



Perspectives by Ruth Lea

Economic Adviser to Arbuthnot Banking Group

The Pre-Budget Report: it's a pity Old Mother Hubbard's cupboard is so bare



Next Monday's Pre-Budget Report will be an unusually significant one – both politically and economically – reflecting the severity of Britain's economic problems. The main economic ingredients of the Report will be the economic forecast, the public finances forecast and the “fiscal stimulus measures”.

The economic forecast

The economic climate – both domestic and international - has worsened dramatically since the Treasury's last forecast at the time of the March Budget. The developments can be briefly analysed in two parts. The first was the run-up to July/August when the effects of the continuing credit crunch engaged with rapidly rising commodity prices, especially oil prices, to provide a lethal combination of a slowing economy with rapidly rising inflation. Escalating inflation, CPI inflation peaked at 5.2% in September, restrained the Bank of England from cutting interest rates during this period. Indeed Bank Rate, which had been cut to 5.00% in April, was unchanged until October.

The financial crisis, which erupted in September with the collapse of Lehmans on 15 September 2008 and has hopefully been contained by the Government's rescue package of early October, marked the second stage. Allied with the financial crisis was increasing evidence of the degree of the deterioration of the British economy. The third quarter GDP figure was far more negative than expected – showing a 0.5% fall in the quarter (after a downwardly-revised second quarter figure). Given that the survey indicators for October and so far for November have been uniformly poor it can only be expected that the fourth quarter GDP figure will show a fall just as great as the third quarter if not worse. Assuming this is the case, the release of the third quarter marked the point when it was clear that the UK was not just going into recession – but it would be a significant one. The Bank of England was not alone when it recently revised its forecasts. November's forecasts were in a different league of gloominess from August's.¹

The one positive aspect of this second stage was the weakening in oil prices which peaked at around \$147pb in the first half of July and have been falling since. By 20 November Brent Crude was around \$50pb. In sterling the degree of the fall was dampened by the weakness of the pound against the dollar – but even so the decrease is significant. In early July oil prices were approximately £70pb – they are currently about £33pb.

Brent Crude Oil \$/barrel: 21 November 2007 to 20 November 2008



Source: BBC website: www.bbc.co.uk

CPI inflation fell to 4.5% in October and the Bank currently expects it will fall to well below the 2% target in the second half of 2009 and remain there throughout 2010. Indeed the talk is now about “deflation” rather than inflation and the possible repercussions if people’s expectations of falling prices encourage them to defer purchases – thus exacerbating the recession. At this stage the discussion is highly speculative. But whether or not the “deferred purchases scenario” develops will depend on which prices fall. If, as looks likely, they will be concentrated in fuel, gas and electricity and possibly foods, then deferring purchases is unlikely to become a widespread development. On the contrary, hard-pressed consumers, who have experienced falls in their real incomes for much of this year as prices have risen, are likely to regard falling prices as a happy respite from the income squeeze rather than a portent of worse to come.

The table below shows the Budget forecast for GDP and CPI inflation and comparison forecasts.

GDP and CPI forecasts (year-on-year, %)

	2008	2009	2010
March 2008 Budget:			
GDP growth	1¾ to 2¼	2¼ to 2¾	2½ to 3
CPI inflation (Q4)	2½	2	2
Consensus:			
GDP growth	0.9	-0.9	Na
CPI inflation (Q4)	4.7	2.1	Na
Arbuthnot Banking Group:			
GDP growth	0.9	-1.9	0.8
CPI inflation (Q4)	4.5	1.5	2.0

Sources: (i) HM Treasury, *Budget 2008: Stability and opportunity: building a strong, sustainable future*, March 2008, HC388.

(ii) *Consensus Forecasts*, Survey date 10 November 2008, Consensus Economics.

It is now clear that growth in 2008 will struggle to be even 1% - never mind the 2% (mid-range) expected by the Treasury 8 months ago. But an even more significant gap opens up for next year and 2010. The Treasury was expecting growth of 2½% and 2¾% - but it is now expected there will be a fall in output next year, followed by weak growth in 2010.

The Public finances

The latest ONS data confirm the severity of the impact of the economic under-performance on the public finances. For the first 7 months of FY2008/09 the current budget is already around £14bn worse than in the previous financial year and public borrowing nearly £17bn higher.

Public sector finances to October 2008, £bn

	Oct 2008	Oct 2007	Apr-Oct 2008	Apr-Oct 2007	7 month comparison
Current budget	1.0	4.0	-23.3	-9.5	-13.8
Public sector net borrowing	1.4	-1.8	37.0	20.1	16.9

Source: ONS, "Public sector finances, October 2008", 20 November 2008.

Taking into account the data already available and the further negative impact of recession on the public finances (lower revenue growth and higher public spending), forecasts for total borrowing, prior to any fiscal stimulus in the Pre-Budget Report, are around £65bn for FY2008, ballooning to £80-90bn in FY2009 and around £100bn in FY2010.

Forecasts of public sector net borrowing, £bn

	FY2008	FY2009	FY2010
October 2007 Pre-Budget Report	36	31	28
March 2008 Budget	43	38	32
NIESR	65	80	94
Arbuthnot Banking Group	65	92	110

Sources: (i) HM Treasury, *Budget 2008: Stability and opportunity: building a strong, sustainable future*, March 2008, HC388.

