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What next?

The impact of Trussonomics, tax cuts and market turmoil

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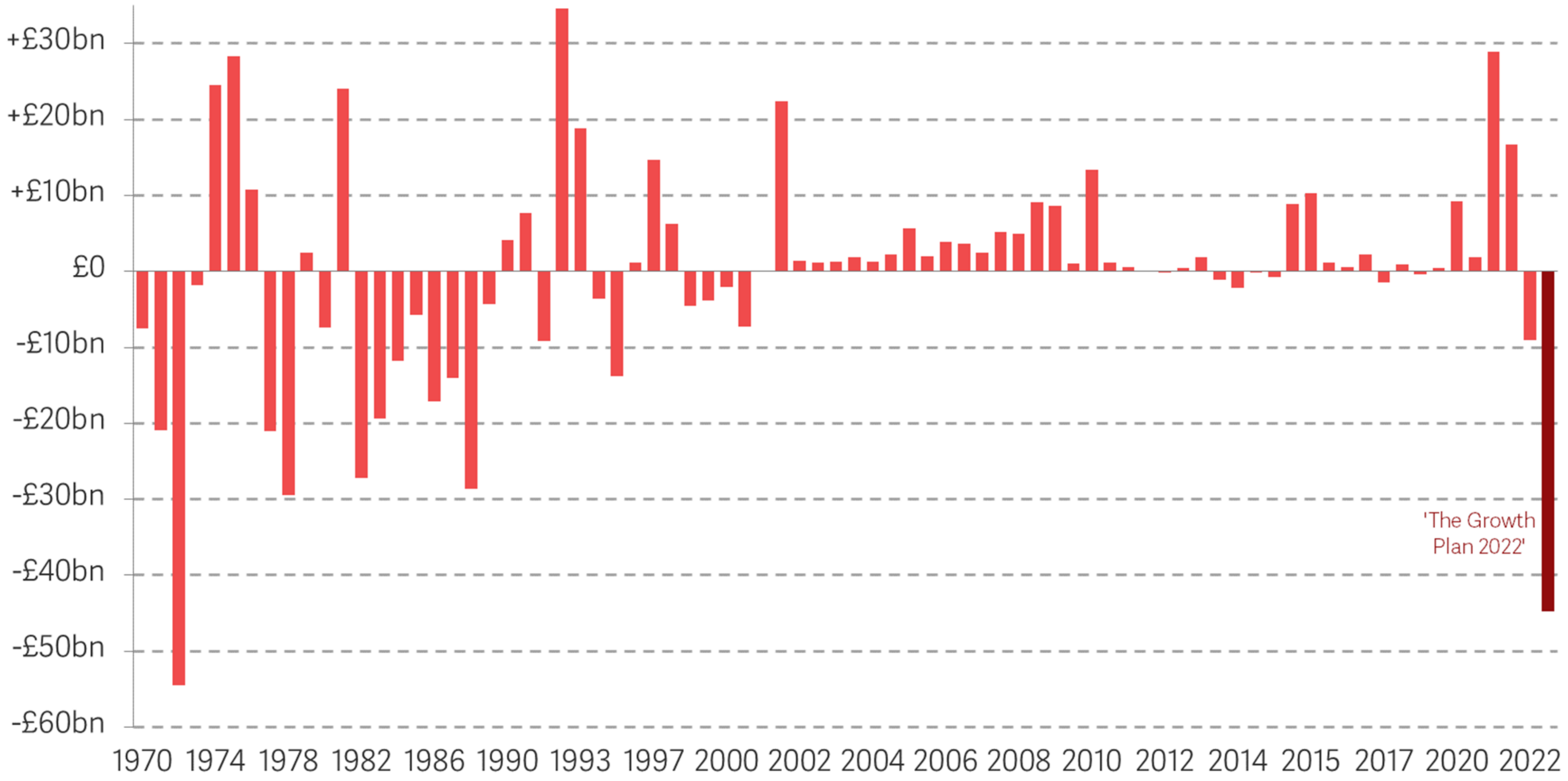
29 September 22

