BERENBERG
PARTNERSHIP SINCE 1590

# UK spring forecast preview: boxed in

- It was not supposed to be like this. UK chancellor Rachel Reeves planned to present the government's official biannual forecast on 26 March without making any changes to policy. However, a rise in market interest rates, high borrowing in fiscal year 2024-25, and a possible downgrade to the Office for Budget Responsibility's (OBR) productivity growth assumption have conspired against her. Without spending cuts or tax rises, the OBR would forecast the government missing its fiscal rule of funding day-to-day spending entirely with tax revenue by 2029-30. To avoid six months of speculation about how Reeves will make up the shortfall in the next fully-fledged budget in the autumn, the chancellor must act now.
- Although the government raised borrowing in the October budget compared to the previous fiscal plan, it also set out to reduce this higher initial deficit significantly over the next three years. It would be wise to stick to this course of action. High interest rates and, relatedly, the drag on net exports from an overvalued pound are major headwinds to the UK economy. Tighter fiscal policy would eventually allow the Bank of England (BoE) to lower interest rates further and sterling to depreciate. First, however, the BoE must deal with uncomfortably sticky inflation.
- The OBR will revise up its forecast for government borrowing for at least two reasons: i) market interest rates are higher than it assumed; and ii) the budget deficit in 2024-25 to date is much higher than expected. Were it to downgrade productivity growth too, the government's predicament would be much worse.
- For deficit reduction to remain credible, the government must either raise taxes or cut spending. The government's promise not to raise personal or corporate tax rates and the slip in employment since the government announced higher taxes in October will prevent it from opting for further tax hikes. Therefore, we expect the government to go against its political instincts and make up most of the shortfall by cutting spending.
- Disability and incapacity benefits have risen by much more in the UK than in other countries over the past five years, suggesting there is scope to cut welfare spending. However, it is difficult to judge how much reforms will save ahead of time. Therefore, a cut to departmental budgets for public services is also likely. Finally, while the government will not raise tax rates, revenue from bracket creep will probably be too tempting to pass up, so we suspect that income tax thresholds will stay frozen beyond 2027-28.

**Chart 1: Illustrative changes to the OBR forecast since October (£bn in 2029-30)**

| | |
|---|---|
| **October 2024 forecast for current budget balance** (target>0) | **10** |
| Higher interest rate assumption | -6 |
| Higher 2024-25 borrowing than anticipated | -12 |
| GDP undershoot, pay and inflation overshoot | uncertain |
| **March 2025 forecast for current budget balance** | **-8** |
| *Memo: Scenario in which OBR downgrades productivity assumption* | |
| *Trend productivity reduced from 1.0% yoy to 0.75% yoy* | *-20* |
| ***March 2025 forecast for current budget balance*** | ***-28*** |
| **Options for remedial action** | |
| Extend income tax threshold freeze for two more years | +10 |
| Sickness and incapacity benefit reform | +6 |
| Reduce planned increase in total departmental spending | +10 |
| Reallocation of spending from aid to defence | +2 |
| **Total of options to raise current budget balance** | **+28** |

*In £bn in 2029-30, forecasts of the impact of changes in inputs to the forecast and policy changes. The current budget balance is tax revenue minus day-to-day spending. The government's main fiscal rule is to move the current budget balance into surplus by 2029-30, i.e. fund day-to-day spending entirely with tax revenue.*
*Sources: OBR, IFS, Berenberg calculations*

Key macro reports



17 March 2025

Andrew Wishart
Senior UK Economist
Andrew.wishart@berenberg.com
+44 20 3753 3017

# The UK is listening to the bond market

*Investors will not give the UK any more fiscal space*

**Held to a higher standard:** The bond market has reminded the UK government that it is close to the limit of what investors are willing to fund on several occasions in recent years. A rise in gilt yields coincided with a depreciation in the pound after the ill-fated Liz Truss "mini budget" and again at the beginning of this year. Moreover, following the recent decline in the 10-year US treasury yield due to worries that the US economic growth may slow, the current UK 10y yield of 4.7% is the highest on any developed market sovereign bond.

