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Novus Capital Markets Research

A Budget for Growth

10 March 2011

OBR forecast – credibility and the output gap: the sharp drop in GDP in 10q4 poses a challenge to the OBR's forecast methodology and to the credibility of its forecast. In theory the 0.6% fall in GDP, which equates to a 1.2% shortfall in the level of GDP relative to the November forecast, widens the output gap from 3% to over 4%. The logic of the OBR (HMT) approach is that this extra spare capacity can be brought back over the medium term. The OBR forecast is already seen as optimistic so to add another 1% to growth over the medium term would scarcely be seen as credible. I thought the OBR missed a trick in November by not downgrading its GDP outlook. Surely this time, either by way of the cyclical indicators or by lowering the productivity assumption, they will not mechanically adjust their GDP forecast upwards. They could follow the lead of the MPC and recognise that the growth of demand consistent with the inflation target is probably less than was previously estimated.

A smaller structural deficit: after January's surplus PSNB is on track for a deficit of £140bn in 2010-11, equivalent to 9½% of GDP and ½pp below the OBR's November forecast. After the Q4 setback GDP growth is likely to be 2%, also ½pp below the OBR forecast. This combination of a smaller than expected deficit and weaker than expected growth suggests that the structural deficit is 7% of GDP or less, below the 7.6% that the OBR estimated in November. If the buoyancy of revenues that produced the January surplus can be sustained over the forecast period, the Chancellor has less of a problem than he was led to believe. He is likely to use this extra breathing space to deliver a 'Budget for Growth' on 23 March. For industry, which has been pushing for a growth strategy, this means more tax breaks on investment. For HMT it means spending small sums of money on improving the supply side of the economy of which the recent announcement on enterprise zones was a pre-Budget taster.

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The OBR forecast – credibility and the output gap

In its November Economic and Fiscal Outlook (EFO) the OBR forecast GDP growth in 2010q4 of 0.5% q/q, 2.9% y/y. Subsequent releases from the ONS show a downward revision to the back data (Q3 growth of 2.5% vs the 2.8% incorporated into the OBR forecast) and a 0.6% decline in GDP in Q4. As a result, the level of GDP currently estimated by the ONS is 1.2% below where the OBR expected it to be (Table 1).

Table 1: GDP data 2010q4, ONS vs OBR forecast

	ONS		OBR	
£bn at 2006 prices and q/q % change	Level	%	Level	%
Household and NPISH consumption	213.6	-0.1	215.1	0.5
General Government consumption	75.2	0.7	75.5	-0.4
Fixed investment	50.9	-2.5	50.8	0.2
Inventories	1.2	0.0	1.4	0.3
Domestic demand	341.0	-0.3	343.1	0.6
Exports	91.4	2.3	89.6	1.5
TFE	432.4	0.2	432.7	0.8
Imports	101.6	3.0	99.7	1.7
GDP	328.9	-0.6	332.9	0.5

Source: ONS, OBR

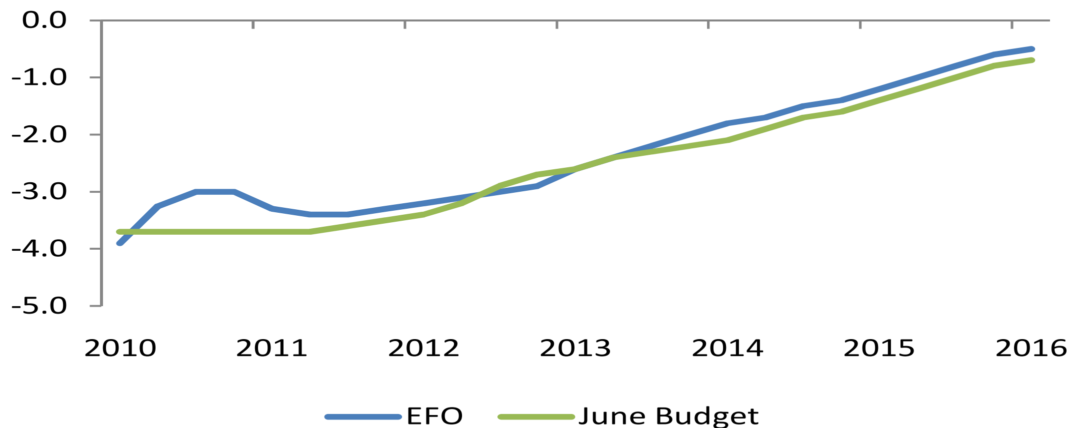
All of the components of private domestic demand were weaker than expected, government consumption was stronger and net trade was in line (both exports and imports were stronger than expected). The statistical discrepancy was much larger than expected (-£1.8bn vs -£0.1bn in the OBR forecast), which tells us that the sum of the expenditure components is some way ahead of the ONS estimates of GDP (which are based primarily on output data).

