UK FINANCE

MONTHLY ECONOMIC INSIGHT

November 2023

Written by:

Lee Hopley
Director,
Economic Insight and Research

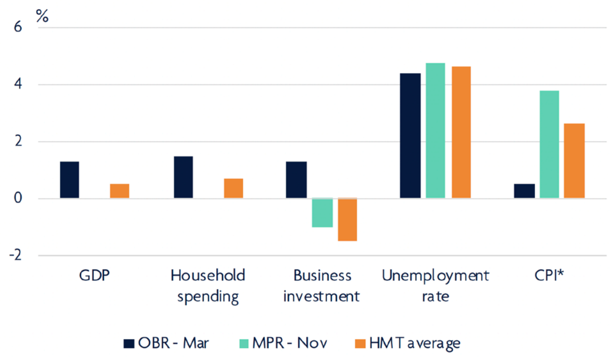
It's autumn statement time again. This month's briefing takes a look at the current state of the public finances and some of the macroeconomic developments that will play into the accompanying OBR forecast update. In addition, we'll take a look at some of the better-than-expected data from the US and China.

OBR SET TO REVISE GROWTH AND INFLATION OUTLOOK

At the time of the spring budget the Office for Budget Responsibility (OBR) was striking a slightly more positive tone in its Economic and Fiscal Outlook (certainly compared with the previous forecast in November 2022).

In its March 2023 forecast, the OBR judged that the risk of prolonged recession in 2023 had receded, and inflation was expected to drop back sharply in response to rising Bank Rate, which it expected to top out at 4.25 per cent. GDP growth was expected to show a small fall of 0.2 per cent this year but return to decent growth of around 1.8 per cent in 2024, though noting the continuing structural challenges facing the UK economy in the medium term.

Chart 1: 2024 forecasts, annual percentage change



Source: OBR, HMT and Bank of England

The OBR's forecast update later in November will likely see an upgrade to their 2023 growth expectations but strike a more cautious note about the year ahead. Inflationary pressures have proved more persistent than expected leading to a greater monetary policy response from the Bank of England.

There has been more resilience on the part of the consumer, than expected, with household spending contributing positively to GDP growth in the first half of 2023. However, this does appear to be tailing off and in the Bank of England's latest Monetary Policy Report (MPR) expectations that this resilience will continue have been scaled back – not least as the full effects of higher interest rates are still to be felt, such that both household spending and GDP are predicted to be flat in 2024. The Bank's outlook is now materially weaker than the OBR's previous forecast (and indeed a downgrade from the Bank's August forecast).

The OBR is also likely to revise up the path of inflation given its persistence, stronger wage growth and a still tight-ish labour market. The Bank sees CPI inflation returning to its 2 per cent target only at the end of 2025. Hence the decision to retain Bank Rate and 5.25 per cent in November, though it was once again a split decision, with three MPC members continuing to vote for a quarter point rise. There was also pretty clear messaging that rate cuts are not on the agenda.

The Bank of England's latest forecast of the UK economy treading water next year as the fight against inflation continues is not out of line with other independent forecasts. If the OBR takes a broadly similar view on the near term outlook, they should be able to offer some good news to the chancellor that the government's target of halving inflation is on track, but the growth ambition looks a lot more challenging.

The OBR will, however, have the benefit of advance sight of any tax and spending announcements that might impact on the economic outlook, but as we'll come too next, there is limited fiscal space for a big giveaway that would provide a big boost to growth in the short term.

BUT PUBLIC FINANCES LOOKING BETTER THAN MARCH EXPECTATIONS

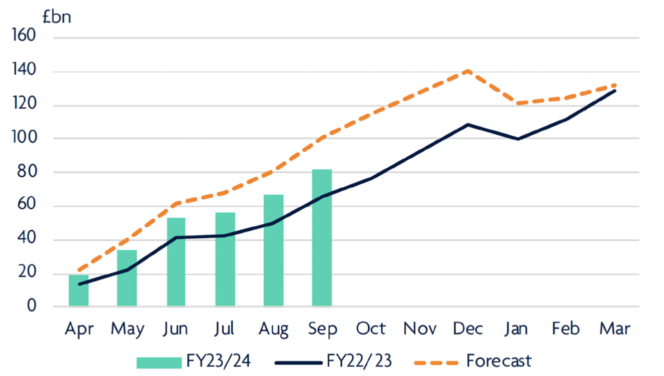
The other important element of the OBR's forecast update will be developments in the public finances. Battered by the legacy of Covid-19 support in recent years and the shadow of that 2022 mini-budget, fiscal credibility remains the order of the day – on both sides of the House.

