MONTHLY ECONOMIC INSIGHT

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The dust has settled on the chancellor's latest Budget Statement and Spending Review. While there was significant commentary and analysis of announcements – before and after the statement – this month's review will look at some of the new OBR forecast highlights as well as a look ahead to the next MPC meeting.

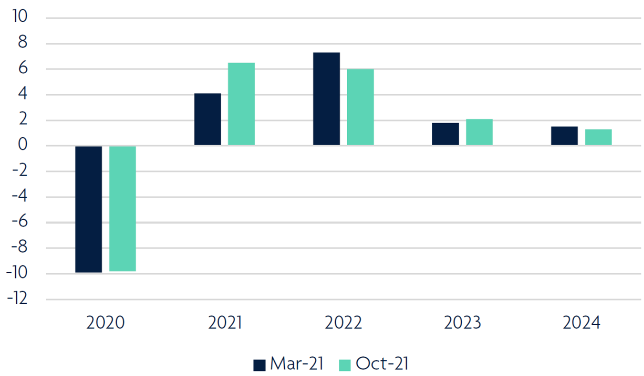
OBR UPGRADES 2021 FORECAST

As noted in last month's briefing, the backdrop to the chancellor's statement was a rather better economic outlook than in March this year and this was reflected in the Office for Budget Responsibility's latest Economic and Fiscal Outlook. As growth in the first half of this year has outperformed previous expectations, there was a material uplift in GDP projections for 2021, with the OBR now expecting the economy to expand by 6.5 per cent (Chart 1).

Official statistics have confirmed that much of the bounce back so far this year has been supported by a recovery in household consumption as restrictions began to be lifted in the spring. Households are expected to do much of the heavy lifting in supporting growth in the remainder of this year and into next, with the pace of expansion easing in the second half of 2022. Pre-pandemic levels of consumption should be achieved at the start of next year. Notably, and in line with more recent independent forecasts, the OBR's labour market outlook is much improved from March, with a much lower peak in unemployment (5.2 per cent at the end of this year), than projected in the spring. This supports continued expansion in consumption in the near term. However, forecasts still come with the important caveat that Covid-19, its path of the winter and the emergence of new variants still pose downside risks to the outlook. Moreover, the confidence level of consumers more broadly has started to wane.

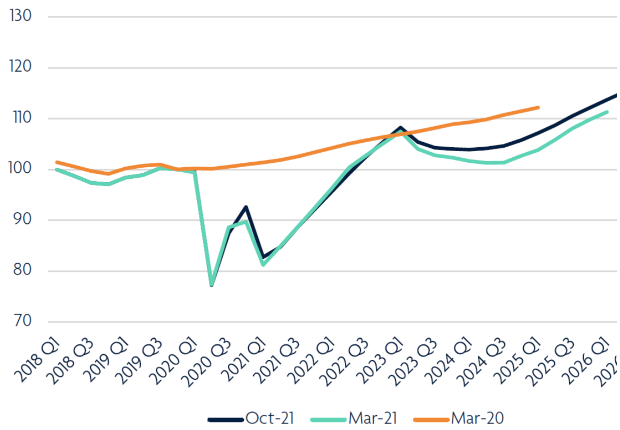
The OBR's medium-term outlook is, however, little changed. There will be limited further bounce back opportunities and beyond next year growth is expected to normalise, falling back to the sub-par levels of expansion we saw prior to the pandemic. While the economy is expected to regain pre-pandemic levels of output around the turn of the year, the economy will not get back on its pre-pandemic trajectory over the forecast period, with GDP still two per cent below the OBR's March 2020 forecast at the beginning of 2025.

Chart 1: Percentage annual change



INVESTMENT FOCUS

Chart 2: Business investment forecast, Q4 2019 = 100



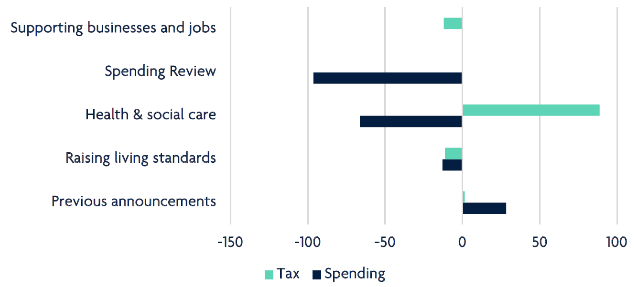
With private consumption in the driving seat this year, business investment is forecast to pick up the baton in supporting growth next year. The OBR has pencilled in a near 16 per cent expansion in business investment next year, with growth expected to carry into 2023.

While many firms will have continued to invest in areas such as IT to enable homeworking through the pandemic, business surveys and official data pointed to a pause in other areas of capital investment. The 'super deduction', a sizeable tax break for business investment announced in March, should encourage firms to restart or accelerate investment plans in the coming year. Other changes announced in the Budget, such as the extension of the Recovery Loan Scheme and reforms to the way investment is treated in the business rates system, should provide further props to business investment.

While this is a generally positive near-term outlook, Chart 2 shows that even with the forecast boost to investment in the next few years, there remains a sizeable gap compared with where investment levels were forecast to be prior to the pandemic. Even before the pandemic investment by UK businesses was thought to be sub-optimal relative to competitors and the shape of the recovery highlights the challenge in delivering the step change in productivity that government aspires to.

