



Perspectives by Ruth Lea

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The MPC and the Budget: marking time

This week's MPC: no change expected

This Thursday will see the announcement of the Monetary Policy Committee's policy decision for April. It is widely expected that there will be a "no change", with an unchanged Bank Rate and no extension (or withdrawal) of Quantitative Easing.

The Bank is of course concerned about the higher prices inflation. But the increasing inflation partly results from higher commodity prices mainly driven by rising demand in the commodity-hungry emerging economies about which the Bank (or indeed any other western central bank) can do nothing. And the Bank still believes that ultimately prices inflation will return to target partly reflecting the persistence of spare capacity:

"Inflation had risen to well above the 2% target as a consequence of higher energy and other commodity prices, increased VAT and the past depreciation of sterling. The Committee's judgment remained that inflation was likely to fall back in the medium term, as the impact of those factors dissipated and as a margin of spare economic capacity persisted".¹

There is therefore much reliance on "spare capacity", otherwise known as the "output gap", to offset the external shocks to inflation and squeeze inflation.² But calculating the output gap is not an exact science. The Office of Budget Responsibility (OBR) has said that estimating the output gap "is difficult because we cannot observe the supply potential of the economy directly so as to compare it to the actual level of GDP." And the Bank of England has conceded that "it was difficult to judge the extent of spare capacity in businesses". So it might be argued that relying on so nebulous and un-measurable a concept to control inflation is something of an act of faith.

But more tangibly it is clear that unemployment, as a measure of spare capacity in the labour markets, is not just high (2½ million) but rising as the economy slows. And this is before fiscal retrenchment really sets in - the pain of the fiscal measures already announced has hardly been felt yet. The slack in the labour market does seem to be restraining wage settlements and earnings growth and preventing a damaging wage-price spiral from developing.

There are of course those on the MPC who believe that policy needs to be tightened in order to bear down on inflationary pressures. In March three members of the nine-man MPC voted for an increase.³ Moreover, since the March meeting the inflationary outlook has darkened. February's CPI inflation data (4.4%) were dreadful and tensions in North Africa and the Middle East have driven oil prices higher, almost ensuring that CPI inflation will touch 5% by mid-year. All this seems to argue for an early rise in interest rates, but with signs of softening growth and weakening credit demand,⁴ the decision is not clear-cut.

The Bank is caught between Scylla and Charybdis. It is caught between rising inflation and concerns over lost anti-inflationary credibility if no action is taken, and signs of a fragile recovery facing fiscal retrenchment which would be damaged by higher interest rates. The OECD recommended recently that interest rates should be kept low, for longer than investors currently think likely, “even if headline inflation is significantly above target.”⁵

If the Bank does not change interest rates this week, then attention will switch to May. But much will then depend on the first estimate for GDP for 2011Q1, due to be released on 27 April 2011.

The March Budget: economic forecasts

The Budget of 23 March was, macro-economically, of little interest. The Chancellor commendably “stuck to his guns” in terms of fiscal tightening, in the face of a voluble opposition, protests and riots. The GDP growth forecast for 2011 was, as expected, revised down by the OBR, reflecting the poor 2010Q4 number (now revised back to a fall of 0.5% in the quarter).⁶ There were few changes to the GDP projections from 2012 to 2015. The CPI forecast for 2011 was, as also expected, revised up – but note that by 2013 inflation it is back bang on target! The forecasts for the key variables are shown in table 1 below.^{7,8}

Table 1 OBR central case forecasts, % change on year earlier (unless otherwise stated), November 2010 and March 2011