The UK government is held to a higher standard than other sovereigns for three reasons. First, as indicated by its sizeable current account deficit, the UK spends more than it earns, so must attract international capital to finance spending. Second, concerns about the long-run growth rate of the economy raise questions about the sustainability of government debt – see Chart 1. Productivity growth has averaged just 0.5% yoy over the past five years. Third, international investors continue to treat UK assets with caution following the Brexit referendum and the ill-fated Liz Truss "mini-budget".

*The government will respond with a major tightening in fiscal policy*

**The correct policy response:** The government has heeded these lessons and plans a serious tightening in fiscal policy over the next three years. Whereas France's divided parliament will struggle to agree on a plan to reduce the French deficit and the US has little appetite to address its shortfall, the UK government has both the credibility (provided by a large government majority) and the determination to reduce borrowing – see Chart 1.

*The UK would benefit from a better policy mix*

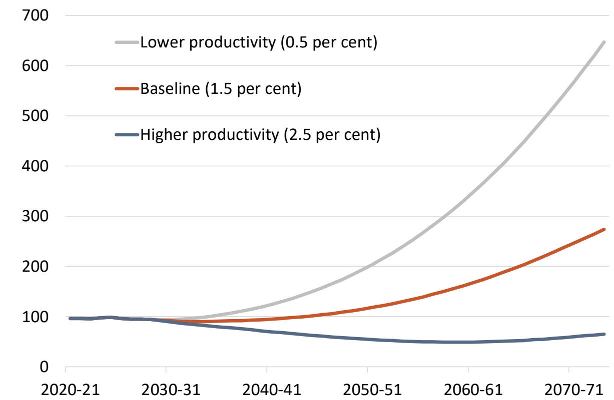
This course of action is the right one, in our view. As we set out in a previous analysis, [UK: trade helps explain economic stagnation] (published 28 January), a loss of international competitiveness is holding the UK back. A fiscal tightening makes interest rate cuts more likely by weighing on aggregate demand. Moreover, unlike during austerity in the 2010s, the BoE has space to reduce interest rates in order to offset the reduction in aggregate demand caused by tighter fiscal policy. That would make interest rate cuts and a depreciation of the pound more likely, although the BoE needs to deal with problematically sticky inflation first.

The chancellor's "iron-clad" primary fiscal rule of funding day-to-day spending entirely with tax revenue by 2029-30 makes a significant tightening of fiscal policy mandatory. In 2024, current spending exceeded revenues by 2.3% of GDP (the "current budget" deficit). Bringing this down to zero will cut the overall deficit in half, from 5% to 2.5%, with the government borrowing only to invest.

*The chancellor must cut spending or raise taxes to keep borrowing on track*

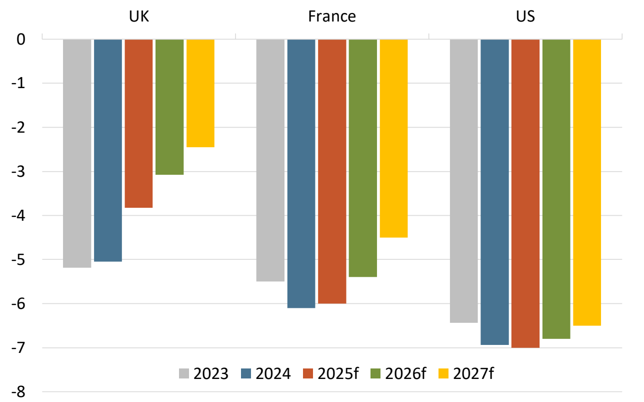
**Risky business:** The chancellor took a risk by meeting her primary fiscal rule by such a narrow margin in October. The current budget surplus of £9.9bn (0.3% of GDP) in 2029-30 projected by the OBR in October is the difference between two large numbers (current spending and tax revenue) of about £1.4trn. Therefore, minute changes to the spending or tax revenue forecasts could quickly eliminate the margin for error, often called "headroom". In the event, most of the key variables have moved against the chancellor. Reeves must now raise taxes or cut spending to put the borrowing forecast back on track.

