OECD Economic Surveys
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OVERVIEW

Executive summary

- *Main findings*
- *Key recommendations*

Main findings

After a period of subdued growth in the aftermath of the global downturn, growth in the United Kingdom has picked up since early 2013 to 2.6% in 2014, the strongest performance among G7 countries that year. Against the background of subdued growth in the euro area, the recovery has benefitted from the cumulative impact of wide-ranging domestic policies. These included highly-accommodative monetary policy and measures to support lending and revive the housing market. For fiscal policy, while there have been some additional consolidation measures, the automatic stabilisers have continued to operate in full. Employment has recovered to its pre-crisis trend and is now at record levels. However, weak labour productivity since 2007 has been holding back real wages and well-being. The sustainability of economic expansion and further progress in living standards rest on boosting productivity growth, which is a key challenge for the coming years.

Securing a balanced recovery through macroeconomic policies. Monetary policy has remained highly expansionary for some time. Inflationary pressures have so far been low owing to ample spare capacity and, more recently, falling commodity prices and a rebound of the exchange rate. Credit constraints have been partly addressed by the Help to Buy and Funding for Lending programmes, which seem to have been effective at reviving lending to households and strengthened housing demand. However, housing supply has not risen to meet demand. In addition, house prices have increased rapidly and may create risks to financial stability in the case of a downward adjustment. The Funding for Lending programme was closed to mortgage lending in late 2013. Conversely, net lending to firms has continued to fall while the large share of loss-making companies could suggest that new loans could have been skewed to inefficient firms to the detriment of young and innovative ones, which could restrain productivity. The budget deficit has been significantly reduced since the peak of 2009, but at a slower pace recently notably as growth has been insufficiently tax-rich. Public debt as a share of GDP is projected to rise further.

Improving the provision of infrastructure. The quality of perceived infrastructure is close to the OECD average, leaving scope to improve productivity and the well-being of citizens. Historic underspending in infrastructure is being tackled by the authorities within tight budget constraints, but greater private infrastructure spending is still needed. Difficulties in attracting private investors can be partly attributed to insufficient long-term infrastructure planning and long decision-making processes that generate investment uncertainties, which the National Infrastructure Plan is starting to address. Although the regulatory framework is robust, the use of some infrastructure is sub-optimal owing to congestion and insufficient incentives for private operating companies. The financing framework for private infrastructure investment is also facing market failures, such as fragmented institutional investors. However, the authorities have been making progress in encouraging green infrastructure investment.

Ensuring sustainable bank lending. The UK banking sector was deeply affected by the crisis and important regulatory reforms have been implemented to address financial stability risks. Given short-term risks emerging in the housing market, regulatory authorities have taken significant precautionary measures to sustain underwriting standards and prevent significant increases in the number of highly indebted households. The Bank of England has also requested from the government additional powers to cap loan-to-value and debt-to-income ratios. Banks remain very large, however, and if they are not well capitalised they could pose a risk to the economy. In addition, banks have been cutting back net lending, making it more difficult for small and medium-sized enterprises to get financing. Part of this financing has been replaced by alternative credit providers, which are creating new regulatory challenges. To support sustainable bank lending, the authorities have taken steps to boost competition in the credit market.

Key recommendations

Securing a balanced recovery through macroeconomic policies

- As underlying inflationary pressures emerge, gradually start increasing the policy rate and, thereafter, begin reducing the size of the Bank of England's balance sheet.
- Continue to pursue the medium-term fiscal consolidation path while letting automatic stabilisers operate, and ensure consolidation efforts are fair.
- Seek further efficiency gains in health and education, and broaden the tax base, such as equalising income taxes and social security contributions between the self-employed and employees.

Improving the provision of infrastructure

- Continue to build on the progress made with the National Infrastructure Plan to further enhance long-term infrastructure strategy and planning.
- Develop further the use of public-private partnerships (PPP) and public guarantees for privately financed infrastructure projects, recording the associated assets and liabilities in the government fiscal accounts. Enhance the provision to investors and the public of comparable data about public guarantees and the financial and operational performance of PPP projects.
- Improve the use of roads by introducing user-paid tolls, and of railways by ensuring the arms-length responsibility for awarding rail franchises.
- Strengthen the Green Investment Bank and other targeted financial aids to further support the implementation of not yet commercially viable low-carbon technologies that have the prospect of becoming so in the foreseeable future.
- Evaluate the interaction between the Electricity Market Reform and existing policies to promote renewable energies.

Ensuring sustainable bank lending

- Consider higher leverage ratios for global systemic banks to complement risk-weighted capital ratios.
- Encourage the development of new credit providers and gradually extend regulatory instruments beyond the banking sector.
- Continue to uphold underwriting standards in mortgage lending. Further relax regulatory constraints to boost housing supply, in particular by thoroughly reviewing the boundaries of protected areas of the Green Belt.
- Collect and share credit information on businesses through credit reference agencies or directly through the regulator.

Assessment and recommendations

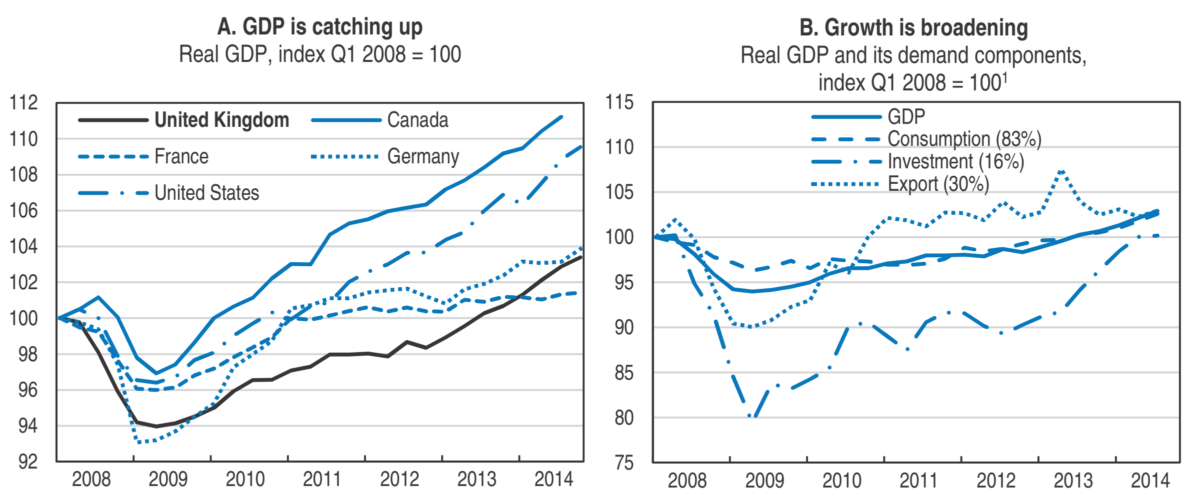
- *Making the recovery sustainable*
- *Normalising macroeconomic policies*
- *Rekindling productivity growth*

Making the recovery sustainable

Key challenges to unleash productivity

Following a deep recession and a subdued recovery, economic growth in the United Kingdom (UK) has bounced back strongly since 2013. Real gross domestic product (GDP) is back above the pre-crisis peak and growth has been broadening (Figure 1). Macroeconomic policies have played a key role. Monetary policy has been very accommodative, measures have been put in place to support the recovery in the housing market, and fiscal policy has contributed to some pick-up in growth. Structural reforms have strengthened work incentives and supported a business-friendly environment, thus sustaining one of the most flexible economies in the OECD.

Figure 1. **Growth is strong**



1. The figures in parentheses show 2010 weights in GDP.
Source: OECD (2015), *OECD Economic Outlook: Statistics and Projections* (database), February and ONS (2014), "Quarterly National Accounts, Q3 2014", Office for National Statistics, December.

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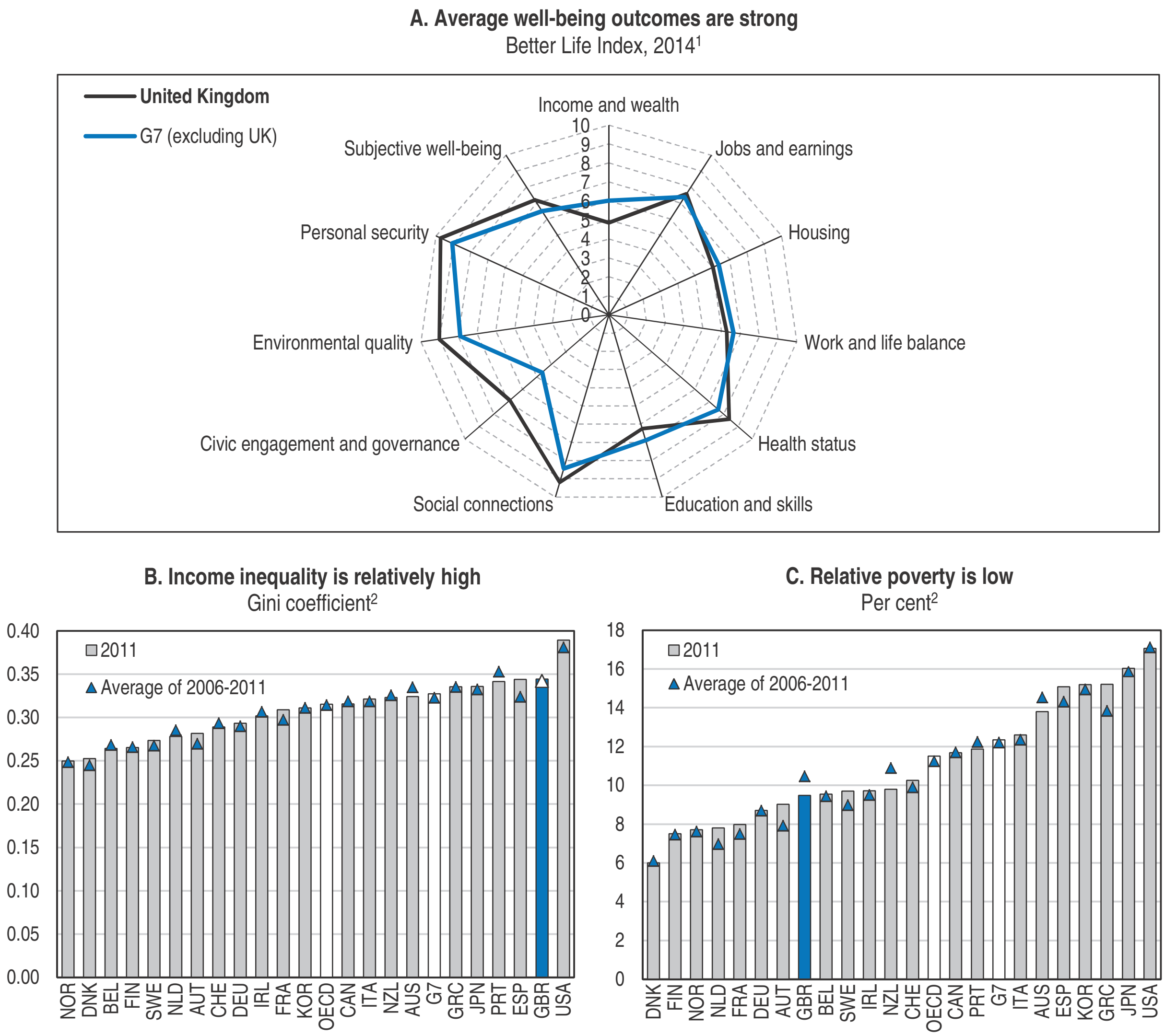
Well-being outcomes remain robust, although income and financial wealth, as well as education and skills, are somewhat weaker than the G7 average (Figure 2, Panel A). Income inequality is high (Figure 2, Panel B). However, relative income poverty is comparatively low and has been falling (Figure 2, Panel C). The average income of the richest 10% of the population is nearly ten times that of the poorest, but the gap shrunk between 2009 and 2011 to slightly below the OECD average. Moreover, the share of wealth held by the top 10% is among the lowest in the G7 (IMF, 2013; Davies et al., 2012).

However, labour productivity has been exceptionally weak since the onset of the crisis, and as a result real wages and GDP per capita have been flat (Figure 3). Investment has rebounded and has recovered close to the pre-crisis peak. Exports have been subdued

Figure 2. **Social indicators are good overall**



1. Each well-being dimension is measured by one to four indicators from the OECD Better Life Index set. Normalised indicators are averaged with equal weights. Indicators are normalised to range between 10 (best) and 0 (worst) according to the following formula: (indicator value – minimum value)/(maximum value – minimum value) x 10. The aggregate for G7 countries (excluding the United Kingdom) (i.e. Canada, France, Germany, Italy, Japan and United States) is calculated as an unweighted average.
2. The Gini coefficient is calculated for household disposable income after taxes and transfers, adjusted for differences in household size and it has a range from zero (when everybody has identical incomes) to one (when all income goes to only one person). Increasing values of the Gini coefficient thus indicate higher inequality in the distribution of income. The relative poverty rate is based on 50% of the median disposable income (adjusted for family size and after taxes and transfers) of the entire population. 2009 and average of 2006-09 for Japan. 2010 and average of 2006-10 for Belgium. 2012 and average of 2006-12 for Australia and Netherlands. The OECD aggregate is calculated as an unweighted average. The aggregate for G7 countries (excluding the United Kingdom) (i.e. Canada, France, Germany, Italy, Japan and United States) is calculated as an unweighted average.

Source: OECD (2014), *OECD Better Life Index* and OECD (2014), "Income Distribution Database", *OECD Social and Welfare Statistics*, December.

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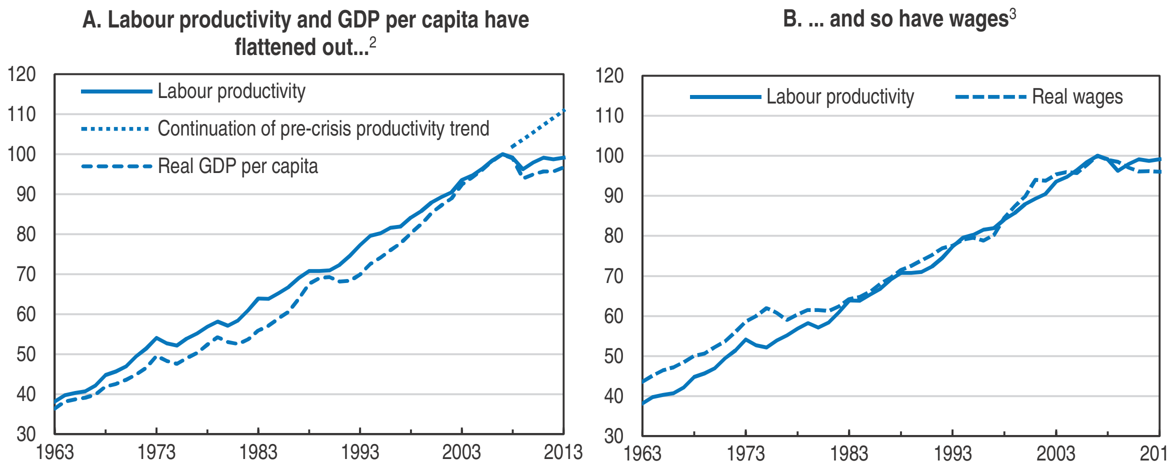
despite exchange rate depreciation of about 20% in real effective terms between 2007 and 2008, notably because of sluggish demand in the euro area. Weak export performance and productivity could be driven by infrastructure weaknesses and difficult access to bank finance, especially for small and medium-sized enterprises (SMEs), holding back the emergence of new firms and high-skilled jobs.

Figure 3. **Subdued labour productivity is holding back living standards**

Index 2007 = 100[1]



1. Labour productivity is defined as output per worker (i.e. real gross value added (GVA) divided by total employment).
2. Pre-crisis linear labour productivity trend is calculated between 1997 and 2007, and is projected from 2008 onwards.
3. Real wages refer to nominal wages divided by dependent employment and deflated by GDP deflator.

Source: OECD (2015), *OECD Economic Outlook: Statistics and Projections* (database), January and ONS (2014), "Labour Productivity, Q3 2014", Office for National Statistics, December.

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This *Survey* analyses ways to address these challenges and finds that:

- Improving productivity requires further structural reforms and is key to higher sustainable GDP and wage growth.
- Accelerated decision-making and activation of new financing channels would raise infrastructure investment needed to support productivity and living standards.
- Significant progress has been achieved to make the banking sector more resilient and further reforms should strengthen financial stability and ensure sustainable lending to support capital stock accumulation.

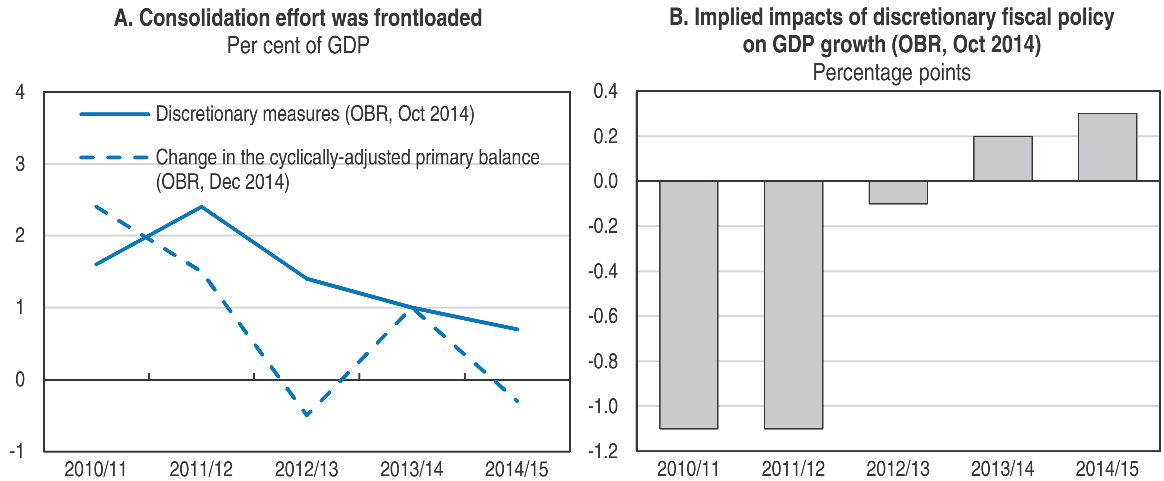
A strong recovery

Growth in the UK has picked up since the first quarter of 2013 to 2.6% in 2014, the strongest performance among G7 countries that year. Quantitative easing and measures to improve credit availability have magnified the transmission of the policy rate that was cut to 0.5% in March 2009. In parallel, automatic fiscal stabilisers have continued to operate and fiscal tightening has been less of a headwind since 2012, which is estimated to have supported growth since 2013 (Figure 4).

Private consumption growth has been supported by a remarkable pace of job creation, low borrowing costs and stronger confidence. The latter has played an instrumental role in reducing household saving ratio (Figure 5, Panel A). Since late 2013, growth momentum has been strengthened by a pick-up in gross fixed investment growth, driven by firming demand, a low cost of capital and a turnaround in business confidence, which has encouraged firms to run down their financial surplus (Figure 5, Panel B; Lewis et al., 2014).

Exports have contributed little to the recovery. The UK has been continuously losing market share, broadly in line with the G7, since late 1990s (Figure 6, Panel A). However,

Figure 4. **Fiscal policy has contributed to some pick-up in growth**



Source: OBR (2014), "Forecast Evaluation Report – October 2014", Office for Budget Responsibility and OBR (2014), "Economic and Fiscal Outlook – December 2014", Office for Budget Responsibility.

