer to those.

As the Managing Director made clear in the press conference in London, the Fund's interest is in stability and growth. As such, the Fund has been arguing that we should be pursuing an agreement between the United Kingdom and the EU27 that minimizes the introduction of trade barriers and allows some time for the implementation of the agreement. That is what the Fund believes is in the best interests of all parties.

Clearly political factors will have a bearing on the eventual outcome of the negotiations and on the path, but it is right that the team has chosen in effect to set these on one side in trying to come up with its baseline.

Whether or not we agree about the forecast assumptions, the important thing is that the analysis is being done. In an environment where politics and political arguments are clearly going to play a significant role, the job of the Fund is to provide an impartial and informed economic analysis. Ultimately the choices for the United Kingdom and the outcome negotiated with the EU27 are for the politicians to decide, but it is important that we as technocrats, the Fund, and my colleagues in the U.K. civil service, are in a position to advise our ministers about the tradeoffs and the pros and cons of different options. The same goes for my colleagues in other European capitals advising their ministers.

The Fund's expertise can play an important role, and I welcome the decision of the team to focus on these questions. Similarly, as has been pointed out by a number of Directors today, we will have some choices to make about future policy frameworks, notably on our immigration policy; and it will be important for the Fund to make the economic arguments, and to make sure those economic arguments are heard as we make some decisions about those policies.

The next point I wanted to make was about spillovers. There is the possibility that Brexit could have spillovers and potential risks not just to Europe, but for the wider membership. That is particularly true because of the United Kingdom's status as a global financial center. The report highlights the potential for a significant increase in trade barriers, not just in the United Kingdom, but also other EU economies; and as Mr. Sobel noted, a more fragmented European financial system will imply costs to EU households and businesses and will require close cross-border regulatory and supervisory cooperation. Mark Carney has made clear in recent evidence to parliament that we are still in a learning process on the scale of the financial stability issues involved. Ms. Erbenova, who has great expertise in this area, recalls in her gray statement the fact that in the great financial crisis, issues often arose in unknown corners of the financial markets. I agree with her and others who have spoken today that this is an area that warrants further scrutiny. It may well be the conclusion of that work that the risks are modest or are well-managed. But returning to my earlier theme, it is important that the political judgments in the negotiations are based on a proper assessment of the risks associated with different outcomes.

In response to the point that Mr. Sobel made about this process, we should also recognize that there is a unique set of circumstances. We start from a point not just of regulatory alignment or regulatory equivalence, but one where we have exactly the same rules and regulations as our EU partners and a great deal of close cooperation with them. I would have thought we should be looking for ways to build on that for the mutual benefit of the United Kingdom and the EU but also the wider membership, because that is the best way we can preserve open markets and financial stability.

The report rightly focuses on preparations for Brexit and open contingency planning. I can assure everyone that that work is ongoing and intensive. The strength of the United Kingdom’s economic institutions means that it is well placed to respond to such risks, and the action taken by the Bank of England in the wake of the EU referendum vote is a case in point.

In that context, I would also welcome Directors’ recognition of the work undertaken since the financial crisis to enhance the resilience of the U.K. financial system. Clearly there is more work to be done, including on fiscal policy, where the government remains committed to achieving a balanced budget by the middle of the next decade. But we are cognizant of these issues.

Through these various actions, we aim to be well-prepared for whatever happens, but clearly an early agreement on a transition and cooperation with our counterparts in the EU will be fundamental to helping us manage those risks effectively; and with that in mind, I welcome the comments of many European colleagues on their countries’ desire to work toward a cooperative and mutually beneficial outcome.

I thank the team for what will be my last Article IV consultation sitting in this chair. I can assure them that the United Kingdom will continue to be a strong advocate for rigorous Fund surveillance after I have moved on; the reason being, it provides an independent assessment of our policies and risks and the implications for others. I would also welcome an informed challenge to my colleagues in London, but as I have said today, its role is all the more important in the current context: first, to make sure that the Fund is fulfilling its mandate in considering potential spillovers and stability risks associated with Brexit. Second, to make sure that while we in the United Kingdom get on with the process of managing our exit from the EU, we also retain our focus on the long-term issues that will determine the success of our economy. And finally, to ensure that in what will inevitably be a political process, the economic arguments are appropriately articulated and are listened to by people on all sides of the negotiation.

