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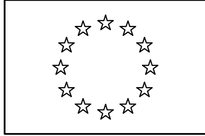

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 18.2.2009
SEC(2009) 184 final

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 9 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the updated convergence programme of the United Kingdom, 2008/09-2013/14

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. In particular, it introduced greater flexibility in the application of the rules governing the excessive deficit procedure, notably with regard to definition of "exceptional circumstances" and the setting of deadlines for the correction of an excessive deficit.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that each Member State has to submit, to the Council and the Commission, a stability or convergence programme and annual updates thereof. Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the convergence programme of the United Kingdom, submitted on 18 December 2008, and has adopted a recommendation for a Council opinion on it.

In order to set the scene against which the budgetary strategy in the updated convergence programme is assessed, the following paragraphs summarise:

(1) the Commission Communication of 26 November 2008 (“A European Economic Recovery Plan”);

(2) the country’s position under the corrective arm of the Stability and Growth Pact (excessive deficit procedure);

(3) the most recent assessment of the country’s position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the convergence programme).

2.1. The Commission Communication of 26 November 2008 (“A European Economic Recovery Plan”)

In view of the unprecedented scale of the global financial and economic crisis, the European Commission has called for a European Economic Recovery Plan (EERP)[2]. The plan proposes a

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[1] OJ L 209, 2.8.1997, p. 1. The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

[2] Communication from the Commission to the European Council of 26 November 2008 - COM(2008) 800.

co-ordinated counter-cyclical macro-economic response to the crisis in the form of an ambitious set of actions to support the economy consisting of (i) an immediate budgetary impulse amounting to €200 bn. (1.5% of EU GDP), made up of a budgetary expansion by Member States of € 170 bn. (around 1.2% of EU GDP) and EU funding in support of immediate actions of the order of €30 bn. (around 0.3 % of EU GDP); and (ii) a number of priority actions grounded in the Lisbon Strategy and designed to adapt our economies to long-term challenges, continuing to implement structural reforms aimed at raising potential growth. The plan calls for the fiscal stimulus to be differentiated across Member States in accordance with their positions in terms of sustainability of government finances and competitive positions. In particular, for Member States outside the euro area with significant external and internal imbalances, budgetary policy should essentially aim at correcting such imbalances. The plan was agreed by the European Council on 11 December 2008. In this context, Member States were asked to submit an addendum to their updated stability or convergence programme, so as to reflect the measures taken in the context of the Recovery Plan. The examination of how measures (budgetary measures as well as structural measures) contribute to the recovery process in the short term is made in the opinions of stability convergence programmes.

2.2. The excessive deficit procedure for the United Kingdom

On 8 July 2008, the Council adopted a decision in accordance with Article 104(6) stating that an excessive deficit existed in the United Kingdom and addressed a recommendation to the UK under Article 104(7) specifying that the excessive deficit should be corrected by the financial year 2009/10 at the latest. To this end, the Council established the deadline of 8 January 2009 for the United Kingdom authorities to take effective action.

2.3. The assessment in the Council opinion on the previous update

In its opinion of 12 February 2008, the Council summarised its assessment of the previous update of the convergence programme, covering the period 2007/08-2012/13, as follows: “The overall conclusion is that the programme confirms a significant deterioration in the United Kingdom’s budgetary position that, coupled with a probably weaker macroeconomic context than envisaged, carries a clear risk that general government deficit will breach the 3% of GDP deficit reference value in the near term. While the programme envisages some fiscal tightening from 2008/09 through a progressive increase in tax revenues and a reduction in previously rapid growth in current expenditure, there are risks to the achievement of this consolidation. These primarily stem from the deterioration in macroeconomic prospects and risks to the achievements of spending targets. The projected speed of consolidation is itself unambitious. The debt ratio remains significantly below the 60 per cent of GDP reference value, increasing slightly before falling from 2010/11 onwards only. The long-term sustainability of UK public finances has deteriorated when compared to the previous programme, mainly due to the deterioration of the starting position, although the United Kingdom remains at medium risk.” In view of this assessment, the United Kingdom was invited to “implement measures necessary for the deficit not to exceed the reference value of 3 per cent of GDP and to strengthen the pace of fiscal improvement over the programme period, which would also address the increased risks to the long-term sustainability of the public finances”.

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On the updated convergence programme of the United Kingdom, 2008/09-2013/14

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[3], and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [10 March 2009] the Council examined the updated convergence programme of the United Kingdom, which covers the period 2008/09 to 2013/14.

