

Novus Capital Markets Research

PSNB £40bn below forecast

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Yes really: on the latest ONS estimate PSNB in 2010-11 was £136.7bn, 9.3% of GDP. At its most pessimistic (the December 2009 PBR) HMT forecast a deficit of £176bn, 12% of GDP. In every forecast since then the deficit has been revised down: not because growth has been stronger than forecast, nor because of policy changes (which account for less than £7bn) but simply because the public finances have turned out far better than expected. So while I accept that a weaker UK growth outlook will have an adverse effect on the public finances (not that this in itself has any policy implications since the fiscal mandate allows for the operation of the automatic stabilisers) and that the output gap may be smaller than the OBR estimated in March (as Chris Giles's research suggests, and which would require a policy adjustment since it would imply a larger structural deficit), I am also very aware that any such calculations can be swamped by unexpected movements (for better or worse) in the public finances.

QE – October or November? Armed with new BoE research that the first £200bn round of QE had significant, positive effects on output and faced with a worsening of the euro area sovereign debt crisis, sharp falls in equity prices and a synchronised slowing in global growth, the MPC gave considerable thought to another round of QE earlier this month. For most members the decision was finely balanced and another round of QE increasingly probable. For some members all that it would take was a continuation of the conditions seen over the last month. That is as close as the MPC has ever got to signalling a policy move in advance. Conditions may change for the better (though no sign of that yet) but on the basis of yesterday's Minutes it would be a surprise if there were not some votes for QE next month and a majority for it by November at the latest. Another £50bn, equivalent to a 37½-75bp cut in interest rates is likely as a first tranche, sufficient to raise GDP by up to ½pp. It has my vote.

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QE – increasingly probable

Two weeks ago, when I concluded that another round of QE was warranted, my thought was that ‘the weakness we saw in the August surveys and ongoing problems in the euro area might just tip the balance’ in favour of more QE. It didn’t though I argued that ‘we still might see some more QE later in the year or in 2012 if the global economy does not show some signs of providing a bit more help to the UK where rebalancing the economy leans heavily on a recovery in global demand’. I also noted that any such move would have come as a surprise to those City economists who argued that more QE at a time when inflation is heading to a peak of 5% or more was hard to justify. Against that I argued that the MPC had repeatedly looked through the near-term inflation outlook and justified its policy decisions by its medium-term forecast. Since that had deteriorated, I saw a strong case for more QE.

Yesterday’s MPC Minutes show that QE is very much back in the frame. It was no surprise that Adam Posen maintained his vote but it was more of a surprise that most of the rest of the Committee ‘thought that it was increasingly probable that further asset purchases to loosen monetary conditions would become warranted at some point’ (Minutes, para 31). The MPC chose not to move this month though, for most members, the decision was finely balanced (‘the weakness and stresses of the past month had significantly strengthened the case for an immediate resumption of asset purchases’). Some members were very close to voting for QE this month since ‘a continuation of the conditions seen over the past month would probably be sufficient to justify an expansion of the asset purchase programme at a subsequent meeting’ (para 32). That is not a very big hurdle.

The justification for further QE is that since the *August Inflation Report* the outlook for the real economy has deteriorated and that the balance of inflation risks has shifted further to the downside. The Minutes cite ‘significant downside news on activity over the month’, notably the problems in the euro area and further weakness in the US, which were pointing to ‘a synchronised slowing in global growth’, and in the UK a marked deterioration in the business surveys, particularly for services.

The weaker global outlook is reflected in the latest IMF forecasts which downgrade the growth outlook everywhere. The forecast for the world as a whole has been lowered from around 4½% this year and next to 4% each year but this is boosted by the relative strength of the non-OECD economies. Within the OECD the US outlook has been cut by around 1% each year (nearly 2% in total) while the euro area and

the UK have been cut by around ½% a year (Table 1, where the change column is the downgrade to 2011-12 combined).

