

## *Novus Capital Markets Research*

### **In the manner to which I am accustomed**

**14 July 2011**

**An unpalatable choice:** ageing populations put pressure on the public finances. A relatively smaller workforce has to bake the bread and pay the taxes that pay for the pensions and medicare of the retired. One way to minimise the cost is through net inward migration so that the burden of retirement is spread over a relatively larger workforce. More than most countries in the EU, the UK is going down this route. According to the ONS more than two thirds of the 10m increase in population that it is projecting over the next 25 years comes from net migration. Even with the boost from an expanding labour force, the OBR estimates that the public finances are on an unsustainable trajectory and that a permanent tax hike or spending cut of 1.5% of GDP is needed to get public sector net debt back down to the 40% that Gordon Brown deemed prudent. The choice – a larger population and all the pressure on the infrastructure that brings or a significant step-up in the tax burden or further cuts in public spending – is unpalatable, but inescapable if I am to be kept in the manner to which I am accustomed.

**Dilnot vs Chote:** the FSR's findings are extremely sensitive to a number of key assumptions, most obviously the size and age-structure of the population, productivity growth and the increase in real health spending per person over the long term. More surprisingly, they are also very sensitive to the starting point. The OBR's methodology is to graft its long-term projections onto the more detailed forecasts it made at the time of the Budget. The FSR shows that, if the primary balance (which excludes debt interest) were 1% of GDP worse in 2015-16 than in the Budget forecast, public sector net debt would rise to 150% of GDP rather than 107% in the central projection. The proposals of Andrew Dilnot's Fair Care Funding Commission add only 0.1% of GDP to spending by 2015-16 but, given how sensitive the whole arithmetic is to where we are in 2015-16, they may be a bridge too far for the Chancellor.

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### **A chilling message**

The message from the OBR's first full-length Fiscal Sustainability Report (FSR) is chilling. Without spending cuts or tax increases over the medium term, the fiscal position is unsustainable. Worse, given the gradual erosion of some important revenue streams (North Sea oil being the most obvious), 'Governments are likely to need some replacement sources of revenue to keep the tax burden constant, let alone to meet the costs of an ageing population'.

Overall the FSR's central estimate is that, on unchanged policy (which is not easily defined over the very long term) the primary budget balance will deteriorate by 4.5% of GDP between 2015-16 (1.3% surplus) and 2060-61 (3.2% deficit). As a result public sector net debt (PSND) is projected to fall from 69 per cent of GDP in 2015-16 to a trough of 60 per cent in the mid-2020s, before rising increasingly quickly to reach 107 per cent of GDP in 2060-61. This is unsustainable and would, the FSR estimates, require a permanent tax increase or spending cut of 1.5% of GDP from 2016-17 to get the debt-income ratio back to the 40% that Gordon Brown deemed prudent or one of 0.8% to stabilise it at 70%.

The FSR presents a variety of scenarios which show either more or less upward pressure on the public finances. Broadly speaking, they show that productivity is good for the public finances (more productivity = more output = a larger tax base) and that inward migration is also helpful (more people of working age = more taxes), though only in the short run since inward migrants will also retire in due course. By contrast, high levels of (publicly financed) health spending are bad.

The starting point for the FSR is the official population projections produced by the ONS. The latest of these produced on 2008 data puts the UK population at 71.6m in 2033 and at 80m in 2016. The present population is of the order of 62m so the projections are for an increase of nearly 10m in the next 25 years and a further 8m in the following 25 years.

Personally I have always found these projections very scary. The demands of an extra 18m people, a near-30% increase over 50 years, on the housing stock, transport infrastructure, schools, health etc are mind-boggling, not least because the ONS analysis shows the bulk of the increase occurring in England, parts of which are already very congested.

While the emphasis of much of the current debate is on the costs of looking after baby-boomers like me as we move out of the labour force and into retirement (some hope in my case), the bulk of the projected increase in the population comes from immigration. The ONS shows that nearly half (45%) of the 10m projected increase in the population in the next 25 years is directly attributable to (the assumption it makes) on net inward migration (180k a year over the medium term) but that this rises to 68% when the effects of migrants having children is taken into account. Only just under one third (32%) of the projected population increase is attributable to current UK residents (and a significant part of this is due to recent inward migrants).