(2) Following several years of robust growth driven by domestic demand, economic activity in the UK slowed sharply over the course of 2008. The fallout from the global financial crisis and a sharp correction in the domestic housing market had a mutually reinforcing recessionary impact on the economy. In response to the economic and financial crisis, the United Kingdom's government adopted a number of measures to ensure the stability of the financial sector, and to increase credit provision to households and companies. In November 2008 the government also launched a fiscal stimulus package, totalling about ¼% of GDP in 2008 and 1½% in 2009. The Bank of England has eased monetary policy via successive interest rate reductions (from 5.75% in July 2007 to currently 1.00%) and an expansion of its balance sheet. The nominal effective exchange rate of the pound sterling depreciated by more than 20% during 2008. The combined effect of the economic downturn, falls in asset prices, and the expansionary fiscal stance have led to a pronounced deterioration in UK public finances. The rapid weakening in the government's primary balance, which was already in deficit in the period leading up to the crisis, has weakened the UK's capacity to pursue a looser fiscal stance without compromising budgetary sustainability. In its

[3] OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

March 2008 Budget the UK reported a planned budget deficit in 2008/09 in excess of the 3% of GDP reference value, which led to the opening of an excessive deficit procedure in June 2008.

(3) The programme contains two macroeconomic scenarios: a central scenario and a more cautious alternative scenario based on trend growth one quarter of a percentage point lower than the central view. The public finances projections are based on the alternative scenario, which is considered the reference scenario in the assessment of the updated programme. This scenario shows the recession that began in the second half of 2008 continuing into the first half of 2009, such that real GDP is forecast by the programme to fall by ¼% in 2008/09 and a further ½% in 2009/10. This is followed by a recovery in GDP growth to 2% in 2010/11 and to 3% per annum from 2011/12 onwards. In view of the rapid deterioration of the macro-economic outlook in recent months, even this more cautious scenario, finalised in November 2008, now appears to be based on favourable growth assumptions, notably for the years 2009/10 and 2010/2011.[4] The Programme's estimate of a positive impact on GDP growth from the fiscal stimulus package of around ½ percentage point in 2009 is in line with estimates made by the Commission services. The projections for inflation are somewhat higher than in the Commission services' January 2009 interim forecast.

(4) For 2008/09, the general government deficit is estimated at 5.7% of GDP in the Commission services' January 2009 interim forecast and 5.5% in the programme, against 2.9% of GDP projected in the previous update of the convergence programme. The unexpected increase in the government deficit primarily reflects a downward revision in revenue growth projections due to the dramatic worsening in the macroeconomic context. The sharp drop in residential property transactions and falling residential property prices contribute to an undershoot in estimated stamp duty revenues by about ½ percent of GDP in 2008/09, while revenue from corporate taxation, which accounted for a quarter of tax revenue increases over the five years to 2007/08, has fallen sharply due to the deterioration in financial sector profitability. On the expenditure side, the update estimates an overshoot in government capital spending by 0.2% of GDP compared to the previous programme, while interest payments are also set to exceed projections due to the effect of higher inflation on the debt servicing costs of index-linked gilts. In addition, the discretionary measures announced by the UK government since the 2007 update contribute to an increase in the estimated deficit in 2008/09 by about ½ percentage point, including through a cut in personal income taxation announced in May 2008, a reduction in the standard VAT rate and additional payments to pensioners. Government gross debt in 2008/09 is estimated to increase by almost 10 percentage points, to around 53% of GDP, half of which reflects government financial sector interventions not directly affecting the deficit.

(5) The latest update projects the general government deficit in 2009/10 to increase by 2¾ percentage points to 8.2% of GDP, compared to a projection of 9.5% of GDP in the Commission services' interim forecast. Government revenue is forecast to drop in nominal terms by 2%, while expenditure is set to increase by almost 5%. The programme estimates that the fall in financial sector and housing market activity will

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[4] The assessment notably takes into account the Commission Service's January 2009 interim forecast, but also other information that has become available since then.

reduce government revenue, including from personal income tax on financial sector earnings, by a total of 1½ percentage points of GDP between 2007/08 and 2009/10. The budgetary projections also include fiscal stimulus measures of around 1% of GDP in 2009/10, including a temporary reduction in the standard VAT rate, which accounts for half the November 2008 stimulus package, and the frontloading of investment spending. The structural deficit in 2009/10, defined as the cyclically-adjusted budget balance calculated according to the commonly agreed methodology, net of one-off and other temporary measures, is estimated to deteriorate by about 2 percentage points. The fall reflects in almost equal share the combined effects of the expansionary fiscal measures and an effect from tax elasticities due to the contraction in financial sector and housing market activities, which until the downturn yielded high tax revenues.

