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Europe

UK Economics Weekly

Private Savings Remain High: Deleveraging and Offshoring

- The private sector financial surplus continues to fall gently, but remains high by historic norms. Indeed, the last few years have seen the highest sustained private savings levels for at least 50 years, and this is a key reason why private sector spending is so sluggish, markedly undershooting prior recoveries. The high level of private savings (plus confidence in the ultimate solvency of the government) also helps keep gilt yields low, even with the UK's large fiscal deficit: high private savings cause depressed economic conditions that keep monetary policy loose and also provide the funds which (directly or indirectly) help fund the fiscal deficit.

- The bias to high private savings largely reflects private sector deleveraging and the rise in pension contributions. In addition, in aggregate, the corporate sector is treating the UK as something of a "cash cow", with low investment in the UK and surplus funds allocated overseas (presumably to higher growth regions). These factors are likely to persist, and we expect that private savings will stay high for a while, hence keeping the economy weak and the MPC on track for more stimulus.

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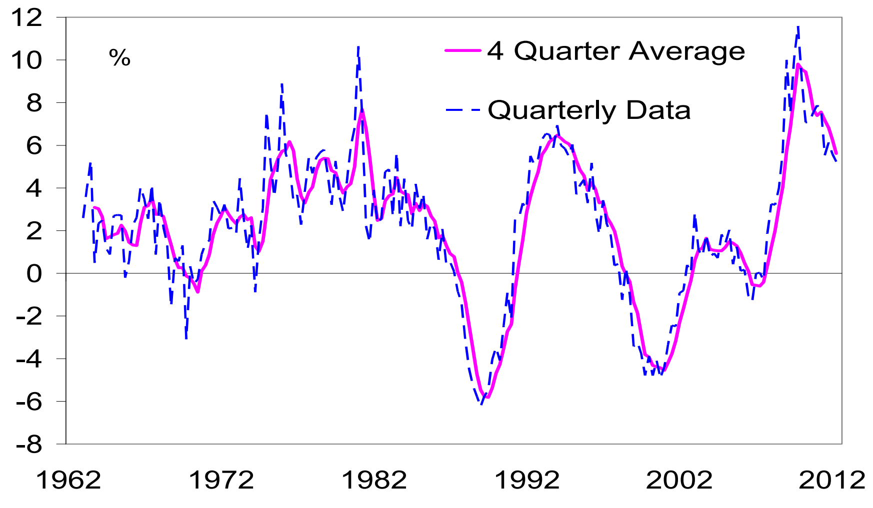
Figure 1. Citigroup Market Forecasts

	Base Rate	QE Target	10 Year Yield	Spread vs Bunds	$/£	£/€
End 2012	0.50	£425bn	1.70	20bp	1.59	0.79
End 2013	0.50	£500bn	2.25	25bp	1.54	0.77

Source: Citi Research

Figure 2. UK — Private Sector Financial Balance as Pct of GDP, 1962-2012



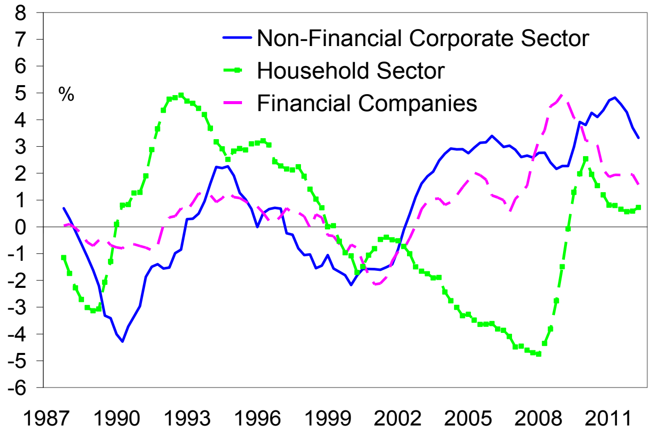
Note: Data for Q2 2012 adjusted to exclude transfer of assets by pension fund of state-owned postal service.
Sources: ONS and Citi Research

Deleveraging and Offshoring

Swings in the private sector financial balance have been a major driver of economic cycles over recent decades

