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UK Budget: Next steps, not complete vision

Reaction to UK Budget and outlook for medium-term public finances

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Key points

- Chancellor Sunak extends emergency support of £65bn to economy. He also introduced a surprise £25bn boost to investment incentives.
- Chancellor pre-announces increase in corporation tax from 2023 and removes threshold indexation, combined these should raise £70bn over forecast horizon.
- OBR economic growth forecasts proved too pessimistic for 2020. It forecasts 4.0% for 2020 (from 5.5%) and 7.3% for 2021 (from 6.5%), broadly in line with our view.
- Deficit is now forecast to rise to 16.9% of GDP for 2020-21 (from 19.0%) and 10.3% in 2021-22 (from 7.4%). The debt level is seen at 100.2% of GDP this year, rising to 107.4% next year and peaking at 109.7% in 2023-24, before falling back to 103.8% by 2025-26.
- At this time, public spending is not a marginal impulse to the economy, rather it is the result of the broader economic situation – and much uncertainty surrounds this outlook.
- The Chancellor acknowledged considering the affordability of debt. OBR forecasts see nominal growth outpacing interest rate, but this outlook could change.

Chancellor delivers flexible response

Chancellor Rishi Sunak delivered only his second Budget, but the first after the full realisation of the impact of the pandemic on the UK economy. Amidst much speculation that he would tighten fiscal policy to address a large deficit, the Chancellor delivered a dynamic fiscal response. This included an expected extension to emergency support measures to the economy, broadly for another six months until the end of September. It did also include the announcement of two revenue raising measures that are estimated to raise £70bn over the forecast horizon. Yet by design, both see revenue gains occurring much later, after the economy has recovered. The Chancellor also delivered a more surprising, short-term boost to investment incentives, a measure that provided additional stimulus of £25bn over the next two years but should help private sector investment to recover more swiftly.

This struck a good balance of ongoing fiscal support to an economy still in a national lockdown, but a medium-term nod to fiscal rectitude designed to retain confidence in the UK's public finances and help underpin low gilt yields that will help the economy reduce its elevated debt levels over the longer-term.

However, we are in no doubt that at present the economy is driving the public finances and not the other way around. While we are now broadly in accord with both the new Office for Budget Responsibility (OBR) and Bank of England (BoE) economic forecasts, we fully recognise the marked

uncertainty that surrounds projections going forwards. With this uncertainty directly feeding through to the public finances, there is a strong likelihood that significant changes to the forecasts will emerge future fiscal events. As such, the Chancellor has retained an appropriately supportive and flexible approach at this stage. As time passes and the economy recovers, we expect the Chancellor will have to consider additional measures to reduce the level of debt and is likely to have to continue to juggle competing political objectives.

Chancellor extends emergency measures

Reflecting the fact that the UK economy was still in a national lockdown, the first order of business for the Chancellor to address was to extend emergency support measures to the economy. As such, the Chancellor announced:

- An extension of the jobs furlough (CJRS[1]) scheme to end-September, although businesses that re-open are set to contribute 10% to this in July and 20% in August and September (cost £7bn).
- An extension of the self-employed support scheme. Two more rounds of grants were made available. 4th round from Feb-Apr will support at 80% of profits. 5th round, from May will support those with a 30% drop in turnover at 80%, but less than 30% at 30% (cost £13bn)
- An extension to the boost to Universal Credit of £20/week until end September (and equivalent in Working Tax Payments) (Cost £2.2bn).
- Announced new Restart Grants for business from April to replace expiring grant schemes. These will make grant of up to £6k/non-essential retail premise and £18k/hospitality & leisure, including personal care and gyms. Separate funds were also included for arts, culture and sports (cost of £5bn)
- Introduction of Recovery Loans Scheme to replace expiring CBILS[2] and BBLS[3]. Loans available for all sizes of firms from £25k-250m. Loans will be 80% government guaranteed.
- Business rates holiday is extended until end-June from end-March, and then will resume at only two-thirds the rates until end-March 2022 (equivalent tax cut of £7bn).
- VAT rate reduction for hospitality and tourism sectors will continue at 5% rate until end-September (from end March) and will then rise to just 12.5% for rest of fiscal year (cost £5bn)
- Stamp Duty cut on house purchases will be extended to end-June (from end March), to allow the completion of delayed transactions. The 0% range will then apply to <£250k (from <£500k) until end-September, when it will revert to <£125k (cost £1.5bn).
- Mortgage guarantee, government will provide guarantee for mortgage borrowers with 5% deposits.