The OBR had been expecting the economy to slow over the turn of the year but the low point in the cycle was expected to be 11q1, when GDP was forecast to rise 0.3% from Q4. But given the Q4 shortfall GDP would need to rise 1.5% in Q1 to get back to the level that the OBR was expecting in November. That is not going to happen (the MPC forecast is for a 0.8% q/q increase) – the Q1 starting point for GDP will be ½-1% below where the OBR expected in November.

In theory that shortfall should go straight onto the output gap. But the OBR methodology is to estimate the output gap directly from cyclical indicators, not just to apply a mechanical approach to the GDP data in the way the Treasury used to do. The November EFO estimated an output gap of 3¼% in 10q2, of which around 1pp was due to output per head relative to potential, ¾pp to below-trend hours and 2pp to employment being below potential.

The OBR estimated that the output gap narrowed to 3% in 10q3 (GDP growth of 0.8%) and forecast it to stay at that level in 10q4 (on the basis of GDP rising 0.5%). The gap then widened out to 3.3% in 11q1 (growth slowing to 0.3%). Over the next five years the OBR forecast methodology assumes above-trend growth which results in a fall in the output gap to 0.5% by 16q1. The very near term apart, the OBR November forecast was very similar to the one that we (the interim OBR) produced at the time of the June Budget (Chart 1).

Chart 1: The output gap (OBR forecast)



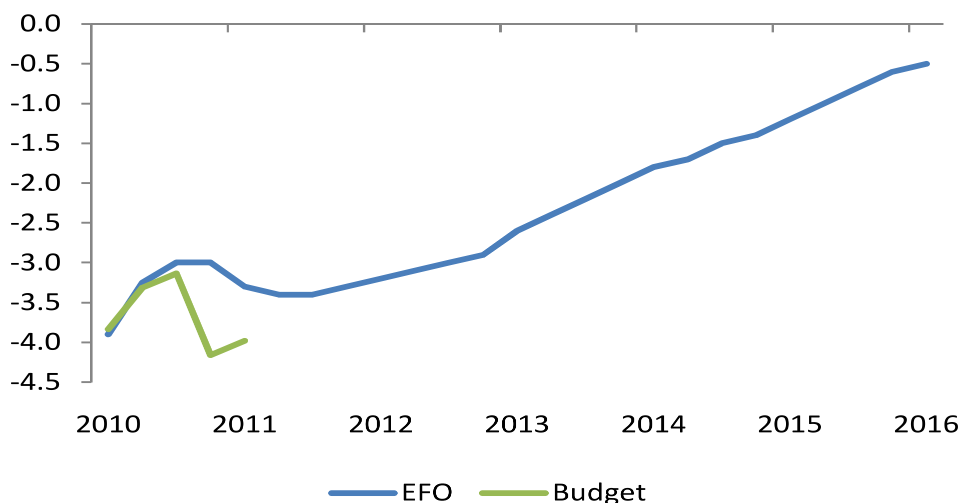
Source: OBR

In my comment on the EFO forecast I expressed some surprise that the OBR had not made a bigger revision to the output gap forecast. The starting point, as estimated from the cyclical indicators was smaller (3¼% in 10q2), narrowing to 3% in the second half of the year but then, according to the OBR

forecast, it widens out again to nearly 3½% in the middle of this year. I had thought that, given the starting point (a smaller output gap), the new permanent OBR might take a gloomier view of the amount of spare capacity (or possibly of the trend rate of growth). This would have implied that more of the deficit was structural and less was attributable to the cycle.

On the basis of the EFO forecast for trend GDP (as implied by the combination of the output gap and actual GDP forecasts), the 1½% shortfall in Q4 GDP relative to the EFO forecast would take the output gap from around 3% in 10q3 to a little over 4% in 10q4. A rise in GDP of 0.8% in 11q1 (in line with the MPC forecast) would cut the output gap to 4%, around ½-¾% above the EFO forecast (Chart 2).

Chart 2: Output gap (based on EFO forecast and latest data)



Source: OBR, ONS, Novus estimates

The implication is clear: a simple application of the OBR's basic forecasting methodology says that (ceteris paribus), from this weaker starting point, growth can – and will – be a cumulative ½-¾% stronger over the coming years since there is more spare capacity to start with than previously estimated.

The EFO forecast was for growth to pick up from 1.8% in 2010 to 2.1% this year and to average 2¾% over the next four years. This is not out of line with the MPC's February forecast (the MPC's median forecast, which is below the mode that is usually cited, is comparable with the OBR forecast), though both are well above the consensus especially in 2012 (Table 2).

