UK FINANCE

MONTHLY ECONOMIC INSIGHT

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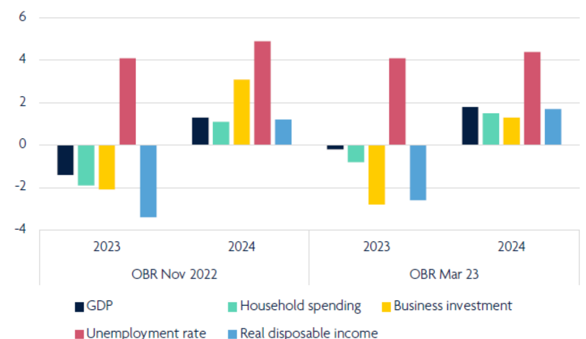
This month we focus on the detail of another fiscal event and a raft of reforecasts that point to a modestly improving economic outlook. We'll also take a look at that surprise increase in inflation and the factors behind the Bank of England's latest rate hike.

FORECAST UPDATE

- Improved near-term outlook, but weak underlying momentum.
- Inflation expected to fall sharply this year.
- Squeeze on real incomes to continue, but not as bad as November's forecast.
- Economy-driven improvements in public finances, with two-thirds deployed to new measures.

In **last month's briefing** we reported that the UK economy avoided a further quarter of contraction at the end of 2022 (indeed ONS revisions did not point to modest 0.1 per cent growth in Q4) and we also highlighted surveys that pointed to tentative signs of a slightly brighter outlook. The Office for Budget Responsibility (OBR) consequently made a number of upward revisions to the UK outlook in its March forecast update, which was published alongside the chancellor's Spring Budget (**chart 1**).

Chart 1: OBR Forecast updates, percentage annual change and percentage rate



Source: OBR

The OBR now expects a modest 0.2 per cent contraction in GDP this year, revised up from its forecast of a 1.4 per cent fall in November. Essentially a fairly stagnant picture rather than one of recession. New forecasts from the OECD put UK growth in a similar ballpark this year.

Despite the slightly better headline number, the underlying narrative for 2023 is one of a continuing squeeze on household disposable incomes, depressing household spending. The squeeze is now expected to be a bit less than was expected in the November forecast. Real household disposable income will shrink by a still hefty 2.6 per cent.

However, helping to ease the pressure on household finances is the expectation that inflation will fall rapidly this year, aided by the extension of the energy price guarantee (EPG). Real incomes will start to recover next year, supporting a broader covering in spending and output.

Other aspects of the forecast were not significantly changed since the last OBR report. The labour market outlook for next year looks slightly better and the peak in unemployment is now a bit lower.

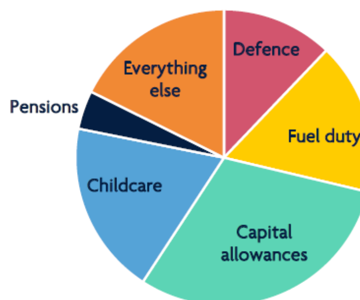
Again, as noted in last month's briefing, business investment fared pretty well in 2022 (though some of the momentum at the end of the year has been revised away in the latest ONS figures). There is expected to be some pull back this year, with the end of the super-deduction which sought to incentivise businesses to bring forward investment after the sharp falls during the pandemic. The super-deduction has been replaced with full expensing of investment for the next three years. The OBR expects this to have a positive near-term impact on the investment profile but little change in the capital stock at the end of the forecast period compared with November's forecast.

BUDGET MEASURES

Also discussed last month were the lower-than-expected borrowing figures for 2022 which would provide the chancellor with some headroom for additional spending. He chose to use about two-thirds of this wiggle room, largely directed towards the prime minister's growth priorities.

There was a long list of measures grouped under the themes of 'enterprise, employment, education and everywhere.' These included measures such as an ambition for 12 new investment zones, additional tax relief for R&D intensive businesses, reform to disability benefits, some additional levelling up funding and a potholes fund. All of which come under the banner of 'everything else' in **chart 2**.