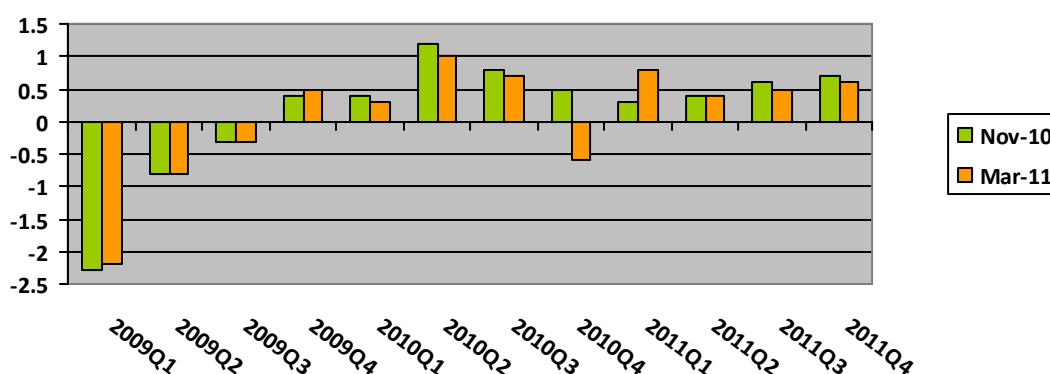
	2009	2010	2011	2012	2013	2014	2015
UK, GDP:							
November 2010	-5.0	1.8	2.1	2.6	2.9	2.8	2.7
March 2011	-4.9	1.3	1.7	2.5	2.9	2.9	2.8
Household consumption:							
November 2010	-3.3	1.1	1.3	1.5	1.9	2.1	2.2
March 2011	-3.2	0.8	0.6	1.3	1.8	2.1	2.2
GGFC:							
November 2010	1.0	1.8	-0.4	-1.3	-1.8	-2.4	-1.7
March 2011	1.0	1.0	0.8	-1.2	-1.8	-2.4	-1.8
Business investment:							
November 2010	-18.8	1.3	8.6	8.4	10.2	9.8	7.6
March 2011	-18.9	2.5	6.7	8.9	10.6	10.2	7.8
Net trade+							
November 2010	0.7	-0.9	0.7	0.9	0.7	0.6	0.5
March 2011	0.9	-0.9	0.7	1.0	0.7	0.6	0.5
CPI (Q4):							
November 2010	2.1	3.0	2.8	1.9	2.0	2.0	2.0
March 2011	2.2	3.3	4.2	2.5	2.0	2.0	2.0

Sources: OBR, *Economic and fiscal outlook*, November 2010; OBR, *Economic and fiscal outlook*, March 2011. GGFC stands for General Government Final Consumption.

+ For net trade: the contribution to GDP growth, percentage points.

But even with the downward revision to the GDP forecast for 2011 it has to be questioned whether the forecast is still too optimistic. Chart 1 shows that the OBR is expecting a quarterly bounce-back of 0.8% in 2011Q1 which may well be undershot if the distinctly patchy evidence from recent Markit PMI surveys are anything to go by. These surveys suggest that whilst manufacturing (just 12% of GDP) is doing well, services (70% of GDP) growth could be weakening.

Chart 1 Quarterly GDP forecasts (QOQ, %), November 2010 and March 2011

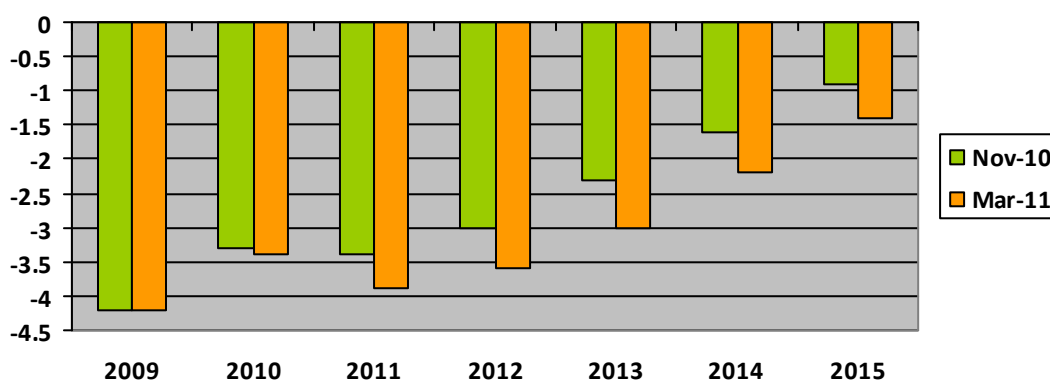


Sources: OBR, *Economic and fiscal outlook*, November 2010; OBR, *Economic and fiscal outlook*, March 2011, table 3.3.