Table 2: GDP forecast

	2010	2011	2012	2013	2014	2015
OBR (EFO)	1.8	2.1	2.6	2.9	2.8	2.7
MPC (median)	1.7	2.0	2.7	2.7		
Consensus	1.5	1.9	2.1	2.5	2.5	2.5

Source: OBR, BoE, HMT

Given the weaker than expected starting point for GDP (on the latest ONS data GDP rose only 1.3% last year), the OBR will probably have to revise down its calendar year forecast for 2011. Will they, as their simple forecasting methodology implies, revise 2012-16 higher to absorb the extra ½-¾% slack that the economy now appears to have? If they were to, that would put them even more at odds with the consensus (and above the MPC's latest median forecast) and more open to the charge of excessive optimism.

At first sight it is difficult for the OBR not to do this. The Q4 drop in GDP was largely, though not entirely, weather-related. There was a modest decline in the overall employment rate (from 70.8% to 70.5%) though, as I have observed before (with incredulity), total hours worked rose 0.3%. Most of the decline in GDP was therefore associated with a drop in labour productivity which, in theory, can be readily recovered. If there really is more spare capacity in the economy today than there was six months ago, then that can be used up over the medium term and growth in the latter years of the forecast will – perforce – be that much stronger.

As we know, the OBR's methodology gives rather more weight to what the cyclical indicators are telling us. For example, at the start of the year the Bank's regional agents were finding that capacity utilisation in manufacturing was running at above its average in recent years while in the service sector it was still some way below average (Chart 3). The Agents findings chime with other surveys which show that the

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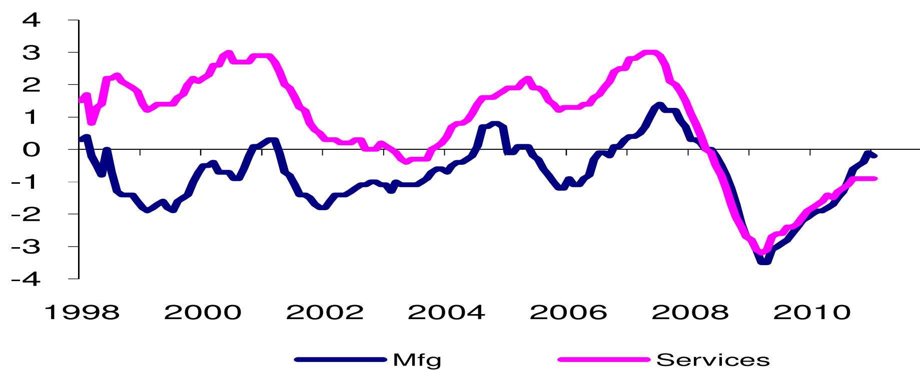
output gap has closed in manufacturing (the CBI reports capacity utilisation is in line with its long-run average) but that there is still some spare capacity in the service sector.

Chart 3: Capacity utilisation



Source: Bank of England

The shortfall in Q4 GDP puts the spotlight on the OBR's forecast methodology. In theory the extra spare capacity represented by that decline should be brought back into play over the medium term and the OBR's already relatively optimistic forecast should be raised further. The OBR's methodology allows it some wriggle room especially as some of the cyclical indicators for manufacturing are already suggesting that any spare capacity in that sector has gone.

Alternatively the OBR can re-visit its forecast for trend growth (2.35% up to the end of 2013 and 2.1% beyond). The obvious candidate is the trend productivity assumption (2% a year throughout). That could readily be reduced, especially as other forecasters such as the Bank are coming round to the view that the growth of demand consistent with the inflation target is lower than previously thought. One way or another I would expect the OBR not to translate the Q4 shortfall into faster growth over the medium term. In my book it missed a trick last time. Its credibility as an independent forecasting organisation will not be enhanced if it comes up with faster medium-term growth forecasts.

The fiscal arithmetic

As I observed two weeks ago, the January PSNB surplus puts us on track for a full-year deficit of around £140bn or 9½% of nominal GDP. Anything can happen over the last two months of the fiscal year but if the simple extrapolation holds, the full-year outturn will be some £8-9bn or a little over ½% of GDP below the EFO predictions. Since GDP growth looks like averaging around 2% in 2010-11, around ½% below the EFO forecast of 2.5% (ie the output gap is about ½% bigger), the implication would appear to be that the structural deficit is rather less than the 7.6% that the EFO estimated. To the extent that this is true and to the extent that the buoyancy of revenues, which is what appears to have cut the deficit, can also be expected to be maintained, the Chancellor has a little bit of leeway to cut taxes or raise spending in the upcoming Budget.

