United Kingdom: Staff Concluding Statement of the 2023 Article IV Mission

May 23, 2023

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

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

Washington, DC: Buoyed by resilient demand in the context of declining energy prices , the UK economy is expected to avoid a recession and maintain positive growth in 2023. Still, economic activity has slowed significantly from last year and inflation remains stubbornly high following the severe terms-of-trade shock due to Russia's war in Ukraine and, to some extent, labor supply scarring from the pandemic. Monetary policy will need to remain tight in order to keep inflation expectations well-anchored and bring inflation to target. Fiscal policy should continue to be aligned with monetary policy in the fight against inflation, while protecting key public services and the vulnerable. The UK financial system has weathered the recent global banking stress well. Continued strong oversight, including of smaller banks and the diverse non-bank financial sector, will be critical to preserve UK financial stability, which the IMF sees as a global public good. Realizing the UK's full growth potential will require wide-ranging, further evidence-based reforms, including addressing the post-pandemic rise in labor inactivity, mainly due to long-term illness; removing impediments to business investment, especially policy and regulatory uncertainty; and enhancing public investment and transformational spending to boost productivity and accelerate the green transition.

Economic Outlook and Risks

The outlook for growth, while improving somewhat in recent months, remains subdued. Staff forecasts growth to slow to 0.4 percent in 2023, held back by tighter monetary and fiscal policies needed to curb inflation, and lingering impacts of the terms-of-trade shock. This latest forecast represents a 0.7 percentage point upgrade to the IMF's April World Economic Outlook forecast of -0.3 percent and reflects higher-than-expected resilience in both *demand* (stronger wage keep-up with inflation, a less contractionary fiscal stance in 2023, and improved confidence amid somewhat reduced post-Brexit uncertainty) and *supply* (declining energy costs and normalization of global supply chains). Growth is projected to rise gradually to 1 percent in 2024, as disinflation softens the hit to real incomes, and to average around 2 percent in 2025 and 2026, mainly on the back of a projected easing in monetary and financial conditions. Thereafter, growth is projected to settle at 1½ percent (staff's estimate of trend growth). Declining energy prices and widening economic slack are expected to substantially reduce inflation to around 5 percent y/y by end-2023; and below the 2 percent target by mid-2025.

Risks are considerable in the period ahead. The major near- to medium-term risk is greater-than-anticipated persistence in price- and wage-setting, which would lead to higher inflation for longer. Should such upside risks to inflation materialize, headwinds to growth would likely be intensified by tighter demand-management policies needed to combat inflation; and/or a drift-up in inflation expectations, which could lead to a re-pricing of long-term financial assets, with adverse macro-financial spillovers. Downside risks also include a further tightening in global financial conditions that restrains credit and trading partner demand. The impact on growth would be amplified if there is contagion to the UK financial sector and/or if adverse macro-financial feedback loops, such as a housing market correction, are triggered.

Macroeconomic Management Priorities

The authorities have acted decisively to fight inflation. The Bank of England (BoE) was the first major central bank to lift its policy rate (in December 2021) and has since hiked Bank Rate by 440 basis points, moving it from substantially below, to sizably above, staff's estimate of the neutral interest rate. The BoE was also the first to undertake quantitative tightening (QT), which commenced in March last year with passive run-off and accelerated in November with active gilt sales. Given transmission lags, sizable rate hikes implemented since August are expected to have their peak impact on demand and inflation from the second half of 2023. Fiscal policy has also appropriately rotated to consolidation mode, supporting disinflation, and successfully re-establishing credibility following the September 'mini-budget' stress episode.

But inflation is showing greater-than-expected persistence. Inflation momentum, measured with annualized 3-month core inflation rates, remains strong, at about 5 percent in March. Measures of underlying inflation—such as services inflation and firms' price and wage-setting expectations—also remain well above the 2 percent target. Staff's analysis of historical inflation shocks indicates that high inflation is often persistent, especially in the aftermath of large terms-of-trade shocks, and cautions about the high prevalence of "premature celebrations," characterized by a decline in inflation as the initial shock dissipates, only to reemerge or plateau at an elevated rate.

Monetary policy will need to remain tight to keep inflation expectations well-anchored and bring inflation back to target. Inflation is projected to return to the 2 percent target only by mid-2025, 6-months later than in staff's April forecast, and risks to this trajectory are tilted to the upside. Accordingly, some further monetary tightening will likely be needed, and rates may have to remain high for longer to bring down inflation more assuredly. This said, elevated uncertainty about the macroeconomic outlook and inflation persistence merits continuous review of the pace and magnitude of monetary tightening. The BoE should continue to focus on underlying measures of inflation—such as wage growth and services inflation—and see-through base effects in energy prices, which would entail a material decline in headline inflation in the coming months, but which may not be sustained.

The QT strategy should continue as envisaged. Shrinking the BoE's balance sheet would help reduce its footprint in financial markets and establish headroom for future asset purchases in case adverse shocks materialize. As the medium-term target range for the BoE's balance sheet hinges on considerations about needed system-wide reserves, which are subject to uncertainty and can change over time, staff sees advantages in the BoE's incremental approach to shrinking its balance sheet while relying on Bank Rate as the key monetary policy instrument.

