

UK Economics Weekly

Fiscal Red Ink Receding

- The last few years have seen repeated fiscal disappointments, with the OBR time after time revising up the outlook for the fiscal deficit and public debts. Now, however, fiscal trends seem to be improving and further improvements probably lie ahead. Last year's deficit has been revised down by £5.2bn since the Budget (continuing the bias to favourable deficit revisions) and recent data point to an undershoot of perhaps £10bn or so in this year's deficit. Next year's fiscal deficit is set to fall further (ie at least £10bn) below the OBR's forecasts as the strong economic recovery boosts revenues, and prior experience has shown that cyclical effects on the fiscal deficit can be very powerful.
- The recent party conference speeches suggest that the government will react to the improving fiscal trends by slightly reducing nearterm austerity, thereby adding upside to 2014-15 growth forecasts while leaving a modest fiscal tightening intact. Such an outcome would still allow the deficit to fall faster than the OBR's 2013 Budget forecasts. The government is likely to accompany this with the commitment to aim for a fiscal surplus by the end of the decade, although this target would not require any extra fiscal consolidation for the next few years.

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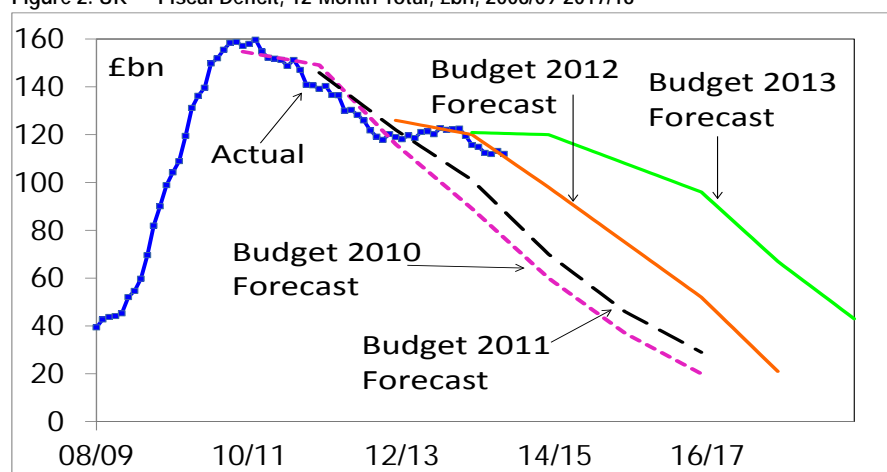
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Figure 1. Citi Market Forecasts

	Base Rate	QE Target	10 Year Yield	Spread vs. Bunds	\$/£	£/€
End-2013	0.50	£375bn	2.80	102bp	1.65	0.83
Mid-2014	0.50	£375bn	3.05	127bp	1.66	0.82

Source: Citi Research

Figure 2. UK — Fiscal Deficit, 12-Month Total, £bn, 2008/09-2017/18



Note: Deficit measured excluding APF and RM transfers. Sources: ONS, OBR and Citi Research

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

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Fiscal Red Ink Receding

The UK's fiscal trends have disappointed in recent years, with repeated upward revisions to the debt and deficit outlook

In the first year after the 2010 election, the fiscal deficit undershot the OBR's start of year forecast by about £10bn. But, ever since then, the UK's fiscal trends have been disappointing, with repeated upward revisions to the UK's expected deficit and debt profile. In total, the OBR has revised up its forecast for the fiscal deficit (excluding the Royal Mail and APF transfers) by £60bn for 2013/14 (from £60bn in the mid-2010 Budget to £120bn in the spring 2013 Budget), by £71bn for 2014/15 (from £37bn to £108bn) and by £76bn for 2015/16 (from £20bn to £96bn). In turn, the OBR has revised up its forecast for public sector net debt in 2015/16 from 67.4% of GDP in the 2010 Budget to 85.1% in the 2013 Budget.