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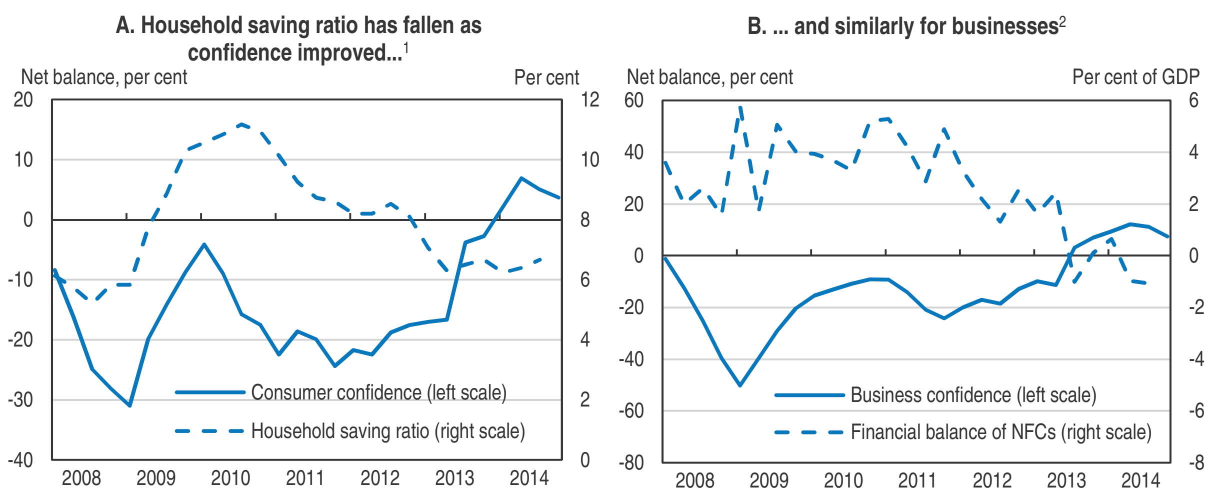
Figure 5. **Growth is driven by domestic demand**



1. Three quarter moving average applied to household saving ratio. Household saving ratio is expressed as a percentage of total available households' resources. Quarterly data for consumer confidence are calculated as unweighted average of monthly figures.
2. Three month moving average applied to business confidence. Confidence indicator is calculated as the arithmetic average of the balances (in percentage points) of the answers to the questions on: production – future tendency; finished goods stocks-level; and order books-level. Net balance is used to summarise answers to multiple-choice questions related to business tendency surveys and it takes value between -100% (unfavourable) and +100% (favourable) with a midpoint of 0. Quarterly data for business confidence are calculated as unweighted average of monthly figures of confidence indicators in manufacturing, construction, retail trade and services (excluding retail trade). NFCs: non-financial corporations.

Source: OECD (2015), *Main Economic Indicators* (database), January and ONS (2014), "Quarterly National Accounts, Q3 2014", Office for National Statistics, December.

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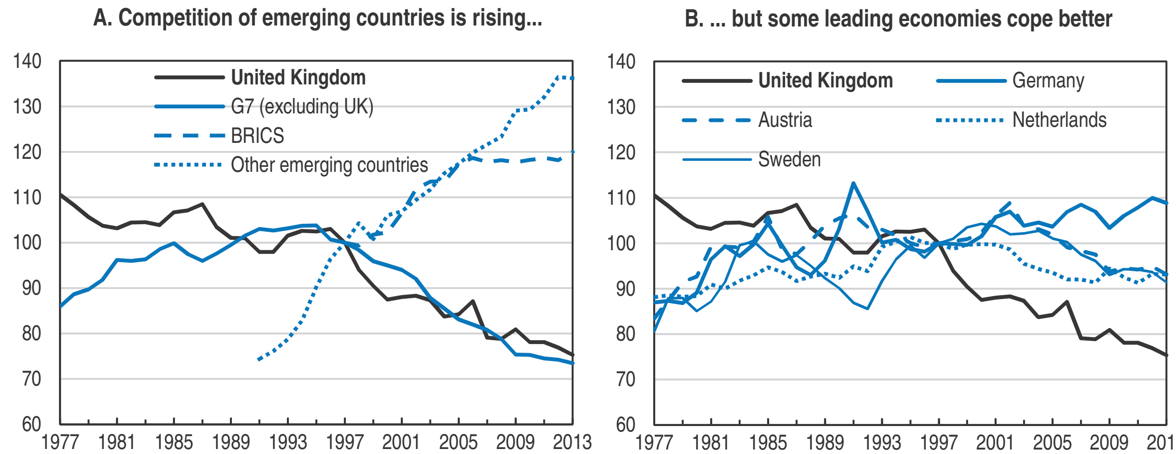
export performance of some affluent OECD countries has proved more resilient (Figure 6, Panel B). Declining market share could in part reflect the rise of China and other emerging market economies, but could also be driven by domestic supply factors as the share of tradable sectors in total gross value added has been falling (Figure 7, Panel A). This could help to explain why currency depreciation has not revived net exports from the manufacturing, oil and gas sectors (Figure 7, Panel B).

Figure 6. **Export performance has been deteriorating**

Index 1997 = 100[1]



1. Export performance is the ratio between export volumes and export markets. Unweighted average of G7 countries (excluding the United Kingdom) (i.e. Canada, France, Germany, Italy, Japan and United States), BRICS countries (i.e. Brazil, Russian Federation, India, China, South Africa) and Other emerging countries (i.e. Czech Republic, Hungary, Korea, Mexico, Poland and Turkey).

Source: OECD (2015), *OECD Economic Outlook: Statistics and Projections* (database), January.

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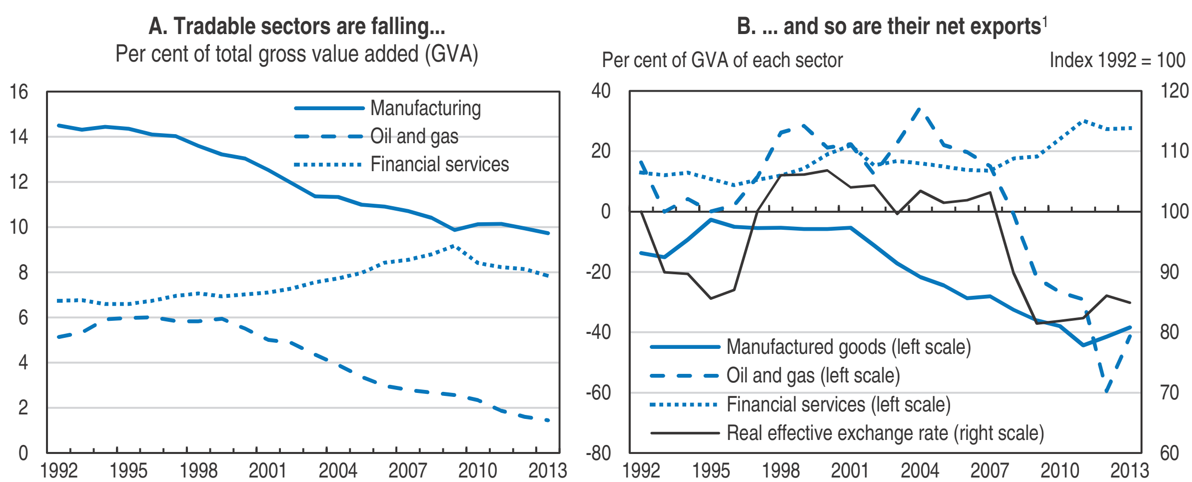
Figure 7. **Declining relative size of export sectors is contributing to weak net exports**



1. Manufactured goods refer to both semi and finished manufactured goods (i.e. Standard International Trade Classification (SITC), Rev. 3: 5-8). Oil and gas refer to SITC, Rev. 3: 32-35 and also include net exports of coal and electricity that are negligible. Competitiveness-weighted real effective exchange rate.

Source: ONS (2014), "Quarterly National Accounts, Q3 2014", Office for National Statistics, December, ONS (2014), "The Pink Book 2014", Office for National Statistics, October and OECD (2015), *OECD Economic Outlook: Statistics and Projections* (database), January.

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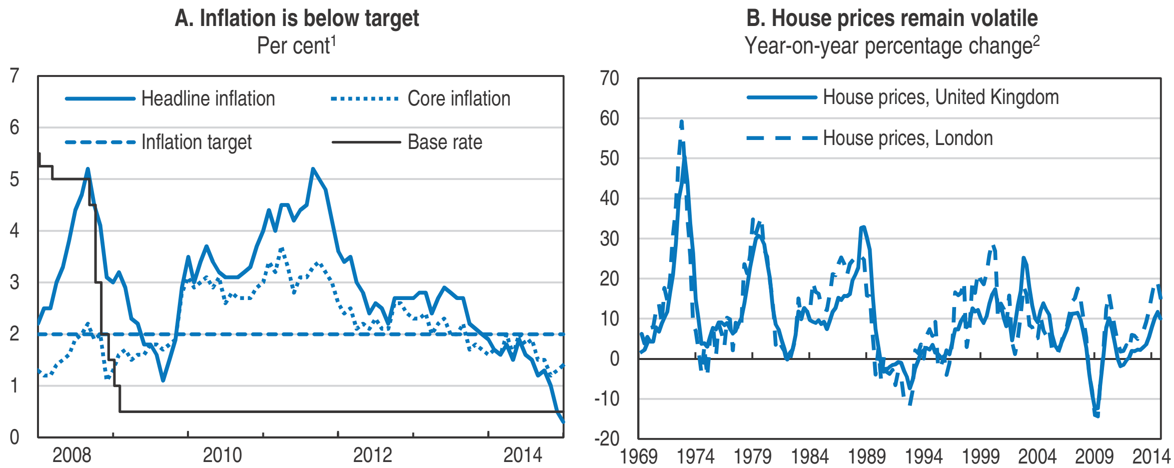
After four years of overshooting, consumer price inflation has fallen significantly below the Bank of England's (BoE) target of 2% to 0.3% in the year to January 2015, the lowest since the consumer price index series began (Figure 8, Panel A). The main driver of this sharp fall has been the reduction in energy prices reflecting plummeting global oil prices, and falling food prices and the appreciation of the exchange rate have also contributed. Low inflation has supported real incomes and provided additional boost to consumption. The recovery in

Figure 8. **Monetary conditions are supportive, but house prices have increased significantly**



1. Headline inflation refers to harmonised consumer prices index. Core inflation excludes energy, food, alcohol and tobacco.
2. Nominal house prices.

Source: Bank of England, ONS (2015), "Consumer Price Inflation, January 2015", Office for National Statistics, February and ONS (2015), "House Price Index, December 2014", Office for National Statistics, February.

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the housing market has been marked by large house price increases, particularly in London (Figure 8, Panel B), raising homeowners' wealth, but also reducing affordability for first-time buyers and contributing to higher household indebtedness. However, there was some moderation in annual house price growth in late 2014.

GDP growth is projected to continue to be driven by private consumption and private investment (Table 1). Capital accumulation should begin to push up labour productivity and real wages. The unemployment rate is projected to continue to fall. Exports will strengthen somewhat, but not enough for market share to rise. Interest rate increases should start as underlying inflation pressures emerge. The pace of interest rate increases will, however, depend on economic developments. Higher interest rates should encourage the selection of more profitable projects and the restructuring of loss-making companies, raising productivity.

Risks are broadly balanced. Regarding domestic risks, uncertainty about the recovery of productivity growth is a major, but to some extent symmetric, risk to the projection. On the downside, labour market pressures could result in real wages rising faster than productivity and lead to cost-push inflation. On the positive side, productivity growth could turn out to be stronger, especially if it is supported by stronger investment, making wage increases sustainable. Planned cumulative fiscal consolidation of almost 2.5% of GDP in 2015 and 2016 could reduce growth by more or by less than projected. House prices could fall, which may create risks for financial stability. The key external risk is the growth of the euro-area economy, which has faltered, but could also bounce more strongly than expected. On the upside, assuming it is sustained, the fall in oil price should boost activity. The UK current account deficit has widened to about 6% of GDP, notably as investment income has disappointed, which could make the economy more sensitive to shift in investor sentiment. Conversely, exports may pick up faster than projected if higher investment and productivity gains allow better export performance.

Table 1. **Macroeconomic indicators and projections**

Annual percentage change, volume (2011 prices)

	2011 current prices (billion GBP)	2011	2012	2013	2014[1]	2015[1]	2016[1]
Gross domestic product (GDP)	1 618	**1.6**	**0.7**	**1.7**	**2.6**	**2.6**	**2.5**
Private consumption	1 039	0.1	1.1	1.7	2.3	2.6	2.1
Government consumption	337	0.0	2.3	-0.3	1.5	-0.3	-1.2
Gross fixed capital formation	261	2.3	0.7	3.4	7.4	6.2	7.6
Housing	104	11.6	-2.9	12.5	7.9	6.1	7.1
Business	123	-1.3	3.9	-1.0	11.1	8.3	9.2
Government	33	-10.1	1.1	-8.9	-3.9	2.0	2.2
Final domestic demand	1 637	0.4	1.3	1.6	3.0	2.6	2.5
Stockbuilding[2]	4	-0.1	0.1	0.2	0.3	-0.1	0.0
Total domestic demand	1 642	0.4	1.5	1.8	3.3	2.5	2.5
Exports of goods and services	499	5.6	0.7	1.5	-1.2	1.4	2.4
Imports of goods and services	523	1.0	3.1	1.4	0.7	1.6	2.2
Net exports[2]	-24	1.3	-0.8	0.0	-0.6	-0.1	0.0
Other indicators (growth rates, unless specified)							
Potential GDP	..	1.2	1.3	1.4	1.9	2.3	2.6
Output gap[3]	..	-2.0	-2.4	-2.0	-1.1	-0.6	-0.4
Employment	..	0.5	1.1	1.2	2.3	1.4	1.1
Unemployment rate	..	8.1	8.0	7.6	6.2	5.6	5.4
GDP deflator	..	2.1	1.7	1.8	1.8	1.4	1.7
Consumer price index (harmonised)	..	4.5	2.8	2.6	1.5	1.3	2.1
Core consumer prices (harmonised)	..	3.0	2.2	2.0	1.6	1.6	2.1
Household saving ratio, net[4]	..	2.9	2.3	0.3	0.3	1.0	1.3
Current account balance[5]	..	-1.7	-3.7	-4.5	-5.6	-5.8	-5.6
General government fiscal balance[5]	..	-7.6	-8.3	-5.5	-5.7	-4.4	-3.1
Underlying general government fiscal balance[3]		-7.2	-7.3	-6.5	-5.5	-4.6	-3.1
Underlying government primary fiscal balance[3]	..	-4.3	-4.8	-4.0	-3.0	-2.1	-0.6
General government gross debt (Maastricht)[5]	..	80.1	83.8	85.3	88.4	90.3	90.6
General government net debt[5]	..	63.1	62.2	61.6	65.0	66.8	67.2
Three-month money market rate, average	..	0.9	0.8	0.5	0.5	1.0	2.3
Ten-year government bond yield, average	..	3.1	1.9	2.5	2.6	2.7	3.5

1. Projections based on OECD (2014), "OECD Economic Outlook No. 96", *OECD Economic Outlook: Statistics and Projections* (database), from November 2014, updated with the latest data available.
2. Contribution to changes in real GDP.
3. As a percentage of potential GDP.
4. As a percentage of household disposable income.
5. As a percentage of GDP.

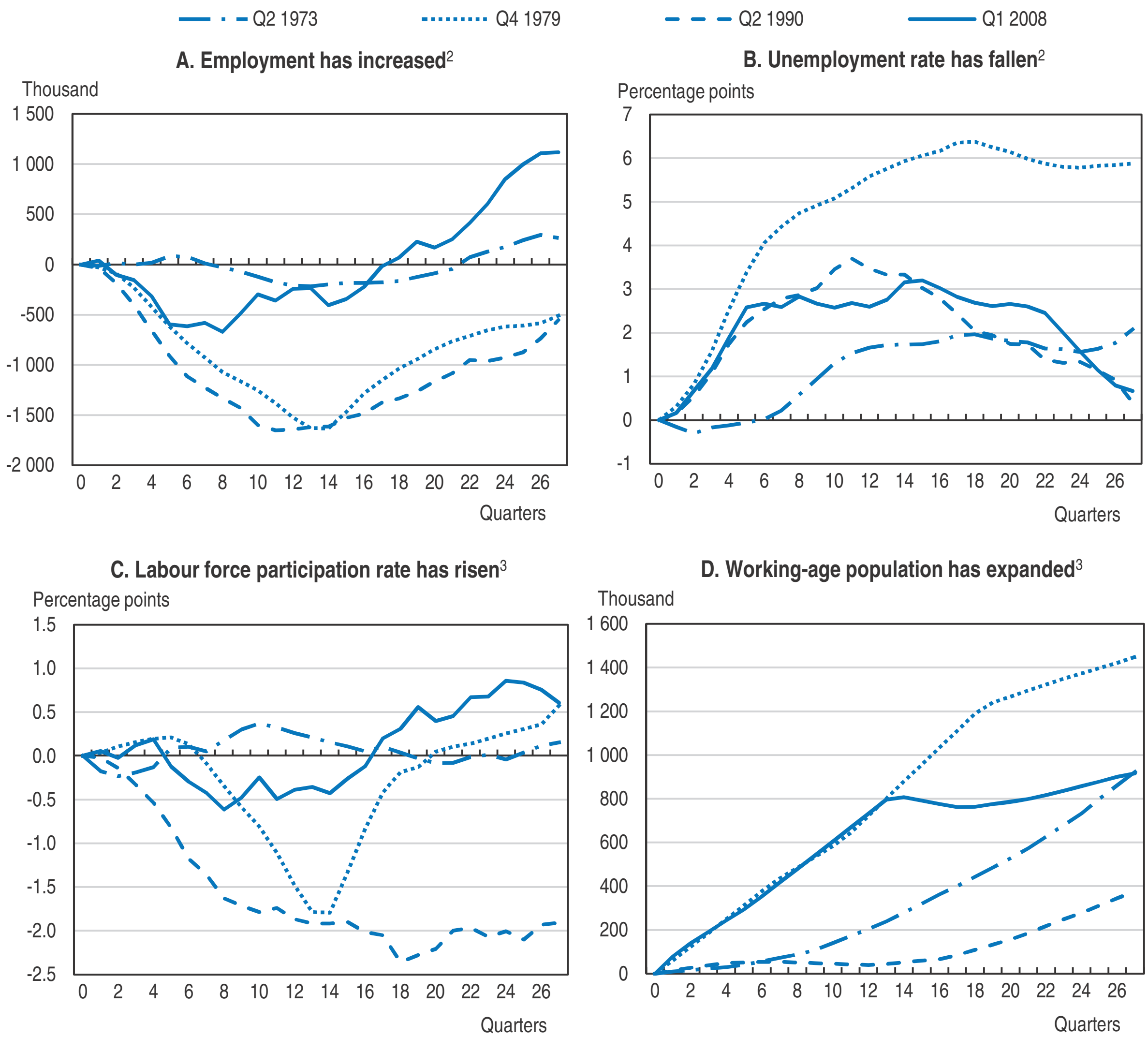
Source: OECD (2015), *OECD Economic Outlook: Statistics and Projections* (database), January.

Employment has been strong, but productivity and real wages have been flat

The labour market has been resilient, with employment rising significantly compared to past recessions (Figure 9, Panel A). Rises in the unemployment rate were contained, compared to output losses, early in the crisis and, more recently, the unemployment rate has declined rapidly (Figure 9, Panel B). However, youth (15-24) unemployment rate remains elevated as it was at nearly 16.5% in the third quarter of 2014 but it fell by about 4.5 percentage points over the year. Activation policies have helped to limit the increase in unemployment (OECD, 2014a). Equally importantly, the labour market has absorbed unusual increases in labour supply (Figure 9, Panels C and D). The participation rate of older workers has risen following pension reforms (Figure 10, Panel A; BoE, 2014a). Welfare

Figure 9. **Labour market developments compared to previous recessions and recoveries**

Deviation from start of recession[1]



1. Change in level for employment and working age population. Change in percentage points for unemployment rate and labour force participation rate. Data for Q4 2014 refer to the period between September and November 2014.
2. Refers to population aged 16 and over.
3. Refers to population aged between 16 and 64.

