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UK: PRODUCTIVITY DOWNGRADES DOMINATE THE FISCAL OUTLOOK

Berenberg Macro Flash

THE UK IS GETTING OUT OF SHAPE FAST ACCORDING TO THE OBR

The overriding theme in today's Autumn Budget was the significant downgrade to the estimate of UK long-run productivity growth by the Office of Budget Responsibility (OBR), the UK's independent fiscal watch-dog. Despite a modest easing of the pace of austerity, the OBR reduced its forecasts for real GDP growth over the next five years by a cumulative 3% while reducing its long-run estimate of productivity growth from 2.0% to 1.3%. This significant downgrade comes against accelerating growth in the UK's major trading partners, the US and the EU, and the strongest sustained pick-up in global demand in a decade. For a medium-sized open economy whose fortunes are strongly linked to its close neighbours, such a large downgrade is highly unusual and reflects the seriousness of the economic challenges facing the Brexit-stricken UK and the uncertainty about what is around the corner.

But have the OBR overdone it? Possibly, yes. Relative to both ours and the BoE's forecasts for real GDP growth, the OBR is lower by an average of 0.3pts per year to 2020 – Table 1. In terms of productivity growth, the BoE estimate trend productivity growth at 1.5%, above the OBR's estimate of 1.3%. It is possible that, after consistently overestimating the UK's growth prospects in the past, the OBR have gone a little too far with the downgrades this time around.

Beyond the next couple of years, the long-term economic and fiscal outlook will be heavily influenced by the post-Brexit relationship between the UK and the EU. In our Brexit base case, where the UK and the EU agree a trade deal covering most goods and some non-financial services, Brexit could reduce the UK's long-term potential growth rate to 1.8% from 2.2%, or 1.5% in case of a no deal hard Brexit. This is slightly more optimistic than the forecasts by the OBR of long-run real GDP growth at 1.6%.

FURTHER DELAYS TO FISCAL REBALANCING

The modest improvement in the near-term borrowing figures thanks to lower than expected unemployment were lost against the slower expected growth towards the end of the forecast – Chart 1. Upon the weaker growth outlook, the OBR now projects that the cyclically adjusted deficit will be 1.5% by 2021 versus 0.9% in August, while total debt as a % of GDP will be 2ppt higher at 86.8% - Chart 2. Chart 3 shows that the much slower pace of rebalancing is due to the downgraded economic outlook alongside a modest front-loaded easing of the pace of fiscal consolidation beginning in 2019. The total planned fiscal consolidation to 2021 has halved from 1.8% of GDP in March to 0.9% in the latest projections.

Without the policy and imagination to pursue pro-growth policies fast, the UK looks set to suffer the full consequences of Brexit in terms of lower long-run economic growth. Chancellor Hammond's basket of policies that include, among other things, measures to boost housing, cuts to income tax, and modest hand-outs to raise R&D, fall short of what is needed to improve the UK's long term prospects – see next section. Hammond has missed a critical opportunity to demonstrate that the UK is committed to tackling its problems. Amid heightened uncertainty linked to Brexit and markets doubting the UK's long-run prospects, a stronger commitment to pro-growth policies would have been well timed – see 'UK: Four key points on the Autumn Budget' for more detail.

KEY POLICY CHANGES

The key policy changes 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. Here are the key changes announced - or re-announced - today:

- Abolishing stamp duty tax land tax up to the first £300k of the value of the property for first-time-buyers (no relief on homes > £500k);
- An additional £3 billion in funds to prepare for Brexit over the next two years;
- To target 300k new homes per year (by increasing total housing support by £15.3bn to £44bn);
- Increase the National Living Wage to £7.83 from £7.50 for 25+ year olds from April 2018;
- £6.3 billion of new funding for the NHS;
- Increase the tax free personal allowance to £11,850 from £11,500 in April 2018;
- Business rates to increase in line with CPI rather than RPI from April 2018 – two years earlier than originally planned;
- Increased spending allocations to devolved national parliaments (£2bn – Scotland, £1.2bn Wales and £660m for N. Ireland);
- Duties frozen on fuel, beer, wine, cider and spirits frozen for a year;
- 2% above inflation rise on cigarette duty and by 3% on hand rolled tobacco;
- Modest rises in spending on maths and science teaching, and training in construction.

