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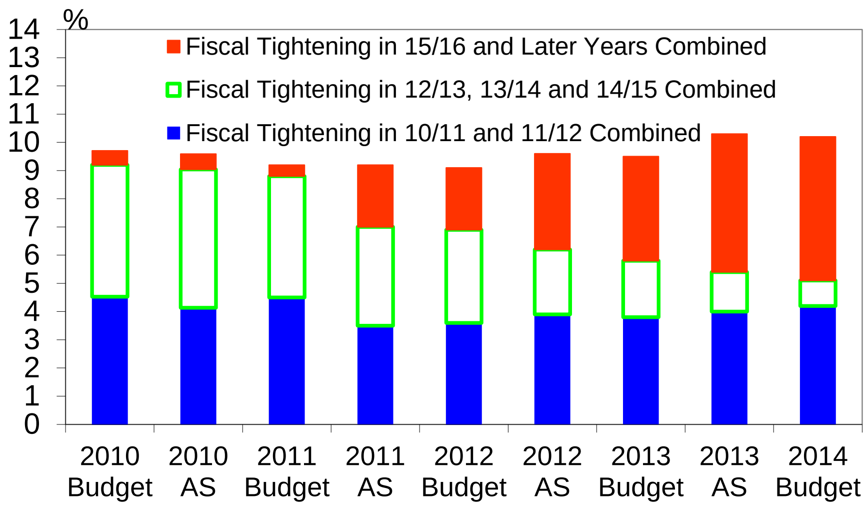
Budget Reinforces Strong Growth/Low Inflation Outlook

Michael Saunders
+44-20-7986-3299
michael.saunders@citi.com

- As expected, the OBR cut its deficit estimates for this year and coming years, while lifting its GDP growth forecasts. But the OBR judges that the improvement in the deficit outlook is all cyclical (ie a side effect of stronger economic growth) and actually slightly raised its estimates for the UK's structural fiscal deficit. The Budget itself is roughly neutral and leaves the UK on a multi-year fiscal consolidation path. However, fiscal tightening is modest in the year ahead (as in the fiscal year just ending). Most of the further fiscal restraint is scheduled for after the 2015 election.
- At the margin, the Budget reinforces the UK's outlook for strong growth with low inflation. The Budget measures should help boost real incomes and the extra capital allowances may further fuel the pickup in business investment. We expect the fiscal deficit to undershoot the OBR's forecast by about £9bn in 14/15.
- If the post-election fiscal consolidation is implemented, then the UK's fiscal deficit should fall markedly further in coming years, with a surplus in prospect towards the end of the decade. However, there are major political risks over this scenario, reflecting uncertainties over whether the post-2015 spending squeeze is politically deliverable, especially if the 2015 election produces a Labour-led majority or coalition government.

Figure 1. UK – Govt Plans for Fiscal Tightening ((Change in Structural Primary Balance), Pct Of GDP, 2010-18/19



AS Autumn Statement. Sources: HM Treasury, OBR and Citi Research

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Budget Reinforces Strong Growth/Low Inflation Outlook

The fiscal deficit is revised down, but the structural deficit is slightly worse

As expected, the OBR cut its deficit estimate for the current fiscal year (2013/14) by £3bn, trimming also its deficit forecasts for coming years, while lifting its GDP growth forecasts. However, the OBR judges that the improvement in the deficit outlook is all cyclical (ie a side-effect of stronger economic growth). Indeed, the OBR has actually further increased its estimate for the UK's cyclically adjusted fiscal deficit in 2013/14 to 5.0% of GDP from 4.3% of GDP a year ago and 4.1% of GDP two years ago. The recovery is boosting revenues and cutting the deficit, but not as powerfully as normal multipliers would imply, perhaps because of weakness in pay growth. In particular, the OBR expects the ratio of taxes to GDP in 13/14 to be 35.2% versus 36.0% in the Spring 2013 Budget forecast.

A roughly neutral Budget leaves fiscal policy on a tightening path…

With this backdrop, the Budget itself is roughly neutral, with various modest tax giveaways funded by anti-avoidance measures. This leaves fiscal policy on the built-in tightening path, with modest restraint nearterm but heavier tightening further ahead. In all, the government's plans imply the cyclically adjusted primary balance will improve by 10.2% of GDP over the whole period from 2009/10 to 2018/19. Of this tightening, half (ie 5.1% of GDP) is scheduled to occur in 2015/16 onwards (ie after the next election, which will be in Q2-2015). The other half (ie 5.1% of GDP) occurs between the 2010 and 2015 elections, but roughly four fifths of this (ie 4.2% of GDP) came in the coalition government's first two years (2010/11 and 2011/12). There has been only very limited tightening in the last two years, with the structural primary deficit down by 0.3% of GDP in 2012/13 and 2013/14 combined. On the government's plans, the structural primary deficit will fall by only 0.6% of GDP in 14/15. By contrast, in the end-13 AS, the Treasury projected the cyclically adjusted primary deficit to fall by 1.0% of GDP in 14/15.

…but most of the further consolidation is set for after the 2015 election

The government has remained consistent in its medium-term aim of fiscal consolidation. But, after the first two years, the government has allowed the timetable to drift, rather than risk throttling the recovery with further heavy upfront fiscal tightening. The Treasury's estimate of the structural primary deficit in 14/15 has risen by about 4½% of GDP since the mid-2010 Budget, and has actually risen in every fiscal statement since then.

