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Austerity will intensify this year and is set to be tougher this decade than previously planned.

The new fiscal forecasts still are based on excessively optimistic assumptions.

The Chancellor will need to tighten further to reach a surplus, but politics will compel him to relent.

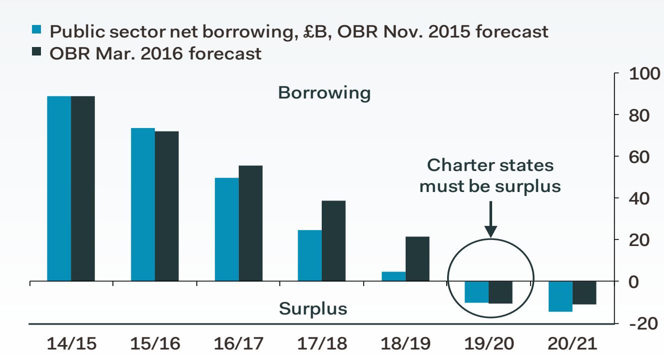
Fiscal Squeeze Still Set to Intensify, Despite the Economic Slowdown

The Chancellor chose in his Budget to increase the total size of the forthcoming fiscal consolidation, to ensure that the Office for Budget Responsibility continues to forecast that a budget surplus will be obtained in 2019/20. The Chancellor's obsession with adhering to his self-imposed rule to reach a surplus by the end of the parliament means that fiscal policy now is *pro-cyclical*, amplifying booms and busts rather than smoothing them out. With the economy continuing to slow this year, now might not be the last time the Chancellor tightens the fiscal thumbscrews.

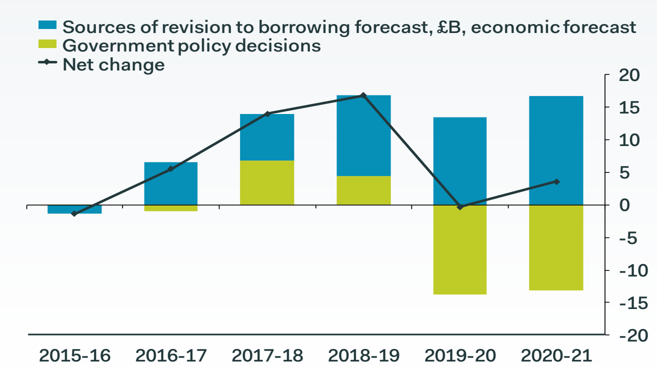
Cumulatively, the new borrowing forecast is £39B higher than the previous forecast in November's Autumn Statement. But this mainly reflects the OBR's lower forecast for GDP growth. The predictions for GDP growth in 2016 and 2017 were cut to 2.0% and 2.2% respectively, from 2.2% and 2.4% in the Autumn Statement. The *level* of GDP also is expected to be 1.4% lower in 2020 than in November. This primarily reflects a lower forecast for trend productivity growth in response to the disappointments of recent years.

The Chancellor preserved the £10B surplus in 2019/20 by resorting to three measures. First, he pencilled in £3.5B of additional, unspecified, departmental spending cuts for 2019/20. Second, he brought forward £1.6B in capex to 2017/18 and 2018/19 from 2019/20. And third, he announced a series of corporation tax changes, which produce a net giveaway in the near-term but result in a net tightening of £8B in 2019/20. A lower forecast for debt interest, which builds to an annual saving of £6B by 2019/20, also helped preserve the forecast surplus.

BORROWING REVISED UP IN NEAR-TERM DUE TO WEAK RECEIPTS...

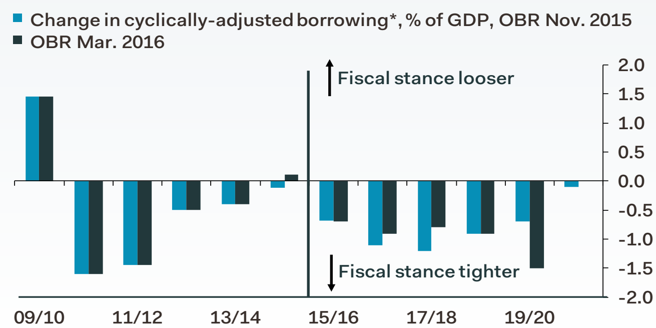


...BUT EXTRA CUTS & LOWER INTEREST PAYMENTS MAINTAIN SURPLUS



The fiscal squeeze still is set to intensify this year and next, despite this tinkering. The Chancellor will push through austerity measures that will reduce the cyclically-adjusted budget deficit by 0.9% of GDP in 2016/17 and by 0.8% in 2017/18. ***These reductions exceed those seen in the current fiscal year and in the previous three years, as our next chart shows.***

