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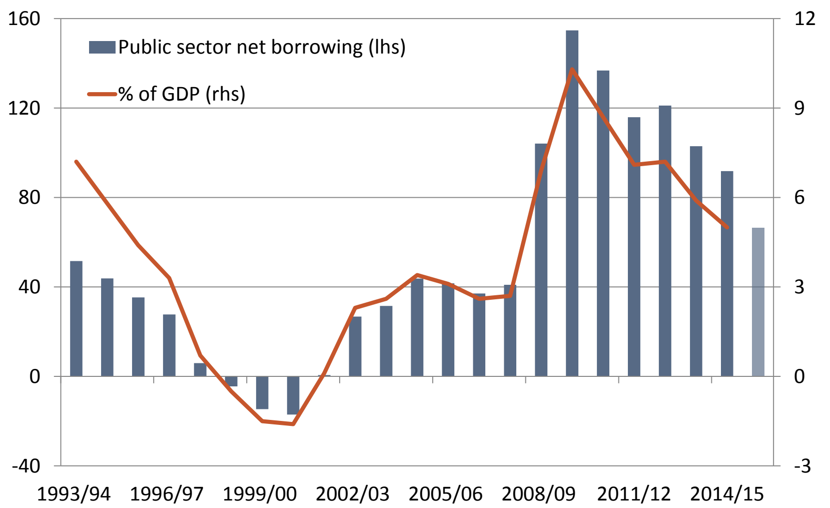
UK BUDGET 2016 – WHAT TO EXPECT

Berenberg Macro Flash

When a government needs to cut spending, the first budget after the election is the most important one. Announcing the big cuts as early as possible provides the most time before the next election to win back the favour of voters. But what do we know going into this year's budget? The economy is smaller and growing slower than we thought a few months ago. Fiscal consolidation is only half way complete - more cuts are needed. And the Conservative party is going through an internal conflict over Brexit. This is not a budget when bold cuts would be either smart economically or easy politically.

Chart 1: There is work to be done - borrowing remains high



Source: ONS. Faded bar shows ytd (Apr to Jan). Lhs scale in £ billions

But Osborne has a problem. His Fiscal Charter "commits" the Government to running a surplus by 2019-20. As Chart 1 shows – there is work to be done. The Chancellor has to make some savings - he simply cannot get around that. Osborne is now finding himself cornered by his previous commitments. Here's what we look out for tomorrow:

Economic downgrades will hurt his revenue forecasts but borrowing costs have fallen

Thanks to a downward revision to back data in December, the economy is £18 billion smaller in nominal terms than previously thought. In addition, global risks have intensified in early 2016 and, in conjunction with Brexit uncertainty, will dent UK growth in the first half of the year. We expect that weaker export and investment forecasts will bring down the OBR's 2016 GDP growth forecast by 0.2 ppt from November to 2.2%. Growth in 2017 will likely be revised down too (see Chart 2).

Labour demand has been a bit stronger than previously forecast. This will improve the outlook for unemployment, probably by around 0.1-0.2ppt across the whole forecast (see Chart 3). However, the unexpected gains in unemployment have come at the expense of slower wage growth. Depending on how the OBR judge the risks to earnings growth, the outlook for wages could be materially weaker.

Every cloud has a silver lining. While heightened risks in the global economy have weakened the outlook for growth, they have driven down the Government's debt servicing costs. The flight to safety since the market rout struck at the start of the year has boosted demand for low-risk government debt. Gilts yields are around 40 bps lower across the curve than in November. Remember too, that just like the BoE, the OBR use market proxies to forecast the Bank Rate and yield curve. Both are ultra dovish. This will provide a fairly hefty saving over the five year horizon.