Further out, we have concerns that the growth forecasts could also be too optimistic for 2012-15:

- The OBR is partly relying on exports growth comfortably outstripping imports growth to drive GDP forward, despite the fact that imports growth easily outstripped exports growth in 2010 (in spite of the weak pound) and the projections for growth in the EU are very subdued (less than 2% annually).
- The OBR has a very positive forecast for business investment, which they upgraded (with the exception of 2011). This is despite the fact that the OBR has increased the estimated output gap throughout the forecast period (see chart 2 below). Given the persistent, albeit shrinking, output gap over the forecast period, the buoyant business investment forecast has to be questioned.
- Another concern is that the estimates for the output gap could be too high. If this were to be the case then the OBR's forecasts could become unfeasible. The OBR is projecting trend growth of 2.35% from 2011-13 and then 2.1% from 2014-15. The remainder of the growth forecast comes therefore from the shrinking output gap. But if the output gap is significantly less than estimated, bottlenecks will be hit sooner than expected, and the OBR's growth rates may not be met.⁹

Chart 2 OBR estimates of the "output gap", November 2010 and March 2011



Sources: OBR, *Economic and fiscal outlook*, November 2010; OBR, *Economic and fiscal outlook*, March 2011, table 3.3. The output gap is expressed as actual output less trend output as a percentage of trend output (on a non-oil basis).

The March Budget: the fiscal measures and the fiscal outlook

Annex table 1 shows the major new tax measures announced in the Budget.¹⁰ The most expensive measures (to the Exchequer) were:

- The further cut in the main Corporation Tax rate.
- The further increase in personal allowances, partly offset by the switch the default indexation assumption to CPI from FY2012.

- The cancellation of some of the increases in fuel duty, offset by the unexpected increase in taxation on North Sea oil companies.

Economically the Budget was fiscally fairly neutral. The OBR's forecasts for the key fiscal aggregates are shown in table 2.

Table 2 OBR's forecasts, key fiscal aggregates, November 2010 and March 2011

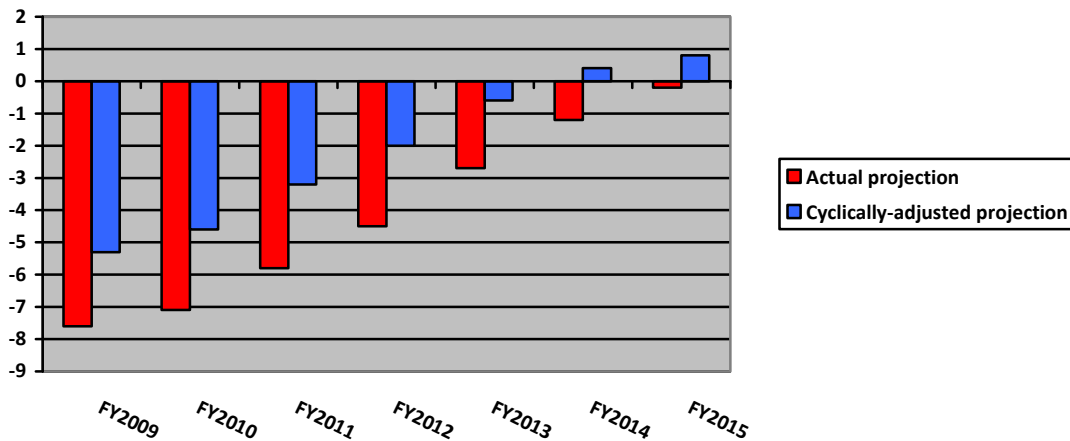
	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015
PSNB (£bn):							
November 2010	156.0	148.5	117	91	60	35	18
March 2011	156.4	145.9	122	101	70	46	29
March -November	0.4	-2.6	5	10	10	11	11
Current surplus (% GDP):							
Actual:							
November 2010	-7.6	-7.2	-5.6	-3.9	-2.1	-0.6	0.3
March 2011	-7.6	-7.1	-5.8	-4.5	-2.7	-1.2	-0.2
Cyclically-adjusted:							
November 2010	-5.3	-4.7	-3.3	-1.8	-0.5	0.5	0.9
March 2011	-5.3	-4.6	-3.2	-2.0	-0.6	0.4	0.8
PSND (£bn):							
November 2010	777.2	922.9	1052	1157	1232	1284	1320
March 2011	759.5	909.2	1046	1164	1251	1314	1359
PSND (% GDP):							
November 2010	53.5	60.8	66.3	69.1	69.7	68.8	67.2
March 2011	52.7	60.3	66.1	69.7	70.9	70.5	69.1

Sources: OBR, *Economic and fiscal outlook*, November 2010; OBR, *Economic and fiscal outlook*, March 2011. PSNB=Public Sector Net Borrowing; PSND=Public Sector Net Debt, excluding financial interventions. Fiscal targets met are in bold.

