The UK budget and the Bank of England: What to look for

The Chancellor looks set to unveil measures to help firms affected by the coronavirus outbreak in Wednesday's budget, but markets will be more interested in any coordinated Bank of England action. That may not take the form of a rate cut this week (although it's only a matter of time), but some targeted schemes to help reach affected firms are possible

A difficult debut for the new Chancellor

It's a little under a month since Chancellor Rishi Sunak took over at the UK Treasury, but the circumstances surrounding his first budget this Wednesday have changed dramatically over that time.

Sterling soared in February on hopes of a sharp increase in stimulus – particularly related to public investment. But with the UK government warning of a wider coronavirus outbreak in the UK, the much greater focus now will be on any measures to mitigate the economic impact.

The challenge facing the Chancellor is well documented. The numbers are tight, assuming the Treasury honours a manifesto pledge to balance day-to-day spending within two-to-three years. Official forecasts back in March 2019 effectively gave the Chancellor £37 billion headroom – money that could be spent while still meeting the target.

But a combination of lower growth, some previous spending announcements and accounting tweaks mean that figure is now at best £10bn, probably less once the forthcoming Covid-19 growth shock is factored in.

Will Sunak bend the rules – and will markets care?

A key focus will be on the slowdown in demand, increased rates of worker-isolation/illness, and what it all means for firms' cashflow. The government is already planning to beef-up its "Time to Pay" system which allows struggling businesses to pay tax bills back in smaller instalments over time, and there are likely to be further measures announced this week.

One option might be to cut VAT temporarily as happened back in 2008, and the government could even allow firms to defer payment of their VAT bills. The former has been a fairly successful form of short-term stimulus in the past, although perhaps consumption-based measures will only go so far in this instance if shoppers are stuck at home.

Either way, with few fresh revenue-raising measures likely to be announced, we may well see some tweaks to the fiscal rules in order to facilitate the extra spending.

The most obvious move would be to allow a current budget deficit for longer - perhaps for the next five years, as opposed to balancing day-to-day spending by 2022/23. That might unlock a bit of extra cash (£5bn, according to the *Resolution Foundation* think tank), but will markets be fazed by the more relaxed approach to fiscal discipline?

Given the current demand for safe havens, our rates strategy team thinks the answer is probably "no".

How likely is coordinated Bank of England cut this week?

Away from the budget itself, markets are questioning whether the Bank of England could announce stimulus in coordination with the budget on Wednesday.

Incoming Bank of England Governor Andrew Bailey noted last week that there should be coordinated action, although a rate cut linked to a budget may inevitably raise some questions surrounding independence – even if the circumstances may warrant it.

Bailey also hinted that the Bank wanted "more evidence than we have at the moment" before making a decision. That helped explain why the BoE opted against joining the Federal Reserve in a coordinated rate cut, which probably also suggests the Bank would ideally wait until its meeting later in March before acting.

Realistically, there's not much officials will be able to glean from the public dataflow before the 26 March meeting, but it would allow extra time to collect information from its network of agents.

BoE officials will also be acutely aware that a rate cut – lowering debt-service costs - is likely to be a less effective demand boost that it normally would, and is unlikely to mitigate the wider cashflow issues facing affected firms as effectively as some fiscal measures.

So what tools might the Bank of England unleash this week?

- **Rate cut:** We're pencilling in a 25 basis point cut this month, although this may not come this week. We still narrowly think this is more likely to come at the formal March meeting.
- **Quantitative easing:** Increasing the stock of government bond purchases seems less imminent – policymakers would probably prioritise rate cuts in the first instance. However given the focus on providing stimulus for firms, policymakers might take another look at corporate bond purchases at its meeting later this month.
- **Targeted measures:** If we do get action this week, we think it is most likely to be in the form of specific schemes designed to complement the budget. Bailey said last week that some form of supply-chain finance was going to be needed rapidly. With some banks offering measures to ease the burden on affected firms, the Bank of England might decide to support those efforts. The jury is out on the form this might take, but for instance, the BoE may be able to play a role in facilitating government-guarantees, which could cover bank loans to affected companies (not dissimilar to the existing Enterprise Finance Guarantee scheme). An adapted version of the Funding for Lending scheme used in 2012 might be another potential alternative. Policymakers might also look at ways of supporting trade finance, in a bid to help supply chains recover.

Author

James Smith
Developed Markets Economist, UK
james.smith@ing.com