Chart 2: GDP outlook

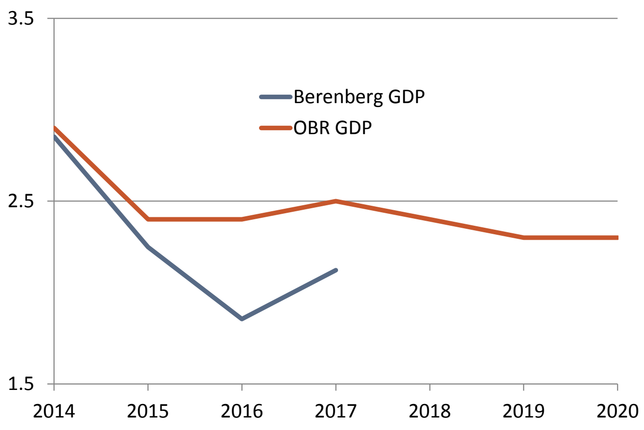
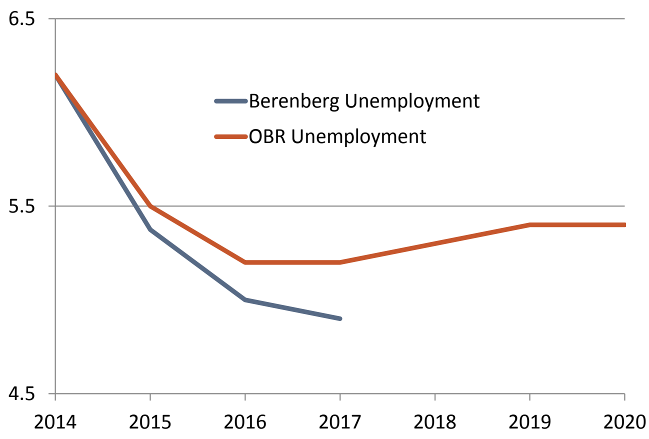


Chart 3: Unemployment outlook



Source: OBR November Economic and Fiscal Outlook, Berenberg. GDP % yoy. Unemployment % workforce.

Making the cut: slicing, dicing and kicking the can down the road

Even with the windfall from lower borrowing costs, the weaker growth and earnings outlook will reduce projected revenues. Further cuts will be needed to meet the 2019-20 surplus target set out in the Fiscal Charter. Osborne has made a career out of austerity. He has no political quips about 'making the difficult decisions'. This time however, he really is in a bind. He faces two problems. First, the Brexit conflict within his party will make it difficult to push through bold changes in the near-term. Second, the moderate Conservatives could be the deciding factor in the EU referendum. The promise of a sweetener for his core base if the UK stays in the EU could be effective at boosting the in vote.

With some of the usual fiddling both across departments *and* over time, he'll get the numbers to add up in the forecasts. Even if it means he doesn't get there in practice – this has been the pattern of the last 6 years. Rather than big policy announcements, we expect lots of tinkering around the edges in the near-term with bigger cuts down the road. This will allow him to keep the peace with his 'in' camp allies and not aggravate his 'out' camp enemies. Whatever the EU referendum result, there will likely be a shake-up in the Conservative party afterwards. Osborne may wait for this before proposing any bold changes to fiscal policy. It still looks more likely according to both the bookmakers and the opinion polls that the UK stays in the EU. We see the Brexit risk at 35%. Osborne will have likely relied on his allies within the party to help muster enough fiscal adjustments in exchange for favours in the post-referendum reshuffle to meet the 2019-20 surplus target. The promise of more tax cuts and rising house prices could help encourage risk averse behaviour on referendum day, boosting support for the 'in' camp. But with a lack of cash to play with he'll rely on the tactic of rehashing and re-announcing existing policies on housing such as 400,000 new affordable homes by 2020-21, pre-planned increases in the tax threshold and the introduction of the National Living Wage to win favour.

What other changes could be in store tomorrow? The ‘Help to’ tactic has been effective with housing. It is likely that Osborne will introduce a new ‘Help to Save’ scheme where low income families receive a top up to their savings. The fall in the oil price might provide a suitable opportunity to hike fuel duty and hikes on the so called ‘sin taxes’ on cigarettes and alcohol would be easily justifiable. We expect a further push to get big companies to pay more tax and behave more transparently. This could include a crackdown on off-payroll tax evasion, tax avoidance and changes to how multinationals can shift profits around to avoid tax. Further rises in the bank levy and the insurance premium tax as well as changes to pension taxes are also likely.

Finally, Brexit will be top of the menu

Because of the economic and political backdrop, we are not expecting radical fiscal change in this budget. Therefore, whatever does take place is not likely to materially change the economic outlook. That is not to say that this budget isn’t crucial - it is. Economically, the emergency budget of 2010 was the most important one for the Conservative government. Politically, Budget 2016 could be the most important one. Few days on the political calendar get more coverage than budget day. This could be the biggest opportunity pro-EU Osborne gets before vote day to stake his case for staying in the EU. He’ll argue that the U.K. has a choice between a ‘certain’ new deal that improves the UK's lot with the worst of austerity over, or, a choice with an uncertain long-term outcome that almost certainly damages the economy near term and sends progress on the public debt into reverse. This is powerful rhetoric to deliver on a key day and it won't be an opportunity he’ll miss.