(ii) *National Institute Economic Review*, October 2008, National Institute of Economic and Social Research.

These projections are quite shocking and indicate the truly appalling management of the public finances since the then Chancellor turned on the spending taps in the early 2000s.² It is not surprising that the present Chancellor all but abandoned his predecessor's fiscal rules,³ at the recent lecture Mais lecture at the City University.⁴ The rules were in effect bust.

It is absolutely vital that, as a priority, the Chancellor presents a credible programme of fiscal consolidation in the Pre-Budget Report. Such a programme should explain how the structural deficit will be repaired, otherwise it could cause a loss of investor confidence in the UK and a run on the pound.⁵ Given the state of the public finances, such a programme will inevitably involve major tax increases, spending restraints or both. It will be painful. It is the hangover from Chancellor Brown's spending spree.

Pre-Budget Report: fiscal stimulus package

Expectations are building up for a major fiscal stimulus in the Pre-Budget Report. Given the state of the public finances, however, such a stimulus should be relatively modest. Public borrowing is ballooning without tax giveaways or extra “Keynesian” spending projects. And it is worth noting that the Chancellor has already fiscally boosted the economy by £3.9bn since the Budget by:

- Compensating the 5 million who lost out when Chancellor Brown abolished the 10p tax band in the Budget of 2007.
- Extending the temporary freeze on fuel duty.
- Introducing temporary stamp duty concessions.

If Old Mother Hubbard’s cupboard hadn’t been so bare, then the Chancellor would have been in the comfortable position of being able to deliver a stimulus of 1% of GDP (nearly £15bn) or even 2% of GDP (nearly £30bn) without feeling that fiscal prudence was being forfeited. But Old Mother Hubbard’s cupboard is bare.

It has been reported that there has been tension in the run-up to the PBR between the Treasury, urging prudence, and the Prime Minister’s office, urging a more aggressive stimulatory package. Inevitably the overall size, as announced on Monday, will be the result of political horse-trading and it is impossible to know what the eventual outcome will be at this stage. But the outcome could be around £10bn for FY2008 and FY2009 taken together in addition to the already announced measures.

Whatever the size of the fiscal stimulus the emphasis should be on tax cuts and help for business rather than extra major spending projects (which probably cannot be delivered sufficiently quickly). Tax rebates can be very effective in stimulating spending as shown by the experience in the USA last summer. Tax rebates are infinitely preferable to tax credits for targeted groups, which are quite simply taxpayer-funded benefits by any other name. If the economy is to be fiscally stimulated in the short-run but taxes are to go up in the medium-term to pay for such fiscal largesse,⁶ then those who are expected to pay in the future should be allowed to benefit from tax rebates now.

And whatever the size of the fiscal stimulus, people should however be under no illusion that it will bring an early end to the recession, even though it should act as a palliative and reduce the effects of the credit crunch on the economy.

There are many speculations about specific measures in the PBR. They include:

- A boost to tax credits, as already discussed, maybe in time for Christmas. This has to be a hot favourite and more likely than cuts in tax rates, rises in personal allowances or cuts in VAT rates.
- Delays to the introduction of retrospective increases in VED rates and more help for OAPs with their heating bills.
- Fast-track spending on schools and hospitals.⁷

- Discussion of progress in and improvements to the efficiency savings programme which was estimated in the 2008 Budget to be worth £30bn for the 3 years FY2008 to FY2010. Note, however, that this programme is not about cutting overall spending totals but a matter of shifting “savings” to “frontline services” in, for example, hospitals.⁸
- Exhorting the banks to relax their lending criteria to small businesses and households, allied with increased taxpayer support for small business lending and possibly help for the mortgage market.

References

1. Bank of England, Inflation Report, November 2008, available from www.bankofengland.co.uk
2. Ruth Lea, “The public finances: prepare for even worse figures”, *Perspective*, 20 October 2008, Arbuthnot Banking Group.
3. Gordon Brown’s fiscal rules were: (i) The golden rule, which stated that, on average over the cycle, the government will borrow only to invest and not to fund current spending. (ii) The sustainable investment rule, which stated that public sector debt as a proportion of GDP would be held over the cycle at a stable and prudent level. The government believed that, other things being equal, it was desirable that public spending net debt should be below 40% of GDP over the cycle.
4. Times leader, “Lost in the Mais”, *Times*, 30 October 2008. This leader also included the statement that “the Government engineered an unsustainable boom, compounding the financial crisis; those policy mistakes are no model for recovery”.
5. FT leader, “Austerity must follow a stimulus”, *FT*, 13 November 2008.
6. Gary Duncan, “Tax-cut gamble will let Britain buy now – but we’ll certainly pay later”, *Times*, 20 November 2008
7. Jean Eaglesham et al, “£5bn cap likely on fast-track spending”, *FT*, 18 November 2008.
8. Jimmy Burns et al, “Darling aims to exceed £30bn savings”, *FT*, 19 November 2008.

**Ruth Lea, Economic Adviser, Director,
Arbuthnot Banking Group,
ruthlea@arbuthnot.co.uk,
Tel: 07800 608 674**