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UK: FOUR KEY POINTS ON THE AUTUMN BUDGET

Berenberg Macro Flash

1. POLITICAL BACKDROP – BREXIT, CORBYN, HAMMOND UNDER THREAT

By getting public finances in order faster, Chancellor Philip Hammond could use the upcoming budget to demonstrate that the UK is committed to solving its problems. A clear signal that the UK is pursuing sound economic policies would be well timed. Although Brexit uncertainty hangs over the UK's long-term outlook, the economy continues to hold up well. Healthy tax receipts so far this year will likely lower projected borrowing modestly in the near term. The Chancellor ought to use this boost to finances to make a stronger commitment to budgetary discipline. Unfortunately, the political barriers between Hammond and this sensible route forward are probably too large.

With Brexit tensions within the different factions of government running high, and the Conservative-DUP alliance operating with only a slim working majority, Hammond would run the risk of a small group of MPs revolting against accelerated cuts. A forced U-turn on the back of such a revolt would add further embarrassment to his already Brexit-beaten government. Meanwhile, opposition Labour under far-left leader Jeremy Corbyn are leading the Conservatives by c2 percentage points in the polls. Moreover, with Hammond's own future as Chancellor in question, he is likely to pursue policies that could generate support for him personally. Thus the most likely outcome on Wednesday is that Hammond uses any extra wiggle room to offer a few sweeteners to try and draw key groups of swing voters towards the Conservatives.

2. ECONOMIC BACKROP – POSSIBLE PRODUCTIVITY DOWNGRADES COULD PUSH UP FUTURE BORROWING

Alongside the Chancellor's updated plans for government spending and taxation, the UK's independent budget watchdog, the Office of Budget Responsibility (OBR), will publish updated economic forecasts. The OBR is likely to sharply revise down its 2017 real GDP growth projection from 2.0% to 1.6%, which is in line with the Bank of England's (BoE) and our projection, while keeping its forecasts to 2019 unchanged at c1.6% (see Table 1). Further out, however, whether or not the OBR continues to expect real GDP growth to rise towards 2.0% depends on its updated projections for productivity growth.

Back in March, the OBR had forecast that growth in trend productivity would return towards its historical average of 2% by the end of the forecast horizon. But then, more recently in October, the OBR announced that it would likely downgrade its productivity forecast at this round. Keep in mind the BoE recently revised down its estimate for trend productivity growth to 1.5%. The outlook for productivity growth will be the most important, yet most uncertain, factor that underpins the updated projections for future taxation and spending plans.

By reducing projected growth rates for wages and profits, the lower outlook for trend productivity growth could steepen the fiscal hill Hammond faces. On its own, this would lower long-run projections of future tax receipts and raise borrowing. However, it must be set against the likely sizeable downward revisions to the OBR's outlook for unemployment. As Table 2 shows, the March OBR estimates set unemployment almost a full percentage point above the BoE's and our own estimates. A stronger employment outlook would raise expected income tax and lower spending on unemployment benefits. How the balance of these positive and negative factors, plus likely downward revisions to borrowing costs despite the recent rate hike, impacts the long-run budget forecast will set the tone for Hammond's longer-run policy decisions.

Table 1. Real GDP (% change yoy)	2016	2017	2018	2019	2020	2021
OBR (March 2017)	1.8	2.0	1.6	1.7	1.9	2.0
Bank of England (Nov 2017)	1.8	1.6	1.6	1.7	1.7	
Berenberg	1.8	1.6	1.6	1.7		

Table 2. Unemployment rate %	2016	2017	2018	2019	2020	2021
OBR (March 2017)	4.9	4.9	5.1	5.2	5.2	5.1
Bank of England (Nov 2017)	4.9	4.2	4.2	4.2	4.3	
Berenberg	4.9	4.4	4.3	4.3		

2. GRADUAL AUSTERITY WILL REMAIN THE MAJOR THEME

Stable – albeit unexciting – growth at full employment does not warrant a major fiscal intervention. The mostly structural fiscal deficit will be just shy of 3% this year – down from 8% in 2009. The Chancellor's key priority, therefore, remains to balance the budget in the most efficient and growth-friendly way in light of the looming self-induced supply-side shock from Brexit. Through less trade, investment and migration with its biggest market, the EU, we expect Brexit to reduce UK trend growth to 1.8% from 2.2% (or 1.5% in case of a hard Brexit). Since becoming Chancellor a little over a year ago, Hammond has promised to get the headline deficit below 2.0% by 2020-21 and balance the budget by the middle of the next decade. We expect him to stick to these targets.