**Chart 2: Sensitivity of the debt-to-GDP ratio to productivity**




*In % of GDP, public sector net debt under different annual productivity growth assumptions. Assumes productivity growth averages 1.0% until 2028-29. Source OBR*

**Chart 3: The UK's plan to tighten fiscal policy stands out**




*In % of GDP, government balance. Forecasts for the UK are the OBR October 2024 projection. For France and the US Berenberg forecasts. Source: Haver, OBR, Berenberg*

# Economics

BERENBERG
PARTNERSHIP SINCE 1590

## A series of unfortunate events

Three changes explain the shift in the OBR's forecast for the current budget balance in 2029-30 from surplus to deficit.

**1) Higher interest rates:** Markets now price in a higher path for the BoE's bank rate than assumed in October, which will raise the government's interest expenditure in the new projection. That is the case despite the OBR adding 25bp to market interest rate expectations in October as it correctly anticipated that UK interest rates would rise in response to the additional borrowing the government announced.

The larger rise in UK interest rate expectations since then means that the new forecast will be based on interest rates that are another 30bp higher. This will raise interest expenditures by about £6bn in 2029-30, reducing the chancellor's headroom to £4bn – see Chart 4.

It could have been worse – by default the OBR's averaging window would have ended in late January, but it broke convention to avoid the spike in bond yields at the start of the year. It chose a period in which the 10-year bond yield was 4.5%. It has risen to 4.7% since, raising the risk of further headaches down the line.

**2) Higher 2024-25 borrowing:** The second source of the deterioration in the forecast is higher than expected borrowing in the fiscal year ending on 5 April. The OBR revised up its 2024-25 borrowing forecast a lot in October due to both the fabled "black hole" (due to large public-sector pay rises and the costs of dealing with immigration) and spending decisions taken in October.

However, the monthly data reveal that the government deficit in the fiscal year to January was above even that upwardly-revised forecast – see Chart 5. Borrowing is on course to exceed the October projection by £16bn this year. The OBR is likely to forecast that much of this surprise persists in future years of the forecast.

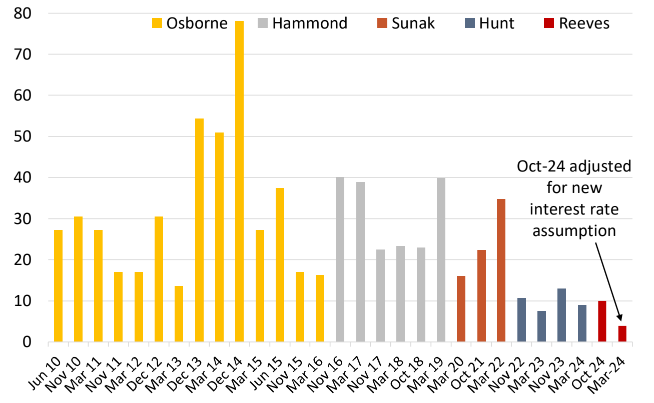
**3) Disappointing growth:** There are too many moving parts in the OBR's economic forecast to accurately anticipate the net effect of forecast changes on the budget deficit.

No doubt the official forecaster will cut its farcical GDP forecast of 2.0% yoy this year (which implies growth of 0.7% per quarter) closer to the consensus – see Chart 6. It is also likely to lower the 2026 forecast of 1.8%.

While the growth downgrade will get a lot of attention, it has little impact on near-term revenue, spending and borrowing. More important are average weekly earnings, which increased by 6% yoy in Q4, above the OBR's call of 5%. A 1% increase in the level of pay raises tax receipts by £5bn. However, the resulting reduction in borrowing will likely be offset by either a downward revision to employment that reduces income tax or an upward revision to inflation that raises welfare spending and inflation-linked coupon payments.

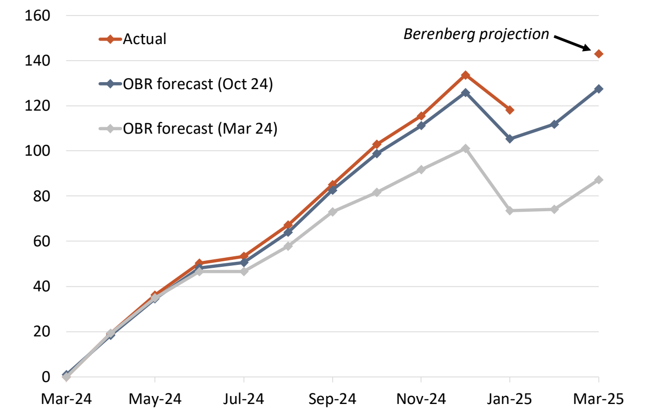
The major risk to the public finances in the forecast is a change to medium-term productivity growth. A downgrade from 1% yoy to 0.75% yoy would add £20bn to 2029-30 borrowing. See [UK: the consequences of sagging productivity], published 18 February.

