

Novus Capital Markets Research

It's a rollover

24 November 2011

The Autumn Statement: Robert Chote has told the Chancellor and George Osborne has told the press that the outlook for GDP growth and the public finances is a lot worse than seemed likely at the time of the Budget. So far so bad. But that in itself has no policy implications since the fiscal mandate is expressed in terms of the structural (cyclically adjusted) current budget which allows for a deterioration in the public finances where it is attributable to a cyclical slowdown. It is only if the OBR concludes that the underlying economic structure is worse that policy needs to adjust. There are two crucial elements: the output gap (a smaller output gap means more of the deficit is structural not cyclical) and underlying productivity growth (which ultimately defines the tax-bearing capacity of the economy). I would not expect the OBR to change its estimate for trend GDP – if they do all bets are off – but the various indicators that the OBR uses to assess the output gap point to much less spare capacity than they estimated in March, enough to add about 1% to the structural deficit. The output gap will widen again over the next year if the OBR adopts something like the MPC's forecast of only 1% growth in 2012. Even with this the OBR may no longer conclude that the structural current budget returns to surplus in 2014-15. But this is where the mandate comes in. It is a rolling five-year target which will be extended by a year to 2016-17. If the OBR forecast shows a return to surplus a year later than before, in 2015-16, George Osborne will still be able to claim that he is on track to meet his mandate a year early.

Joining the euro would have been good for us – ha ha. Paddy Ashdown's suggestion that the UK would have benefited from euro membership is pure wishful thinking. It ignores the fact that we would have had euro area interest rates which at their low point touched 2%. I shudder to think what that would have done to our already buoyant credit demand and to house prices.

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The Autumn Statement

So Robert Chote has told George Osborne the bad news and Osborne has told the press, figuring that it is better to get the bad news out there and come back next week with something more positive. But how bad is the bad news?

1. Growth will be weaker than expected in the Budget

At the time of the March Budget the OBR forecast was for GDP growth of 1.7% this year, picking up to 2.5% in 2012 and nearly 3% from 2013 onwards (Table 1). On the latest ONS data 2010 was stronger than thought in March (1.8% rather than 1.3%) but 2011 is proving weaker than expected – after three quarters growth is averaging 0.9%. This week the MPC, which ‘backcasts’ (revises up) the ONS data, lowered its 2011 forecast to 1.3% (from 1.6% in August). The consensus, which uses the ONS data, is lower at 1%.

Table 1: GDP forecast

%	2010	2011	2012	2013	2014	2015
OBR (March)	1.3	1.7	2.5	2.9	2.9	2.8
BoE (November)	1.9	1.3	0.9	2.8	3.3	

source: OBR, BoE

For 2012 the MPC forecast, which has the economy stagnating in 11q4 and 12q1, has been cut from 2% in August to just under 1%. In 2013 and beyond growth picks up to an above-trend rate but by the end of the forecast period the level of GDP is still lower than it was expected to be three months ago. The 2012 consensus forecast is a little higher (1.2% in this month’s Treasury compendium) but is likely to come down as more forecasts take on board the weaker outlook for the euro area.

Since the ONS typically stays close to the consensus in the near term (its primary role is to produce a forecast for the public finances based on a non-controversial view of where the economy is heading over the next year or so), we can expect it to lower its 2011/2012 forecasts to about 1%. In 2013 and beyond, depending on its current view on the output gap and trend growth, it is likely to forecast something close to 3%. But, as with the MPC, the level of GDP by the end of the forecast period will be lower than it expected in March.

2. The public finances will be worse than expected in the Budget

At the time of the Budget the OBR forecast a reduction in borrowing (on the PSNBex definition which excludes the temporary effect of financial interventions) from £145.9bn (9.9% of GDP) in 2010-11 to £121.8bn (7.9% of GDP) in the current financial year (Table 2). This was based on current receipts rising 7.3% against 3.8% for current expenditure and a reduction in net investment of over 20%. Since March the 2010-11 outturn has been revised down from £145.9bn to £137.1bn. After seven months of the 2011-12 financial year (and from this improved starting point) the public finances are broadly on track to meet the OBR's March forecast – in level terms, ie the improvement between 2010-11 and 2011-12 will be less than expected in March.

Table 2: OBR forecast (Mar11)

£bn	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Surplus on current budget	-104.8	-90.0	-72.8	-46.0	-22.0	-4.8
Net borrowing (PSNBex)	145.9	121.8	100.6	69.8	46.2	29.3

source: OBR

Beyond 2011-12 the OBR forecast was for a gradual reduction in borrowing such that by the final year (2015-16) the deficit on current budget had all but been eliminated and PSNB (on the ex definition) was below £30bn. A slower growth forecast implies that the cash deficits will be higher throughout the forecast period.

That much is clear but it tells us very little about policy. The Chancellor has two fiscal targets, a fiscal mandate and a supplementary target. The fiscal mandate is:

- a forward-looking target to achieve cyclically adjusted current balance by the end of the rolling, five-year forecast period; the supplementary target requires:

- public sector net debt as a percentage of GDP to be falling at a fixed date of 2015-16.