Source: ONS (2015), "Labour Market Statistics, January 2015", Office for National Statistics.

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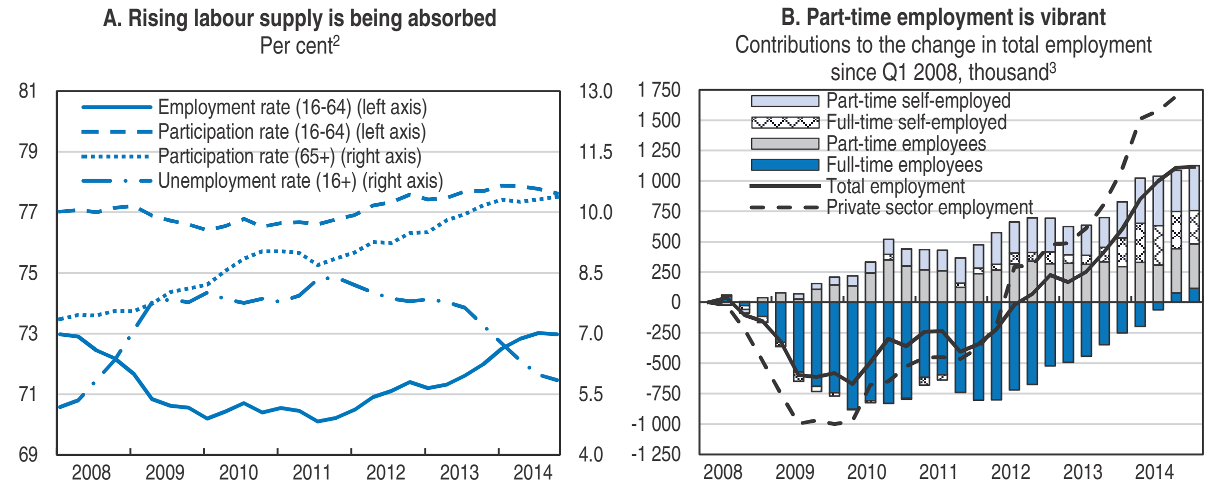
reforms have also lifted the overall participation rate (Figure 10, Panel A) as they sharpened work incentives (Blundell et al., 2014). Sustained inflows of well-educated immigrants have boosted the working-age population (Wadsworth and Vaitilingam, 2014).

Against the background of strong increases in the labour force, private-sector employment has risen by almost three million people since 2010 (Figure 10, Panel B). Employment gains since early 2008 have mainly resulted from part-time workers, many of them self-employed, but more recent increases have been in full-time employment, the number of which slightly exceeds the pre-crisis level. The system of tax credits may have

Figure 10. **Employment performance since the last recession has been strong**[1]



1. Data for Q4 2014 refer to the period between September and November 2014.
2. Employment (16-64) and participation (16-64) rates refer to population aged between 16 and 64. Participation rate (65+) refers to population aged 65 and over. Unemployment rate (16+) refers to population aged 16 and over.
3. Total employment also comprises unpaid family workers and those on government-supported training and employment programmes.

Source: ONS (2015), "Labour Market Statistics, January 2015", Office for National Statistics.

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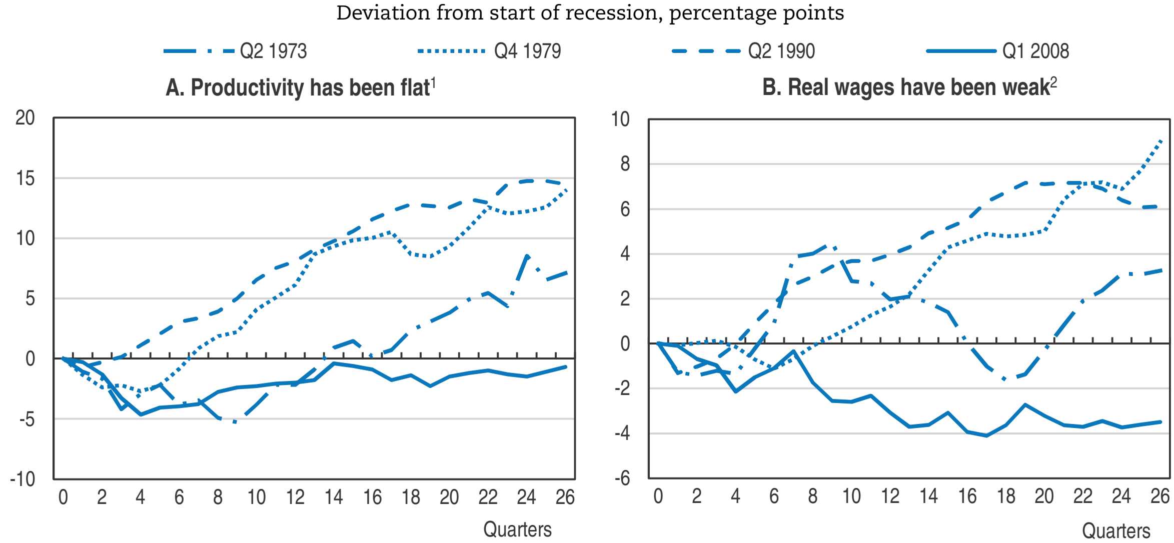
Figure 11. **Productivity and wages have not recovered compared to previous recessions and recoveries**

Deviation from start of recession, percentage points



1. Labour productivity is defined as output per worker (i.e. real gross value added (GVA) divided by total employment).
2. Real wages refer to nominal wages divided by dependent employment and deflated by GDP deflator. Three quarter moving average applied.

Source: ONS (2014), "Labour Productivity, Q3 2014", Office for National Statistics, December and OECD (2015), *OECD Economic Outlook: Statistics and Projections* (database), January.

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encouraged stronger prevalence of part-time work and self-employment (OECD, 2014a). The rise in self-employment could also be traced to structural determinants linked to population ageing and more self-employment among older people (BoE, 2014b). Other important drivers include government programmes and tax incentives, and possibly a higher potential for tax evasion (Ashworth et al., 2014; Goodhart and Ashworth, 2014).

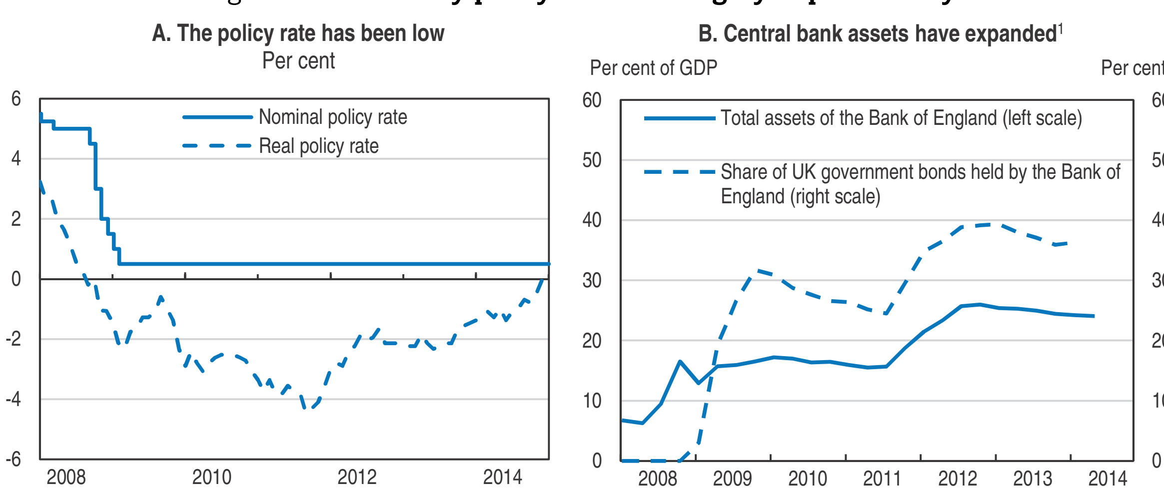
However, labour productivity per employee (and labour productivity per hour) has failed to rise since the global downturn, in contrast to previous recessions and recoveries (Figure 11, Panel A). Income and wealth are below the G7 average (Figure 2, Panel A) and real earnings have been exceptionally weak as they have continued to reflect poor productivity (Figure 11, Panel B). In 2013, real GDP per capita was slightly more than 10% lower than in the upper half of OECD countries, with the gap being essentially explained by lower labour productivity (OECD, 2015). Developing a knowledge-based economy, strengthening infrastructure investment and improving the financing of the economy are all critical in this regard (see below).

Normalising macroeconomic policies

Gradually reducing the size of monetary stimulus

In response to the global crisis, the policy rate was cut to 0.5% in March 2009, and has been negative in real terms until recently (Figure 12, Panel A). Between March 2009 and October 2012, the BoE implemented quantitative easing (QE) by purchasing GBP 375 billion (nearly 25% of GDP) of long-term securities, essentially government bonds (Figure 12, Panel B). Empirical studies suggest that the QE programme may have lowered 10-year gilt yields by 90 basis points, corresponding to a cut in the policy rate by around 350 basis points, and providing temporary boost to real GDP estimated at about 2% (Rawdanowicz et al., 2014). The overall short-term stimulus of QE on GDP is likely to have been higher, as the programme also weakened the exchange rate and improved household financial wealth.

Figure 12. **Monetary policy has been highly expansionary**



1. Government bonds refer to conventional gilts.

Source: Bank of England, ONS (2015), "Consumer Price Inflation, January 2015", Office for National Statistics, February and UK Debt Management Office.

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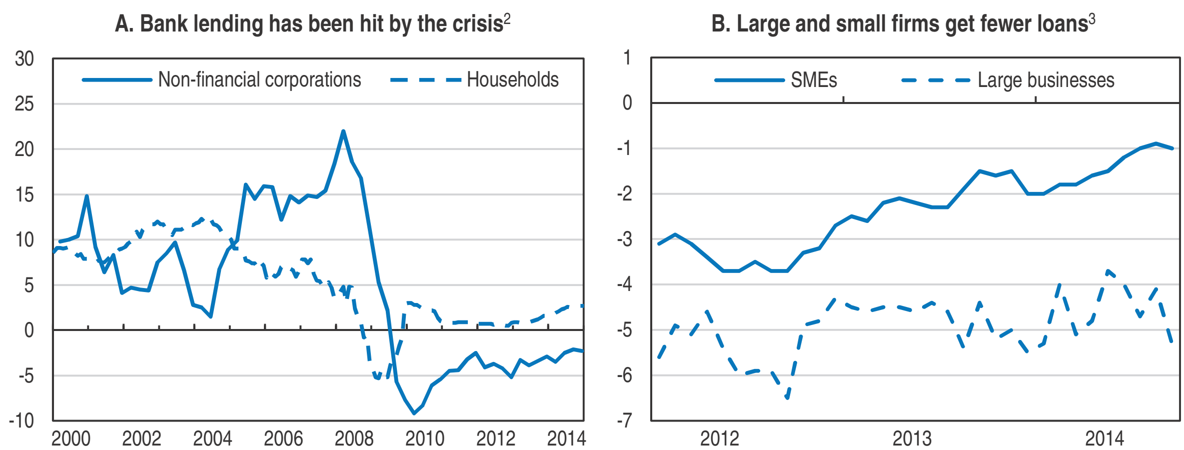
In July 2012, the Treasury and the BoE launched the Funding for Lending Scheme (FLS) to provide funding to banks and building societies on attractive conditions linked to their lending performance. Since then, the programme was modified by further increasing incentives to lend to SMEs in April 2013, but was terminated for mortgages in November 2013. The FLS has contributed to a reduction in bank funding costs, helping to unblock access to bank lending. Survey evidence suggests that broader credit conditions have improved for businesses of all size, including SMEs. Although bank lending to businesses has continued to fall (Figure 13), the programme may have prevented steeper declines (BoE, 2014b). Yet, empirical evidence has not found an impact on the loan supply to SMEs from the expansion of the scheme between April and December 2013, at the time declining market funding costs were reducing banks' incentives to use the programme (Havrylchyk, 2015). To insure against an increase in banks' funding costs, in December 2014 the Treasury and the BoE extended the scheme to January 2016. The UK government has also established the British Business Bank to unlock lending to smaller businesses, bringing together existing and new support programmes.

Figure 13. **Net loan growth of monetary financial institutions has been weak**

Per cent[1]



1. 12-month growth rates. Data are not seasonally adjusted.
2. Lending to non-financial corporations (NFCs) refers to UK resident monetary financial institutions' sterling and all foreign currency net lending to NFCs. Lending to households refers to monetary financial institutions' sterling net lending (M4) to the household sector.
3. These data relate to loans and advances in all currencies made by UK monetary financial institutions (MFIs) to non-financial businesses, including to small and medium-sized enterprises (SMEs). SMEs are defined as those with an annual debit account turnover on the main business account of up to GBP 25 million. Those with an annual debit account turnover on the main business account above GBP 25 million are termed "large businesses".

Source: Bank of England (2015), "Monetary and Financial Statistics", *Statistical Interactive Database*, January.

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In March 2013, the government announced the Help to Buy programme to stimulate loan demand for high loan-to-value mortgages (a deposit of only 5% is required) and to encourage housing supply. Help to Buy has so far supported a total of close to 70 000 transactions, broadly in line the authorities' expectations, compared to transactions of about 100 000 per month that were executed in 2014. The programme has been used predominantly by first-time buyers outside London, with average transaction prices being significantly below the national average.

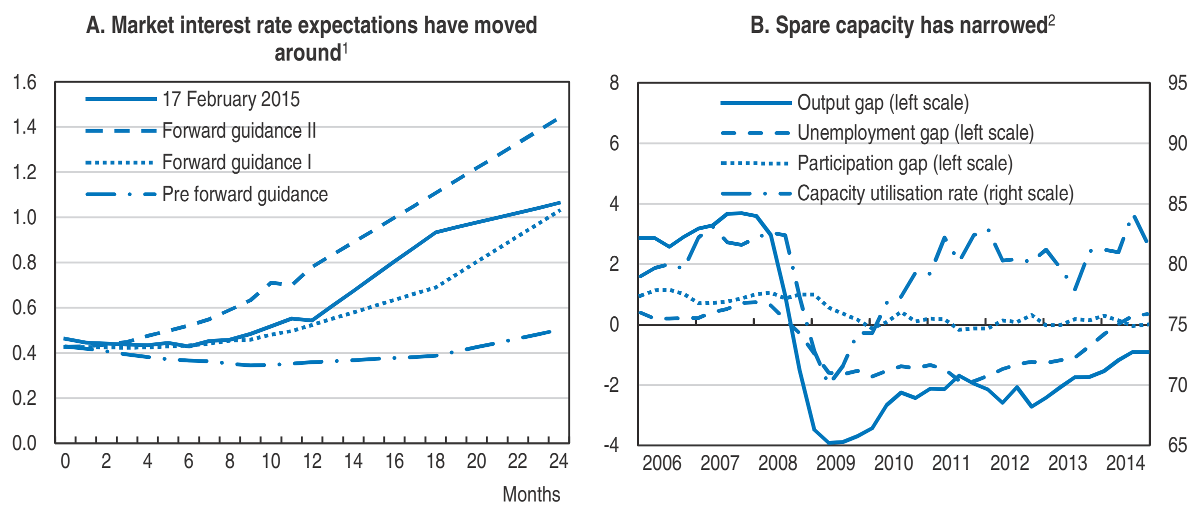
In August 2013, the BoE adopted forward guidance, emphasising the importance of communicating the factors that would frame the monetary policy stance, in particular the unemployment rate. Survey evidence suggests that greater certainty about interest rates may have supported confidence, particularly of businesses, contributing to higher investment and hiring decisions of some firms (BoE, 2014c). As the unemployment rate rapidly plunged toward the threshold of 7%, forward guidance was refined in February 2014 with the BoE starting the publication of a wide range of variables since then. Moreover, the

Monetary Policy Committee indicated that there remained scope to further absorb spare capacity before lifting the policy rate, and that future interest rate normalisation would be limited and gradual, to a level materially below the pre-crisis average of 5%.

Monetary accommodation has so far proved sustainable in the sense that inflation has fallen below the inflation target of 2% (Figure 8, Panel A) and wage pressures have been non-existent, although real wage growth has become positive more recently. The timing and pace of the withdrawal of monetary support will depend on economic developments, notably, and in accordance with the BoE's symmetric inflation target to ensure that inflation expectations remain anchored. Market participants' expectations of interest rate normalisation have moved around (Figure 14, Panel A). Slack has been closing, although such measures are uncertain and there is evidence that some workers would like to work longer hours (Blanchflower and Machin, 2014) (Figure 14, Panel B). The number of vacancies has been rising steeply in the main sectors and the number of unemployed per vacancy has been falling (Figure 15). Policymakers should look through temporary effects on inflation of weaker commodity prices and a stronger exchange rate.

Figure 14. **Normalisation of policy rates should start soon**

Per cent



1. Future interest rates derived from zero yield curves. Horizontal axis refers to the number of months into the future. Pre forward guidance refers to the average of interest expectations for the period between 2 Jan. 2013 and 6 Aug. 2013. Forward guidance I refers to the average of interest expectations for the period between 7 Aug. 2013 and 11 Feb. 2014. Forward guidance II refers to the average of interest expectations for the period between 12 Feb. 2014 and 17 Feb. 2015.
2. Capacity utilisation rate in the manufacturing sector. Output gap is defined as the difference of actual and trend output as a percentage of trend. Unemployment gap is defined as the difference between non-accelerating inflation rate of unemployment (NAIRU) and unemployment rate. Participation gap is defined as the difference of actual and trend participation rate as a percentage of trend.

Source: OECD calculations based on Datastream and OECD (2015), *OECD Economic Outlook: Statistics and Projections* and *Main Economic Indicators* (databases), January.

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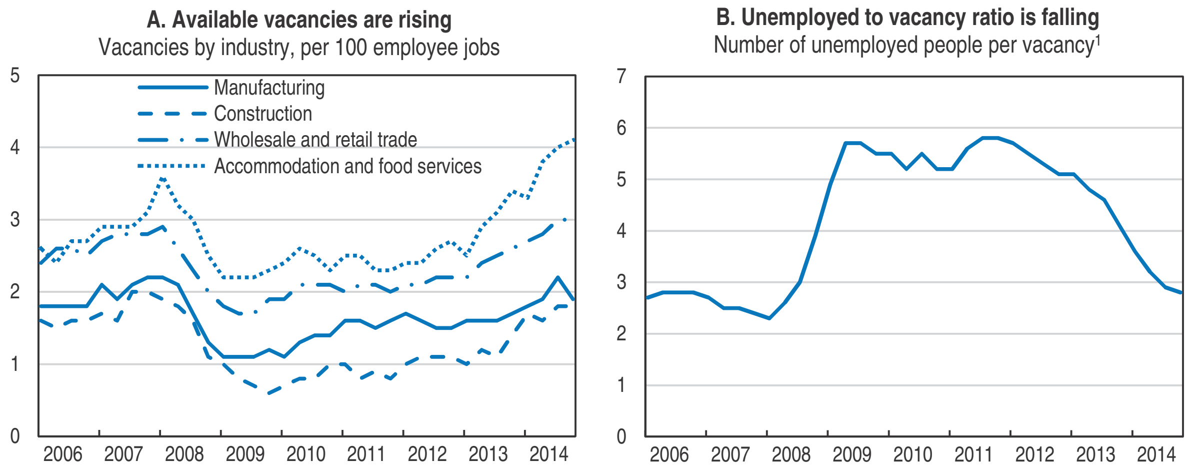
The BoE does not plan to reduce the stock of purchased assets until after the first interest rate hike (BoE, 2014c). This sequencing would give it some room for manœuvre to use the policy rate as an active tool in response to adverse shocks to activity. In any case, transparent communication will be needed during the exit from years of a highly-accommodative policy stance.

