

Economics

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Sterling Weekly

On the Path Back to Fiscal Sustainability

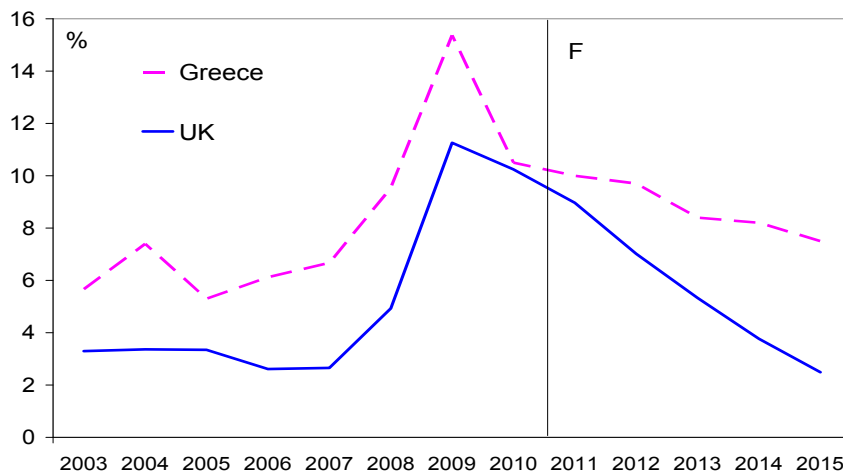
- The rise in the fiscal deficit in the first two months of this year reflects temporary factors rather than a sustained trend. We expect the deficit to fall substantially over this fiscal year, as it did last year.
- Underlying revenue growth remains solid, with some positive factors to come over the rest of the fiscal year. Spending growth is above plan so far, but part of this reflects a surge in benefit outlays which is likely to prove temporary (although the overshoot in debt service payments is likely to continue). The OBR's fiscal forecasts are quite realistic and, if anything, we expect the full-year deficit will undershoot slightly, by about £10bn. There is some uncertainty stemming from the ONS's tendency to revise the fiscal data quite substantially, but recent revisions have tended to be downwards rather than up.
- With little risk of fiscal slippage, the UK — uniquely among the high-deficit EU countries — remains on track to return to fiscal sustainability in coming years.

Figure 1. Citigroup Market Forecasts

	\$/£	£/€	Base Rate	10 Year Yield	Spread vs Bunds
End 2011	1.65	0.86	0.75	3.50	15bp
Mid 2012	1.73	0.85	1.00	3.90	10bp

Source: Citi Investment Research and Analysis

Figure 2. UK and Greece — Fiscal Deficit (General Government) as Pct of GDP, 2003-2015F



F Forecast. Sources: ONS, IMF and CIRA forecasts

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

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On the Path Back to Fiscal Sustainability

Despite higher borrowing in April-May, the UK remains on track for a lower deficit in the year as a whole

There is some disquiet at the fact that the fiscal deficit rose to £27.4bn in April-May from £25.9bn in the same months a year ago. However, we believe the downtrend in the deficit remains on track. Indeed, as last year, the deficit may well drop faster than the consensus and OBR expect. We expect that the deficit will fall from £156.5bn (11.1% of GDP) in 09/10 and £143.2bn (9.7% of GDP) in 10/11 to about £112bn (7.2% of GDP) in the current fiscal year, 2011/12, on the standard measure that excludes financial interventions. Our projection is somewhat below the OBR's forecast £122bn and the consensus (£123bn). With the current tax and spending plans, the deficit will probably be down to about £86bn (5.3% of GDP) in 12/13 and about £62bn (3.7% of GDP) in 13/14, going below 3% of GDP in 14/15. The key point is the general path of falling deficits rather than the exact numbers.

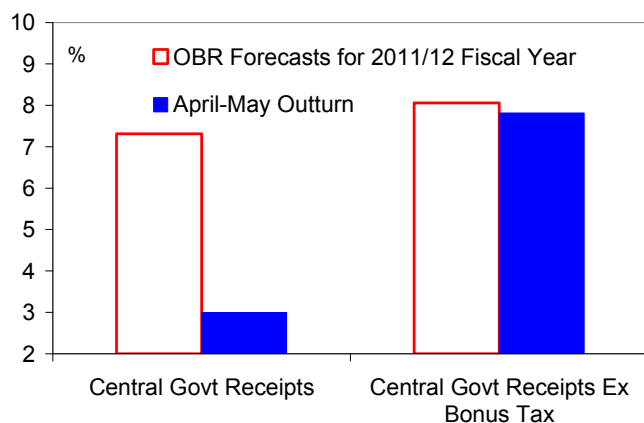
Uniquely among the high-deficit countries, the UK has a clear path back to low deficits in the next few years

The UK was not alone in suffering a massive fiscal deterioration in 07-09. But the UK is fairly unique in having a clear path back to low deficits in the next few years. The UK has a serious and agreed plan for large multi-year fiscal consolidation (unlike the US and Japan) and also has the flexibility in monetary policy and the exchange rate (unlike euro area countries) to support the economy and hence to ensure that fiscal consolidation will not produce a vicious circle of undershooting growth and undershooting revenues.

