What to expect in the post-election UK landscape

UK Economic and Markets Outlook

Paul Dales, Chief UK Economist

Ruth Gregory, Deputy Chief UK Economist

Ashley Webb, UK Economist

Hubert de Barochez, Senior Markets Economist

CAPITAL ECONOMICS

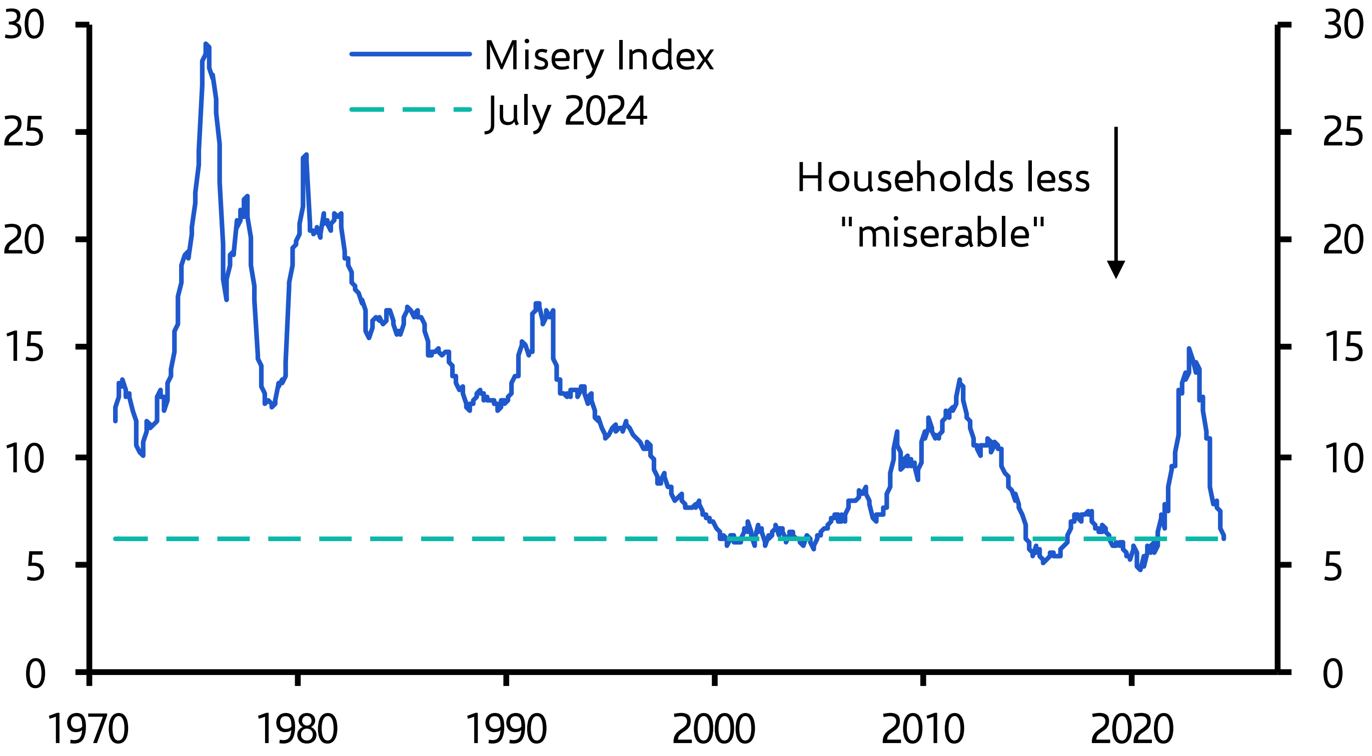
Agenda

- Is the economic and fiscal inheritance as bad as the government suggests?
- How will the government change spending, taxes and borrowing in the Budget?
- What will those changes mean for activity, inflation and interest rates?
- Will the government's reforms boost the economy's long-term growth rate?

The current economic situation

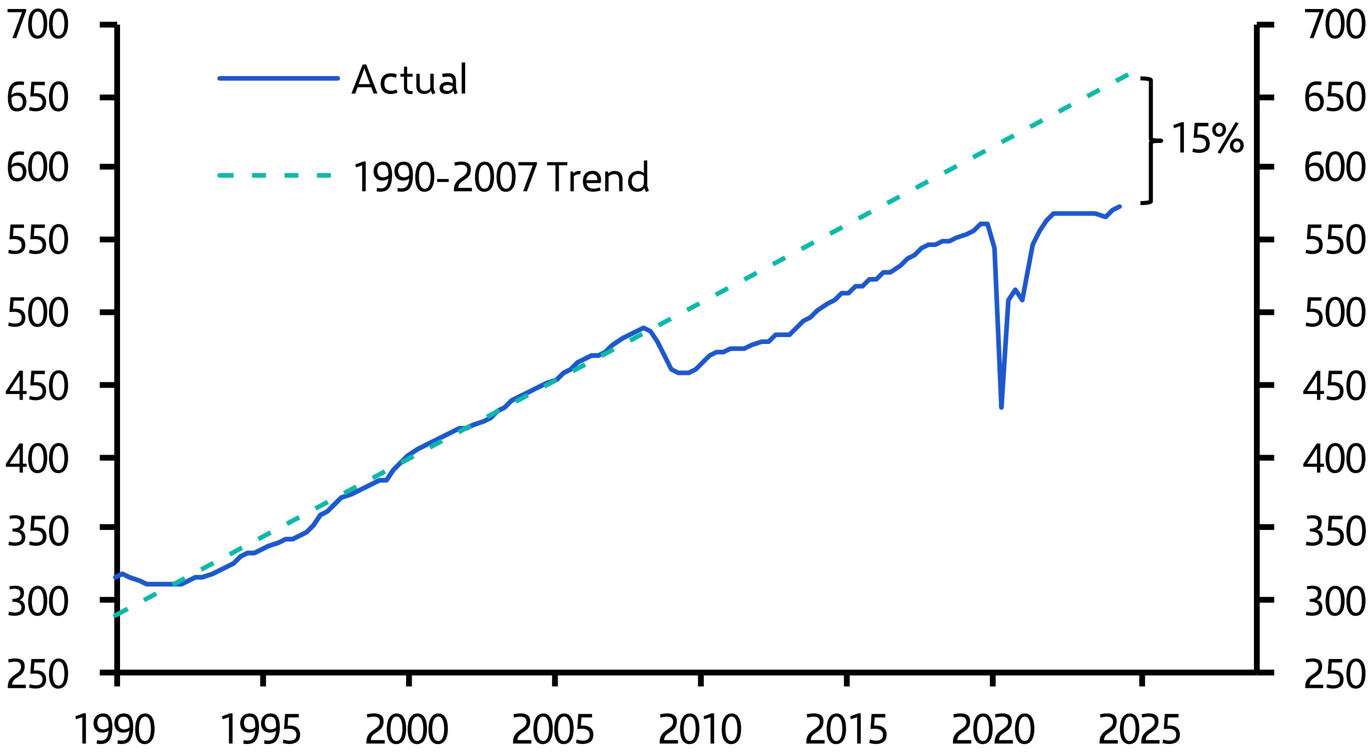
- The economy is growing.
- Interest rates are falling.
- At 4.1%, the unemployment rate is historically low.
- At 2.2%, CPI inflation is only a touch above the 2% target.