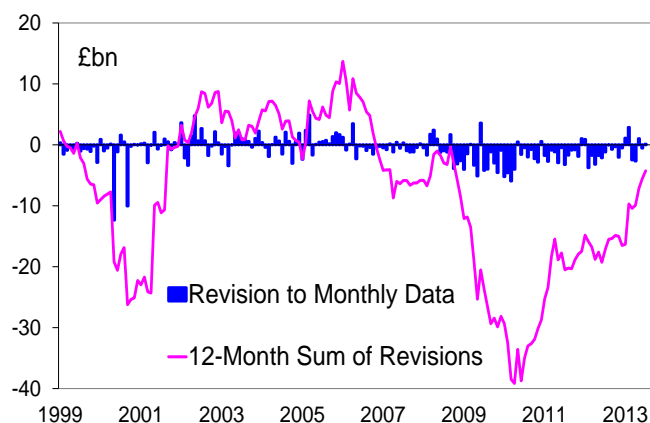
The fiscal position is now turning out better than the OBR expected

However, there are signs that this year's Autumn Statement (expected in November or December) will be very different. For once, the Chancellor is likely to announce relatively good fiscal news, with a lower outturn for last year's deficit, prospects of an undershoot this year and downward revisions to future deficit figures. Since the Budget, there have been four important developments for the UK fiscal outlook.

Last year's deficit has been revised down by £5.2bn since the Budget...

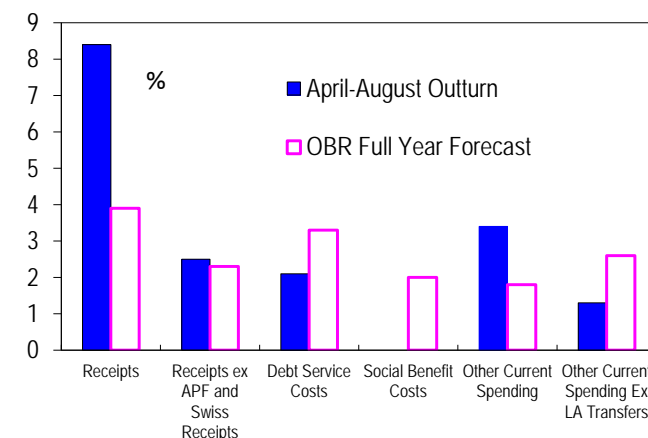
■ The fiscal deficit in 2012/13 has been revised down by £5.2bn from £120.9bn to £115.7bn. In particular, public sector receipts have been revised up by £6.1bn (1.0%) since the Budget, featuring a £2.6bn upward revision to central government revenues, a £3.9bn upward revision to public corporations' revenues (chiefly higher trading profits) and a £0.4bn downward revision to local government revenues. These revisions continue the recent trend, with a clear bias to downward revisions: over the six years since Aug-2007, the monthly fiscal deficit figures have been revised down by an average of £1.4bn per month from their first release, with 57 downward revisions and just 15 upward revisions. This revision has persisted recently, with the deficit revised down in 18 of the last 24 months. As a result of these repeated revisions, deficit figures for recent years generally look better than when first released.

Figure 3. UK — Revisions to the Fiscal Deficit Data Since the First Release, £bn, 1999-2013



Note: We use total public sector borrowing to June 2010 and public sector borrowing excluding financial transactions since then. A negative figure implies a revision to a smaller deficit. Sources: ONS and Citi Research

Figure 4. UK — Central Government Receipts and Spending YoY, April-August Outturn and OBR Forecast for Full Year, 2013/14



Note: For central government spending excluding LA transfers, we use data for LA transfers in Q2-13 and assume that LA transfers in July-August match the monthly average for Q3-2012. Sources: OBR, ONS and Citi Research