The rise in the deficit from a year ago in April-May entirely reflects base effects from the bonus tax

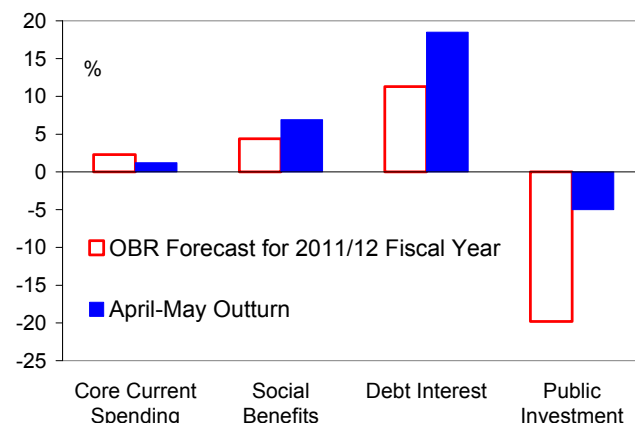
The £1.5bn rise in borrowing from a year ago in April-May is more than fully accounted for by adverse base effects from last year's bonus tax (which generated £3.5bn in April 2010). Excluding that, the deficit in April-May has fallen by £2bn from a year ago. And recent trends in revenues and spending point to a continued downtrend in the deficit in coming months.

Figure 3. UK — Central Government Receipts YoY, 2011/12 Fiscal Year



Sources: OBR, ONS and Citi Investment Research and Analysis

Figure 4. UK — Government Spending YoY, 2011/12 Fiscal Year



Note: Core current spending excludes debt interest and social benefits.
Sources: OBR, ONS and Citi Investment Research and Analysis

Revenue growth is OK, with some positive factors to come

■ In the first two months of the year, central government revenues rose 7.8% YoY (excluding the bonus tax), close to the OBR's forecast for the full year (8.1% YoY). Revenues are driven mainly by nominal GDP growth, and this is unlikely to undershoot the OBR's forecasts (4.8% YoY in 11/12, 5.0% in 12/13) and may overshoot slightly, with higher inflation offsetting the probable undershoot in real GDP growth. As last year, there may be a slight improvement in revenue elasticity (ie revenues rising slightly faster relative to nominal GDP growth). In particular, with employment doing better than expected, there may be some overshoot in income tax and national insurance (NI receipts are up 5.1% YoY in April-May, versus the OBR's 3.0% forecast for the full year). Moreover, there are

helpful revenue boosts to come from the recent hike in offshore corporation tax plus self-assessment proceeds in January-February 2012 at the new higher 50% rate. We expect that revenues will overshoot the OBR forecast by about £7bn (just over 1%) during the full year.

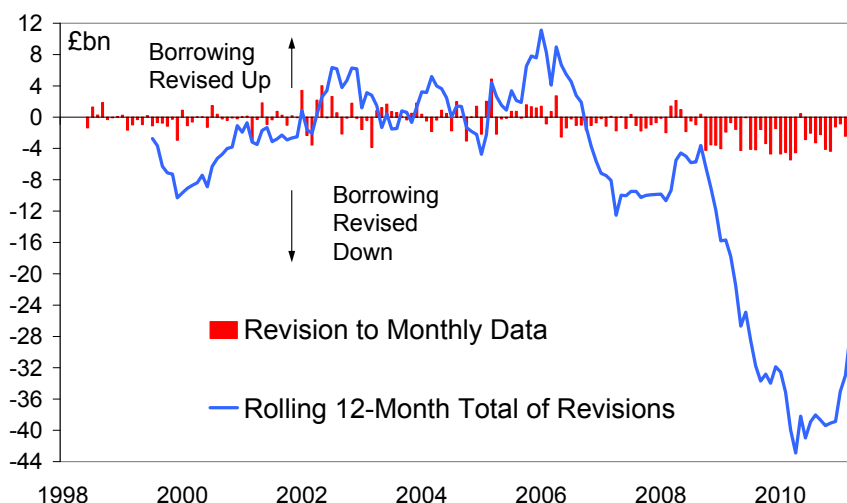
Spending growth is high, but this may in part be temporary

- At the same time, spending remains reasonably under control, with core current spending up just 1.2% YoY in April-May, whereas the OBR projects 2.3% growth over the full year. The evidence of the spending squeeze is clear, with public sector employment down 140,000 people (2.3%) YoY in Q1. The weakness in this category has been offset to an extent by the ongoing surge in debt service payments on index-linked gilts (which is likely to continue) plus a temporary surge in social security payments (which probably will not continue). With core current spending well contained and the bulk of the planned drop in capital spending still to come, we expect that spending will be about £3bn below the OBR forecast over the full year.

