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Europe

UK Economics Weekly

Weak Economy Undermines the Public Finances, Again

- The over-riding theme of the Autumn Statement is the continued weakness of the economy and the need to adapt the public finances to the UK's diminished economic position and shrunken prospects. The OBR's forecasts paint a grim picture: even with an extended period of fiscal austerity, further large revenue shortfalls will lift the general government debt/GDP ratio (on the standard Eurostat measure) close to 100% of GDP in coming years, from just 43% of GDP in 2007/08.

- In practice, we suspect the outturn will be even worse. Early data suggest the UK is heading for a "treble dip", with GDP shrinking again in Q4. We expect the economy will continue to underperform the OBR's forecasts in 2013-14, leading to further sizeable revenue shortfalls and deficit overshoots. Our base case is that the general government debt/GDP ratio will rise above 100% of GDP in coming years. We have argued for a while that the UK will lose its AAA rating in the next 2-3 years and it now seems likely that this will happen in the next 12-18 months, reflecting the higher path for the debt/GDP ratio plus rising uncertainty over how and whether the government will achieve the savings needed to stabilise and reverse the debt trajectory. In other countries, the loss of AAA status has often not provoked a major market reaction, but a downgrade in the UK probably would heighten political risks and hence also increase implementation risks in the fiscal consolidation plans.

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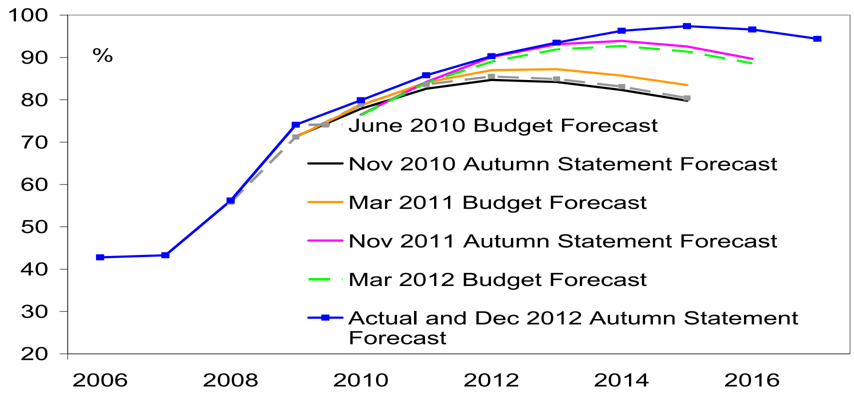
Figure 1. Citigroup Market Forecasts

	Base Rate	QE Target	10 Year Yield	Spread vs. Bunds	$/£	£/€
2Q 2013	0.50	£400bn	1.95	21bp	1.54	0.79
4Q 2013	0.50	£450bn	1.80	31bp	1.52	0.79

Source: Citi Research

Figure 2. UK — General Govt Debt/GDP Ratio, Fiscal Years 2006/07-2017/18F



F OBR Forecast. Sources: ONS and Citi Research.

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

Adjusting to the Bleak Economic Outlook

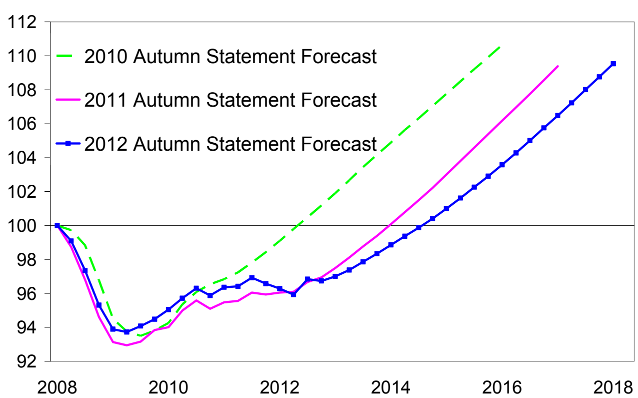
The Autumn Statement is dominated by the continued weakness of the economy

The over-riding theme of the Autumn Statement is the continued weakness of the economy and the need to adapt the public finances to the UK's diminished economic position and shrunken prospects.