At the time of the Budget the OBR judged that both the fiscal mandate and the supplementary target would be met with a year to spare. The forecast was that, because even by 2015-16 GDP was still not back on trend, some of the current deficit in cash terms was attributable to the cycle and that once this is stripped out the underlying current budget was in surplus – by 0.4% of GDP in 2014-15 and 0.8% in

2015-16. Similarly the net debt ratio was forecast to peak at just under 71% in 2013-14 and to fall back to just over 69% by 2015-16 (Table 3).

Table 3: OBR forecast March 2011

% GDP	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Surplus on current budget	-7.1	-5.8	-4.5	-2.7	-1.2	-0.3
o/w cyclical	2.5	2.6	2.5	2.1	1.6	1.1
o/w structural	-4.6	-3.2	-2.0	-0.6	0.4	0.8
PSNB	9.9	7.9	6.2	4.1	2.6	1.5
o/w cyclical	2.5	2.6	2.5	2.1	1.6	1.0
o/w structural	7.4	5.3	3.7	2.0	1.0	0.5
Net debt	60.3	66.1	69.7	70.9	70.5	69.1

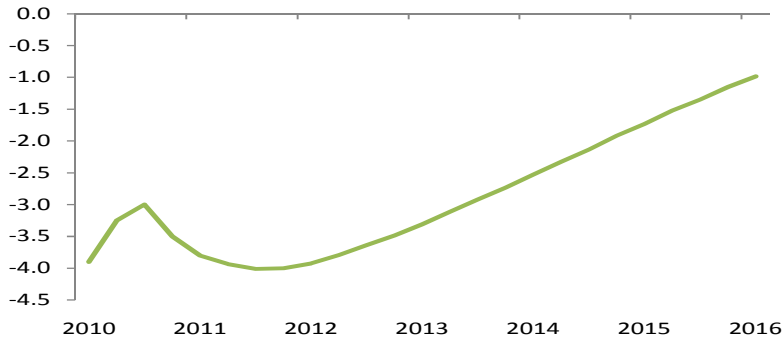
Source: OBR

3. What will the OBR do about the output gap and trend GDP?

Since the mandate is specified in terms of the structural, not the cash, deficit the larger cash deficit that the OBR will presumably be forecasting does not in itself require a policy offset – the policy framework allows for a cyclical deterioration in the public finances. It is only if the OBR assesses that the underlying structural deficit is higher that the Chancellor would have to take action. This could come in the form of a smaller output gap, which would mean that more of the current deficit is structural, or in the form of a lower estimate for trend growth.

In March the OBR estimated an output gap of 3% in 10q3 and trend growth of 2.35% up to 2013 and 2.1% thereafter as the baby-boomers hit 65 and withdraw from the labour market. Its forecast of sub-trend growth in 2010 (1.3%) and 2011 (1.7%) implied a widening of the output gap to 4% in the second half of 2011 and a gradual narrowing thereafter. At the end of the forecast in 2015-16 the output gap was still around 1% (Chart 1).

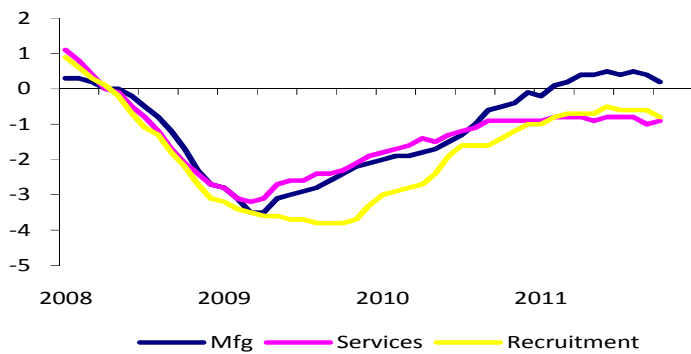
Chart 1: The output gap (OBR forecast, March 2011)



Source: OBR

In the year since 10q3, even though GDP has risen only 0.5%, many of the indicators of spare capacity that the OBR uses to estimate the output gap have decreased. For example the Bank's Agents' measure of recruitment difficulties, though falling in recent months, still came in at -0.8 in October against a 10q3 average of -1.6 while the measures of capacity constraints were 0.2 in manufacturing and -0.9 in services against 10q3 averages of -1.0 and -1.1 (Chart 2).

Chart 2: BoE Agents' scores (recruitment difficulties & capacity constraints)



Source: BoE

Similarly the CBI measure of capacity utilisation shows fewer firms working below capacity (58% this October against 64% a year ago), though here again there has been some easing in capacity from the July survey (where 50% of firms reported below-capacity working).

These readings look odd against other measures of spare capacity such as unemployment which on the LFS measure has risen from 7.7% a year ago to 8.3% but they do suggest that, although the amount of spare capacity is rising, there is less than there was a year ago when the recovery was only just getting going and quite a bit less spare capacity than the 4% the OBR estimated to be available currently.