Figure 15. **Tensions are emerging in the labour market**



1. Unemployment data refer to the population aged 16 and over. Data for Q4 2014 refer to the period between September and November 2014.

Source: ONS (2015), "Labour Market Statistics, January 2015", Office for National Statistics.

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Continuing fiscal consolidation

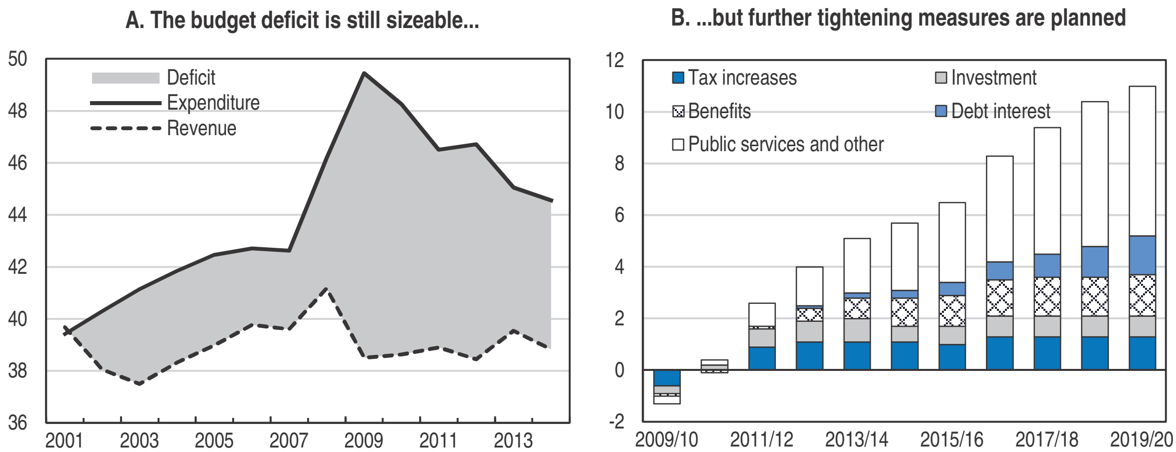
Public finances were hit hard by the crisis and the budget deficit reached nearly 11% of GDP in 2009 (Figure 16, Panel A). From 2010 to the end of 2014, the government had been pursuing two fiscal targets: i) to balance the current budget (which is overall budget net of investment spending) in cyclically-adjusted terms by the end of a rolling five-year period; and ii) to begin to reduce public sector net debt (which is gross debt excluding liquid assets) as a share of GDP in 2015-16. To reach both targets, the authorities have been implementing a medium-term fiscal consolidation plan (Figure 16, Panel B). The budget, net of investment spending, is projected to reach a cyclically-adjusted surplus of 0.7% in 2017-18 and public sector net debt is projected to peak in 2015-16 and start falling the year after (OBR, 2014). From Budget 2015, the updated fiscal mandate will aim to achieve cyclically-adjusted current balance by the end of a rolling three-year period and a falling public sector net debt as a share of GDP in 2016-17. Implementation of fiscal consolidation has been monitored by the Office for Budget Responsibility (OBR), a high-profile fiscal watchdog created in 2010, whose stability and independence could be consolidated if it were funded by a multiannual commitment under Parliament's scrutiny. OBR's independence could also be strengthened by defining the term span of the chair independently of the electoral cycle (OECD, 2014b).

Between budgets 2009-10 and 2014-15, discretionary measures amounted to 7% of GDP, with three-quarters of the adjustment on the spending side, including cuts in public services, investment and benefits. More recently, some revenues have disappointed owing to weaker wage growth, lower residential property transactions and lower oil and gas revenues. This will require further offsetting measures to stick to the medium-term consolidation plan.

Fiscal consolidation has had important distributional effects, as it mainly fell on the top 20% of earners essentially because of tax increases, and the bottom 20% of earners because of cuts in tax credits and benefits, partly offset by successive above-inflation increases in the tax-free allowance (Figure 17, Panel A). However, the net position of the

Figure 16. **Fiscal consolidation is underway**

Per cent of GDP



Source: OECD (2015), *OECD Economic Outlook: Statistics and Projections* (database), January and Institute for Fiscal Studies.

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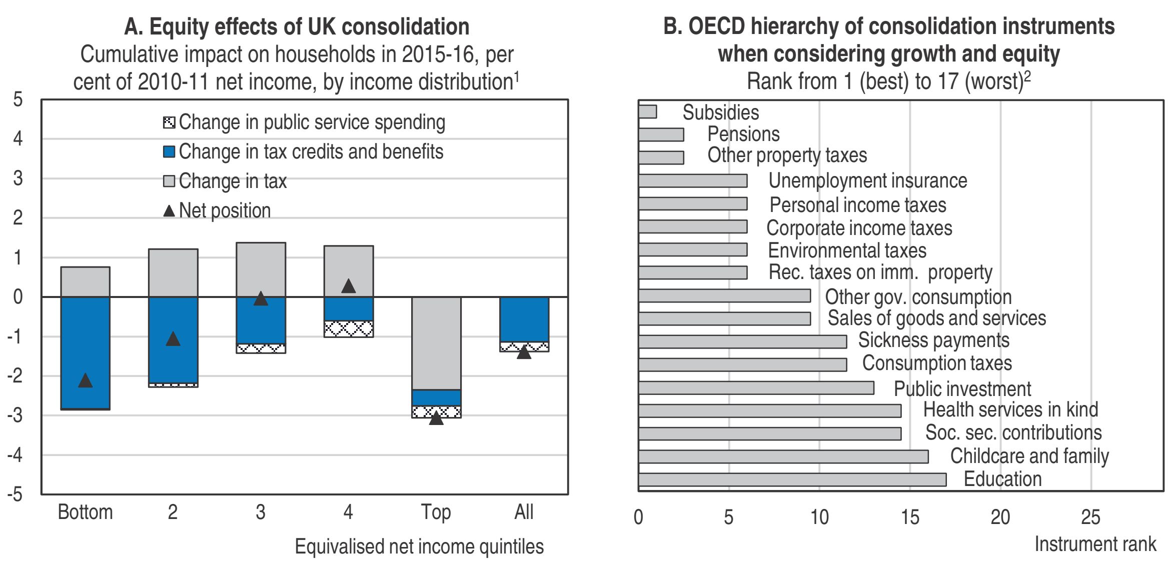
Figure 17. **Distributional impact of fiscal consolidation**



1. Cumulative impact of public service spending, tax and welfare changes on households in 2015-16 as a percentage of 2010-11 net income (including households' benefits in kind from public services). Net income quintiles adjusted for household size.
2. The ranking of instruments is determined based on their short-term and long-term effects on growth, short-term and long-term effects on equity, with equal weights and scores of +1 (positive influence) or -1 (negative influence) attributed in each case.

Source: HM Treasury (2014), "Impact on Households: Distributional Analysis to Accompany Autumn Statement 2014", December and Cournède, B., A. Goujard and Á. Pina (2013), "How to Achieve Growth- and Equity-friendly Fiscal Consolidation?: A Proposed Methodology for Instrument Choice with an Illustrative Application to OECD Countries", *OECD Economics Department Working Papers*, No. 1088, OECD Publishing.

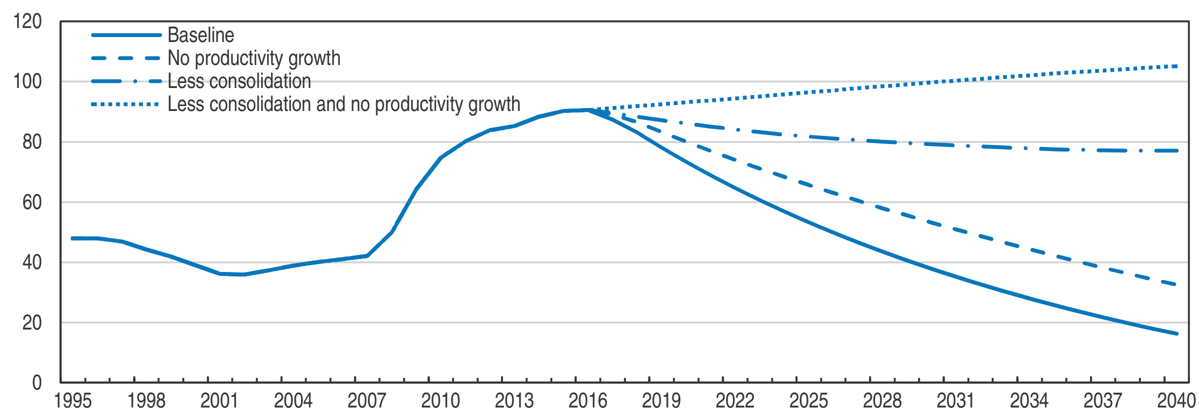
StatLink http://dx.doi.org/10.1787/888933189117

third and fourth income quintiles has so far been little affected. Once real wage increases start to be sustained, a stronger contribution from average-income earners to additional fiscal consolidation efforts would help to reduce pressure on low-income earners. The authorities' assessment of distributional impacts of fiscal consolidation is welcome and should be continued. Performing such analysis as policy proposals evolve would further support sound decision-making.

If the latest medium-term projection of the OBR to reach a budget surplus of 1% of GDP in 2019 is achieved (OBR, 2014) and assuming nominal GDP growth is about 4.5%, debt will fall sharply relative to GDP (Figure 18, baseline scenario). Structural reforms would make it easier to maintain such a surplus, though. In particular, raising the state pension age for men and women to 66 in 2020 and to 67 between 2026 and 2028, as already legislated, and linking the pension age to life expectancy, as the government has announced, would mitigate spending pressures. On the other hand, a recent decision to allow higher lump-sum withdrawals of pension assets, designed to give people flexibility and to make an informed choice, could however result in people having too little saving for retirement, ultimately resulting in political pressure to raise state pensions (OECD, 2014c). Public debt would only stabilise at nearly 80% of GDP if fiscal consolidation were to stop in 2016 and the budget deficit remained at close to 3% of GDP thereafter (the "less consolidation" scenario). Should productivity be flat and the deficit maintained at 3% of GDP, the public debt would rise steadily (the "less consolidation and no productivity growth" scenario).

Figure 18. **Simulations show that reducing public debt will require further efforts**

General government gross debt, Maastricht definition, per cent of GDP[1]



1. The baseline scenario shows projections based on the *OECD Economic Outlook: Statistics and Projections* database until 2016, prolonged with the growth scenario used in the OECD (2014), "Long-term Baseline Model" (GDP growth in the period 2017-40 averaging 2.6% in real terms and 4.6% in nominal terms). It excludes financial transactions and assumes achieving budget balance in 2018 and a surplus of 1% of GDP from 2019 onwards. The "no productivity growth" scenario assumes only employment growth (averaging 0.5% in real terms) over 2017-40. The "less consolidation" scenario assumes that the budget deficit stabilises over 2017-40 at 3.1% of GDP. The "less consolidation and no productivity growth" scenario is a combination of constant budget deficit at 3.1% of GDP and only employment growth over the period 2017-40.

Source: Calculations based on OECD (2015), *OECD Economic Outlook: Statistics and Projections* (database), January and Office for Budget Responsibility (2014), "Fiscal Sustainability Report", July.

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Fiscal consolidation needed to fulfil the authorities' medium-term plan amounts to an estimated reduction in the primary structural budget balance of nearly 2.5% of GDP from 2014 to 2016 (Table 1). From 2015-16, the authorities plan to cap welfare spending (apart from pension and unemployment benefits) while public services are expected to bear the major part of the adjustment (Figure 16, Panel B). This would imply reducing government consumption of goods and services by around 6.5% of GDP between 2010-11 and 2019-20, to the lowest level at least since 1948 (OBR, 2014). However, the exact composition of fiscal adjustment will need to be set out by the next government. Continuing the current policy of protecting (i.e. maintaining or slightly raising real spending) some departments (health, education and international development) would imply average cuts in real terms on the others of close to 40% between 2010-11 and 2019-20 (Crawford, 2014). The current government is aiming to achieve further efficiency gains in public administration, but there is evidence suggesting the potential scope for this is rather low (Hribernik and Kierzenkowski, 2013). Hence, the composition of fiscal adjustment should be reviewed to ease pressure on public services that have already contributed to consolidation.

There is scope to boost further efficiency in the health sector and education (OECD, 2011a; OECD, 2011b). In the former, by addressing excessive remuneration for general practitioners and by further increasing competition in health care provision. In the latter, efficiency can be strengthened by supporting higher and more equal autonomy across school types, and focusing investment and policies on disadvantaged children could generate more long-term savings. Yet, reforms should be carefully calibrated to preserve high health status (Figure 2, Panel A), growth and equity (Figure 17, Panel B).

There is room to increase revenue while making the tax system more efficient. Income tax expenditures are large and reducing them in certain areas could also improve resource allocation and productivity (Cournède et al., 2013). In particular, the self-employed could be subject to the same income taxes as employees, as recommended by the *Mirrlees Review* (Mirrlees et al., 2011), which would support the quality of entrepreneurship and hence productivity. Moreover, higher social security contributions could be levied on the self-employed. Updating property valuations of the council tax, as discussed below, would further support public finances and improve equity, and would not hurt growth much (Figure 17, Panel B). Removing preferential and zero value-added tax (VAT) rates could generate substantial revenue (Cournède et al., 2013; OECD, 2011a). Only reduced VAT rates on food, energy and water supply have major progressive effects and therefore removing them could require adjustments to welfare programmes to protect the poor (Thomas, 2014).

Key macroeconomic policy recommendations

- As underlying inflationary pressures emerge, gradually start increasing the policy rate and, thereafter, begin reducing the size of the Bank of England's balance sheet.
- Continue to pursue the medium-term fiscal consolidation path while letting automatic stabilisers operate, and ensure consolidation efforts are fair.
- Seek further efficiency gains in health and education, and broaden the tax base, such as equalising income taxes and social security contributions between the self-employed and employees.

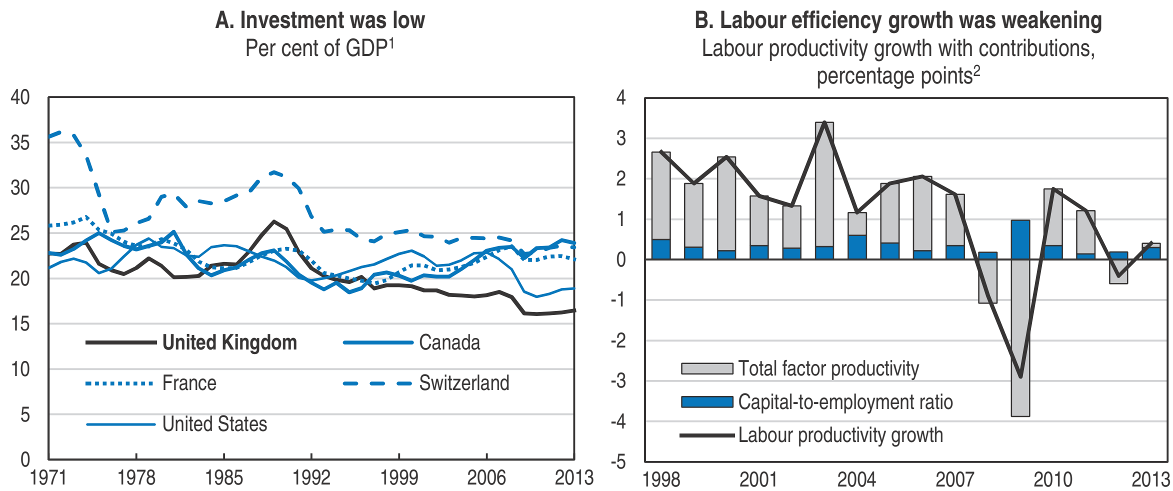
Rekindling productivity growth

Drivers of the productivity puzzle

Subdued productivity since the crisis may reflect a combination of shocks that have lowered capital stock accumulation, reduced labour efficiency and boosted labour supply. These shocks have compounded productivity developments that were losing momentum in the run-up to the crisis.

The investment ratio was trending downward and was low in international comparison prior to the crisis (Figure 19, Panel A). It has been further hit by the global downturn, which led to weak demand, large uncertainty and depressed business confidence (Figure 5, Panel B). Impaired credit availability (Figure 13) and higher bank lending spreads, particularly for SMEs (Figure 20), have held back business investment. Tighter financial regulation needed to enhance financial stability and the reassessment of risk could have long-lasting effects (Cournède, 2010; Slovik and Cournède, 2011; Broadbent, 2012; McCafferty, 2014; Daly, 2014; Lewis et al., 2014). Fiscal consolidation has contributed to lower accumulation of the capital stock by the public sector (Figure 16, Panel B). At the same time, high wage flexibility may have encouraged substitution of labour for capital.

Figure 19. **Productivity growth was losing momentum before the crisis**



1. Investment refers to gross fixed capital formation.
2. Labour productivity is defined as output per worker (i.e. real gross value added (GVA) divided by total employment). Contributions to growth are calculated using a weight of 0.67 for employment and 0.33 for productive capital; total factor productivity is calculated as a residual. Productive capital excludes investment in housing.

Source: OECD (2015), *OECD Economic Outlook: Statistics and Projections* (database), January, ONS (2014), "Labour Productivity, Q3 2014", Office for National Statistics, December, ONS (2014), "Capital Stocks and Consumption of Fixed Capital, 2014", Office for National Statistics, November and ONS (2015), "Labour Market Statistics, January 2015", Office for National Statistics.

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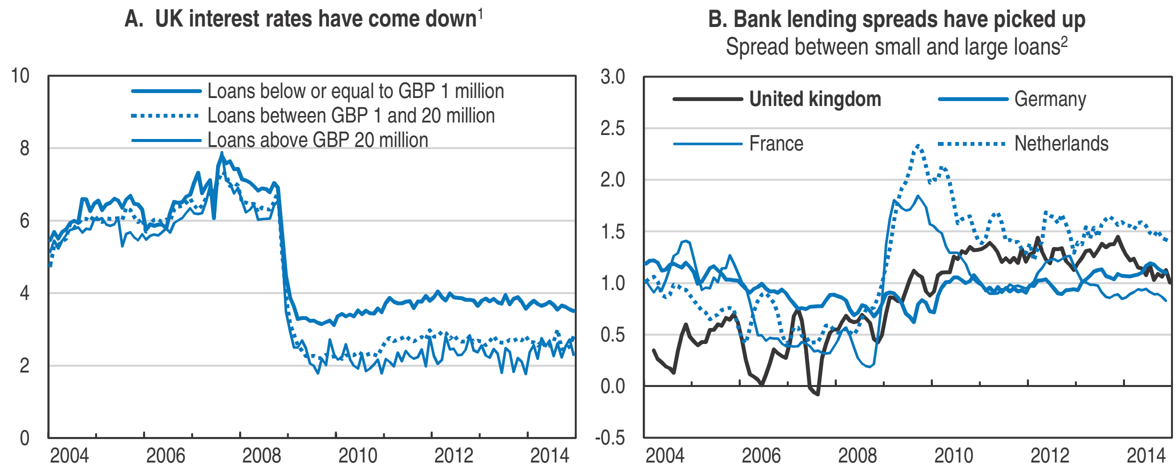
Total factor productivity (TFP) growth was weakening before the crisis (Figure 19, Panel B). Since the crisis, the build-up of intangible capital has fallen as the proportion of companies reporting product and process innovation has dropped (Barnett et al., 2014a). Moreover, capital and labour reallocation has weakened, holding back TFP. Churn in the labour market tumbled, although it has been rising more recently (Figure 21, Panel A), and there is evidence of less worker reallocation from low to high productivity firms (Barnett et al., 2014b). The movement of capital across and within sectors has been particularly low despite a significant increase in the dispersion of rates of returns, which should have increased incentives to reallocate (Barnett et al., 2014c). Pressure for corporate restructuring may have been lower than in the previous recession as reflected by a high share of loss-making firms, one reason being weak lending efficiency and possibly a crowding out of lending to new firms (Figure 21, Panel B). Also, business liquidations have been low compared to the size of the output shock and relative to the previous recession of the early 1990s. Poor resource reallocation may have resulted from bank forbearance and

Figure 20. **Businesses face lower bank lending rates, but higher risk premiums**

Percentage points



1. Monthly average of weighted average interest rates of UK resident monetary financial institutions' (excluding Central Bank) new sterling loans to private non-financial corporations. Not seasonally adjusted.
2. Three month moving average applied. In the United Kingdom, small loans are defined as loans below GBP 1 million, while in France, Germany and Netherlands small loans are defined as loans below EUR 1 million.