Misery Index (Unemployment Rate Plus Inflation Rate, %)



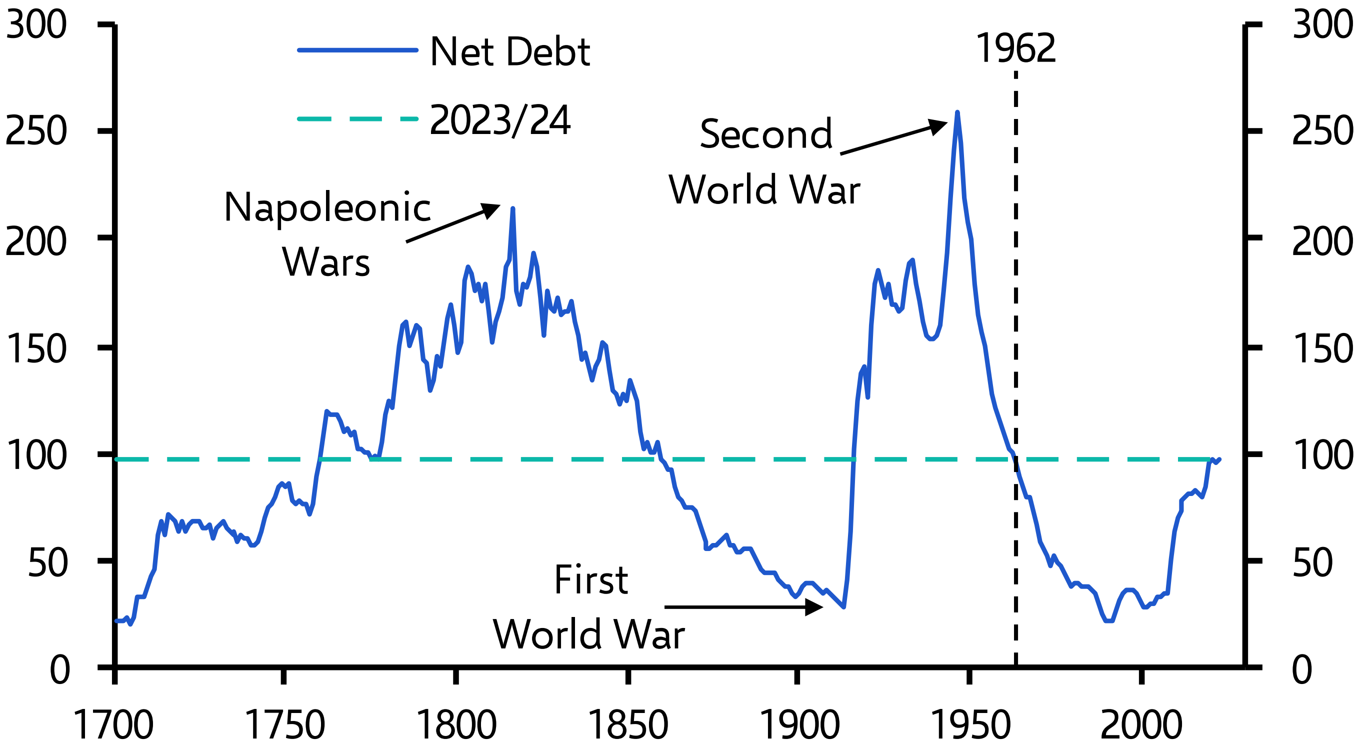
Sources: LSEG Data and Analytics, Capital Economics

Real GDP (£bn)



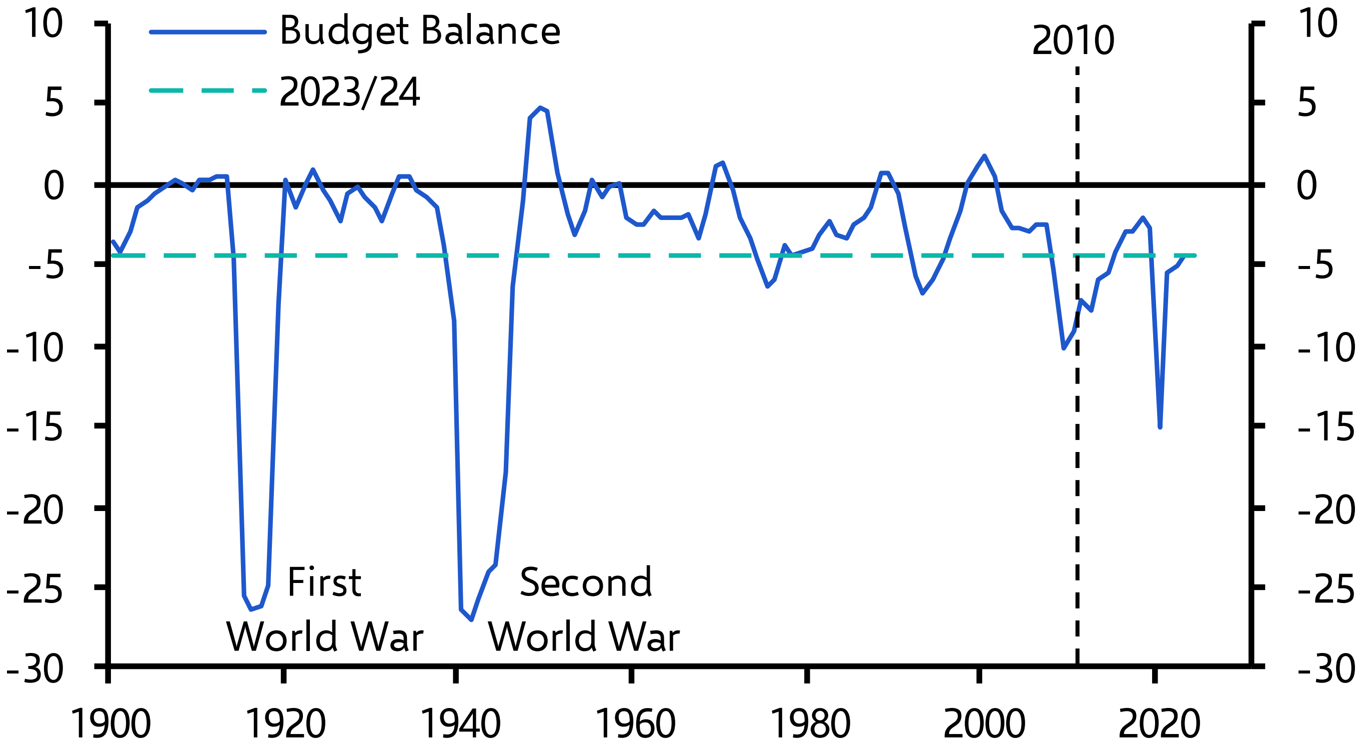
Sources: LSEG Data and Analytics, Capital Economics