The specific measures aim to boost growth and median real incomes…

Within a roughly neutral Budget, the emphasis is on measures to boost real incomes of middle earners, and to support growth (especially investment, exports and housebuilding). This reflects a general desire to aim for a broad-based and more balanced recovery, but also the government's political aim of ensuring that voters feel the benefits of recovery more widely. Hence, personal tax allowances rise again, while the freeze on petrol and spirits duties (with a cut in beer duty) will help pull inflation lower. We had already anticipated these excise duty changes, and our base case is that CPI inflation will fall to about 1.5% during this year. With pay growth picking up, the long period of falling real wages is likely to end during this year, with average earnings rising above the falling path of CPI inflation.

…and the investment allowance could further boost the investment recovery

Among the new measures, the most eye-catching in our view is the rise in the 100% capital allowances ceiling to £500K from £150k previously. If there is anything in the Budget that is a potential game-changer for the economy, it is this in our view. The UK's normal system of capital allowances is relatively unfavourable by international standards, but for smaller firms the UK's system is now highly favourable. As the Chancellor said "*99.8% of businesses will get a 100% investment allowance*". This measure, along with the high level of corporate liquidity and rising business confidence may well be a powerful further stimulus for the nascent pick up in business investment which now seems to be underway. And if this measure is successful in lifting investment, it could well be expanded or extended in the future.

Budget measures support strong growth/low inflation outlook, aim to restore voters' support

At the margin, the specific measures reinforce the likelihood that the UK is heading for strong and broad-based growth with low inflation. Fiscal drag is modest, the drop in real wages seems to be ending, and small/medium sized firms have powerful incentives to lift investment. All this may help the coalition regain some support from voters in the runup to the 2015 election, although it remains to be seen whether it will be enough to prevent a Labour victory (or Labour-led coalition) in next year's election.

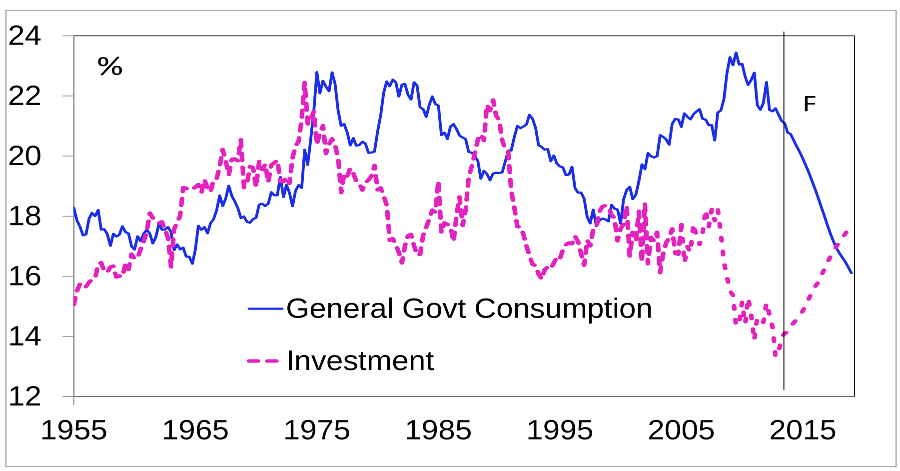
Fiscal deficit likely to undershoot in 14/15, with a marked further drop if the planned post-election spending squeeze is delivered…

We currently expect that strong GDP growth will cut the 14/15 deficit to about £87bn (5.0% of GDP), roughly £9bn below the OBR's forecast. If the current fiscal plans (which are partly in outline form only) are implemented in later years, then the fiscal deficit is likely to keep falling, with the net debt/GDP ratio starting to fall in 16/17 and (as the OBR project) an eventual move into budget surplus towards the end of this decade. The government's plans imply that, even with the cap on welfare spending, general government consumption (which does not include welfare) will fall from 20.8% of GDP (nominal terms) in Q4-13 to 16.1% of GDP in Q1-2019 (the OBR's forecast horizon) – the lowest since data began in 1955. In the OBR's forecast, the drag on growth from this spending squeeze is offset by a strong investment recovery, with investment spending (nominal terms) up by 54% from Q4-13 to Q4-18, while general government consumption falls by 3%.

…but there is considerable uncertainty over the political deliverability of those plans

We are reasonably confident in the prospects for such an investment pick up, and hence in the prospect for continued economic growth. However, the *political* deliverability of these spending plans remains in doubt, given the 2015 election[1]. The post-2015 squeeze in the current plans would probably require a major reduction of the size and role of the state, well beyond the measures implemented so far. Within the current coalition, the Lib Dems may be reluctant to go along with such a plan, and in any case the longevity of a renewed Conservative-Lib Dem coalition may be undermined by divisions over whether to hold an EU referendum and, if so, which side to support. If the election delivers a Labour majority or Labour-led coalition then, unless constrained by market pressure, we suspect their preference would be to opt for higher borrowing and higher taxes rather than such an aggressive spending squeeze. Of course, if the post-2015 spending squeeze is not implemented, then hopes for a fiscal surplus would be undermined.

Figure 2. UK – General Government and Investment Spending, Pct of GDP, 1955-2019F



F OBR Forecast. Sources: OBR, ONS and Citi Research

[1] See "*Policy Continuity and Flexibility*", Michael Saunders, UK Economics Weekly, 14 March 2014, Citi.

Appendix A-1

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