...and recent fiscal data suggest the deficit is falling this year

■ Fiscal data for the first five months of 2013/14 have been quite promising. In the March Budget, the OBR projected the fiscal deficit (excluding the RM and APF transfers) to be £119.8bn (7.5% of GDP), similar in cash terms to what, at the time, was expected to be the 2012/13 outturn (£120.9bn, 7.8% of GDP). With the 2012/13 deficit revised down to £115.7bn, the 13/14 deficit would now need to rise by £4.2bn YoY to meet the OBR's forecast. In practice, the deficit for the first

five months of the year is £3.7bn lower than a year ago, and the 12-month rolling total for the deficit is down to £111.9bn (£8bn below the OBR's forecast for 2013/14). Public corporations' profits remain buoyant, up 39% YoY in Q2, well ahead of the OBR's forecast for the full year (4%). Central government revenue growth (2.5% YoY excluding the APF transfer) is marginally above the OBR's forecast for the full year (2.3%). Central government current spending is up 5.4% YoY so far this fiscal year, well above the OBR's full year forecast (3.4%). However, this has been distorted by relatively early grants from central government to local authorities (up 11.6% YoY in Q2, but are set to rise by only 0.6% over the whole fiscal year). Excluding these, spending growth is slightly below the full-year target so far. Outlays on benefits also are undershooting, with zero growth so far this year compared to the Budget forecast of a 2.0% gain over the full year. Some undershoot in social benefits is likely to be sustained: in particular, the claimant count jobless rate is 150,000-200,000 below the Budget forecast, which should save about £1bn in benefit spending this year.

Cyclical effects should lift revenues and cut benefit payments

- The strong economic recovery is likely to lift revenues in coming quarters. We expect real GDP growth of 1.4% this year and 3.0% in 2014, well above the OBR's forecasts (0.6% and 1.8%). With weak inflation, nominal GDP growth may be only a bit above the OBR's forecasts (2.7% YoY in 2013 and 3.8% in 2014), but the split of growth is likely to be more revenue-friendly than the OBR expects, with buoyant trends in consumer spending and housing activity (which are taxed quite highly) but weakness in business investment (which is deductible from the corporation tax base). For example, stamp duty receipts rose 31% YoY in Q2 and probably will gain substantially further in coming months. Moreover, the jobless rate probably will continue to undershoot the OBR's forecast. The consensus expects the jobless total in Q4-2014 to be 240,000 below the OBR's forecast, and such an outturn would magnify the benefit savings to £1½-£2bn in 2014/15 with, potentially, larger savings in later years.

The rise in gilt yields should add modestly to debt service costs nearterm

- 10-year gilt yields are up by about 80bp. This has little effect on debt service cost this year, but adds about £2bn next year, rising to £6-7bn in 17/18.

Recent trends suggest this year's fiscal deficit will undershoot by about £10bn...

Overall, we expect this year's deficit (ex financial interventions, APF transfers and the RM transfer) to come in at about £110bn, 6.8% of GDP, and about £10bn below the Budget forecast (£119.8bn, 7.5% of GDP). Our forecast assumes that the recent improvement in public corporations' receipts will not unwind, with a modest overshoot in central government revenues, a catchup in central government spending ex social security but a slight undershoot in benefit outlays. Our forecast implies that the deficit in the remaining seven months of the fiscal year will be marginally down from a year ago.

...and another deficit undershoot lies ahead for 2014/15

Another deficit undershoot probably lies ahead for 2014/15 versus the OBR's £108bn forecast (6.5% of GDP). Indeed, we expect the 13/14 deficit will be only £2bn above the OBR's 14/15 forecast. At this stage, we pencil in a £10bn deficit undershoot for 14/15 (ie deficit of £98bn, 5.8% of GDP), based on cyclical effects and assuming the improvement in public corporations' profits fades. But this is a cautious forecast and we will update it as the Autumn Statement nears.

There are uncertainties in these forecasts, but the trend is improving

We stress the uncertainties in these forecasts, in particular over the persistence of the improvement in public corporations' revenues and possible revisions to the fiscal data. However, revisions would have to be quite large and unusually adverse to change the key point that the deficit is more likely to undershoot than overshoot. Moreover, business surveys suggest that GDP growth could well turn out significantly above our forecasts (1.4% for 2013, 3.0% for 2014), which would create even more powerful helpful cyclical effects to cut the deficit.

