HENRY COOK
Senior Europe Economist

Economic Research Office

T: +44 (0)20 7577 1591
E: henry.cook@uk.mufg.jp

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The end of ‘Trussonomics’

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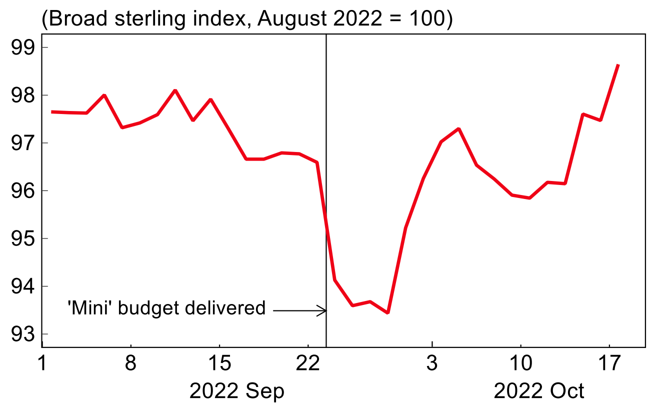
The fiscal measures introduced by prime minister Truss have almost entirely been overturned after the political and market fallout forced her to appoint a new chancellor. For now it is a political rather than an economic crisis, but a tough period of austerity beckons for the UK with less support for energy bills and lower public spending on services.

A screeching fiscal U-turn

The UK’s ‘mini budget’ announced on 23 September (see here) is now firmly in the bin. After weeks of fallout the UK government has had to face up to the market reaction (chart 1) and has completely reversed its low-tax strategy.

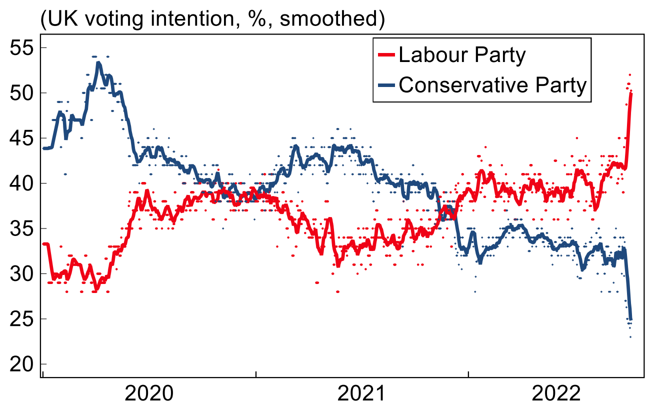
Last Friday prime minister Truss cancelled the planned change to corporation tax, which will now rise from 19% to 25% in April 2023. She had already reversed her planned tax cut for the UK’s highest earners. In an attempt to shore up her position Truss replaced her original chancellor with Jeremy Hunt, a former foreign minister, who is seen as a safe pair of hands. With Truss essentially now a lame duck prime minister, Hunt is totally in control of UK fiscal policy. Yesterday, he announced that almost all the remaining measures from the ‘mini Budget’ would be reversed. Markets responded favourably, with gilt yields down across all maturities.

CHART 1: STERLING HAS MOSTLY RECOVERED



Source: BoE, MUFG Bank Economic Research Office

CHART 2: A STARK SHIFT IN POLLING



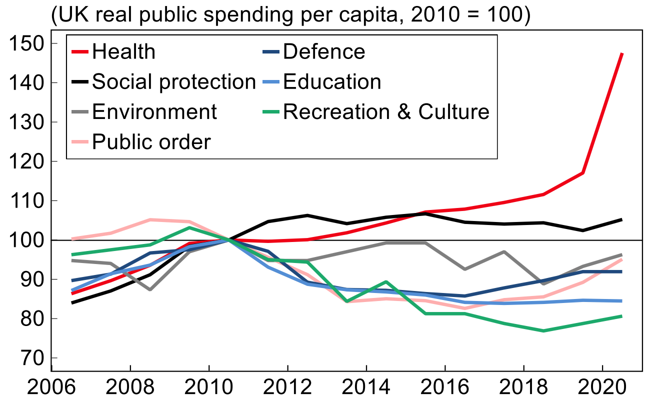
Source: Europe Elects, MUFG Bank Economic Research Office

It is a complete repudiation of ‘Trussonomics’ and is nothing short of a humiliation for the prime minister. Truss has only been in office for just over a month. In that time, polling for her Conservative Party has plunged to long-term lows (chart 2). Truss is clinging on, but it is certainly possible that she will be forced to resign in the not-to-distant future. Her position has been severely (and probably irreversibly) weakened and she will have no authority to introduce any further meaningful change.

