UK INSIGHT: Mini-Budget Torched, Now Hunt Must Balance the Books

2022-10-17 11:55:59.989 GMT

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(Bloomberg Economics) -- The clean-up from the government's disastrous mini-budget continues. Very little of the initial package of tax cuts now remains but Chancellor of the Exchequer Jeremy Hunt still has some way to go to put the public finances on a sustainable footing – we estimate a hole of up to £36 billion (about $41 billion) remains.

The result of the U-turn towards fiscal prudence is that pressure on the Bank of England to hike aggressively at coming meetings has fallen. We now think the central bank will lift rates by 75 basis points in November, rather than opting for a three-digit increment.

* Following Prime Minister Liz Truss's backtracking on corporation tax Friday, Hunt has wasted no time ditching almost all the remaining tax cuts in the mini-budget including VAT free shopping for tourists, repeal of the off-payroll working rules and reversing the dividend tax cut. Those measures add up to about £7 billion. He also announced that the cut to the basic rate of income tax in April 2023 will not go ahead at all, raising up to £6 billion in years to come. Taken alongside the announcement Friday, the measures will raise £32 billion.
* That means the only things that are left from the mini-budget are the reversal of the National Insurance (a payroll tax) increase in April and the cut to stamp duty – both have already been legislated for.

* The fiscal giveaways from the mini budget that still stand are now closer to £20 billion, £25 billion lower than set out in the original package. And with up to £6 billion raised through permanently scrapping a cut to the basic rate of income tax, the total net giveaways are about £14 billion.
* Our latest assessment, taking on board the change in borrowing costs since Hunt’s announcement and the policies in the statement, is that a further £13 billion will still need to be found to just get debt falling relative to GDP. It would take more like £36 billion of consolidation to put it on the same trajectory as we projected before the mini-budget was published in September.

Debt Still On Explosive Path

* Finding a package of spending cuts that are politically viable and deliverable will be extremely challenging -- much of the low-hanging fruit has already been picked. Hunt faces an uphill struggle to win the faith of markets as he formulates a budget, to be delivered on Oct. 31.
* Hunt also said that the universal household energy price cap will be replaced from April 2023 with more targeted measures. It’s not clear what those measures will be but removing the government cap altogether and reverting to Ofgem’s methodology from April would imply a 75% rise in energy bills for households. Inflation would jump to 11.6% in April, against 6.4% under the cap.

* The combination of austerity and less support for households next year means the risks to our forecast for a 0.4% drop in GDP in 2023 have shifted to the downside. We will update our forecast in coming days.

Bank of England's response

* As we noted here, the combination of the mini-budget and the energy cap on household energy bills meant the Monetary Policy Committee was set to plug a significant amount of fiscal stimulus into its forecasts.
* The direction of travel has changed materially, with a majority of the mini-budget now gone, energy support scaled back and austerity looming.
* Given that, we think the MPC will be minded to opt for a smaller rate rise at its November meeting – lifting rates by 75bps rather than the bumper 100bps we previously expected.
* With the BOE announcing on Oct. 17 that that it would restart corporate bond sales, it looks like it is on course to start active gilt sales on Oct. 31. There is a clear risk, though, that the start of the program needs to be delayed again given the MPC's desire to undertake the reduction of the balance sheet "without disrupting the functioning of financial markets."

--With assistance from Ana Andrade (Economist).

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