The last two budgets have aligned fiscal policy with monetary policy in the fight against inflation and should stabilize debt. The authorities have set out a medium-term fiscal consolidation path that envisages, under staff's forecast, a 3 percent of GDP headline deficit reduction between FY2022/23 and FY2027/28, with public sector net debt (excluding the BoE) stabilizing at 97 percent of GDP at the end of the forecast period. With a close-to-neutral fiscal stance in 2023, and a contraction thereafter, fiscal policy is supporting monetary policy in lowering inflation. The balanced composition and gradual phasing of the planned consolidation should help soften the impact on near-term growth while reducing fiscal imbalances.

Fiscal policy should stay the course by adhering to the announced consolidation path. In the near term, saving any revenue overperformance—which would likely portend resilient demand and inflation persistence—would avoid complicating the task for monetary policy, and would also help rebuild fiscal buffers that have been eroded by a succession of adverse shocks. Given the recent easing in energy prices, it would be important to ensure that the Energy Price Guarantee scheme expires as planned, and that any future support—in the event of resurgent energy prices—is well-targeted. To this end, investing now in data and IT systems could help the authorities reach vulnerable households outside the welfare system in the future.

Over the medium term, the fiscal strategy will need to take better account of spending pressures to preserve service delivery, and investment needs to enhance the growth potential. The Spring Budget assumes expenditure envelopes after FY2024/25 that, under realistic allocations for public services such as health, education, welfare, pensions and security could imply large reductions for some departmental budgets. Moreover, additional funding will likely be needed to account for possible pay agreements in the context of ongoing industrial action; address well-known challenges in the National Health Service (NHS) and social care; and enhance the growth potential via public investments in skills, innovation, infrastructure, and the green transition.

Accommodating these critical needs, while delivering the announced medium-term consolidation, will require structural expenditure savings and high-quality revenue measures. To this end, we see opportunities in replacing the triple lock on pensions with the best practice of inflation-indexation; strengthening carbon taxation to more assuredly deliver the UK's ambitious Net Zero targets; reforming property taxes, including by updating real estate valuations and rebalancing away from transaction taxes which constrain housing and labor mobility; and improving the efficiency and fairness of the tax system by eliminating loopholes in wealth and income taxation, and national insurance contributions.

The calibration of macroprudential policies is finely balanced but continued monitoring of credit conditions and financial stability risks is warranted. The current credit downturn is showing signs of bottoming out. Household and corporate balance sheets have thus far shown resilience to the economic slowdown and rise in interest rates. However, corporate insolvencies have risen, and pressures have intensified in the mortgage and commercial real estate markets. Against this backdrop, staff supports the BoE's Financial Policy Committee's (FPC) decision to keep the countercyclical capital buffer (CCyB) at 2 percent for now but encourages continued close monitoring of credit conditions and financial stability risks to calibrate the buffer going forward. At the same time, strengthening the BoE's top-down stress testing capacity, as recommended by the 2022 Financial Sector Assessment Program (FSAP), will provide more timely analyses of systemic risks.

Recent global banking stress events underscore the importance of continued strong regulation and supervision of all banks. Major UK banks maintain capital and liquidity buffers well above prudential requirements, which should allow them to endure significant stress. The Prudential Regulation Authority's (PRA) intensified liquidity monitoring in the wake of recent global banking stress is welcome. Staff encourages the authorities to deepen their understanding of depositor behavior via expanded data collection and analysis. This will help inform any future international policy deliberation on the liquidity coverage ratio (LCR), as well as potential adjustments to domestic stress testing with a view to informing liquidity risk assessments. Separately, the PRA is working on a new Strong and Simple Framework to simplify the prudential framework for non-systemic domestic banks and building societies while maintaining their resilience. As recommended in the 2022 FSAP, the PRA should carefully weigh pros and cons before amending supervisory requirements for smaller banks.

The BoE's financial stability intervention swiftly restored market functioning during the pension funds' liability-driven investment (LDI) crisis last fall. Several factors contributed to the success of the intervention, notably, timely market intelligence; close coordination among key stakeholders, including overseas regulators; the use of reserve pricing for gilt purchases, which helped distinguish the operation from quantitative easing (QE); and firm public communication on the temporary/targeted nature of the intervention, which reinforced the needed swift actions from pension funds to recapitalize their LDI strategies, and curtailed moral hazard. Staff also welcomes the authorities' more recent actions to strengthen the resilience of LDI funds to large interest rate increases and supports the FPC recommendation that the remit of The Pension Regulator (TPR) take into account financial stability considerations.