Back in March the OBR forecast public sector net borrowing of £132 billion in 2023/4, more than five per cent of GDP. Data from ONS to September shows the deficit tracking sightly better than those forecasts – by around £20 billion in the first six months of the fiscal year (**chart 2**).

Behind the better-than-expected data thus far is stronger than expected receipts, notably income tax and VAT as a result of higher nominal tax bases, and lower spending on debt interest and benefits (thought offset somewhat by pay increase in the NHS and civil service).

While this provides a more comfortable backdrop for the chancellor's autumn statement (certainly compared with a year ago), it doesn't necessarily offer much room for manoeuvre, not least as the OBR's spring fiscal forecasts further out showed borrowing falling gradually over the forecast period, but debt to GDP ratio continuing to rise through to 2026/7.

Chart 2: Public sector net borrowing, £ billion



Source: ONS and OBR

As the Institute of Fiscal Studies also notes in its Green Budget the medium-term fiscal outlook is subject to both economic and policy uncertainty. For example, the IFS notes that forecasts for the public finances assume increases in fuel duty will resume (unlikely) and the Chancellor (whoever that may be) will stick with previous commitments to freeze personal tax thresholds out to 2027/8 (politically difficult given this equates to a substantial tax rise and will essentially double the number of higher and additional rate taxpayers compared with the start of this decade).

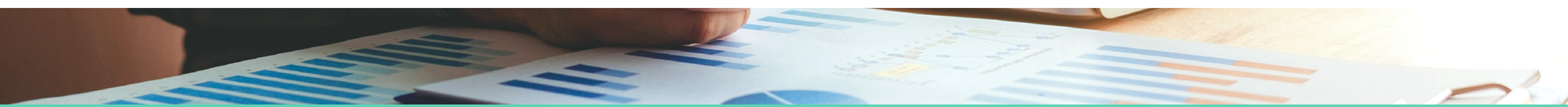
The conclusion from the IFS therefore is in the current environment of high inflation and rising interest rates, a fiscal loosening would be extremely difficult to justify – especially given the high and volatile costs of servicing debt.

So, what might the chancellor's options be? Typically, a month out, there's no shortage of recommendations and speculation – here are a few of the apparent frontrunners.

The UK housing market has seen major challenges this year through higher mortgage rates, and in turn falls in house prices. Annual rental growth has also seen significant increases on the back of rate hikes and strong demand. Support for the housing sector and home ownership may be one area of focus in the statement. For example, the chancellor may target some additional help to First-Time Buyers with a package of support, which could include an extension of the government's mortgage guarantee scheme. Potential changes to house price limits on existing ISAs, like the Help to Buy ISA, could also be on the agenda. And probably prudent never to rule out the option of stamp duty changes.

There are also calls for wider ISA reform targeted towards making it simpler and easier for individuals to invest and save. This could involve increasing overall ISA allowances, potential changes to the Lifetime ISA penalty charges, and (as UK Finance is calling for) a review of the ISA framework to incentivise investment in UK equities.

A somewhat trickier decision is what next for the pension's triple lock. The policy, which increases the state pension by the highest of average earnings, CPI or 2.5 per cent, is set to lead to an increase the value of the state pension by July's average earnings growth of 8.5 per cent next April. Though, the Treasury could opt to exclude the bonus element of average earnings, which would take the uplift to 7.8 per cent. Either uprating would come with a fairly sizeable price tag and will continue to fuel debate about the sustainability of the triple lock rule, especially under the current economic conditions, leaving public finances potentially exposed to the significant increases in the pension costs in the long term.



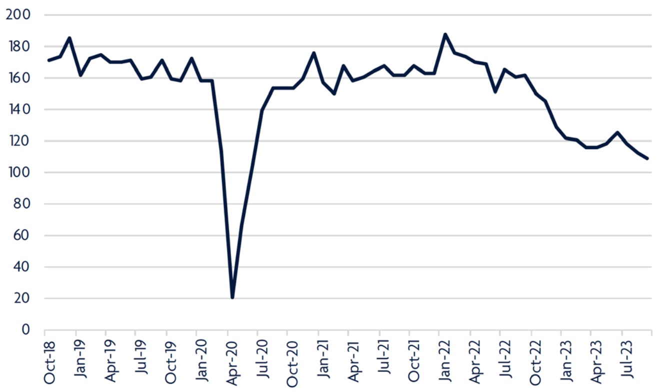
BRICKING IT

Since the economy emerged from the pandemic, the construction sector has been an important contributor to overall growth, with activity expanding in every quarter since the end of 2021. There has been a notable expansion in this period in repair and maintenance (up around 13 per cent on average in 2021/2) and housing (up 12 per cent on average).