Public Sector Net Debt (As a % of GDP)



Sources: Bank of England, OBR, Capital Economics

Public Sector Budget Balance (As a % of GDP)



Sources: Bank of England, OBR, Capital Economics

Economic and fiscal inheritance

- Current economic situation isn’t so bad.

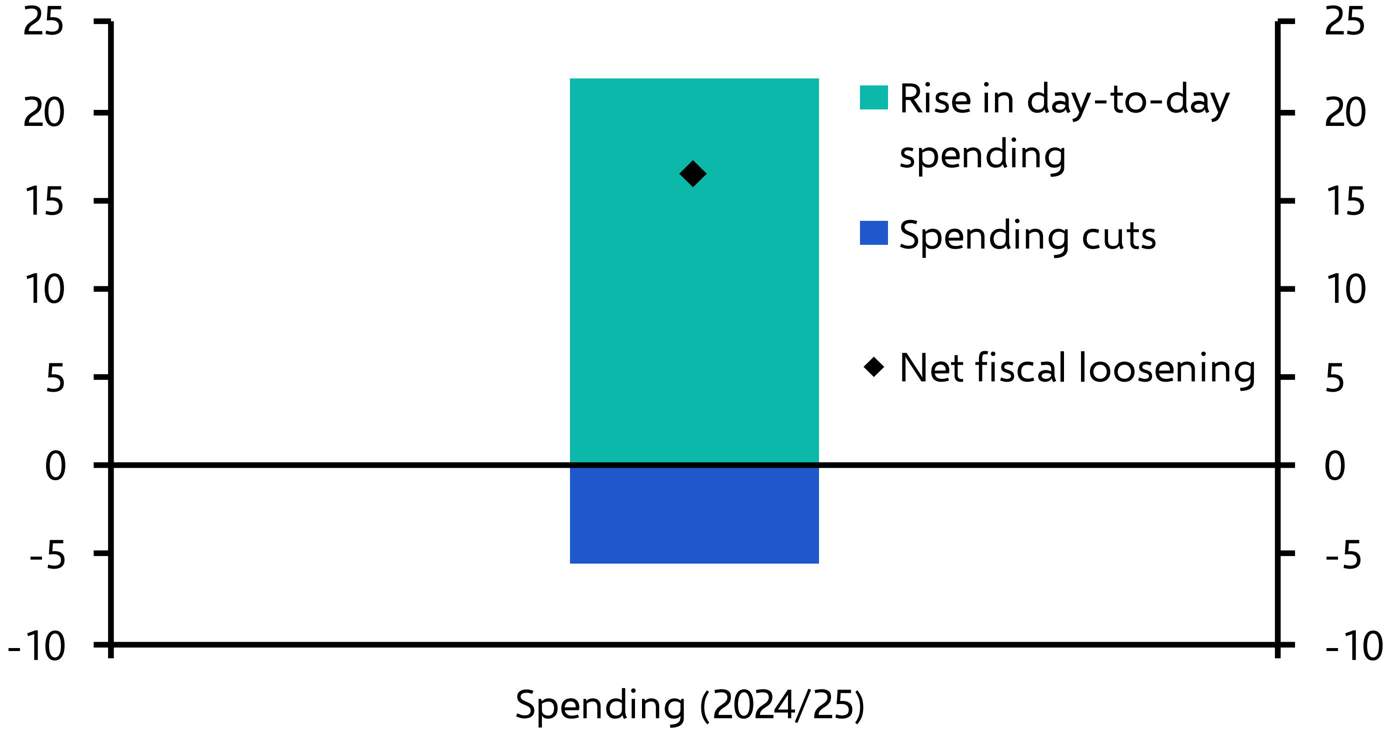
- Weak supply has continued to restrain activity.

- There has been a structural decline in the public finances.
    - This is why existing plans are for fiscal policy to be tightened.
    - The budget deficit is scheduled to shrink from 4.4% of GDP in 2023/24 to 1.2% in 2028/29.

