United Kingdom—2016 Article IV Consultation Concluding Statement of the Mission

May 13, 2016

Outlook and risks

1. This year's Article IV mission has taken place as the British people prepare to make a momentous decision. Uncertainty over the outcome of the referendum on EU membership, and about the implications of a potential Leave vote, already appears to be having an impact on investment and hiring decisions, with recent surveys of economic activity falling to their weakest levels in three years.

2. In the event of a vote to remain in the EU, growth is expected to rebound during the second half of the year. As anticipated, the slower first half, and some lingering referendum-related effects, mean that growth is likely to fall below 2 percent for the full-year 2016, before returning to an average of around 2¼ percent over the medium term, roughly in line with potential. Inflation, which is currently only ½ percent, is expected to revert to target gradually, as effects from commodity price falls dissipate and low unemployment helps push up wages.

3. This broadly positive baseline forecast is subject to notable risks. As elaborated on during our previous consultation, key vulnerabilities include a low household saving rate; still-high levels of household debt and fiscal deficits, despite substantial reductions in both since the crisis; a wide current account deficit; and risks that productivity growth may remain low for an extended period. In some cases, these longstanding risks have risen since our previous consultation, with the current account deficit widening further in late 2015 and productivity growth slowing.

4. However, the largest risks and uncertainties relate to the upcoming EU referendum. A vote to leave the EU would create uncertainty about the nature of the UK's long-term economic relationship with the EU and the rest of the world. It would also have the potential to crystallize some of the baseline risks noted above. Given the importance of the referendum, we elaborate below on its potential macroeconomic implications, while recognizing that the choice of whether to remain in the EU is for UK voters to make and that their decisions will reflect both economic and noneconomic factors.

Possible economic effects of an exit from the EU

5. A vote for exit would precipitate a protracted period of heightened uncertainty, leading to financial market volatility and a hit to output. Following a decision to exit, the UK would need to negotiate the terms of its withdrawal and a new relationship with the EU—unless it abandoned single market access and relied on WTO rules, which would significantly raise trade barriers. It seems likely that ratification of a new deal would require unanimous consent of all EU member governments, making agreements subject to considerable political risks. As EU-level agreements also cover the UK's trading relationship with 60 non-EU economies (and prospective arrangements with another 67 countries are in the works), the UK would also need to simultaneously renegotiate these arrangements, or else see them revert to WTO rules. These processes and their eventual

outcomes could well remain unresolved for years, weighing heavily on investment and economic sentiment during the interim and depressing output. In addition, volatility in key financial markets would likely rise as markets adjust to new circumstances.

6. The long-run effects on UK output and incomes would also likely be negative and substantial.

- Most assessments point to sizable long-run losses in incomes, as increased barriers would reduce trade, investment, and productivity. The wide range of estimated losses—from 1½ to as much as 9½ percent of GDP—does not represent fundamental disagreement among these experts that exit would be costly, but largely reflects differing assumptions about the UK's future economic relationships with the EU and the rest of the world.
- Any output losses in excess of 1 percent of GDP would result in net fiscal losses for the UK, as reduced revenue due to lower output would more than offset any gains from eliminating the UK's net EU budget contribution of ⅓ percent of GDP.
- London's status as a global financial center could also be eroded, as UK-based firms may lose their "passporting" rights to provide financial services to the rest of the EU and much euro-denominated business may over time move to the continent.

7. Another risk is that markets may anticipate such adverse economic effects, provoking an abrupt reaction to an exit vote that effectively brings these costs forward. This could entail sharp drops in equity and house prices, increased borrowing costs for households and businesses, and even a sudden stop of investment inflows into key sectors such as commercial real estate and finance. The UK's record-high current account deficit and attendant reliance on external financing exacerbates these risks. Such market reactions could sharply contract economic activity, further depressing asset prices in a self-reinforcing cycle. Any limited support for net exports caused by an abrupt sterling depreciation would only partly offset the hit to GDP from reduced consumption and investment, and inflation could also rise well above target for some time. Contagion effects could result in spillovers to regional and global markets, although the primary impact would be felt domestically. While there is wide uncertainty around the market reaction to a leave vote, as the historical experience with similar events is limited, it is expected to be negative and could be severe.