The thought of an extra 10m people living here in 25 years time (for obvious reasons I'm rather less exercised about what happens in 2061) may be scary but it is the net inward migration of people of working age, and the expansion of the tax base that it brings about, that makes the public finances data less bad than they otherwise would be. This helps explain why, as Chart 3.2 in the FSR shows, the UK's position is not as bad as that faced by many other developed countries. The chart, which is based on an EC analysis, shows the population aged 65+ as a % of the working age (20-64) population. Currently the UK is at about 27-28%, which is close to the EU average. By 2061 we are projected at just under 50%, the fourth lowest in the EC (Ireland is lowest at 45%), while eight countries, including Germany, Italy and Spain are above 60%. Portugal is highest at 70%.

To be consistent with the forecasts that the OBR produced at the time of the Budget (which assumed net inward migration of 140k a year over the next five years), the FSR adopts the ONS low migration variant of 120k a year. This results in a central population projection in the FSR of 75m by 2060. Of these 43.4 m (58%) are aged 16-65. Also consistent with the Budget forecast, the central scenario assumes productivity growth of 2% a year.

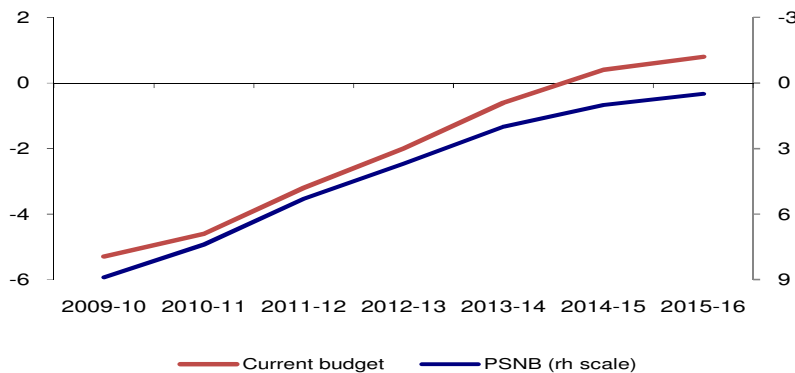
The FSR also explores scenarios in which the age structure of the population is older (lower fertility, higher life expectancy), younger (higher fertility, lower life expectancy and more inward migration). The first of these produces a smaller (72m) but relatively older population (56% aged 16-65). The latter produces a larger (87.4m) and relatively younger (60% aged 16-65) population. A higher (240k a year) net migration scenario produces a population of 84m (59% aged 16-65). Broadly speaking, the larger the population, whether through increased fertility of more net inward migration, the younger it is.

The effects of these scenarios on the public finances are dramatic. Compared with the central projection in which PSND gets to 107% of GDP in 2060-61, under the old age structure scenario PSND tops 120% of GDP while under the young age structure and high immigration scenarios PSND is steady at about 60% of GDP. Similarly under a low productivity scenario (1.5%) PSND gets to nearly 140% of GDP while under a higher productivity scenario (2.5%) it reaches 90%. Even more dramatically, the FSR shows that if health spending per person rises by 3% a year in real terms PSND ends up well above 200% of GDP.

### What chance the FFC?

A key finding of the FSR is just how sensitive it is to the course of the economy and the public finances over the next few years. In the Economic & Fiscal Outlook which accompanied the March Budget the OBR forecast a steady improvement in the public finances over the forecast period (to 2015-16). By 2015-16 the cyclically adjusted deficit on the current budget (5.3% in 2009-10) had been eliminated and a small surplus (0.8%) was in place. Similarly cyclically adjusted public sector net borrowing (8.9% in 2009-10) had fallen to a very modest 0.5% in 2015-16 (Chart 1).

**Chart 1: Public sector finances (cyclically adjusted, % GDP)**



Source: OBR

The 2015-16 starting point is then locked into the OBR’s longer-term projections. The key variable is the structural primary balance (borrowing excluding debt interest), rather than the surplus on the current

budget or PSNB in total. The FSR estimates that the primary budget balance will be a surplus of 1.3% of GDP in 2015-16; it then shows that 'if the structural primary balance in 2015-16 was worse by 1 per cent of GDP than in our March forecast, then by the end of the period net debt would increase to around 150 per cent of GDP rather than around 107 per cent in our central projections. A structural gap in 2015-16 which is 1 per cent of GDP better than in our March forecast would keep debt on a relatively sustainable path' (FSR para 3.60).