The key issues for the Budget

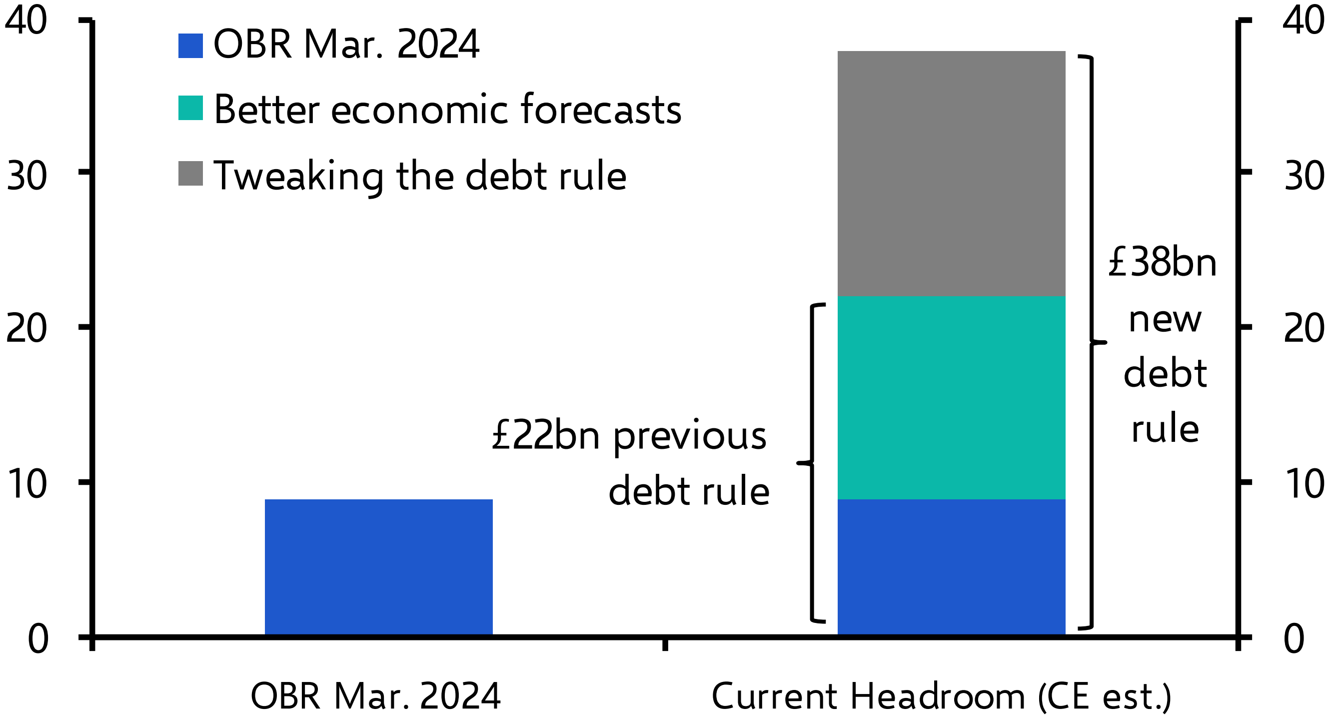
- The government’s new spending plans.
- How much will taxes rise?
- What should the Chancellor do and what will she do?

What has the Government already announced? (£bn)



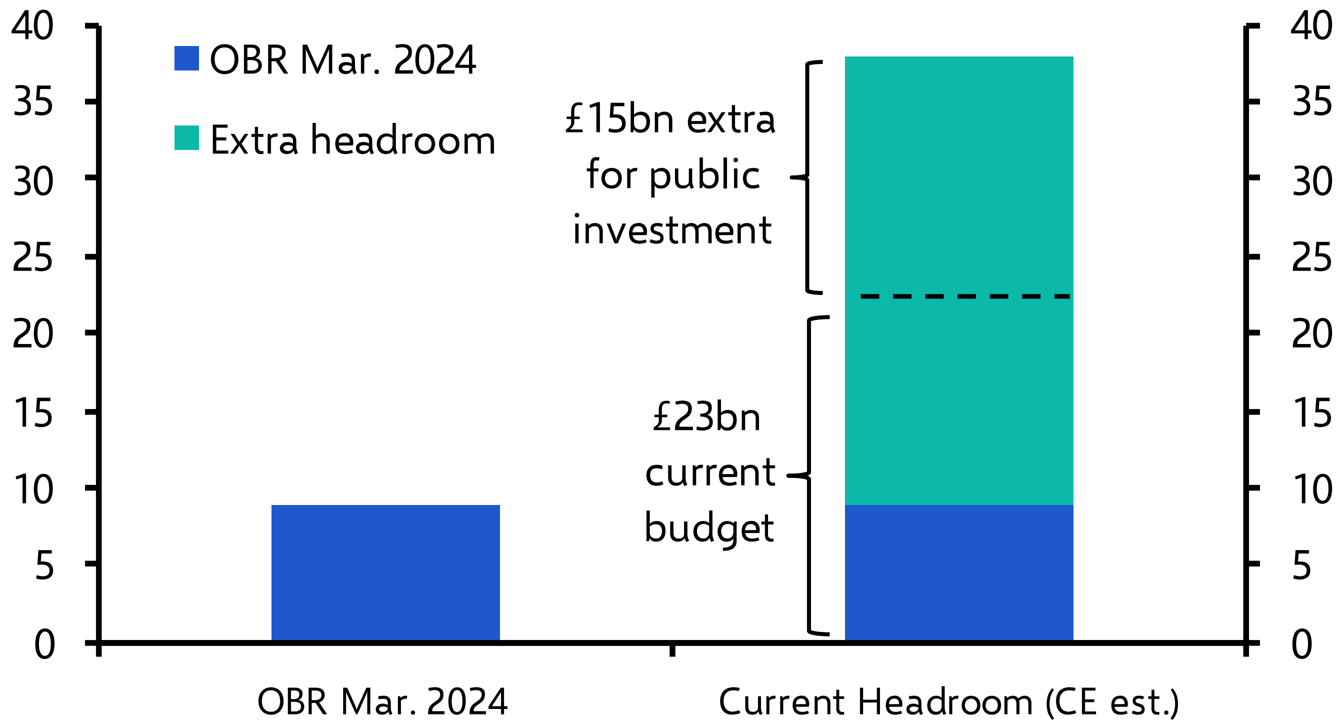
Sources: HMT, Capital Economics

Estimates of Headroom Against Fiscal Rules (£bn)



Sources: OBR, Capital Economics

Estimates of Headroom Against Fiscal Rules (£bn)



Sources: OBR, Capital Economics

Possible policy options for the Budget

1. Fiscal stance unchanged from previous plans:
   - Raise ‘current’ spending by £16bn and raise taxes by £16bn.

2. Fiscal policy tightened versus previous plans:
   - Raise ‘current’ spending by £16bn and raise taxes by £26bn.

3. Cancel planned tightening in fiscal policy:
   - Raise ‘current’ spending by £16bn, raise taxes by £16bn and raise public investment by £15bn.

