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UK: JUMP IN BORROWING HIGHLIGHTS RISKS FROM FISCAL STIMULUS

Berenberg Macro Flash

Fiscal policy is not yet fully in the safe zone: The UK fiscal position has improved dramatically over the past decade. Having fallen from a peak of 9.9% of GDP in 2009, public sector borrowing was just 1.1% last year. However, the improvement may not last long. Debt as a % of GDP remains high and could limit the size of any fiscal response to a genuine crisis (think hard Brexit). Further, Boris Johnson and Jeremy Hunt, the candidates to be the next Conservative Party leader and UK prime minister (PM), promise significant fiscal easing if they end up in 10 Downing Street. The latest fiscal data for June highlight the risks of fiscal profligacy. Public sector borrowing increased by 33% in the current tax year to June (begins April). The rise was driven by growth in expenditures that outpaced rises in tax receipts. Although the rise looks substantial, due to the varying timing of major spending decisions and taxation on a year-by-year basis, data for just three months of the current tax year is not reliable enough to paint a likely trend. Taken at face value it suggests that borrowing as a percentage of GDP may end up slightly higher than the Office for Budget Responsibility forecast of 1.3% for 2019.

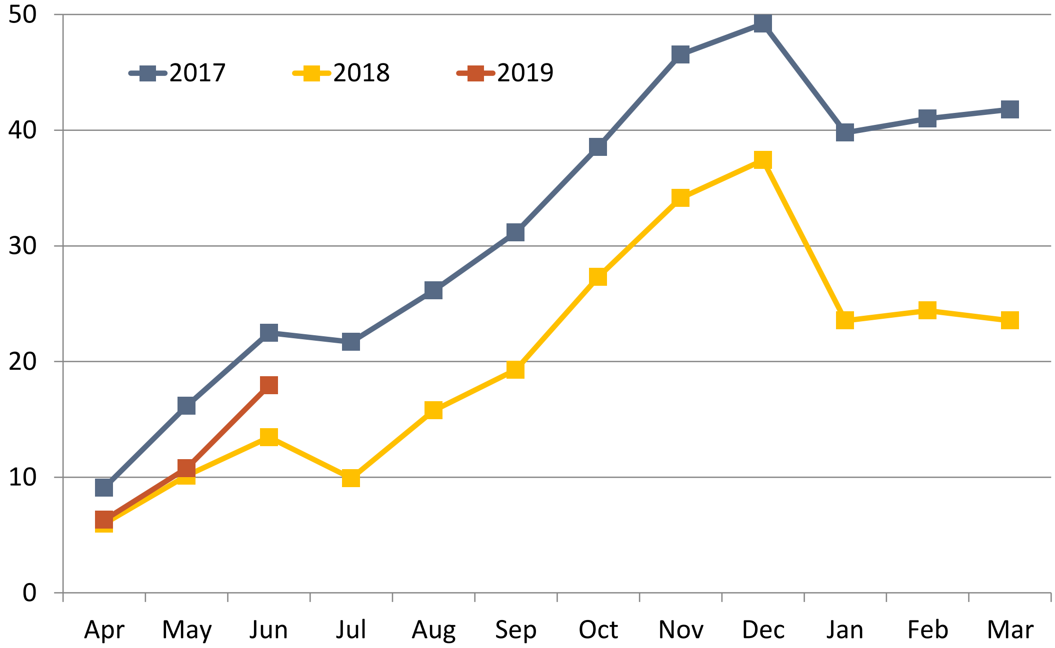
Key points from the June public finances

- Borrowing (public sector net borrowing excluding financial interventions) was £7.2 billion, up from £4.5 billion in May and the highest since borrowing in June since 2015.
- Borrowing in the current financial year to date (April-June) was £17.9 billion, £4.5 billion higher than in 2018 – which was the lowest borrowing for that period since 2007 – Chart 1,2.
- Central government receipts increased by 1.5% yoy with increases in income tax revenues and national insurance contributions.
- Central government spending increased by 7.2%, mostly linked to rising expenditure on goods and services, an increase in the UK's contribution to the EU budget and rising interest payments.
- Debt (public sector net debt excluding public sector banks) as a % of GDP was 83.1% in June, 1.5 percentage points lower than a year ago – Chart 3.

