Macro Comment 12/24

Shahin Kamalodin

UK Budget: Another missed opportunity

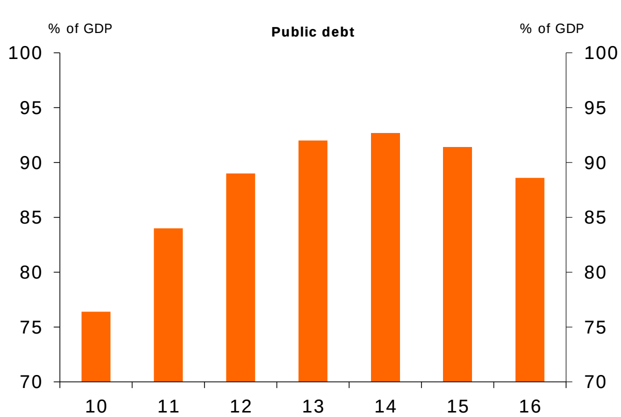
The Chancellor decided to stick to his guns. This is unfortunate given the weak economic outlook. The private sector is itself busy cleaning its balance sheet and the external environment remains challenging. Thus, a slower pace of fiscal consolidation would have been better for the economy.

The UK Chancellor, George Osborne, presented his fiscally neutral Budget today. The government argued that deficit-cutting remains the best option for the country even in the face of a sluggish economic recovery. The main giveaways – a rise in the personal tax allowance and an extra 1% cut in corporation tax – are to be paid for by higher taxes on the rich, including a new 7% rate of stamp duty and a crackdown on tax avoidance. The Office for Budget Responsibility's (OBR) forecast for the economy remained broadly unchanged from its previous forecast in November. It revised its growth forecast for this year from 0.7% to 0.8% (we forecast 1%), and from 1.8% to 2% for next year (Rabo: 1.5%). On a positive note, the Chancellor stated that the state pension age will increase automatically in line with changing longevity. The details of this policy will not be published until July.

If everything goes according to plan, the OBR forecasts gross public debt-to-GDP to peak at 92.7% in 2014 and be on a downward trajectory in the years after. Public sector net borrowing is expected to fall from its post-war peak of 11.1% of GDP in 2009–10 to 1.1% in 2016–17. The upshot is that the country will be going through years of fiscal austerity (see figure 2). This will happen while the private sector is also busy repairing its balance sheet.

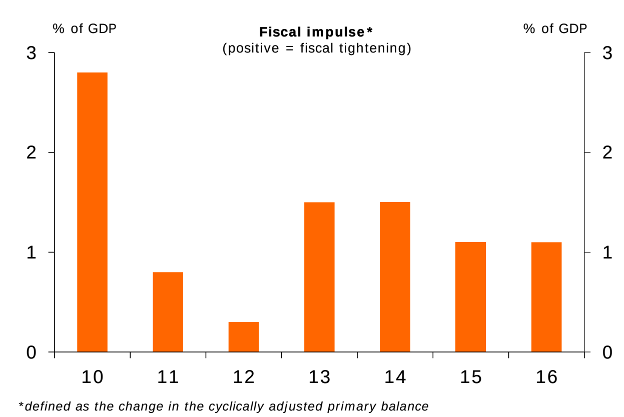
The government believes its fiscal consolidation plan will not weigh too much on activity because they have a floating exchange rate and an independent central bank. The idea is that "*activist monetary policy will support the economy, while currency flexibility can support net exports*". As regards the former, we have already written extensively about the failure of Bank of England's (BoE) quantitative easing measures to ease financial conditions (e.g. see our Macro Comment 12/15). Similarly, the weaker pound has failed to boost net exports amid a weak global demand. The government's last hope can be that domestic demand can prove more resilient than currently anticipated. We have recently argued that consumer spending may surprise on the upside as falling inflation should continue to alleviate the squeeze on real incomes. But this does not imply that consumers are now out of the woods. The labour market is still on a weakening trend

Figure 1: Public debt expected to peak in 2014



Source: HM Treasury

Figure 2: Fiscal policy on a tightening mode



Source: HM Treasury

and credit conditions remain tight. It is important to remember that consumers will face these strong headwinds while being busy cleaning their balance sheets. Thus, not much positive contribution to growth can be expected from household consumption. The only glimmer of hope is private sector investment. Cash-rich companies are mostly delaying investment plans due to an uncertain macroeconomic backdrop. Should demand conditions improve, then a modest pickup in activity on the back of stronger private sector investment can be expected. However, this is unlikely to materially alter the outlook.

Our take:

The UK Chancellor missed a great opportunity to switch to plan ‘B’ by slowing down the pace of fiscal adjustment so that the recovery gets a chance to pick up some steam. This is especially necessary given that the private sector is busy deleveraging and the external environment remains very challenging. The risk is that fiscal belt-tightening measures lead to a weaker recovery and this, in turn, forces the government’s hands to carry out even further austerity to reach its 2016-17 fiscal target. Such macro policy might hurt the country’s long-term growth rate as some workers who have lost their jobs for a prolonged period will eventually leave the labour market. Against this backdrop, we continue to think that the OBR’s growth forecasts look optimistic and that the government will either have to miss its budget targets or accept the harsh consequences of restrictive fiscal policy on growth while the private sector is also on a deleveraging mode.

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