UK Watch

Budget review: optimistic

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United Kingdom

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Borrowing close to expectations

Today's UK Budget saw updated borrowing forecasts close to our expectations. Forecast public sector net borrowing of £152bn in 2022/23 and £132bn in 2023/24 were each £7bn above our expectations (Exhibit 5)

As Chancellor spends two-thirds of improved outlook

Big picture, higher receipts as the economy proves more tax rich than expected and stronger growth were offset by higher spending (Exhibit 1). This was largely as expected. The news was that the OBR (Office for Budget Responsibility) forecast better underlying public finances than expected (£20bn in 2027/28), giving the Chancellor room to raise spending more than we expected. The OBR still projects the tax burden to rise to a post-war high in 2027/28 and public spending to settle at its highest sustained level since the 1970s. The big picture remains rising pressures on public spending from an aging population bumping against tax receipts growth held back by a sluggish economy.

Based on optimistic forecasts

These Budget forecasts are in our view based on optimistic economic assumptions. Improved growth in 2023 is uncontroversial, driven by lower energy prices. But the OBR surprisingly made no downgrades to its medium-term potential growth assumptions. The OBR continues to assume much stronger medium-term growth than the Bank of England (BoE) and other independent forecasters (Exhibit 2). In the near-term we see risks skewed to weaker growth in 2024 than the OBR, who assume the BoE can defeat inflation with a modest rise in the unemployment rate to 4.4% that cuts wage growth to just 1.8% next year and inflation to just 0.6%.

Debt becomes the constraining factor

The OBR forecasts the Chancellor to meet both of his fiscal rules: borrowing less than 3% of GDP and the debt-to-GDP ratio falling in five years' time, but with the smallest headroom any Chancellor has set aside since the OBR was established. The debt-to-GDP rule is the constraining rule now, given softer than the historical average GDP growth. The Chancellor meets it by £6.5bn in 2027/28 (Exhibit 3). We see upside risks to these borrowing forecasts. Whether that matters for fiscal policy soon is a separate issue. The Chancellor's fiscal rules require him to forecast to meet the rules in five years. Tax cuts and spending increases are possible in the near-term if balanced by forecast consolidation in the medium term. The current forecasts not only assume stronger growth than other forecasters they also incorporate historically weak public spending growth from 2025, which we think will be hard to deliver. The impact of the rules can be seen in the Chancellor's new investment allowances. The former as currently planned will end in 2026/27, causing a forecast business investment fall after (Exhibit 4). Yet in a year's time the Chancellor can extent the allowances to 2027/28 and still meet his fiscal rule, which will then be for 2028/29. We see risks to borrowing skewed firmly upwards.

(Continued on next page.)

Marginally hawkish for Bank of England

The OBR estimates that the fiscal changes will boost GDP by 0.3% in a couple of years' time which would be modestly hawkish for the BoE, consistent with perhaps one more rate hike than previously planned. That said, this size forecast change is easily lost in the margins error around growth and inflation forecasts, especially given recent events.

Supply side boosting measures, but small

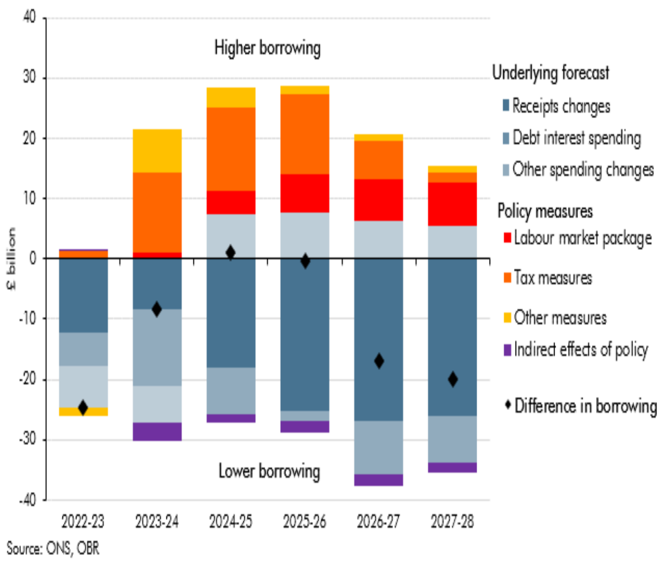
Moving from the tax and spending figures to the impact of policy measures, the good news was the government implementing supply side boosting policies as well as help with the cost of living in the near term.

As expected, the Chancellor froze the Energy Price Guarantee at £2500, froze fuel duty for another year, and raised defence spending. He also announced: increased free childcare allowances for working parents, improved childcare support within Universal Credit, increased pensions lifetime and annual allowances and changes to disability benefits. The OBR sees the first of these as the most significant, raising the workforce by 60k by 2027/28. Importantly though the full changes to childcare support will be rolled out in phases from April 2024 so will take time to have an effect.

