

UK Chancellor's four budget challenges

Expect the UK budget to be tailored more towards the hardest-hit service sectors, as the government prepares for a fairly gradual exit from social distancing measures over the spring and summer



Source: Shutterstock

Just a few months ago, UK Chancellor Rishi Sunak would have hoped that his spring budget would be an opportunity to move the economic agenda away from Covid-19, and back towards the government's 'levelling up' commitment. But as he prepares to announce his latest set of measures on 3 March, the reality looks very different.

That's because it's becoming increasingly clear that it could be some time before Covid-19 restrictions are removed entirely, despite the considerable progress on vaccinations. The good news at least is all priority groups (including over 50s) will likely have received their first dose by Easter, and that combined with the strong impact lockdowns are having on cases, it will lower hospital pressure considerably by May.

For the Chancellor the main takeaway is that Covid-19 is set to linger

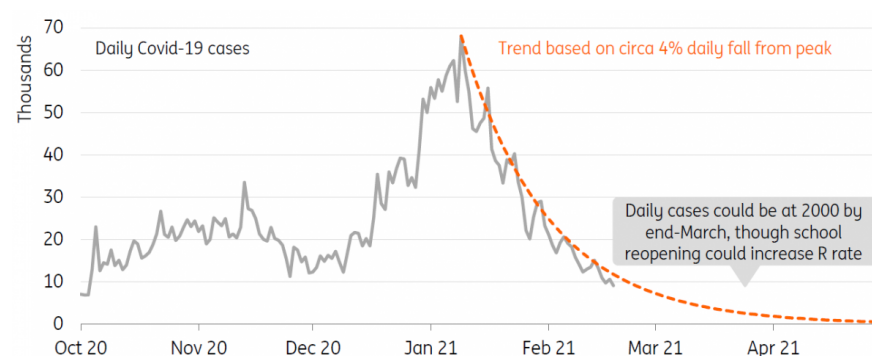
That's likely to justify reopening most sectors around the same time, but it'll probably take until late June/July at the earliest for all adults to receive their first dose, assuming supply capacity can increase to accommodate both first and second doses.

In the meantime, community transmission will likely rise again among the younger population. The government's new concern is that this could drive the spread, or even development, of vaccine-resistant strains, and that implies some social distancing measures are likely to stay in place (limits on mass gatherings as an example).

The extent of these will depend on how far the reproductive number, or R number goes above one, which is intrinsically linked to the effect vaccines have on transmission ([early signs are relatively encouraging](#)). This will determine how quickly social distancing can end entirely, or indeed if certain restrictions need to be temporarily brought back.

Either way, for the Chancellor the main takeaway is that Covid-19 is set to linger, and that poses a number of potential challenges.

UK Covid-19 cases have fallen rapidly despite high prevalence of new variant



Source: Macrobond, ING

Trend line based on average percentage fall in cases between peak on 9 January and now. Note this is based on recorded cases, rather than estimated prevalence

1 Extending furlough

This is undoubtedly the most pressing issue, and some form of extension of wage support seems inevitable. The current furlough scheme, where employees can receive 80% of their normal wages if unable to work, expires at the end of April. It feels like the hospitality sector (and possibly others) won't be open by then.

The Chancellor may be tempted to focus the policy to areas where social distancing is still restrictive

But beyond an extension of a few months, the challenge when tapering the support will be to limit job losses to roles that are definitely no longer viable.

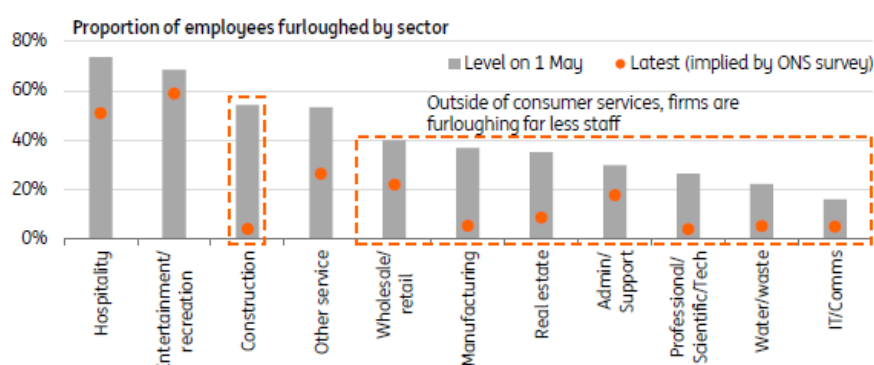
Premature removal of support for sectors still covered by social distancing restrictions potentially risks amplifying redundancies - which is what we started to see last September ahead of the original furlough expiration date.