The Acting Chair (Mr. Lipton) noted that the United Kingdom is an Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They noted that output growth remains positive and labor market performance strong, notwithstanding the moderation in economic activity that reflects the impact of the exchange rate depreciation on consumption and the heightened uncertainty following the decision to leave the European Union (EU). This uncertainty will continue to weigh on growth, and the outlook depends crucially on the outcome of the negotiations with the EU. At the same time, significant risks remain, on both the domestic and external fronts. Directors agreed that policies should focus on maintaining stability and investor confidence, raising productivity growth and household saving, and reducing the current account deficit.

Directors welcomed the recent progress in negotiating the U.K. departure from the EU, which allowed discussion to move to issues related to a transition period and the framework for the future relationship. They encouraged both parties to continue their best efforts to reach the most beneficial outcome, limit disruptions and global spillovers, and more specifically, minimize barriers to trade, services, and labor flows.

Directors welcomed the authorities' plans to rebuild fiscal buffers in a gradual, growth-enhancing manner, alongside improvements in fiscal transparency practices. They noted that reforms on the revenue side would help create space and promote efficiency. With inflation above target, Directors supported the planned gradual withdrawal of monetary stimulus to bring inflation back to target over the medium term. They concurred that this balanced policy mix would also help the process of external rebalancing over time.

Directors appreciated the authorities' commitment to respond flexibly to shocks, with contingency planning in place for a range of outcomes. In the event of a disorderly EU exit, Directors encouraged the judicious use of flexibility embedded in the fiscal framework to support the economy, stressing that any easing of fiscal policy should be temporary, limited, and anchored by credible medium-term consolidation plans. Directors welcomed the monetary authorities' intention to stand ready to respond to developments as they unfold. They underscored that clear and timely communication will be particularly important in this regard.

Directors welcomed the resilience of the U.K. financial sector, owing in part to post-crisis regulatory reform. They encouraged the authorities to maintain robust prudential and supervisory standards, and continue monitoring consumer credit and bank risk weights. Directors commended the authorities for proactively helping financial institutions prepare for the exit, given the uncertainties regarding the future of financial service arrangements with the EU. They called on all parties involved to work together to mitigate transition risks related to changes in regulatory regimes and responsibilities. More generally, they underscored the importance of close cross-border cooperation in a potentially more fragmented European financial system.

Directors agreed that structural reforms should prioritize enhancing productivity, inclusiveness, and external competitiveness. They welcomed the planned increase in infrastructure investment and the improved framework for selecting and implementing infrastructure projects. They encouraged sustained efforts to strengthen human capital and boost housing supply. Directors looked forward to further progress in enhancing AML/CFT supervision and information sharing, building on recent reforms to improve corporate transparency.

It is expected that the next Article IV consultation with the United Kingdom will be held on the standard 12-month cycle.

APPROVAL: April 17, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook/Risks

1. ***Does staff have an assessment of the effect on GDP of their baseline scenario compared to GDP under a no exit scenario? Relatedly, we would appreciate staff's assessment of the EU Exit Analysis paper which indicated a free trade type arrangement would reduce GDP by 8 percent over 15 years compared with a no exit scenario.***

We appreciate it if staff could elaborate more on the implications of Brexit for different sectors, such as manufacturing and financial sectors. Which cities or countries could benefit from the possible relocation of some financial operations? Overall, what are the costs and benefits of Brexit for the United Kingdom?

While we appreciate the focus of the policy discussions on the Brexit and the impact of an U.K.-EU agreement, we missed an analysis of the status and prospects of the United Kingdom's trading relationship with non-EU economies and we would appreciate staff elaborations on any recent development. In this context, we noted from ¶9 that staff considers that new trading arrangements with these countries could affect positively the level of potential output in the United Kingdom. Since such agreements would take time to finalize, could staff elaborate on the cost for the United Kingdom of reverting to WTO rules?

We are interested in staff 's assessment of a comparison of the effect on GDP of the baseline scenario compared to a no exit scenario.

We would be interested in staff's assessment of the growth effect of a tail-risk scenario. Such scenario may include protracted negotiations on Brexit—which would exacerbate uncertainty—or a Brexit that results in non-zero tariffs and increased non-tariff barriers on trade with the EU. Sectors such as manufacturing, agriculture and tourism—which incidentally seem to rely on immigrant labor force—could be significantly affected under such a scenario, with an impact on overall growth.