THE FISCAL SQUEEZE STILL IS SET TO INTENSIFY THIS YEAR



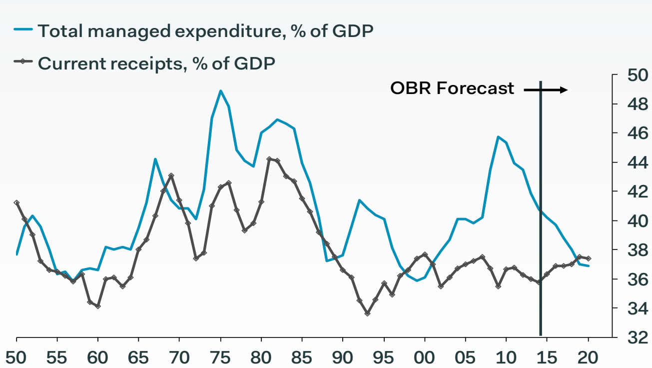
* Excluding impact of Royal mail pension fund transfer in 12/13

We still doubt that borrowing will fall as swiftly as the OBR expects, despite the upward revision to its forecast. The OBR continues to take an overly optimistic view on the impact of the fiscal squeeze on GDP growth. It expects GDP growth to average 2.1% over the next five years—slightly more than the 2.0% recorded over the previous five years—even though the fiscal consolidation will be bigger in this parliament than the last.

In addition, the OBR's forecast for debt interest payments is based on the markets' current view that interest rates won't rise for another three years. But if year-over-year growth in average weekly wages picks up to 2.5% this year and 3.6% in 2017, as the OBR expects, then the Monetary Policy Committee likely will raise interest rates considerably before 2019.

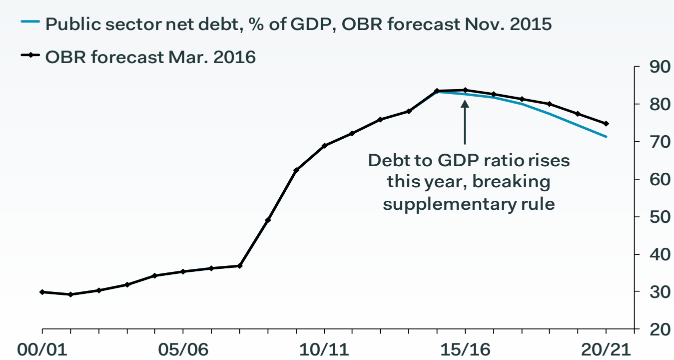
The OBR also continues to take the Government's spending plans at face value, without assessing whether they are achievable. Total managed expenditure is forecast to fall to 36.9% of GDP in 2020/21, the lowest percentage since 2000/01. This looks like a very tall order; pension spending will be much higher than in the early 2000s, and the budget of several key departments, like health and schools, have been ringfenced.

THE CONSOLIDATION REMAINS FOCUSSED ON SPENDING CUTS



We therefore still think that the Chancellor is heading for a crisis in the middle of this parliament, where he will have to decide either to tighten fiscal policy even further or break his primary rule. Breaking the rule likely will be the sweetest pill to swallow. He has already broken the other two rules set out in the Budget last year. The debt-to-GDP ratio now is projected to *rise* this year—despite public asset sales totalling £25B—and the welfare spending cap will be breached during all of the next three years. *Meanwhile, his party is likely to be very unenthusiastic for a severe fiscal consolidation in 2019/20, immediately before the next general election in May 2020.*

THE DEBT-TO-GDP RATIO NOW RISES THIS YEAR, BREAKING A RULE



In the meantime, however, the economy is set to endure a re-intensification of the fiscal squeeze. ***This will require monetary policy to be looser than it otherwise would have been, but it will not rule out interest rate increases altogether.*** The MPC will remain focussed on the outlook for inflation, which will be boosted by rising wage costs and a weaker pound brought on by interest rate increases in the U.S. So, with both fiscal and monetary policy tightening, we doubt that the Chancellor will be able to boast about the U.K. economy's outperformance for much longer.

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THIS WEEK IN BRIEF

Note: "**D**" prefix denotes Datanotes for these releases.

Monday, March 14

- **No significant data released.**

Tuesday, March 15

- **No significant data released.**

Wednesday, March 16

- **D: Labour Market Data (1/2)/09:30 GMT**

The headline—three-month average—unemployment rate held steady at **5.1%** in January. But the sharp 18K month-to-month fall in the timelier claimant count measure of unemployment in February—the largest for 12 months—and the relative strength of the latest employment surveys suggests that the unemployment rate will fall again soon. Meanwhile, the headline rate of year-over-year growth in average weekly wages rose to **2.1%** in January, from 1.9% in December. This reflected a 2.5% year-over-year increase in wages in January, the biggest rise since August. We expect wage gains to pick up further, in response to the tight labour market, rising inflation, and the introduction of the National Living Wage in April.

