COUNCIL OPINION
of 10 March 2009
on the updated convergence programme of the United Kingdom, 2008/2009-2013/2014
(2009/C 68/07)

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 surveil-
lance of budgetary positions and the surveillance and coordination of economic policies (1), 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 2008/2009 to 2013/2014.

(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, in line with the European Economic
Recovery Plan agreed in December 2008 by the European Council, the government also launched a
fiscal stimulus package, totalling about 0.25 % of GDP in 2008 and 1.5 % in 2009, in addition to
allowing the automatic stabilisers to operate in full. 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 down-
turn, 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 affected the UK’s scope to pursue fiscal loosening
and ensure budgetary sustainability. In its March 2008 Budget the UK reported a planned budget
deficit in 2008/2009 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 macro-economic 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 0.25 % in 2008/2009 and a further 0.5 % in 2009/2010. This
is followed by a recovery in GDP growth to 2 % in 2010/2011 and to 3 % per annum from
2011/2012 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 2009/2010 and 2010/2011 (2). The Program-
me’s estimate of a positive impact on GDP growth from the fiscal stimulus package of around
0.5 percentage point in 2009 is in line with estimates made by the Commission services. The projec-
tions for inflation are somewhat higher than in the Commission services’ January 2009 interim fore-
cast.

(1) OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website:
(2) The assessment notably takes into account the Commission Service’s January 2009 interim forecast, but also other infor-
mation that has become available since then.
For 2008/2009, 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 macro-economic context and the operation of the automatic stabilisers. The sharp drop in residential property transactions and falling residential property prices contribute to an undershoot in estimated stamp duty revenues by about 0.5 percent of GDP in 2008/2009, while revenue from corporate taxation, which accounted for a quarter of tax revenue increases over the five years to 2007/2008, has fallen sharply due to the deterioration in financial sector profitability. On the expenditure side, the update estimates an increase in government capital spending by 0.2% of GDP compared to the previous programme, reflecting the action being taken to support the economy, while interest payments are 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 of about 0.5 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 2008/2009 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.

The latest update projects the general government deficit in 2009/2010 to increase by 2.75 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 reduce government revenue, including from personal income tax on financial sector earnings, by a total of 1.5 percentage points of GDP between 2007/2008 and 2009/2010. The budgetary projections also include fiscal stimulus measures of around 1% of GDP in 2009/2010, 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 2009/2010, 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 shares 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.

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 2010/2011 and 2013/2014. 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 2010/2011 and 2013/2014 is forecast to improve by an average of around 1.25 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 2010/2011 and 2013/2014 reflects a drop in the expenditure ratio. The annual nominal rate of increase in expenditure between 2011/2012 and 2013/2014 is assumed to decelerate to 4% from an average of 5.25% in the preceding three-year period, although the sharp slowdown in spending growth is not yet backed by detailed departmental spending plans, reflecting the established three-year spending review process. The government has announced tax rises and an increase in social security contributions, as well as an increase in planned efficiency savings in public services from 2010/2011 onwards. Government gross debt is projected to increase by 15.5 percentage points over the programme period, to 68.5% of GDP in 2013/2014. The intention of the programme is for debt as a share of GDP to fall after the end of the programme period, by 2015/2016.

The budgetary outcomes are subject to downside risks. The Commission services’ January 2009 economic growth forecast for 2009/2010 and 2010/2011 is significantly weaker than envisaged in the programme, which would raise the deficit in 2010/2011 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 programme recognises that over the medium term the contribution of the financial sector to economic activity will be lower than previously forecast and the composition of aggregate demand is likely to be less tax-rich. However, the revenue elasticity implied in the programme after 2010/2011 appears favourable 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 2009/2010 onwards, carrying a risk of higher debt servicing. Moreover, the government financial sector interventions also carry a risk of higher deficit and/or debt levels than foreseen in the programme (1). However, the greater part of the increase in government debt as a result 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 financial crisis can also have a negative impact on the long-term sustainability of public finances if the costs of the government support are not fully recouped. 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 risks to the long-term sustainability of public finances, which, on the basis of the commonly agreed methodology are assessed as high, stemming from the current high structural deficit.

(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 2015/2016, 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 nationalisation of two financial institutions, Northern Rock in February 2008 and Bradford & Bingley in September 2008, the government

(1) 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, is currently being examined by Eurostat.
injected State capital equivalent to GBP 37 billion (2.5% 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
GBP 50 billion (3.5% 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, amounting to
around 1.5% of GDP in 2009, that are expected to cushion the contraction in GDP in 2009 by
around 0.5 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 limited initial room for fiscal manoeuvre and the absence of a credible fiscal framework
in the medium term, implies that it is crucial to reverse the stimulus through sustained consolidation
over the medium term. 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. Consistent with this consolidation strategy, stimulus measures are planned to be temporary.
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

(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 (1).

The overall conclusion is that the programme confirms a rapid deterioration in the United Kingdom’s
budgetary position, which has strained the sustainability of UK public finances. The probably significantly
weaker-than-envisaged macro-economic context in the near term carries the risk of a higher government
deficit throughout the programme period. After the expansionary fiscal measures in 2009/2010 the
programme envisages sustained fiscal tightening from 2010/2011 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 the absence of a significant economic recovery, weaker revenue elasticities, and risks to the achieve-
ment 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 a need for
a more ambitious consolidation effort in the medium term. The debt ratio is projected to increase from
43.25% of GDP in 2007/2008 to 65% in 2010/2011, stabilising at close to 70% at the end of the
programme period.

(1) In particular, the lack of labour market data has significantly complicated the recalculation of output gaps according to the
commonly agreed methodology.
In view of the above assessment, the United Kingdom is invited to:

(i) implement the fiscal plans, including the stimulus measures in line with the EERP and within the framework of the SGP, while avoiding any further deterioration of public finances;

(ii) implement a significant budgetary consolidation in 2010/2011 and beyond, and further specify measures underpinning the adjustment, to ensure that the deficit is rapidly brought below the reference value;

(iii) set out how the fiscal framework will be applied in the future, 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 macro-economic and budgetary projections

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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) Data for total revenues and expenditure are not presented in the programme on a harmonised ESA95 basis. Therefore, they are not directly comparable with the projections made in the Commission services' January 2009 interim forecast. For 2012/2013 and 2013/2014, general government revenue and expenditure figures are extrapolated from public sector projections.

(4) 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.