**Chart 4: Higher interest rate assumption will slash "headroom"**




*In £bn. Margin fiscal target projected to be met by in each OBR forecast. Sources: OBR, Bloomberg, Berenberg calculations*

**Chart 5: Year-to-date government deficit in 2024-25**




*In £bn. Sources: OBR, Haver, Berenberg*

**Chart 6: Comparison of forecasts**

| | | OBR (Oct.) | Bloomberg | Berenberg |
|---|---|---|---|---|
| GDP | 2025 | 2.0 | 1.0 *(-0.3)* | 0.9 *(-0.6)* |
| | 2026 | 1.8 | 1.4 *(-0.1)* | 1.4 *(-0.1)* |
| | 2027 | 1.5 | 1.6 | 1.4 |
| | | OBR (Oct.) | Bloomberg | Berenberg |
| CPI Inflation | 2025 | 2.6 | 2.9 *(+0.6)* | 3.7 *(+1.2)* |
| | 2026 | 2.3 | 2.3 *(+0.3)* | 3.0 *(+0.5)* |
| | 2027 | 2.1 | 2.0 | 2.2 |
| | | OBR (Oct.) | Bloomberg | Berenberg |
| Unemployment | 2025 | 4.1 | 4.5 *(+0.1)* | 4.7 *(+1.0)* |
| | 2026 | 4.0 | 4.5 *(0.0)* | 4.6 *(+1.0)* |
| | 2027 | 4.1 | 4.6 | 4.6 |

*In % yoy, apart from unemployment, which is the unemployment rate in %. Figures in brackets are change in forecast since October. Sources: OBR, Bloomberg, Berenberg*

# What to cut?

**Between £8bn and £28bn to find:** Higher interest rates and government borrowing in 2024-25 will wipe out the October headroom and force the chancellor to find at least £8bn to meet the main fiscal rule. A downgrade to the medium-term productivity assumption could increase the shortfall to £28bn – see Chart 7.

Political and economic considerations will force the government to cut spending rather than increase taxes. By committing not to raise corporation tax, income tax, employee national insurance or VAT, the government has ruled out most major sources of revenue. Meanwhile, the tax burden appears to be close to the tipping point over which disincentives to work and invest become more severe. Chart 8 shows that the tax burden will increase to a 50-year high in 2025-26. The risk to profitability, jobs and growth from tax hikes is fresh in the government's mind following the slip in employment since the October budget.

**One tax rise:** That said, extending the freeze in income tax thresholds for a further two years to 2029-30, raising £10bn in the target year, will be too attractive to pass up.

**Several spending cuts:** Even if the OBR predicts that the government will miss the fiscal rule by an amount towards the bottom of the plausible range before changes to policy are accounted for, the chancellor would be wise to go further and build enough headroom to avoid a repetition in the autumn. Therefore, we expect three major changes to spending.

First, the government will reform incapacity and disability benefits to reign in the huge increase in such spending from under 2% of GDP in 2019 to over 3% by the end of the decade (a c£30bn increase) – see Chart 9. Some of the rise could reflect a genuine deterioration in population health. However, the fact the jump in sickness benefits is unusually large by international standards, mainly due to a rise in take-up among young people with mental heath issues, and followed a shift to a less onerous eligibility assessment suggests that there is scope to make savings.

Second, the government is likely to reduce the size of the spending envelope for departmental spending over the next four years. Reducing real growth in overall departmental spending from 1.3% yoy in current plans to 0.9% yoy would save £10bn in 2029-30 but result in cutbacks outside of protected health and defence spending.

Finally, by reallocating funds for an increase in defence spending from the international aid budget, the government will exempt some of it from the main fiscal rule, which only limits day-to-day spending. One third of the defence budget is capital expenditure, so £2.3bn of the £6.7bn being reallocated from aid will move from current spending into investment.

