Group Economics

Ulster Bank

"The Comeback Country" or Brokeback Debt Mountain?

Contact: Richard Ramsey
Chief Economist, Northern Ireland
02890 276354 or 07881 930955

Richard.ramsey@ulsterbankcm.com
www.ulstereconomix.com
Twitter @UB_Economics

This is an extended version of an article appearing in today's Belfast Telegraph Business Month published 13th April 2015

Last month the Chancellor of the Exchequer delivered his sixth and perhaps final Budget. It was his most polished delivery to date. After five years of austerity, anyone listening to the 8,000 word speech would have felt uplifted. *"Today, I report on a Britain that is growing, creating jobs and paying its way. We took difficult decisions in the teeth of opposition and it worked - Britain is walking tall again."* The Chancellor highlighted that last year the UK expanded at a faster rate than any major advanced economy and *"more people have jobs in Britain than ever before".* Meanwhile the UK's much maligned "deficit" as a share of national income has halved over the last five years.

The text exuded confidence, positivity and ambition. The latter was summed up by the Chancellor setting a lofty goal for Britain to become the most prosperous major economy in the world, with that prosperity widely shared. The overall feel good factor was supplemented with a liberal sprinkling of gimmicks and giveaways (*e.g. cuts in beer duty)*. These low impact media friendly initiatives attracted the attention away from the higher impact, less media friendly, issues that didn't feature in the speech.

Osborne's predecessor, Gordon Brown, was famed for his Gatling gun-style delivery of statistics. Instead, Osborne has developed a style of rattling off short bursts of positive bullet points. Indeed, these reached a crescendo at the end of his Budget speech. "The deficit down, Growth up. Jobs up. Living standards on the rise. Britain on the rise. This is the Budget for Britain. The Comeback country".

Even economists were briefly on a high at the end of the latest Budget. This positivity was followed up with what the Chancellor dubbed a "hat trick of good news about the British economy". This was reference to new data showing economic growth was revised up, consumer confidence was up and living standards were now officially higher than at the last election.

In light of the above, you would be forgiven for thinking that all things in the UK economy are improving. However, a quick look at the public finances and the associated economic forecasts swiftly act as the smelling salts of reality. Notwithstanding the significant progress that has been made in recent years, huge economic and fiscal challenges remain.

One deficit may be falling, however, another – the current account deficit - is rising. A couple of weeks ago it was revealed that the UK's current account deficit for 2014, at 5.5% of GDP, represented the largest deficit since records began in 1948. This means the UK's businesses, government and individuals are importing more goods, services and capital than they export. This is not quite the "paying its way" that the Chancellor referred to in his opening remarks. Such a deficit could start to attract negative sentiment towards sterling. Indeed, Minutes from the Bank of England's Financial Policy Committee (FPC) meeting on 24th March revealed that members were worried about Britain's current account deficit.

The word 'productivity' was not even mentioned in last month's Budget speech. However, it remains critical to the health of the UK economy and its public finances. Unfortunately the headline on the 1st April that *"UK productivity weakness worsening"* was not an April Fools' joke. Output per hour worked in 2014 was broadly unchanged relative to 2013, and slightly lower than in 2007. The official statistical release noted that *"the absence of productivity growth in the seven years since 2007 is unprecedented in the post-war period".* Rising economic output is only coming about from additional workers employed for longer hours. Productivity was the central plank of the Labour government's economic strategy from 1998-2010. Tackling the productivity challenge is likely to be a top priority after the General Election.

The Office for Budget Responsibility's fiscal plans laid out last month assume that labour productivity growth returns and averages over 2% p.a. for the next the 5 years. There is a significant risk that this, and the associated strong rates of average earnings growth (3.5% p.a.), simply don't materialise. Without productivity growth there will be no meaningful rise in wages and living standards. In turn, rising incomes are required to boost revenues and repair the public finances. If productivity growth doesn't return the UK public finances will deteriorate further necessitating a combination of additional expenditure cuts, tax rises and borrowing.
The UK's medium term fiscal outlook is still pretty dire even with some optimistic assumptions about productivity. Public sector borrowing is falling. Nevertheless, the government still has to borrow £75bn for 2015/16 alone to balance the books between revenue and expenditure. A surplus of revenue over expenditure does not materialise until 2018/19. Meanwhile the UK's deficit expressed as a share of GDP is one of the highest in the developed world. At 5% in 2014/15 it is only set to fall below the EU Stability & Growth Pact threshold of 3% in 2016/17.

The UK's overall stock of debt *(or the sum of all the deficits)* expressed as a share of national income peaks at 80.4% in 2014/15. It only starts falling in 2015/16 (80.2%) due to the sell-off of a number of state assets. By 2019/20 the UK debt to GDP ratio will still be at an uncomfortably high 71.6%. Looking at the overall stock of public sector net debt, this is set to breach the £1.5 trillion mark later this year and £1.6 trillion by 2017/18. This is perhaps not quite "The Comeback Country" the Chancellor was referring to.

Outside of public debt, private debt, particularly amongst households, remains high. UK household debt as a share of income has been falling from 2008-2013. However, it has started to rise again and is set to return to its 2008 peak of 169% in four years time. To date, the economic recovery has been facilitated by interest rates being kept at record lows. These emergency rates will not last forever.

While the pace of austerity appears to have eased lately, people should be under no illusion – the UK faces a second Parliament of fiscal pain. Day-to-day public spending is potentially facing cuts in 2016/17 and 2017/18 that are more than twice what has been experienced on average over the last 5 years. The 2015 General Election has acted as a speed camera for the pace of austerity, and after May the austerity accelerator will have a heavy right foot on it again. We just don't know who the driver will be. It is likely that the most unpalatable medicine will be delivered at the start of the fixed 5 year Parliament with a potential "Emergency Budget II" in June.

Irrespective of which parties form the next UK Government they all face the same fiscal and economic challenges. While we can be certain that the politics of austerity will be with us over the next Parliament the only uncertainty is what form that austerity will take.

Richard Ramsey
3rd April 2015

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