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BRIEFING

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WHEN REBALANCING GOES BAD

WHY THE CHANCELLOR'S DEFICIT REDUCTION PLAN THREATENS THE ECONOMIC RECOVERY

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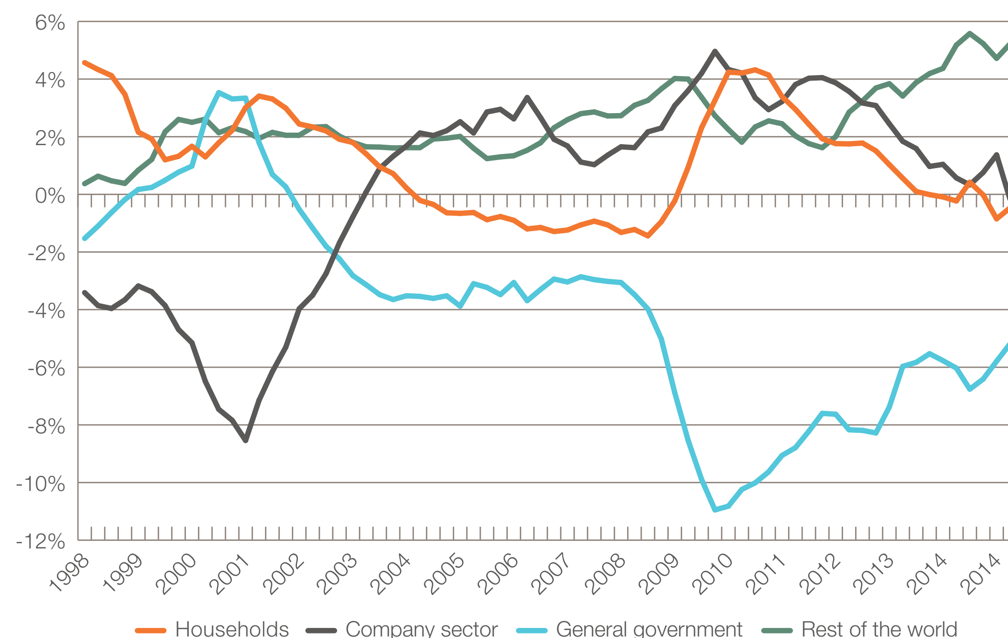
IDEAS to
CHANGE OPINIONS

The headline figures in the Office for Budget Responsibility's (OBR's) latest forecasts (OBR 2014), which were published alongside the chancellor's Autumn Statement announcement, suggest a benign outcome for the UK economy over the next five years: steady growth and low inflation. The details, however, reveal weaknesses that suggest that if the next government pursues the chancellor's plan to eliminate the fiscal deficit by 2018/19 then it will risk derailing the economic recovery. Here's why.

The economy is made up of four sectors: households, companies, government and the overseas (import/export, or 'rest of the world') sector. The outgoings of any one sector are reflected in the income of the others. Thus, taxes paid by households are income for the government and the money they spend on goods and services are income for UK companies or for the overseas sector if they are imported. This means total spending across the four sectors must equal total income. It also means that if one sector has net savings (its income is greater than its spending), then the opposite must be true for at least one other sector, and that the balance of net savings (positive and negative) across the four sectors must sum to zero.

These net savings balances are not just interesting for their arithmetical properties, however. Their development over time tells us a lot about the economy. Here is the UK's track record over the last 17 years.

Figure 1
UK financial balances by sector (% of GDP), 1998–2014



Source: ONS Quarterly National Accounts, Q2 2014 (ONS 2014)
Note: The chart shows four-quarter moving averages to smooth out volatility in the data.

There are a number of points of interest:

- The household sector shifted gradually from being a net saver to a net borrower, starting in around 2001. When the financial crisis hit, it shifted dramatically back to being a net saver again, but this position has subsequently been eroded.

- The big shift in the company sector's position came in the early 2000s, when it went from being a net borrower to a net saver, a position it has sustained for over a decade (although the last quarterly figure, for the second quarter of 2014, showed a tiny deficit).
- The government had a deficit of 3 to 4 per cent of GDP in the five years leading up to the financial crisis. This deficit trebled as a result of the subsequent recession. It has been reduced over the last five years, somewhat unevenly, but remains relatively large.
- The overseas sector has been in surplus throughout the period. What this means is that the rest of the world's income from the UK (our imports) has been greater than our income from the rest of the world (our exports). Recently, this gap has been increasing, and is now at its highest level during this period.
- The last time the government sector was in balance (in 2001/02) the corporate sector had a large deficit while the household and overseas sectors were in surplus.

