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UK BUDGET 2017: PUBLIC FINANCES HEADING IN THE RIGHT DIRECTION, BUT LACK EMPHASIS ON INVESTMENT

Berenberg Macro Flash

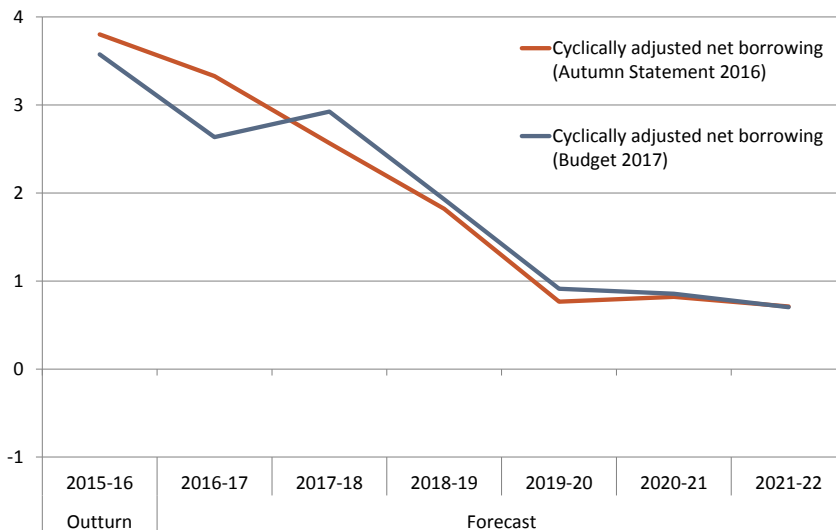
From a macroeconomic point of view, Budget 2017 provides us with very little to get excited about. Capital spending continues to fall short of what the economy needs as it faces slower long-term growth from Brexit. Meanwhile, any positive effects on consumption from income tax reductions will be mostly offset by the real terms cuts to spending for some departments and components of welfare. While the steady-as-she goes approach to fiscal consolidation limits the political fallout, the balancing act is risky from an economic point of view. It hinges on a strategy of crossed-fingers that the economic expansion continues apace, without any major shocks, all the while constraining any ambition to seriously take on the UK's productivity challenge.

NO CHANGE IN CUMULATIVE GROWTH OUTLOOK = LITTLE CHANGE IN OUTLOOK FOR PUBLIC FINANCES

Due to the better-than-expected performance since the Brexit vote the OBR (Office of Budget Responsibility) raised its forecast for real GDP growth in 2017 to 2.0% from 1.4% in the November 2016 Autumn Statement. Further out the OBR lowered its forecasts a little. Overall, it expects no cumulative change in real GDP growth by 2021 versus November. An initially more resilient outlook for household consumption and business investment contributed to the near-term upgrades while modest downgrades to these components of demand led to the reduced medium-term outlook for GDP growth. The average rate of unemployment was revised down by 0.3ppt to 5.1% over the forecast horizon.

Apart from a modest reduction in borrowing for 2017, with little change to the cumulative forecast for GDP and no major policy changes announced, the destination for the cyclically adjusted deficit and debt as a % GDP in five years time barely changed versus November – Charts 1 and 2. While the Chancellor looks set to easily reach his new target set out in the Fiscal Charter - to reduce the cyclically adjusted budget deficit to less than 2% by 2020-21 – Brexit looks still set to cost the taxpayer at least £100bn comparing today's OBR forecasts to a year ago.