Trump-style stimulus for the UK: Both candidates for the next prime minister have promised to lift the economy with a large fiscal boost. Johnson proposes significant income tax cuts to stimulate demand along with some headline grabbing spending projects. Hunt promises a combination of tax-and-spending policies that will mostly lift demand but could boost supply too. Both candidates plan to finance their policies through additional borrowing. In our view, a large demand-side stimulus at this stage of the economic cycle would be misguided and carries risks. A stimulus would add to inflationary pressures and amplify existing long-run fiscal challenges. While markets may respond well to the initial sugar high of fiscal easing, the risks are not worth it. See UK fiscal stimulus ahead? Consequences and risks.

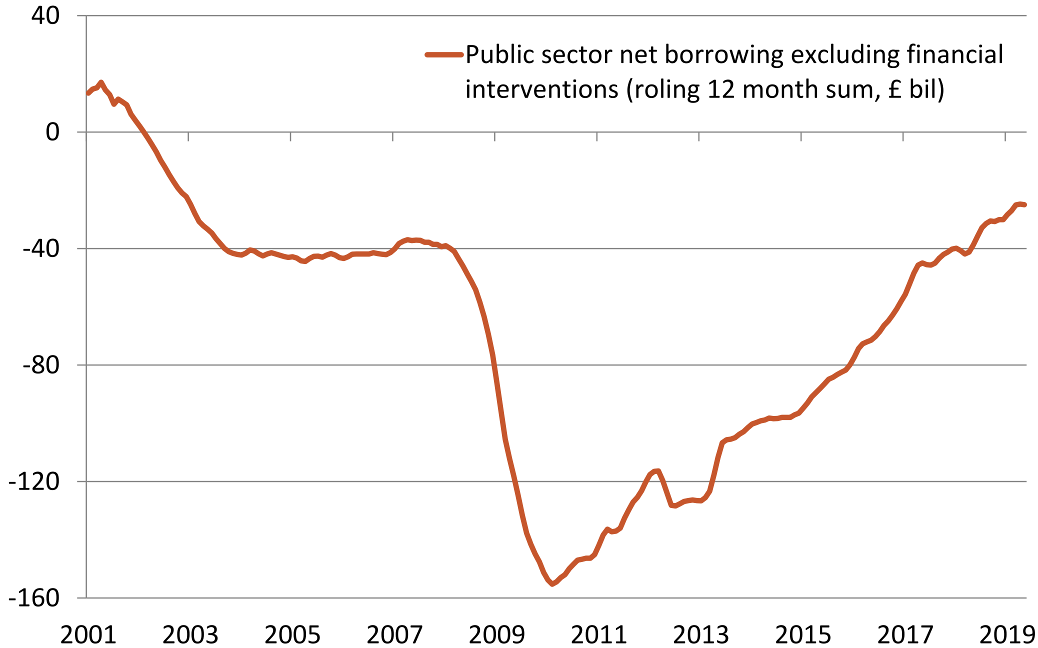
Watch the long-run risks: The OBR's most recent forecasts highlight the long-term risk from such plans – Chart 4. Based on current tax-and-spending projections, the public sector primary balance is forecast to worsen from -0.5% of GDP in 2023, to -8% of GDP by the 2060s as debt as a percentage of GDP rises above 250%. The expected explosion in borrowing is mainly the result of a likely sharp rise in healthcare costs and other spending linked to the UK's ageing population. As the OBR does not project that the costs will really begin to accumulate in a major way until the 2030s, when the deficit could begin to rise above 2% of GDP, there is still time to set fiscal policy on a sustainable course. However, the Johnson and Hunt proposals would bring these risks and challenges to the fore.

Chart 1: UK public sector net borrowing excluding financial interventions (£ bil)



