UK INSIGHT: How £170 Bln of Energy-Aid Could Upend BOE's Outlook

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Incoming UK Prime Minister Liz Truss is reported to be considering an energy-cap freeze for households, as well as fresh support for businesses. It's early days, but if her plans materialize, the emergency relief would be similar in scale to government support during the pandemic. That would drastically change the economy's outlook.

In this scenario, inflation won't rise much further from current levels and the Bank of England's 2% target would be in sight within a year. A recession is also likely to be avoided. For the BOE, it would reduce the chances of a 75-basis-point hike in September. By raising the risk of the the economy overheating, however, the flipside could be higher rates for longer.

Big Fiscal Boost Coming?

According to a Bloomberg News report, Truss has drafted plans to cap annual electricity and gas bills for a typical household at or below the current level of £1,971 ($2,300). That would have a significant impact on inflation, which our baseline scenario forecasts will reach 15% in January. Mechanically inputting the cap freeze into our forecast shows inflation peaking in July (at 10.1%) and then falling back at a faster pace -- approaching 2% within a year.

Energy Cap Freeze Radically Lowers Inflation

Source: ONS, Bloomberg Economics

The cost of implementing that measure would be a whopping £130 billion over the next 18 months, according to Bloomberg News. If we then add fresh support to businesses, which may total £40 billion based on draft government plans, the full size of the package could reach 7% of GDP. That's a massive fiscal boost, close to the level of government support seen during the pandemic.

But it's early days. There's a high probability that the reported plans will face significant push-back from the Treasury or from within the Conservative Party -- especially as these measures would be poorly targeted. A key question will be how the energy cap is funded. It could be clawed back from households later, keeping energy prices higher for longer, or purely financed by government borrowing. The latter option would create a significant hole in the government's finances -- even if the cap delivers around £30 billion of savings from lower inflation-linked debt payments in 2023-24.

Another possibility is the government intervening in wholesale energy markets. That could dampen the impact on the public finances, because it would open up the possibility of reducing bumper profits from some electricity producers. The snag here is it would be akin to a windfall tax, which Truss has previously said she would not pursue.

What Does it Mean for the BOE?

At its latest meeting in August, the BOE delivered an outsized 50-bp hike while forecasting a recession as deep as the one seen in the 1990s -- the peak-to-trough fall is expected to be 2.2%. The message was clear: the Monetary Policy Committee's priority is to bring inflation under control, regardless of the cost to the economy.

With inflation surprising to the upside in July and the labor market still running red-hot, that remains very much the case -- we anticipate another 50-bp move at the Sept. 15 meeting. A bigger hike remains a possibility, but we think Truss's proposed energy cap makes this a little less likely. By guaranteeing lower inflation for the foreseeable future, the cap could pour some cold water on medium-term expectations, which have been drifting in recent months. That would temper the risks around the MPC's biggest concern and reduce the need for front-loading -- for now, at least.

But there's a flipside to less immediate, aggressive tightening and that's higher rates for longer. Our base case is for interest rates to top out at 3% early next year. Truss's fiscal package would provide a massive demand boost, with the potential to add further heat to an already-tight labor market. While it would help to avoid a recession, the plan carries a high risk of the economy overheating. For inflation, the problem could become smaller, but at the same time persist for longer. That would cause discomfort on the MPC, probably requiring rates to move above the 3% peak in our baseline forecast and to remain elevated for longer.

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