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

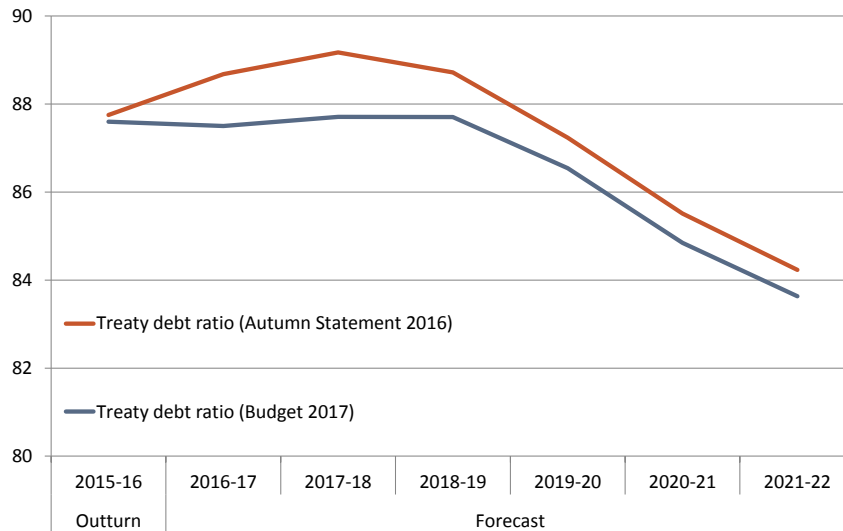


Source: OBR



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



Source: OBR

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:

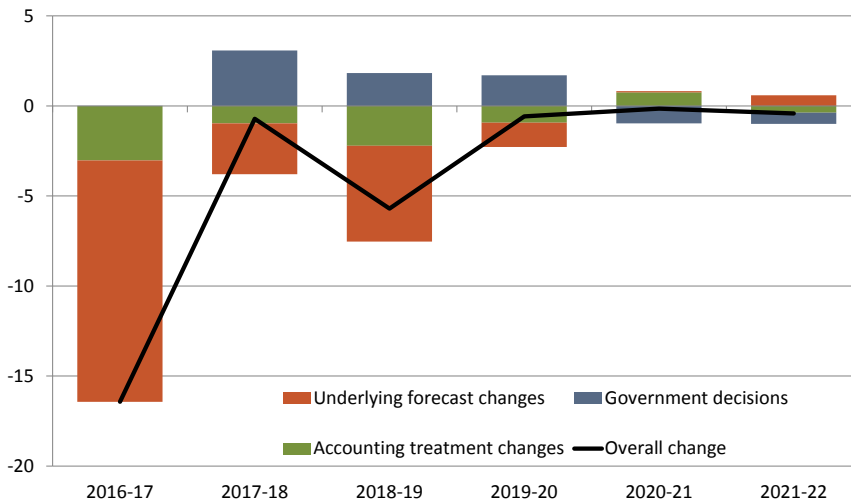
- Income tax: An increase in the personal allowance for income tax to £11,500
- National insurance: A rise in the main rate of Class 4 NICs (for the self-employed) to 10% in April 2018 and to 11% in April 2019 from the current rate of 9%
- Dividend allowance: A reduction in the tax-free dividend allowance to £2,000 from £5,000 from April 2018
- Corporate tax: A reduction from 20% to 19% in April this year and to 17% in 2020
- Business rates: An additional £435million to the £3.6bn fund allocated to business rates transitional relief in Budget 2016
- Minimum wage: Set to rise to £7.50 per hour in April from £7.20
- Social care: An additional £2bn in grant funding for social care in England over the next three years

In short, changes announced today were fiscally neutral – as Chart 3 shows, the major changes to the outlook for borrowing come from the underlying forecast changes and not the impact of government's tax and spending changes.



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



Source: OBR

THE BIG PICTURE

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. The Chancellor continues to take a low risk approach to fiscal policy, setting generous fiscal targets with sufficient headroom in case growth slows by more than expected. Nevertheless, the risks associated with UK public sector debt are exaggerated. 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. While the UK's fiscal position is gradually becoming more sustainable, the UK could benefit from a temporary rise in borrowing to finance a larger rise public sector capital spending over the medium-term.

Brexit could reduce the UK's long-term potential growth rate to 1.8% from 2.2%. An increase in spending on projects designed to boost productivity and raise trend growth would be well timed. Done properly, additional capital spending could raise the long-term GDP growth rate and raise future tax revenues. Despite the c£23bn step-up in capital spending announced last November, at c11% of total government expenditure, allocated funds for capital investment for the next five years still fall way short of the mark.

