The UK's options to win back markets

Investors want to see bold changes from new Chancellor Jeremy Hunt later today. Further wholesale changes to the "mini" Budget are likely, and so is a fall in 10yr government bond yields to 4%. But closing the fiscal hole entirely will be challenging, and without the Bank of England's bond buying, sustaining the rally in gilts could prove challenging too

New UK Chancellor poised to announce fresh U-turn

The story is once again moving pretty fast in the UK. New UK Chancellor Jeremy Hunt will unveil further U-turns on the government's "mini" Budget later today (11am UK time), in effect bringing forward large parts of the 'Medium-Term Fiscal Plan' from 31 October.

With Prime Minister Liz Truss under heavy political pressure, there's a sense that Hunt now has the latitude to make sweeping changes. The goal is to meet a fiscal rule that says debt should fall as a percentage of GDP in the medium term. Friday's lukewarm market reaction to reinstated plans to increase corporation tax showed that a piecemeal/incremental approach to policy change is unlikely to be sufficient to reassure investors.

According to reports in the Sunday Times, the Office for Budget Responsibility (OBR) forecasts that including the measures in the Growth Plan a few weeks ago, the government faces a shortfall of

£72bn. That's now closer to £50bn as a result of the most recent U-turns. So what options does the Chancellor have?

Seven possible options for the Chancellor

1. **Delay (or cancel entirely) the planned cut to the basic rate of income tax and abandon smaller plans.** This looks like it's essentially a done deal, judging by press reports. Abandoning plans for a 1p cut to income tax would save roughly £5bn, and a further £5-8bn could be saved by getting rid of smaller measures in the growth plan, including on tax-free shopping for visitors.

2. **Reverse the planned cut in national insurance (a tax on workers/their employers).** Previous Chancellor Rishi Sunak had increased this tax last year, and new PM Truss committed over the summer to reverse it. Treasury costings suggest this decision would cost £18bn per year by 2026-27. The government will be highly reluctant to do a U-turn here, partly because a bill repealing Sunak's NI change passed through the House of Commons last week.

3. **Cut day-to-day public spending.** Chancellor Hunt hinted in TV interviews over the weekend that spending is unlikely to rise as quickly as previously planned. But promising spending cuts is often much easier than delivering them. Partly that's because many departmental budgets have already been cut heavily in recent years, but also because many were already set to see their funding fall sharply in real terms over the next couple of fiscal years. As a result, we think investors will treat any pledges to cut spending with some caution.

4. **Cut public sector net investment plans.** Before Covid, government capital spending was typically 2% of GDP in each fiscal year, but under former PM Boris Johnson, this was projected to increase to 3%. Cutting back these plans could potentially save £25bn a year, though in practice this could take time. Needless to say, this is inconsistent with plans to grow the supply side of the economy. But we think cuts here are likely given the challenges involved with reducing current (day-to-day) spending.

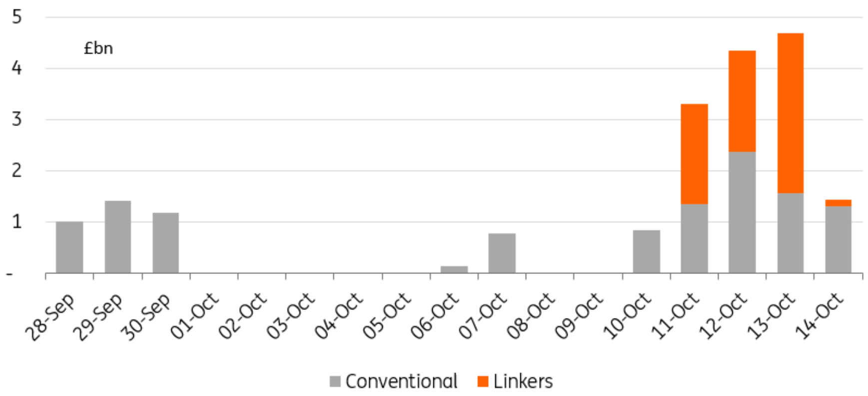
5. **Look at other tax rises.** Given challenges elsewhere of closing the fiscal hole entirely, the government may find it needs to look at more wide-ranging tax increases. An increase in the rate of VAT for instance would raise upwards of £10bn depending on the scale.

6. **Revenue cap on renewable energy producers.** The FT reported last week that this is effectively a done deal, subject to the finer details. It would work in a similar way to the EU's proposals, which would heavily tax any revenues made by renewable energy producers above a certain level of wholesale electricity prices. Depending on its construction this could potentially raise tens of billions of pounds. But perhaps more importantly, it would act as a natural hedge against the cost of the government's energy price guarantee.

7. **Make the energy price guarantee less generous.** The government's decision to cap

household electricity/gas prices for two years went further than many expected when it was announced in early September. The fact that it applies equally to all households does suggest some room to make the policy more targeted, though in practice that's complicated. Without the cap, households in most income deciles were set to see energy costs top 10% of disposable incomes. With few ways to target support beyond the income tax and benefits system, the practicalities of adjusting support based on economic need could be challenging. Nevertheless, there are potentially big savings to be made if a mechanism can be found to target the policy more accurately. Increasing income tax rates temporarily is the most obvious way of achieving this, though clearly would be hugely politically challenging.

The BoE has pushed back against expectations of more gilt purchases



Source: Refinitiv, ING

A rally in gilts is likely - but can it be sustained?

The latest reports suggest that we should expect most of the "mini" Budget to be scrapped today, with the exception of the stamp duty cut (that has already come through) and the national insurance cut. But the lesson from the menu of options presented above is that the government will likely find it needs to go further than that to balance the budget - and indeed may find it needs to lean more heavily on tax rises than spending cuts in order to make the biggest impression on financial markets.

The chancellor will also be acutely aware that wherever borrowing costs settle over the coming days will have a bearing on OBR forecasts due on 31 October. A fall in gilt yields would translate into a fall in projected interest costs and in turn, reduce the fiscal hole a little bit further. OBR ready-reckoners suggest a 1 percentage point fall in gilt yields and short-term rates would see a £16bn fall in annual spending requirements by 2026/27.

So far, gilt markets have reacted positively this morning to the latest fiscal press reports. But ultimately, the monetary value of the deficit reduction measures to be announced today matters, and so does the message sent about the importance of fiscal sustainability. A rally to 4% for 10Y gilts is a likely outcome but a more difficult question is whether these gains will be sustained.

The BoE confirmed this morning its reluctance to engage in more gilt purchases, after buying £19.3 in recent weeks. effectively leaving the chancellor to deal with market turmoil on his own.

Meanwhile, market functioning is and will likely remain impaired for a while. Investors will understandably fret about the prospect of BoE gilt sales resuming at the end of the month.

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