We note that staff estimates that a moderate increase in non-tariff costs would reduce EU output by about ¼ percent in the long run. Could staff comment on the possible impact on the U.K. economy of an increase in non-tariff costs, particularly on the financial services sector.

Given the uncertainties, we encourage staff to do an exit scenario analysis on the U.K. economy.

- In the baseline scenario, staff assumes that the United Kingdom exits the customs union and the single market, in line with policy intentions announced by the U.K. authorities. The scenario assumes that a new free trade deal will be agreed by the United Kingdom and the EU authorities, with zero trade tariffs and a moderate increase in non-tariff trade costs. It also assumes a smooth transition to the new arrangement. In addition, the current trading agreements with non-EU economies are assumed to remain unchanged over the forecasting horizon.

- With respect to the financial sector, it is assumed that EU and U.K. financial firms continue to provide some financial services on a cross-border basis over the forecasting horizon (for example through equivalence arrangements for some financial services), while others be provided by EU and U.K.-domiciled entities instead (including subsidiaries of foreign firms). Specifically, the baseline scenario assumes a reduction of the United Kingdom’s net financial services exports to the EU by about 40 percent by the end of forecasting horizon.
- With respect to the manufacturing sector, the overall impact from higher tariffs on GDP is very small since the United Kingdom runs a goods trade deficit. However, the impact is uneven across subsectors. For example, textiles and chemicals manufacturing firms would be affected more than other sectors since the potential non-tariff and tariff trade barriers are higher. In addition to the direct effect from higher trade barriers, gross FDI inflows could decline, weighing down on economic activity.
- The migration assumptions underpinning the baseline forecast are taken from the 2016 population projections by the U.K. Office for National Statistics. The projection entails a decline in net inward migration from 246000 per year in 2016/17 to 165000 per year by 2023. The projection is based on trends and does not take a position on the likely Brexit effects. The staff’s use of this projection in the baseline is consistent with staff’s assumption that there will be a transitional period during which the migration regime will not change, therefore any new restrictions on migrations flows will have little effect over the 5-year forecasting horizon (though they may have a significant effect over the longer run). The latest forecast by the Office for Budget Responsibility is based on the same population projections.
- The conditioning assumptions for the baseline scenario do not represent a judgement on what is the most likely outcome of the negotiations.
- The medium-term level of output in the baseline scenario is about 3 percent lower compared to a no-Brexit scenario. According to staff analysis presented in the 2016 selected issues paper (SIP), a tail risk scenario of a disorderly Brexit with reversion to WTO tariff schedules would generate a peak output loss of about 5½ percent relative

to a no-Brexit scenario, of which part would be temporary but most would be permanent. This analysis did not account for any negative migration effects. A decline in net migration over the medium term to 100000 per year (from 165000) would reduce GDP further by 0.5 percent. The effect may be greater if migrant workers are more productive than domestic workers on average. Therefore, compared to our baseline, a disorderly Brexit could have an additional effect of up to 3 percent of GDP.

- It is difficult to say which cities could benefit from the possible reallocation of some financial operations at this stage. The long-term benefits of renegotiating trade arrangements with non-EU trading partners would depend on the specifics of the new arrangements.
- A large number of studies have been conducted by various entities assessing the potential economic impact of Brexit using different horizons and methodologies. A summary of studies cited in the 2016 SIP gives a range of 2.2 and 9.5 percentage points output loss for a “no deal exit” (with one study showing 14 percent long-term loss). We cannot provide an assessment of the leaked results from the EU Exit Analysis since the paper has not been published, but the results quoted in press accounts are consistent with those coming from other studies.
- The baseline assumes that trade arrangements with countries outside the EU remain unchanged relative to the status quo over the 5-year forecasting horizon. This is consistent with the fact that new trade arrangements typically take several years to be negotiated. The U.K. authorities have recently asked non-EU countries to preserve their current trade arrangements during the transition period.
- We have corrected the likelihood of “Leaving the EU with no deal” in the RAM to low (10 percent probability or less), which is consistent with its description as a tail risk in the main text. It is very difficult to attach a probability range to this scenario, and the perceived probability changes over time. We have classified the risk as low based on our assessment that a no deal outcome would have significant negative economic consequences for both parties and is therefore unlikely to be the result of the negotiations.
- The 2016 Article IV SIP (page 36) analyzes negative spillovers from the United Kingdom to the rest of the world under both a limited scenario (corresponding to an EEA type arrangement) and an adverse scenario (WTO schedules). The results suggest output falls by about
  0.2 to 0.5 percent below the baseline in the countries in rest of the EU; and by 0 to 0.2 percent in the rest of the world. The variation in output losses across individual economies reflects differences in their trade and financial exposures to the United Kingdom.
- The potential output has been recalculated relative to the 2016 staff report, taking into account: (1) the latest ONS population projection (2016) which have lower projections for net international migration over the medium term, and (2) lower actual and projected labor productivity growth (as discussed in Box 1).