The OBR, which will update its estimate to 11q2 next week, will have to acknowledge this and reduce its estimate of the output gap to about 2½%. That would mean that more of the current deficit is structural and in need of tackling. The rule of thumb is that a 1% change in the output gap is worth about 0.7% on the structural budget. On that basis an output gap of 2½% rather than 4% would add 1% to the deficit. So where in March the OBR estimated a structural current budget deficit of 3.2% of GDP in 2011-12, it might have to raise this to more than 4%. All other things equal this might mean the current budget stays in deficit right through to 2015-16.

The OBR's estimate of trend growth is based on underlying productivity growth of 2% and 0.7% growth in the population of working age (0.5% after 2013) with offsets from falling hours and the employment rate. The key assumption is the first one (trend productivity measured on an output per hour basis). In the year to 11q2 productivity rose 1.4% on this measure, below the OBR's estimate of trend. I would guess that at this stage the OBR will stay with the 2% assumption but the risk is that at some stage they may have to take a gloomier view of underlying productivity.

If the OBR forecast follows that of the Bank in the near term, that will take some 2% off growth in 2011 and 2012 combined. If the OBR stays with its estimate of trend, that will mean a widening of the output gap over the next year. So, although the output gap currently may be only about 2½% rather than the 4% shown in the March forecast, there would still be a significant amount of spare capacity at the end of 2012, possibly as much as the 3½% the OBR estimated in March. Even if growth picks up to something like 3% from 2013 onwards there should still be some spare capacity at the end of the forecast period –

as there was in March. If so, some of the cash deficit on the current budget will still be attributable to the cycle.

More than that, the mandate is expressed in terms of a five-year rolling target which, if the OBR follows the Treasury tradition and extends the forecast to 2016-17, will effectively give the Chancellor an extra year in which to achieve his mandate (shades of Gordon Brown here). So bizarrely, even if the OBR translates the weaker outlook for the public finances into not achieving cyclically adjusted current budget surplus until 2015-16, a year later than currently projected, the Chancellor may still be able to claim that he is achieving his mandate a year early – not that I would expect the Labour opposition to be convinced by this, though – which is far more important – financial markets might be.

In summary, we know that next week's OBR forecast will show weaker growth and a deterioration in the public finances compared with March. But crucially the OBR may be able to attribute most of the deterioration to the cycle so that even if the return to structural surplus is not achieved until 2015-16, George Osborne may still be able to claim that he is meeting his mandate with a year to spare. The one major rider to that is if the OBR downgrades its estimate of trend productivity. I don't expect it to at this stage but, if it does, all bets are off.

Joining the euro would have been good for us – ha ha

What is it about pro-euro politicians that they are so prone to wishful thinking? I witnessed it at first hand ten years ago at an RBS gilts conference in Tokyo when the late Robin Cook said he was prepared to bet his RBS overdraft that the UK would be in the euro by the end of the decade. (That was after I had said, as I always did, that UK entry into the euro was unlikely 'in the foreseeable future' – though when wasn't that the case?)

There was another example of it in the Times on Monday when former Liberal leader Paddy Ashdown argued that, if we had joined the euro back in 1997, it would have been good for us. We would have responded, he suggests, by accepting the discipline of a fixed exchange rate regime (where the devaluation option has gone) and improving our competitiveness over the long haul. He cites the example of Germany which entered the euro at an uncompetitive exchange rate but which after years of holding down wages and keeping costs under control is now one of the most competitive economies

in the euro area. Thanks to Mrs Thatcher's reforms, he argues, we would have been well placed to do the same.

So far so good. But what Lord Ashdown doesn't mention is that inside the euro area we would have had the interest rates that the ECB judged appropriate for the area as a whole. Rates were on a rising trend in the late 1990s with the refi rate peaking at 4% in late 2000. But from May 2001 the trend was down reaching a low of 2% for 2½ years from mid-2003 onwards. From Dec05 the trend was upwards with a peak of 4% ahead of the financial crisis. Here the low was 3½% in 2003 and up to 2007 our rates were typically about 1% higher than those set by the ECB. I shudder to think what would have happened to the growth in credit and the housing market with 2% rates here.

Lord Ashdown stops short of telling us that if Britain had joined the euro there would not have been a US sub-prime housing crisis and everything that went with that (unless there is a sub-text that has the US also joining the euro). Nor does he seem to think RBS would not have taken over ABN-AMRO or HBOS made the commercial loans which led to its downfall. In short, as the history of the financial crisis tells us, there is nothing inherent in a single currency regime that can prevent the extravagance that leads to financial crisis (the US has a common currency and is far more homogenous than the euro area yet it spawned the financial crisis). Worse, as we are seeing today, where the constituent parts of the currency area are put together for political purposes (and where the economic pre-conditions for a viable currency union are absent), the currency area can exacerbate problems rather than cure them.

Economists are always wary of the counter-factual, re-writing history on a what-if basis. But one thing I am absolutely certain of. If Britain had been in the euro, and without the safety mechanism of devaluation, the financial crisis and all that has followed from it would have been a lot, lot worse. To argue otherwise is wishful thinking, self-delusion on a grand scale. Ditto Michael Heseltine's suggestion also made this week that the UK would join once France and Germany had taken the necessary steps to secure the future of the euro. Ha blooming ha.

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