The policy

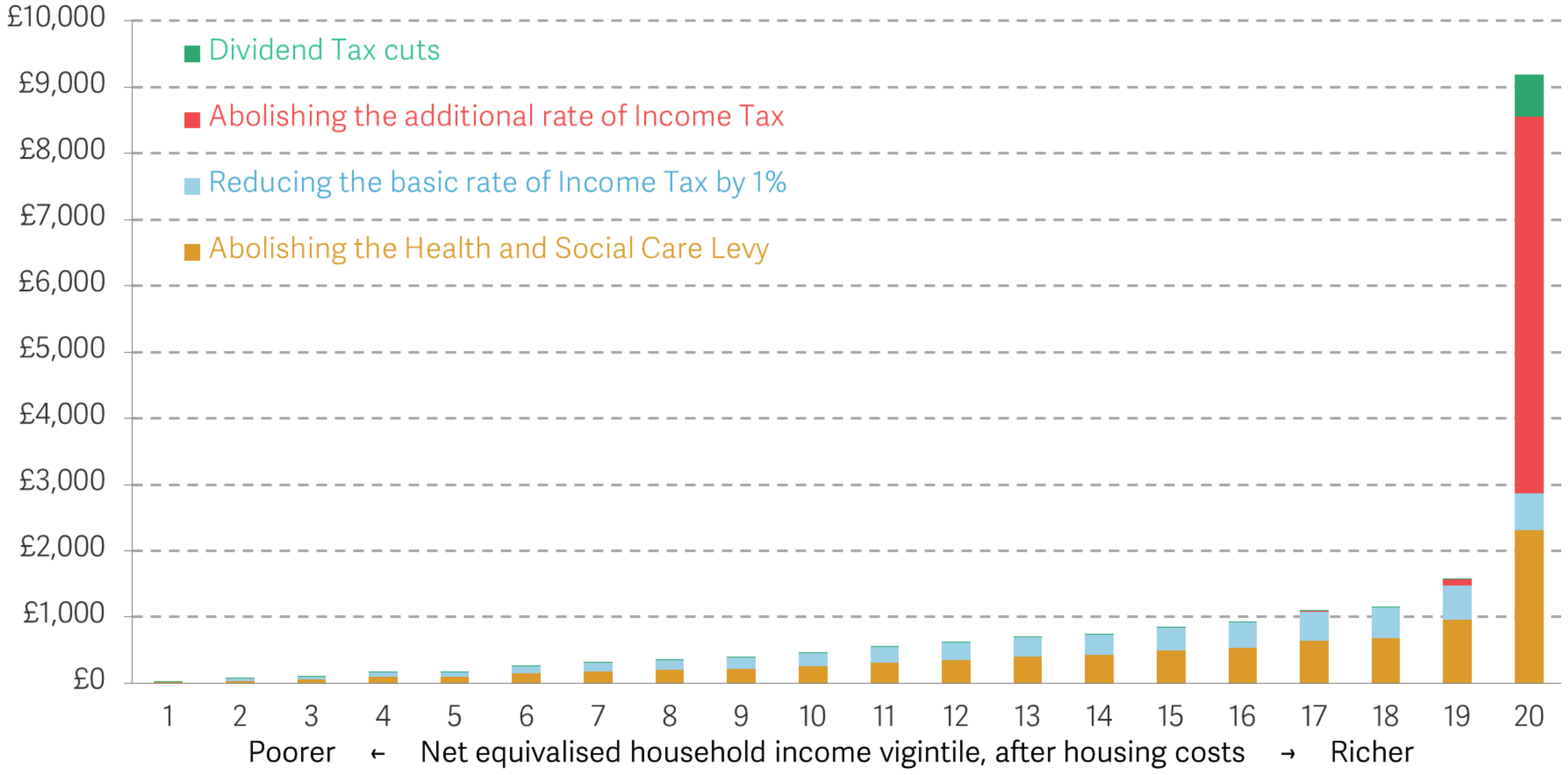
To deliver the biggest tax cuts in five decades…

Net long-term annual impact of tax policy announcements at each fiscal event, 2026-27 nominal GDP terms: UK



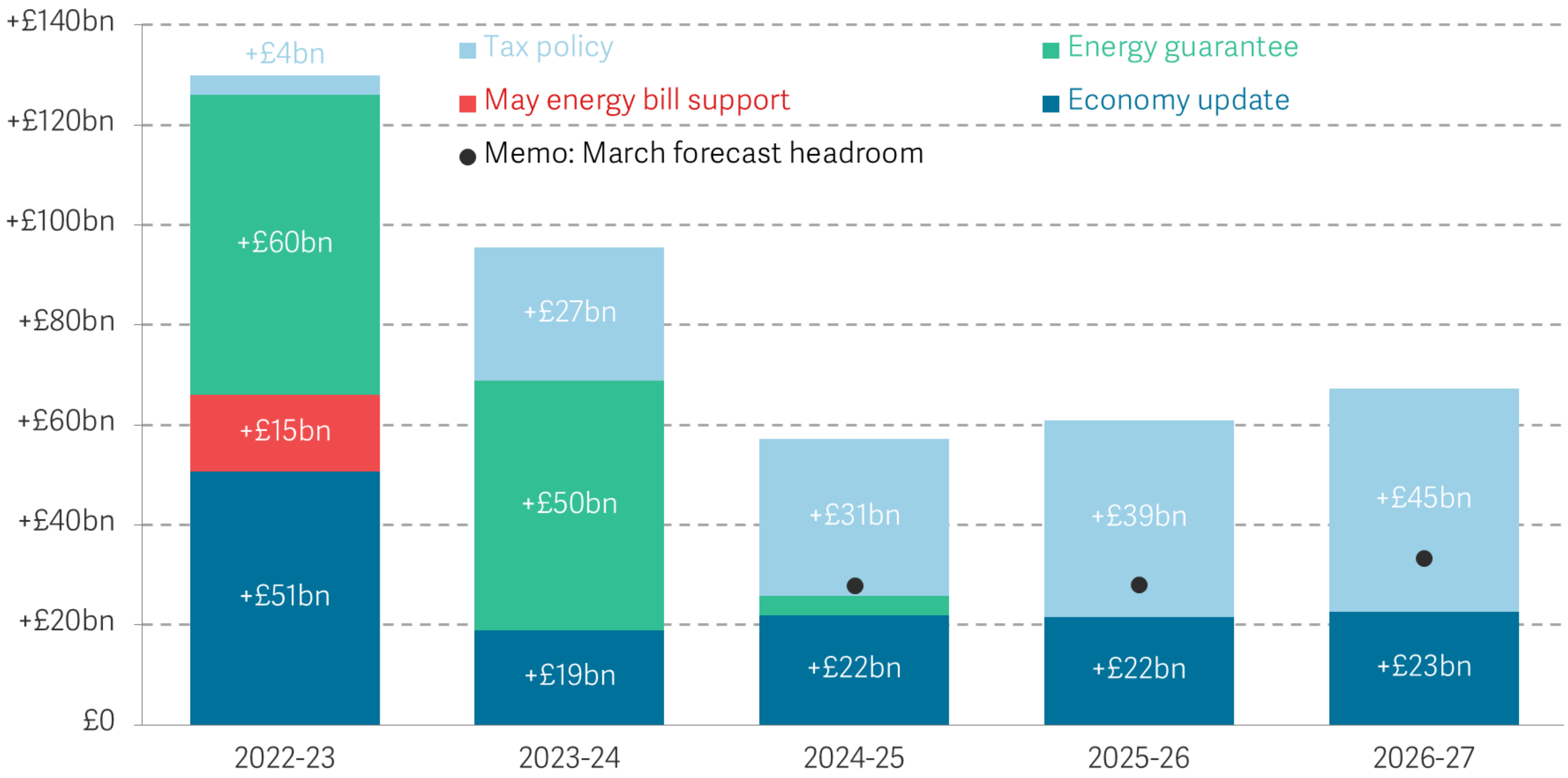
…in particular for higher income households…