8. Such concerns may have already begun to affect UK markets in recent months. In the commercial real estate market, transactions plunged about 40 percent in the first quarter of 2016. Although the residential real estate market remains buoyant, this may reflect temporary effects due to tax changes, as discussed in more detail below. In financial markets, sterling has depreciated by 9 percent in trade-weighted terms since November, the cost of insuring against a UK sovereign default has doubled (albeit from a low level), and the cost of insuring against exchange rate volatility around the time of the referendum has spiked.

9. In the event of a Leave vote, policies should be geared toward supporting stability and reducing uncertainty. If markets reacted sharply and adversely, it would be important to ensure that the financial system has adequate liquidity. In this regard, the Bank of England has appropriately announced plans to hold additional liquidity auctions in the weeks around the referendum. There may also be a need to activate swap facilities with other major central banks in the event of a shortfall of foreign exchange liquidity. The implications for macroeconomic policies are not clear as the authorities will be faced with a difficult trade-off between stabilizing inflation and stabilizing output and employment: the scope for macroeconomic policies to cushion a sharp fall in economic activity will depend on an assessment of supply and demand and the extent to which longer-run inflation expectations remain well-anchored. At the same time, plans for additional medium-term budget consolidation may need to be developed to offset the longer-run adverse fiscal effects.

Macroeconomic policies

10. Under the baseline of a Remain vote, policies should focus on promoting steady growth while reducing vulnerabilities. This includes fiscal consolidation—which is needed over the medium term to further rebuild buffers—that is gradual enough to avoid overburdening monetary policy and flexible enough to adjust to shocks; continued accommodative monetary policy to offset fiscal headwinds and support growth; and sufficiently tight macroprudential policies to mitigate financial

stability risks, including those associated with high household debt. Such a policy mix would also support orderly current account adjustment and should be reinforced by structural reforms to boost productivity and incomes.

11. Fiscal policy should remain geared toward gradual deficit reduction while maintaining flexibility in the event of shocks. The March budget avoided additional tightening in the near term to offset lower revenue projections following the growth downgrade by the Office for Budget Responsibility. Instead, the budget targeted additional adjustment in the outer years to maintain the government's target of fiscal balance by FY19/20. This backloading was appropriate given the near-term growth weakness and heightened uncertainty. Going forward, it will be important for fiscal policy to continue to respond to changing conditions. For example, in the event of an extended period of sluggish demand growth and inflation undershooting, the authorities should use the scope allowed under the fiscal framework to ease the pace of structural adjustment and avoid overburdening monetary policy.

12. At the same time, efforts should continue to further strengthen the pro-growth and pro-stability aspects of consolidation. A top priority in this regard is to further boost infrastructure spending, as needs remain high. As we have noted in the past, increases could be funded by measures such as scaling back distortionary tax expenditures (e.g., nonstandard VAT rates), which would also increase economic efficiency and tax neutrality. Financial stability could be enhanced by reducing the tax code's bias toward debt. This could be achieved by, for example, adopting an Allowance for Corporate Equity, with offsetting changes in other corporate tax parameters.

13. Monetary policy should remain accommodative to support growth and ensure that inflation rises back to target. Underlying inflationary pressures remain subdued, as core inflation is below target and wage growth is muted. Although inflationary pressure is expected to increase gradually in response to a tighter labor market, clearer signs of this pressure should be seen before any tightening cycle is initiated, especially given the need to offset ongoing headwinds from fiscal consolidation. Indeed, if risks of a protracted period of low demand and inflation undershooting rise, monetary policy may need to be eased via some combination of policy rate cuts and quantitative easing.

Financial sector policies

14. This year's consultation coincided with an in-depth assessment of the UK's financial sector under the IMF's Financial Sector Assessment Program (FSAP). Key findings and recommendations of the FSAP include the following:

- Owing to a large extent to a wave of welcome regulatory reforms since the crisis, the main parts of the UK financial system appear resilient: banks have more than doubled their risk-weighted capital ratios from pre-crisis levels, strengthened liquidity, and reduced leverage. Stress tests indicate that the major elements of the financial system—large banks, insurers, asset managers, and central counterparties—appear resilient in the face of shocks.
- Nevertheless, interconnectedness across sectors has the potential to amplify shocks and turn sector-specific distress systemic. One priority is thus to further strengthen analysis and data on interconnectedness and related risks.
- Much progress has been made toward the goal of ensuring that the failure of a financial firm, regardless of its size, would not compromise financial stability or burden the taxpayer. Further efforts are needed to complete the reform agenda in this area and ensure the resolvability of financial firms, especially those of systemic importance. In particular, the authorities should build on current arrangements to develop operational principles for funding of firms in resolution, and work with international partners to develop an effective resolution regime for insurance firms that could be systemically significant.