What should Reeves do?

- Option 3:
  - Demonstrates fiscal prudence.
  - Lays the foundations for higher long-term economic growth.
  - Markets would be forgiving.

What will the Budget bring?

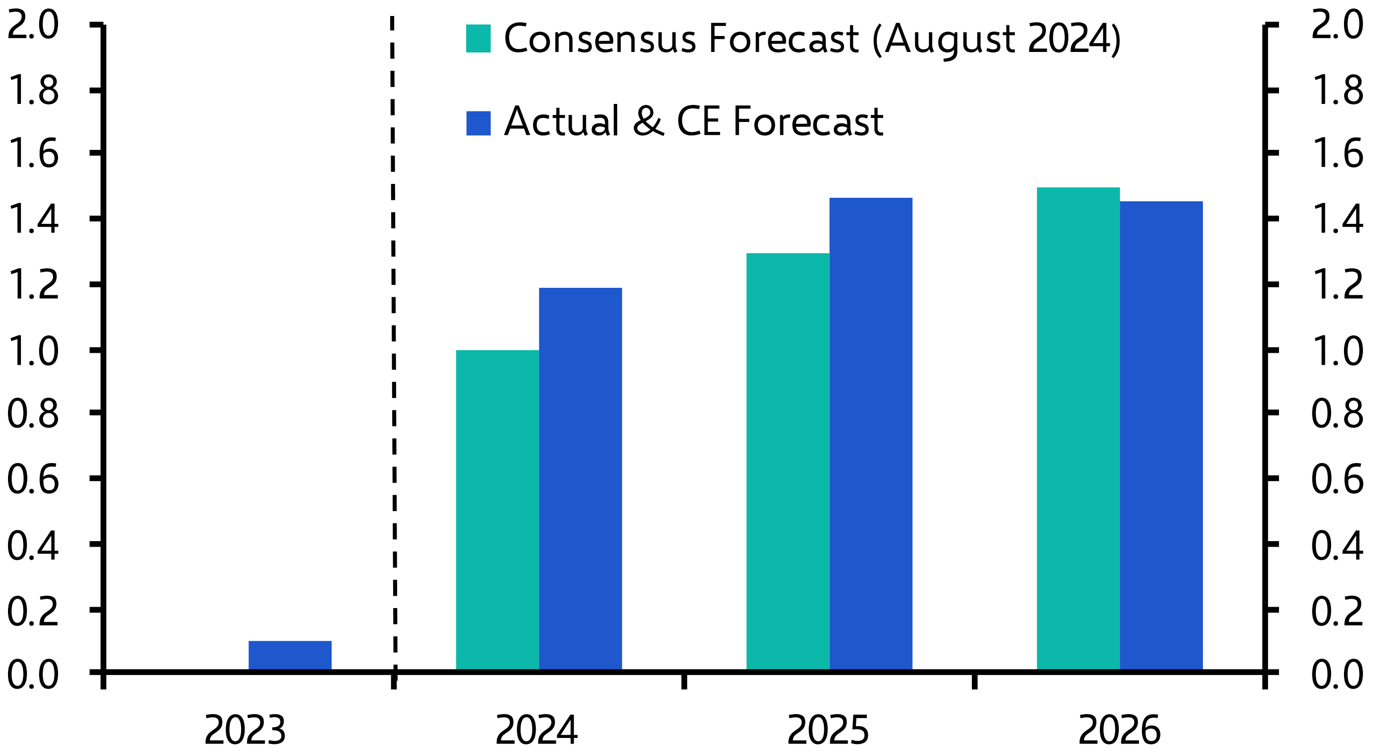
- Unchanged debt rule.

- OBR fiscal headroom (pre-measures) of £22bn.

- Increases in ‘current’ spending worth £16bn, increases in taxes worth £16bn, left over headroom of £22bn.

- Extent of fiscal tightening broadly unchanged from existing plans.

Real GDP (%y/y)



