Market Update: 25th November 2020

Spending Review and OBR Forecasts for the Year Ahead

Earlier today, Chancellor of the Exchequer Rishi Sunak outlined the UK government's spending review for the year ahead, as policy makers battle the need for providing support nationally alongside the eventual need to stabilise the rising levels of debt. Forecasted to borrow a total of £394 billion this year, 19% of this year's GDP and the highest in peacetime, the measures outlined have been targeted to those most vulnerable and where funding is urgently required. As a result, the Chancellor has focused on three core priorities, including protecting the health and jobs of individuals, and delivering a record investment in infrastructure.

The support announced on Wednesday received opposition from Shadow Chancellor Anneliese Dodds, who criticised the measures for not going far enough as the UK's GDP forecasts paint a bleak picture going forward. Given that the future is uncertain and significantly dependent on both vaccine and Brexit developments, the spending review appears to ensure the areas that urgently need fiscal support receive it in the short-term, with the three-year comprehensive spending review postponed until next year when forecasts and the UK's long term needs are clearer.

What is the Spending Review?

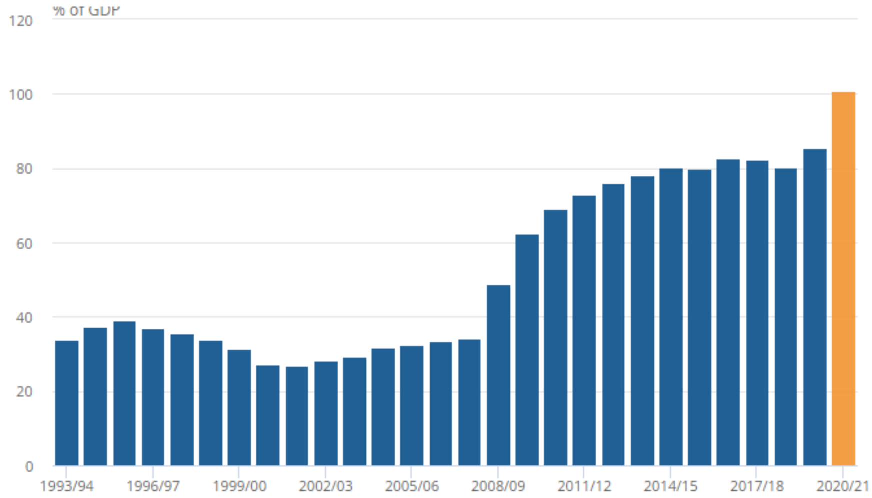
Spending reviews are held infrequently, covering periods between one to five years. The purpose of the spending review is to cover day-to-day spending on wages and administration, as well as infrastructure investment on things such as roads, schools, and hospitals. The review covers about 50% of total government outlays, with harder to predict items including welfare payments and debt interests excluded. Unlike a budget, spending reviews are not typically used to set or alter taxes, so it is unlikely that we will receive many details about how the Chancellor will seek to fund the outlays mentioned. That being said, Rishi Sunak and Prime Minister Boris Johnson had previously ruled out a return to austerity which characterised much of the post financial crisis economy, implying that taxes will be increased to fund the spending spree in the future.

Current Economic Context

With much of the UK economy being shutdown for up to 5 months of 2020, Britain has so far funded its fiscal support measures with its highest levels of borrowing in British peacetime history. Public sector borrowing in 2020, which the Office for Budget Responsibility (OBR) has forecasted to reach £394 billion by year-end, has reflected the impact of the pandemic on the public finances as the furlough schemes alone added £54.4 billion to borrowing in the financial year-to-October. The reduced level of cash receipts and a fall in GDP has helped push public sector net debt as a ratio of GDP to levels last seen in the early 1960s, reaching 100.8% from the beginning of the year to October.

In figure 1, the extent of the increase in public sector net debt is significantly higher than the 50-65% levels seen in the financial crisis of 2008. Based on the OBR's forecasts, if the government wanted to get the deficit back to pre-virus levels in 2025-26, it might have to tighten fiscal policy by about £48 billion (2.1% of GDP) a year. If it wished to stop debt rising relative to GDP, then a lesser fiscal tightening of £21 billion (0.9%) a year would be required.

Figure 1. **Public sector net debt excluding public sector banks, UK, March 1994 to the end of October 2020**



Source: Office for National Statistics – Public Sector Finances

With public net debt at historical highs, a measured fiscal approach that accommodates the areas urgently in need of financial support is arguably the best option, such that it does not send the level of debt to further unsustainable levels. Another factor that the government had to consider was the amount overall GDP is set to decline in 2020. Rishi Sunak mentioned that GDP is forecasted to fall 11.3%, the largest annual fall since the Great Frost in 1709. With GDP falling and public debt rising at the same time, greater emphasis is put on public debt as a percentage of GDP, which is expected to reach 105% by year-end.