Austerity beckons

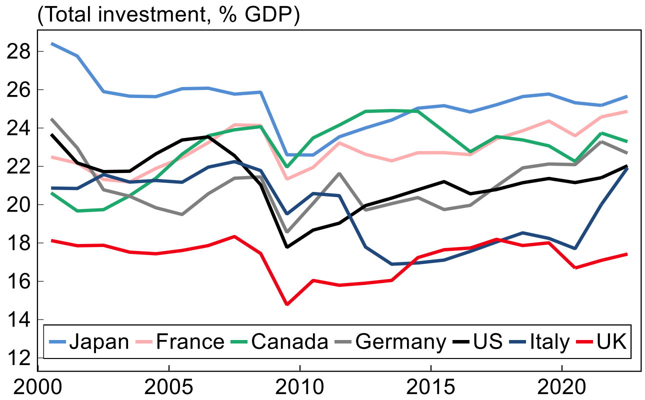
The UK treasury estimates that the reversal of tax policies, which include postponing the cut to the basic rate of income tax from 20% to 19% indefinitely, will save around 32bn GBP annually by 2026. Rumours are that the OBR (the UK's independent fiscal watchdog) believes there is a 70bn GBP gap in the UK's medium-term fiscal position. Even assuming that a favourable market reaction will reduce new borrowing costs, there is still a big hole to fill. Hunt confirmed this by saying that there will need to be "difficult decisions" on spending and that some areas will need to be cut. So, after widespread spending cuts from 2010 after the GFC (chart 3), it seems that the UK government is now about to embark on a second period of austerity. The problem is that the low-hanging fruits have already been found. There are not many obvious candidates for spending cuts (and much less public acceptance for it after public services have been squeezed), and so it could be a painful period for the UK.

CHART 3: FEW OBVIOUS TARGETS FOR SPENDING CUTS



Source: UK Treasury, MUFG Bank Economic Research Office

CHART 4:UK LAGS BEHIND ITS PEERS ON INVESTMENT



Source: IMF, MUFG Bank Economic Research Office

Any spending cuts would have to be considered alongside the UK's longer-term structural problems with productivity growth. The UK has lagged behind its peers when it comes to investment as a share of GDP (chart 4). It's hard to see how this will change. Without an increase in government capital spending it will be up to the private sector to do the heavy lifting. But when it comes to firms' investment decisions, the credibility of economic policy and institutional stability are important - and these have been left in tatters after the debacle of recent weeks. Given the extra drag from Brexit, we are not especially positive on the UK's medium-term growth.

Scaled-back energy support

Hunt also announced a significant change to the government's Energy Price Guarantee which caps energy costs for all households (chart 5). The scheme was due to run for two years from this month, but the new chancellor has reduced this to six months, and launched a review into the future of the policy beyond that. From a fiscal perspective this seems sensible. The policy is a blunt tool which supports all households regardless of income and reduces incentives to lower usage. It is a 'blank cheque' policy with the government obliged to cover the difference between the cap and wholesale costs to producers, no matter what happens to gas prices.

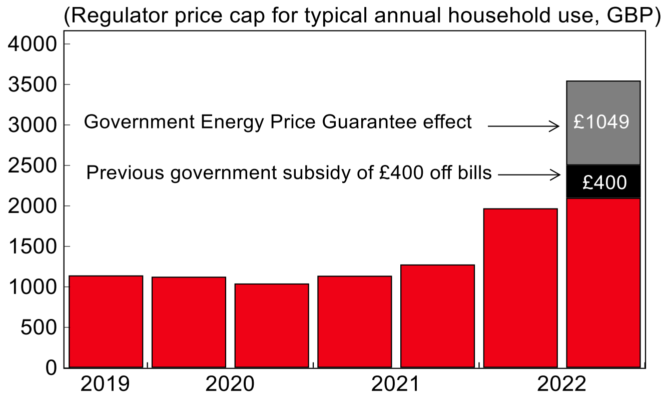
Despite this liability, the UK government has bizarrely opted not to introduce any sort of public information campaign or policies to reduce energy consumption. There are signs now from Germany and other European countries that these measures can be effective. There might be a change of tack with Truss now hamstrung.