Source: Bank of England (2015), "Interest and Exchange Rates Data", *Statistical Interactive Database*, January and ECB (2015), "MFI Interest Rates", *Statistical Data Warehouse*, European Central Bank, January.

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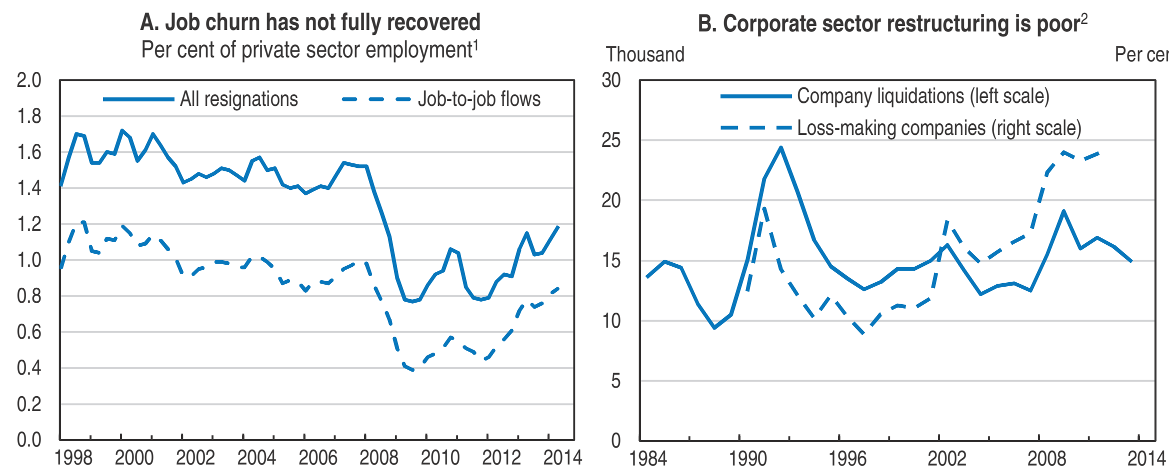
low interest rates (Arrowsmith et al., 2013), and some tax reliefs for firms (Barnett et al., 2014a).

Structural reforms have strengthened labour supply. Welfare, pension and immigration reforms have lowered reservation wages, and declines in labour unionisation have reduced labour's bargaining power (Blundell et al., 2014; Pessoa and Van Reenen, 2014; OECD, 2014a). These reforms have lifted the participation rate (Figure 9, Panel C; Figure 10, Panel A), which otherwise would have been falling if only accounted for by population ageing (BoE, 2014d). Increased labour supply has put downward pressure on productivity and it may take time for the capital stock to adjust to the higher level of labour (Carney, 2014). Moreover, recent job growth has partly been concentrated among individuals who may have lower-than-average productivity, moving into employment with generally lower skills and/or remaining self-employed.

Subdued productivity since 2007 is reflected in a persistent gap between actual and trend output, while employment has essentially converged to its pre-crisis trend (Figure 22) and total hours worked are already slightly above pre-crisis trend. However, this masks important heterogeneity across sectors (Figure 23; Kierzenkowski et al., 2015).

In non-financial services (explaining about a third of the overall productivity shortfall), employment and output have been recovering since 2010 but productivity growth has weakened, notably as the sector has absorbed increased labour supply (Figure 23, Panels A and B). In fact, this sector has been a high recipient of self-employed. In manufacturing (accounting for almost 30% of the overall productivity shortfall), employment was steadily falling prior to the crisis but it has been remarkably stable since 2010, suggesting weaker corporate restructuring and substitution of labour for capital (Figure 23, Panels C and D). In parallel, weak output may have reduced incentives for business investment. In the finance and insurance sector (contributing nearly 25% to the total productivity gap), output has

Figure 21. **The reallocation of labour and capital resources has been weak**



1. All resignations refer to the number of people who report resigning three months ago, and report being employed, unemployed or inactive. Job-to-job flows refer to the number of people who report resigning three months ago, and report being in employment for less than three months. Two quarter averages.
2. Loss-making firms refer to the number of companies that reported negative pre-tax profits in each year as a percentage of the total number of private non-financial corporations in the Bureau van Dijk data set that report data on pre-tax profits. Companies in the mining and quarrying, electricity and gas supply, and water supply sectors and extra-territorial organisations are excluded from the calculations. For company liquidations changes to legislation, data sources and methods of compilation mean the statistics should not be treated as a continuous and consistent time series. Since the Enterprise Act 2002, a number of administrations have subsequently converted to creditors' voluntary liquidations.

Source: Bank of England (2014), "Inflation Report, November 2014" and "Inflation Report, August 2013", and Bank of England (2014), "The UK Productivity Puzzle", *Quarterly Bulletin 2014 Q2*, June.

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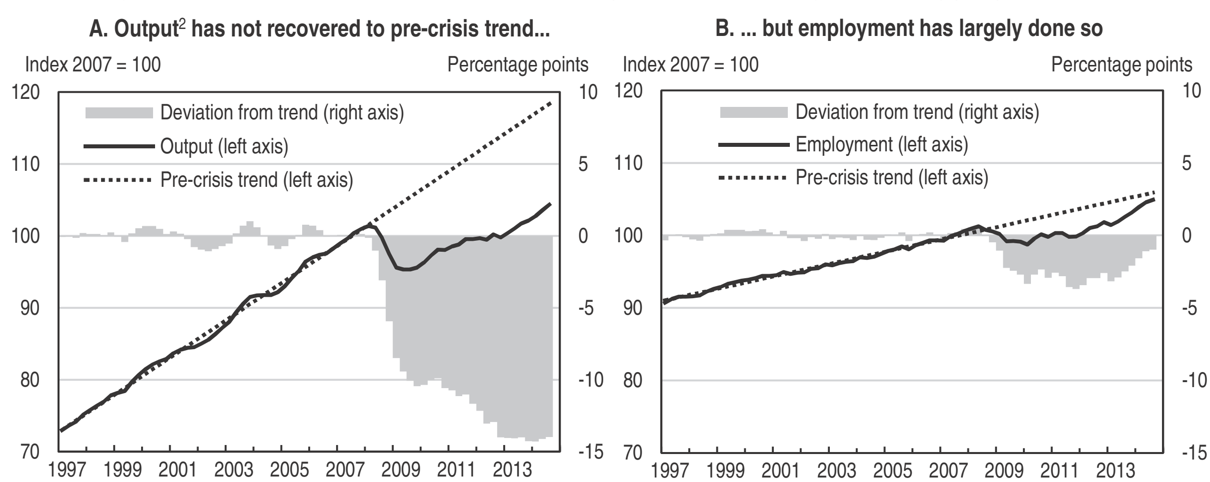
Figure 22. **Weak output is the main drag on productivity at the aggregate level**[1]



1. Pre-crisis linear output and employment trends are calculated between 1997 and 2007, and are projected from 2008 onwards.
2. Real gross value added (GVA).

Source: ONS (2014), "Quarterly National Accounts, Q3 2014", Office for National Statistics, December and ONS (2014), "Labour Productivity, Q3 2014", Office for National Statistics, December.

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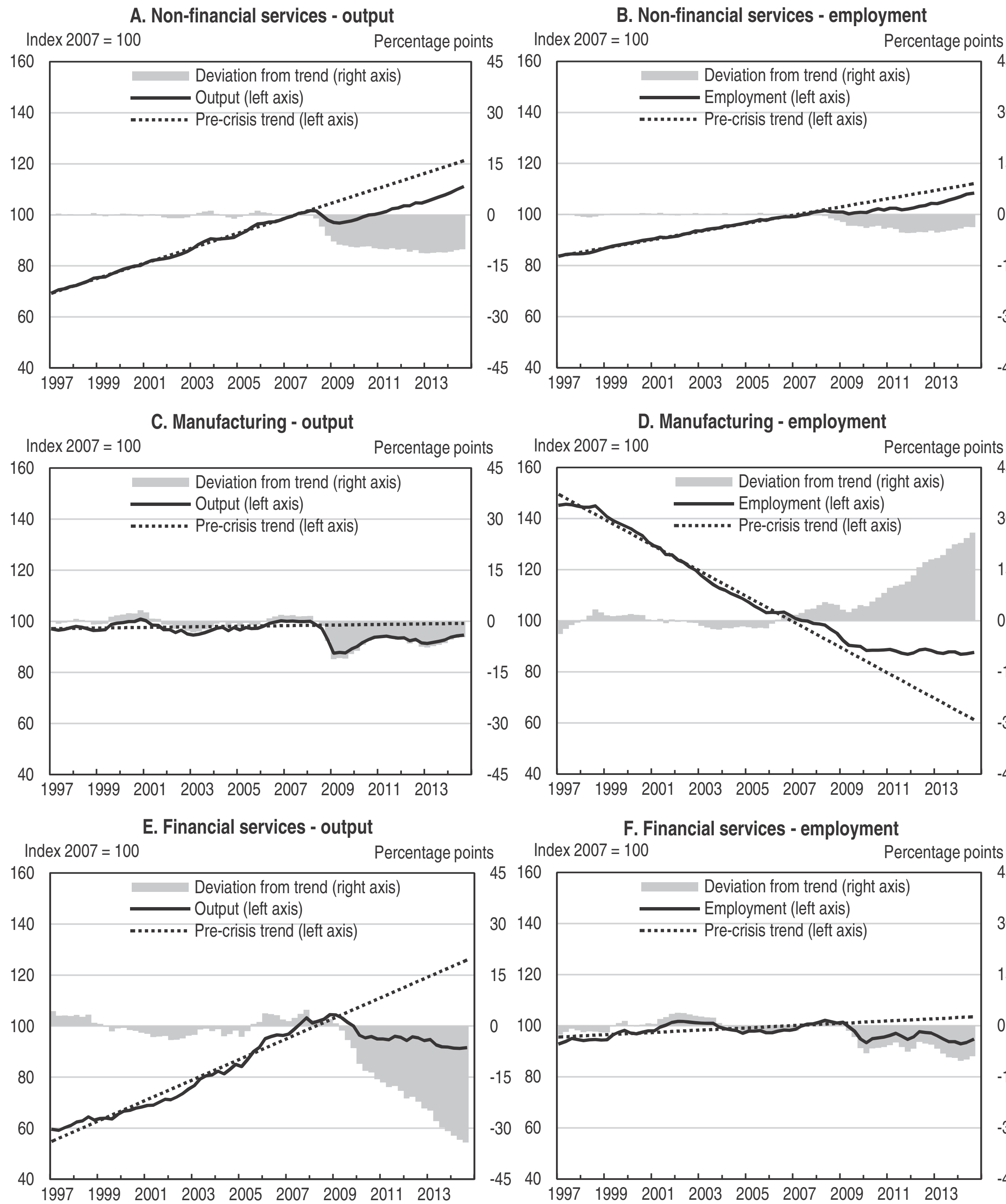
been falling in the wake of the financial crisis, but employment has been fairly steady perhaps owing to redeployment of staff to address higher compliance costs of tighter financial regulation (Figure 23, Panels E and F). With shrinking mining and quarrying

Figure 23. **There is significant heterogeneity in output and employment developments across sectors**[1]



1. Output refers to real gross value added (GVA). Pre-crisis linear output and employment trends are calculated between 1997 and 2007, and are projected from 2008 onwards.

Source: ONS (2014), "Quarterly National Accounts, Q3 2014", Office for National Statistics, December and ONS (2014), "Labour Productivity, Q3 2014", Office for National Statistics, December.

StatLink *http://dx.doi.org/10.1787/888933189175* sector (Figure 7, Panel A) (driving around 3% of the aggregate productivity shortfall) employment and output were on a secular decline before the crisis, but rising maintenance costs and willingness to improve production may explain an expansion in labour between 2009 and 2012. Indeed, output of the sector has stabilised since late 2012.

Enhancing a knowledge-based economy

Reforms are needed to strengthen the supply side of the economy and to unleash productivity. The UK has long-standing challenges related to education and skills (Figure 2, Panel A), take-up of research, infrastructure and land-use planning, and access to finance for young and innovative firms. Policies to favour a knowledge-based economy could include encouraging highly qualified immigrants to work and live in the UK, which would help to address skill shortages and to boost labour productivity. To that end, the government should ease quotas on company-sponsored visas, which were introduced between 2008 and 2010 at a time of low labour demand, but are too restrictive for the tightening labour market.

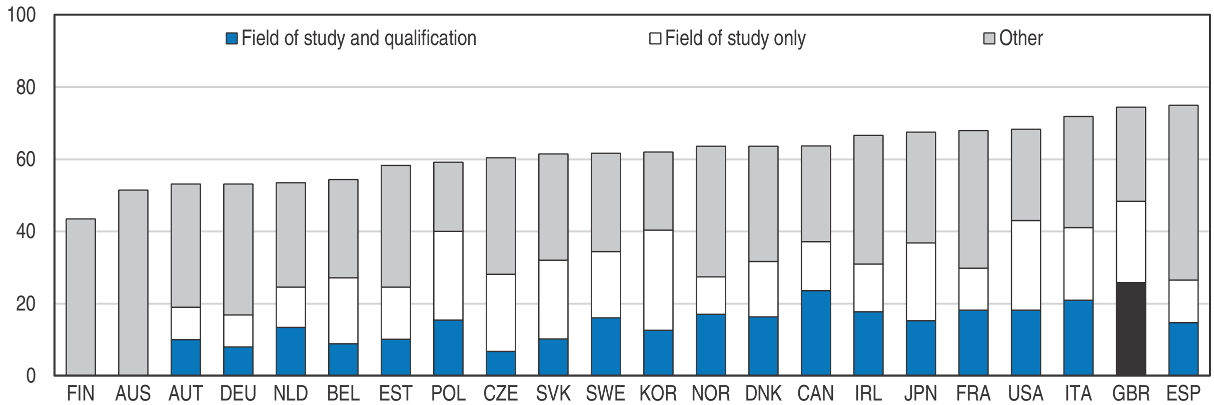
The youth employment rate is close to 50% and exceeds the OECD average by nearly 10 percentage points, but the UK slightly lags behind the rest of the G7 in terms of education and skills (Figure 2, Panel A). Reducing the incidence of labour market mismatches of youth in employment – which is high in terms of field of study and qualification, and field of study only (Figure 24) – would also improve labour efficiency. This could be achieved by requalification and lifelong learning. Improving career guidance and encouraging the combination of work and study would be additional steps to reduce mismatches of labour market entrants (OECD, 2014d), and the government has put strong emphasis on developing apprenticeships. Reforms of vocational education in England (OECD, 2013a) – including the expansion of high quality post-secondary programmes, employer engagement in the development of qualifications, and improvements in teacher qualification requirements – would be additional steps forward to enhance skills and productivity.

Vibrant competition in product markets is also an effective spur to productivity. The UK product market regulation is among the least restrictive in the OECD, although there is scope to reduce barriers in services sectors and relax the licence and permits system (Figure 25). In particular, a “silence is consent rule” is not a standard procedure, there are no single contact points for all licences and at the local level (at least in the three largest cities), and access to some commercial activities is subject to entry requirements (road freight business, retail outlets, accountancy, architecture). According to 2015 *Doing Business* survey of the World Bank, the UK overall ranks 8th out of 189 countries, but only 45th for starting a business, 68th for registering property, 70th for getting electricity, and 36th for enforcing contracts. More generally, continued efforts to develop knowledge-based capital, maintaining market dynamism and sustaining the diffusion of new technologies are key to raise productivity growth.

Tax measures continue to be implemented to encourage innovation and business investment (OECD, 2013b). The government has increased tax incentives for research and development and has announced a temporary business rates relief for small businesses. Business investment will also benefit from a more generous annual investment allowance until the end of 2015. The corporate income tax rate was cut in steps from 30% in 2007 to 20% in 2015, the lowest single rate for businesses of all sizes in the G20. Also, in 2013 the authorities introduced a “Patent Box”, a tax rate of 10% on profits derived from patents. Such attractive tax conditions need to be coupled with requirements for substantial

Figure 24. **Youth job mismatch is high**

Total mismatch among youth (16-29) by type of mismatch, per cent of all youth in employment[1]



1. Data for Belgium and United Kingdom refer to Flanders and England and Northern Ireland respectively. Workers are classified as mismatched by qualification if they have higher or lower qualifications than required by their job and by field of study if they are working in an occupation that is not related to their field of study. The category of other includes mismatches by qualification only and by the combination of literacy, qualification and field of study. Occupation is only available at the 2-digit level in the ISCO-08 classification for Australia and Finland. Hence it is not possible to assess the extent of field of study mismatch in these two countries using the same definition used for the other countries.

Source: OECD (2014), *OECD Employment Outlook 2014*.

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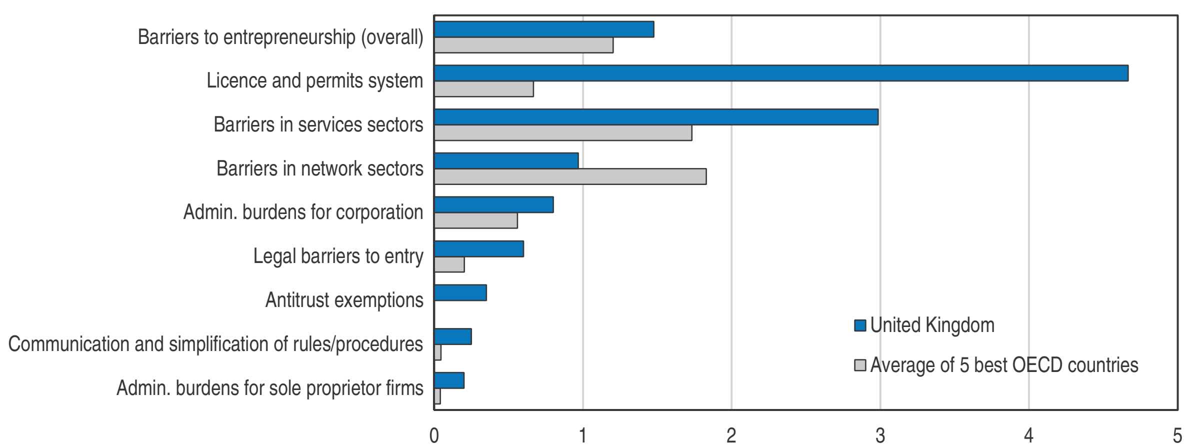
Figure 25. **There is scope to reduce barriers to entrepreneurship**

Product market regulation (PMR) score, index scale from 0 (least restrictive) to 6 (most restrictive)[1]



1. For antitrust exemptions the PMR score of the average of 5 best OECD countries is zero (i.e. least restrictive).

Source: OECD (2013), *OECD Product Market Regulation Database*.