Sources: LSEG Data and Analytics, Bloomberg, Capital Economics

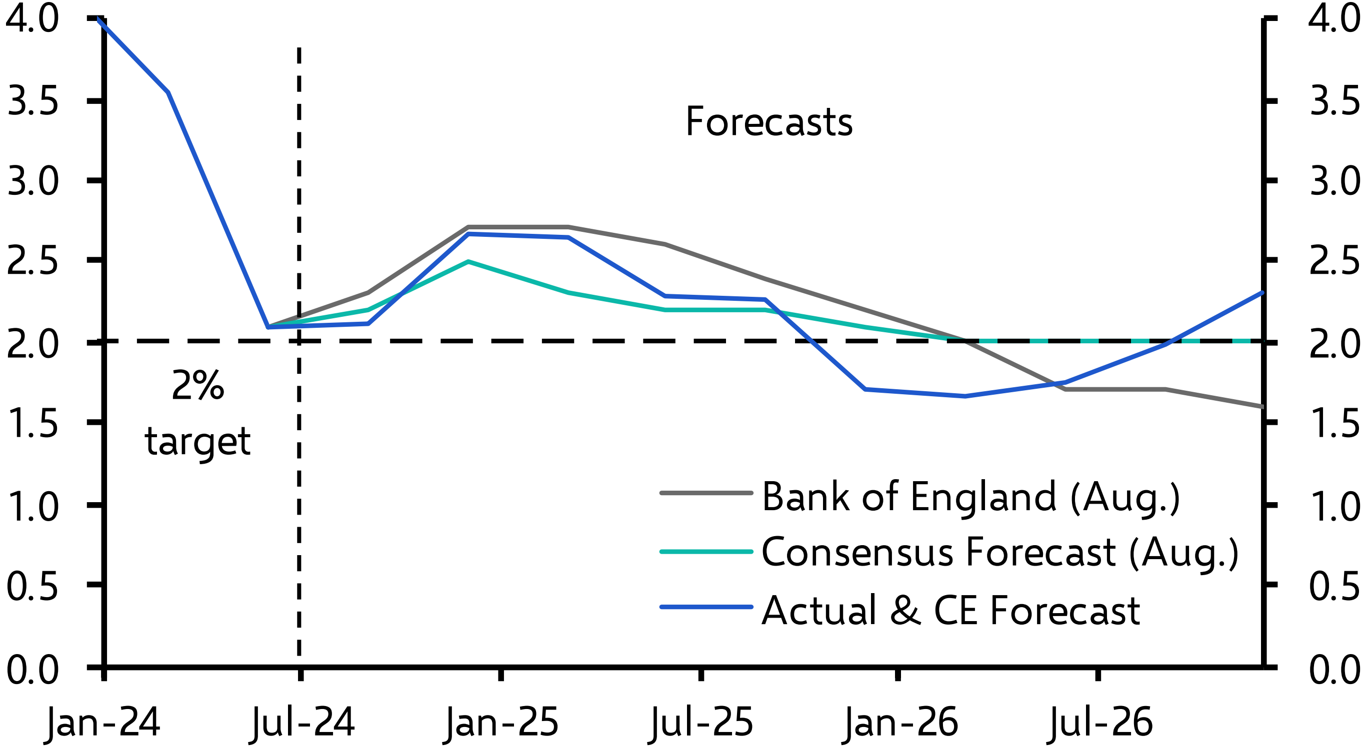
Influences on GDP growth

- Budget effects:
  - Extent of fiscal tightening similar to existing plans: **0.0ppts in 2025**.
  - Multiplier effects from higher spending and higher taxes: **+0.2ppts in 2025**.

- Inflation effects:
  - Higher inflation due to higher wage growth and energy prices: **-0.2ppts in 2025**.

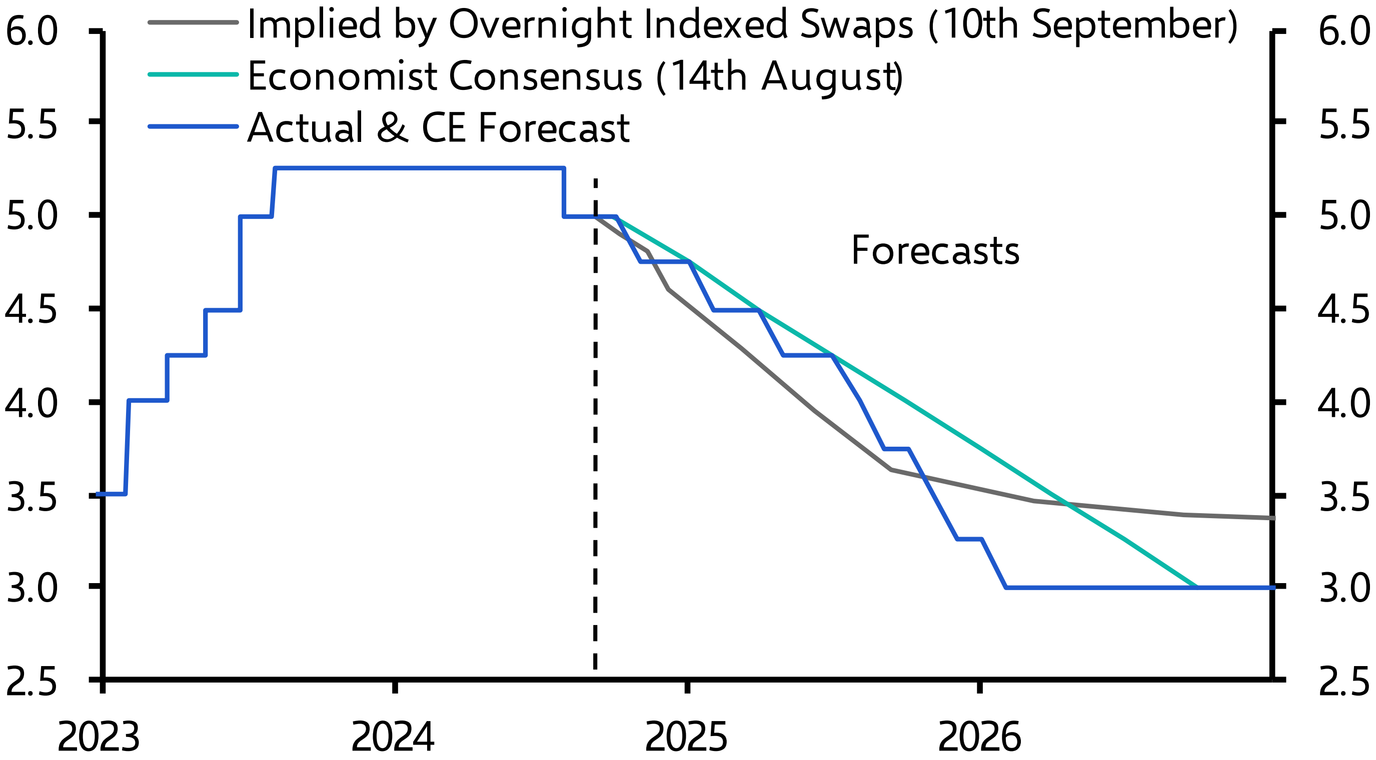
- Net effect:
  - GDP growth forecasts unchanged.
  - **1.2% in 2024, 1.5% in 2025, 1.5% in 2026**.

CPI Inflation (%)