The OBR once again have had to sharply cut their forecasts for real and nominal economic growth

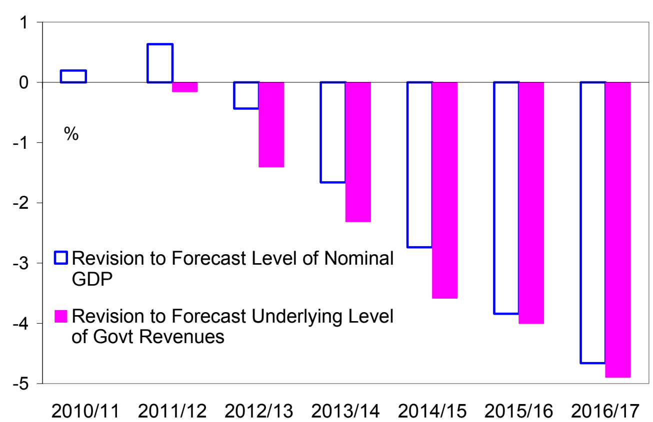
The OBR have had to repeatedly cut their economic forecasts in recent years in response to persistent economic weakness. For example, in the 2010 AS, the OBR forecast that real GDP would get back to the pre-recession peak (Q1-08) in Q3-12. In practice, it is still 3.1% below the Q1-08 level. In the 2011 AS, the OBR cut their growth forecasts sharply, deferring that recovery date back to Q1-14. And the OBR has again cut its forecasts sharply, not just for the year ahead but for several years, and for both real and nominal GDP. The OBR now judge that real GDP will not regain its prerecession peak until Q4-14 (a quarter later than the MPC's latest forecast). In all, the OBR cut their forecast for the level of nominal GDP in Q1-17 by 5.0% versus the Budget forecast, leading to a similar downward revision to the underlying forecast for government revenues in 2016/17 (ie excluding policy changes and the APF transfer) versus the March Budget forecast.

Figure 3. UK — Level of Real GDP, Indexed to Q1-2008 = 100, 2008-18F



F OBR Forecasts. Sources: OBR and Citi Research

Figure 4. UK — Autumn Statement Revisions to Level of Nominal GDP and Government Revenues, 2010/11-16/17F



F OBR Forecasts. Sources: OBR and Citi Research

The weakness in the economy is broad-based, and — even if it is partly cyclical — is likely to be persistent

In explaining the latest forecast downgrade, the OBR stresses the adverse effects from the EMU crisis, which has hit exports and net trade, but in practice business investment also again is lower than the OBR expected a year ago. The OBR regard the persistent weakness in the economy as partly cyclical and partly structural, and now expect that the economy will still have a sizeable output gap of about 2% of GDP even in 2017/18. But, whether the shortfall in demand is cyclical or structural, the key point is that it is persistent. In our view, the divide between structural and cyclical weakness blurs when the economy is sluggish for such a long period, and extended cyclical weakness can become structural: for example, spare resources decay, capital stock erodes and skills are lost. In any case, even if part of the economy's extended weakness is truly cyclical, it could lead to such a large rise in public debt that the public finances have a structural problem.

Even with the tight spending plans, prospects for the fiscal position continue to worsen

The government has more or less stuck to the tight spending plans laid out in the June-2010 Budget. But even so, with this weaker path for nominal GDP — and hence revenues — the government once again face upward revisions to the debt and deficit forecasts, and the OBR now believe that the government's target of a falling debt/GDP ratio in 2015/16 is out of reach. We had expected that the OBR would revise down nominal GDP and revenues by only about 3%, in which case the

APF interest income to the Treasury would just about allow the debt target to be hit in 2015/16[1]. But, the scale of the downward revisions to the OBR forecasts for revenues and nominal GDP swamps possible savings from the APF transfer.

The Chancellor chose to defer extra fiscal tightening in the face of continued economic weakness

With these OBR forecasts, the Chancellor faced a highly awkward choice between having to impose even more nearterm fiscal tightening on top of the existing tight plans, or to accept further slippage (debt ratio missed in 2015/16, cyclically adjusted current balance deferred until 2017/18). The Chancellor's decision — to accept near-term fiscal slippage and aim for gradual tightening — is reasonable under these adverse circumstances, in our view. We would not advocate extra near-term fiscal tightening given the low level of gilt yields, high level of private savings, and the ongoing drags on the economy from private deleveraging and the EMU crisis. However, this decision does expose the weakness of the UK's fiscal position:

The UK has made only limited progress in tackling the structural current deficit…

- **Persistently high structural deficit**. On the OBR's estimate, only very limited progress has been made in eliminating the UK's structural deficit: it peaked at 5.3% of GDP in 09/10 and — after three years of austerity — it has fallen by only 1% of GDP, to 4.3% of GDP in 2012/13 (excluding the APF transfer). Only a small share of the fiscal austerity has actually occurred so far.