Impact of personal tax policies announced in September 2022, by equivalised household income vigintile, after housing costs, in 2022-23 prices: UK, 2023-24



…with borrowing taking the strain

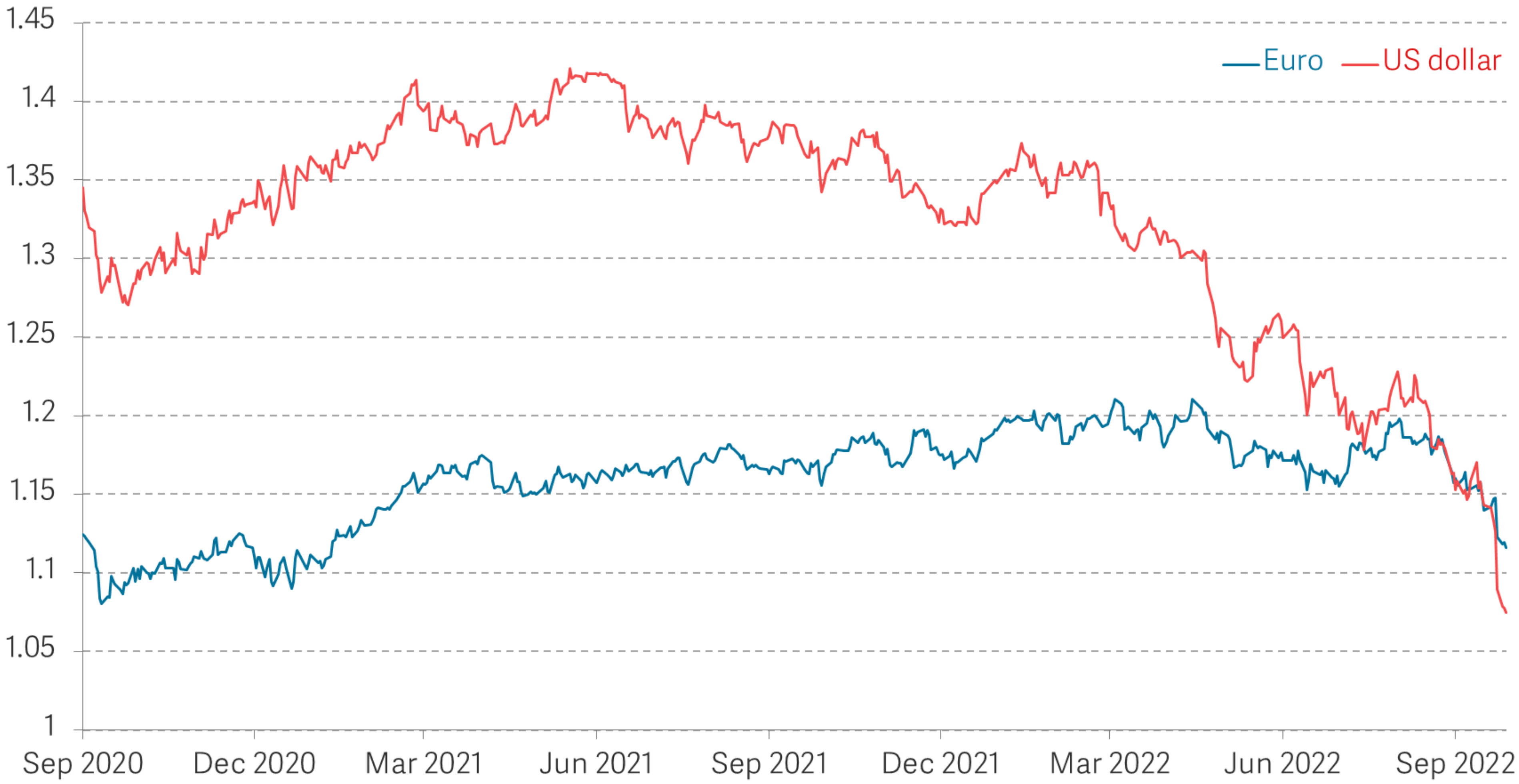
Estimated change in public sector net borrowing forecast since March 2022: UK



The reaction

People would rather not hold £s, amidst a wider $ surge

Sterling-US dollar and Sterling-Euro exchange rates: 2021 – 2022



Source: Bank of England Exchange Rates.