(6) The update does not present a medium-term objective (MTO) for the budgetary position. The fiscal projections in the programme imply a narrowing in the structural deficit averaging close to 1 percentage point per annum between 2010/11 and 2013/14. The programme presents medium-term projections on a no-policy-change basis and envisages a sustained reduction in the general government deficit. According to the programme, the headline deficit between 2010/11 and 2013/14 is forecast to improve by an average of around 1¼ percentage points of GDP per annum, to 3.4% of GDP by the end of the programme period. Around three-fifths of the targeted adjustment in the nominal balance between 2010/11 and 2013/14 reflects a drop in the expenditure ratio. The annual nominal rate of increase in expenditure between 2011/12 and 2013/14 is assumed to decelerate to 4% from an average of 5¼% in the preceding three-year period, although the sharp slowdown in spending growth is not backed by detailed departmental spending plans. The government has announced tax rises and an increase in social security contributions, as well as planned efficiency savings in public services from 2010/11 onwards. Government gross debt is projected to increase by 15½ percentage points over the programme period, to 68½% of GDP in 2013/14.

(7) The budgetary outcomes are subject to downside risks. The Commission services' January 2009 economic growth forecast for 2009/10 and 2010/11 is significantly weaker than envisaged in the programme, which would raise the deficit in 2010/11 by about 2 percentage points compared to the programme. Moreover, the likelihood that economic activity in 2010 will be weaker than envisaged in the programme carries a risk that the stimulus measures, planned to be temporary, will not be withdrawn in 2010. The revenue elasticity implied in the programme after 2010/11 also appears favourable, given the probability that in the medium-term the contribution of the financial sector to economic activity will be lower than in the pre-recession period and the composition of aggregate demand could even be less tax-rich than the programme acknowledges. In view of these negative risks, the evolution of the debt ratio is also likely to be less favourable than projected in the programme from 2009/10 onwards, carrying clear risks for debt servicing costs. Moreover, the government financial sector interventions also carry a risk of higher deficit and/or debt levels than foreseen in the programme[5]. However, the greater part of the increase in government debt as a result

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[5] The acquisition of shareholding in financial institutions could lead to a one-off increase in the general government deficit, depending on the share purchase price relative to the prevailing market price or fair value. The statistical treatment of government debt securities issued to finance the special liquidity scheme and the asset purchase facility, which are not treated as government debt in the programme, are currently being examined by Eurostat.

of financial sector support operations, which in the programme amounts to about 5 percentage points of GDP, is not expected to be permanent. Once the economy recovers and financial sector conditions stabilise, the UK authorities would be expected to unwind, at least in part, the increase in debt due to financial sector interventions through the proceeds from selling equity stakes in financial institutions back to the private sector and by calling in loans.

(8) Whereas the UK is starting from a position of relatively low public debt and the long-term budgetary impact of ageing in the UK is close to the EU average, the budgetary position in 2008 as estimated in the programme, which is significantly worse than the starting position of the previous programme, constitutes an increased risk to sustainable public finances even before the long-term budgetary impact of an ageing population is considered. The contingent liabilities established by state guarantees to the financial sector pose an additional risk due to their negative impact on the long-term sustainability of public finances if called. If the 2009 budgetary position as projected by the Commission services' interim forecast were taken as the starting point, the sustainability gap would worsen substantially. Moreover, the gross debt ratio is projected to exceed the Treaty reference value before the end of the programme period. Reducing the primary deficit would contribute to reducing the increased risks to the sustainability of public finances.

(9) The recent marked deterioration of the UK's public finances has put the domestic fiscal framework under intense pressure. In the 2008 Pre-Budget Report the two existing fiscal rules were suspended and replaced with a temporary operating rule. The aim of the new rule, to be applied once the economy emerges from the downturn, is to improve the cyclically-adjusted current budget each year so that it reaches balance and the debt-to-GDP ratio is reduced. It is designed to accommodate higher government borrowing to support the economy in the short term, although once the UK economy emerges from the current recession it would impose a quantitatively unspecified constraint in terms of minimum fiscal consolidation. A new framework is expected to be put in place before 2015/16, but the exact timing is uncertain. An effective and credible revised fiscal framework will be an important element for the UK in order to deliver the needed fiscal consolidation in the medium term. The new efficiency programme, which was introduced as part of the 2007 Comprehensive Spending Review and expanded in the 2008 Budget and Pre-Budget Report, demonstrates the authorities' intentions to keep up the momentum of the UK’s focus on value for money issues in the public sector, including by setting an ambitious efficiency savings target as well as introducing a new monitoring and reporting framework. The update outlines some concrete supportive measures, but it remains unclear to what extent different departments and policy areas will be affected.