Although it does not seem to be in the best interests of the UK government to increase public debt, a lack of expansionary fiscal policy would be expected to create deeper economic scarring that could exacerbate the fall in GDP over the long run. As a result, it was expected that further spending to mitigate the level of economic scarring would be delivered in the spending review, and the government are unlikely to try and balance the budget in the next twelve to eighteen months as contractionary measures would detract the UK from its existing growth trajectory.

Three Core Priorities of the Spending Review

The Chancellor covered an array of fiscal measures which are due to be implemented over the next twelve months, however there were three core priorities that stood out in this spending review. The first two are protecting people's health and jobs, whilst the third priority being the delivery of a record investment in infrastructure.

Protecting people's jobs have been a key feature of the UK's policy measures in 2020. As mentioned above, the £54 billion spent this year so far highlights this commitment. By supporting job retention, individuals' disposable income can be maintained, which maintains consumption expenditure whilst also reducing the reliance on the welfare state in the case of unemployment. Although the existing furlough scheme is still in place until March, OBR forecasts of a peak unemployment rate of 7.5% in Q2 2021 has encouraged additional measures to be established. These include:

- £3 billion to deliver a 3-year restart programme to help 1 million unemployed find new work
- Provide a pay rise to 1 million NHS staff
- Protect 2.1 million public sector workers on low incomes, with pay rises of at least £250
- Increase the national living wage by 2.2%, whilst bringing the threshold down from 25 to 23 years old.

These measures have been targeted at the most vulnerable as well as those in the NHS who have faced significant strain in combating the pandemic throughout 2020. Although many would welcome the above measures, the remainder of public sector workers who are not on low incomes and are not employed by the NHS will face a pay freeze. This was met with opposition from the labour party; however, it was arguably justified by the discrepancy between the continual wage increases of public sector wages compared to the stagnant movement of private sector wages in recent years. Additionally, by targeting those on the lowest incomes, the Chancellor has ensured the employees with the highest marginal propensity to consume (the proportion of an aggregate rise in pay that a consumer spends on consumption) maintain or increase their disposable income levels, supporting consumption and hence GDP growth.

Protecting the health of individuals is the second focus of the spending review. Totalling over 1.5 million cases and 55,000 deaths in the UK, the health sector has been key to mitigating the effect of coronavirus whilst trying to ensure the economy continues to function. With its key role in the pandemic at the forefront of the government's minds, the Chancellor announced that the core health budget will increase by £6.6 billion in 2021, an extra £55 billion in public funding for 2021's Covid response as well as a capital expenditure increase. The latter is focused on the biggest hospital construction programme to date, with a commitment to build 40 new hospitals alongside upgrading 70 existing hospitals.

Lastly, the final priority of the government is to deliver a record investment in infrastructure. Infrastructure spending has been a key method to boost jobs, support low-paid workers and to increase the potential supply capacity of the economy in the long-term. It appears Rishi Sunak is attempting to do just that, with a £100 billion commitment to infrastructure projects over the course of the next four years. Projects will include home building, delivering faster broadband, improving 5G coverage, developing road, rail, and zero emission buses as well as to help deliver Boris Johnson's 10-point plan to tackle climate change.

Although these were the three areas of focus, the government has also committed to increasing defence spending, providing additional funds to the different nations of the UK as well as increased funding for regions outside of London. Many of these measures were aligned to existing expectations, including little being mentioned about how the majority of this spending will be funded. Additionally, small business owners and entrepreneurs who account for 99.5% of businesses across the UK economy received additional support from the Chancellor, suggesting that there will not be significant corporate tax rises for these going forward. That being said, the Chancellor did highlight several areas of spending which had been reduced, such that the funds could be allocated elsewhere. This includes the already mentioned pay freeze for many public sector workers, but also the reduction of overseas aid to 0.5% of GDP, which would still make the UK the second highest donor among the G7 nations.

Our View

Prior to the spending review announcement, the FTSE 100 was already trending downwards in anticipation. However, on announcement, the FTSE remained roughly level as the spending review was largely in line with the expectations of financial markets. It is our view that appropriately targeted spending will be key to reducing the economic scarring within the UK, albeit at the expense of rising levels of debt. On reflection, the measures mentioned by the Chancellor do not suggest that debt levels will rise unsustainably over the next twelve months, and the measures which have been mentioned will also contribute to long-term potential supply capacity, supporting economic growth. Debt servicing costs remaining low will reduce the concern amongst the government, and it is reasonable to believe that the bleak OBR forecasts are underestimating the positive impact expected from the roll out of a vaccine in mid-2021. Lastly, the 3-year spending review expected next year will provide a more accurate picture for the UK economy's recovery going forward, helping to set business and consumer expectations. For these reasons, we are not concerned about the increased spending, and see it as being necessary to support the country's emergence from the pandemic over the medium and long-term.