…the debt ratio continues to rise rapidly…

- **Rising debt ratio**. The OBR now expect that the general government debt/GDP ratio (on the Eurostat measure) will rise from 90.3% of GDP in 2012 to peak at 97.4% of GDP in 2015/16, having been just 43.3% of GDP in 2007. By contrast, just two years ago the OBR forecast the debt ratio would peak in 2012/13 at 84.7% of GDP and then would fall each year, reaching 79.8% of GDP in 2015/16.

…there is growing implementation risk in the fiscal plans…

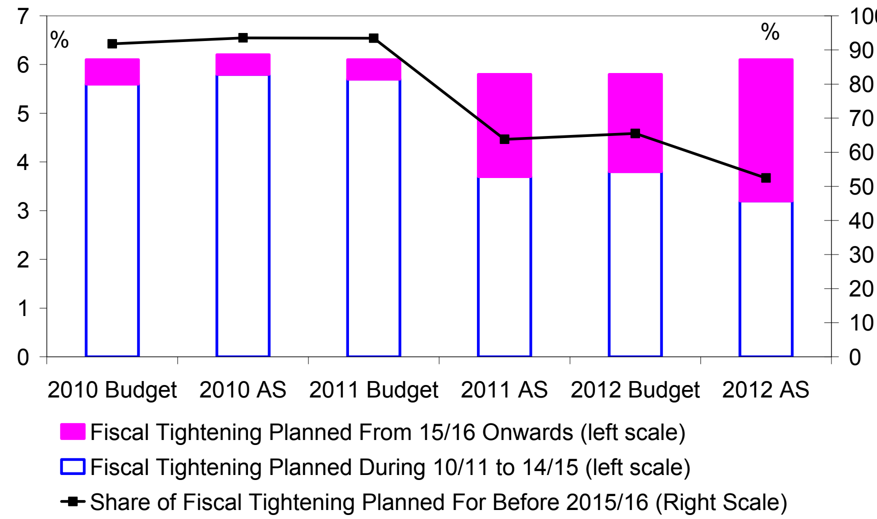
- **Rising implementation risk**. In June 2010, the OBR judged that 92% of the fiscal tightening would be complete by the end of 2014/15 (ie before the next election, which is due in June-2015). Now, they judge that only 52% of the tightening will have been done before the 2015 election, with three years of post-election austerity. As yet, the fiscal plans beyond 2014/15 are largely just in outline form, with no detailed plans of where the spending axe will fall. In any case, even if the current government did now produce detailed post-election plans, opinion polls point to sizeable risks that the coalition parties will do badly in the 2015 election. This creates rising implementation risk, either via pre-election slippage or post-election slippage if the election produces a Labour government in 2015 (or perhaps a Labour-led coalition). The Labour leadership has repeatedly opposed the coalition's fiscal tightening plans and may well not be committed to post-election plans laid out by the current coalition.

…and the fiscal rules are greatly weakened

- **The UK's fiscal rules have been greatly weakened**. The Chancellor simply acknowledged he will miss the debt rule and decided not to take action to close the gap. The Autumn Statement did contain plans to trim current spending in coming years, but these savings were recycled as tax cuts for companies, car drivers and lower-income earners rather than used to try to get close to the debt target. The new forecasts show the debt/GDP ratio falling in 2016/17 but the Chancellor did not commit to achieve a falling debt ratio in that or any other year. It appears that the "debt target" has become merely an aspiration — for the debt/GDP ratio to fall in one year (2015/16) if the economy surprises on the upside — rather than a genuine target that will constrain policy. By contrast, we had expected that, whether or not the Chancellor hit the debt target for 2015/16, he would announce a new and credible target to extend beyond that.

[1] See UK Economics Weekly – "Dodging the Autumn Statement Dilemma", Michael Saunders, 23 November 2012, Citi.