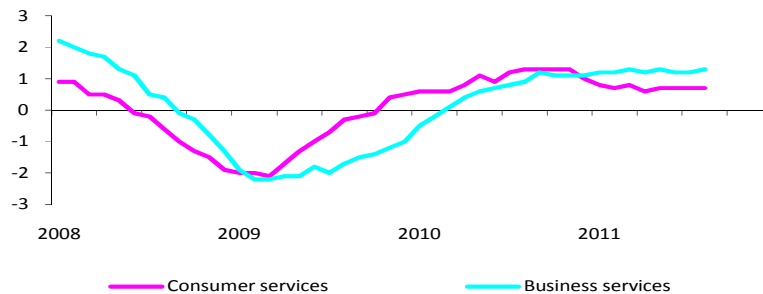
Table 1: IMF forecasts

	2011	2012	change
World	4.0	4.0	-0.8
US	1.5	1.8	-1.9
Euro area	1.6	1.1	-1.0
UK	1.1	1.6	-1.1

Source: IMF

The weakness in the service sector is evident in the August PMI, which fell from 55.4 in July to 51.1; the 4.3pp fall constitutes the second largest 1-month deceleration in activity in the history of the survey (though some of this may be due to the riots). The manufacturing survey was also weak, dropping to 49.0, below the 50% expansion line for the second successive month and way below the 60+ readings that we saw at the start of the year. Strange to relate the weakness in the service sector was not picked up by the Bank's Agents who reported unchanged turnover in consumer services and a slight pick-up in business services where rising private sector activity was offsetting slowing public sector work (Chart 1).

Chart 1: BoE Agents' scores



Source: BoE

An article in the current BEQB suggests that 'While there is considerable uncertainty about the magnitudes, the evidence suggests that QE asset purchases have had economically significant effects'.¹ The authors examine a wide range of evidence and conclude that, in broad terms, the £200bn QE programme that the Bank carried out between March 2009 and January 2010:

lowered gilt yields by around 100bp; took the sterling effective exchange rate down by around 4%; added 1½-2% to GDP; boosted inflation by ¾-1½%; and was approximately equivalent to a 150-300bp cut in Bank Rate.

As the authors note, the conditions under which the first round of QE took place were very different from where we are today and so the magnitude of the effects of another round might not be the same. In particular it would be difficult to take another 100bp off gilt yields. But in the current conjuncture, with the global outlook deteriorating rapidly, and the evidence suggesting that QE is effective in raising output, another round could be initiated as soon as next month. Indeed, on one reading of the Minutes, the MPC would have gone for more QE this month if the City had been expecting it.

There are some commentators like David Smith of the Sunday Times who would not go down this route since they regard QE as an 'emergency tool and the question of whether to use it again depends on whether you think this is an emergency or merely a period of soft growth'. There are others who doubt that it has much of an effect, though the Bank's research should provide reassurance. My own view, as set out two weeks ago, is that with Bank Rate effectively at a floor, the MPC is right to try less conventional approaches to monetary policy and that there is no need to reserve QE for emergencies only. In fact, as the Minutes reveal, the MPC considered a number of other measures this month 'including: changing the maturity of the portfolio of assets held in the Asset Purchase Facility; revisiting the earlier decision not to lower Bank Rate below 0.5%; and providing explicit guidance about the likely future path of Bank Rate beyond the information about the Committee's judgement of the medium-term outlook for inflation contained in the *Inflation Report* and the MPC minutes', before concluding that, if there were a need for further loosening, QE would be the appropriate tool.

¹ <http://www.bankofengland.co.uk/publications/quarterlybulletin/qb110301.pdf>

Operation Twist

While the MPC specifically rejected 'changing the maturity of the portfolio of assets held in the Asset Purchase Facility' in favour of more QE (should it be needed), the Fed has gone down this route. At its meeting this week it announced that it would sell \$400bn of short-dated Treasuries and purchase an equivalent amount at the long end. The aim is to twist the yield curve, pushing up short-term yields and depressing those at the long end.