THE BIG PICTURE

The slow pace of deficit reduction since the financial crisis has not created significant economic risks or led to a sharp rise in borrowing costs. Meanwhile, employment has reached a record high. Over time, the UK's fiscal position is gradually becoming more sustainable. However, the Osborne-style 'steady-as-she goes' approach to fiscal consolidation carries increasing risks the longer it goes on. It hinges on a strategy of crossed-fingers that the economic expansion continues, without any major shocks. All the while, as highlighted today, it constrains any ambition to seriously take on the UK's productivity challenge. The longer it takes to balance the books, the more the UK is exposed to an eventual recession that could come at a time when the government does not have the headroom to tackle it.

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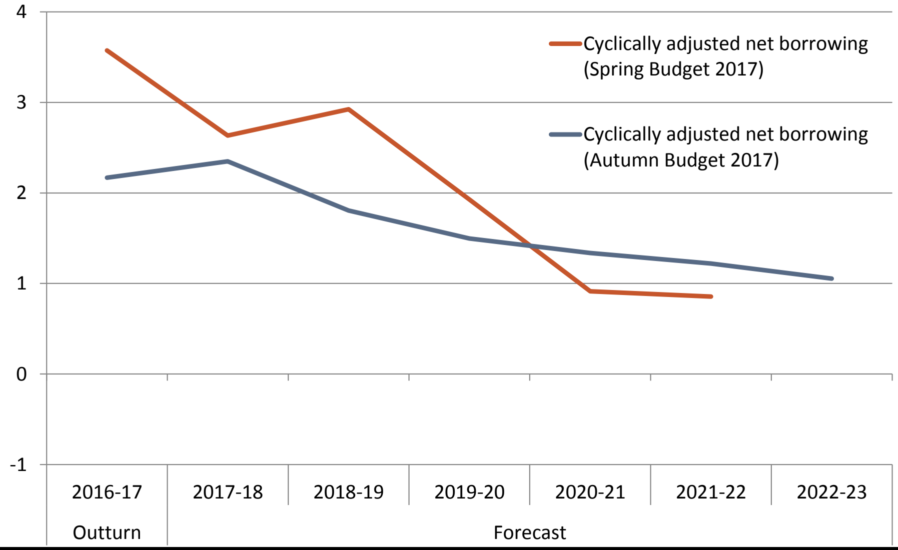
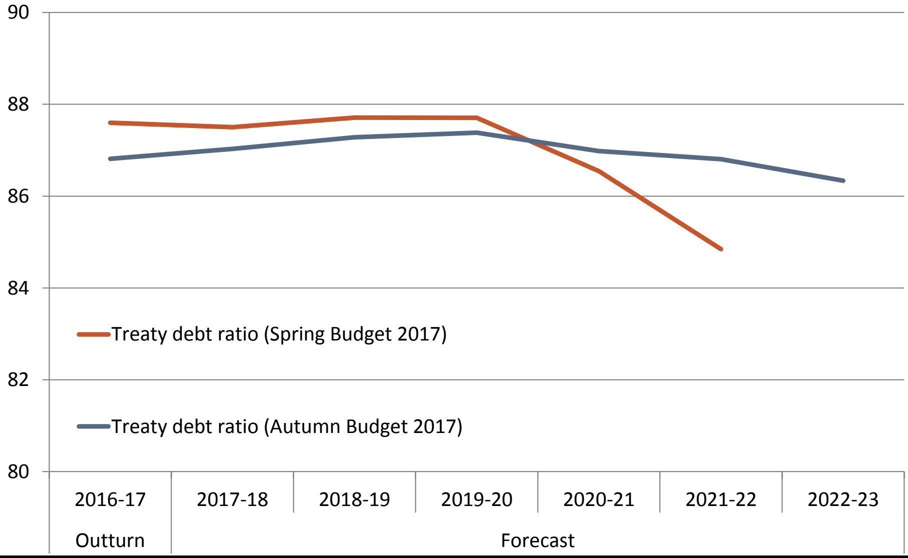
Chart 1: Forecast revisions to cyclically adjusted net borrowing (% GDP)