Figure 5. UK — Govt Plans for Improvement in Cyclically Adjusted Current Balance (Ex APF Transfer), Pct of GDP, Fiscal Years 2010/11 to 2017/18F



OBR Forecast. Note: We exclude the effects of the APF transfer. Sources: OBR and Citi Research

The key challenge is to lift demand in the economy, and the Autumn Statement does little on this

Moreover, the Autumn Statement does little to break the economy out of extended weakness. Once again, the emphasis is mainly on trying to adjust the public finances to the weaker prospects for the economy rather than seeking to change the outlook. In each Budget and Autumn Statement, the Chancellor has seemed to accept official forecasts that growth will revive soon with current policies. To be sure, there are no easy routes for the government to break out of this economic torpor. But, there are some things that could be done. We favour further monetary stimulus, renewed labour market deregulation (especially for younger workers), urgent recapitalisation of the banks (especially state-owned banks) on a sufficient scale to end worries over their balance sheets, acceleration of infrastructure projects (perhaps with state guarantees or partial stakes), a further squeeze on government current spending (especially public sector pay and pensions) to fund greater capital spending, and a broader property tax to fund lower national insurance contributions.

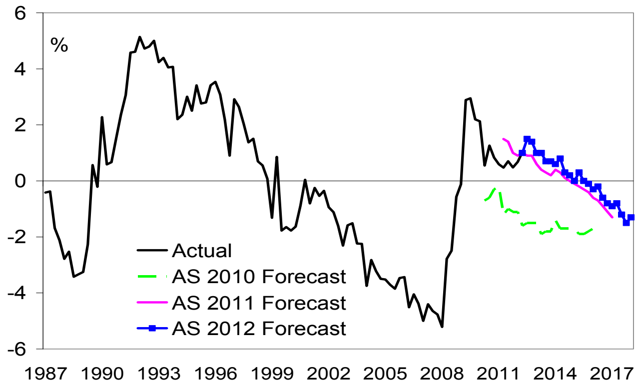
We expect the economy will continue to undershoot official forecasts…

In practice, we expect that the economy will continue to undershoot the OBR's forecasts. Recent data and surveys suggest that the economy is heading for a treble dip, with GDP likely to shrink in Q4 after the rebound in Q3. Our base case is for real GDP growth of about 0.8% in 2013, and roughly 1.0% YoY in 2014-15 — and if anything risks lie to the downside of our forecast, especially for 2013. The EMU crisis will probably continue to cap exports, while domestic demand probably will continue to be constrained by a more extended bias among households to deleveraging and savings than the OBR assume. The OBR have repeatedly anticipated that business investment will surge to record levels as a share of GDP, and that consumer spending will be lifted by a renewed decline in personal savings and rising household debt/income ratio. In practice, neither shift has occurred, and in our view neither is likely anytime soon.

…with the general government debt/GDP ratio likely to rise above 100% in coming years

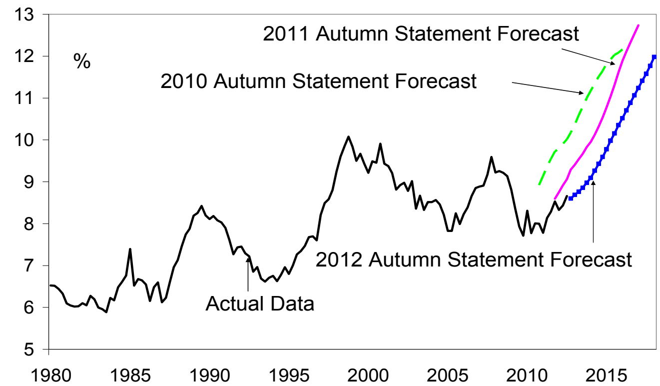
As a result, we look for further shortfalls in revenues versus the OBR's forecasts, pushing the debt/GDP ratio (on the Eurostat definition) above 100% of GDP in 2015-2016 (and with the public sector net debt/GDP ratio probably around 90%). We stress this slippage is solely the result of our weaker forecast for nominal GDP (and hence tax revenues) rather than any retreat from the fiscal consolidation plans.