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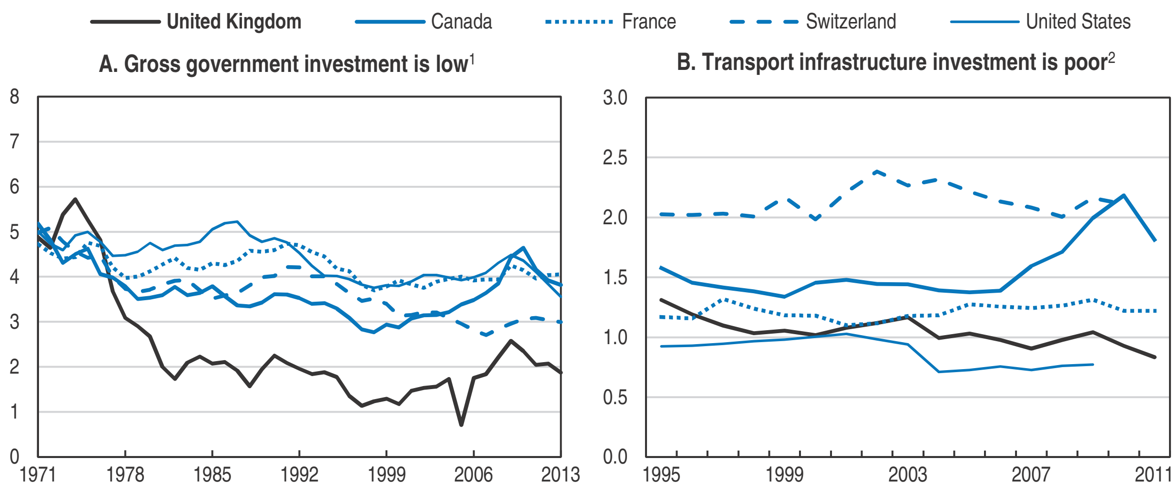
activity to encourage productivity spillovers. The measures unveiled in the Autumn Statement 2014 demonstrate the willingness of the UK to put an end to double non-taxation. Also, international co-ordination is needed to avoid potential efficiency losses stemming from excessive tax competition, as well as to ensure a predictable and fair environment for business taxation.

Improving infrastructure

Physical infrastructure is a key driver of productivity as it facilitates activity in other sectors via logistics, information and so forth. There are important complementarities between public and private infrastructure spending. Gross government investment is only a fraction of total infrastructure investment, and is lower as a share of GDP in the UK than in other countries (Figure 26, Panel A), but it has started to rise in nominal terms since 2010. Overall spending on transport as a share of GDP is low (Figure 26, Panel B). Although there is no objective comparable data on the quality of infrastructure, surveys indicate that the perceived quality of UK overall infrastructure is lower than in a number of other advanced OECD economies (Figure 27).

Figure 26. **The United Kingdom has spent less on infrastructure compared to peers**

Per cent of GDP



1. Gross government fixed capital formation.
2. Also includes maintenance expenditure.

Source: OECD (2015), *OECD Economic Outlook: Statistics and Projections* (database), January and ITF (2013), "Spending on Transport Infrastructure 1995-2011", International Transport Forum, May.

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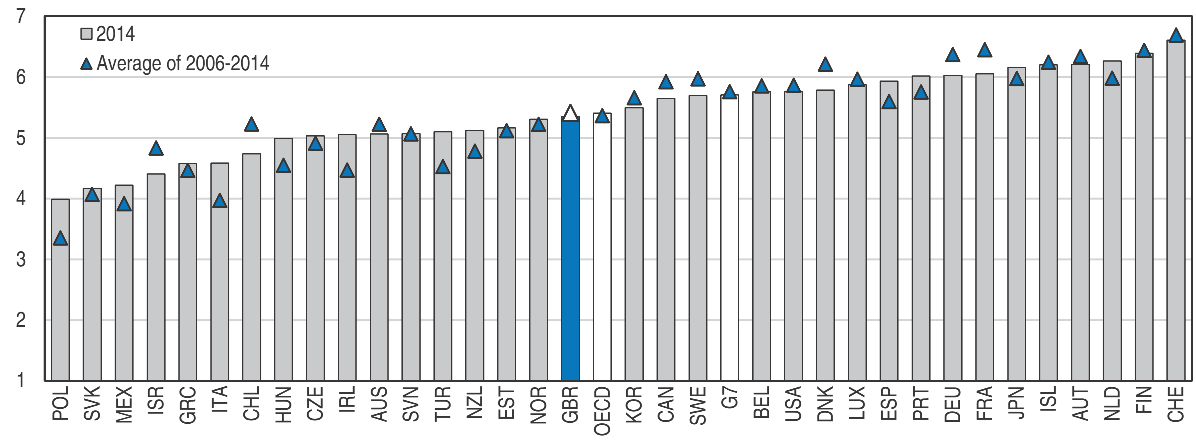
Upgrading road and railway infrastructure

Roads and railways are perceived of low quality (Figure 28, Panels A and B). Roads, which carry most of the freight, are congested. The government plans to expand the road network in the North of England, which would contribute to the development of the so-called Northern Powerhouse, thereby reducing regional disparities. The introduction of a user-paid toll system for the busiest parts of the road network, ideally with charges varying over time, would contribute to a more rational use of infrastructure by pricing congestion and therefore smoothing peaks in road traffic. The government could allocate the responsibility of managing the user toll system to the Highways Agency.

Following severe train accidents in the late 1990s and early 2000s, the quality of rail infrastructure has improved noticeably because of increased investment and maintenance spending. The UK railways system is now among the safest in Europe (ORR, 2013). However, OECD estimates point to cumulative investment needs of 3.5% of GDP between now and 2030 (OECD, 2012). Also, the UK railways system has in recent years been 20% to 40% less efficient than in Europe (McNulty, 2011). The government is attempting to reduce costs of operating trains and has garnered some success.

Figure 27. **There is scope to improve the perceived quality of overall infrastructure**

Value from 1 (worst) to 7 (best)[1]



1. Figures refer to the following question: How would you assess general infrastructure (e.g., transport, telephony, and energy) in your country (from 1 = extremely underdeveloped – among the worst in the world to 7 = extensive and efficient – among the best in the world)? The United Kingdom ranks 27th out of 144 countries in terms of perceived quality of infrastructure in 2014. The OECD aggregate is calculated as an unweighted average. The aggregate for G7 countries (excluding the United Kingdom) (i.e. Canada, France, Germany, Italy, Japan and United States) is calculated as an unweighted average.

Source: World Economic Forum (2014), *The Global Competitiveness Report 2014-2015*, Geneva.

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Railway infrastructure and trains operation are unbundled. This arrangement represents the best practice for attracting private investment and it promotes competition, but it is more complex to manage than a vertically integrated sector. The government should attempt to promote more co-operation between train operating companies and Network Rail, which manages the railway infrastructure assets, and to pursue efforts to reduce railway operation costs, which are higher than in other European countries.

There is scope to reform railway franchises and granting the responsibility of awarding them to an independent or quasi-independent agency could be beneficial. The government is studying the opportunity of extending the high-speed railways network. It should make sure that developing the high-speed network will not divert the resources for maintaining and improving the traditional one.

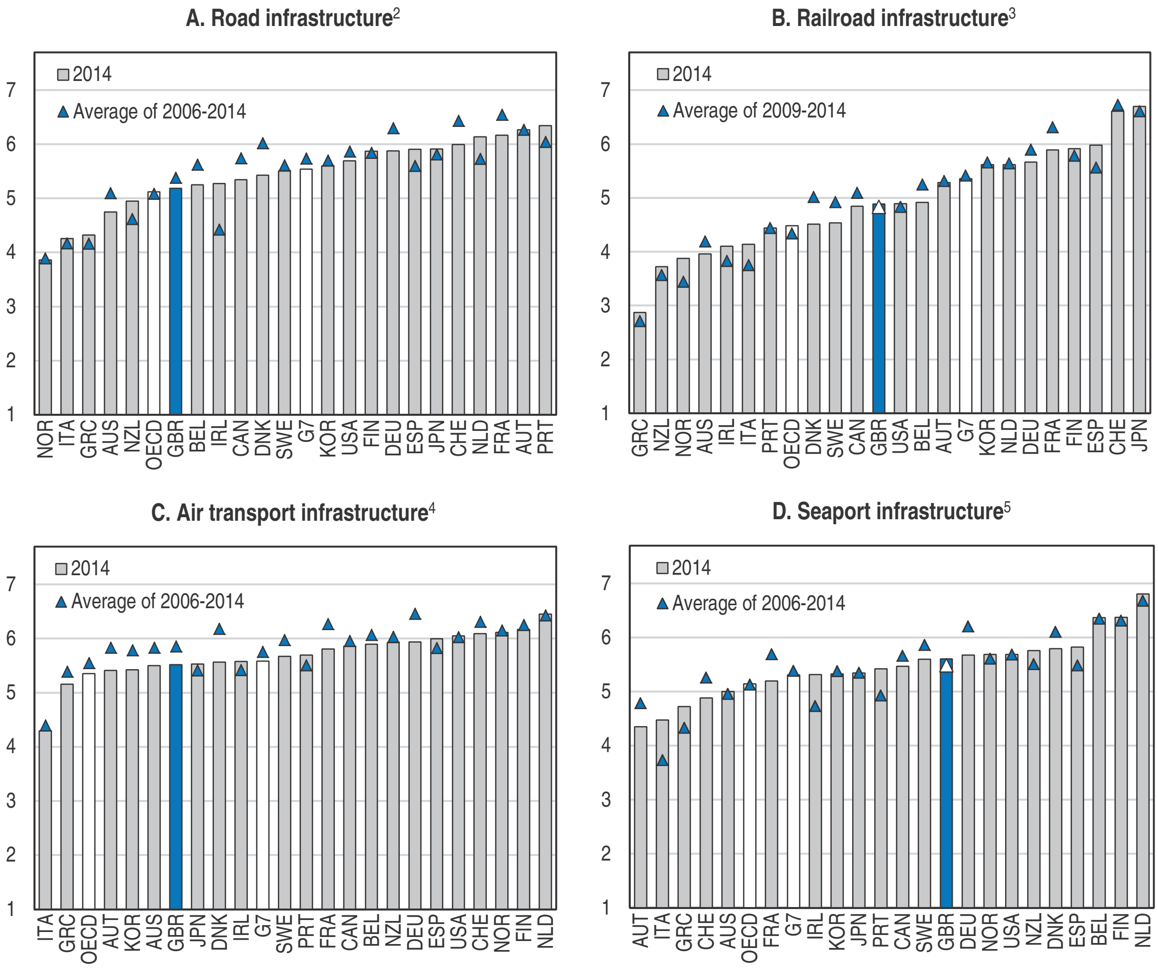
Infrastructure connecting the UK to the outside world

Being an island, airports and seaports are keys to connect the UK to the rest of the world. Airports are used efficiently but tight capacity hampers the air transport sector, especially in the South, where only one runway was built over the last two decades (Airports Commission, 2013). Moreover, the perceived quality of air transport infrastructure is weak and has been falling (Figure 28, Panel C). In 2012, the government set up an independent Airports Commission to analyse options for expanding airport capacity in the South. A final recommendation is expected in the summer of 2015, after the general election. It is very important that the government then takes a final decision to effectively tackle airport congestion while ensuring strong competitive pressures among airports.

Port infrastructure has been supported by steady investment, but greater capacity is needed to accommodate future increases in freight traffic and further improve quality (Figure 28, Panel D). Moreover, the operation and maintenance of electricity generation based on offshore renewable sources will require the use of port services, such as container

Figure 28. **Perceived quality of infrastructure is lagging behind compared to other affluent countries**

By sector, value from 1 (worst) to 7 (best)[1]



1. Figures refer to the following question: In your country, how would you assess the road, railroad system, air transport infrastructure and seaport facilities (For landlocked countries: How accessible are seaport facilities?) (from 1 = extremely underdeveloped – among the worst in the world to 7 = extensive and efficient – among the best in the world)? The OECD aggregate is calculated as an unweighted average. The aggregate for G7 countries (excluding the United Kingdom) (i.e. Canada, France, Germany, Italy, Japan and United States) is calculated as an unweighted average.
2. The United Kingdom ranks 30th out of 144 countries in terms of perceived road infrastructure quality in 2014.
3. The United Kingdom ranks 16th out of 104 countries in terms of perceived railroad infrastructure quality in 2014.
4. The United Kingdom ranks 28th out of 144 countries in terms of perceived air transport infrastructure quality in 2014.
5. The United Kingdom ranks 16th out of 144 countries in terms of perceived seaport infrastructure quality in 2014.

Source: World Economic Forum (2014), *The Global Competitiveness Report 2014-2015*, Geneva.

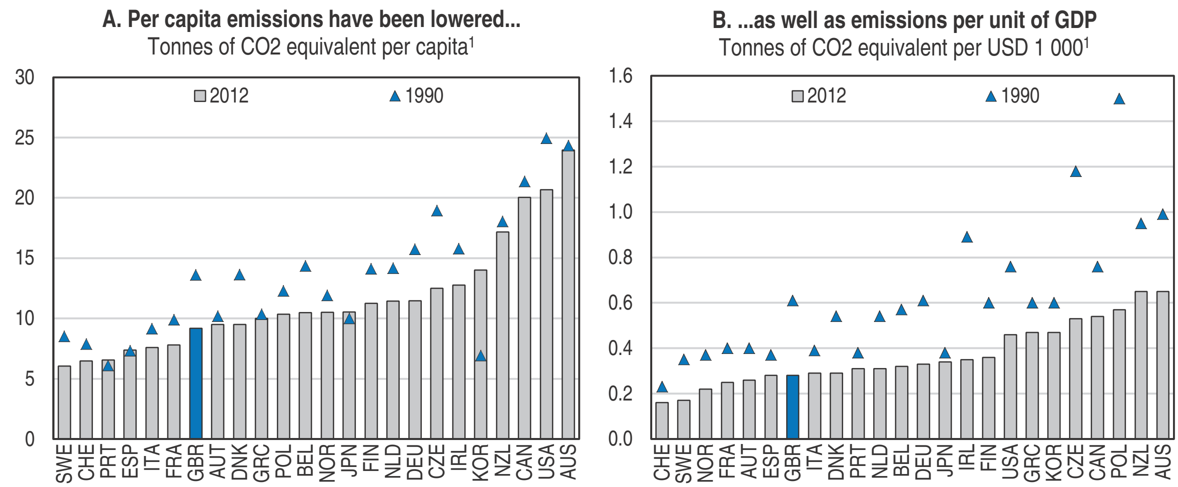
StatLink *http://dx.doi.org/10.1787/888933189228*

terminals. Because of the government's targets for renewables, ports' infrastructure plans should explicitly integrate impacts on offshore energy sources. This would support investor confidence and help to pay for ports' investments.

Greening the infrastructure

Infrastructure will also be key to achieving emission reduction targets and transitioning towards green growth and therefore contribute to well-being. Greenhouse gas (GHG) emissions have been significantly lowered over the last twenty years or so (Figure 29) and the UK scores high on environmental quality indicators (Figure 2, Panel A). For the

Figure 29. **Greenhouse gas emissions have been reduced**



1. Excluding emissions or removals from land-use, land-use change and forestry (LULUCF). 2011 instead of 2012 for Korea. CO_2: carbon dioxide.

Source: OECD (2014), "Greenhouse Gas Emissions", *OECD Environment Statistics* (database), December.

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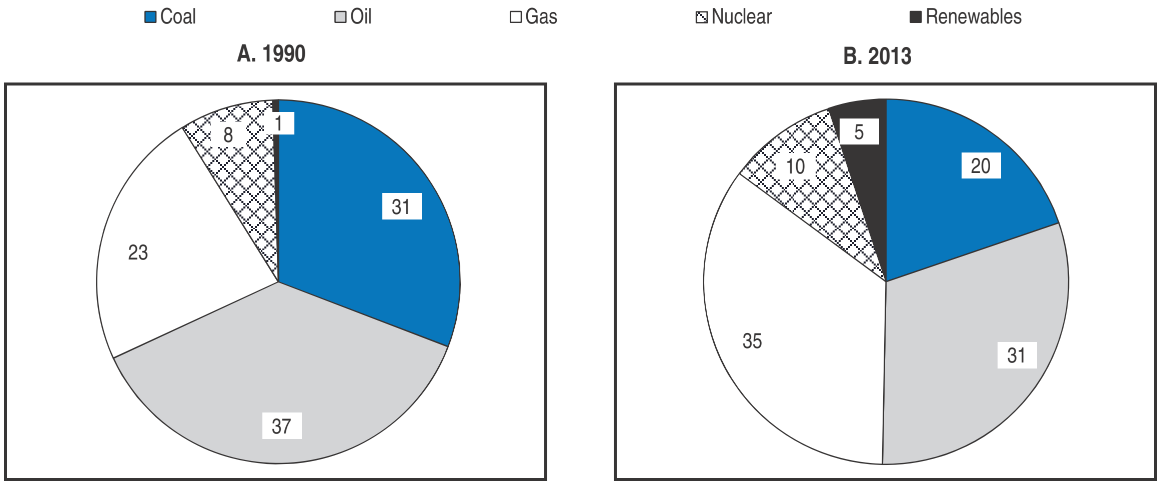
second Kyoto Protocol's commitment period, and as defined in the European Union (EU) Effort Sharing Decision, the UK needs to cut emissions not covered by the EU Emissions Trading System by 16% by 2020, relative to 2005. Additionally, the UK unilaterally committed in the 2008 Climate Change Act to reducing its GHG emissions by 34% by 2020 and by 80% by 2050, based on 1990 levels.

The share of renewables in the energy mix has increased rapidly, but remains low as the UK started from a lower base than other OECD countries (Figure 30). Ageing energy infrastructure poses investment challenges but also offers the opportunity to decarbonise the energy sector. Electricity plants accounting for about a fifth of the country's electricity generating capacity exiting in the early 2010s are scheduled to close and to be replaced by the end of the decade (IEA, 2012). The government should address non-financial barriers to increase the share of renewables in electricity generation. Supply chains for renewables should be reinforced, particularly in the offshore wind sector, and clarity on planning issues improved, so as to maintain investors' confidence. The Green Investment Bank (GIB) can play an important role in supporting this shift towards renewable energy sources. The GIB is the world's first investment bank focusing on accelerating the transition towards green economy by financing commercially viable projects. The government should further support through grants and guarantees low-carbon technologies that are not yet commercially viable but have the prospect of becoming so, such as carbon capture and storage, marine energy, and biofuels for transport. Although energy use per unit of GDP is already low in the UK, given the small share of energy-intensive industry, there is potential for further energy efficiency improvements, especially in the building sector.

The government has passed an ambitious Electricity Market Reform. Its aim is to raise competition, support investment and promote the use of low-carbon energy sources for electricity generation, which is commendable. The mechanisms to achieve these objectives are: i) the Contract for Difference (CfD), which will guarantee a price for electricity generated from low-carbon energy sources for at least 15 years; and ii) the Capacity Market, where the first auction was successfully held in December 2014, which will provide

Figure 30. **Share of renewables in the energy mix has improved but remains low**

Per cent of total primary energy supply



Source: IEA (2013), "World Energy Balances", *IEA World Energy Statistics and Balances* (database), International Energy Agency.

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regular payments to generators for ensuring a certain degree of spare capacity is available to use when needed. The government should carefully implement this reform, transparently quantify the risks that the support for low-carbon energy sources in electricity generation entails for the exchequer, and evaluate its interaction with already existing policies to support renewable energies.