The Fed is wary of undertaking more QE because of its monetarist backwoodsmen who seem to believe that cutting interest rates to zero is fine but printing money is the devil's own work. I don't see it and even though I had my mind on other things when Operation Twist was tried before in the 1960s, if my memory serves me correct, the verdict then was it achieved very little.

Fiscal policy – structure and cycle

The Chancellor was careful to express his primary fiscal target in terms of the structural budget deficit – his aim is to eliminate the deficit on the current budget by the final year (2015-16) of the forecast. At the time of the March Budget the OBR's verdict was that the Chancellor was on track to meet his target a year early (the structural current budget was in surplus in 2014-15 and 2015-16). Similarly, the supplementary target of reducing public sector net debt as a % of GDP would also be met by 2014-15.

There are disadvantages to a target framed in terms of the structural budget, most obviously that, unlike a cash target, it is not a simple thing to measure. It is calculated with reference to trend or potential GDP which itself has to be estimated. (In Gordon Brown's period as Chancellor, where the estimate of the cycle was made by the Treasury, this might have been seen as an advantage.)

But the advantage of a structural target is that it is invariant to the economic cycle and therefore allows for the operation of the automatic stabilisers. A lot of the media commentary seems to miss this point since it equates a worsening of the economic outlook with a deterioration in the public finances (rightly) but then equates this to the need for a fiscal tightening. Where the deterioration is caused by a cyclical downturn in activity, there is no need to adjust policy; where it is a permanent, structural hit to output, policy does need to adjust.

In March the OBR forecast a fall in the overall budget deficit to 9.9% of GDP in 2011-12 (from 11.1% in 2010-11) and a decline in the deficit on the current budget to 7.1% of GDP (from 7.6%). It estimated that 2.5% of the deficit was due to the cycle and the rest was structural; in the case of the current budget this left a deficit of 4.6% of GDP to be eliminated over the next four years (Table 2).

Table 2: OBR forecast March 2011

% GDP	2011-12	2012-13	2013-14	2014-15	2015-16
Surplus on current budget	-7.1	-5.8	-4.5	-2.7	-1.2
o/w cyclical	2.5	2.6	2.5	2.1	1.6
o/w structural	-4.6	-3.2	-2.0	-0.6	0.4
PSNB	9.9	7.9	6.2	4.1	2.6
o/w cyclical	2.5	2.6	2.5	2.1	1.6
o/w structural	7.4	5.3	3.7	2.0	1.0

Source: OBR

Table 2 also shows that the current budget remains in deficit in 2015-16 because GDP has not got back to trend. Even four years down the track there is still a shortfall attributable to the cycle worth 1.6% of GDP. Only when GDP is back on trend (some time after 2015-16) is it reasonable and sensible to aim for the current budget to be in surplus in cash terms.

The economic rationale for a target expressed in terms of the structural budget is clear but it puts a lot of weight on estimates of trend GDP. That requires an estimate of trend growth and where the economy is relative to trend. The OBR has taken a gloomier view than the Treasury had previously taken of both trend growth and the starting point for where the level of GDP was relative to trend, ie the output gap. Both of these adjustments make the Chancellor's job more difficult since they mean that the effect of the cyclical starting point is smaller and the growth of GDP (and hence the tax base) will be slower.

In March the OBR estimated that the output gap was 3% of GDP in 2010q3, made up of approximately equal contributions from shortfalls in productivity (output per head), hours worked and the rate of employment. In the near term the forecast was for the output gap to widen to around 4% (mainly because GDP was estimated to have fallen 0.6% in 2010q4) and to narrow from 2012 onwards as GDP growth picked up to an above-trend rate.

Chris Giles, economics editor of the FT (and like me a convert to QE this month), has replicated the OBR's methodology and calculates that the output gap was 2.6% of GDP in 2011q2, some 1½pp below the OBR's estimate. This raises the 2011-12 structural deficit from £49bn to £61bn on Giles's calculations and leaves the Chancellor needing to reduce his borrowing by another £12bn.