Meanwhile, for households, the lack of certainty around energy costs from April next year could weigh on consumer confidence (which is already at a record low) if gas prices start to rise again. For now, there are some encouraging signs on the energy front. European gas storage sites have been replenished, thanks in part to LNG shipments over the summer. Mild temperatures at the start of the 'heating season' means that these buffers are looking more secure, although the risk of an exceptionally cold snap will continue to loom large over the European economy.

Housing market risks brought sharply into focus

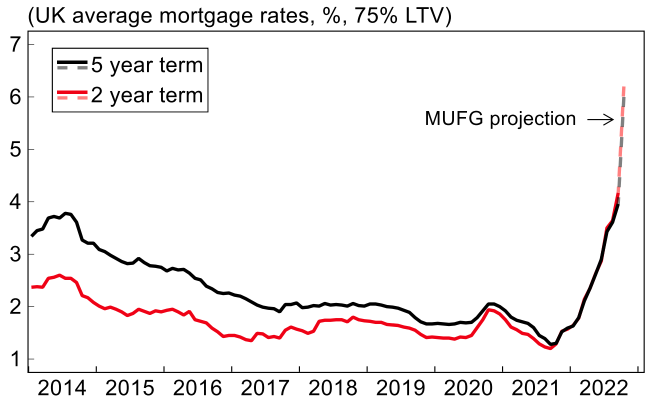
The removal of the ceiling for household energy prices will have ramifications for the inflation outlook. We currently expect UK inflation to peak this quarter before declining fairly quickly next year given recent trends in energy and food commodity prices, as well as the easing of supply-chain pressures. However, depending on the details of the new policy, that might now change if wholesale energy prices surge once more. And so the earlier withdrawal of the price cap may affect monetary policy. The BoE may have thought that it could ignore household energy prices and instead focus on domestically-generated inflation, but that's no longer the case, further complicating the navigation of an already-tricky monetary path.

CHART 5: ENERGY PRICES CAPPED FOR SIX MONTHS



Source: Ofgem, MUFG Bank Economic Research Office

CHART 6: UK MORTGAGE RATES HAVE SOARED



Source: BoE, MUFG Bank Economic Research Office

Markets are now pricing in a terminal BoE rate of just over 5%, down more than 1ppt from the post-mini budget peak. We're doubtful that the BoE can raise rates even to this level without serious vulnerabilities emerging, however. In particular, the effect on mortgage rates is becoming a concern (chart 6). The nature of the UK's housing market means that rate hikes will pass through to homeowners relatively quickly (most mortgages are either linked to bank rate or fixed, typically for two or five years).

The effect of this on the real economy will be in sharp focus over coming months as the UK heads into what is set to be a tough winter period. Monthly GDP contracted by more than expected in August (-0.3% m/m) and should decline again in September after the extra Bank Holiday for the Queen's funeral. The UK is probably already in recession, and we now expect a negative 2023 growth figure (table 1), with higher mortgage payments and less energy support weighing on the outlook.

TABLE 1: UK MACRO FORECASTS

% Y/Y unless otherwise stated	2019	2020	2021	2022F	2023F
GDP	1.6	-11.0	7.5	4.3	-0.1
Household spending	1.1	-13.2	6.2	4.6	-0.2
Government spending	4.1	-7.3	12.6	0.8	0.6
Fixed investment	1.9	-10.5	5.6	4.8	0.7
Unemployment rate (%)	3.8	4.6	4.5	3.9	4.4
CPI	1.8	0.9	2.6	8.9	6.2
Average weekly wages	3.5	1.7	5.9	5.9	4.4

Source: ONS, MUFG Bank ERO

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