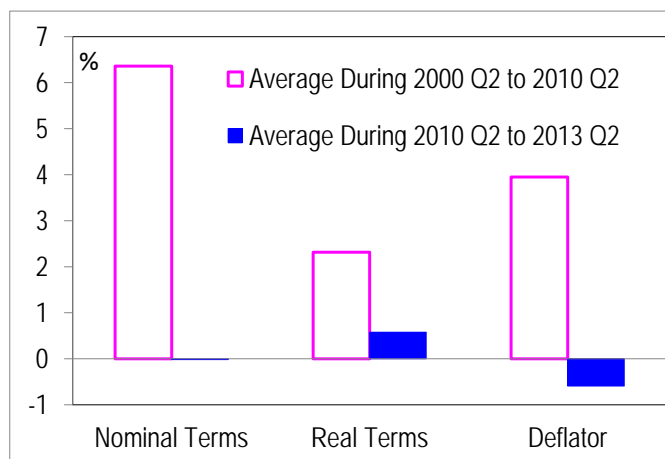
In statistical terms, the direct squeeze on public sector pay and jobs has shown up more in the deflator than in volumes...

GDP growth this year (about 1½%) probably is close to potential, and hence the probable drop in this year's fiscal deficit (about £6bn, roughly 0.4% of GDP), implies a modest structural fiscal tightening. This is reflected in particular in the drop in public sector employment and weakness in public sector pay, together with tightening benefit eligibility. However, the adverse effect of this fiscal tightening on the published GDP data is relatively modest, because in statistical terms the direct effect of the squeeze on public sector pay and jobs largely shows up as a weaker deflator for government services rather than weaker volumes.

...with the deflator for general government consumption falling in recent quarters

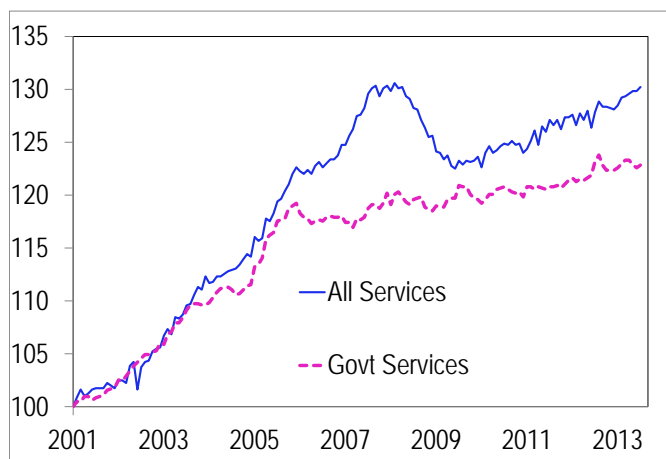
For example, the trend growth of the volume of government services (in the service output data) has remained steady at about 1% YoY since 2010, similar to the 2005-10 period. Using the expenditure split of GDP, over the three years since the 2010 election, the QoQ change in nominal general government consumption has been close to zero on average, well below the average gain over 2000-07 (6.4% QoQ SAAR). The QoQ SAAR growth of real government consumption has slowed from 2.3% to 0.6%, while the QoQ SAAR change in the deflator has tumbled from 4.0% to minus 0.6%. In other words, only about one quarter of the slowdown in nominal spending growth (more than 6 percentage points) has showed up in statistical terms as weaker volumes, and roughly three quarters has come through in lower inflation.

Figure 5. UK — QoQ SAAR Change in General Government Consumption in Real Terms, Nominal Terms and Deflator, 2000-2013



Sources: ONS and Citi Research

Figure 6. UK — Monthly Output of Service Sector and Government Services, Volume Terms, Indexed to Jan 2001 = 100, 2001-13



Sources: ONS and Citi Research

This effect limits the direct adverse effect of fiscal restraint on real GDP growth

The reason this disparity arises between public sector job cuts and the rising volume of outputs is because nominal spending is measured as cash spent, while the volume figures are based on output measures (eg the numbers of pupils achieving specified levels of educational attainment) — which have continued to grow¹. This is reflected in higher productivity growth, as measured by the ONS. Of course, there have also been second round effects of cuts in public sector costs on consumer spending as well. But the OBR has not allowed for such extreme weakness in the deflator for government spending in its forecasts and to the extent it continues this reflects an additional upside risk to their GDP forecasts.