The Chancellor added full investment expensing for the next three years, which the OBR sees boosting the level of business investment 3% (temporarily, so it has no effect on the long-term capital stock). Overall, the OBR assesses these supply measures will increase the level of potential supply 0.2% in 5 years' time (Exhibit 6). While this is, as the OBR says, the largest upward revision to potential output due to policy measures the OBR has made since it was established in 2010, that is more a statement of the relative lack of such positive measures previously than of a particularly large change this time. Indeed, these measures could undo perhaps one-twentieth of the 4% cut to potential productivity the OBR factors in from Brexit.

Exhibit 1: Public sector borrowing, change since November

Higher tax receipts offset by spending increases and tax cuts



Source: OBR

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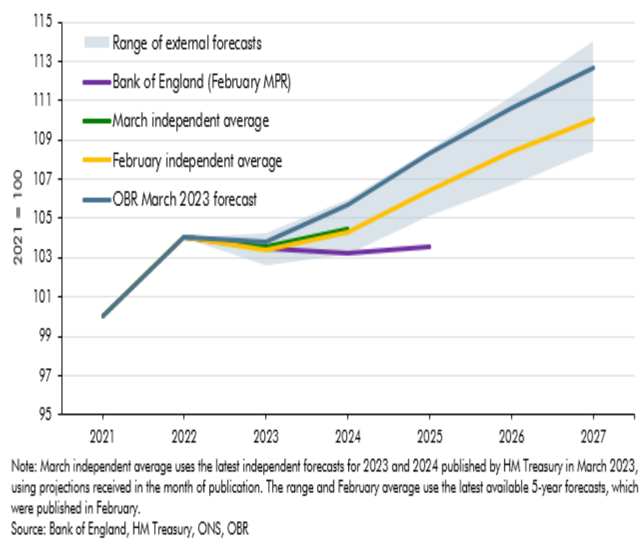
Exhibit 2: Real GDP forecast comparison

OBR expects much stronger growth than Bank of England and other forecasters



Source: OBR

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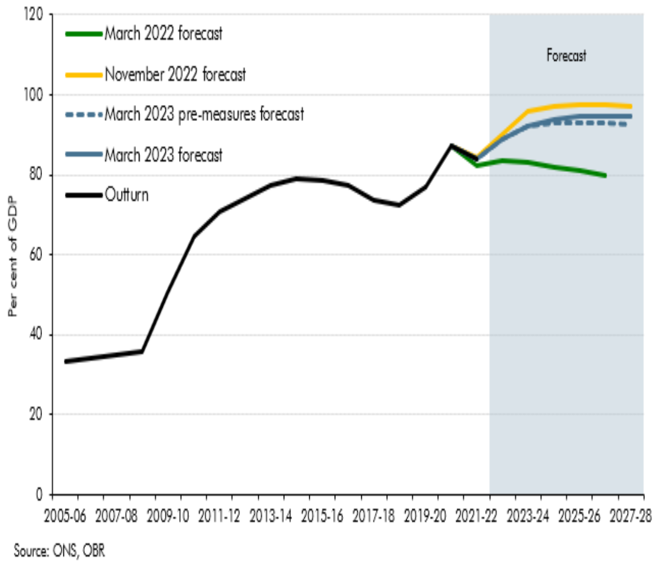
Exhibit 3: Public sector net debt ex-BoE, % GDP
Public sector net debt falls marginally in 2027/28



Source: OBR

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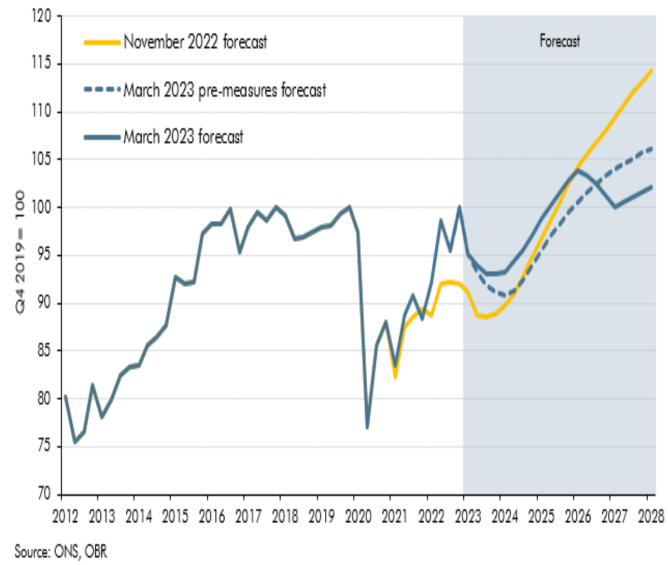
Exhibit 4: Business investment
Business investment rollercoaster as tax incentives planned to expire in 2027