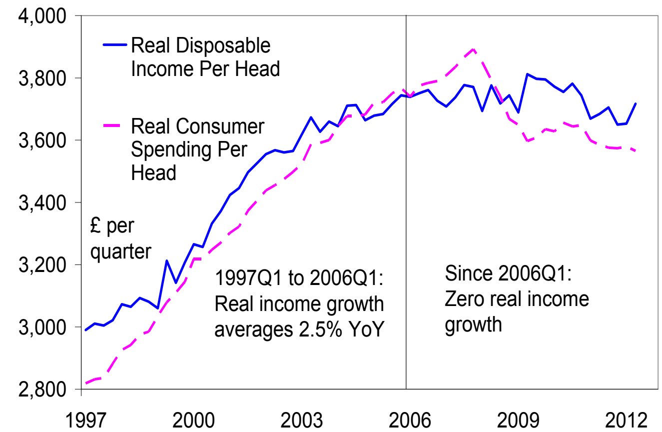
The private sector financial balance is the gap between income and spending for the whole private sector. Including households and companies, in the same way that the fiscal balance measures the gap between income and spending for the government. Over the whole period 1963-2011, the private sector financial surplus has averaged 2.1% of GDP, but swings around that have been the key driver of cyclical swings in the economy over the last 30 years (although external shocks and fiscal policy have also played a role). The booms (late 1980s, late 1990s, 2003-07) were fuelled by falling private savings, with spending growth running well ahead of incomes. In turn, slowdowns and recessions have chiefly been driven by increases in private savings (ie spending falls relative to incomes). The private sector financial surplus can be measured as the aggregate of the combined surpluses of households, non-financial companies and financial companies, or derived as the gap between the current account deficit and fiscal balance (by definition, the current account balance equals the fiscal balance and private sector financial balance).

Figure 3. UK – Sectoral Split of Private Sector Financial Balance, Pct of GDP, 4 quarter Average, 1987-2012



Note: Data for Q2 2012 adjusted to exclude transfer of assets by pension fund of state-owned postal service. Sources: ONS and Citi Research

Figure 4. UK – Real Disposable Income and Real Consumer Spending Per Head, £ per Quarter, 2009 Prices, 1997-2012



Sources: ONS and Citi Research

The private sector moved into a massive financial surplus since the boom…

During the long boom, the private sector financial surplus stayed low for many years, with a peak deficit of 0.5% of GDP (£7bn) in 2006. When the circle of rising asset prices and easy credit availability went into reverse, the private sector slashed spending and moved into a financial surplus of 9.8% of GDP in 2009 (£138bn).

…and this has been a major factor in the persistent weakness in spending

This £145bn swing (more than 10% of GDP) in private savings was the main cause of the deep recession, and has never really reversed. The private sector surplus edged down to 7.7% of GDP in 2010 and 6.8% in 2011, and has fallen a little further, to 5.6% of GDP in Q1 and 5.2% of GDP in Q2 – but remains far above average[1]. The last few years have seen the highest sustained private savings levels for at least 50 years. Within the private sector, the household sector has moved from a financial deficit of 4.7% of GDP (record high) in 2007 to a surplus of 1.0% of GDP in Q2-2012. The non-financial corporate sector has stayed in surplus, which was 3.0% of GDP in 2007, rose to 6.8% of GDP in 2010 and fell back to 2.3% of GDP in Q2-12. The flipside of the rise in aggregate private savings is that the economy continues to undershoot official forecasts, with real consumer spending 4.7% below the pre-crisis peak, and business investment 12.4% down. Real consumer spending per head is 8.4% below the peak and the lowest since 2003.

[1] Adjusted to exclude transfer of assets by pension fund of state-owned postal service.

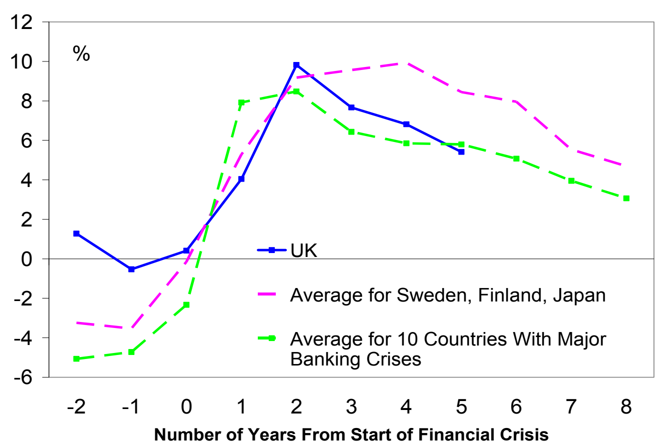
Trends in the UK private sector financial surplus are similar to those in previous boom-bust cycles overseas