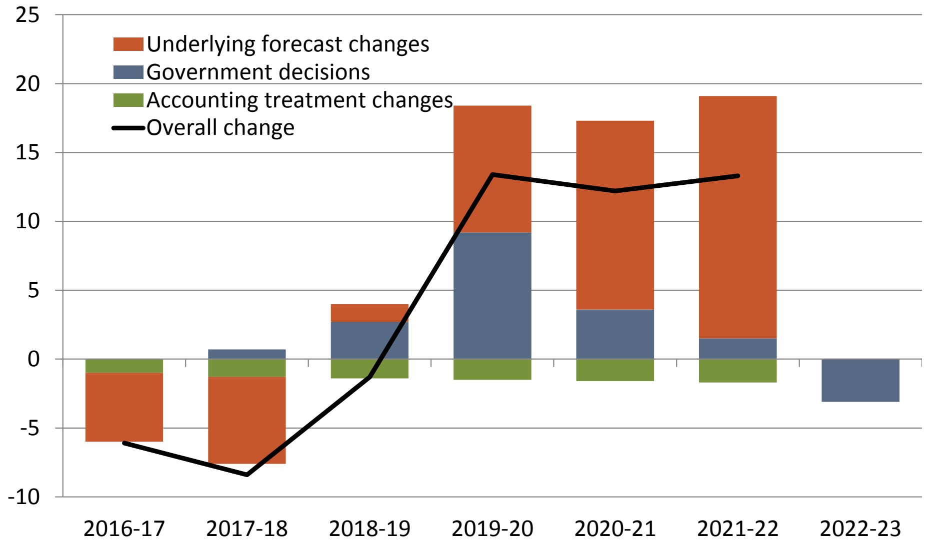
Source: OBR

Chart 2: Forecast revisions to Maastricht Treaty debt ratio (% GDP)



Source: OBR

Chart 3: Changes to public sector net borrowing forecasts since March (£bn)



Source: OBR

SUMMARY TABLES FOR ECONOMIC OUTLOOK AND PUBLIC FINANCES

Table 1: Economic projections

	Outturn			Forecast			
	2016	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
Output at constant market prices							
Gross domestic product (GDP)	1.8	1.5	1.4	1.3	1.3	1.5	1.6
GDP per capita	1.0	0.9	0.8	0.7	0.7	0.9	1.0
GDP levels (2015=100)	100.0	101.5	103.0	104.3	105.7	107.2	108.9
Output gap	-0.2	-0.2	-0.1	-0.2	-0.2	-0.1	0.0
Expenditure components of real GDP							
Household consumption	2.8	1.5	0.8	1.2	1.2	1.5	1.6
General government consumption	1.1	0.3	1.0	0.7	0.5	1.0	1.0
Business investment	-0.4	2.5	2.3	2.3	2.4	2.4	2.4
General government investment	1.5	2.4	1.4	2.3	6.2	1.1	0.9
Net trade[1]	-0.9	0.4	0.2	0.0	0.0	0.0	0.0
Inflation							
CPI	0.7	2.7	2.4	1.9	2.0	2.0	2.0
Labour market							
Employment (millions)	31.7	32.1	32.3	32.4	32.5	32.6	32.7
Average earnings	2.8	2.3	2.3	2.3	2.6	3.0	3.1
LFS unemployment (rate, per cent)	4.9	4.4	4.3	4.4	4.6	4.6	4.6
Changes since March forecast							
Output at constant market prices							
Gross domestic product (GDP)	0.0	-0.5	-0.1	-0.4	-0.6	-0.5	
GDP per capita	-0.1	-0.4	-0.1	-0.4	-0.5	-0.4	
GDP levels (2015=100)	0.0	-0.5	-0.6	-1.0	-1.6	-2.1	
Output gap	-0.2	-0.4	0.0	-0.1	-0.1	-0.1	
Expenditure components of real GDP							
Household consumption	-0.2	-0.3	-0.1	-0.5	-0.5	-0.4	
General government consumption	0.2	-0.8	0.3	0.3	-0.4	-0.3	
Business investment	1.1	2.5	-1.4	-1.9	-1.4	-1.2	
General government investment	0.1	2.3	0.2	0.2	0.2	-2.7	
Net trade[1]	-0.6	0.1	-0.1	0.0	0.0	0.1	
Inflation							
CPI	0.0	0.3	0.0	-0.1	0.0	0.0	
Labour market							
Employment (millions)	0.0	0.2	0.2	0.2	0.2	0.2	
Average earnings	0.6	-0.3	-0.4	-0.6	-0.8	-0.6	
LFS unemployment (rate, per cent)	0.0	-0.5	-0.8	-0.7	-0.6	-0.5	