Lowest exchange rate vs dollar since February 1985

Sterling fall vs US dollar is more than twice the Euro fall vs US dollar in the past month

This matters for family finances not just financial markets

- Sterling around 3% lower ➡ higher import prices ➡ implies a 1% fall in living standards

- Bank Rate now expected to peak at around 6% ➡ a rise in typical mortgage of:
  - over £400 per month (£4,800 a year) vs last December
  - around £80 (£1,000 a year) since Thursday

What next?
For the Bank of England

BoE Chief Econ: “significant monetary policy response“ coming

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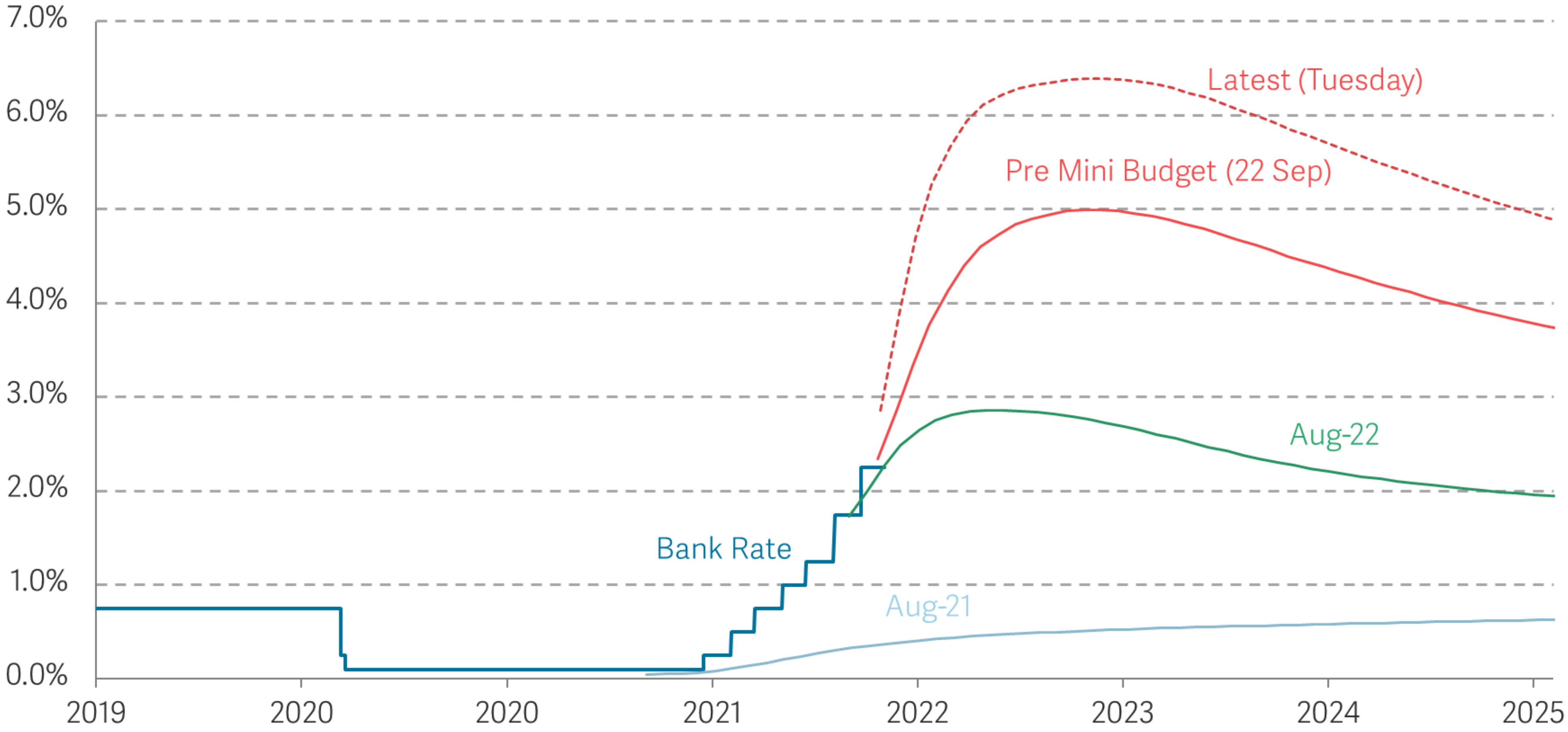
Bank Rate and overnight index swap forward curves: UK



Next MPC meeting is 4 November

Source: Bank of England, Yield curves.