The Chancellor explained that the additional measures to support the economy in this Budget added a further £65bn to government spending. This takes the total additional spending the government has undertaken since the start of the pandemic, including Budget 2020's additional infrastructure spending and the Spending Review's boost, to £407bn (18% of GDP). The Chancellor rightly described this as a commitment that was "unimaginable only twelve months ago".

Sunak resists urge for premature fiscal tightening

Despite the huge increase in spending announced at today's Budget, the Chancellor broadly resisted the urge to try and rein in the deficit at this point with the economy still in lockdown. Indeed, the Chancellor said that now was not the right time to consider specific fiscal rules and precise targets and timelines. Instead the Chancellor identified three broad fiscal objectives:

- That in normal times the government should not borrow to invest in day-to-day public spending.
- Over the medium-term to not allow the debt to increase adding that we must make sure that it remains affordable.
- Take advantage of low interest rates to invest in long-term capital projects to help build longer-term growth.

The Chancellor acknowledged that it would be "irresponsible to withdraw support too soon". He added that it would also be "irresponsible" to let levels of debt continue to rise, adding that the unprecedented fiscal support delivered had only been possible because of the sound nature of the public finances before the crisis. And with this he announced two measures that will bring in additional revenues over the coming years:

A freezing of the income tax thresholds as well as those for inheritance tax, capital gains and VAT exemptions. The removal of this indexation, particularly for the lower income tax thresholds, begins to immediately unwind in real terms the progressive increase in the lower rate threshold (to be completed to £12.5k in the coming fiscal year). This measure is less visible – termed "tax creep" over time and allowed the Chancellor to say that people's (nominal) incomes will not be affected as a result of this change. However, the estimated boost of this measure was £19.1bn, over the next five years, which is small relative to the scale of the UK's deficit.

Pre-announced future increase in corporation tax rate to 25% from 19%. This increase will take effect from April 2023 – a point considered to be long after the economy has recovered. The full 25% rate will only apply to large business (>£250mn), with small business (<£50k) benefitting from a small business tax rate (which will remain at 19%) and a tapered rate for those

[1] Coronavirus Job Retention Scheme
[2] Coronavirus Business Interruption Loans
[3] Bounce Back Loans

in between. This is a significant tax raise for future years, with the OBR estimating a £47.7bn increase in tax revenue over the next five years, albeit not starting until 2023-2024.

Both measures underscored the Chancellor's commitment to longer term commitment to fiscal rectitude. However, both only kick-in later, as the economy is projected to have broadly closed its output gap and completed recovery. Additionally, the Chancellor announced the following measure, a short-term fiscal boost that should boost the prospects for economic recovery in the short term.

"Super-deduction" for investment. Investment committed over the next two years would come with a 130% reduction in tax bill, a measure designed to incentivise business investment and something that the OBR estimated would lift business investment by 10ppt. This was by far the costliest of the longer-term support measures. At an estimated £25bn over the two years, this is a greater give-away than the total expected gains from removing threshold indexing.

Medium-term economy and finances outlook

The significant changes in government spending – and the OBR's underlying shift in its outlook for underlying economic activity combined to see a significant shift in the outlook for the public finances.

While the economy contracted at a record 9.9% in 2020, this was still 1.4% better than the OBR had forecast in November. The OBR's outlook for this year is 4.0% and 7.3% for 2022 (now similar to our own 4.6% and 7.5%), with the OBR revising their outlook for this year down from 5.5% and for next year up to 6.5%. However, over the long-term the OBR forecasts the steady state of the level of UK economic activity now 3% lower than it did before the pandemic.