The Chancellor is likely to aim for a middle way between the 2013 deficit forecast and the much lower deficit paths projected in 2010-11

With these hints of fiscal improvement, the Chancellor has a range of fiscal options:

- **Aim to return to the 2010 or 2011 deficit path.** This would require the Chancellor to fully stick to the existing fiscal plans (which imply a structural fiscal tightening of about 1% of GDP per year in 2013-15), or even tighten further

¹ See "Public Service Productivity Estimates, Education 2011", ONS, 1 October 2013.

nearterm. This would have the apparent virtue of prudence. But, it also contains sizeable risks for the Chancellor, in that it might hinder the economy's recovery and limit scope to woo voters ahead of the 2015 election.

- **Stick for the 2013 deficit path.** This would allow the Chancellor to end the nearterm fiscal tightening, banking on the improving economy to lift revenues and keep the deficit close to the gentle decline projected in the 2013 Budget. This choice would reinforce the economy's nearterm growth prospects. But, it would probably also raise worries over the UK's medium-term fiscal sustainability. And, politically, the Government would like both an improving economy *and* falling fiscal deficit for the 2015 election in our view.
- **Aim for the 2012 deficit path?** We expect something of a middle way, with the Chancellor tolerating some modest slippage from the fiscal plans while still leaving in place a significant structural fiscal tightening (perhaps ½%-¾% of GDP per year) in 2014 and 2015. Broadly, we expect him to largely stick to the squeeze on public sector current spending (especially benefits, public sector jobs and pay), while easing the squeeze on public investment and looking for some modest tax cuts. This would still allow the OBR to project that, with the improving economy, the deficit will fall faster than the March 2013 Budget plans, perhaps close to the 2012 Budget plans.

The party conferences showed signs of modest nearterm fiscal slippage...

There are hints of this middle way in the political party conferences, with four modest giveaways: free school meals for children aged under 7 years, a new tax allowance for married couples, two-year freeze to petrol taxes and a commitment to at least maintain public investment as a share of GDP. The combined cost of these measures probably is £2-3bn (0.2% of GDP or so) per year for the next few years². Even if there are no offsets, such measures would still imply a sizeable fiscal tightening in 2014-15 of perhaps ¾% of GDP per year. There may well be other further modest giveaways as the 2015 election approaches.

...within a framework of medium-term consolidation...

But, unless fiscal slippage is large, the improving economy will still probably keep the deficit falling quite quickly. Moreover, the Chancellor's speech indicated that he would aim to reinforce the UK's commitment to medium-term fiscal consolidation with a commitment to aim for a fiscal surplus by the end of the next parliament: *"So I can tell you today that when we've dealt with Labour's deficit, we will have a surplus in good times as insurance against difficult times ahead. Provided the recovery is sustained, our goal is to achieve that surplus in the next Parliament. That will bear down on our debts and prepare us for the next rainy day."*

...although the new target of a surplus in the next parliament will probably not need any extra immediate fiscal tightening

This will be converted into a specific fiscal mandate after the 2015 election (if the Conservatives are in government). We suspect this will translate into a requirement for the government to aim for a surplus on the fiscal balance excluding financial interventions and the APF and RM transfers, no later than 2019/20 (with a five-year term, there will be elections in 2015 and 2020). The target probably will be set in terms of the headline deficit measure, although the language makes it clear there will be some allowance for cyclical factors. If so, this target probably would not require any extra fiscal tightening than is already planned for the 2013-16. In the 2012 Budget, the OBR projected the deficit at just 1.1% of GDP in 2016/17. In the March 2013 Budget, the OBR project the headline deficit (ex financial interventions, and transfers from the APF and Royal Mail) at 2.2% of GDP for 2017/18. That forecast will probably be pulled a little lower in the Autumn Statement, and the surplus target need only be met an extra two years later — well beyond the horizon for policy decisions in the Autumn Statement.

