UK Flash

UK: Osborne's plans: To meet fiscal targets later, as growth will be lower

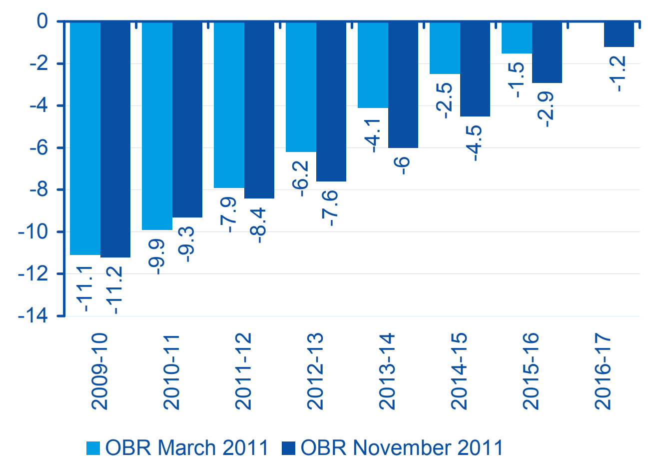
The UK economy requires additional public financing as economic prospects deteriorate

Chancellor George Osborne has presented the Autumn Statement, which is a review of the economy, government spending and taxes. As the growth projections for the medium term have been revised downwards, due to the gloomier international environment and to lower productivity growth, the UK will not be able to fulfil its previous deficit targets. Instead of applying further budget cuts to maintain those targets, the government has decided to apply small additional cuts and thus meet the targets later. The redistribution of spending will be achieved mainly through more infrastructure outlays, but they are unlikely to foster productivity growth in the short term. A measure with small budgetary effects but still relevant for the banking sector is the rise of the bank levy tax from 0.075% to 0.088% of banks' balance sheets.

- **Gloomier prospects on economic activity**
  The Office of Budget Responsibility (OBR) has revised substantially the growth outlook for the years ahead, to 0.9% this year instead of 1.7% and to 0.7% for 2012, 1.8 pp points below its previous forecast. This implies additional financing requirements compared to the ones presented in Spring, up to a total of 111 bn GBP in the next 5 fiscal years. The deficit this year will be at 127 bn GBP, falling progressively to 79 bn GBP by 2014-15 and to 24 bn GBP by 2016-17. Chart 1 shows the revisions in terms of GDP, which implies substantially higher figures for the whole projection period.

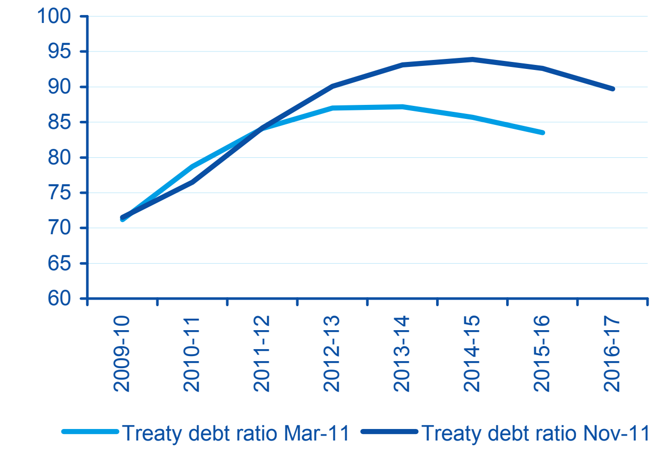
- **The structural component of the deficit is now higher than previously estimated**
  A closer look to deficit components shows that, in spite of the revision in growth prospects, the cyclical part is not worsening accordingly, as the OBR has revised downwards potential output and therefore the output gap is smaller, while the projection of interest payments has not changed as interest rates remained under control, in spite of the financial market turmoil in the Euro zone. This implies that the structural deficit is bigger than originally estimated, and therefore the need of fiscal adjustment is higher or will take longer. The UK government has chosen not to stick to the targets and postpone them by a couple of years. The statement also revised projected **debt levels, which will peak in 2014-15** at 93.9% of GDP, using the Maastricht definition of deficit (78% according to the national definition).

Chart 1
UK: OBR Public Deficit forecast (% of GDP)



Source: HM Treasury, OBR and BBVA Research

Chart 2
UK: OBR Public Debt forecast (% of GDP. Maastricht definition)



Source: HM Treasury, OBR and BBVA Research:

- ## The worsened outlook is accompanied with a bunch of measures re-shuffling spending to boost economic growth

The chancellor announced a bunch of new measures so as to boost economic activity. The plan lies on additional saving measures with respect to April's budget, but the savings, instead of reducing deficit, will be used to tackle some of the economic weaknesses of the British economy: credit constraints of small enterprises, investment in infrastructure, regional growth, education and youth unemployment.

- ## Additional saving measures…

Public wages: The wage freeze will come to an end, but the increase will be capped to a 1% in the next two years**. This policy will save over 1 bn GBP in current spending by 2014-15.**

Other spending measures: The indexation on child tax will be removed; according to the HM Treasury this will save almost 5 bn GBP.