If that is correct (and the OBR does not cut into this by lowering its forecasts for trend growth), we can expect measures to boost growth over the medium term. The Government has already been criticised by industry for not having a plan for growth to go alongside the deficit-reduction agenda and the Chancellor is keen to meet these criticisms. At the time of the OBR forecast he announced (with Vince Cable) a growth review which was to focus on removing barriers to investment. More recently the Chancellor announced the creation of at least ten Enterprise Zones offering simplified planning rules and corporate tax breaks.

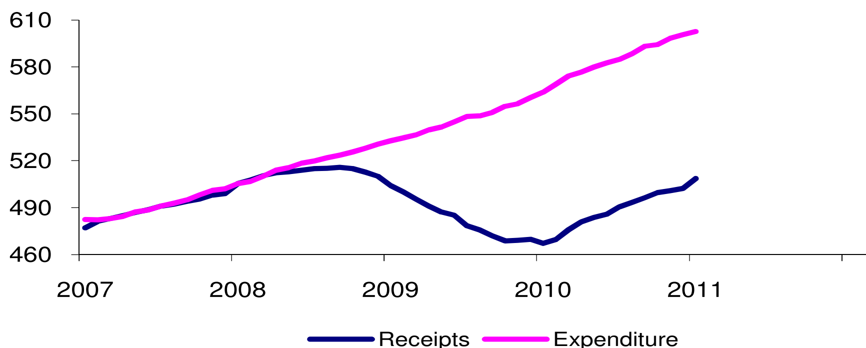
There is of course a problem because what industry typically means by a growth strategy is tax breaks for investment (which are not easy to deliver in the context of a deficit-reduction agenda) while what the Chancellor (or the Treasury) tend to mean is a series of limited supply-side measures which do not cost very much. The Chancellor can also point out that, even in last June's emergency Budget, he found room to lower the main rate of corporation tax from 28% to 24% over the next four years (though only as an offset to cutting capital allowances).

Be that as it may, this will be a Budget for growth with a series of relatively cheap (spending) measures and some tax simplification aimed at improving the supply side of the economy. It won't cost a lot but it will show that the Chancellor is listening and responding to the concerns of industry.

And another thing

I read this week that 'the surge in the PSNB deficit in 2009-10 was entirely the result of public expenditure rather than a collapse in tax receipts'. To me that seems to be a little wide of the mark. PSNB excluding the effects of financial intervention rose from £96.4bn in 2008-09 to £156.4bn in 2009-10. Central government receipts were down by around 4% for a second successive year while spending rose 7%, an acceleration from 5.2% the previous year. As a result, a huge £100bn gap opened up between the two, which I think it is fair to attribute primarily to a collapse in revenues rather than any obvious surge in spending (Chart 4).

Chart 4: Central government receipts and spending (£bn, rolling 12m total)



Source: ONS

What is also true is that GDP collapsed in 2009-10 so that, expressed as a share of GDP, receipts were relatively stable and close to pre-crisis levels, while expenditure rose sharply. That has left expenditure out of line with GDP (which is a large part of the argument that the deficit should be tackled by cutting expenditure) but that does not mean that expenditure caused the increase in PSNB. It would be more accurate to say that GDP collapsed from 08q1 onwards, taking government revenues down with it. Expenditure was maintained on its pre-crisis trend with some additional, discretionary spending on top. Put this way, it was the collapse in GDP that caused the surge in borrowing. The task ahead is to accommodate spending to this lower level of GDP and the smaller tax base that goes with it.

We are rebalancing

This week's data confirm the buoyancy of the export-oriented manufacturing sector. Yesterday the ONS reported the biggest one-month decline in the trade deficit on record. The goods shortfall fell from a record £9.7bn in December to £7.1bn in January on the back of a 5.4% rise in export receipts and a 4% drop in spending on imports. Much of the latter was due to a sharp fall in imports of aircraft but even excluding oil & erratic items the goods deficit shrank by £6.6bn. In the last three months underlying export volumes are up nearly 14% from a year earlier against less than 10% for imports. Within the total, exports of manufactures are up 18.9% and finished manufactures are up 20.8%. Unless something very perverse happens in Feb-Mar, net trade should make a significant positive contribution to Q1 GDP.

Today the ONS reported that manufacturing output rose 1% in January and 6.8% from the previous year. This was the fastest annual growth since 1994, though only because it was boosted by the fact that output fell 1.1% in the severe weather of January 2010. Even so, and as the surveys have been telling us for some time, manufacturing industry is benefiting from strong global demand and a competitive exchange rate.

If manufacturing were a larger part of the economy (not just 12.8%), higher interest rates would be a done deal. As it is, what happens in the far larger service sector (75.8%) will determine the path of interest rates. We don't get the January data for services until 30 March (the day after the full Q4 national accounts). What will be critical is whether output fully recoups December's 1.4% fall. If it does, we are on track for a 1% rise in GDP in Q1, which will probably be enough to deliver a rate hike in May.

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