² See "UK - Osborne Speech", Michael Saunders, 30 September 2013, Citi.

Economic Indicators

Wed 9 Oct	Industrial Production (Aug) Manufacturing Output (Aug)	Forecast: 0.5% MoM, -0.6% YoY Forecast: 0.2% MoM, 0.8% YoY	Prior: 0.0% MoM, -1.6% YoY Prior: +0.2% MoM, -0.7% YoY
Base effects from the 2012 Olympics (which saw industrial production fall 1.3% MoM in Aug-2012) probably will lift the YoY rate further, and we expect the first positive reading for YoY manufacturing output since mid-2011. A figure in line with our forecast would put the level of IP 1.2% above the Q2 level, hence implying a solid gain in Q3 GDP.			
Wed 9 Oct	Trade Balance – Goods & Services (Aug)	Forecast: £-1.8 billion	Prior: £-3.1 billion
The deficit on goods and services trade jumped to £3.1bn in July from £1.3bn in June, reflecting a sharp drop in exports (down 4.6% MoM). For the August data, we expect exports to rebound sharply, hence bringing the trade deficit sharply lower again.			
Tue 15 Oct	Consumer Prices (Sep) CPI Ex Food, Drink, Tobacco, Energy (Sep) Retail Prices (Sep) RPIX – Excludes Mortgages (Sep)	Forecast: 0.3% MoM, 2.6% YoY Forecast: 0.2% MoM, 2.0% YoY Forecast: 0.4% MoM, 3.2% YoY Forecast: 0.4% MoM, 3.2% YoY	Prior: 0.4% MoM, 2.7% YoY Prior: 0.4% MoM, 2.0% YoY Prior: 0.5% MoM, 3.3% YoY Prior: 0.5% MoM, 3.3% YoY
Base effects from the relatively large rise in petrol prices (2.7% MoM) a year ago probably will cause CPI inflation to edge down by 0.1% in September, leaving Q3 CPI inflation about 0.2% below the MPC's forecast in the August <i>Inflation Report</i> . Such an outcome would be the second consecutive quarter with GDP growth below the MPC's quarter-ahead forecast.			
Tue 15 Oct	Producer Input Prices (Sep)	Forecast: -0.9% MoM, 1.8% YoY	Prior: -0.2% MoM, 2.8% YoY
The continued rise in sterling (with the trade-weighted index up about 2% MoM on average in September) probably will push input prices down again for the second consecutive month, leaving input prices down by about 3% from six months earlier.			
Tue 15 Oct	Producer Output Prices (Sep) Output Prices Ex Tax (Sep) Excluding Food, Drink, Tobacco, Energy (Sep)	Forecast: 0.0% MoM, 1.2% YoY Forecast: 0.0% MoM, 1.3% YoY Forecast: 0.0% MoM, 0.8% YoY	Prior: 0.1% MoM, 1.6% YoY Prior: 0.1% MoM, 1.7% YoY Prior: 0.1% MoM, 1.0% YoY
Surveys suggest that manufacturers' prices remain weak and, with sterling creeping higher, we expect that output price inflation will weaken further. A figure in line with our forecast would put the 6-month annualised rate (ex tax) at just 0.3%, the lowest since 2009.			
Wed 16 Oct	LFS Unemployment (Jun-Aug) Claimant Count Unemployment (Sep)	Forecast: -42,000 QoQ, 7.6% Rate Forecast: -15,000 MoM, 4.2% Rate	Prior: -24,000 QoQ, 7.7% Rate Prior: -36,300 MoM, 4.2% Rate
The single month LFS data show the jobless rate at 8.0% in May, 7.4% in June and 7.7% in July, and (assuming that the August figure also is 7.7%) we expect the three-month average will edge down to 7.6% from 7.7% last month. That would put the three-month average at the lowest since early 2009 (when the jobless rate was rising rapidly) and a full 0.8 percentage points below the late-2011 peak.			
Thu 17 Oct	Retail Sales Volumes (Sep)	Forecast: 0.3% MoM, 1.9% YoY	Prior: -0.9% MoM, 2.1% YoY
Surveys suggest that retail sales continued to expand in September, and hence we expect another gain in the official data and ascribe the August weakness to weather effects. A figure in line with our forecast would put volumes in Q3 up by 1.4% from Q2, hence (along with other guides) signalling a fairly strong rise in Q3 GDP.			