The ONS recently has tended to revise the deficit data down quite markedly from the first release of the data

Moreover, it must be noted that the ONS has tended to revise deficit figures down recently. In all, the monthly deficit has been revised down from the first release in 50 of the last 60 months (ie from May 2006 to April 2011). The revisions average £2.8bn per month in fiscal years 2009/10 and 2010/11. For example, if we sum the data published at the time for public borrowing (including costs of financial interventions) it would give full-year deficits of £167.9bn in fiscal year 09/10 and £143.8bn in 10/11: the latest figures give deficits for those years of £128.0bn and £116.4bn, respectively. Note that the bulk of these revisions have occurred more than three months after the data were first published. The ONS has only published monthly figures for the deficit excluding financial intervention costs since June 2010, but the same revisions bias is evident for this measure since then. The monthly deficit on this measure has been revised down in 9 of the 11 months since June 2010. On the data as initially released, borrowing from June 2010 to March 2011 summed to £128.1bn. The latest data for that period give a total deficit of £117.3bn, a cumulative downward revision of £10.8bn.

Figure 5. UK — Revisions to Public Sector Borrowing Data, 1998-2011



Sources: ONS and Citi Investment Research and Analysis

The possibility of further revisions adds to uncertainties in the fiscal outlook

The cause of these revisions is unclear, and we do not believe there is any deliberate attempt at data manipulation. The issue may well stem from the use of overly cautious accruals adjustments in the initial data. Either way, the recent bias in the revisions is striking. We do not assume further revisions in our forecasts. But the possibility of revisions to the last few months' data adds to the fiscal uncertainties, but on balance — since revisions have tended to be downwards — reinforces our sense that the deficit is more likely to undershoot consensus than to overshoot.

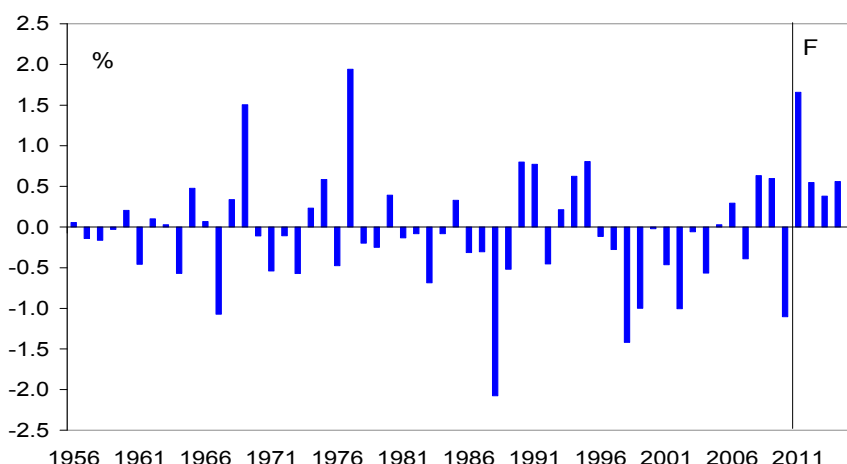
We see minimal risk of serious fiscal slippage in the UK

Despite the downtrend in the fiscal deficit, we believe there is negligible risk of significant fiscal slippage. In our view, there is pretty much a zero probability that the government will follow the advice of Shadow Chancellor Ed Balls and cut VAT to stimulate consumer spending. Even with the recent decline, the UK fiscal deficit remains large by historical standards, and the euro area sovereign crisis highlights the large costs if a government loses fiscal credibility. Moreover, if the OBR shares the MPC's judgment that the economy's supply side is weaker than previously believed, then the OBR will have to conclude that more of the deficit is structural rather than cyclical.

The downtrend in the fiscal deficit is part of the broader picture of rebalancing in the UK economy, albeit at the cost of a persistent inflation overshoot

Hence, the government is likely to conclude that the probable costs of any fiscal slippage — in the form of higher gilt yields, sovereign downgrade risk and earlier MPC hiking to restore the UK's anti-inflation credibility — far outweigh the likely short-term boost to growth. In short, monetary policy (ie low pound and low interest rates) and the stability that comes from confidence in medium-term fiscal sustainability are more important for the economy's growth prospects than fiscal stimulus. The path back to fiscal sustainability is undoubtedly painful but is probably less painful than the alternative that would face the UK if the government were to retreat from fiscal consolidation. The improvement in the UK's fiscal deficit is part of a broader picture whereby the economy is likely to rebalance markedly over the next few years, with a large drop in the fiscal deficit, a sustained boost to growth from net trade and marked improvement in the current account — albeit at the cost of a persistent inflation overshoot. We expect that net trade will add about 1½% to GDP growth this year, the biggest boost since 1977, with a further large contribution in coming years.