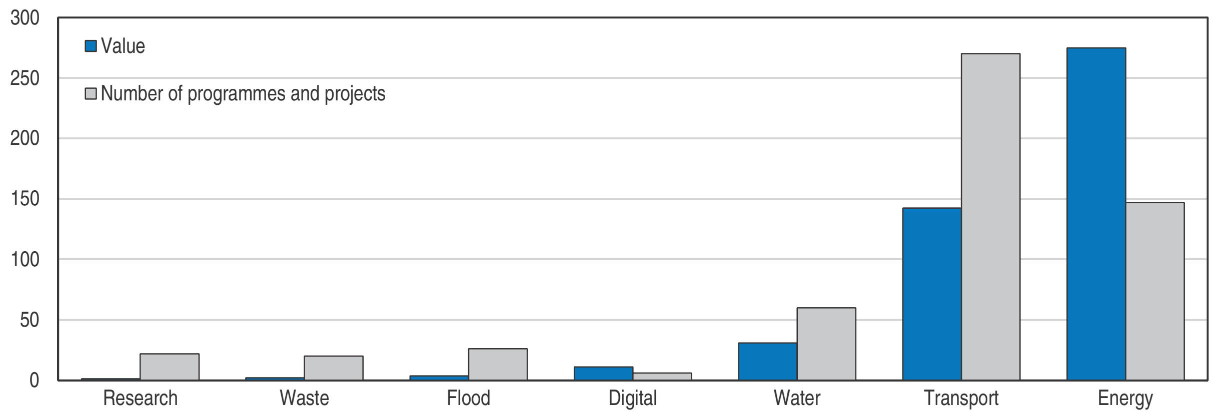
Improving long-term planning

As infrastructure is highly interconnected, the government launched the National Infrastructure Plan (NIP) in 2010 and has been updating it with a list of strategically important projects for which private investment is sought (the so-called National Infrastructure Pipeline) (Government, 2014). The NIP lists major planned and potential infrastructure investments in the UK to 2020 and beyond (Figure 31), which amount to about GBP 460 billion (around 25% of GDP) and is in line with independent estimates (Helm et al., 2009). The UK infrastructure-project appraisal framework is sound, comprehensive and uses fairly low and declining discount rates to properly take into account benefits accruing to future generations. The key challenge for the NIP is to encourage private infrastructure investment, which up to now has been held back by unclear signals regarding the country's long-term infrastructure needs and strategy.

The regulatory framework of infrastructure sectors is sound and supported by independent regulators. Investment plans of private sector operators in regulated sectors are agreed with regulators within the framework of price-cap regulation. Since 2010, the NIP has been regularly updated and now includes more on the long-term infrastructure strategy. However, the UK's infrastructure strategy could be further enhanced, as suggested by analyses such as the WEF (2014) blueprint and the LSE Growth commission (2013). This would contribute to lower uncertainty concerning the broad direction of infrastructure policies and plans and therefore stimulate private investment, helping to achieve the long-term objectives of the strategy.

Figure 31. **Infrastructure pipeline 2014 focuses on energy and transport reflecting major investment needs**

GBP billion and number of programmes and projects[1]



1. Value of infrastructure projects is in constant 2013/14 prices. Includes public and private investment. UK-wide projects may impact on several regions. The total value of infrastructure projects is GBP 466 billion while the total number of programmes and projects is 551.

Source: HM Treasury (2014), "National Infrastructure Pipeline 2014", December.

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Improving infrastructure financing

Long-term private investment, which has been a priority for successive UK governments, has been insufficient especially for greenfield infrastructure. This could be seen as an opportunity to increase public infrastructure spending as the current economic environment is favorable with low government borrowing costs and low inflation. Unfortunately, the UK fiscal position and the government's consolidation plans leave little space to significantly increase public infrastructure spending. In this context, the government should reprioritise public spending towards infrastructure whenever possible and do more to attract private finance into infrastructure. In this respect, the UK is well placed to benefit from the Juncker plan at the European Union level, which notably aims to leverage public resources with private infrastructure investment.

In 2012, the government launched the Private Finance 2 (PF2) scheme to improve the value for money and transparency of public-private partnership (PPP) projects, including those for infrastructure. To improve the management of liabilities, the government has introduced a cap on off-balance sheet PPP commitments funded by the central government of GBP 70 billion (about 4% of GDP) between 2015-16 and 2019-20. The government has made progress in transparently recording the future and contingent liabilities arising from PPPs in the Whole Government Accounts. The OECD Principles for Public Governance of PPPs define a set of framework conditions to increment a transparent and well-informed use of PPPs for infrastructure projects. In particular, the government should make sure to devote sufficient resources to collect comparable data about the financial and operational performance of PPP projects and make it available to investors and the public so as to impartially assess their value for money. Also, recent G20-OECD work on long-term investments in infrastructure suggests the need to find a balance between public support to private investors and ensuing moral hazard from the private sector (OECD, 2014e).

Another promising financial instrument is project bonds. These are corporate bonds created specifically for a given infrastructure project, allowing more clear risk identification. The government should work in partnership with national and European financial institutions to increase the issuance of infrastructure project bonds by developing an insurance market for them.

There is also a need to promote a long-term investment culture and improve skills and knowledge of institutional investors on infrastructure issues. A good example is the Pensions Infrastructure Platform (PIP) established in 2012, which includes the National Association of Pension Funds, the Pension Protection Fund and a group of smaller funds. The government should support the PIP and scale it up by attracting other potential institutional investors so as to build expertise in assessing infrastructure investment opportunities and overcoming the problems for infrastructure investment caused by the fragmentation of the UK pension system.

Infrastructure investment could be supported by mobilising public guarantee schemes more extensively. In 2012, the government introduced sovereign-backed guarantees (UK Guarantee Scheme) to help projects that may have stalled because of adverse credit conditions. The government could consider extending these guarantees further, currently worth GBP 40 billion (nearly 2.5% of GDP). However, it will be important to limit taxpayer risks and to transparently record the associated contingent liabilities. The use of guarantees could be confined to projects which have attracted little private investment thus far, such as greenfield projects.

Capital recycling is another enticing option to finance greenfield infrastructure projects. It involves reinvesting the revenues from the privatisation of brownfield assets (which are already existing), alongside private sector funds, into new greenfield projects. The government should explore in depth the opportunity of using capital recycling to finance greenfield projects and clarify its strategy in this respect.

Key infrastructure policy recommendations

- Continue to build on the progress made with the National Infrastructure Plan to further enhance long-term infrastructure strategy and planning.
- Develop further the use of public-private partnerships (PPP) and public guarantees for privately financed infrastructure projects, recording the associated assets and liabilities in the government fiscal accounts. Enhance the provision to investors and the public of comparable data about public guarantees and the financial and operational performance of PPP projects.
- Improve the use of roads by introducing user-paid tolls, and of railways by ensuring the arms-length responsibility for awarding rail franchises.
- Strengthen the Green Investment Bank and other targeted financial aids to further support the implementation of not yet commercially viable low-carbon technologies that have the prospect of becoming so in the foreseeable future.
- Evaluate the interaction between the Electricity Market Reform and existing policies to promote renewable energies.

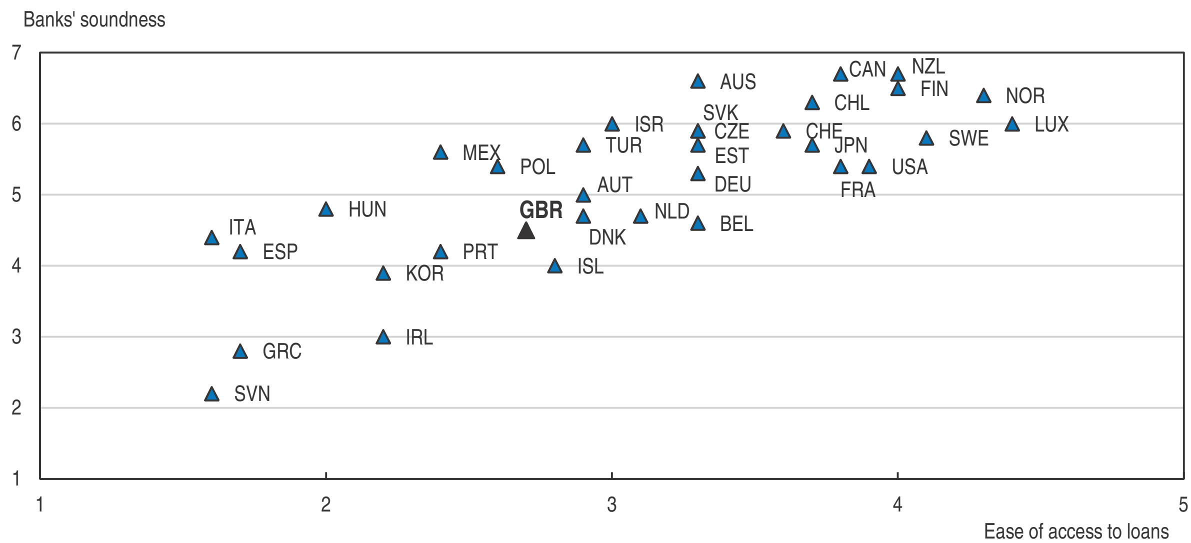
Ensuring sustainable bank lending

Financing of the economy requires sound banks and stronger competition

Continued efforts to restore the banking sector to health should boost productivity by encouraging infrastructure financing and eventually more efficient allocation of lending to healthy, growing businesses (Figure 32). However, the ratio of loans to GDP is significantly below the OECD average for businesses (Figure 33), but non-bank finance (including new credit providers, see below) is also more developed. Moreover, lending to non-financial corporations is still contracting reflecting both weak demand and tighter supply, although the Funding for Lending Scheme may have reduced the rate of decline of credit (Figure 13).

Figure 32. **Banks' soundness and access to loans**

Index scale from 1 (worst) to 7 (best), first half of 2014[1]



1. Figures for soundness of banks refer to the following question: In your country, how would you assess the soundness of banks (from 1 = extremely low – banks may require recapitalisation; to 7 = extremely high – banks are generally healthy with sound balance sheets)? Figures for ease of access to loans refer to the following question: In your country, how easy is it to obtain a bank loan with only a good business plan and no collateral (from 1 = extremely difficult; to 7 = extremely easy)?

Source: World Economic Forum (2014), *The Global Competitiveness Report 2014-2015*, Geneva.

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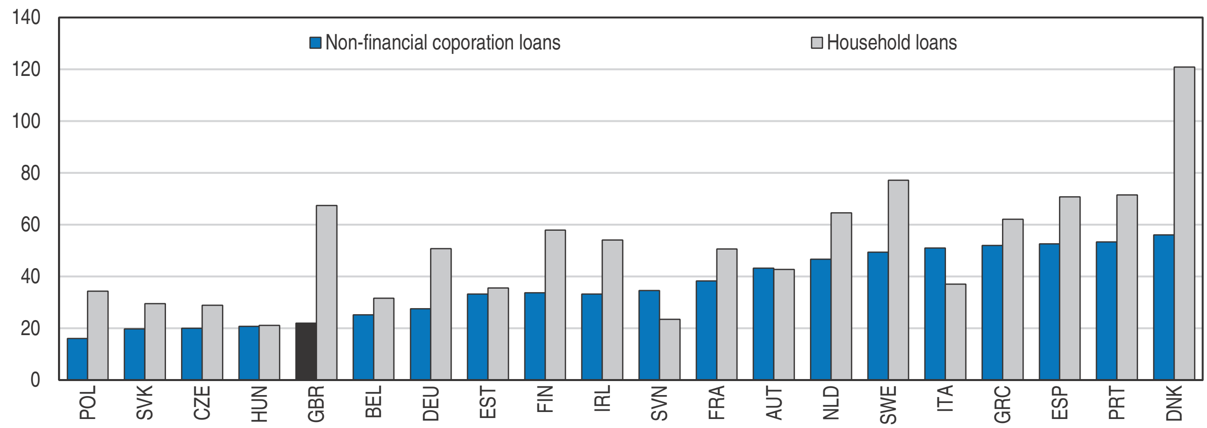
The global downturn triggered an unprecedented policy response to rescue and stabilise the UK banking sector in 2008-09. This included large increases in public guarantees, liquidity and capital injections, and bank closures (OECD, 2009). Since then, banks' situation has been improving, but risks remain. Their capital position has strengthened as a result of public recapitalisation and asset divestment (Figure 34). However, as risk weights have also diminished, the leverage ratio (capital to unweighted assets) has increased less than risk-weighted capital measures. Liquidity risks have fallen significantly since the crisis, but banks still have a significant amount of short-term external debt and may face higher and more volatile risk premiums than before the crisis (Figure 35).

After the crisis, the UK embarked on a number of regulatory reforms to strengthen the banking sector. The responsibilities of the BoE have been expanded and, since April 2013, it has been in charge of financial regulation and supervision (Prudential Regulation Authority), the prevention of systemic risks (Financial Policy Committee), and resolution of failed banks

Figure 33. **Loans to non-financial corporations are low and are high for households**

Per cent of GDP, September 2014[1]



1. Outstanding stock of domestic loans from monetary financial institutions excluding European System of Central Banks (ESCB). Households include non-profit institutions serving households.

Source: ECB (2015), "MFI Balance Sheets", *Statistical Data Warehouse*, European Central Bank, January and OECD (2015), *OECD Economic Outlook: Statistics and Projections* (database), January.

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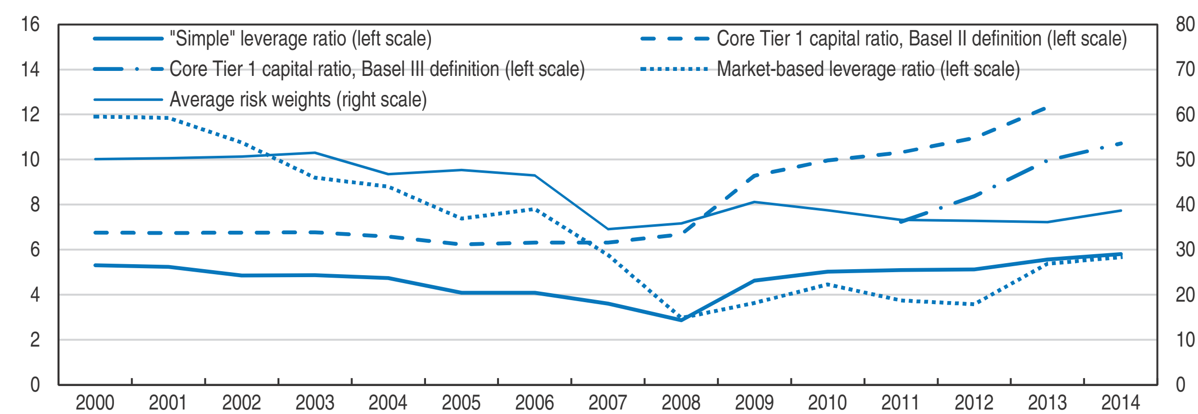
Figure 34. **UK banks' capitalisation has improved**

Per cent[1]



1. Figures for "simple" leverage ratio, Core Tier 1 capital ratio (Basel III definition) and average risk weights for 2014 refer to first half of 2014. "Simple" leverage ratio is calculated as aggregate peer group equity (shareholders' claims) over aggregate peer group assets. Core Tier 1 capital ratio (Basel II definition) refers to major UK banks' aggregate core Tier 1 capital as a percentage of their aggregate risk-weighted assets. The Basel II series was discontinued on 1 January 2014. Core Tier 1 capital ratio (Basel III definition) is calculated as aggregate peer group common equity Tier 1 levels over aggregate risk-weighted assets. Market-based leverage ratio is calculated as total peer group market capitalisation divided by total peer group assets (note a discontinuity due to introduction of International Financial Reporting Standards (IFRS) accounting standards in 2005, which tends to reduce leverage ratios thereafter). Average risk weights are calculated by dividing aggregate peer group risk-weighted assets by aggregate peer group assets.

Source: Bank of England (2014), "Financial Stability Report, December 2014", Issue No. 36, December.

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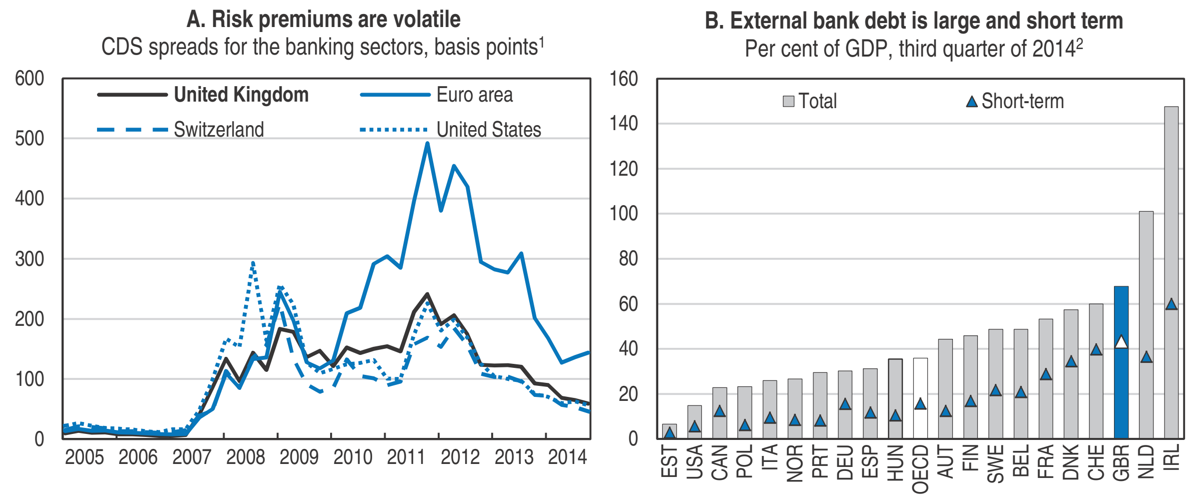
and building societies (Resolution Directorate). In turn, the Financial Conduct Authority has been mandated to ensure conduct supervision of all regulated financial firms and the prudential supervision of those not supervised by the Prudential Regulation Authority.

Figure 35. **Exposure to liquidity shocks remains high**



1. Five-year senior debt, mid-rate credit default swap (CDS) spreads for the banking sectors. Quarterly data calculated as the unweighted average of end-of-month figures.
2. Total international debt liabilities and international debt liabilities with residual maturity below one year towards BIS reporting banks. The OECD aggregate is calculated as an unweighted average and excludes Luxembourg.

Source: Datastream and BIS (2015), "Consolidated Banking Statistics", *BIS Statistics*, Bank for International Settlements, January.

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The market for bank lending to SMEs suffers from insufficient competition (CMA and FCA, 2014), which could have increased credit constraints facing SMEs. The government is legislating to increase the sharing of credit information about SMEs and to require banks to indicate other providers of finance for rejected loan applications. These are welcome steps, but it is important that credit information is shared widely across different bank and non-bank credit providers through existing credit reference agencies (including trade credit providers and investors in securitised credit). Alternatively, a central credit registry could be created by the regulator. The BoE is currently consulting on the benefits of such a registry.

Addressing future challenges to sustainable access to finance

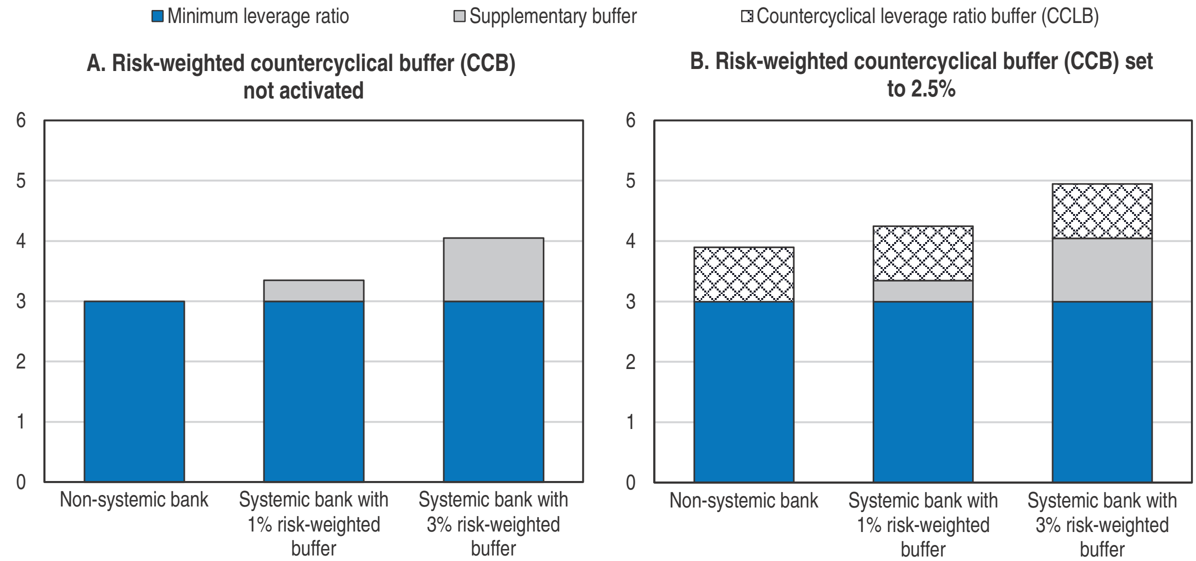
The UK banking sector remains one of the largest in the world, with total assets of around 400% of GDP in late 2014, and could roughly double its current size by 2050 (Bush et al., 2014). This implies a large exposure of the economy to shocks and, as shown by the recent financial crisis, such shocks can create huge economic damage. Robust prudential regulation and supervision should continue to minimise the size of the implicit government subsidy to limit risks to the taxpayer and financial stability. Improving banks' resolvability and capitalisation are key.