Economic Calendar, 30 September — 18 October 2013

30 September	1 October	2 October	3 October	4 October
Mortgage Approvals (Aug) Jul 60, 914 MoM, 30.0% YoY Aug 62,226 MoM, 30.6% YoY Consumer Credit (Aug) Jul £636mn, 3.5% YoY Aug £577mn, 4.0% YoY	Manufacturing PMI (Sep) Aug 57.1 Sep 56.7	Government Debt & Deficit (2012) ECB Meeting (Paris): Refi Rate Unchanged at 0.5%	Halifax House Prices (Sep, 08:00) Aug 0.3% MoM, 6.2% YoY Sep 0.3% MoM, 6.6% YoY Services PMI (Sep) Aug 60.5 Sep 60.3	
7 October	8 October	9 October	10 October	11 October
During The Week IMF/World Bank Annual Meetings (Washington, DC)	British Chambers of Commerce Quarterly Economic Survey (Sep) (00:01) IMF Releases World Economic Outlook (14:00)	Industrial Production (Aug) Jul 0.0% MoM, -1.6% YoY AugE 0.5% MoM, -0.6% YoY Manufacturing Output (Aug) Jul 0.2% MoM, -0.7% YoY AugE 0.2% MoM, 0.8% YoY Trade Balance – Goods & Services (Aug) Jul £-3.1B AugE £-1.8B Productivity of UK Companies (Q2) MPC Meeting Starts IMF Global Financial Stability Report and Fiscal Monitor	MPC Meeting Ends: Outcome At Noon G-20 Finance Ministers & Central Bank Governors Meeting (Oct 10-11, Washington, DC)	Construction Output (Aug)
14 October	15 October	16 October	17 October	18 October
Eurogroup Meeting of Euro Area Finance Ministers (Luxembourg)	Consumer Prices (Sep) Aug 0.4% MoM, 2.7% YoY SepE 0.3% MoM, 2.6% YoY CPI Ex Food, Drink, Tobacco, Energy (Sep) Aug 0.4% MoM, 2.0% YoY SepE 0.2% MoM, 2.0% YoY Retail Prices (Sep) Aug 0.5% MoM, 3.3% YoY SepE 0.4% MoM, 3.2% YoY RPIX – Ex Mortgages (Sep) Aug 0.5% MoM, 3.3% YoY SepE 0.4% MoM, 3.2% YoY Producer Input Prices (Sep) Aug -0.2% MoM, 2.8% YoY SepE -0.9% MoM, 1.8% YoY Prod. Output Prices (Sep) Aug 0.1% MoM, 1.6% YoY SepE 0.0% MoM, 1.2% YoY Ex F, D, T, E (Sep) Aug 0.1% MoM, 1.0% YoY SepE 0.0% MoM, 0.8% YoY Ecofin Meeting (Luxemb'g)	LFS Unemploym't (Jun-Aug) May-Jul -24K MoM, 7.7% Rate Jun-AugE -42K MoM, 7.6% Rate Claimant Count Unemployment (Sep) Aug -35,300 MoM, 4.2% Rate SepE -15,000 MoM, 4.2% Rate	Retail Sales Volumes (Sep) Aug -0.9% MoM, 2.1% YoY SepE 0.3% MoM, 1.9% YoY	

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, ONS, national sources and Citi Research.

Notes

Appendix A-1

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