In the meantime the Bank had been planning to sell bonds…

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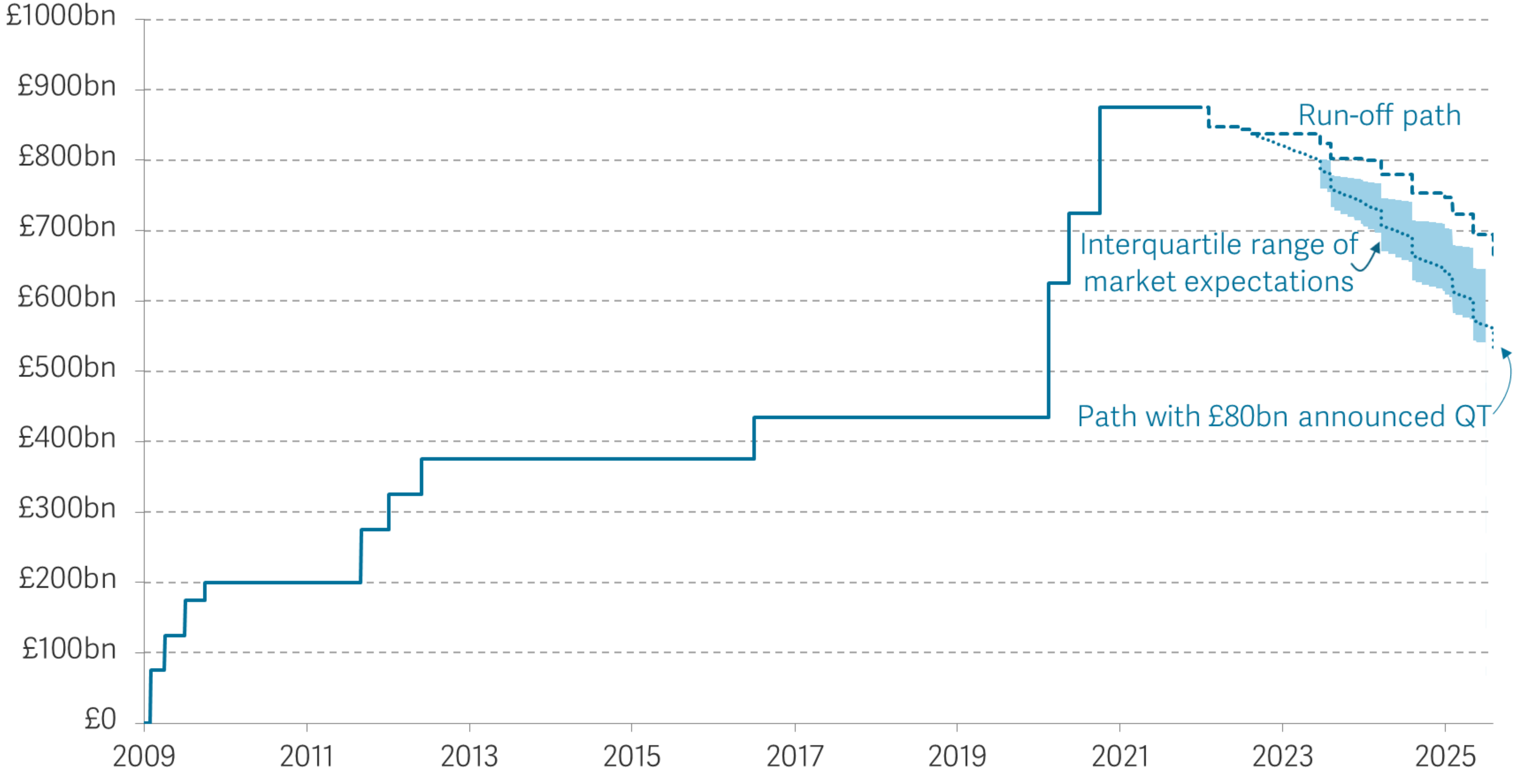
Stock of Bank of England gilt purchases : UK



The Bank had been planning to start <u>selling</u> gilts starting on Monday

Notes: asset sales are assumed to happen at a constant daily rate with sales taking place proportionately with maturity profile of existing stock. Market expectations are taken from the Bank of England's Market Participants Survey for June 2022.
Source: Bank of England, Asset Purchase Facility Quarterly Report, various & Results and usage data; Market Participants Survey results – June 2022.

...but has been forced back into the business of buying them

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30-year UK Government bond yields

Huge volatility in gilt markets forcing BoE to act

Yields were ~2% in August but hit 5% yesterday

But are now ~4% after BoE buying

Source: Bank of England, Yield Curve Data.

What next?
For the Chancellor

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The Chancellor "will then set out his Medium-Term Fiscal Plan on 23 November. The Fiscal Plan will set out further details on the government's fiscal rules, including ensuring debt falls as a share of GDP in the medium–term."

There is a large, and uncertain, fiscal hole to fill

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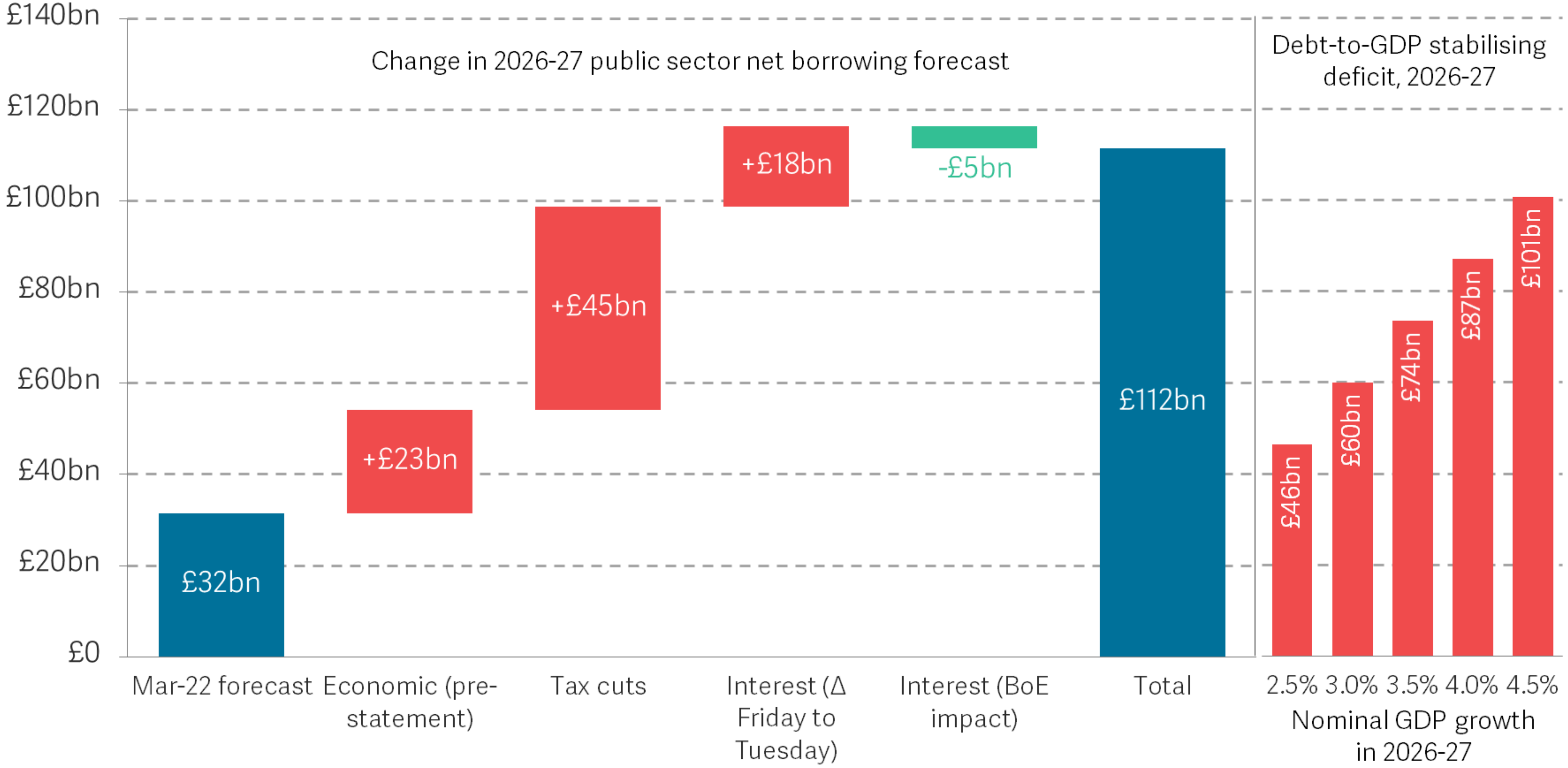
Change in public sector net borrowing forecast since March 2022 (left chart) and the implied borrowing for a constant debt-to-GDP ratio, by growth rate of the economy (right chart): UK, 2026-27