15. It will be imperative to maintain a robust and intrusive approach to prudential supervision and regulation as the financial cycle matures and memories of the crisis fade. This includes continuing to take a prudent approach to reviewing dividend payouts, being proactive in challenging banks'

internal risk-weight models through processes including stress testing, and seeking international agreement on maintaining effective standards for risk-weights.

16. The authorities should continue to improve their understanding of the scale and drivers of the “derisking” phenomenon. UK global banks have been reviewing their account relationships for several years in response to post-crisis deleveraging, efforts to address conduct and governance issues in the financial industry, and reduced risk appetite. As a result, the number of correspondent banking relationships has declined, and certain categories of customers, notably money transmitters and non-profit organizations, have seen accounts terminated. The authorities should tailor responses to mitigate potential adverse impacts by further promoting stakeholder dialogue, clarifying regulatory expectations, and enhancing AML/CFT supervision of money transmitters.

Macroprudential policy

17. Macroprudential policy will need to tighten later this year if housing and mortgage markets remain buoyant.

- Housing and mortgage markets decelerated somewhat between mid-2014 and mid-2015 following macroprudential tightening. More recently, however, house price growth rose to more than three times income growth, and the share of new mortgages at high loan-to-income (LTI) ratios is again rising.
- The recent increased activity may partly reflect a temporary rush to buy houses before higher transaction taxes on some home purchases took effect in April. However, if current housing and mortgage market trends persist, further macroprudential tightening (e.g., tighter LTI or loan-to-value limits) will be needed later this year to avoid financial stability risks that may arise from excessive household indebtedness.
- The buy-to-let market has grown rapidly in recent years. It should, like the owner-occupied market, be subject to macroprudential measures to mitigate financial stability risks following the now-concluded Treasury consultation on this matter.
- It will also be important to continue closely monitoring potential risks in the commercial real estate market, which saw rapid price growth during 2014-15 that has recently paused.

18. More generally, macroprudential policy should remain focused on financial stability and stand ready to act where necessary. This includes communicating the objectives and tools of the Financial Policy Committee to a broader audience, and raising the countercyclical capital buffer (CCB) as warranted by credit and asset price conditions. Indeed, the CCB may well need to be increased later this year.

Structural reforms

19. Structural reforms can also help boost productivity and reduce vulnerabilities. A top priority is to continue efforts to boost housing supply, which supports growth by fostering construction and bolsters financial stability by increasing home affordability, thereby reducing households’ need to take on high debt. Such efforts should include easing planning restrictions, mobilizing unused publicly-owned land for construction, and reforming property taxes to encourage more efficient use of the housing stock, as recommended in the *Mirrlees Review* and recent IMF reports. Other structural reform priorities include (i) further expanding vocational training, including through more high-quality apprenticeships, which would help reduce double-digit youth unemployment and make growth more inclusive, and (ii) further increasing childcare support to boost labor force participation by single women with children, which, despite recent rapid improvement, remains below the OECD average.

20. The government recently adopted a comprehensive set of reforms to enhance corporate transparency and combat tax evasion, corruption, and other financial crimes. Among other measures, these reforms include the establishment of a register of people with significant control (i.e., beneficial ownership) of UK companies and limited liability partnerships and a new initiative for the automatic sharing of beneficial ownership information between countries. These reforms should be complemented by enhancing AML/CFT regulatory compliance among trust and company

service providers, lawyers, and accountants, including by strengthening the effectiveness of their AML/CFT supervision. In setting their financial services and AML/CFT regulation, those Crown Dependencies (CDs) and British Overseas Territories (BOTs) with financial centers also committed to establishing central beneficial ownership registries, or equivalent systems, for entities incorporated in their jurisdictions; the government has concluded arrangements with the CDs and BOTs on the effective and unrestricted access to this information by law enforcement and tax authorities. Key to the success of these initiatives will be ensuring the quality of beneficial ownership information contained in these registries, or equivalent systems, including by making them publicly accessible, through adequate enforcement, and by pursuing similar initiatives with respect to trusts.

The mission thanks the authorities and representatives from the private sector and academic institutions for open and productive discussions.