Figure 6. UK — OBR Forecasts for Household Financial Balance (Pct of GDP), 1987-2018F



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

Figure 7. UK — Real Business Investment as Pct Real GDP, 1980-2018F



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

The UK is likely to lose its AAA rating in the next 12-18 months…

With this backdrop of high and rising debt/GDP ratio and rather tattered set of fiscal rules, we believe that the UK's AAA rating looks precarious. The UK no longer has credible plans to put the debt/GDP ratio on a stable or declining path in our view, given that roughly half of the planned fiscal tightening is scheduled beyond the next election and beyond the end of the current detailed spending plans. We have argued for a while that the UK is likely to lose its AAA rating over the next 2-3 years[2]. It now seems likely that the mix of the rising debt ratio, weakened fiscal framework and uncertainties over the implementation of fiscal consolidation will lead to a one-notch downgrade of the UK by at least one major agency in the next 12-18 months. We still expect that, before this, S&P will put the UK on "negative outlook" in H1-2013, with Moody's putting the UK on "negative watch" (indeed, this may be implicit in their statement that they will "assess" the UK's rating in early 2013). Risks of a ratings downgrade could fall if the economy recovers strongly (improving the fiscal numbers), electoral uncertainties fade, or the Chancellor announces a new and credible medium-term fiscal framework that gains broad political support.

…and this probably will add to political uncertainties and hence implementation risk on fiscal consolidation

Many investors currently seem to assume that the loss of the UK's AAA rating would not, by itself, be a major problem for markets. However, a ratings downgrade would be a major blow for the government and hence, by adding to risks that the coalition parties do badly in the 2015 election, it would increase uncertainty over the implementation of fiscal austerity in the runup to the 2015 election and beyond it — and such uncertainties probably would be bad for sterling assets in our view.

Monetary policy will remain biased to stimulus, most likely via extra QE

Monetary policy probably will remain biased to further stimulus, probably via further QE. That change to pension regulation will, if carried out, reduce the extent to which extra QE raises pension deficits, and hence make QE a more effective tool for stimulus. It also is possible that from mid-2013 the new Governor will take a different view on whether 0.5% is the effective zero bound for Bank Rate. We doubt that the MPC will believe the FLS can be used to add more near-term stimulus, given the low takeup and the fact that banks that have used the FLS have, in aggregate, cut lending to households and businesses more than banks that have not used the FLS[3]. It appears that, so far, the FLS is mainly acting as a subsidy for weak banks rather than a trigger for new lending.

[2] See "*Global Economic Outlook and Strategy*", Willem Buiter et al, November 2012, Citi.

[3] See "*BoE Data Confirm Initial Impact of FLS Is Small*", Michael Saunders, December 2012, Citi.

Economic Indicators

Wed 12 Dec	***Claimant Count Unemployment (Nov)***	**Forecast: +10,000 MoM, 4.8% Rate**	**Prior: +10,100 MoM, 4.8% Rate**
	LFS Unemployment (Aug-Oct)	**Forecast: -120,000 QoQ, 7.8% Rate**	**Prior: -49,000 QoQ, 7.8% Rate**

These figures may again show a contrasting story. The claimant count fell during the Olympics, reflecting temporary jobs created by the Games, but began to rise after the Games in October and may well rise again in November. By contrast, the LFS measure is a three-month average, which will still include the sharp drop in unemployment in August, and hence will probably continue to show a decline this month.

Thu 13 Dec	***CBI Industrial Trends Survey (Dec)***		
	Monthly Output Expectations Net Balance (Dec)	**Forecast: -7%**	**Prior: -9%**
	Monthly Order Books Net Balance (Dec)	**Forecast: -20%**	**Prior: -21%**
	Monthly Selling Prices Net Balance (Dec)	**Forecast: +6%**	**Prior: +8%**

The November survey showed a sharp deterioration in output expectations, and these may well improve a little — albeit still remaining below levels of most recent months.

Tue 18 Dec	***Producer Input Prices (Nov)***	**Forecast: % MoM, % YoY**	**Prior: -0.2% MoM, -1.2% YoY**
Tue 18 Dec	***Producer Output Prices (Nov)***	**Forecast: % MoM, % YoY**	**Prior: 0.1% MoM, 2.5% YoY**
	Output Prices Ex Tax (Nov)	**Forecast: % MoM, % YoY**	**Prior: 0.2% MoM, 2.3% YoY**
	Excluding Food, Drink, Tobacco, Energy (Nov)	**Forecast: % MoM, % YoY**	**Prior: 0.1% MoM, 1.4% YoY**
Tue 18 Dec	***Consumer Prices (Nov)***	**Forecast: 0.0% MoM, 2.5% YoY**	**Prior: 0.5% MoM, 2.7% YoY**
	CPI Ex Food, Drink, Tobacco, Energy (Nov)	**Forecast: 0.0% MoM, 2.6% YoY**	**Prior: 0.7% MoM, 2.6% YoY**
	Retail Prices (Nov)	**Forecast: 0.0% MoM, 3.0% YoY**	**Prior: 0.6% MoM, 3.2% YoY**
	RPIX — Excludes Mortgages (Nov)	**Forecast: 0.0% MoM, 2.9% YoY**	**Prior: 0.5% MoM, 3.1% YoY**