The fact that there were still 1.3 million jobs 'fully furloughed' back in October before restrictions tightened again, suggests there are potentially hundreds of thousands of roles that fall into this category. To help mitigate all of this, the Chancellor may be tempted to focus the policy on areas where social distancing is still restrictive. We've already seen an uptake of furlough become ever-more concentrated in the hardest-hit consumer-services sectors, while elsewhere usage has fallen (see chart).

In practice, we could see the Treasury either restrict 'full furlough' to sectors formally covered by social distancing rules, or by means-testing the scheme by revenue loss. The latter is perhaps more efficient but probably more logistically challenging to get right. A pre-announced strategy, if restrictions are reintroduced in certain sectors, may also help businesses to plan for the summer months.

For sectors no longer covered by restrictions, the government will presumably revert to the plan it first formulated last autumn. The Job Support scheme, which never actually came into effect, gave wage subsidies where staff were only able to work a fraction of their usual hours.

Furlough usage now more concentrated among fewer, hard-hit sectors



Source: HMRC, ONS, ING

Latest ONS percentages based on 'Business insights and impact on the UK economy' wave 23. May data from official HMRC statistics

2 Supporting struggling cashflows

Aiding firms cashflow is also going to be key for the jobs market. The furlough scheme can only protect jobs as long as firms are strong enough to support them in the recovery phase. And again, the picture is unsurprisingly very sector-specific.

At an aggregate level, firms' cash holdings have risen through the pandemic, no doubt linked to the flurry of financing activity through the middle of 2020. But in the hospitality sector and among other consumer services, the alarm bells are starting to ring.

Over half of these firms are now reporting they have less than four months cash in reserve, according to the Office for National Statistics. While it's hard to know how these figures compare to

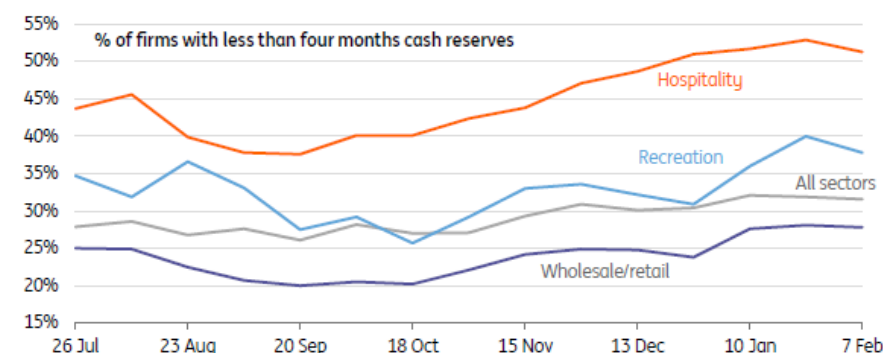
pre-pandemic norms, the fact that a third of hospitality firms say they have little or no confidence they can survive the next three months is striking.

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Limiting the wave of business failures through 2021 will therefore be key. To some extent a rise is inevitable, given that [company insolvencies were lower than in previous years](#). But it's likely that many of the measures designed to aid cashflow will continue, and perhaps be bolstered. There's likely to be a renewed focus on grants, which unlike furlough, are already targeted directly at businesses that are closed. Many are also expecting the government to delay the time when firms will need to repay their deferred VAT payments, as well as extend business rates relief (a tax based on premises' value).

We might also see a further extension to the guaranteed-loan programmes, though given the current cashflow crunch appears more concentrated in smaller firms and in specific sectors, this potentially risks storing up issues for later. Higher debt levels could feasibly constrain hiring and investment in years to come.

Half of hospitality firms have less than four months cash reserves



Source: ONS, ING calculations

Data from ONS 'Business insights and impact on the UK economy' surveys - wave 9 to 23. Proportion of firms reporting 'no cash reserves', 'less than one month', or 'one to three months'

3 Unlocking pent-up demand

One piece of better news for the Chancellor is that there's a good amount of consumer firepower available once the economy reopens. Involuntary savings have risen substantially, and the challenge is to make sure some of this is spent.