- Cyber attacks pose a growing threat to the stability of the provision of U.K. financial services. The U.K. authorities have been proactive in managing these risks, mandating that firms at the core of the U.K. financial system regularly complete cyber attack resilience tests and develop individual cyber resilience action plans (see Box 7 in the Bank of England's June 2017 Financial Stability report for details on the recent policy actions). To mitigate the systemic financial stability risks associated with cyber attacks, the U.K. authorities are currently designing regulation to safeguard the capacity of the financial system to respond to and recover from a major cyber attack.
- In case of a hard Brexit, there is some fiscal space to help smooth the adjustment. The appropriate monetary policy response would depend on the relative shifts of supply and demand, the change in the exchange rate, as well as the stability of inflation expectations, and could involve tightening or loosening.
- The smoothing of the consolidation path reflects a weaker growth forecast and a policy decision to increase public investment to support potential growth, while continuing to make progress towards the framework's objectives. The staff emphasizes that steady fiscal consolidation remains critical to set the public debt ratio on a downward path, rebuild buffers against future shocks, and help reduce the current account deficit (paragraphs 19 and 53). Moreover, staff suggests that additional revenue measures may be needed over the medium term to balance the budget by the mid-2020s.
- This analysis was part of the 2016 staff report. The difference in pension spending under the triple lock scheme and CPI indexation is estimated based on simulated mean growth rates under the two different indexation schemes.
- We have not included in our baseline a one-off "divorce bill" as precise numbers and modality of payment are still to be determined. We have instead followed the OBR practice of assuming that amounts equivalent to the net payments to the EU remain in the budget over the forecast horizon: where they are not paid to the EU, they are spent domestically.
- The role of the U.K. tax and benefit systems in reducing inequality is in line with OECD average (OECD, 2015). Some of the tax reform proposals in the staff report could be implemented while fully compensating low-income households and leaving additional funds for antipoverty spending.
- On fiscal policy, structural developments (population aging, productivity growth) argue in favor of adopting revenue measures to meet the objective of balanced budget over the medium-term. The wide-ranging tax reforms recommended by staff—covering VAT rates, the tax code's bias, the orientation of property and labor taxations—should help meet this goal while reducing economic distortions. We invite staff to further elaborate on the authorities' view on these recommendations.
- On the composition of consolidation, the authorities view their plans as supporting growth by facilitating a competitive, lower-tax economic environment and intend to continue to rely on expenditure restraint to reduce deficits in the near term, while

prioritizing spending in key areas such as health, science, education, and infrastructure investment.

- The U.K. government plans to ensure financial regulatory continuity through Brexit with the EU Withdrawal Bill and related secondary legislation. This will largely transpose the EU law applicable to U.K. financial services into U.K. law. The authorities told us that they have made significant progress in transposing the relevant financial regulations.
- The latest available consistently defined aggregate NPL ratio for the U.K. banking system is 1.0 percent in 2017Q1. This NPL ratio has remained broadly unchanged since end-2015.
- To manage the financial stability risks associated with rapid consumer credit growth, the U.K. authorities gave guidance to regulated lenders on strengthening loan underwriting standards. They also raised PRA capital buffer requirements for some firms based on information from the stress test results, taking into account the uneven distribution of consumer credit related risk exposures across lenders.
- Central counterparties (CCPs) based in London currently clear about 90 percent of euro-denominated derivatives. Currently the supervisory and regulatory arrangements for the clearing of euro-denominated derivatives are under review and discussion by the European authorities. If EU banks lose the ability to clear euro-dominated derivates on U.K.-based CCPs post Brexit, they will need to migrate any existing contracts to a EU clearing house, which would involve transition costs. As noted in the staff report, a geographical fragmentation of derivatives clearing may result in netting efficiency losses. These and other issues will be covered in more detail in the forthcoming EA FSAP.
- The low profitability of U.K. banks since the GFC has primarily reflected low investment banking returns and legacy misconduct redress costs, and to a lesser extent compressed lending spreads. Investment banking profitability has been depressed worldwide; it is difficult to predict how it will evolve going forward. Misconduct charges are expected to decline over time as major legacy cases get resolved, while banks intensify their mitigation and avoidance measures. Lending spreads are expected to widen as monetary policy normalization proceeds, with banks passing through policy rate increases more to lending than to deposit rates.
- As noted in the selected issues paper, there are significant costs associated with the British planning system, which affect house prices (Hilber and Vermulen 2015, Ball et al. 2009, Chesire and Hilber 2009). Relaxing regulatory constraints, including land use regulations, could help improve the affordability of housing by reducing costs and increasing housing supply. A recent Housing White Paper commissioned by the government identifies other factors constraining housing supply, such as weak competition and low productivity in the construction sector and lack of long-term planning by local authorities. Therefore, policies supporting competition and innovation in the construction sector, and encouraging better local governance would also support housing supply. Property tax reform along the lines discussed in the 2015