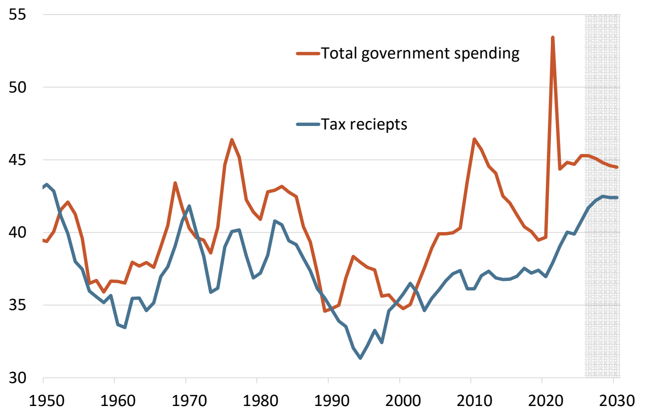
All told, these measures will increase the current budget balance by about £28bn. That would be just enough to close the deficit by 2029-30 even if the OBR downgrades its productivity growth assumption. If the forecast is more favourable, the changes would provide a bigger buffer against future forecast changes.

**Chart 7: Possible changes to the OBR's forecast (£bn in 2029-30)**

| | |
|---|---|
| **October 2024 forecast for current budget balance** (target>0) | **10** |
| Higher interest rate assumption | -6 |
| Higher 2024-25 borrowing than anticipated | -12 |
| GDP undershoot, pay and inflation overshoot | uncertain |
| **March 2025 forecast for current budget balance** | **-8** |
| *Memo: Scenario in which OBR downgrades productivity assumption* | |
| *Trend productivity reduced from 1.0% yoy to 0.75% yoy* | *-20* |
| ***March 2025 forecast for current budget balance*** | ***-28*** |
| **Options for remedial action** | |
| Extend income tax threshold freeze for two more years | +10 |
| Sickness and incapacity benefit reform | +6 |
| Reduce planned increase in total departmental spending | +10 |
| Reallocation of spending from aid to defence | +2 |
| **Total of options to lower current budget balance** | **+28** |

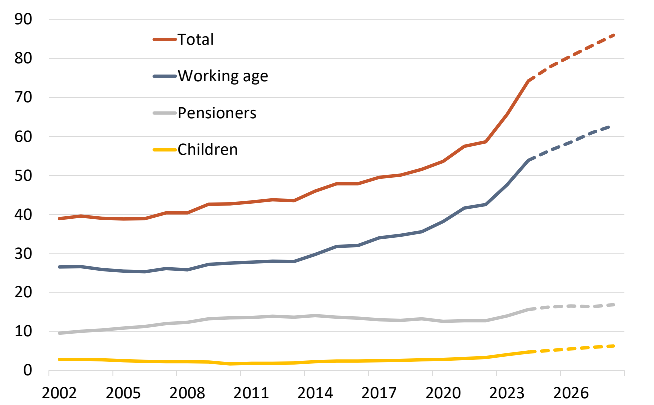
*In £bn in 2029-30, forecasts of the impact of changes in inputs to the forecast and policy changes. The current budget balance is tax revenue minus day-to-day spending. The government's main fiscal rule is to move the current budget balance into surplus by 2029-30, i.e. fund day-to-day spending entirely with tax revenue. Sources: OBR, IFS, Berenberg calculations.*

**Chart 8: Big state: government spending and revenue**




*In % of GDP. Sources: Haver, OBR.*

**Chart 9: Incapacity and disability spending has rocketed**




*In £bn at 2024-25 prices. Source: Institute of Fiscal Studies.*

## Disclaimer

This document was compiled by the above mentioned authors of the economics department of Joh. Berenberg, Gossler & Co. KG (hereinafter referred to as “the Bank”). The Bank has made any effort to carefully research and process all information. The information has been obtained from sources which we believe to be reliable such as, for example, Thomson Reuters, Bloomberg and the relevant specialised press. However, we do not assume liability for the correctness and completeness of all information given. The provided information has not been checked by a third party, especially an independent auditing firm. We explicitly point to the stated date of preparation. The information given can become incorrect due to passage of time and/or as a result of legal, political, economic or other changes. We do not assume responsibility to indicate such changes and/or to publish an updated document. The forecasts contained in this document or other statements on rates of return, capital gains or other accession are the personal opinion of the author and we do not assume liability for the realisation of these.
This document is only for information purposes. It does not constitute investment advice or recommendation to buy financial instruments. It does not replace consulting regarding legal, tax or financial matters.