Given likely growth rate of economy cuts of £37-47bn will be required in 2026-27 to meet debt falling rule

Notes: Forecasts are based on the Bank of England's August 2022 Monetary Policy Report economic forecasts. These forecasts are expanded and extended to provide an economic scenario which is used in the Resolution Foundation fiscal model. The inflation component input to these forecasts are based on the Resolution Foundation's inflation forecast model (for more information see J Leslie, In the dread of winter: Prospects for inflation in the coming months ahead of the Bank of England's Monetary Policy Report, Resolution Foundation, August 2022). Interest rates are based on market yield curves up to 16 September 2022. Energy guarantee costings are from the Government in 2022-23 and based on gas futures curves from 21 September 2022 for subsequent years. Costings do not include money for business support for energy bills after 2022-23. Interest costs are shown assuming persistent changes in gilt yield curves between Friday 23 September 9:30 and Tuesday 27 September 16:30, and for post-Bank of England market action between Tuesday 27 September 16:30 and Wednesday 28 September 15:00. Impact of sterling devaluation since the statement is not included.

Source: RF analysis of Bank of England, Monetary Policy Report & Yield Curves; OBR, Economic and fiscal outlook, various; ONS, Consumer price inflation; BEIS, Weekly Fuel Prices; Cornwall Insight; ICE; HMT.

Apparently there'll be no u-turn…

Apparently there'll be no u-turn so spending cuts are to come

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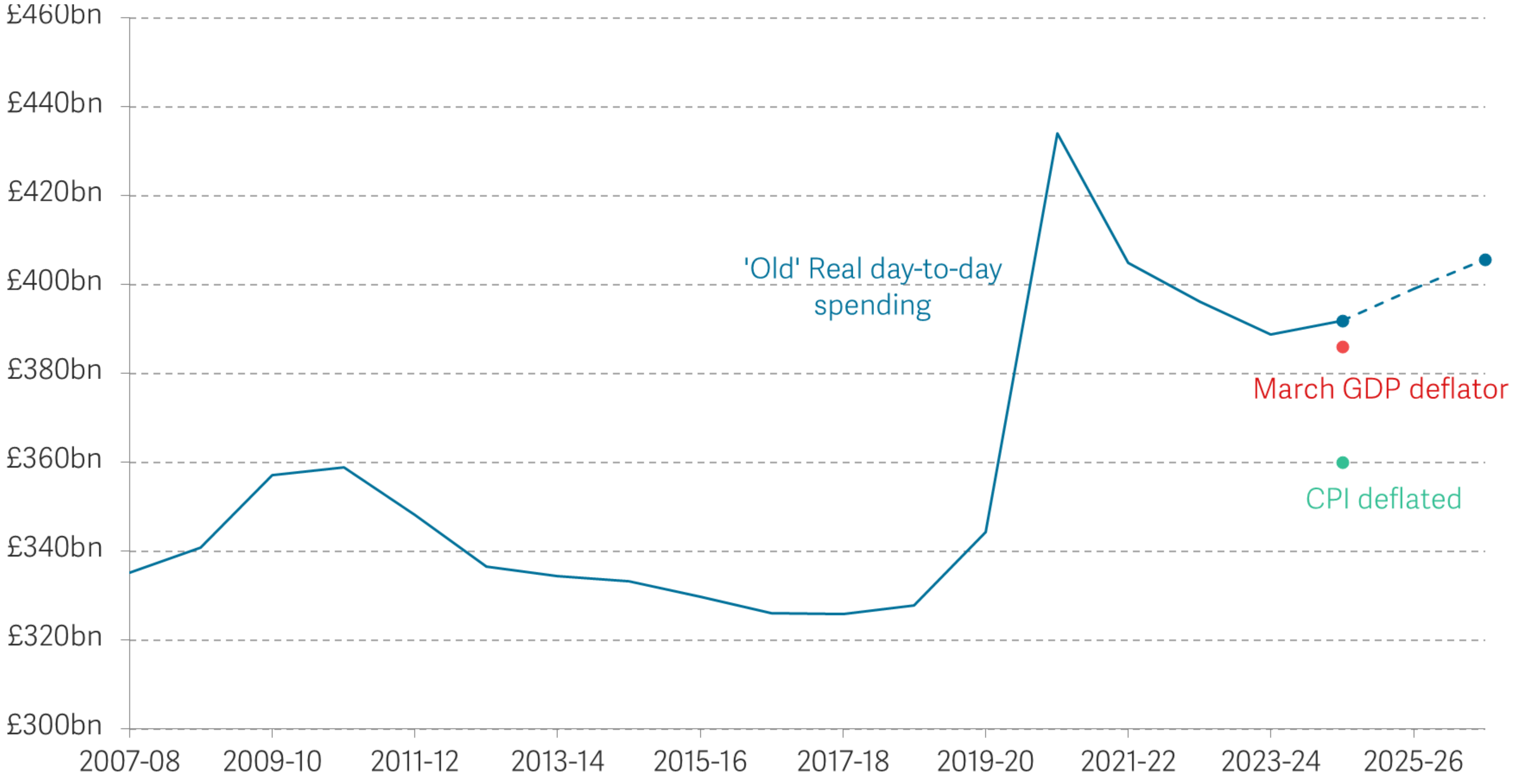
The context: inflation is already cutting into budgets