This persistent bias to high private savings and a long period of ultra-low interest rates is a familiar pattern from other cases where countries had major boom-bust credit cycles, both recently and in previous years. In the US, the private sector has moved from a financial deficit of 3.9% of GDP in 2006 to a surplus of about 6.4% of GDP in 2011. The UK's experience so far has been somewhere between the average for Sweden, Finland and Japan after their 1990s crises, and a broader set of 10 countries (including those three) which have faced major banking crises in the last 30 years. Of course, private savings may well have risen further if the MPC had not cut rates sharply and massively expanded unconventional policies.

The high level of private savings is a key reason why interest rates remain so low

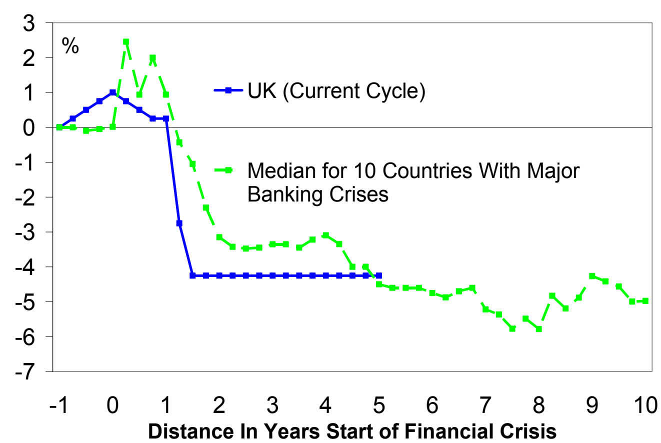
At first glance, it may seem strange that private savings are so high when interest rates are so low. By all standard measures (nominal and real interest rates, central bank balance sheet), monetary policy appears very loose. However, the causality is the other way round: the high level of private savings is the main reason why interest rates are so low (because this is a key reason why the economy is so depressed). Indeed, the trend in UK interest rates (sustained decline of 4-5 percentage points from the precrisis level) is similar to that seen on average across 10 major banking crises over recent decades. Similarly, the persistently high level of private savings is also the key reason why the UK's large fiscal deficit has not (so far) caused significant upward pressure on gilt yields: the high level of private savings causes depressed economic conditions that keep monetary policy loose and also provides the funds which (directly or indirectly via banks and pension funds) help fund the fiscal deficit.

Figure 5. Selected Countries – Private Sector Financial Balance During and After Banking Crises, 1980-2012



Note: We date the start of the current UK financial crisis as in 2007. We date the crises of Sweden, Finland and Japan at 1991, 1991 and 1997 respectively. The sample of 10 countries uses these three countries plus Norway (1991), Mexico (1994), plus Indonesia, Malaysia, the Philippines, Korea, and Thailand (all 1997).See Systemic Banking Crises Database", IMF 2012. Sources: IMF and Citi Research

Figure 6. Selected Countries – Change in Interest Rates During and After Banking Crises, 1980-2012



Note: We use the same 10 countries as in the left chart. We date the start of the current UK crisis as Q3-2007.
Sources: IMF, Datastream and Citi Research