selected issues (i.e. reducing council tax discounts and reliance on transaction taxes) could promote a more efficient use of the housing stock and help ease supply constraints.

- Some measures supporting factor reallocation across firms and industries might be warranted. Policies targeting retraining of workers and facilitating the adjustment of firms to the new regime—such as providing guidance on compliance with the new rules and allowing firms enough time to adjust—would help smooth the adjustment.
- The government has published the general principles of its industrial strategy, which includes a combination of horizontal (economy-wide) and vertical (targeted towards specific sectors or localities) policy proposals. The staff has done a preliminary assessment of the proposed policies in the selected issues paper “Regional Disparities in Labor Productivity in the United Kingdom” (section C), with the following conclusions and recommendations.

2. ***The staff report has elaborated on the impact of Brexit on other EU members, and we would appreciate staff assessment of potential impact on the 60 countries with which the EU has preferential trade agreements, in particular in Sub-Saharan Africa and South and East Mediterranean.***

3. ***As the RAM highlights that both the risk and impact of “leaving the EU with no deal” is high, the staff report would have benefited from assessing a range of outcomes and the effects on the U.K. economy and potential spillovers on its main trading partners. The staff’s comments would be welcome on the range of outcomes.***

We would appreciate staff’s clarification of their definition of “tail risks” in their assessment of the likelihood of a disorderly Brexit. While we understand political sensitivity of the language in the report, we believe that staff should be as realistic as possible under the highly fluid circumstances.

4. ***In view of the Brexit consequences mentioned in paragraph 7 of the staff report and lower labor force and employment growth due to a sharp decline in net migration from the EU, has the potential output been recalculated?***

5. ***We recognize that AIV reports face constraints on their length, but if cyber risks are important enough to be included in the RAM – and we accept that they are – some discussion of the related policy advice should feature in the main body of the report. The staff’s comments would be welcome.***

Fiscal Policy

6. ***Can staff quantify the potential gains of the tax measures identified in paragraph 22*?**

- The staff's recommendation to scale back distortionary tax expenditures, and move towards a more equal treatment of employees, the self-employed, and corporations, can reduce economic distortions and have a positive impact on public finances.

- Tax expenditures in the United Kingdom are relatively high by international standards (IMF Fiscal Transparency Report 2016). The government estimates that total tax expenditures equal about 7.1 percent of GDP, though some of these have economic justification and not all are distortionary. Tax relief on value added taxes is the largest item
(2.6 percent of GDP). The range of goods with a zero-rate is high in the United Kingdom compared to other EU countries (Mirrlees Report, 2011). The fiscal impact of broadening the VAT base would depend on the extent to which the personal tax and benefit system is adjusted to address the distributional and work incentive consequences of the change. A simulation presented in the Mirrlees report (2011) suggested that extending VAT at the standard rate (17.5 percent at the time of the study) to all goods would allow the government to make each household as well off as it is in the baseline, and still have around 0.2 percent of GDP of revenue per year left over.
- The self-employed pay around £3 billion a year in National Insurance Contributions. IFS (2017) estimates suggest that if the self-employed were treated the same as employees, they would pay £8 billion a year. This amounts to higher annual revenues of 0.25 percent of GDP, which would increase over time if the post-crisis trend increase in self-employment were to continue. Levelling the playing field with corporations could provide additional resources. In 2016, the OBR estimated that the rapid expected growth in owner-managed companies would reduce revenues by £3.5 billion 2021–22 relative to a scenario in which small companies and employment grew at the same rate.