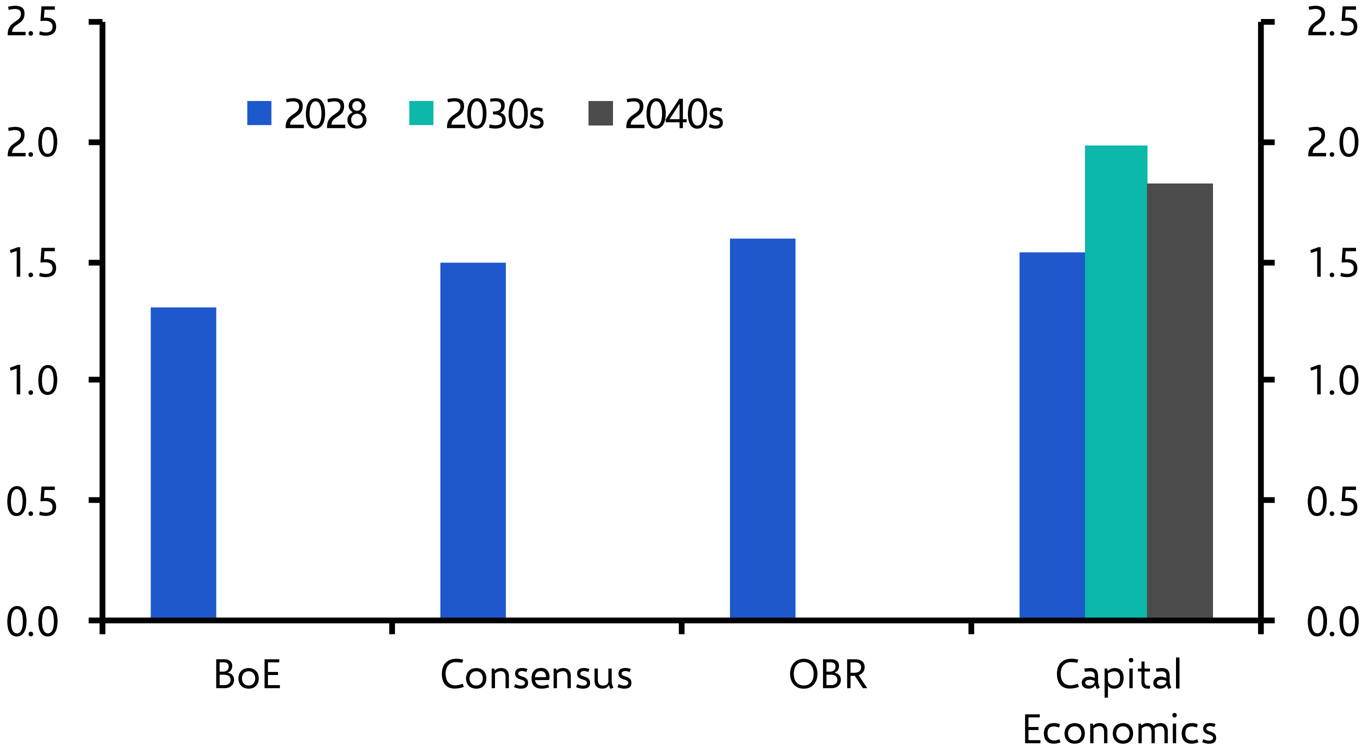
Sources: LSEG Data and Analytics, Bank of England, Bloomberg, Capital Economics

Bank Rate (%)



Sources: LSEG Data and Analytics, Bloomberg, Capital Economics

Estimates of Potential Rate of GDP Growth (%)