**Remarks regarding foreign investors**
The preparation of this document is subject to regulation in the United Kingdom. The distribution of this document in other jurisdictions may be restricted by law, and persons into whose possession this document comes should inform themselves about, and observe, any such restrictions.

**United Kingdom**
This document is meant exclusively for institutional investors and market professionals, but not for private customers. It is not for distribution to or the use of private investors or private customers.

**United States of America**
This document has been prepared exclusively by Joh. Berenberg, Gossler & Co. KG. Although Berenberg Capital Markets LLC, an affiliate of the Bank and registered US broker-dealer, distributes this document to certain customers, Berenberg Capital Markets LLC does not provide input into its contents, nor does this document constitute research of Berenberg Capital Markets LLC. In addition, this document is meant exclusively for institutional investors and market professionals, but not for private customers. It is not for distribution to or the use of private investors or private customers.

This document is classified as objective for the purposes of FINRA rules. Please contact Berenberg Capital Markets LLC (+1 646 949 9000), if you require additional information.

# Economics

BERENBERG
PARTNERSHIP SINCE 1590

JOH. BERENBERG, GOSSLER & CO. KG

Internet: www.berenberg.com E-mail: firstname.lastname@berenberg.com

## EQUITY RESEARCH

### GENERAL MID CAP

**MID CAP - EUROPE**

| | |
|---|---|
| Fraser Donlon | +44 20 3465 2674 |
| Amelie Dueckelmann-Dublany | +44 20 3753 3172 |
| Gustav Froberg | +44 20 3465 2655 |
| Anna Frontani | +44 20 3465 2697 |
| Lucas Glemser | +44 20 3753 3091 |
| Christoph Greulich | +44 20 3753 3119 |
| Simon Jonsson | +44 20 3207 7878 |
| Gerhard Orgonas | +44 20 3465 2635 |
| Grégoire Hermann | +44 20 3753 3241 |
| Patrick Laager | +41 44 283 2020 |
| Trion Reid | +44 20 3753 3113 |
| Giovanni Selvetti | +44 20 3753 2660 |
| Wolfgang Specht | +49 69 9130 90476 |
| Yasmin Steilen | +49 69 9130 90739 |
| Lasse Stueben | +44 20 3753 3208 |
| Benjamin Thielmann | +49 69 9130 90593 |
| Karl-Oskar Vikstroem | +44 20 3465 2647 |
| Nicole Winkler | +49 69 9130 901113 |
| Jenna Xu | +44 20 3753 3098 |

**MID CAP - UK**

| | |
|---|---|
| Matthew Abraham | +44 20 3465 2633 |
| Hannah Alderman | +44 20 3207 3182 |
| Stephen Barrett | +44 20 3753 3128 |
| James Bayliss | +44 20 3753 3274 |
| Alexander Bowers | +44 20 3753 3275 |
| Robert Chantry | +44 20 3207 7861 |
| Anne Critchlow | +44 20 3753 3295 |
| Ciarán Donnelly | +44 20 3465 2637 |
| James Fletcher | +44 20 3207 7857 |
| William Larwood | +44 20 3465 2695 |
| Edward Prest | +44 20 3753 3356 |
| Alex Short | +44 20 3753 3068 |
| Andrew Simms | +44 20 3753 3080 |
| Alex Smith | +44 20 3753 3036 |
| Eleanor Spencer | +44 20 3753 3323 |
| Adam Tomlinson | +44 20 3753 3104 |

### BUSINESS SERVICES

| | |
|---|---|
| Carl Raynsford | +44 20 3753 3239 |

### LEISURE

| | |
|---|---|
| Jack Cummings | +44 20 3753 3161 |
| Benjamin Sandland-Taylor | +44 20 3753 3151 |
| Luka Trnovsek | +44 20 3753 3032 |