- **D: Budget/12:30 GMT**

The Chancellor increased the total size of the planned fiscal consolidation in response to the economy's slowdown, to ensure that the Office for Budget Responsibility continues to forecast a budget surplus of £10B in 2019/20. At least most of the additional policy tightening has been pencilled in for 2019/20. In addition, the total borrowing forecast cumulatively is £39B higher than in the Autumn Statement. But borrowing is higher solely because the OBR has lowered its forecast for GDP growth. The Chancellor still intends to push through austerity measures that will reduce the cyclically-adjusted budget deficit by 0.9% of GDP in 2016/17 and 0.8% of GDP in 2017/18, the biggest reductions since 2011/12. Meanwhile, the OBR continues to take an overly optimistic view of the impact of the fiscal squeeze on GDP growth, the yield from tax avoidance measures, the ability of government departments to implement severe cuts, and the outlook for debt interest payments. We still doubt that a surplus will be obtained.

Thursday, March 17

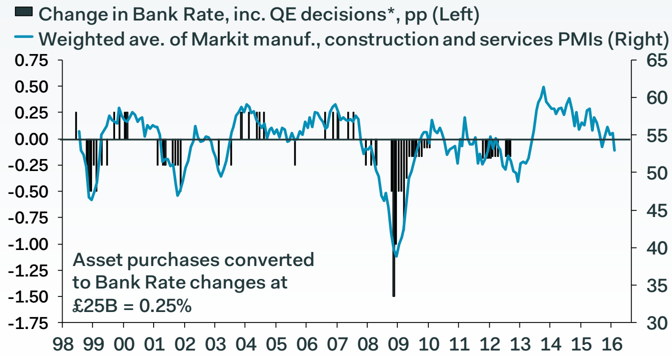
- **D: MPC Announcement and Minutes (3)/12:00 GMT**

The MPC probably will vote **9-0** in favour of keeping interest rates at 0.5%, the same as last month. The fall in the composite PMI to a level consistent with quarter-on-quarter GDP growth of just 0.2% might mean that a rate *cut* will be discussed. External Committee member Gertjan Vlieghe said on February 23 that he had "relatively little tolerance for further downside surprises." But the improvement in financial market sentiment since his comments and the drop in sterling, which has similar effects to a rate cut and will boost inflation, suggest that he won't vote to ease at this stage. **Consensus: 9-0.**

Friday, March 18

- **No significant data released.**

CHART OF THE WEEK: WILL THE MPC DISCUSS A RATE CUT?



PANTHEON'S FINANCIAL FORECASTS

		End-month:				
	4pm Wed.	Mar	Jun	Sep	Dec 16	Dec 17
Bank Rate	0.50	0.50	0.50	0.75	1.00	2.00
3m Libor	0.59	0.60	0.70	1.00	1.30	2.30
12m Libor	1.02	1.10	1.50	1.70	2.00	3.00
2-year Gilt	0.50	0.50	1.00	1.50	1.80	3.00
10-year Gilt	1.51	1.80	2.20	2.40	2.60	3.50
30-year Gilt	2.33	2.60	3.00	3.20	3.40	4.00
FTSE 100	6178	6000	6050	6100	6200	6500
USD/GBP	1.41	1.40	1.38	1.40	1.42	1.40
EUR/GBP	1.27	1.35	1.37	1.39	1.41	1.40
Sterling TWI	85.9	88.6	89.2	90.5	91.8	91.2

PANTHEON'S ECONOMIC FORECASTS

	Period average:						
	Q4 15	*Q1 16*	*Q2 16*	*Q3 16*	*2015*	*2016*	*2017*
GDP, q/q%	0.5	0.4	0.3	0.4	-	-	-
GDP, y/y%	1.9	1.7	1.4	1.4	2.2	1.5	2.2
Employment, y/y%	1.8	1.4	1.7	1.3	1.5	1.2	0.7
Unemp. rate, %	5.1	5.0	5.0	5.0	5.4	5.0	4.8
Wkly earnings, y/y%	1.7	2.3	2.5	3.0	2.5	3.0	3.5
CPI, y/y%	0.1	0.6	0.9	1.1	0.0	1.0	2.2
RPI, y/y%	1.0	1.7	2.2	2.5	1.0	2.3	3.5
PSNB FY, £B	-	-	-	-	78	55	40
Cur. acc't., % GDP	-3.8	-3.9	-4.0	-4.0	-4.1	-3.9	-3.3
House prices, y/y%	4.4	5.4	6.2	7.4	4.4	8.0	4.0