Source: OBR

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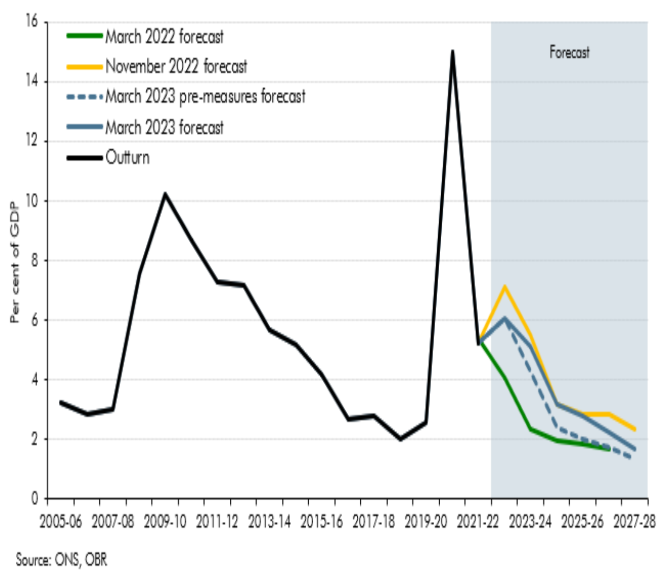
Exhibit 5: Public sector net borrowing
Public sector net borrowing declines over the forecast



Source: OBR

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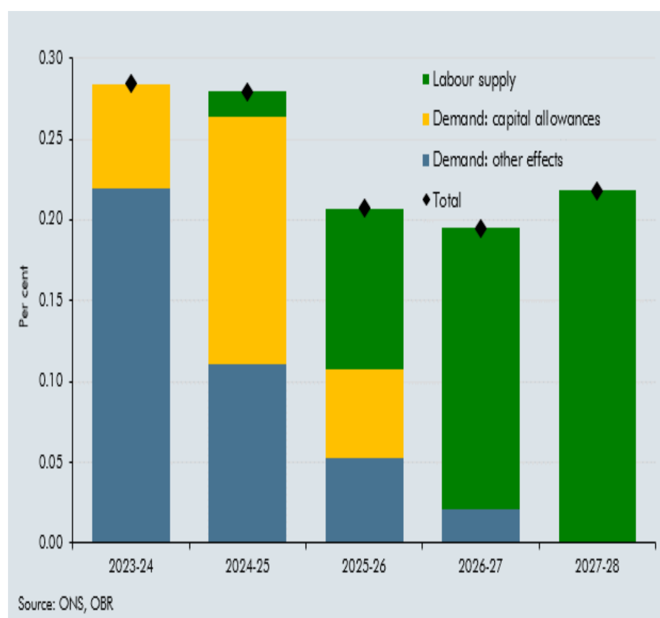
Exhibit 6: Impact of policy measures on real GDP
Welcome supply side boost, but small



Source: OBR

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NS&I and T-bills not utilised to the extent we had hoped

The Debt Management Office (DMO) cut its Net Financing requirement (NFR) for the current fiscal year by £21bn to £182bn vs. the update published in November (Exhibit 7).

For next fiscal year, a combination of £160bn Central Government Net Cash Requirement (CGNCR) – lower than November's DMO estimate for £188bn, but not far off our estimate of £166bn heading into the Budget – together with £117bn Gilt redemptions and a £21bn expected adjustment from the current fiscal year imply a

£255bn Gross Financing Requirement. A broadly unchanged projection for National Savings & Investment (NS&I) - £7.5bn in 2023/24 - implies £246bn NFR.

Of that, planned gross Gilt issuance of £241bn next fiscal year will be £72bn higher than this year's £170bn. The numbers expected by consensus (a Bloomberg survey of 15 banks released earlier this week suggested consensus was £233bn). The £241bn number is meaningfully higher than our own expectation of £167bn largely because we had expected an ambitious expansion in the NS&I programme. The £5bn of net T-bill sales pencilled in by the DMO was also much lower than our expectation of a £35bn increase in the T-bill stock.

Exhibit 7: DMO financing arithmetic for Fiscal Year (FY) 2022/23 and 2023/24, £bn
£72bn more Gilts to be sold next fiscal year than in fiscal year 2022/23