Chart 2: Breakdown of new measures announced in the spring budget, percentage of total cost



Source: OBR

The bigger spending areas, in terms of total new or additional spend over the forecast horizon, were focused on productivity enhancing measures – notably increasing investment and tackling economic inactivity, an increase in the defence budget (for obvious reasons) and fuel duty freezes.

Starting with the UK's perennial productivity problem – the chancellor zeroed in on two contributing factors, the UK's poor track record on business investment, which has flatlined since 2016 and higher economic inactivity since the pandemic.

In an effort to tackle the first, the chancellor introduced full expensing for qualifying capital expenditure in the year of purchase for three years, with the intention of making it permanent when deemed affordable. This will move the UK's capital allowances regime right up the international competitiveness rankings. But is pretty costly in the short term – however to a large extent this is a timing effect rather than a permanent cost to the Exchequer.

This will no doubt be a welcome move providing a helpful cashflow boost to investing businesses. Stability in this part of the tax system would also be welcome as the capital allowance regime has been subject to an average of one change every two years in the past four decades.

There has also been much discussion about inactivity in the labour market, including in a recent speech from the Bank of England governor Andrew Bailey. He noted the fall in participation was notable among older workers – those retiring early and an increase in long-term sickness since the pandemic. The policy response was sweeping change to pensions tax, which can disincentivise people remaining in work and continuing to save, and some smaller scale measures to encourage reskilling. Additional funding for childcare, most of which kicks in at the start of the next parliament, could also support increases in female participation rates.

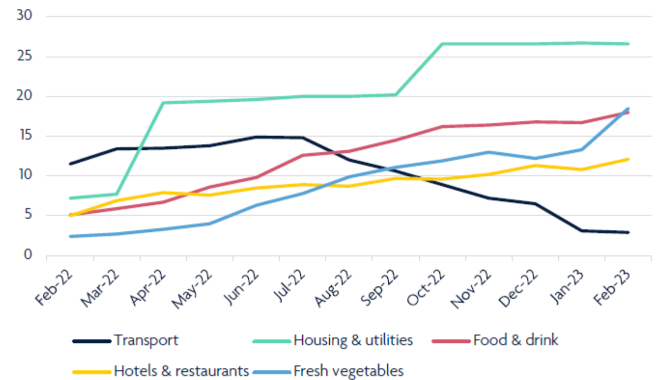
INFLATION SURPRISE

Not long after the OBR's forecast of rapidly declining inflation through this year, the latest ONS data showed a surprise rise in CPI from 10.1 per cent to 10.4 per cent in February. As **chart 3** illustrates, there were a couple of specific contributing factors behind the increase.

Rising food prices have been a feature of elevated inflation over the past year and a key factor in squeezing household budgets, as highlighted by surveys. There was no sign of any let up in February with food price inflation picking up to 18 per cent – the highest reported in the series. Within this, fresh vegetables were a significant contributor, reflecting some of the weather-related shortages, e.g. tomato shortages made headlines last month. This should, at least, prove to be transient.

In addition, last year's jump in energy prices will start to drop out of the calculation, which will see the headline rate head lower in the coming months. The Bank of England expects CPI to fall significantly in 2023 Q2, further aided by the Budget announcement that the EPG will remain at current levels as well as falls in wholesale energy prices.

Chart 3: CPI components, percentage change on a year ago



Source: ONS

BANK OF ENGLAND RESPONSE

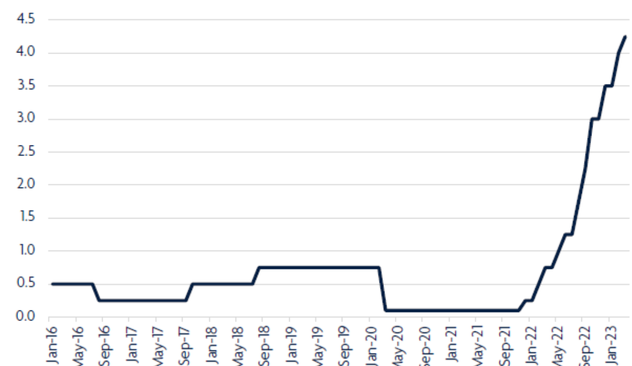
In line with expectations, the Bank of England raised the Bank Rate again in March, but by a quarter point and unlike previous rises, the decision was not seen as a racing certainty by markets. This pushed up rates to 4.25 per cent – where the OBR expects the peak (**chart 4**).