Shifts in these balances help us to understand what calls to rebalance the economy mean in practice. If the government wants to further reduce its deficit, one or more of the other sectors will have to reduce its surplus or move into (larger) deficit. One possibility is for households to borrow more (or equivalently, to run down their savings). But UK households already have one of the highest debt-to-income ratios in the world and their borrowing tends to push up house prices, creating the potential for a subsequent price fall. Better options, therefore, are a shift into deficit for the company sector, as a result of strong business investment spending, and a reduction in the surplus of the overseas sector, achieved through stronger UK exports.

In the past few years, unfortunately, the UK has scored only one out of three on the rebalancing front. Business investment spending has accelerated in recent quarters and was up 11 per cent over the year to the second quarter of 2014. As a result, the company sector's surplus has contracted, offsetting some of the reduction in the government's deficit.

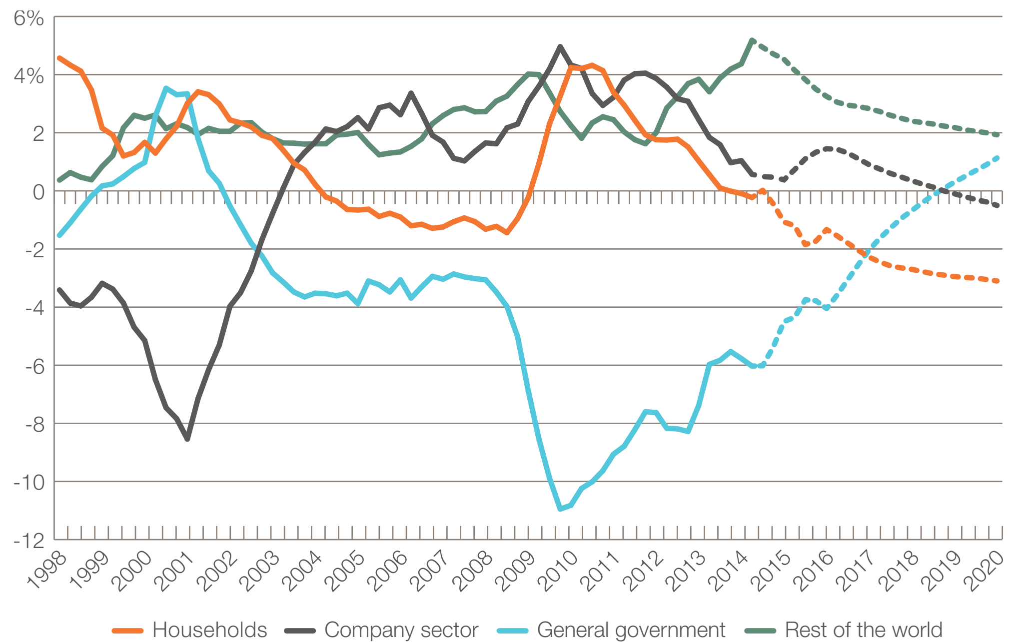
But over the last three years, the overseas surplus has got bigger. Imports have increased only moderately in real terms over this period, but exports are actually lower than they were in the second quarter of 2011. The hope was that the fall in sterling's exchange rate that occurred during the financial crisis would lead to an improvement in the UK's trade position. In fact, the reverse has happened. And the household sector has again moved into deficit, spending more than its income and so running down savings or taking on debt.

So much for the past, what about the next five years? Is there any prospect of the economic recovery becoming better balanced? Not much according to the OBR's latest economic forecasts (see figure 2).

These forecasts show the government deficit being eliminated by 2018/19 – in line with the chancellor's pledge. A small part of this move is offset by a shift from surplus to deficit for the company sector. But the bulk of the counterbalancing adjustment is shared equally by a fall in the overseas surplus and an increased deficit for the household sector.

The OBR expects UK exports to increase at an annual rate of 4.2 per cent between 2014 and 2019, despite worries about the economic outlook for Europe (which receives half of the UK's exports), the recent appreciation of sterling and the poor performance of the last three years. Meanwhile, extraordinarily, the OBR thinks that by 2019 the household sector will have a financial deficit more than twice as big as it did in 2007/08 when the financial crisis hit. Compared to 2001/02, when the government last had a zero balance, the household and company sectors will have swapped positions.