The BoE has bail-in and other resolution powers, although the new framework has yet to be put to the test. A major structural reform is being implemented to ring-fence retail activities of large banks, to increase bank resolvability and protect the taxpayer in the event of bank failure. Lowering banks' complexity and raising transparency about their structures would also ease resolvability, since the four largest UK banks have altogether more than 5 000 subsidiaries, a third located in offshore financial centres.

To strengthen capital requirements of UK banks, the Financial Policy Committee concluded in October 2014 that it should have powers to set a leverage ratio, ranging from 3% for non-systemic banks to 4.05% for global systemic banks (Figure 36). The Financial

Figure 36. **The leverage ratio framework in the United Kingdom**

Per cent[1]



1. Countercyclical leverage ratio buffer (CCLB) show an example of the size of the CCLB for a bank with UK exposures only.

Source: Bank of England (2014), "The Financial Policy Committee's Review of the Leverage Ratio", October.

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Policy Committee has also requested from the government the ability to impose a countercyclical leverage buffer, which would bring the overall leverage ratio for global systemic banks to almost 5% in a boom when applying Basel III standards. The introduced leverage ratio will be a useful complement to risk-weighted capital ratios. While the latter help reduce risks taken by banks, risks can also be mispriced, as illustrated by the recent financial crisis. This reform would further protect the banks and the taxpayer in the event of turmoil. OECD estimates show that a leverage ratio of 5% would ensure that banks are at a more prudent distance from default (Blundell-Wignall and Roulet, 2013). However, this level of ratio is conditional on a credible reform of ring-fencing retail banking and withdrawing all implicit government subsidies for investment banking (Blundell-Wignall et al. 2014). Hence, a higher leverage ratio would be a useful backstop to reduce excessive leverage, especially of the biggest banks, and the Financial Policy Committee will review the proposed leverage framework in 2017.

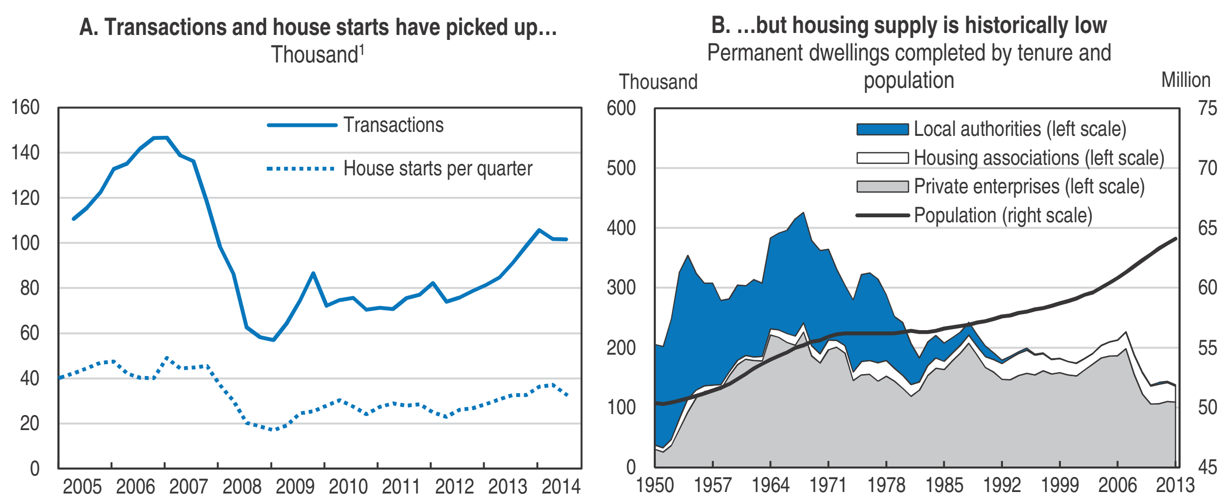
Macro-prudential regulation should act to prevent financial crises, notably by trying to head off the build-up of imbalances linked to credit cycles, which last longer and have higher amplitude than business cycles (Haldane, 2014). It is important that decision-making about the size of the counter-cyclical capital buffer and the timing of its implementation be supported by a range of indicators, and such multifaceted approach is currently being developed.

Although net lending growth to households has remained moderate (Figure 13, Panel A), precautionary measures have been taken to contain risks associated with recent housing market developments. In April 2014, the Financial Conduct Authority took action to insure against the risk of a marked loosening of underwriting standards. In June 2014, the Financial Policy Committee capped loans carrying loan-to-income ratio of above 4.5 to

15% of banks' new residential mortgages, which should ward off risks of significant rise in the number of highly indebted households. The Committee also asked the government for new powers to cap loan-to-value ratios and debt-to-income ratios for mortgages. The share of interest-only mortgages (principal repayment is postponed to the maturity of the mortgage) in new loans has been falling steadily since the crisis, and is now about 20% of new mortgages, which is welcome. Raising risk-weights would reinforce this trend and prevent a weakening of underwriting standards should the risk appetite for such loans increase.

In addition to macro-prudential measures, which are aimed at addressing demand side developments, the key ongoing challenge is to make the supply side of housing more responsive to prices. The housing market has been recovering as reflected by higher transactions and house starts (Figure 37, Panel A), but housing supply remains historically low as resident population continues to expand (Figure 37, Panel B). As discussed in the previous Surveys, some protected lands should be made available for building houses and skyline restrictions relaxed in some cases (OECD, 2011a, 2013b). In particular, thoroughly reviewing the boundaries of the Green Belt – introduced in 1955 to prevent urban sprawl around historical towns and cities covering close to 12.5% of England – would free up land for development. Additional structural reforms would balance the housing market (OECD, 2011a; André, 2011). Greater provision of social housing could enhance housing supply where private sector activity is insufficient, while regularly updating the property valuations (unchanged since 1991 in England and Scotland) that determine the rate of the council tax would dampen large swings in house prices. The government has announced a reform of the residential stamp duty land tax, which should lower transactions costs on most properties and hence favour labour mobility in the medium term. However, the reform may create upward pressure on house prices in the short term (OBR, 2014).

Figure 37. **Housing market activity has been recovering against the background of tight housing supply**



1. Transactions refer to the number of residential property transactions in the United Kingdom with a value of GBP 40 000 or above per month. Quarterly figures for transactions are calculated as an average of monthly data.

Source: Bank of England (2014), "Financial Stability Report, December 2014", Issue No. 36, December, Department for Communities and Local Government, ONS (2014), "Annual Mid-year Population Estimates, 2013", Office for National Statistics, June and Datastream.

StatLink http://dx.doi.org/10.1787/888933189316

A number of new sources of credit (peer-to-peer lending, crowd funding), and so-called shadow banks (broker dealers, investment and hedge funds, etc.) but also pension funds, insurance companies, and so forth, have been starting or expanding direct and indirect lending. This should broaden financing options available to households and businesses, but there is a risk that these new sources of credit are not subject to the same level of regulation and scrutiny, and that they will prove to be a source of instability themselves. Potential risks to financial stability from the new sources of credit and the shadow banking sector in particular should continue to be closely monitored to prevent excessive risks migrating from, or spilling over to banks. The BoE has recently made available its liquidity facilities to some investment firms, in return for collateral requirements and direct supervision, but consideration should also be given to subject them to macro-prudential tools of the Financial Policy Committee.

Key recommendations to ensure sustainable bank lending

- Consider higher leverage ratios for global systemic banks to complement risk-weighted capital ratios.
- Encourage the development of new credit providers and gradually extend regulatory instruments beyond the banking sector.
- Continue to uphold underwriting standards in mortgage lending. Further relax regulatory constraints to boost housing supply, in particular by thoroughly reviewing the boundaries of protected areas of the Green Belt.
- Collect and share credit information on businesses through credit reference agencies or directly through the regulator.

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ANNEX

Progress in main structural reforms

This annex reviews action taken on recommendations from previous Surveys *since the February 2013* Survey. *Recommendations that are new in this* Survey *are listed in the relevant chapter.*

Labour market and social policies

Recommendations in previous *Surveys*	Actions taken
Enhance workforce skills. Central and local government should enhance co-operation with employers on vocational education and training, and apprenticeship programmes. Simplify the training and apprenticeship systems, and enhance co-operation between different stakeholders (local authorities, schools and enterprises) to strengthen the labour market integration of graduates.	Since October 2013, the government has started the preparation of more employed-led apprenticeships standards in England. The 2014 Budget announced an extension of the Apprenticeship Grant for Employers (AGE) to fund over 100 000 additional incentive payments for employers to take on young apprentices (16-24). Small employers can receive a GBP 1 500 grant for up to ten new apprentices they employ in their business. The government has setup a competitive GBP 340 million fund to co-design and co-invest along with employers in new skills provision needed to grow their business. New eligibility criteria for public funding are being adopted for adult vocational qualification. In July 2013, the Skills Funding Agency removed 1 800 qualifications from public funding which had low or no enrolments and at the end of January 2014 a further 1 000 were removed. In April 2014, schools received new guidance to co-operate with local authorities so as to support youth education and training.
Improve work incentives for lone parents and second earners under the Universal Credit welfare reform. Increase the refund rate for childcare, and/or reduce the taper rate for those with childcare support, and/or introduce a dedicated disregard for second earners in couples. Increase the value of free childcare by increasing flexibility for users and reduce the cost by increasing flexibility of provision.	The government is investing GBP 350 million to increase support for childcare within Universal Credit, raising eligible costs from 70% to 85% from April 2016. Greater flexibility has been introduced for users by extending working hours in early education places.
Improve the Work Capability Assessment (WCA) and support for return to work for those who are fit. Ensure earlier intervention for people suffering from mental health problems. Monitor homelessness trends and ensure prevention and early intervention.	The government has implemented over 60 of the 83 recommendations made from the first four annual independent reviews of the WCA, with the remainder in progress. In October 2014, the government launched a new 5-year plan for mental health, Achieving Better Access to Mental Health Services by 2020. The plan has led to additional spending on mental health of GBP 40 million in 2014-15 and GBP 80 million for 2015-16. In February 2014, the Crisis Care Concordat was launched to improve emergency support for people in mental health crisis. Since February 2013, funding available to prevent and tackle homelessness has reached around GBP 190 million.
Monitor efficiency gains in public services. To avoid an increase in inequality, efficiency gains should be exploited in implementing fiscal consolidation.	Slightly more than GBP 5 billion of efficiency savings will be made between 2013-14 and 2014-15, bringing overall savings to GBP 20 billion since 2009-10.
Take steps to tackle fuel and water poverty through better targeted financial support, and measures to improve energy efficiency and resource management.	The Energy Companies Obligation (ECO) was introduced in January 2013 to reduce the UK's energy consumption and support people living in fuel poverty. The programme does this by funding energy efficiency improvements in households across the country. By May 2014, eight of the eighteen companies in England and Wales providing water and/or sewerage services had introduced new social tariffs that reduce bills for customers who have difficulties to pay, with many more expected to have done so by April 2015. This is in addition to the national Watersure scheme, which caps bills for vulnerable customers. From April 2013, the government has provided GBP 40 million per year to reduce every customer bill by GBP 50 in the South West Water area, which has the highest bills in the country due to historic underinvestment.

Innovation

Recommendations in previous *Surveys*	Actions taken
Continue to improve the business environment and promote exports. Avoid excessively restrictive limitations on student visas.	The UK Trade & Investment (UKTI) has continued to expand the number of companies that are helped to trade oversees, which is on course to double since 2009. The government will triple the number of Chevening Scholarships from 2015-16.
Reform some tax rules to encourage research and development (R&D). Review fiscal rules which may hamper firm growth, such as preferential tax treatment for small firms and debt finance relative to equity.	In April 2013, the government introduced a 10% Above the Line (ATL) credit for large company R&D investment, which will increase to 11% from April 2015. In April 2014, the government raised the rate of the tax credit payable to loss-making small and medium-sized enterprises (SMEs) to 14.5%. From April 2015, the deduction for SME research and development will increase from 225% to 230% of taxable profit. Since February 2013, the government has cut the main rate of corporation tax to 21%. In April 2015, the main rate will be reduced to 20% and applied to companies of all sizes. Reductions in the corporate income tax have decreased the bias in the tax regime towards debt over equity financing.

Housing

Recommendations in previous *Surveys*	Actions taken
Ensure access to decent affordable housing through a mix of means-tested housing benefits and subsidies for affordable housing construction, paying attention to the diversity of local needs.	Spending on housing benefits amounted to GBP 24 billion in 2013-14. The 2011-15 Affordable Homes Programme is on track to deliver 170 000 new affordable homes, with public funding of GBP 4.5 billion. Spending Round 2013 announced over GBP 3.3 billion of new funding for affordable housing to support total delivery of another 165 000 affordable homes in England over 2015-18.
Enhance competition between developers by facilitating even access to land.	Local authorities have made further progress in the adoption of up-to-date local plans, which reached 80%.
Provide high quality apprenticeships in construction-related trades to ensure no shortage of skilled workforce hinders construction growth when demand picks up.	The government is supporting competitive funds to increase apprenticeships alongside investment in a National Colleges programme, to develop skills capacity in construction and infrastructure delivery. The National Infrastructure Pipeline is being used to map potential peaks in labour demand for infrastructure construction.

Productivity

Recommendations in previous *Surveys*	Actions taken
Facilitate the entry of new businesses by reforming planning regulations, especially in the area of retail trade.	The government has introduced new permitted development rights, to enable certain businesses to change use to other business uses without the need for full planning permission.
Free-up land for development by reconsidering the boundaries of the "green belts" in fast-growing areas.	The National Planning Policy sets out that when local authorities draw up green belt boundaries as part of their local developments plans, they should consider the consequences for sustainable development. The government has also taken steps to support more widespread and effective use of brownfield land, including measures to remove planning obstacles on brownfield sites suitable for housing, and allowing easier conversion between unused offices and shops and homes.

Education

Recommendations in previous *Surveys*	Actions taken
Simplify the system of vocational education, and focus further on high-quality apprenticeships. Raise incentives for participation for children from low-income families.	The government has allocated GBP 40 million to deliver additional 20 000 higher apprenticeships in the 2013/14 and 2014/15 academic years. The 2014 Budget provided a further GBP 20 million over 2014-15 and 2015-16 to support apprenticeships up to the postgraduate level.
Increase focus and transparency of funding for disadvantaged students. Review the effects of schooling reforms, including Free Schools, on equity, fair access and user choice for disadvantaged students. Encourage the highest quality teachers to move to the most disadvantaged schools.	The government increased the Pupil Premium by GBP 625 million in 2013-14 spent on the most disadvantaged school pupils and by the same amount in 2014-15.

Health

Recommendations in previous *Surveys*	Actions taken
Improve methods and data to evaluate health care reforms.	From January 2015, four new research projects, based in English Universities, will assess: i) the new commissioning system in the National Health Service (NHS); ii) Commissioning of public health services; iii) the provider landscape in the NHS; and iv) the operation of Health and Wellbeing Boards.

Green growth

Recommendations in previous *Surveys*	Actions taken
Seek a higher carbon price at the international level through tighter quotas within the EU emission trading system (EU ETS) and the adoption of a 30% EU emissions reduction target by 2020.	The UK continues to favour an increase in the EU's 2020 emissions reduction target from 20% to 30%, with the higher target reflected through changes to the EU ETS cap and the Effort Share decision (which includes sectors not covered by the EU ETS). The UK has played an important role in the endorsement of an ambitious EU emissions reduction target for 2030 of at least 40%, as part of the EU's 2030 Climate and Energy Policy Framework agreed by the European Council in October 2014. As part of the implementation of this target, the allowance cap in the EU ETS will be reduced at a faster rate from 2021, which will tighten quotas within the system.
Move towards a uniform carbon price across sectors and fuels.	The adoption of the Carbon Price Floor in April 2013 set a minimum carbon price across all fuels used to generate electricity.
Continue to build capacity to adapt to climate change, with a focus on reducing market failures such as the appropriate provision of public goods, including information, better risk-assessment frameworks and more advanced metrics for monitoring and evaluation.	The government continues to support climate change adaptation through policies and actions identified in the first National Adaptation Programme (NAP) published in July 2013. A report to Parliament on the NAP's implementation is expected over summer 2015, and should contain metrics and indicators amongst other tools available for evaluation. The government has also taken action in conjunction with industry to set clear objectives and establish best practice to decarbonise the provision of infrastructure.
Raise the value-added tax (VAT) rate on domestic energy use over time to the standard rate. Address relevant distributional concerns through targeted support.	No action taken.

Chapter Summaries

Chapter 1

Improving infrastructure

The United Kingdom (UK) has spent less on infrastructure compared to other OECD countries over the past three decades. The perceived quality of UK infrastructure assets is close to the OECD average but lower than in other G7 countries. Capacity constraints have emerged in some sectors, such as electricity generation, air transport and roads. Developing and regularly updating a national infrastructure strategy, with the National Infrastructure Plan being a welcome first step in this direction, would contribute to reduce policy uncertainty and tackle capacity constraints in a durable way. The design of coherent development plans by local authorities congruent with the national and local planning systems should continue to improve project delivery. The government intends to finance a large share of infrastructure spending to 2020 and beyond through private capital. Unlocking private investment in a cost effective and transparent way could be supported by further improving incentives for greenfield investment, continuing to carefully assess and record public-private partnerships, and promoting more long-term financing instruments.

Chapter 2

Enhancing the financing of the real economy and financial stability

The banking sector in the United Kingdom (UK) was deeply affected by the crisis. Bank credit has collapsed reflecting both weak demand and tighter supply. New prudential requirements have improved the resilience of the banking sector and a number of measures were taken to support credit supply. These included conventional and unconventional monetary policies, policies to address credit constraints with Help to Buy and Funding for Lending programmes, and a number of public programmes to improve access to finance united under the roof of the British Business Bank. Further structural reforms are needed to improve competition in the SME credit market and to boost credit provision to SMEs in the medium term. Sustainable financing of the economy and greater financial stability should be achieved by sound regulation, ensuring high capital requirements for systemically important banks, improving banks' resolvability and fine-tuning the use of countercyclical measures. Data should be collected on a wider set of financial institutions than currently done and macro-prudential regulation should be gradually extended beyond the banking sector to prevent the migration of systemic risks.

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries

The economic situation and policies of the United Kingdom were reviewed by the Committee on 19 January 2015. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 3 February 2015.

The Secretariat's draft report was prepared for the Committee by Rafał Kierzenkowski and Olena Havrylchyk (external consultant), under the supervision of Pierre Beynet. The survey also benefited from contributions from Mauro Pisu, Barbara Pels and Novella Bottini (external consultant). Research assistance was provided by Gabor Fulop.

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Further information

For further information regarding this overview, please contact:

Mr. Pierre Beynet
(e-mail: pierre.beynet@oecd.org, tel.: +33 1 45 24 96 35) or

Mr. Rafał Kierzenkowski
(e-mail: rafal.kierzenkowski@oecd.org, tel.: +33 1 45 24 90 62) or

Mr. Mauro Pisu
(e-mail: mauro.pisu@oecd.org, tel.: +33 1 45 1 45 87 04).

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