### CONSUMER

**FOOD MANUFACTURING AND HPC**

| | |
|---|---|
| Fulvio Cazzol | +44 20 3207 7840 |
| Samantha Darbyshire | +44 20 3753 3144 |
| Bethan Davies | +44 20 3753 3280 |
| Ana Nogueira | +44 20 3207 7913 |

**GEN. RETAIL, LUXURY & SPORT. GOODS**

| | |
|---|---|
| Nick Anderson | +44 20 3465 2640 |
| Harrison Woodin-Lygo | +44 20 3753 3181 |

### ENERGY & ENVIRONMENT

| | |
|---|---|
| James Carmichael | +44 20 3465 2749 |
| Richard Dawson | +44 20 3207 7835 |
| Andrew Fisher | +44 20 3207 7937 |
| Louis Hudson | +44 20 3753 3105 |
| Henry Tarr | +44 20 3207 7827 |

### FINANCIALS

**INSURANCE**

| | |
|---|---|
| Michael Christodoulou | +44 20 3207 7920 |
| Michael Huttner | +44 20 3207 7892 |
| Craig Sinclair | +44 20 3753 3076 |

**REAL ESTATE**

| | |
|---|---|
| Miranda Cockburn | +44 20 3753 3126 |
| Kai Klose | +44 20 3207 7888 |
| Yudith Karunaratna | +44 20 3753 3259 |

### HEALTHCARE

**MED. TECH/SERVICES**

| | |
|---|---|
| Sam England | +44 20 3465 2687 |
| Beatrice Fairbairn | +44 20 3753 3283 |
| Tom Jones | +44 20 3207 7877 |
| Victoria Lambert | +44 20 3753 7829 |

**PHARMACEUTICALS**

| | |
|---|---|
| Harry Gillis | +44 20 3753 3249 |
| Luisa Hector | +44 20 3753 3266 |
| Kerry Holford | +44 20 3207 7934 |
| Kritika Kalia | +44 20 3753 3183 |

### INDUSTRIALS

**AEROSPACE & DEFENCE**

| | |
|---|---|
| George McWhirter | +44 20 3753 3163 |
| Philip Buller | +44 20 3753 3071 |
| Lavinia Norton | +44 20 3753 3094 |

**AUTOMOTIVES**

| | |
|---|---|
| Romain Gourvil | +44 20 3465 2722 |

**CAPITAL GOODS**

| | |
|---|---|
| Philip Buller | +44 20 3753 3071 |
| Scott Humphreys | +44 20 3753 3057 |

### MATERIALS

**CHEMICALS**

| | |
|---|---|
| Aron Ceccarelli | +44 20 3207 7864 |
| Sebastian Bray | +44 20 3753 3011 |
| Andres Castanos-Mollor | +44 20 3753 3218 |

**CONSTRUCTION**

| | |
|---|---|
| Harry Goad | +44 20 3753 3061 |

**METALS & MINING**

| | |
|---|---|
| William Dalby | +44 20 3753 3243 |
| Richard Hatch | +44 20 3753 3070 |
| Cody Hayden | +44 20 3753 3133 |

### TMT

**TECHNOLOGY**

| | |
|---|---|
| Nay Soe Naing | +44 20 3753 3131 |
| Meha Pau | +44 20 3753 3292 |
| Tammy Qiu | +44 20 3465 2673 |

**TELECOMMUNICATIONS & MEDIA**

| | |
|---|---|
| Shekhan Ali | +44 20 3753 3021 |
| Usman Ghazi | +44 20 3207 7824 |

### EQUITY STRATEGY

| | |
|---|---|
| Leoni Externest | +44 20 3753 3282 |
| Ashley O'Malley | +44 20 3753 3176 |
| Jonathan Stubbs | +44 20 3207 7916 |

### ESG

| | |
|---|---|
| Lauma Kalns-Timans | +44 20 3753 3127 |
| Marina Kitchen | +44 20 3465 2741 |

### DATA

| | |
|---|---|
| Toni Gurhy | +44 20 3753 3185 |

### ECONOMICS

| | |
|---|---|
| Atakan Bakiskan | +44 20 3207 7873 |
| Salomon Fiedler | +44 20 3753 3067 |
| Dr Felix Schmidt | +49 69 9130 901167 |
| Holger Schmieding | +44 20 3207 7889 |
| Andrew Wishart | +44 20 3753 3017 |