Figure 6. UK — Contribution to GDP Growth from Net Trade, Annual Data, 1956-2015F



F Forecast. Sources: ONS and CIRA forecasts

Economic Indicators

Tue 28 Jun	Balance of Payments (Q1)	Forecast: £-2.7 Billion	Prior: £-10.5 Billion
	Figures already have been released showing a sharp drop in the UK's deficit on goods and services trade to £8.5bn in Q1 from £14.7bn in Q4, and we expect this to pull the overall current account deficit down to about £2.7bn, from £10.5bn in Q4. Such a figure would be the lowest deficit since Q1-08 and, unless the data are revised significantly, we expect the UK will move into current account surplus during the next year or two.		
Tue 28 Jun	GDP (Q1, 3rd Release)	Provisional: 0.5% QoQ, 1.8% YoY	Prior (Q4): -0.5% QoQ, 1.5% YoY
	We do not anticipate any significant revisions to the overall figures for GDP growth. The split is likely to show that rising inflation caused household real personal disposable income to fall by about 1.5% QoQ, leaving real income down by about 2.9% YoY — the biggest drop since 1977.		
Wed 29 Jun	Service Sector Output (Apr)	Forecast: 0.0% MoM, 2.0% YoY	Prior: 0.7% MoM, 1.0% YoY
	Surveys suggest that service sector output continues to expand but, after strong gains in recent months, we suspect that output will be roughly flat this month, with some adverse effect from the late Easter and Royal Wedding.		
Fri 1 Jul	Manufacturing Purchasing Managers' Index (Jun)	Forecast: 52.0	Prior: 52.1
	The PMI slid last month on softer domestic demand plus supply-chain disruption stemming from Japan, and probably will remain subdued this month. Nevertheless, there are early signs that supply chain disruptions are beginning to ease, which may lift sentiment in the next month or two.		

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Economic Calendar, 20 June May — 8 July 2011

20 June	21 June	22 June	23 June	24 June
	Public Sector Net Borrowing (May) May 10 £18.4bn Deficit May 11 £17.4bn Deficit Fiscal Year To Date Apr-May 10 £25.9bn Deficit Apr-May 11 £27.4bn Deficit CBI Industrial Trends (Jun) Output Expectations (Jun) May +20% Jun +13% Order Books (Jun) May -2% Jun +1% Selling Prices (Jun) May +24% Jun +27%	MPC Minutes (Jun 9) Agents' Summary of Business Conditions (Jun) Norges Bank: Rates Unchanged at 2.25% FOMC Outcome: Rates Unchanged at 0.125%	BBA No. of Mortgage Approvals for Home Purchase (May) Apr 29,747 MoM, -18.0% YoY May 30,509 MoM, -14.7% YoY CBI Retail Survey (Jun, 11:00) May Sales +18% YoY Jun Sales -2% YoY	European Council of EU Heads of State & Government (Brussels) Investment by Insurance Companies, Pension Funds And Trusts (Q1) BoE Financial Stability Report (Press Conference, 10:30)
Eurogroup Meeting Continues at 07:30 (Luxembourg) ECOFIN Meeting of EU-27 Finance Ministers Starts at 14:00 (Luxembourg)				
27 Jun	28 June	29 June	30 June	1 July
<i>(During The Week)</i> Nationwide House Prices (Jun, 07:00)	Balance of Payments (Q1) Q4 £-10.5bn Q1E £-2.7bn GDP (Q1, 3rd Release) Q4 -0.5% QQ, 1.5% YY Q1P 0.5% QQ, 1.8% YY	Service Sector Output (Apr) Mar 0.7% MoM, 1.0% YoY AprE 0.0% MoM, 2.0% YoY No. of Mortgage Commitments for Home Purchase (May)	GfK Consumer Confidence (Jun, 00:01) BoE Credit Conditions Survey (Q2)	Manufacturing PMI (Jun) May 52.1 JunE 52.0
4 July	5 July	6 July	7 July	8 July
<i>(During The Week)</i> Halifax House Prices (Jun, 09:00) BoE Housing Equity Withdrawal (Q1) US: Independence Day Holiday	Services PMI (Jun) Riksbank Interest Rate Announcement (08:30)	Profitability of UK Companies (Q1) MPC Meeting Starts	Industrial Production (May) Manufacturing Output (May) MPC Meeting Ends: Outcome at Noon ECB Meeting 12:45 Outcome 13:30 Press Conference	Producer Prices (Jun) Construction Output (May)

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 Investment Research and Analysis.

Notes

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Appendix A-1

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