As we do not expect the budget or economic forecasts to change too dramatically over the next five years, we expect the OBR to continue to project a gradual decline in the deficit as a percentage of GDP and total debt as a percentage of GDP to peak, either this year or next, before trending down thereafter (see Table 3 for the OBR's March projections). Any policy changes will remain in line with the broad framework for fiscal policy in place since the Conservatives came into power in 2010. That is, a gradual fiscal tightening from three main areas: (1) discretionary tax changes to raise revenues, (2) measures to reduce working-age benefits, and (3) reduced spending on public services. We will take any big announcements linked to capital spending with a lot of caution. The government has a habit of rehashing headline sums in these politically sensitive areas. All too often, they are simply old policies re-announced and thus rarely reflect additional spending.

Possible announcements could include the following on:

- Business: re-announce target to reduce corporation tax to 17% by 2020 and a revision of business rates;
- Housing: to remove stamp duty for first-time buyers and re-announce an extra £10bn for Help to Buy to extend it to 2021;
- Income tax: to continue to commit to raising the personal allowance on income tax to £12,500 by 2020 while raising the higher rate (40% tax) threshold to £50,000 by the same deadline;
- National insurance: review and simplification;
- Fuel: increase taxation and levies linked to diesel cars, which might include higher duty on diesel fuel to enable a cut on petrol duty;
- Public sector pay: lift the 1% pay growth cap for some workers;
- Student loans: review and simplify how interest payments are calculated.

Table 3. OBR budget forecasts (March 2017)

	Per cent of GDP						
	Outturn	Forecast					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
Revenue and spending							
Public sector current receipts	36.2	36.7	36.7	37.1	37.2	37.1	37.2
Total managed expenditure	40.0	39.3	39.6	39.0	38.2	38.0	37.9
Deficit: Current and previous fiscal mandate measures							
Cyclically adjusted net borrowing	3.6	2.6	2.9	1.9	0.9	0.9	0.7
Public sector net borrowing	3.8	2.6	2.9	1.9	1.0	0.9	0.7
Cyclically adjusted current budget deficit	1.9	0.8	0.9	-0.1	-1.1	-1.4	-1.6
Debt: Supplementary target							
Public sector net debt	83.6	86.6	88.8	88.5	86.9	83.0	79.8
	£ billion						
Revenue and spending							
Public sector current receipts	682.3	721.1	744.2	776.4	806.5	834.8	869.5
Total managed expenditure	753.9	772.8	802.4	817.2	827.9	855.4	886.4
Deficit: Current and previous fiscal mandate measures							
Cyclically adjusted net borrowing	67.4	51.8	59.3	40.4	19.8	19.3	16.5
Public sector net borrowing	71.7	51.7	58.3	40.8	21.4	20.6	16.8
Cyclically adjusted current budget deficit	35.8	15.2	19.3	-1.5	-22.9	-30.9	-37.5
Debt: Supplementary target							
Public sector net debt	1606	1730	1830	1885	1918	1904	1904

Source: Office of Budget Responsibility: Economic and fiscal outlook (March 2017), table 1.2, p. 11.

3. THE HOUSING MARKET IS LIKELY TO BE THE CHANCELLOR'S TOP PRIORITY

The housing market is the Achilles' heel of the UK economy. The decades-long deficit in annual house building has contributed significantly to the rise in household debt and wealth inequality. The long-run benefits from building more houses to limit future price growth are significant. However, governments have traditionally opted to stimulate demand through policies such as Help to Buy – the mortgage subsidy scheme – rather than tackle the root causes of the supply deficit: poor planning laws, labour shortages and other regulatory problems.

While Hammond recently acknowledged that supply is the major issue, saying "it is certainly not just about pouring money in, because if you pour money in without fixing the other elements of supply, you will simply create more house price inflation which will make things worse, not better", we are pessimistic about his chances of providing a long-term solution in light of the political challenges facing the sector. Expect a basket of tax, training and supply-side measures that will go some way to unlocking more supply, but that will ultimately fall short of what is need to provide a lasting solution.

The critical problem remains that, in the short term, only would-be homeowners are set to benefit from a rise in housing supply and fall in prices. Because of the negative impact on the economy from the deteriorative effects on household balance sheets and house-builder profits from lower house prices, the government, existing homeowners and some house builders might suffer initially from a supply-driven house price correction. As a result, despite the major long-term economic benefits of solving the UK's housing shortage – such as limiting future debt growth linked to mortgages and increasing wealth among the young – the initial costs are likely to be too high for the current government to face head on.

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