The benefit of policies like 'Eat Out To Help Out' over conventional policy levers like VAT tax cuts is that it directs consumer savings

to where the money is most needed

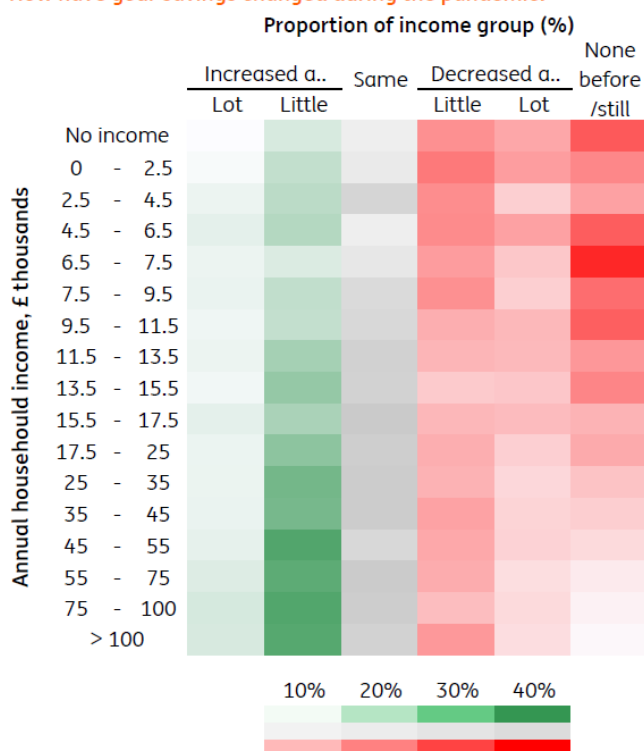
One option would be to look at policies like 'Eat Out to Help Out' again, which subsidised meals out in August 2020. The benefit of this sort of thing over conventional policy levers (e.g VAT cuts) is that it directs consumer savings directly to where the money is most needed, but it's not clear if this is compatible with the wider Covid-19 containment strategy. Consumer confidence is going to be key this summer, and the government is likely to remain wary of introducing policies that risk pushing up the number of cases and therefore prompting more cautious behaviour.

Instead, the bigger issue is that the rise in involuntary savings has been unequally distributed across income groups. Lower earners have typically seen savings fall, according to Bank of England survey data (see chart), and this is tied to higher rates of furlough and redundancy.

Ensuring these workers get back on their feet will be key to the consumer recovery story. That has been neatly demonstrated in the US, where spending in [low-income areas spiked by 20% in January](#) days after stimulus payments were received, while expenditure was largely flat in high-income neighbourhoods.

The rise in savings has been concentrated among higher earners

"How have your savings changed during the pandemic?"



Source: ING analysis of Bank of England NMG survey

Full question: "As a result of any changes in income or spending due to the coronavirus pandemic, would you say that your household's total savings have increased, decreased, or stayed the same?" Data is from the Bank of England/NMG survey, taken from 25 August-15 September 2020

Managing borrowing

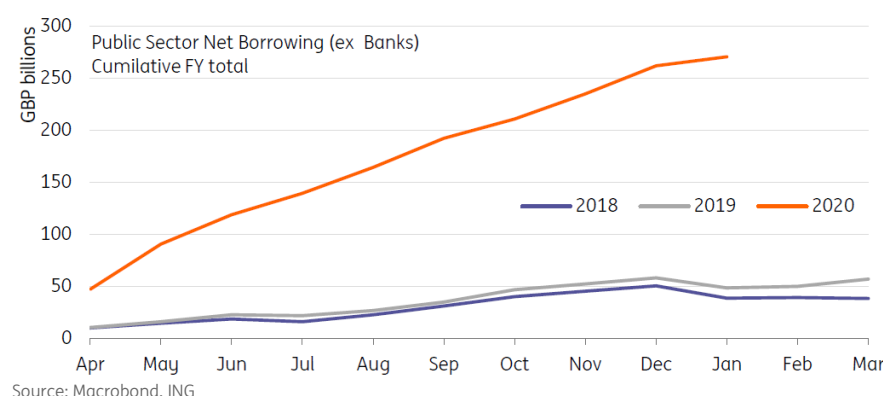
Finally, the outlook for Covid-19 and the previously-discussed policy measures means the deficit in the next fiscal year will remain in the high single digits (down from around 13.5-14% for 2020/21). Unemployment is also likely to rise this year, while pandemic-related expenses (e.g test-and-trace) will also continue to be felt through most if not all of next year.

Arguably this shouldn't come as much of a concern. Government borrowing costs are at record lows, and that means the pressure to look at balancing the books is pretty minimal, to say the least.

Nevertheless, we suspect there is likely to be a renewed discussion about this later in the year, and we may therefore see some renewed focus on tax rises this time next year, to help finance higher spending on the government's (non-Covid) election priorities.

We'll be taking a more detailed look at what all of this implies for UK gilt markets next week.

Borrowing has hit £270bn so far in 2020/21 (12.8% of 2020 GDP)



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