WHAT WAS ANNOUNCED?

Chart 3: Estimated cost of budget measures 2022/3 – 2026/7, £bn (negative figures indication cost to the Exchequer)



Source: OBR

The economy is back on the up, but as noted last time, the pandemic has not just impacted on the UK's economic potential, it has also had some hefty consequences for the public finances, as we set out last month. On the one hand the chancellor wanted to boost his fiscally responsible credentials, but on the other there were expectations that the Budget would address longstanding pressures on public services and alleviate more recent challenges on household budgets.

To address the former, a new set of fiscal targets were announced – a Charter for Budget Responsibility – though it remains to be seen whether these will have a longer shelf life than previous fiscal rules.

On the latter, the chancellor's speech was announcement heavy (Chart 3) – covering measures to ease the squeeze on households, as well as spending review announcements focusing on longer-term priorities such as education and skills, innovation and regional regeneration. Support for businesses came primarily from further reforms to the business rates system, and positively for financial services, a planned reduction in the Bank Surcharge. And it would be remiss not to mention the reform of alcohol taxes, given how much of the speech was devoted to it.

Some of the biggest numbers contributing to the public finances in the coming years were previously announced measures, such as the new health and social care levy and the changes to the state pension triple lock.

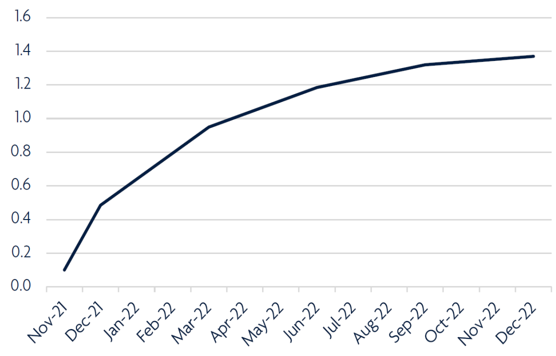
Overall, this was a giveaway Budget, with large increases in department spending in the near term. However, in some cases such as education this is addressing the real terms cuts departments faced post-financial crisis. The actions announced to raise living standards, a combination of tax cuts and freezes, universal credit reform, and the pre-announced increase in the national living wage, were generally thought to be redistributive, but not a game changer, particularly for median income households and for future living standards, given the outlook for inflation.

THE BANK'S NEXT MOVE?

And speaking of inflation, with the Budget done and dusted, the spotlight turns to the next Monetary Policy report, which will present the Bank of England's latest assessment of economic prospects, and the interest rate decision from the MPC. Speculation about the timing of a change of policy from the Bank has been heating up. Inflationary pressures have been clearly building since the global recovery found a surer footing, driven initially by surging commodity and energy prices.

The outlook for inflation has strengthened further in recent months, with the OBR presenting significant upside risks, noting the peak could be as high at five per cent next year. And with it, inflation expectations are also elevated. As such, expectations for the first increase in Bank Rate have been pulled forward, with markets expecting a move to come this year (Chart 4). And with the announcement of a fiscally expansionary Budget, some analysts think the odds of a move as soon as this month have shortened.

Chart 4: Implied path of Bank Rate, three-month sterling futures



Source: ICE

With the recovery underway and inflation likely to overshoot its target well into next year, there is a case for the Bank to begin to move rates gradually from their emergency 0.1 per cent, not least on the grounds of maintaining credibility. However, there are still a number of big unknowns which were highlighted in the minutes of previous meetings, namely the path of the labour market following the end of the furlough scheme and the path of new Covid-19 cases as we move into the winter months. Some MPC members have signalled a preference to wait until there is more evidence on these before moving to raise rates.

Economists are split on whether the move will come in November and it's likely the Committee will be too, whatever the decision. Whether the move comes now or in December, next month's review will look at the potential impact of rate rises on businesses and households.

ROUND UP

The chancellor did a creditable job in balancing the need to present a firm(ish) grip on the public finances, while taking steps to address politically sensitive challenges to the recovery. Additional spending in areas such as health, education, and levelling up provide something of a down payment on future growth, but ambitions for the UK to up its game on post-Brexit trade, building a science powerhouse and boosting productivity around the UK still feel like a work in progress, particularly given the OBR's medium-term growth outlook.

The next balancing act for the government is delivering a successful global climate change deal at COP26 this month (perhaps a bit trickier in the wake of some not-very-climate-friendly Budget announcements).

Aside from the upcoming MPC meeting there will be some key data points to watch in the coming weeks. Among them, more detail on the numbers on furlough as the CJRS ended in Septembers (numbers at the end of August were still north of 1.5 million) and an update on employment number, and expectations of a slowdown in the quarterly GDP growth rate in Q3.

Indicator	Period	Value	Change	2021 Forecast*
GDP	Q2 2021	5.5%	↑	7.0%
CPIH inflation	Sep 2021	2.9%	↓	3.5%
Unemployment rate	Aug 2021	4.5%	↓	5.0%
Average earnings	Aug 2021	7.2%	↓	5.0%
Brent crude	Sep 2021	$74.49	↑	-
$ Exchange rate	Oct 2021	$1.37	↔	-
PSNB	Sep 2021	£21.8 bn	↑	£202.2 bn

Source: ONS, HM Treasury, Bank of England