UK DMO financing Remit arithmetic (£bn)	FY 2022/23 (DMO - Nov'22)		FY 2023/24 (DMO - Nov'22)	FY 2022/23 (BofA - Mar'23)		FY 2023/24 (BofA - Mar'23)		FY 2022/23 (DMO - Mar'23)		FY 2023/24 (DMO - Mar'23)	
CGNCR	136.1		188.1	99.6		166.0		115.4		159.5	
Redemptions	107.1		117.0	107.1		117.0		107.1		117.0	
Adj. from prev. FY	-33.1			-33.1		-36.5		-33.1		-21.3	
Gross Financing Req. (GFR)	210.1		305.1	173.6		246.5		189.4		255.2	
Less:											
NS&I & NS&I green	6.0			6.0		45.0		6.1		7.5	
UK Sukuk	n/a			n/a				0.5			
Other financing	1.4			1.4				1.4		1.5	
Net Financing Req. (NFR)	202.7			166.2		201.5		181.9		246.1	
To be financed through:											
Gilt sales, through:	169.5			169.5		166.5		169.5		241.1	
Short conventional	66.5	39%		66.5	39%	68.5	41%	66.5	39%	86.7	36%
Medium conventional	43.2	25%		43.2	25%	40.5	24%	44.6	26%	65.3	27%
Long conventional	39.8	23%		39.8	23%	32.5	20%	40.8	24%	50.9	21%
Index-linked	17.0	10%		17.0	10%	15.0	9%	17.5	10%	26.2	11%
Unallocated	3.0	2%		3.0	2%	10.0	6%	0.0	0%	12.0	5%
Net T-bill sales	33.2			33.2		35.0		33.2		5.0	
Total financing	202.7			202.7		201.5		202.7		246.1	
DMO net cash position	2.3			2.3		2.3		23.6		2.3	

Source: DMO, BofA Global Research
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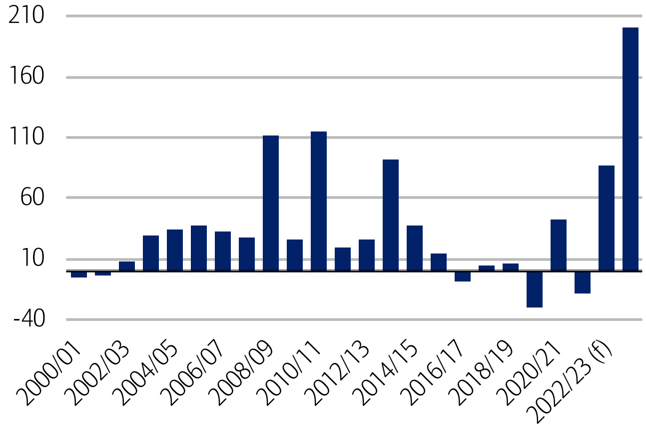
In our Budget preview, we said that even if Gilt sales stayed around the same level as this fiscal year, Gilt issuance from the Bank of England (BoE) and DMO will reach a new historical record high. The DMO's plan for £241bn of Gilt sales implies that net Gilt sales to private investors will more than double from the current fiscal year, and almost double versus the previous historical record high (Exhibit 8).

Across the "buckets", the DMO allocated 63% of Gilt sales to shorts (36%) and mediums (27%), but the skew shorter was less pronounced than expected by us. Of course, some of the £12bn (5%) unallocated could end up in short bucket, increasing the share of short-dated Gilts further. Meanwhile, the share of longs and inflation-linked Gilts came in broadly in line with our expectation (Exhibit 9).

Heading into the budget we argued that our expected Gilt skew shorter should imply more cheapening of Gilts relative to Sonia at the front-end than further out on the curve. The 2s20s Gilt ASW curve – our preferred way to look at Gilt Remit skew effect on the market – shows the 20y being 10bp richer relative to the 2y today than at the start of the week. However, price action due to banking sector upheavals is hard to disentangle from the Budget effect. Although the skew shorter was not quite as aggressive as we had expected, we hold onto the trade for the time being.

Exhibit 8: Gilt net supply to private investors, £bn
More than double the amount to be sold in 2022/23



Source: DMO, BoE, BofA Global Research
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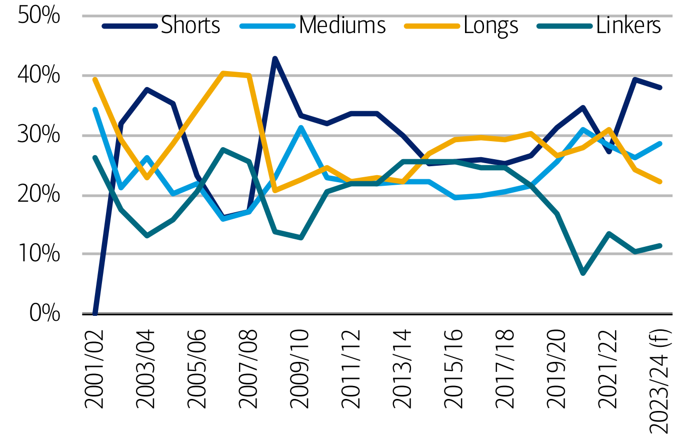
Exhibit 9: Past breakdown of planned Gilt sales & BofA f'casts, %
Share of shorts could rise further if some "unallocated" ends up in shorts



Source: DMO, BofA Global Research
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