Real (2021-22 cash terms) RDEL as expected at October 2021 EFO and with March GDP deflator and RF CPI forecast: UK



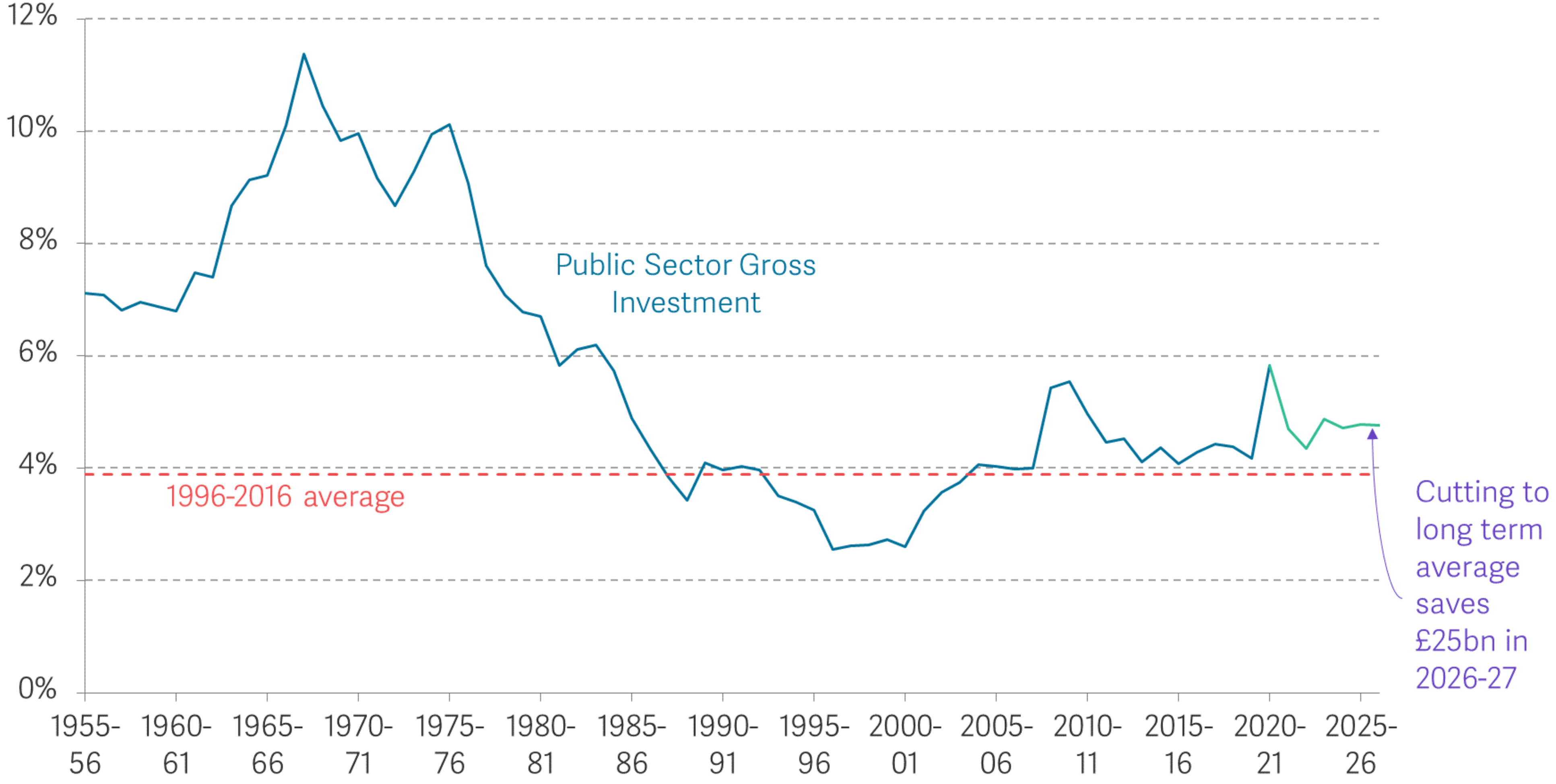
Spending is £6bn lower in 24-25 real terms than expected when SR announced with March OBR GDP deflator.