**MACRO NEWS****SUMMARY TABLES FOR ECONOMIC OUTLOOK AND PUBLIC FINANCES**

| | Outturn | | | Forecast | | | |
|---|---------|-------|-------|----------|-------|-------|-------|
| | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 |
| Output at constant market prices | | | | | | | |
| Gross domestic product (GDP) | 2.2 | 1.8 | 2.0 | 1.6 | 1.7 | 1.9 | 2.0 |
| GDP per capita | 1.4 | 1.1 | 1.3 | 0.9 | 1.1 | 1.2 | 1.4 |
| GDP levels (2015=100) | 100.0 | 101.8 | 103.9 | 105.5 | 107.3 | 109.4 | 111.5 |
| Output gap | -0.3 | 0.0 | 0.2 | 0.0 | -0.1 | -0.1 | 0.0 |
| Expenditure components of real GDP | | | | | | | |
| Household consumption | 2.4 | 3.0 | 1.8 | 0.9 | 1.7 | 1.7 | 1.9 |
| General government consumption | 1.3 | 0.8 | 1.2 | 0.7 | 0.4 | 0.9 | 1.3 |
| Business investment | 5.1 | -1.5 | -0.1 | 3.7 | 4.2 | 3.9 | 3.6 |
| General government investment | -2.6 | 1.4 | 0.1 | 1.2 | 2.1 | 6.1 | 3.8 |
| Net trade ¹ | 0.0 | -0.4 | 0.3 | 0.3 | 0.0 | -0.1 | -0.1 |
| Inflation | | | | | | | |
| CPI | 0.0 | 0.7 | 2.4 | 2.3 | 2.0 | 2.0 | 2.0 |
| Labour market | | | | | | | |
| Employment (millions) | 31.3 | 31.7 | 31.9 | 32.1 | 32.2 | 32.3 | 32.5 |
| Average earnings | 1.9 | 2.2 | 2.6 | 2.7 | 3.0 | 3.4 | 3.6 |
| LFS unemployment (rate, per cent) | 5.4 | 4.9 | 4.9 | 5.1 | 5.2 | 5.2 | 5.1 |
| Changes since November forecast | | | | | | | |
| Output at constant market prices | | | | | | | |
| Gross domestic product (GDP) | 0.0 | -0.2 | 0.6 | -0.2 | -0.4 | -0.2 | 0.0 |
| GDP per capita | 0.0 | -0.2 | 0.6 | -0.2 | -0.4 | -0.2 | 0.0 |
| GDP levels (2015=100) | 0.0 | -0.2 | 0.4 | 0.2 | -0.1 | -0.3 | -0.3 |
| Output gap | 0.0 | 0.2 | 0.7 | 0.6 | 0.2 | 0.0 | 0.0 |
| Expenditure components of real GDP | | | | | | | |
| Household consumption | -0.1 | 0.1 | 0.6 | -0.2 | -0.4 | -0.3 | -0.1 |
| General government consumption | -0.2 | -0.2 | 0.5 | 0.2 | 0.1 | 0.3 | 0.4 |
| Business investment | 0.0 | 0.7 | 0.2 | -0.4 | -1.2 | -0.2 | 0.0 |
| General government investment | -0.6 | -1.0 | -3.2 | -0.9 | 0.2 | -2.7 | 0.5 |
| Net trade ¹ | 0.4 | -0.1 | 0.0 | 0.0 | 0.1 | 0.0 | 0.0 |
| Inflation | | | | | | | |
| CPI | 0.0 | -0.1 | 0.1 | -0.2 | -0.1 | 0.0 | 0.0 |
| Labour market | | | | | | | |
| Employment (millions) | 0.0 | 0.0 | 0.1 | 0.2 | 0.2 | 0.1 | 0.1 |
| Average earnings | 0.0 | 0.0 | 0.2 | -0.1 | -0.4 | -0.2 | -0.1 |
| LFS unemployment (rate, per cent) | 0.0 | -0.1 | -0.3 | -0.3 | -0.2 | -0.2 | -0.2 |

¹ Contribution to GDP growth.