- The staff's recommendations to reduce the tax code's bias towards debt and to rebalance property taxation away from transactions are justified on efficiency and financial stability grounds and could be designed to be broadly revenue neutral.

7. ***We would appreciate more information on the technical aspects of the transition period regarding financial flows between the government and the European Commission and the magnitude of these flows. Also, it would be useful to have an estimate of the costs of the capacities that need to be rebuilt at the national level.***

- The ONS estimates that the U.K. net contribution to the EU (net of the U.K. rebate and EU funded public sector credits such as the European Regional Development Fund, and the European Agricultural Guarantee Fund) has been around £10bn sterling per year on average in recent years. In addition, the U.K. private sector also benefits from EU transfers (for example to fund research in U.K. universities). ONS data does not separately identify direct flows to the U.K. private sector. Based on European Commission data that includes credits from the EU to U.K. public and private sectors, the United Kingdom's average annual net contribution over 2012–16 was £8.1bn.
- The authorities reached an agreement in December on a methodology to determine the financial settlement, including a list of components and a broad set of principles for calculating the value of the financial settlement and payment modalities. The details of the financial settlement are an issue for the British and European authorities to determine. In our baseline, we have not included a one-off "divorce bill," as precise numbers and modality of payment are still to be determined. We have instead followed the OBR practice of assuming that amounts equivalent to the net payments to the EU remain in the budget over the forecast horizon: where they are not paid to the EU, they are spent domestically.

- Estimating the cost of the capacities that need to be rebuilt at the national level is difficult, as the needed capacity would depend on the outcome of the negotiations between the two parties.

8. ***While the temporary use of fiscal space in contingent situations is reasonable, does staff consider the fiscal headroom of £15 billion available with the authorities in 2020–21 sufficient to mitigate permanent output shocks in the event of 'no-deal' Brexit?***

- The fiscal framework allows several layers of flexibility to provide temporary support in case of a shock. First, the net borrowing ceiling exceeds the current medium-term deficit projections by about 0.9 percentage point of GDP. Second, the interim target is defined in term of the cyclically-adjusted deficit, allowing room for automatic stabilizers to operate. Finally, the framework includes an escape clause allowing the Treasury to review the appropriateness of its interim targets in the event of a significant negative shock.
- However, as noted in the staff report, a permanent decline in the level of output would require an eventual fiscal adjustment to maintain sustainability. Moreover, fiscal space may become more restricted in practice if the shock affects confidence and raises risk premia. Therefore, any policy easing should be limited, temporary and anchored by credible medium-term fiscal consolidation plans.

9. ***Could staff comment on the hierarchy of fiscal and monetary policies that is best suited to managing the economic consequences in the likely event of hard Brexit?***

10. ***U.K. fiscal policy is more flexible since the last Article IV, and the fiscal consolidation speed was mitigated. Although debt and fiscal deficits are smaller than in other AEs, such as the United States and France, it is important to consider reducing them, due to the highly sensitive fiscal position with regards to macroeconomic shocks. In the same vein, rebuilding buffers would protect against future shocks and reduce the current account deficit. The staff's comments would be appreciated.***

11. ***To reduce demographic spending pressures, the staff proposes to remove the "triple lock" guarantee on state pensions. Would the staff explain the simulations made to reach this conclusion?***

12. ***Do the debt sustainability projections include the disbursements under the financial settlement with the EU?***

13. ***We would appreciate staff's comments on the scope for introducing more progressivity in the tax system with a view to reducing inequality.***

14. ***In addition to the current spending restraint, we concur with staff that additional revenue measures, particularly growth-friendly tax reforms, are needed to balance the budget in the medium term. This is particularly important given the potential rise in demographic-related spending, given United Kingdom's aging population problem. In this respect, we would like to invite staff to provide further explanation on the authorities' plan to adopt staff's proposed tax reforms.***

Monetary Policy

15. ***On monetary policy, we noted from the February 8, 2018 Bank of England's Monetary Policy Committee (MPC) communiqué, that based on the recent Inflation Report projections "monetary policy would need to be tightened somewhat earlier and by a somewhat greater extent over the forecast period than anticipated at the time of the November Report, in order to return inflation sustainably to the target." We consider this indication as consistent with staff's view in paragraph 28 that "a more accelerated pace of interest rate increases would be warranted if inflation expectations become unmoored or domestic cost pressures increase faster than expected." Could staff clarify our understanding that this indeed is the case?***

- Indeed, the Banks's view that "monetary policy would need to be tightened somewhat earlier and by a somewhat greater extent over the forecast period than anticipated at the time of the November Report, in order to return inflation sustainably to the target" is consistent with staff's recommendation. In the February inflation report, the Bank of England revised growth up to 1.8 and 1.7 percent for 2018 and 2019 respectively, which implies higher excess demand and higher domestic cost pressures compared with the assessment in the November inflation report.