Unsurprisingly, the OBR forecast the majority of the rebound in economic activity over the coming years to come from a rise in household consumption growth and a strong rebound in business investment next year. The rebound in household spending is underpinned by a recovery in employment and a significant drop in the household saving ratio to reach a longer-term sustainable rate by next year. However, unlike the BoE, the OBR does not expect the economy to quickly move from excess supply to excess demand, instead envisaging an output gap nearly closed (-0.2%) by 2023, but not quite totally closed by the end of its forecast horizon. This likely explains the OBR's inflation forecast remaining around the BoE's 2% inflation target from 2022 onwards.

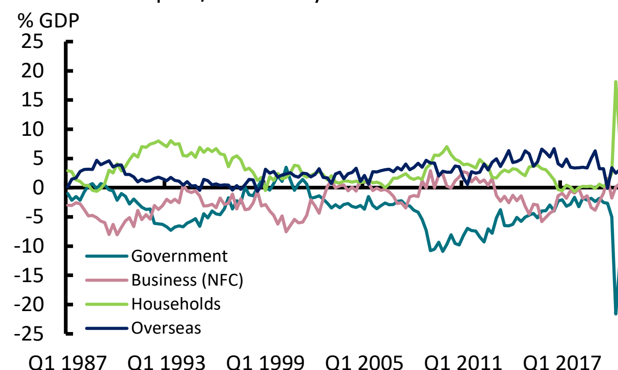
The better-than-expected outturn for the economy this year helps explain a smaller projected deficit of £355bn (16.9% of GDP) this fiscal year (from £394bn and 19.0% of GDP), but with a weaker growth forecast and significant additional government spending in the early months of 2021-22 it projects the deficit for next year to rise to £234bn (10.9% of GDP) from November's estimate of £164bn (7.4% of GDP). The forecasts are similar for 2022-23 at 4.5% of GDP (from 4.4%), but then fall more quickly to 3.5%, 2.9% and 2.8% to 2025-26 (from 4.1%, 3.9% and 3.9%). The Chancellor highlighted that the projected deficits for this year and next are the largest peacetime deficits on record.

The level of debt follows a similar pattern. Debt is now forecast to rise to 100.2% of GDP this year, compared to a November forecast of 105.2%. It is then seen at 107.4% in 2021-22 (108.0%) and is expected to peak at 109.7% (109.4%) in 2023-24. The debt level is then forecast to fall somewhat quicker now to 103.8% (104.7%) by 2025-26, in keeping with the somewhat smaller projected deficit, in turn helped by the pre-announced revenue raising measures that kick-in later in the forecast horizon.

In terms of the fiscal stance (the adjustment in the cyclically-adjusted measure of the deficit), the reduced outlook for this year's deficit suggests less fiscal expansion in 2020-21 – despite the better growth outlook – than expected in November. With support continuing into next year the fiscal stance tightens less in 2021-22, down 6.8ppt of GDP compared to a forecast of -11.9ppt in November. The fiscal stance is projected to continue to tighten further in 2022-23 (-5.5ppt vs -2.8ppt) and more modestly (-0.9ppt vs -0.1ppt) the year after.

In normal times, our assessment of a Budget is based around an assessment of the marginal impulse that additional fiscal loosening or tightening will have on an economy, where we assume other sectors are broadly stable, and, hence assessing the overall economic impact. In effect we view the public sector as the active agent of change.

Exhibit 1: Public and household sectors' financial positions mirror each other



Source: National Statistics and AXA IM Research, March 2021

This Budget is held in conditions that are far from normal. With the UK economy still in a full national lockdown, the restrictions imposed on individuals and businesses are unprecedented. Our forecasts are for these restrictions to be eased over the coming months and for this to have a material impact on activity in the other sectors of the economy. This

will be the main driving force for the economy over the next couple of years and both public sectors actions (in terms of extending support or not) and its metrics, particularly the finances.