(10) In response to the financial crisis, the UK authorities have adopted a series of policy measures aimed at stabilising the financial sector and supporting credit provision. A credit guarantee scheme guarantees commercial paper issued by banks to refinance their maturing wholesale debt. Furthermore, the special liquidity scheme operated by the Bank of England until January 2009 allowed participating banks to swap illiquid assets for UK treasury bills. This scheme has been succeeded by the Bank of England's discount window facility, which continues to give banks access to long-term liquidity, but using a wider range of collateral. In addition to the nationalization of two financial institutions, Northern Rock in February 2008 and Bradford & Bingley in September 2008, the government injected state capital equivalent to £37 billion (2½% of GDP)

into a number of banks. From February 2009, the Bank of England will also be authorised by the Treasury to purchase up to £50 billion (3½% of GDP) of private sector securities. In January 2009 the government also announced a scheme that would offer banks insurance against losses on assets that have been mostly affected by the current economic slowdown, while a statement by the Financial Services Authority (FSA) on the regulation of capital requirements clarified that banks were able to draw down on capital buffers during economic downturns, thereby facilitating continued lending.

(11) In line with the European Economic Recovery Plan agreed in December 2008 by the European Council, the United Kingdom announced in November 2008 fiscal stimulus measures that are expected to cushion the contraction in GDP in 2009 by around ½ percentage point. The package is temporary and timely, as measures are targeted towards supporting domestic demand in 2009. However, the forecast increase in the government deficit, coupled with the lack of room for fiscal manoeuvre and the absence of a credible fiscal framework in the medium term, raises serious concerns on the sustainability of UK public finances. Most fiscal stimulus measures aim at supporting household purchasing power and tend to favour individuals with a relatively higher propensity to consume. Other measures, including of a structural nature, are intended to support business and investment activities and increase the capacity of public employment services and training opportunities for the unemployed. Finally, building on the September 2008 Homeowners Support Package, further measures to support the adjustment process in the housing market have been announced. These measures correspond to the policy objective of short-term output stabilisation and are related to the UK Lisbon structural reform agenda.

(12) Following the expansionary fiscal stance of recent years during predominantly good economic times and the stimulus package for 2009, the UK authorities plan to pursue fiscal consolidation equivalent to an improvement in the structural balance of around 1 percentage point per annum in the medium term. However, there is a risk that the stimulus measures, planned to be temporary, will not be withdrawn in 2010 if, as projected in the Commission services interim forecast, the economic recovery envisaged by the UK authorities in 2010 does not materialise. Finally, the debt ratio is expected to increase substantially over the programme period and to exceed the reference value of 60% of GDP from 2009/10 onwards.

(13) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has significant gaps in the provision of required and optional data[6].

The overall conclusion is that the programme confirms a rapid deterioration in the United Kingdom's budgetary position, which has considerably strained the sustainability of UK public finances. The probably significantly weaker-than-envisaged macroeconomic context in the near term carries the risk of a higher government deficit throughout the programme period. After the expansionary fiscal measures in 2009/10 the programme envisages some fiscal tightening from 2010/11 onwards, but there are risks to the achievement of this consolidation. These reflect the possibility of an extension of the stimulus measures to 2010 in

[6] In particular, the lack of labour market data has significantly complicated the recalculation of output gaps according to the commonly agreed methodology.

the absence of a significant economic recovery, weaker revenue elasticities, and risks to the achievement of spending targets. Taking into account the probability of a worse-than-expected deterioration in the UK's budgetary position in the near term and the heightened risks to fiscal sustainability, there is need for a more ambitious consolidation effort in the medium term. The debt ratio increases from 43¼% of GDP in 2007/08 to 65% in 2010/11, stabilising at close to 70% at the end of the programme period.

In view of the above assessment, the United Kingdom is invited to:

(i) proceed in financial year 2009/10 with the stimulus measures consistent with the EERP, while avoiding any further deterioration of public finances;

(ii) strengthen the pace of budgetary consolidation from 2010/11 onwards to ensure a rapid correction of the excessive deficit;

(iii) define a fiscal framework consistent with an improvement of the long-term sustainability of its public finances.

The United Kingdom is also invited to improve compliance with the data requirements of the code of conduct.