The OBR, which will update its own calculations in its forecast due on 29 November, has previously noted quite how important the estimate of the output gap and the amount of spare capacity that can be brought back into play is for the public finances. It has calculated that 'roughly speaking, the output gap would have to be about 1.5% of output smaller than our central estimate ... to make it more likely than not that the mandate would be missed' (Economic & fiscal outlook, March 2011, para 5.26). Coincidentally the 1.5pp shortfall that would endanger the Chancellor's calculations is precisely in line with what Chris Giles estimates we now have.

Another advantage of a fiscal target expressed in terms of the current budget is that it excludes investment. Reducing public spending on investment is an integral part of the Government's overall strategy of reducing the cash deficit and getting net debt down as a % of GDP but it is not a part of the primary fiscal mandate. This gives the Chancellor a little more room for manoeuvre.

Under current plans net investment is projected to fall from 3.5% of GDP in 2010-11 to 1.3% by 2015-16. Some of the decline reflects the near-completion of the London Olympic Games venues but most of it is just easy pickings – it has always been easier to cut investment than spending on current goods and services (and employment). But since the economic outlook has deteriorated significantly over the last year or so, there is a good case for some extra infrastructure-type spending in the near term.

While all the talk is of a deteriorating outlook for the public finances, it is worth noting how much better the outturn has been than the Treasury and the OBR initially feared. At the height of its pessimism (the November 2009 PBR), HMT was forecasting deficits in 2009-10 and 2010-11 in excess of £175bn. Between the two years scant improvement was expected. Since then HMT and, following the May 2010 election, the OBR have repeatedly had to lower their projections. On the latest data the 2009-10 PSNB was more than £20bn down on HMT's most pessimistic estimate and, following a near-£20bn decline between 2009-10 and 2010-11, PSNB was £40bn below the Treasury's worst fears (Table 3).

Table 3 PSNB forecasts

	2009-10		2010-11	
	£bn	% GDP	£bn	% GDP
2009 PBR	177.6	12.6	176.3	12.0
2010 March Budget	166.6	11.8	163.2	11.1
2010 June Budget	154.7	11.0	149.1	10.1
2010 November EFO	156.0	11.1	148.5	10.1
2011 March Budget	156.4	11.1	145.9	9.9
Latest ONS data	154.5	11.1	136.7	9.3

Source: HMT, OBR, ONS

The PSNB undershoot owes nothing to the GDP forecast which, with the exception of the November 2010 EFO forecast (I had left by then) has changed little over the last two years (Table 4). There have been policy changes in this period, most obviously the increase in Vat to 20% at the start of this year and the £5bn+ expenditure cuts which the coalition government introduced for 2010-11, though the net effect of all the measures combined is under £7bn (on HMT arithmetic). The message is clear: growth is a major determinant of the public finances but it is not the only factor; simple forecasting errors are just as important and, over the last two years, have dwarfed the £12bn hole in the public finances that Chris Giles's research has uncovered.

Table 4: GDP

	2009-10		2010-11	
	real %	nominal £bn	real %	nominal £bn
2009 PBR	-3.5	1409	2.0	1472
2010 March Budget	-3.8	1406	2.0	1464
2010 June Budget	-3.7	1408	1.8	1474
2010 November EFO	-3.7	1403	2.5	1483
2011 March Budget	-3.6	1405	1.9	1473
Latest ONS data	-3.6	1404	1.8	1472

Source: HMT, OBR, ONS

I have suggested somewhat cynically in the past that the Treasury's, and now the OBR's, forecasting methodology, which involves a meticulous line-by-line analysis of the public finances, will be correct to

the nearest pound, conditional on a GDP forecast that everybody knows will be wrong. The outturns of the last two years suggest the opposite, that even after the most thorough and detailed approach the forecast for the public finances will be wrong even when it is conditioned on a near-perfect forecast for GDP. Draw your own policy conclusions.

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