Exhibit 1 illustrates the relationship between the sectors. Considering the financial surplus/deficits by sector, we can see that the public sector deficit was a corollary of the surge in household sector surplus over the last year (latest data only to Q3 2020). This illustrates how a resurgence in household spending and business investment should be expected to underpin a reduction in the public sector financial deficit.

As such, we should be mindful to the uncertainties that surround this outlook. BoE officials have recently discussed that the prospective scale of UK excess saving is large. BoE Chief Economist Andrew Haldane estimated this could be around £250bn by mid-2021 (>11% of GDP). The BoE currently estimates that only a small proportion of this will be actively spent over the coming few years, but Haldane warns that there is the "potential for much more, perhaps even most of this savings pool to leak into the economy". This would have a material impact on the economic forecasts and the public finances.

Considering affordability of debt

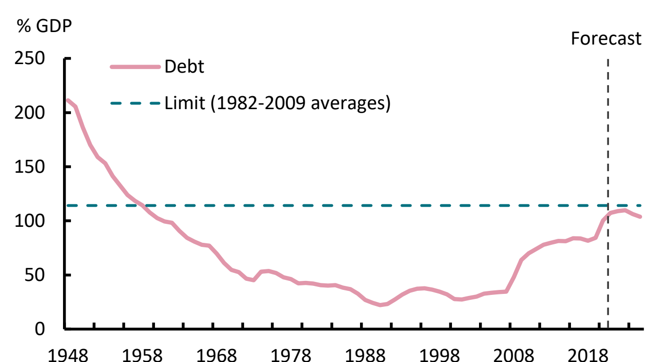
One additional factor to consider is the longer-term sustainability of the public finances. The debt level Is projected to rise to its highest since 1958. As discussed in research notes[4,5] published last year, fiscal sustainability is affected by a multitude of factors, including the medium-term outlook for economic growth, the prevailing level of interest rates and market confidence. The currently projected level of UK debt would be close to levels of sustainability based on historic (1985-2009) outlooks for growth and interest rates (Exhibit 2). However, the UK has managed debt levels far in excess of this in the past, with debt exceeding 250% of GDP in the wake of World War 2.

Moreover, based on the current OBR estimates, the nominal growth rate of the economy is projected to exceed the projected market rate on gilt yields, and hence the average interest paid on the government debt. This allows the UK to run a deficit over the medium-term and still see the debt level shrink: Indeed OBR forecasts suggest a deficit stabilising just under 3% of GDP in 2024-25 and 2025-26, while the debt to GDP ratio shrinks by an average of 3ppt in each year.

However, this relies on the UK's nominal growth rate and the outlook for market rates. Our own view is that the OBR's view could be challenged from both perspectives. While we are encouraged by incentives to boost investment spending, we still consider the post-Brexit headwinds and demographic factors as something that will push nominal growth in the UK closer towards 3.25% (from the OBR's 3.8/3.9%) in steady state. The OBR also forecasts the weighted average interest rate of gilt yields likely to rise from an average 0.40% this year to 0.90% over the next five years – an estimated rise of just 50bps over five years. We note that 10-year and 30-year gilt yields have risen by more than 50bps since the end of January.

Exhibit 2: Estimated limits of debt sustainability

UK historic debt and estimated debt limits



Source: National Statistics and AXA IM Research, March 2021

Richard Hughes, Head of the OBR, last year warned that it was a "big question" as to how long low yields would last. This year has underlined that fact and illustrated that it is not only domestic developments that can change the outlook for domestic funding costs. And today Chancellor Sunak warned that a 1% increase in interest rates and inflation would increase debt interest payments by £25bn.

Accordingly, we judge the Chancellor's moves this year as prudent. We support the additional stimulus that the Chancellor is providing in this Budget, both through the extension of emergency support measures and the specific boost to investment spending from the "super deduction" change to investment incentives. However, the Chancellor's nod to long-term sound public finances with the pre-announcement of around £70bn of back-end loaded tax revenues should help to maintain broader market confidence in the UK's finances, helping to maintain the low interest rates that will help the UK reduce its indebted position over the long-term.