The rise in interest rates and wobblier buyer confidence has led to a drop off in new housing activity in 2023. And the runes don't look great for the near-term outlook – the runes being trends in brick deliveries (hat tip to the Construction Products Association for highlighting the data).

Year-to-date deliveries are around 30 per cent down on the same period in 2019, which would point to housing construction activity remaining fairly depressed and maintaining the pressure on the UK's housing supply challenges.

Chart 3: Brick deliveries, millions of bricks seasonally adjusted



Source: : Department for Business and Trade

A BIT OF BETTER GLOBAL NEWS

Leaving the UK behind, there have been a couple of international upside surprises in recent GDP data. Q3 growth in both the US and China was stronger than forecasters were expecting (**chart 4**).

Starting with China – GDP expanded at a quarterly rate of 1.3 per cent, against expectations of a one per cent expansion and up from Q2's 0.5 per cent reading. Potentially an indication that earlier stimulus to support the property sector, interest rate cuts, and liquidity injections are feeding through.

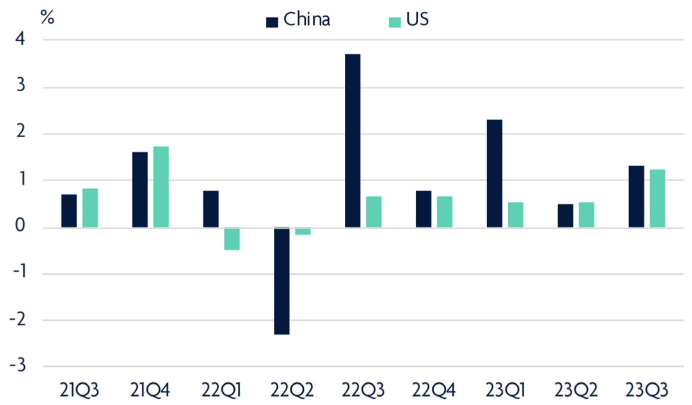
The release from China's National Bureau of Statistics pointed to the robust growth in services. There were solid rates of expansion in retail sales, industrial activity, and investment, though the trade picture remained fairly lacklustre.

The IMF expects China to hit its five per cent growth target this year but is forecasting some weakening in 2024. The debt overhang in the stricken property sector remains a sizeable challenge. And emerging Q4 indicators point to a bit of a loss of momentum in the final months of this year, prompting discussion about fresh stimulus measures.

Chart 4 also shows a solid first estimate of US growth in Q3 (1.2 per cent quarter-on-quarter), with the breakdown of contributions to growth in **chart 5**. Household spending (PCE) and investment were the bigger contributors, with residential investment also posting its first quarter of growth since the start of 2021.

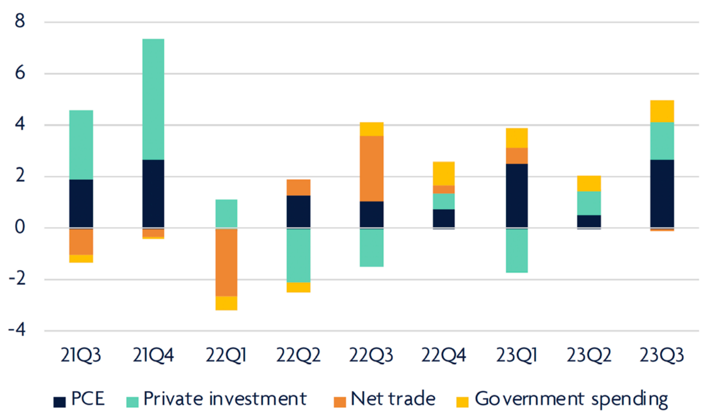
The Fed noted the strong Q3 performance but continued to leave interest rates on hold. Data in the days after the Fed's meeting – private sector PMIs and payroll numbers – were also slightly softer, fuelling the view that the Fed is now finished with rate hikes.

Chart 4: China GDP growth, percentage quarter on quarter change



Source: Trading Economics

Chart 5: US GDP growth, contributions to growth



Source: Bureau of Economic Analysis

Indicator	Period	Value	Change	2023 Forecast*
GDP	Q2 2023	0.2%	↑	0.5%
CPI inflation	Sep 2023	6.7%	↔	6.1%
Unemployment rate*	Aug 2023	4.2%	↑	4.4%
Average earnings	Aug 2023	8.1%	↑	6.7%
Brent crude	Oct 2023	$90.60	↓	-
$ Exchange rate	Oct 2023	$1.22	↓	-
PSNB	Sep 2023	£14.3 bn	↑	£121.7bn

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

** New ONS experimental series*