Pensions: The pension age rise to 67 is brought forward to 2026-2028, in response to demographic changes and with the aim to save £59bn, coming in between 2026-27 and 2035-2036. According to the original plan, this measure would take place between 2034 and 2036. This does not have effects on deficit or debt figures in the short to medium term.

- ## … accompanied with measures aimed to promote growth

Credit easing: Credit easing programme to underwrite up to 40bn GBP in low-interest loans to small and medium-sized firms, and 1bn GBP finance to business partnerships to help raise money for medium-sized firms.

Education: 1.2 bn GBP will be devoted to education, of which approximately 600mn GBP will be used to create 40,000 new primary school places, while the rest will fund 100 new free schools.

Infrastructure: 5bn GBP plan to improve national infrastructure over three years.

Housing: The government will help fund new mortgages for first-time buyers, with families in social housing getting discounts of up to 50%.

Table 1
Total autumn policy decisions (million GBP)

		2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	TOTAL	as % of GDP
		-35	**-55**	**-135**	**220**	**8310**	**15120**	**23425**	**1.5**
Total tax policy decisions		**-35**	**-305**	**145**	**130**	**20**	**15**	-30	0.0
Total spending decissions		**0**	**250**	**-280**	**90**	**8290**	**15105**	23455	1.5
of which spending saving:	Child tax credit: remove over indexation	0	975	955	1020	995	995	4940	0.3
	Working tax credit: freeze	0	265	290	275	275	280	1385	0.1
	Public sector pay restraint	0	75	600	1075			1750	0.1
	ODA to meet 0.7% target	0	380	265	525			1170	0.1
of which additional spending:	Infrastructure spending (new funding)	0	-760	-1785	-2145			-4690	-0.3
	Youth contract	0	-365	-310	-265			-940	-0.1
	Early Years childcare	0	-85	-240	-455			-780	0.0
	Rail fares	0	-105	-105	-135			-345	0.0
	Carbon price floor	0	0	-40	-60			-100	0.0
	Science	0	-30	-30	-30			-90	0.0
	Reserve reprofiling	0	100	330	500			930	0.1

Source: HM Treasury Autumn Statement 2011 and BBVA Research

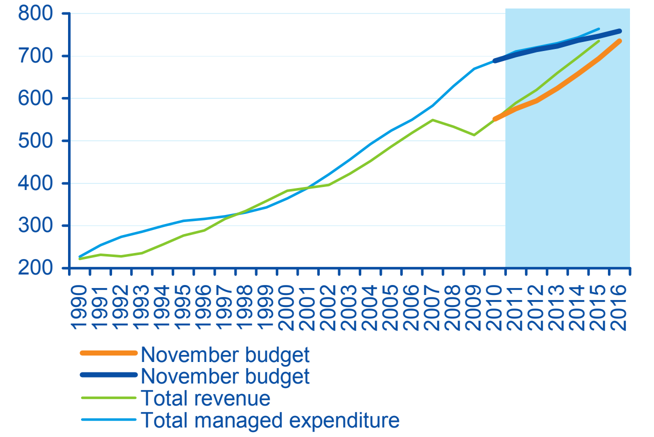
Other small measures...

The planned increase by 3% in petrol duty, due to come into effect in January 2012, will be deferred to August 2012. A cap will be placed on rail fare hikes to 1% above inflation next year, rather than 3%, which would cost the Treasury £130m.

The annual **levy on the banking sector will be increased** from a projected 0.075% of banks' balance sheets to 0.088%, to ensure that the government collects the targeted £2.5bn.

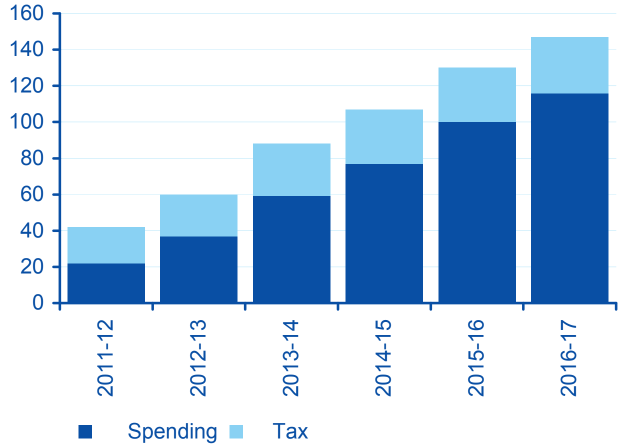
On employment, a youth contract will be offered to young people unemployed for more than three months, totalling £940mn over the Spending Review 2010 period.

Chart 3
UK: Receipts and expenditure (bn GBP)



Source: ONS, OBR and BBVA Research

Chart 4
UK: Total discretionary consolidation (in bn GBP)



Source: HM Treasury, OBR and BBVA Research:

Miguel Jiménez
mjimenezg@bbva.com
+34 91 537 37 76

Agustín García Serrador
agustin.garcia@bbva.com
+34 91 374 79 38

Elvira Prades
elvira.prades@bbva.com
+34 91 537 79 36

Katerina Deligiannidou
aikaterini.deligiannidou@bbva.com
+34 91 537 79 38

BBVA RESEARCH | Castellana 81, Floor 7, 28046 Madrid | Tel.: +34 91 374 60 00 | www.bbvaresearch.com

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