Gilt issuance

In keeping with developments in broader measures, the UK's cash deficit (central government net cash requirement) is now forecast smaller for 2020-21 than in November, at £369.7bn from £402.5bn. However, as is usual by this time of year, the Debt Management Office (DMO) has already planned for £485.5bn (including a £2bn reduction in

[4] Page, D., "How governments can respond to the COVID-19 debt surge", AXA IM Research, 7 October 2020

[5] Page, D., Menut, A. and Le Damany, H., "Individual government challenges and the COVID-19 debt surge", AXA IM Research, 22 October 2020.

outstanding T-bills) for this year in line with the November remit. However, the remit also had to account for a £15bn shortfall in National Savings this year. As such, the DMO will raise its short-term cash position by £17.8bn to account for this year's overfinancing and will plan to unwind most of that in next year's remit.

Next year's planned gilt issuance is, however, still larger than suggested by November's illustrative gross financing requirement, despite the unwind of this year's unexpected cash accumulation. The DMO aims for £296bn in gilt sales next year.

As we have seen in previous cycles, with the DMO aiming to finance a smaller (though still large) deficit next year, its issuance tends to revert towards longer-term issuance. Even allowing that 9.5% of next year's gilts sales are as yet unallocated, including the issuance of future green gilt sales, higher duration long-term and index-linked issuance is planned to proportionally exceed issuance from this year. The DMO plans to issue 28% of next year's gilts into longs (from 27.8% this year) and 11.1% into index-linked (from 6.8% this year). Short gilt sales are currently planned to fall as a proportion to 29.4% (from 34.6%) and mediums to 22.1% (from 30.8%).

BoE remit change

The Budget also included a change to the BoE's remit. The substance of the remit on monetary policy was unchanged with a symmetric Consumer Price Index (CPI) inflation target of 2% and confirmation that the Asset Purchase Facility – the BoE's quantitative easing vehicle – will remain in place for the coming financial year. The Chancellor also reiterated the broader BoE objectives to support financial stability and the government's broader policy objectives. However, this time the Chancellor added that the BoE's remit should also "reflect the government's economic strategy for achieving strong, sustainable and balanced growth that is also environmentally sustainable and consistent with the transition to a net zero economy".

Over the longer-term this change to the BoE's remit could have a bearing on the conduct of broader policy. However, in the short-term it puts additional focus on the BoE's corporate bond asset purchases. These had been bought broadly in line with market cap so as to minimise any price distortion. However, the BoE has undergone criticism that this has seen them buying debt of corporates with policies not consistent with achieving a net zero emission target by 2050. The BoE issued a short statement saying that it would implement changes to this portfolio in accordance with its new remit objectives by the time of the next scheduled reinvestment phase in Q4 this year.

Market reaction

Market reaction has been mixed and as ever influenced by developments outside of the UK, including softer ADP employment and ISM non-manufacturing index releases from the US.

The initial market reaction to the Budget, however, appeared one surprised by a more stimulative budget than anticipated. While markets had broadly expected the extension of emergency support measures announced by the Chancellor today, commentary ahead of the Budget had focused on how much fiscal tightening the Chancellor would enact. The outcome a Budget that back-loaded some down payment on fiscal tightening and provided additional stimulus – particularly in incentives for investment over the coming years, appear to have provided a modest surprise.

2-year and 10-year gilt yields both rose initially by 4bps and 6bps, before retreating somewhat in the face of softer US data. 2-year yields are currently ay 0.075% (up 1.5bps) and 10-year yields at 0.77% (up 5bps).

Sterling also made initial gains after the Budget, up 0.2% against the US dollar and a little more to the Euro. Sterling has been volatile since the initial gains but is currently still up modestly to both currencies at £1.396 to the dollar and £0.864 to the euro.

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