16. ***The Term Funding Scheme, introduced in 2016 to strengthen the passthrough from the policy rate to lending rates, is to be discontinued this month. Has this policy fulfilled its objective? The staff response would be appreciated.***

- Market participants noted that the TFS has helped lower borrowing costs and increase the availability of credit. Indeed, lending rates for households and non-financial corporates have declined following the stimulus package announced in August 2016, although it is difficult to disentangle specifically the contribution of the TFS from the other policy measures taken at the same time.

Financial Sector

17. ***Could staff inform about the progress made by the authorities so far in harmonizing EU financial regulation with the U.K. law?***

18. ***We see in the table on page 17 of the staff report, Financial Soundness Indicators for Major U.K. Banks, that there are no figures for 2017 on non-performing loans (NPLs). Does the decreasing trend for NPLs continue in 2017? The staff's comments would be appreciated.***

19. ***We note that the pervasive uncertainty seems not to have affected consumer credit, whose rapid growth may signal a loosening of credit standards. The staff's comments on the recent measures adopted by the authorities are welcome.***

20. ***Could staff elaborate what are the most salient issues in the cross-border swaps, futures, and repo markets, and the possible migration from U.K.-based central counterparties which constitute these risks, as well as whether these themes will be taken up in the Spillover Report and other multilateral surveillance products?***

21. ***We note that bank profitability remains subdued after the GFC. Could staff comment the background of the low profitability and outlook of profitability in the future?***

Structural Reforms and Regional Disparities

22. ***We therefore encourage the authorities to make every effort to restore housing affordability of the productive areas. In this regard, we would like to hear staff's long-run policy advice, especially supply side measures, in detail.***

23. ***Other than housing sector, there may be a need for governmental support to certain segments of industries including SMEs which may be severely affected by the Brexit. Are there any possible measures to be adopted in this regard?***

24. ***We would be interested in more details on the authorities' embrace of industrial policy. While staff warned against any attempts to pick up losers and winners among the sectors and geographic areas, we would be interested to hear more about the safeguards established by the authorities to prevent slippages in this complex area of government activities. It would be useful to compare the British authorities' approach with that of the authorities in Ireland in the aftermath of the financial crisis.***

- The horizontal initiatives are in line with staff's assessment of structural priorities: improving skills and addressing the chronic underinvestment in infrastructure and R&D and infrastructure spending.

- Policy intervention should be based on an understanding of the market friction it seeks to address. This is particularly important for interventions targeting specific sectors or localities. A set of transparent rules for intervention, and evidence-based evaluation both ex-ante and ex-post, could play an important role guarding against the risk of arbitrary policy intervention in the economy driven by vested interests (Banks 2015, Crafts 2017, and Valero 2017). Selective industrial policy is currently generally limited by the EU state aid framework, but this may potentially change when the United Kingdom leaves the EU.

- A strong institutional framework is important to give the industrial strategy stability and protection from the political cycle. For instance, the LSE Growth Commission (2017) recommended that industrial policy should be given a new law or long-lasting mandate, and independent decision-making or oversight, and enhanced transparency and accountability.

- As the government's industrial strategy is still being fleshed out, it is difficult to compare specific approaches with other country experiences at this point.

25. ***Regarding the recommendation on structural reforms, could staff provide further explanation on the sequencing and prioritization of their recommended structural reforms?***

- Given the United Kingdom's persistently low productivity growth, relatively low public R&D and infrastructure spending, staff's advice is to prioritize reforms in these areas. This is consistent with the authorities' reform plans and measures announced over the last few years.

- At the same time, it is important to note that structural reform priorities differ on a regional level: addressing congestion and housing restrictions is most important for more successful regions, while other regions should focus on increasing human capital and improving transport.

- Measures to address housing supply can be implemented in parallel to other reforms. Housing affordability remains a significant issue, although house price growth has eased since mid-2016 (especially in London and the South East).