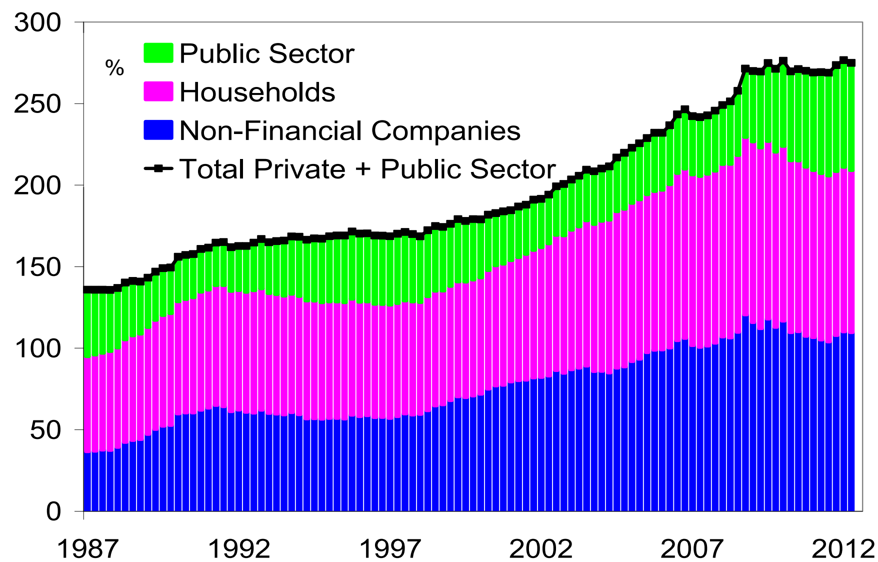
Other than high inflows to occupational pension schemes, overall the large private sector financial surplus is not being recycled into UK savings products

Overall, the large private sector surplus is not being recycled into high inflows to bank deposits. Corporate sterling deposits at UK banks rose 4.3% YoY in July, while household deposits rose 4.6% YoY, and neither rate is particularly high. One notable trend is that private sector contributions to funded occupational pension schemes rose by 17.3% YoY in H1, reaching to £26.2bn (3.4% of GDP), a record in cash terms and as a share of GDP, the highest half-year total since quarterly data began 10 years ago (and, comparing with annual data before that, probably the highest as a share of GDP since 1982).

The emphasis is on deleveraging…

However, the large private financial surplus is chiefly reflected in the ongoing trend of private deleveraging. Credit growth remains negative, and the ratio of household debt/GDP has edged down from 110.8% in Q-09 to 99.3% in Q2 this year. At the same time, the debt/GDP ratio for the non-financial corporate sector has edged down from 120.6% in Q4-08 to 109.7% in Q2. Nevertheless, both ratios remain well below the pre-boom levels: in mid-97, the household debt/GDP ratio was 69% while that for the corporate sector was just 58%. Indeed, at an aggregate level, the UK has not really delevered significantly at all, with the rise in the public debt/GDP ratio broadly offsetting the drop in the private debt/GDP ratio. The combined sum of public and private debts surged from 170% of GDP in mid-97 to 276.6% of GDP in Q1-12 (the peak so far), and has merely edged down to 274.9% in Q2-12.

Figure 7. UK — Debt/GDP Ratios for UK Private and Public Sectors, 1987-2012



Note: We exclude debt of non-bank financial companies. Sources: ONS and Citi Research

…and, for the corporate sector, the accumulation of assets overseas

In addition, for the corporate sector, the bias to high savings in the UK is being used to finance expansion overseas, via FDI, mergers and the accumulation of FX deposits outside the UK. During the five years ending Q2-2007, the UK corporate sector in aggregate ran a £173bn financial surplus (ie retained profits less investment, interest, dividends, tax etc). In terms of assets and liabilities, this surplus was reflected in a £90bn rise in sterling bank deposits at UK banks, a £236bn rise in bank deposits at non-UK banks, an £18bn rise in FX deposits at UK banks, and £247bn in net outward FDI investment plus purchases of overseas equity (as part of M&A transactions). Hence, with this rapid growth in foreign assets, corporate debts rose by £496bn even though the corporate sector was running a large financial surplus.

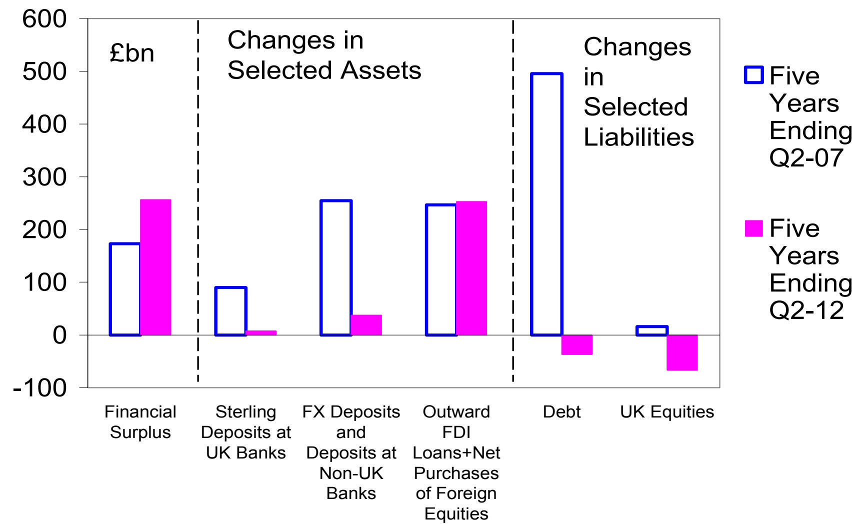
On the whole, the large corporate sector financial surplus is not creating a reserve of funds available to finance investment in the UK…