The episode nonetheless calls for a redoubling of efforts, including globally, to reduce non-bank financial institution (NBFI) vulnerabilities. Further policy actions are needed to: (i) strengthen NBFI liquidity (domestically, but also in coordination with the Financial Stability Board (FSB) and other jurisdictions) via enhanced liquidity management and operational readiness to face margin calls, and more stringent liquidity regulation of NBFIs holding leveraged exposures in core markets; (ii) improve the understanding of risks posed by NBFIs, including through the authorities' ongoing "system-wide exploratory scenario"; (iii) close data gaps, which requires securing enhanced cooperation among national regulators and coordination with other major jurisdictions and the FSB; and (iv) consider allowing the extension of BoE liquidity backstops to NBFIs that are systemically important and adequately supervised.

Reforms to Enhance Policy Frameworks

The fiscal framework should be further strengthened by drawing on the experience of the 'mini-budget' stress episode. Staff recommends that all major discretionary fiscal policy changes be accompanied with a full set of macroeconomic and fiscal forecasts by the Office for Budget Responsibility (OBR), unless the OBR assesses that such a forecast is not necessary. A mechanism could also be established for the OBR to provide to parliament an analysis of the impact of any proposed changes in the fiscal rules before these are voted upon. Moreover, better defined escape clauses (with clear conditions under which the rules could be suspended and reactivated) would help avoid the potential loss of credibility associated with very frequent changes to the rules. In this context, building on the UK's strong institutions, the authorities could also consider the case for a framework anchored in the probability of debt stabilization that has the potential to be stabler, while also providing somewhat greater flexibility.

Recent bank resolutions have highlighted opportunities for further strengthening resolution frameworks. The BoE effectively used its resolution powers under the 2009 Banking Act to facilitate the sale of Silicon Valley Bank (SVB) UK to HSBC UK Bank plc, which fully protected all SVB UK depositors without any cost to the taxpayer. However, as shown by the recent global banking stress, the observed high speed of deposit withdrawals, the risk of significant disruptions to businesses holding uninsured deposits, and the lack of loss-absorbing capacity (for example via Additional Tier 1 or 2 bonds) held by smaller banks, have emerged as complicating factors for effective depositor protection in a resolution scenario. In this context, the authorities are considering options to improve their approach to depositor payouts in case of bank failure. Reforms in this area should be supported by careful analysis of depositor data and possible moral hazard implications. In this context, as recommended in the 2022 FSAP, the Financial Services Compensation Scheme should build up a prefunded deposit insurance fund with an appropriate target level, to expand its financial firepower with sufficient funds under its direct control and investment.

The financial regulatory reforms currently in train are ambitious and should preserve the primacy of financial stability, safety and soundness, and market integrity objectives. While many details on the reforms are still pending, staff stresses that any reforms should: (i) safeguard, in line with FSAP recommendations, the primacy of the FPC's financial stability objective and strengthen its focus on global financial standards and cross-border surveillance; and (ii) allow for adequate time for consultation and consideration of proposed changes, to produce balanced outcomes on stability vs. innovation, with competition and innovation mandates subordinate to that of financial stability. In this regard, any adjustment to the ring-fencing regime for banks should be carefully weighed; and the review of the Senior Managers and Certification Regime (SMCR) should maintain its robustness.

Structural Policies to Uplift Growth and Accelerate the Green Transition

The authorities are cognizant of, and taking measures to, address the UK's long-term challenges of weak labor supply, investment, and productivity growth. The Spring Budget set out supply-side measures, notably the increase in childcare support and the introduction of a capital investment allowance, which should have a positive effect on medium-term growth. Moreover, the recent decline in uncertainty due to the "Windsor Framework" agreement and a more measured approach for retained EU laws will also favorably impact business investment. Finally, the Chancellor's 4Es' vision (enterprise, education, employment, everywhere) aims to enhance innovation and productivity by targeting key growth areas, such as advanced manufacturing, life sciences, and clean energy.

To add momentum to these efforts, staff recommends further ambitious, evidence-based reforms, including: (i) further enhancing policy certainty via wider permanent capital investment incentives and predictable tax and regulatory regimes for businesses; (ii) boosting small and medium-sized firms' access to finance and R&D support (including, for example, via a return to *Horizon Europe*); (iii) easing planning restrictions and accelerating catalytic public investments for the green transition and the delivery of critical network and healthcare infrastructures; (iv) raising labor force participation and productivity by strengthening skills and education outcomes, and improving healthcare services; and (v) fine-tuning the immigration system to alleviate sectoral and skilled labor shortages and enhance labor market flexibility.

The green transition should be expedited to meet Net Zero objectives and enhance energy security . The UK has set for itself ambitious targets, underpinned by a strong legal framework, and has recently articulated some plans to achieve these targets. Still, there is scope for additional quantifiable measures to fully meet the Net Zero targets, including by more rapidly extending the UK's ETS and legally clarifying the phase-in of carbon pricing regulations. It would also be desirable to provide more incentives for the green transition (e.g., by expanding the grant program for low-income households' heat pump installations and home insulation) and remove existing bottlenecks, including by setting out longer-term plans to attract private investment. The transition to a greener energy mix would also open up further opportunities to lower energy input costs and increase energy security.