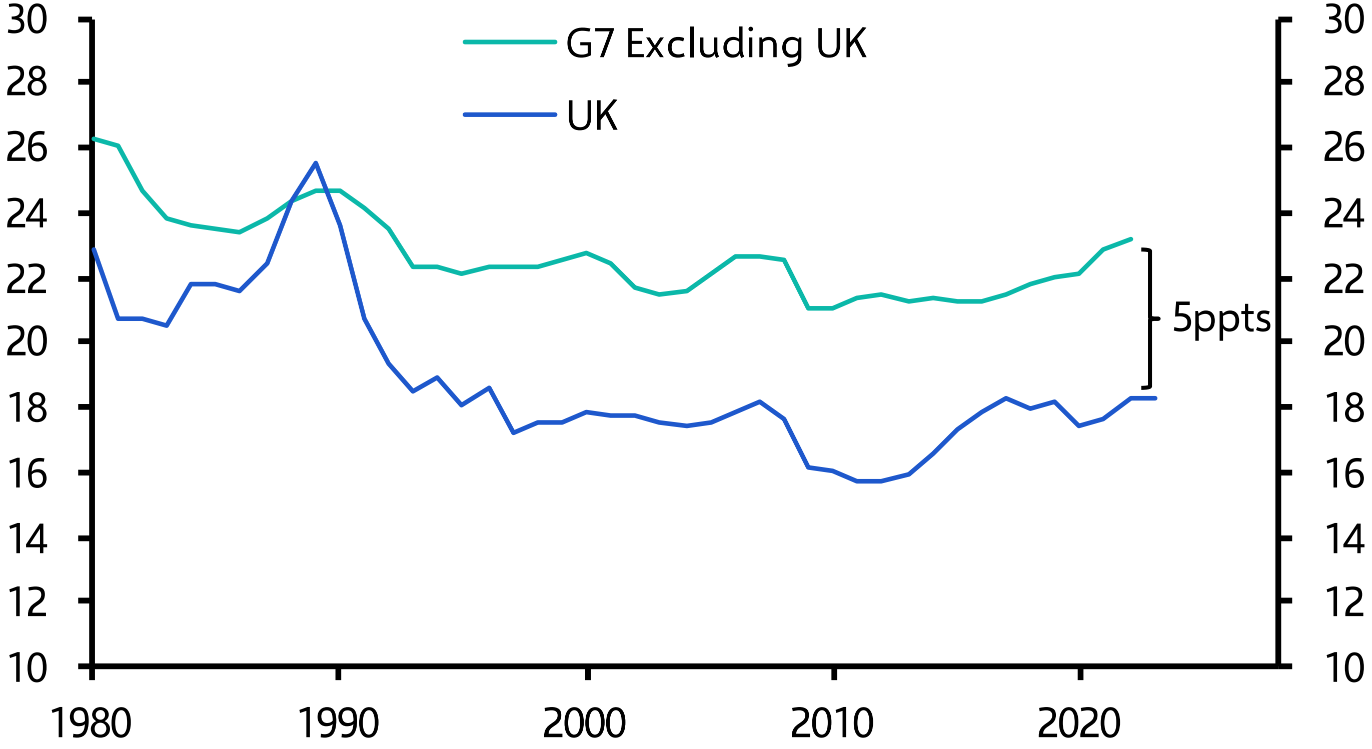


Sources: Bank of England, Consensus Forecasts, OBR, Capital Economics

Long-term economic growth

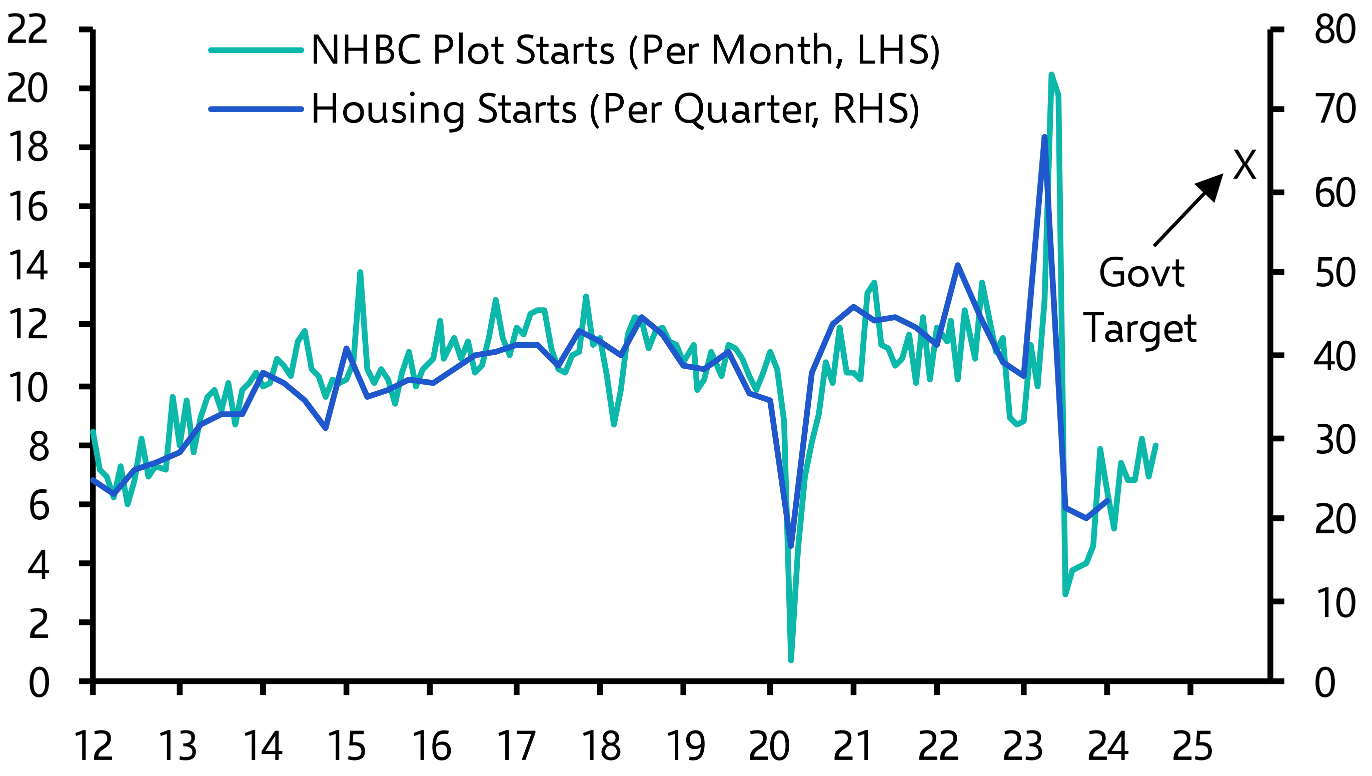
- Government reforms:
  - Possibly positive – Closer working relationship with the EU.
  - Possibly negative – Changes to workers' rights may restrain employment/productivity.
  - Big opportunity, but big challenge – boosting business investment and homebuilding.

Nominal Investment (Gross Fixed Capital Formation, % of GDP)



Sources: LSEG Data and Analytics, Capital Economics

Number of Housing Starts, England (000s)



Sources: LSEG Data and Analytics, NHBC, Capital Economics

Long-term economic growth

- Government reforms:
  - Possibly positive – Closer working relationship with the EU.
  - Possibly negative – Changes to workers' rights may restrain employment/productivity.
  - Big opportunity, but big challenge – boosting business investment and homebuilding.

- The influence of artificial intelligence (AI):
  - We assume that businesses will harness AI to become more productive.

Conclusions

- The inheritance is not as bad as the govt suggests, but there are fiscal challenges.
- Budget may not tighten fiscal policy by more than already planned, but both spending and taxes will be higher.
- The boost to growth from the Budget will be offset by a drag from inflation being higher.
- Bank Rate will eventually fall to 3.00% rather than to 3.50% as investors expect.
- Our optimism on long-term growth stems from AI, not from government policies.

UK Markets Forecasts

End period	10th Sep.	2024	2025	2026
Bank Rate	5.00	4.75	3.25	3.00
10-year gilt yield	3.86	4.00	3.50	3.25
$/£	1.31	1.25	1.30	1.30
€/£	1.19	1.19	1.13	1.13
FTSE 100	8,240	9,000	9,500	9,000

EUROPE – LONDON

Capital Economics Ltd
5th Floor, 100 Victoria Street
Cardinal Place
London
SW1E 5JL

Telephone: +44 (0)20 7823 5000

Capital Economics Ltd. is registered in England,
Registration No. 2484735. VAT No. GB 198 2919 50.

NORTH AMERICA – TORONTO

Capital Economics (N.A.) Ltd
Suite 600, 77 Bloor Street West
Toronto, ON
M5S 1M2

Telephone: +1 416 413 0428

The North American office is a branch of Capital Economics (N.A.) Ltd, a wholly-owned subsidiary of Capital Economics Ltd. Registered in England, Registration No. 6190831. Registered in Canada, Registration No. BN 851886358.

NORTH AMERICA – NEW YORK

Capital Economics (USA) Inc
C/O Capital Economics (N.A.) Ltd
77 Bloor Street West, Suite 600
Toronto, ON
M5S 1M2

Telephone: +1 416 413 0428

Capital Economics (USA) Inc. is registered in the State of Delaware, 1209 Orange Street, Wilmington, New Castle, Delaware 19801, Registration No. 150368300

ASIA – SINGAPORE

Capital Economics (Asia) Pte. Ltd
Collyer Quay Centre
#26-03, 16 Collyer Quay
Singapore 049318

Telephone: +65 6595 5190

The Asian office, Capital Economics (Asia) Pte. Ltd, is a wholly-owned subsidiary of Capital Economics Ltd. Registered in Singapore, Registration No. 200909395K.

Subscription enquiries: sales@capitaleconomics.com • **Consultancy:** commissioned.projects@capitaleconomics.com
Recruitment enquiries: business@capitaleconomics.com • **General enquiries:** support@capitaleconomics.com