Source: OBR

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| % GDP | Outturn | | | Forecast | | | |
|--|---------|---------|---------|----------|---------|---------|---------|
| | 2015-16 | 2016-17 | 2017-18 | 2018-19 | 2019-20 | 2020-21 | 2021-22 |
| Receipts and expenditure | | | | | | | |
| Public sector current receipts (Autumn Statement 2016) | 36.1 | 36.4 | 36.9 | 36.9 | 37.0 | 37.0 | 37.1 |
| Public sector current receipts (Budget 2017) | 36.2 | 36.7 | 36.7 | 37.1 | 37.2 | 37.1 | 37.2 |
| Difference | 0.1 | 0.3 | -0.2 | 0.2 | 0.2 | 0.0 | |
| Total managed expenditure (Autumn Statement 2016) | | | | | | | |
| Total managed expenditure (Autumn Statement 2016) | 40.1 | 39.9 | 39.8 | 39.1 | 38.0 | 38.0 | 37.8 |
| Total managed expenditure (Budget 2017) | 40.0 | 39.3 | 39.6 | 39.0 | 38.2 | 38.0 | 37.9 |
| Difference | -0.2 | -0.6 | -0.3 | -0.1 | 0.2 | 0.0 | |
| Deficit and debts | | | | | | | |
| Public sector net borrowing (Autumn Statement 2016) | 4.0 | 3.5 | 2.9 | 2.2 | 1.0 | 0.9 | 0.7 |
| Public sector net borrowing (Budget 2017) | 3.8 | 2.6 | 2.9 | 1.9 | 1.0 | 0.9 | 0.7 |
| Difference | -0.2 | -0.9 | -0.1 | -0.3 | 0.0 | 0.0 | |
| Cyclically adjusted net borrowing (Autumn Statement 2016) | 3.8 | 3.3 | 2.6 | 1.8 | 0.8 | 0.8 | 0.7 |
| Cyclically adjusted net borrowing (Budget 2017) | 3.6 | 2.6 | 2.9 | 1.9 | 0.9 | 0.9 | 0.7 |
| Difference | -0.2 | -0.7 | 0.4 | 0.1 | 0.1 | 0.0 | |
| Primary balance (Autumn Statement 2016) | -2.4 | -1.7 | -1.1 | -0.5 | 0.6 | 0.6 | 0.8 |
| Primary balance (Budget 2017) | -2.1 | -0.9 | -0.9 | -0.2 | 0.7 | 0.7 | 0.9 |
| Difference | 0.3 | 0.8 | 0.2 | 0.2 | 0.0 | 0.1 | |
| Treaty deficit (Autumn Statement 2016) | 4.0 | 3.6 | 2.9 | 2.2 | 1.1 | 1.0 | 1.0 |
| Treaty deficit (Budget 2017) | 4.0 | 2.7 | 2.8 | 1.9 | 1.1 | 0.9 | 0.9 |
| Difference | -0.1 | -0.9 | -0.1 | -0.3 | -0.1 | 0.0 | |
| Cyclically adjusted Treaty deficit (Autumn Statement 2016) | 3.8 | 3.4 | 2.5 | 1.8 | 0.9 | 0.9 | 1.0 |
| Cyclically adjusted Treaty deficit (Budget 2017) | 3.7 | 2.7 | 2.9 | 1.9 | 1.0 | 0.9 | 0.9 |
| Difference | -0.1 | -0.7 | 0.4 | 0.1 | 0.1 | 0.0 | |
| Treaty debt ratio (Autumn Statement 2016) | 87.8 | 88.7 | 89.2 | 88.7 | 87.2 | 85.5 | 84.2 |
| Treaty debt ratio (Budget 2017) | 87.6 | 87.5 | 87.7 | 87.7 | 86.5 | 84.8 | 83.6 |
| Difference | -0.2 | -1.2 | -1.5 | -1.0 | -0.7 | -0.7 | |

Source: OBR

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