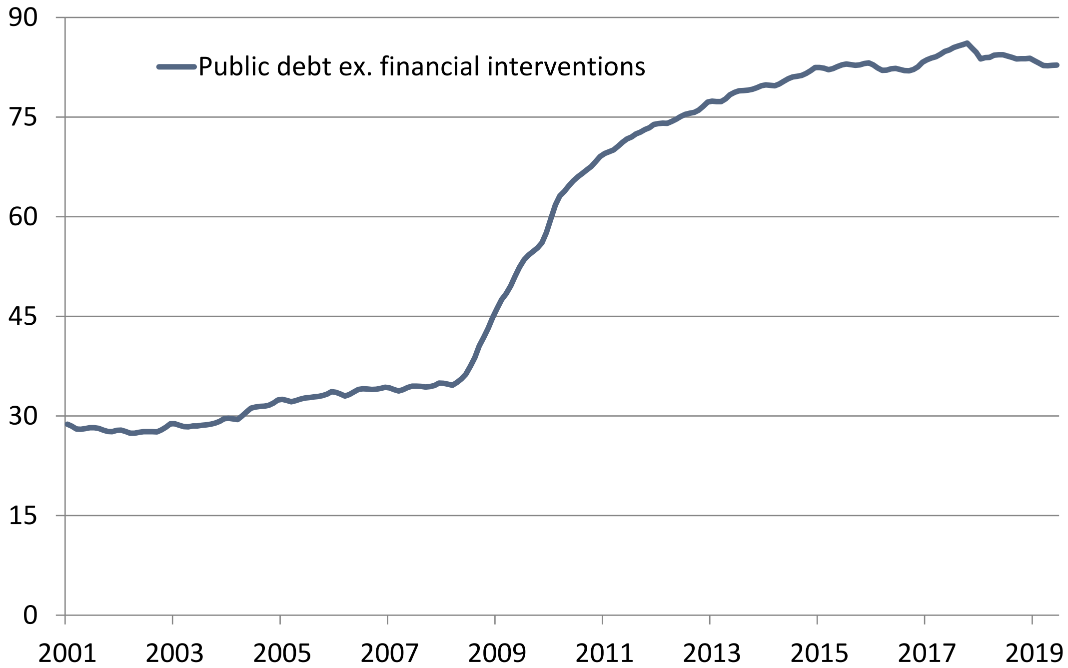
Monthly data. Source: ONS.

Chart 2: Public sector net borrowing (rolling 12 month sum, £ bil)



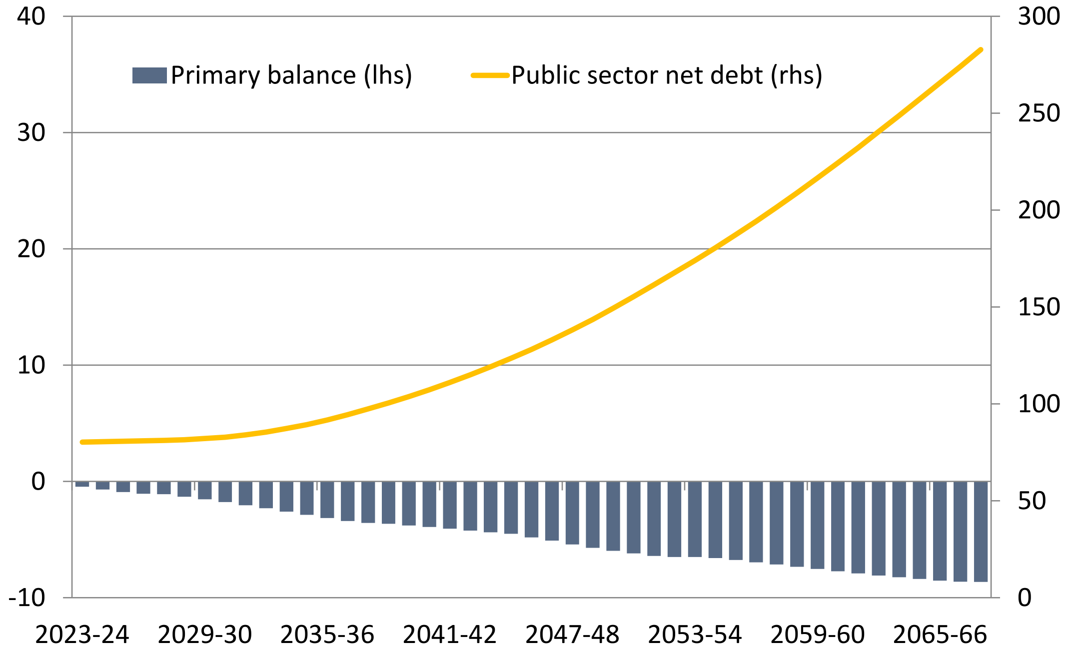
Monthly data. Source: ONS. Three month moving average.

Chart 3: Total public debt (% GDP)



Monthly data. Source: ONS. Three month moving average.

Chart 4: Projections for long-run fiscal aggregates (% GDP)



Monthly data. Source: Office for Budget Responsibility long-run projections