Austerity Plan A
28 March 2011

Despite the Office for Budget Responsibility's weaker forecast for economic growth, the UK Chancellor stuck with austerity Plan A in the 2011 Budget. There was no change to the public spending plans announced last June and elaborated in October. As the Chancellor noted, the success of the plan depends partly on continued loose monetary policy, but with inflation at 4.4%y/y and set to rise further, this is not a certainty. Indeed, the longer high inflation persists, the greater the risk of a wage-price spiral, leading to higher interest rates. In the Eurozone, Portugal looks set to join Ireland and Greece in the bail out club as the prime minister's austerity measures were voted down. While in the US, growth is stronger than was expected, but the housing market continues to be a drag.

Osborne sticks to the script in Budget 2011. The Chancellor was in no mood to dilute the planned cuts in public expenditure in the 2011 Budget. A strong stance should add much needed certainty, but there are still risks that the spending plans may squash the recovery. The Office for Budget Responsibility lowered its forecasts for economic growth to 1.7% from 2.1% for 2011. But its projections are above consensus for 2012. It also continues to expect the cyclically adjusted budget deficit to be eliminated by 2014-15.

There were some sweeteners for companies and households. The most eye catching budget initiatives were the 2% cut to the main corporation tax rate and the reduction in duty on fuel. These measures will be largely financed by the bank levy and increased tax on the oil sector. The £630 increase in the personal income tax allowance from April 2012 was some good news that costs nothing today. The government will save some money on pensions and other index linked benefits because calculations will switch from RPI to the lower CPI measure. A nod to the plight of the housing market came with £250m for the FirstBuy Scheme. Government and housebuilders will provide favourable loans to help an estimated 10,000 low income first-time buyers raise a 25% deposit. This is great for housebuilders because the scheme is available only for newly built homes, but overall its scale is too small to change the market significantly.

UK inflation continues to break records. The CPI rose by 4.4%y/y in February. This is up from 4.0%y/y in January and is the highest since October 2008. The RPI, which includes housing costs, rose by 5.5%y/y in February - the fastest pace since July 1991. Rising costs of clothes and shoes was a major cause for the lift in February. Domestic fuel costs also pushed inflation up, but this was largely because of a big fall in costs in February 2010.

The retail sales data were a mixed bag. At first glance things look quite good for retailers. The value of sales grew by 4.4%y/y in the three months to February, the fastest growth for more than two years. But things are unlikely to get better. Surveys and anecdotal evidence from retailers suggest shoppers are already in belt tightening mode and higher prices are putting them off further. Indeed, the volume of sales increased by only 1.7%y/y in the three months to February.

Who would be a central banker? There was no change in the voting at the March MPC meeting, and little change in the thrust of the debate. The MPC is trying to balance the need to subdue rising inflation expectations with sustaining a fragile recovery. Recent rises in oil prices ï up 25% since the start of the year and almost 50% over six months ï only made that job tougher.

Portugal looks set to join the bail out club. The Portuguese prime minister resigned after parliament rejected his austerity measures. This caused yields on Portuguese two-year bonds to jump to their highest since the euro's inception. There is no shortage of drama in the Eurozone. Inflation is rising at its fastest pace in two and a half years prompting the ECB signal of a rate rise as soon as April.

US growth better than expected. The US economy grew at a 3.1% annualised rate in Q4 2010, up from Februaryŝ estimate of 2.8%. Business investment and stronger inventories triggered the upward revision while consumption was strong at 4% in annualised terms. It is not clear how long this will continue though. Higher oil prices, weaker consumer confidence and the housing market will all act as drags on personal expenditure.

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