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An enormous fiscal gamble

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Last week's budget announcements have markedly weakened the UK's fiscal standing but may do very little for growth in the coming years. Investors are rightly nervous about the UK's long-term prospects.

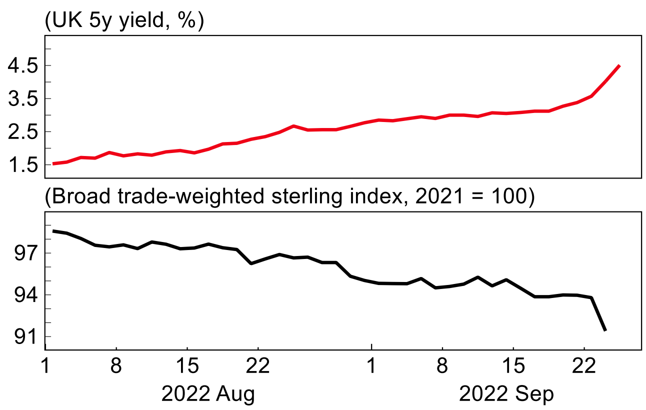
A seismic budget announcement

The UK government has taken a huge gamble by sweeping tax cuts – a permanent loosening of fiscal policy – just weeks after announcing a 'blank cheque' policy to cap household and business' energy costs. Meanwhile, there was not a single measure to increase revenue or reduce expenditure in the 'mini budget' (in reality it was a seismic fiscal event). The UK government is hoping that a lower tax and more loosely regulated economy will experience higher growth, and that it will happen in short order to prevent a snowballing government debt-to-GDP ratio. But with the UK economy probably already in a technical recession and new borrowing increasingly costly, the market reaction was stark: gilt yields surged, sterling plunged.

Let's start with the positives in the chancellor's statement. A focus on streamlining the UK's restrictive planning laws could be an important structural change if meaningfully enacted. Lower stamp duty (a tax on property transactions which gums up the housing market) is also welcome. New measures to incentivise capital spending clearly make sense given that business investment remains below its pre-pandemic peak (and even further short of the pre-Brexit referendum mark). More broadly, this government seems to at least have a coherent economic plan – it might be argued that the same could not always be said of the previous government.

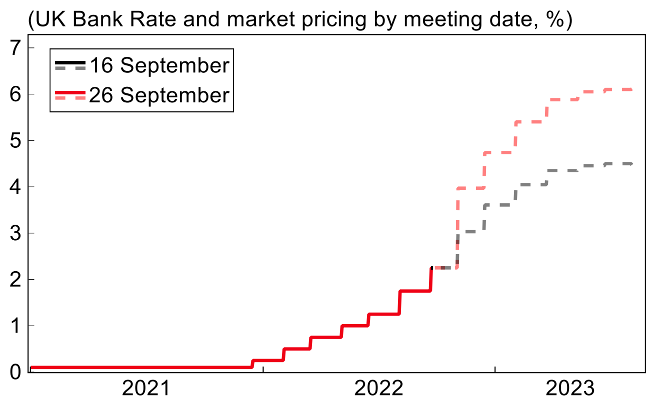
But, for this plan to work, the government will be relying on luck more than anything else. To our minds, it will mostly be a gamble on external conditions. Energy prices, supply-chain constraints and global confidence will matter more than the measures announced last week for the UK's growth rate. A synchronised global upswing may be needed – at a time when risks to the world economy are tilted to the downside.

NEW BORROWING COSTS UP, STERLING DOWN



Source: Bloomberg, BoE, MUFG Bank Economic Research Office

MARKETS NOW EXPECT BANK RATE TO REACH 6%



Source: Bloomberg, MUFG Bank Economic Research Office

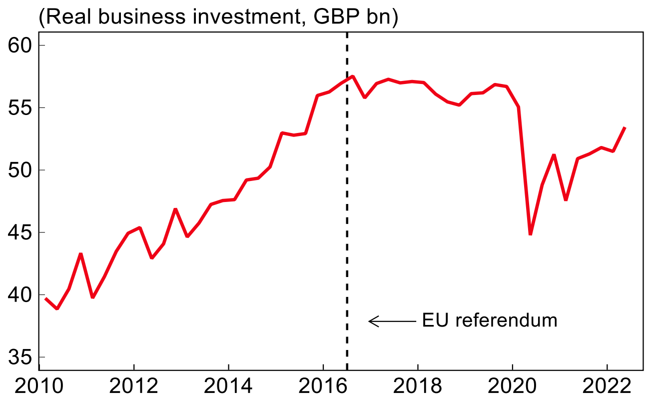
New measures unlikely to spur growth revival

In terms of the domestic agenda, the range of tax cuts will help household disposable income and give some additional support to the UK economy through what is set to be a challenging winter, even with the government's new energy price policy.