This emphasis on the accumulation of external assets has continued in recent years. In the five years ending Q2-2012, the UK corporate sector financial surplus has risen to £256bn, but the corporate sector's holdings of sterling bank deposits at UK banks has risen by just £8bn. Debt has fallen by £37bn, net UK equity liabilities have fallen by £67bn, but in aggregate the large financial surplus has gone overseas, with a £37bn rise in FX bank deposits and deposits at banks outside the UK, plus £253bn in net overseas FDI and purchases of foreign equity.

…the money has already gone overseas

So the large corporate sector financial surplus generated by low investment in the UK is not, in aggregate, piling up in sterling deposits at UK banks: it already has gone overseas, lured by faster economic growth and higher capital allowances. In aggregate, the corporate sector treats the UK as something of a "cash cow", generating surplus funds to invest overseas.

Figure 8. UK — Cumulative Changes Over 5-Year Periods in Selected Assets and Liabilities of Non-Financial Corporate Sector, £bn, 2002-12



Note: We show net change in UK equity liabilities – ie issuance less purchases. The change in assets and liabilities shown does not match the financial surplus, because there are a few other minor asset and liability categories not shown. Sources: ONS and Citi Research

The private sector financial surplus is likely to stay high for a while, capping domestic demand

We expect this trend of high private savings is likely to persist for a while, reflecting both deleveraging and offshoring. Private debt levels remain high, while income growth is weak (at best). From Q1-97 to Q1-06, real personal incomes per head rose by an average of 2.5% YoY, and the precrisis credit boom probably was fuelled by the widespread assumption that those gains could be extrapolated into the future - which appeared to make high debt levels sustainable. But in practice, real income per head has stagnated and in Q2 this year was a little below the Q1-06 level and only 0.2% up from Q2-04. Surveys suggest consumers remain gloomy over their financial prospects. In turn, declining optimism over income prospects probably will lead to continued caution over high debt levels, with a preference for lower debt levels among both borrowers and lenders. At the same time, company pension contributions are likely to remain high, while better growth prospects and capital allowances probably will continue to tempt firms to invest overseas rather than in the UK. With this backdrop, private spending is likely to remain sluggish and, with the UK facing heavy fiscal drag plus ongoing weakness in key EMU export markets, the overall economy is likely to remain stagnant.

…and keeping the MPC biased to loosen

We believe the BoE remains likely to expand QE further, probably at the November meeting but if not then, soon after. And, provided the government's ultimate fiscal solvency is not questioned, these conditions probably will ensure that gilt yields stay low in the year ahead (at least) even with the emerging overshoot in the fiscal deficit.

Economic Indicators

Mon 1 Oct	***Manufacturing PMI (Sep)***	**Forecast: 48.0**	**Prior: 49.5**
	The PMI rose quite sharply in August, by more than four points, but we anticipate a weaker reading in September given the ongoing recession in the euro area and slowdown in major emerging markets. A figure in line with our forecast would mark the fifth consecutive sub-50 reading.		
Wed 3 Oct	***Services PMI (Sep)***	**Forecast: 52.5**	**Prior: 53.7**
	After the marked bounce in August (nearly 3 points) we expect a slightly softer September reading, leaving this index close to the average of the last six months (53.0). Other surveys suggest that service sector growth remains modest.		
Tue 9 Oct	***Industrial Production (Aug)***	**Forecast: -0.2% MoM, -0.8% YoY**	**Prior: 2.9% MoM, -0.8% YoY**
	Manufacturing Output (Aug)	**Forecast: -0.3% MoM, 0.3% YoY**	**Prior: 3.2% MoM, -0.5% YoY**
	The sharp July rise in output reflected the unwind of the adverse effect n output of the Queen's Jubilee in June, and we do not expect to see another strong rise this month. Indeed, with weakness in surveys, we expect that manufacturing output probably fell back during the Olympics month.		
Tue 9 Oct	***Trade Balance – Goods & Services (Aug)***	**Forecast: £-2.0 billion**	**Prior: £-1.5 billion**
	The trade deficit fell sharply in July, as exports rebounded from the depressed levels seen in June (affected by the Queen's Jubilee holidays). For the August data, we expect the deficit to widen slightly again. A figure in line with our forecast would bring the total for the full year to £22.6bn, close to the total for all of 2011 (£23.6bn).		