The key points to note are:

- Reflecting the poorer GDP outlook, the projections for Public Sector Net Borrowing (PSNB) are worse. Cumulatively there is over £45bn of extra borrowing from FY2011 to FY2015.
- Also reflecting the poorer GDP outlook, the projections for the **actual current surplus** are worse. Instead of being in surplus by FY2015, the current balance now shows a small deficit for FY2015.
- But the deterioration in the **cyclically-adjusted current surplus** is not nearly so marked because of the offsetting effects on the current surplus of the changes to the output gap forecasts. The difference between the actual projections and the cyclically-adjusted projections are shown in chart 3 for the March forecast.
- This outcome has major implications for the Chancellor's ability to meet his fiscal mandate, which is couched in terms of the **cyclically-adjusted current surplus** and not the actual current surplus. The mandate is "to achieve a cyclically-adjusted current balance by the end of the rolling, 5-year forecast period (FY2015)".¹¹ If growth falters then, on this basis, the target wouldn't necessarily be vulnerable. Meeting the target (or not) is virtually immune (in theory) to growth shortfalls. This is one reason why the Chancellor's fiscal plans could be less binding than they should be. It should also be noted that, if growth did falter badly and the actual borrowing didn't fall as projected then the ratings agencies could well take another hard look at Britain's AAA rating. The target may be clever – but not that clever.
- This fiscal mandate was met by FY2014 in both the November and March forecasts.
- Public Sector Net Debt (PSND), though starting from a lower base owing to data revisions, ended higher in March than in November reflecting the additional borrowing.
- The Chancellor's supplementary "second target" is for the PSND (as a % of GDP) "to be falling at the fixed date of FY2015".¹² This was met by FY2014 in both the November and March forecasts.

Chart 3: Current surplus, OBR projections, March 2011



Source: OBR, *Economic and fiscal outlook*, March 2011.

Plan for growth

Several of the Budget's policy announcements were aimed at stimulating economic growth in line with the intentions laid out in the Government's *Growth Review*.¹³ The Budget, and the accompanying *Plan for Growth*,¹⁴ listed the Government's enacted policies and proposals under the 4 objectives:

- To create the most competitive tax system in the G20.
- To make the UK the best place in Europe to start, finance and grow a business.
- To encourage investment and exports as a route to a more balanced economy.
- To create a more educated workforce that is the most flexible in Europe.

The details are contained in annex table 2 and we won't repeat them here. Suffice to say that, given the fiscal and political restraints on the Chancellor, there were some welcome decisions, especially in taxation and finance. But the deregulatory measures, though steps in the right direction, barely touch on the increase in regulatory costs since 1997, the policies on transport and energy infrastructure are quite inadequate (unfortunately, disproportionate cuts are being made to public sector capital spending), and the Enterprise Zones may only succeed in distributing rather than creating growth. We will return to the issue of growth in future Perspectives.

References

1. Bank of England, "Minutes of the Monetary Policy Committee meeting, 9 and 10 March 2011", 23 March 2011.
2. The output gap is expressed as actual output less trend output as a percentage of trend output (on a non-oil basis).
3. OECD, *Economic Surveys, United Kingdom*, March 2011, www.oecd.org.uk.
4. The 3 were Andrew Sentence (arch hawk, due to retire in May and be replaced by Ben Broadbent), Spencer Dale (the Bank's Chief Economist) and Martin Weale.
5. Bank of England, *Credit Conditions Survey, 2011Q1*, 31 March 2011.
6. ONS, "Quarterly National Accounts, 2010Q4", 29 March 2011.
7. OBR, *Economic and fiscal outlook*, November 2010
8. OBR, *Economic and fiscal outlook*, March 2011, Cm8036
9. *FT*, "Doubt cast on growth forecast", 25 March 2011.
10. HM Treasury, *Budget 2011*, March 2011, HC836
11. See HM Treasury, *Budget 2010*, HC61, June 2010.
12. See HM Treasury, *Budget 2010*, HC61, June 2010.
13. HM Treasury and BIS, *The path to strong, sustainable and balanced growth*, November 2010.
14. HM Treasury & BIS, *The Plan for Growth*, March 2011

15. Ruth Lea, "Britain needs a radical pro-growth strategy", Arbuthnot Banking Group, 7 February 2011.

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