£32bn lower if deflating using new CPI forecasts.

Notes: GDP deflator from OBR March, using RF estimate of inflation path accounting for EPG for CPI deflator.
Source: RF analysis of OBR, Economic and Fiscal Outlook, March 2022; BoE, Monetary Policy Report, August 2022.

History says public sector investment is at long term risk…

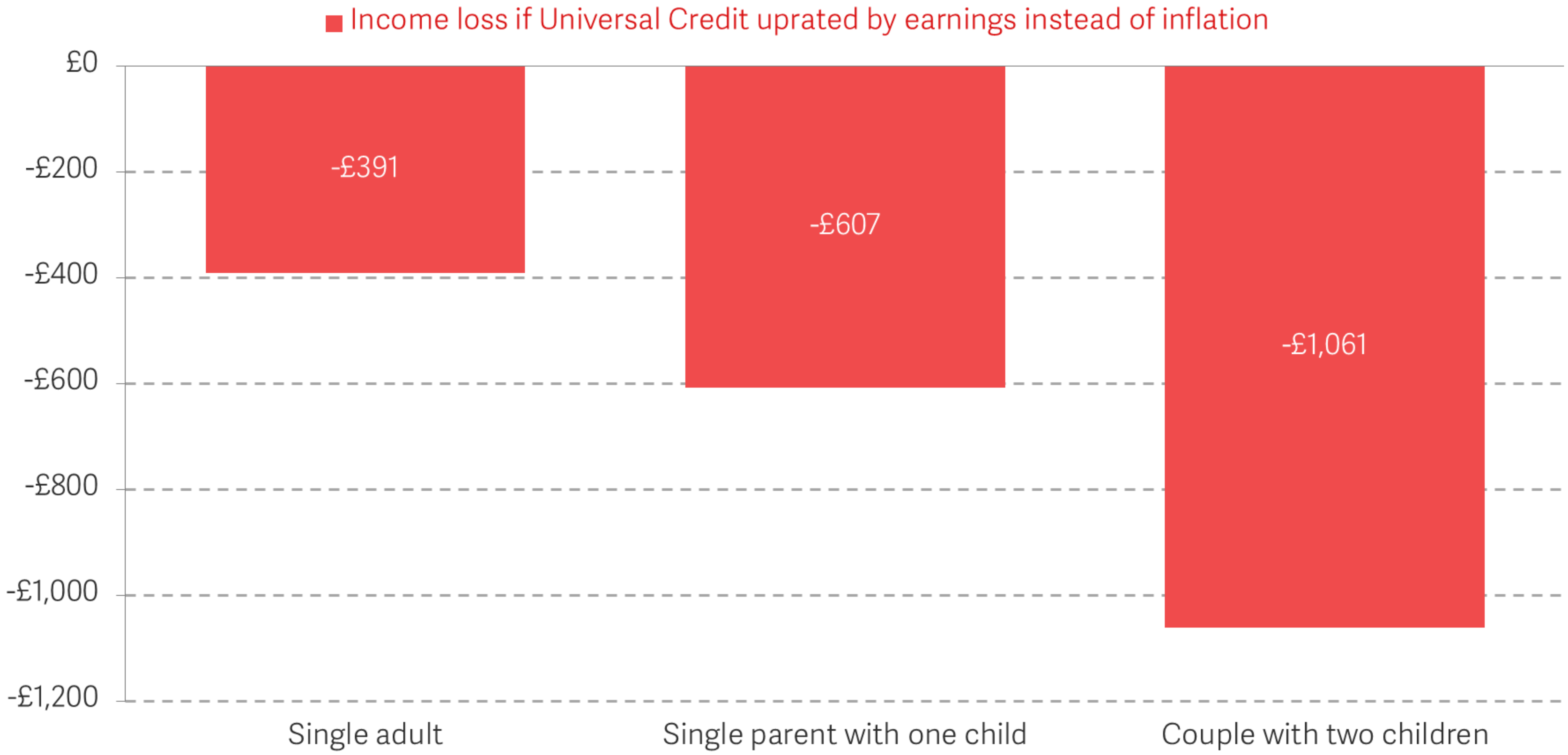
Public sector gross investment as a proportion of GDP: UK



Notes: Uses RF projection of nominal GDP from 2021-22 onwards
Source: RF analysis of OBR, Economic and Fiscal Outlook March 2022.

…while benefit uprating may be the short term debate

Income loss in 2024-25 if benefit uprating by earnings instead of inflation for the next two years



Uprating benefits by earnings saves £11bn in one year, and £20bn across two years

Raising defence spending to 3% of GDP would require a further £12bn of cuts elsewhere by 2026-27

Notes: Uprating is by 5.4% (August 2022 earnings growth) and 5.25% (Bank of England forecast for earnings growth in 2023), rather than 10.1% (projected September 2022 CPI) and 9.5% (Bank of England forecast Q3 2023 inflation).
Source: RF analysis.

Conclusion

It has been a long week, with lasting consequences for public and family finances

The immediate price of lower (than expected) taxes is higher interest rates:

- How much higher rests with the Bank of England
- Will sterling/inflation take some of the strain?

The longer term price is likely to be lower (than expected) spending:

- Chancellor has 8 weeks to decide if he's u-turning or echoing Osborne
- Will investment and welfare be in the firing line?

This was always going to be a difficult period for economic policy makers. But the Government has just made it a whole lot harder.

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We do this by undertaking research and analysis to understand the challenges facing people on a low to middle income, developing practical and effective policy proposals; and engaging with policy makers and stakeholders to influence decision-making and bring about change.

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