Figure 2
UK financial balances by sector (% of GDP), actual and forecast to 2019



Source: ONS Quarterly National Accounts, Q2 2014 (ONS 2014) and OBR Economic and fiscal outlook – December 2014 (OBR 2014), economy supplementary tables
Note: The chart shows four-quarter moving averages to smooth out volatility in the data.

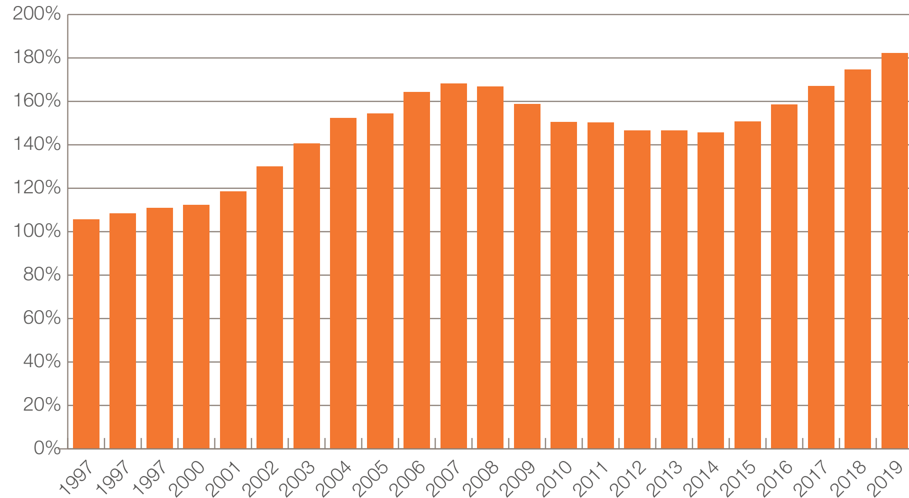
This increase in the household deficit could result from a further rundown of savings, but it is likely that we are already approaching the limit of what this might achieve. Instead, the OBR thinks the household debt-to-income ratio will rise to new highs. A lot of this increase in debt is secured (largely mortgage) lending, but the OBR also expects other liabilities to increase by 78 per cent over the next five years (see figure 3).

If the OBR is right, the economic recovery will not be driven by investment and exports but by households taking on more debt. The period from 2008 to 2019 is characterised by two shifts in debt: the first was from households to government, and the second will be from government back to households again.

If this seems implausible, then it reveals the limits of this type of analysis. The OBR is constrained by the chancellor's fiscal plans to forecast that the government deficit is eliminated, and so it has to make projections for the balances of the other sectors that are consistent with this outcome. It already has an optimistic forecast for exports, and arguably for business investment too (it is expected to increase at an annual rate of 6.7 per cent in real terms between 2014 and 2019). So the household sector has to take the strain.

If the OBR instead started with a projection of the most likely outcome for the household sector's financial balance and added in its current forecasts for the company and overseas sectors, leaving the government sector as the residual, then it would end up with a forecast for much more modest reduction in the government deficit.

Figure 3
Household debt-to-income ratio, actual and projected, 1997–2019



Source: ONS Quarterly National Accounts, Q2 2014 (ONS 2014) and OBR Economic and fiscal outlook – December 2014 (OBR 2014), economy supplementary tables

An alternative way of looking at this is that it suggests the chancellor's timetable for eliminating the government deficit is too short. The pace of deficit reduction should be sensitive to the ability of the rest of the economy to adjust to it. If the next government insists on trying to stick to the timetable for deficit reduction set out in this latest autumn statement, then the risk is that the adjustment will take place in the other sectors, through weak growth. The household deficit will increase due to lower incomes, not higher spending; the company sector surplus will move into deficit due to poorer profits, not higher investment spending; and the surplus of the overseas sector will shrink due to weak imports as a result of a weak UK economy, not strong exports. And weak growth, in turn, will blow the government's deficit elimination plan off course. This is precisely what happened in 2011 and 2012, and it could happen again in the first half of the next parliament.

If the next government tries to follow the chancellor's stated deficit reduction path, one of two outcomes is likely. Either it will succeed in the short term only because the household sector takes on debt at a faster pace than it did before the financial crisis – with the associated risk of a house-price bubble and burst, followed by a recession and ultimately a new blow-out in the government deficit. Or it will fail even in the short term because the necessary adjustment in other sectors occurs only through weaker growth. Neither of these appears to be a sustainable basis for economic recovery.

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