[1] Contribution to GDP growth.

Source: OBR

Table 2: Fiscal projections

% GDP	Outturn	Forecast					
	2016-17	**2017-18**	**2018-19**	**2019-20**	**2020-21**	**2021-22**	**2022-23**
Receipts and expenditure							
Public sector current receipts (Spring Budget 2017)	36.2	36.7	36.7	37.1	37.2	37.1	
Public sector current receipts (Autumn Budget 2017)	36.7	36.5	36.6	36.7	36.7	36.6	36.7
Difference	0.5	-0.2	0.0	-0.4	-0.5	-0.5	
Total managed expenditure (Spring Budget 2017)	40.0	39.3	39.6	39.0	38.2	38.0	
Total managed expenditure (Autumn Budget 2017)	39.0	38.9	38.5	38.3	38.2	37.9	37.7
Difference	-1.0	-0.4	-1.0	-0.7	0.0	-0.1	
Deficit and debts							
Public sector net borrowing (Spring Budget 2017)	3.8	2.6	2.9	1.9	1.0	0.9	
Public sector net borrowing (Autumn Budget 2017)	2.3	2.4	1.9	1.6	1.5	1.3	1.1
Difference	-1.5	-0.2	-1.0	-0.3	0.5	0.4	
Cyclically adjusted net borrowing (Spring Budget 2017)	3.6	2.6	2.9	1.9	0.9	0.9	
Cyclically adjusted net borrowing (Autumn Budget 2017)	2.2	2.3	1.8	1.5	1.3	1.2	1.1
Difference	-1.4	-0.3	-1.1	-0.4	0.4	0.4	
Primary balance (Spring Budget 2017)	-2.1	-0.9	-0.9	-0.2	0.7	0.7	
Primary balance (Autumn Budget 2017)	-0.6	-0.6	-0.3	-0.1	0.0	0.1	0.3
Difference	1.5	0.2	0.6	0.1	-0.7	-0.5	
Treaty deficit (Spring Budget 2017)	4.0	2.7	2.8	1.9	1.1	0.9	
Treaty deficit (Autumn Budget 2017)	2.3	2.4	2.0	1.8	1.6	1.6	1.2
Difference	-1.7	-0.3	-0.9	-0.1	0.6	0.7	
Cyclically adjusted Treaty deficit (Spring Budget 2017)	3.7	2.7	2.9	1.9	1.0	0.9	
Cyclically adjusted Treaty deficit (Autumn Budget 2017)	2.2	2.3	1.9	1.7	1.5	1.5	1.2
Difference	-1.6	-0.4	-1.0	-0.2	0.5	0.7	
Treaty debt ratio (Spring Budget 2017)	87.6	87.5	87.7	87.7	86.5	84.8	
Treaty debt ratio (Autumn Budget 2017)	86.8	87.0	87.3	87.4	87.0	86.8	86.3
Difference	-0.8	-0.5	-0.4	-0.3	0.4	2.0	

Source: OBR