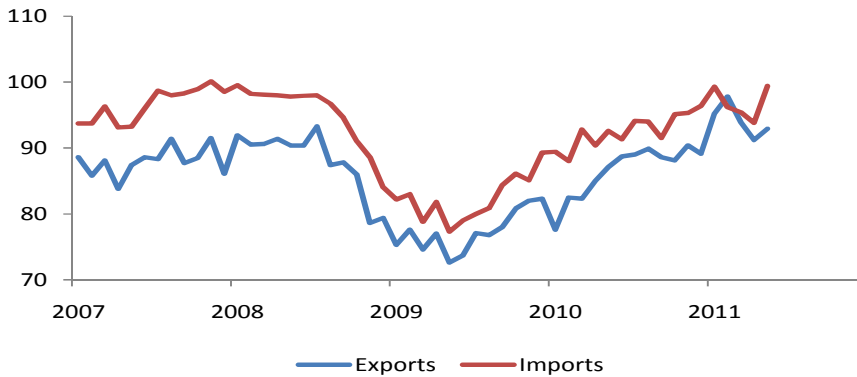
Last week, Andrew Dilnot's Commission on Fairer Care Funding (FCF) called on the Government to cap an individual's life-time contribution to their own personal care at £35k and to increase the means-testing threshold from £23,250 to £100k. The cost of this proposal is £1.7bn if it were introduced in 2010-11, rising to £2.2bn by 2015-16 and to £3.6bn by 2025-6. On the OBR's forecast for nominal GDP (£1915bn in 2015-16) an extra £2.2bn of spending is trivially small at just over 0.1% of GDP.

Nevertheless, given the extreme sensitivity of the long-term projections to the 2015-16 starting point, there is very little room for manoeuvre and any extra spending is a risk, one presumably that the Chancellor would be unwilling to contemplate. That was why I asked last week what chance the FCF proposals if, say, the OBR report is gloomy about the sustainability of the public finances under the current system and projected demographic changes?

## **Q2 GDP**

The May trade data were disappointing – how many times have I written that over the last 35 years? In volume terms exports of goods rose a healthy 3.7%, fully reversing April's decline, but this was dwarfed by a 5.9% rise in import volumes which, on an underlying basis, are at their highest level since the onset of recession in January 2008 (Chart 2).

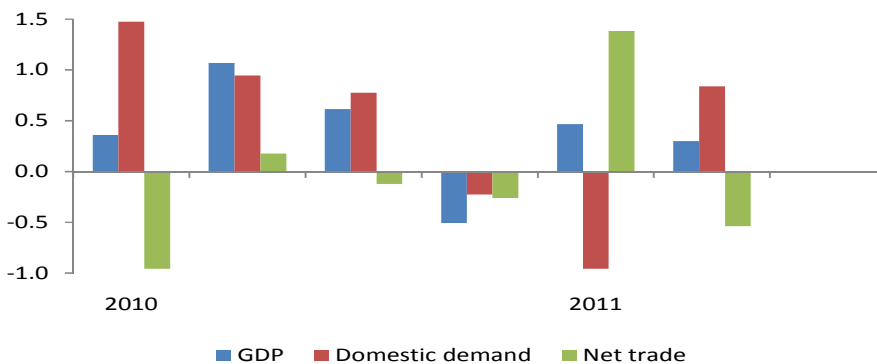
**Chart 2: Export and Import volumes (ex-oil & erratics, 2006 = 100)**



Source: ONS

In April-May combined exports of goods were down 3.3% compared with the 11q1 average against a 0.2% fall in imports. Unless these data are revised (or unless June produces the unlikely combination of a very sharp rise in exports and an equally large drop in imports), net trade will make a significant negative contribution to Q2 GDP. For example, if the Q2 outcome is in line with the April-May average, net trade will take 0.5% off Q2 GDP – in sharp contrast to Q1 when net trade added 1.4% (Chart 3).

**Chart 3: GDP, domestic demand and net trade (contribution to q/q GDP growth)**



Source: ONS, Novus

I suggested last week that the output data are pointing to a rise in GDP of 0.3% in Q2 (the preliminary estimate is released on 26 July). So, while a negative contribution from net trade would be disappointing, the interesting question is where a 0.8pp contribution from domestic demand might be coming from. In 11q1 general government consumption rose 0.5% (adding 0.1pp to GDP), but all of the components of private demand were negative: household consumption fell 0.6% and investment (including the public sector) was down 2% (business investment fell 3.2%). Together household (and NPISH) consumption took 0.4pp off GDP, investment accounted for a further 0.3pp and inventories another 0.4pp.

The trade data, which feature a 20% increase in the volume of chemical imports between April and May, suggest that inventories should be making a significant positive contribution. But beyond that it is difficult to see which components of domestic demand might be buoyant – retail sales were fractionally lower in Apr-May than in Q1 but, to judge by the John Lewis clearance sales, may have bounced in June, though little is known about the non-retail components of consumer spending. Investment does not look promising with industrial production of capital goods down 2% in Apr-May compared with Q1 and the import numbers showing no growth in capital goods in May. Does this mean that, yet again, and in spite of all the hoo-ha about public spending cuts that government consumption is still growing?