Alongside the decision, the MPC minutes also took a slightly more upbeat tone about the outlook. The global growth outlook had improved, and a provisional assessment of the measures announced in the spring budget were expected to have a positive impact on the level of GDP in the coming years.

For the majority of the committee, this improved outlook and the upside surprise on the latest CPI data sealed the deal for another rise. There are deemed to be risks that renewed labour demand could lead to more persistent inflation. Despite the rise, the absence of anyone calling for a 50-basis point increase was notable.

Looking ahead and against the backdrop on recent events in the financial sector, the Bank noted '...that the UK banking system maintains robust capital and strong liquidity positions, and is well placed to continue supporting the economy in a wide range of economic scenarios, including in a period of higher interest rates.' The Bank will be closely monitoring credit conditions for businesses and households, in addition to labour market developments, wage growth and services inflation. Again, it is how these develop that will determine if and when monetary policy needs to respond.

Chart 4: Bank of England Rate, per cent



Source: ONS

CHINA'S NEW GROWTH TARGET

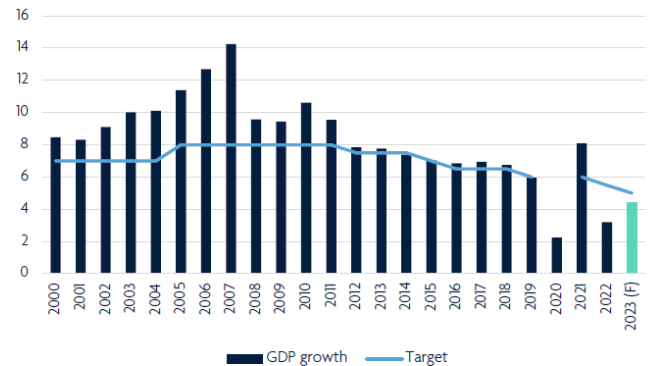
And to something completely different... As noted earlier, the OECD forecast update in March indicates a firmer outlook for the global economy in 2023 with some strengthening in 2024. It uprated its forecast for global growth to 2.6 per cent this year, up from 2.2 per cent previously. Two key factors behind the upgrade – falls in wholesale energy prices and the earlier than expected reopening of the Chinese economy – eased supply chain pressures and provided a boost to international tourism.

And with China now back in the game, the government has set out a new growth target. It aims to achieve an economic growth target of around five per cent for 2023. China fell short of its 2022 target of 5.5 per cent. There is confidence that the new target is more realistic and will be underpinned by household consumption following the conclusion of the zero-Covid policies.

This had been China's lowest target for the last three decades as President Xi Jinping aims to restore pre-pandemic levels of growth to prioritise stability (**chart 5)**. If met, this stabilisation could allow China to set themselves on a path to eventually become the world's largest economy, overtaking the US.

The global economy has become used to the important Chinese growth engine. Is the more realistic target likely to be met? Achieving it will be helped by China emerging from a weak 2022. In addition, manufacturing activity has taken off again with the PMI hitting a decade high in February. Also announced was a widening of the annual budget deficit to three per cent in an effort to expand domestic demand. Infrastructure investment is expected to be a key driver to boost economic growth in 2023.

Chart 5: China GDP growth and target, percentage annual change



Source: IMF

Indicator	Period	Value	Change	2023 Forecast*
GDP	Q4 2022	0.1%	↑	-0.5%
CPI inflation	Feb 2023	10.4%	↑	7.4%
Unemployment rate	Jan 2023	3.7%	↔	4.4%
Average earnings	Jan 2023	5.7%	↓	5.1%
Brent crude	Feb 2023	$82.59	↑	-
$ Exchange rate	Feb 2023	$1.21	↓	-
PSNB	Feb 2023	£16.7 bn	↑	£138.1bn

Source: ONS, HM Treasury, Bank of England, EIA