Overview of key macroeconomic and budgetary projections

Financial years		2007/8	2008/9	2009/10	2010/11	2011/12	2012/13	2013/14
Real GDP (% change)	**CP Dec 2008**	**3**	**-¼**	**-½**	**2**	**3**	**3**	**3**
	COM Jan 2009	3.0	-0.6	-2.3	0.9	n.a.	n.a.	n.a.
	CP Nov 2007	*3*	*3*	*2*	*2¾*	*2½*	*2½*	n.a.
HICP inflation (%)	**CP Dec 2008**	**2¼**	**3¾**	**1**	**2**	**2**	**2**	**2**
	COM Jan 2009	2.2	3.4	-0.3	1.3	n.a.	n.a.	n.a.
	CP Nov 2007	*2¼*	*2*	*2*	*2*	*2*	*2*	*n.a.*
Output gap[1] (% of potential GDP)	**CP Dec 2008**	**1.0**	**-0.5**	**-2.4**	**-2.1**	**-1.2**	**-0.4**	**0.2**
	COM Jan 2009	2.0	0.5	-2.4	-2.8	n.a.	n.a.	n.a.
	CP Nov 2007	*0.0*	*-0.5*	*-0.3*	*-0.4*	*-0.4*	*-0.3*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)[2]	**CP Dec 2008**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
	COM Jan 2009	-2.6	-2.0	-5.5	-5.7	n.a.	n.a.	n.a.
	CP Nov 2007	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
General government revenue (% of GDP)	**CP Dec 2008**	**37.9**	**36.7**	**35.5**	**36.6**	**37.3**	**37.7**	**38.0**
	COM Jan 2009	42.1	41.4	41.2	41.6	n.a.	n.a.	n.a.
	CP Nov 2007	*38.6*	*38.8*	*39.0*	*39.2*	*39.3*	*39.5*	*n.a.*
General government expenditure (% of GDP)	**CP Dec 2008**	**40.7**	**42.2**	**43.7**	**43.7**	**42.9**	**42.1**	**41.4**
	COM Jan 2009	44.9	47.2	50.8	50.8	n.a.	n.a.	n.a.
	CP Nov 2007	*41.6*	*41.7*	*41.4*	*41.3*	*41.1*	*41.1*	*n.a.*
General government balance (% of GDP)	**CP Dec 2008**	**-2.8**	**-5.5**	**-8.2**	**-7.1**	**-5.6**	**-4.4**	**-3.4**
	COM Jan 2009	-2.8	-5.7	-9.5	-9.2	n.a.	n.a.	n.a.
	CP Nov 2007	*-3.0*	*-2.9*	*-2.4*	*-2.1*	*-1.8*	*-1.6*	*n.a.*
Primary balance (% of GDP)	**CP Dec 2008**	**-0.6**	**-3.4**	**-6.4**	**-4.5**	**-2.6**	**-1.4**	**-0.3**
	COM Jan 2009	-0.6	-3.5	-7.1	-6.4	n.a.	n.a.	n.a.
	CP Nov 2007	*-0.8*	*-0.9*	*-0.3*	*0.0*	*0.3*	*0.5*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**CP Dec 2008**	**-3.2**	**-5.3**	**-7.2**	**-6.2**	**-5.1**	**-4.2**	**-3.5**
	COM Jan 2009	-3.7	-5.9	-8.5	-8.0	n.a.	n.a.	n.a.
	CP Nov 2007	*-3.0*	*-2.7*	*-2.3*	*-1.9*	*-1.6*	*-1.5*	*n.a.*
Structural balance[3] (% of GDP)	**CP Dec 2008**	**-3.2**	**-5.3**	**-7.2**	**-6.2**	**-5.1**	**-4.2**	**-3.5**
	COM Jan 2009	-3.7	-5.9	-8.5	-8.0	n.a.	n.a.	n.a.
	CP Nov 2007	*-3*	*-2.7*	*-2.3*	*-1.9*	*-1.6*	*-1.5*	*n.a.*
Government gross debt (% of GDP)	**CP Dec 2008**	**43.2**	**52.9**	**60.5**	**65.1**	**67.5**	**68.6**	**68.5**
	COM Jan 2009	43.2	53.7	64.6	71.9	n.a.	n.a.	n.a.
	CP Nov 2007	*43.9*	*44.8*	*45.1*	*45.3*	*45.2*	*44.9*	*n.a.*

Notes:

[1]Output gaps and cyclically-adjusted balances from the programmes as recalculated by Commission services on the basis of the information in the programmes using the commonly agreed methodology. COM Jan 2009 figures are based on estimated potential growth of 1.5%, 0.9%, and 1.0% respectively in the period 2008-2010.

[2] Data refers to calendar years.

[3]Cyclically-adjusted balance excluding one-off and other temporary measures. There are no one-off and other temporary measures during the programme period.

Source :
Convergence programme (CP); Commission services' January 2009 Interim economic forecasts (COM); Commission services' calculations