A sizeable decline in petrol prices, which fell by 3-4p/litre, probably will help bring CPI inflation a little lower this month, despite gains in some utility prices. Nevertheless, we expect that CPI inflation will stay slightly above the 2% target for some time.

Sources: BoE, CBI, CML, ONS, national sources and Citi Research.

Economic Calendar, 3 December — 21 December 2012

3 December	**4 December**	**5 December**	**6 December**	**7 December**
Manufacturing PMI (Nov) Oct 47.3 Nov 49.1 *During The Week* **Halifax House Prices** (Nov, 09:00) **Eurogroup Meeting** (Brussels)	**M&A Involving UK Companies (Q3)** **EcoFin Meeting** (Brussels) **Bank of Canada Interest Rate Announcement** (14:00)	**Services PMI (Nov)** Oct 50.6 Nov 50.2 **Chancellor Osborne's Autumn Statement (12:30)** **MPC Meeting Starts** **Ireland: 2013 Budget** (14:30)	**Halifax House Prices (Nov)** Oct -0.1% MoM, -2.2% YoY Nov 1.0% MoM, 0.0% YoY **Trade Balance – Goods & Services (Oct)** Sep £-2.5bn Oct £-3.6bn **Foreign Direct Investment (2011)** **MPC Meeting Ends:** **Rates Unchanged at 0.5%** **QE Unchanged at £375bn** **ECB Meeting** **Rates Unchanged at 0.75%**	**Industrial Production (Oct)** Sep -2.1% MoM, -3.2% YoY Oct -0.8% MoM, -3.0% YoY **Manufacturing Output (Oct)** Sep 0.0% MoM, -1.7% YoY Oct -1.3% MoM, -2.1% YoY **New Construction Orders (Q3)** **BoE/GfK Inflation Survey (Nov)**
10 December	**11 December**	**12 December**	**13 December**	**14 December**
	RICS House Price Survey (Nov)	**Claimant Count Unemployment (Nov)** Oct +10.1K MoM, 4.8% Rate NovE +10.0K MoM, 4.8% Rate **LFS Unemploym't (Aug-Oct)** Jul-Sep -49K QoQ (7.8%) Aug-OctE -120K QoQ (7.8%) **FOMC Meeting** (17:30)	**Swiss National Bank Monetary Policy Assessment** (08:30) **CBI Industrial Trends (Dec, 11:00)** **Output Expectations (Dec)** Nov -9% DecE -7% **Order Books (Dec)** Nov -21% DecE -20% **Selling Prices (Dec)** Nov +8% DecE +6% **European Council** of EU Heads of State and Government (Brussels)	**Construction Output (Oct)** **European Council** (continued)
17 December	**18 December**	**19 December**	**20 December**	**21 December**
	Consumer Prices (Nov) Oct 0.5% MoM, 2.7% YoY NovE 0.0% MoM, 2.5% YoY **CPI Ex Food, Drink, Tobacco, Energy (Nov)** Oct 0.7% MoM, 2.6% YoY NovE 0.0% MoM, 2.6% YoY **Retail Prices (Nov)** Oct 0.6% MoM, 3.2% YoY NovE 0.0% MoM, 3.0% YoY **RPIX – Ex Mortgages (Nov)** Oct 0.5% MoM, 3.1% YoY NovE 0.0% MoM, 2.9% YoY **Producer Input Prices (Nov)** **Prod. Output Prices (Nov)**	**MPC Minutes (6 Dec)** **BoE Agents' Summary of Business Conditions (Dec)**	**Retail Sales Volumes (Nov)**	**Public Sector Net Borrowing Ex Costs of Financial Intervention (Nov)** **Balance of Payments (Q3)** **GDP (Q3, 3rd Release)** **Service Sector Output (Oct)**

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.

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Appendix A-1

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