However, lower taxes seem unlikely to drive trend growth meaningfully higher. The cut to National Insurance (a tax on salaries paid by both employers and employees) is simply a reversal of an increase announced only a year ago by the previous Chancellor. One of the most eye-catching measures was the reduction in the UK's top rate of income tax from 45% to 40%. This will affect the top 1% of earners. Wealthier households are more likely to save rather than spend extra money so the immediate boost for the economy is likely to be negligible. The lowest rate of tax is also to be cut, from 20% to 19%, in April next year. Again, a small move that is unlikely to move the needle much when it comes to growth.

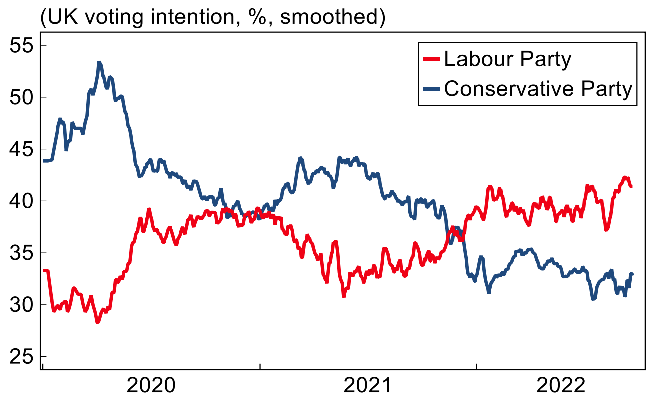
Meanwhile, the measures to incentive business investment such as greater tax relief on qualifying capital expenditure look sensible, but should be considered alongside other recent efforts. The previous Chancellor, Rishi Sunak, introduced a 'super deduction' scheme (see here) which was designed to bring forward investment ahead of the planned increase in corporation tax in 2023 but did not lead to a surge in capital spending. Business investment is still 7% below its 2016 peak. It's not clear that keeping corporation tax at 19% instead of the planned increased to 25% will help either (there isn't much empirical evidence that lower rates lead to greater investment). The broader picture, including the credibility of economic policy and institutional stability, probably matters more regarding firms' investment decisions. Market participants seem to have a dim view on these at the moment when it comes to the UK. At any rate, we doubt UK firms will have a huge appetite for investment given the challenging macro outlook over the winter and into 2023.

BUSINESS INVESTMENT HAS BEEN DISMAL FOR YEARS



Source: ONS, MUFG Bank Economic Research Office

CONSERVATIVES TRAIL IN THE POLLS



Source: Europe Elects, MUFG Bank Economic Research Office

Political uncertainty is also a factor. These policies have not been announced at the start of a full parliamentary term. The next UK election is due in 2024 and the governing Conservative Party have consistently trailed the opposition Labour Party in the polls since the end of 2021, so there is a considerable chance that the measures announced last week, especially on tax, could be reversed within just a few years.

More immediately, there is a risk that spending plans (e.g. on infrastructure) could be pared back by the government following the market reaction and concerns over fiscal sustainability. But, in terms of investor confidence in the economy, any spending cuts would have to be considered alongside the UK's long-term structural issues.

The short-term outlook remains challenging

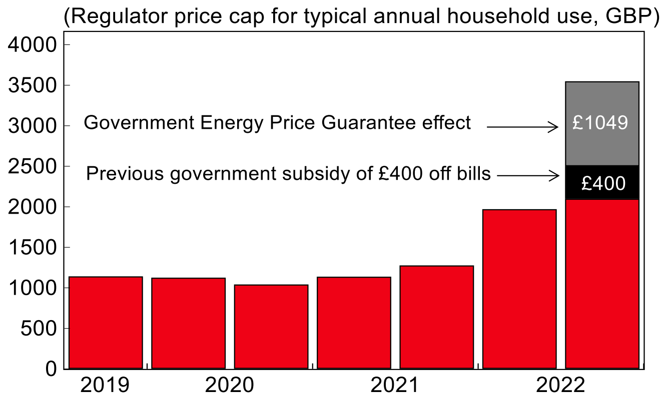
After a contraction in Q2 and weak monthly data in July, the extra bank holiday for the Queen's funeral this month probably means that the UK is already in a technical recession. It could be short. The return to a full complement of working days in Q4 will boost the Q/Q growth rate.

More significantly, the outlook over winter has improved markedly since the government moved to cap household energy prices for the next two years with its Energy Price Guarantee policy. At £2500 a year for the typical household, the scheme represents a saving of £1000 annually versus the regulators' previously announced pricing that would have applied from October. Support measures that had been announced back in May will remain: every household will see £400 taken off energy bills this winter, with additional support for more vulnerable households. For businesses, there is similar support for six months (which may be extended).