Economic Calendar, 24 September — 12 October 2012

24 September	25 September	26 September	27 September	28 September
BoE's *Financial Stability Report*	**BBA Mortgage Approvals (Aug)** Jul 28.8K Aug 30.5K **IMF's *Global Financial Stability Report*** Chapters 3 & 4 Released	**BoE Credit Conditions Survey (Q3)** Q2 -4% QoQ Q3 +22% QoQ **CBI Retail Survey** Aug Sales -3% YoY Sep Sales +6%YoY	**Balance of Payments (Q2)** **GDP (Q2, 3rd Release)** Q1 -0.3% QoQ, -0.2% YoY Q2 -0.4% QoQ, -0.5% YoY **Record of BoE Financial Policy Committee Meeting on 14 Sep** **IMF's *World Economic Outlook*** Chapters 3 & 4 Released	**GfK Consumer Confidence** Aug -29 Sep -28 **Service Sector Output (Jul)** Jun -1.5% MoM, -0.6% YoY Jul 1.1% MoM, 0.7% YoY **Labour Productivity (Q2)** **Bi-Annual Gov't Deficit & Debt Return to EU Commission**
1 October	**2 October**	**3 October**	**4 October**	**5 October**
During The Week **Nationwide House Prices** (Sep, 07:00) **Manufacturing PMI (Sep)** Aug 49.5 SepE 48.0 **Personal Borrowing (Aug)** **Labour Party Conference (Manchester, Sep 30-Oct 4)**	*During The Week* **Halifax House Prices (Sep, 09:00)**	**Services PMI (Sep)** Aug 53.7 SepE 52.5 **BoE Housing Equity Withdrawal (Q2)** **MPC Meeting Starts**	**Profitability of UK Companies (Q2)** **MPC Meeting Ends: Outcome at Noon** **ECB Meeting (Ljubljana)** 12:45 Outcome 13:30 Press Conference	
8 October	**9 October**	**10 October**	**11 October**	**12 October**
Conservative Party Conference (Birmingham, Oct 7-10) **EuroGroup Meeting** (Luxembourg)	**Industrial Production (Aug)** **Manufacturing Output (Aug)** **Trade Balance – Goods & Services (Aug)** **EcoFin Meeting** (Luxembourg)			**IMF/World Bank Annual Meeting** (Tokyo, Oct 12-14)

E Citi estimate. B Billion. P Provisional. R Revised. Note: All data are released at 9.30 a.m., except those marked otherwise.
Sources: BoE, CBI, CML, ONS, national sources and Citi Research.

Appendix A-1

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Data current as of 30 Jun 2012	**Buy**	**Hold**	**Sell**	**Buy**	**Hold**	**Sell**
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% of companies in each rating category that are investment banking clients	44%	43%	40%	48%	43%	45%
Citi Research Global Closed End Fund Coverage	0%	0%	0%			
% of companies in each rating category that are investment banking clients	0%	0%	0%			
Citi Research Quantitative World Radar Screen Model Coverage	30%	40%	30%			
% of companies in each rating category that are investment banking clients	27%	22%	18%			
Citi Research Quantitative Decision Tree Model Coverage	50%	0%	50%			
% of companies in each rating category that are investment banking clients	52%	0%	45%			
Citi Research Asia Quantitative Radar Screen Model Coverage	20%	60%	20%			
% of companies in each rating category that are investment banking clients	25%	23%	20%			
Citi Research Australia Radar Model Coverage	48%	0%	52%			
% of companies in each rating category that are investment banking clients	34%	0%	13%			

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