### **Labour market data**

The headline numbers look ok (employment up 50k in the Mar-May period and unemployment down 26k) but the monthly breakdown isn't so good. Employment was up 40k in April to 29.3m, its highest level since 2008 but so too was unemployment – by 22k, the first rise this year. The more timely claimant count, which is a count not a survey response, rose for a fourth successive month to 1.52m in June, the highest reading in over a year. And hours worked appear to have collapsed in the last two months. Why, I ask myself, if employers require fewer worked hours, are they taking on more staff? Or, more particularly, why has the relationship between employment and hours, which has been quite close in the past, suddenly shifted (Chart 4)? I suppose the answer is something to do with record high levels of people working part time through not being able to obtain a full-time job but it all seems rather convoluted.

**Chart 4: Employment and total hours worked (m)**

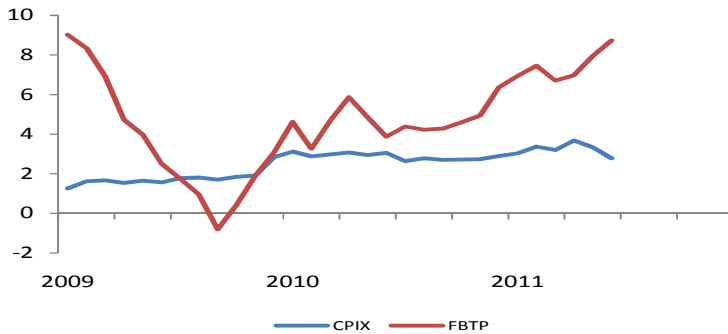


Source: ONS

**Inflation – all food and energy**

CPI inflation surprised on the downside in June, falling to 4.2% from 4.5% in May, below consensus forecasts of no change. Behind the fall was a second monthly decline in the core (CPIX rate) to 2.8% from 3.3% in May and April’s high of 3.7%. Non-core inflation by contrast is moving steadily higher. Food, beverages, tobacco and fuel inflation combined reached 8.7% (6.5% food, 15.1% petrol), the highest since Jan09 (Chart 5).

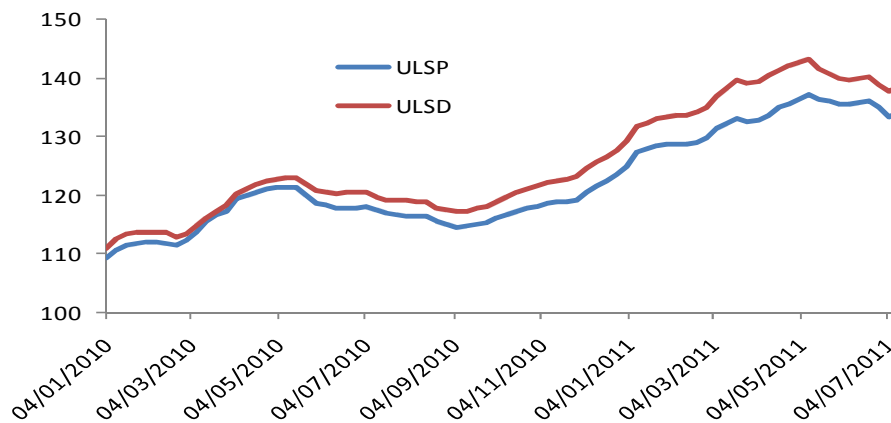
**Chart 5: CPI inflation: core & non-core**



Source: ONS

As in March, when inflation unexpectedly fell back, the June data are probably just the lull before the storm. One reason for the fall in the core rate was that the summer sales appear to have started earlier than usual so there will be less to come in July. Against that there might just be a drop in petrol price inflation next month. On the ONS weekly data pump prices peaked at the start of May and have been gradually edging lower over the last two months (Chart 6). So far this has not shown up in the annual inflation rate since something similar was happening a year ago. In fact the inflation rate peaked in the middle of June and in the first half of July was around 1pp off the peak. Depending on what happens in the second half of the month (prices edged higher in the second week), petrol price inflation could be fractionally down in July. Even so the slight easing in the oil price on global markets is too little and too late for the gas & electricity companies, where another round of double-digit price rises is under way. This will take CPI inflation back up to a round 5% later in the year.

**Chart 6: Petrol and diesel pump prices**



Source: ONS

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