However, while this significant support should prevent a deep recession (and all the scarring effects through higher unemployment rates and insolvencies that would involve), it is still going to be a tough period for the UK economy.

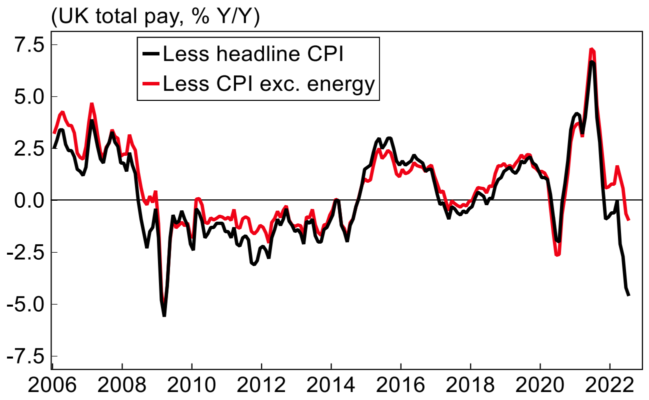
The UK composite PMI fell into contraction territory in September, reaching a 20-month low. Weakness in the services component suggests that any boost from post-pandemic pent-up demand is swiftly dissipating as households feel the pinch. Consumer confidence fell to a fresh all-time low this month, despite the announcement of the new energy price cap during the survey period. Inflationary pressures are broadening beyond just energy. Pay growth is not keeping up. Even excluding energy from CPI, real wage growth is in negative territory. At the same time, Bank of England tightening will increasingly weigh on households through higher mortgage costs. We expect annual GDP growth of just 0.2% in 2023.

GOVERNMENT POLICY WILL CUSHION THE ENERGY SHOCK



Source: Ofgem, MUFG Bank Economic Research Office

REAL HOUSEHOLD INCOMES REMAIN UNDER PRESSURE



Source: ONS, MUFG Bank Economic Research Office

A widening gulf between fiscal and monetary policy

For the BoE, the government's latest policies have changed the inflation outlook significantly. On the one hand, the scheme to cap energy prices means that the BoE can worry less about developments in international gas markets. We had previously expected UK CPI to peak at 16% – now it is more likely to be around 11%. Falling global commodity prices will ease the pressure. However, the government's measures make it likely that domestically-generated inflation will remain higher for longer. The cap on energy prices, which entails serious support to household disposable income, will be especially inflationary.

On the external front, weaker sterling will also contribute to inflation. On a trade-weighted basis, the pound was down 2.6% on Friday alone. Typically the pass-through from depreciation to import prices to CPI can take 12-18 months because of market hedging, but some dollar-denominated commodities will have a more immediate impact. UK consumers stand to benefit less from the recent falls in oil prices and hence pump prices given sterling weakness.

It remains to be seen how attentive the BoE will be to the rapid fall in sterling. The next monetary policy meeting is not scheduled until 3 November. If sterling continues to weaken this week then speculation could increase about an emergency rate hike

What is certain is that the gulf between fiscal policy and monetary policy will continue to widen over coming months. With the UK labour market still extremely tight, the BoE will not want to relent from its hiking cycle until it is reasonably sure that the risk of a wage-price spiral has diminished. Markets are now suggesting that Bank Rate could 6% by the end of 2022. In terms of the BoE's balance sheet, the BoE's plans for active bond sales, which were due to start in early October, could be kicked into the long grass given the turmoil in gilt markets.

So, the government has created a lot of headaches for the BoE. The bottom line is that the chancellor has announced a series of measures that may not move the dial much on growth, but could come at great cost to investor confidence and the UK's fiscal sustainability.

Over the longer-term, we doubt the target of 2.5% for trend GDP growth announced by the chancellor can be achievable. Five-year average GDP growth hasn't reached 2.5% since 2008, and Brexit will remain an extra drag on the UK economy. The pattern for lower productivity growth has shown no signs of reversing – and it could feasibly get even worse after years of low investment – while a surge in immigration, which would boost growth, seems politically unviable.

UK MACRO FORECASTS

% Y/Y unless otherwise stated	**2019**	**2020**	**2021**	**2022F**	**2023F**
GDP	1.7	-9.3	7.4	3.4	0.2
Household spending	1.2	-10.5	5.9	3.9	0.0
Government spending	4.2	-5.9	14.3	-0.3	1.3
Fixed investment	0.5	-9.5	5.9	6.3	2.6
Net exports (*contribution, pp*)	0.1	1.0	-1.4	-3.6	-0.7
Unemployment rate (%)	3.8	4.6	4.5	3.9	4.2
CPI	1.8	0.9	2.6	8.8	6.2
Average weekly wages	3.5	1.7	5.9	5.1	4.5

Source: ONS, MUFG Bank Economic Research Office

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