UK Spring Statement: Chancellor avoids deeper bond sell-off but tough decisions loom in the autumn

UK Chancellor Rachel Reeves has avoided a further rise in bond yields, despite lifting spending in the near-term and pushing back cuts until later this decade. In the absence of more good news on growth, we think further tax rises in the autumn are becoming increasingly inevitable

UK Chancellor Rachel Reeves can breathe a sigh of relief that gilt yields haven't risen any further following the latest announcements – but we think that relief could be short-lived

OBR revises up growth forecasts in unexpected gift to Reeves

The task facing UK Chancellor Rachel Reeves at her Spring Statement was simple yet fraught with risk.

Higher borrowing costs had eradicated all of her fiscal 'headroom', money left over under the main fiscal rule mandating a current budget surplus by the end of the decade. The Treasury had little choice but to cut spending, without invoking a fatal political backlash, jeopardising the government's ambition to boost growth, or sending bond yields even higher than they already are.

It's a challenge the Chancellor largely seems to have pulled off, at least judging by the market reaction. Gilt yields are little changed after the Spring Statement. And what's more, despite making cuts to public spending, the Chancellor has been gifted by an unexpected upgrade to Britain's growth forecasts later this decade.

Sure, the Office for Budget Responsibility – the government's independent forecaster – has cut its 2025 growth numbers. No surprises there; the 2% forecast published last October always looked too optimistic. That is now set at 1%.

But thereafter, the Treasury has succeeded in convincing the OBR that its planning reforms will lift GDP growth by 0.2% a year by the end of the decade. That's a win for Reeves, given there has been a widespread perception that the OBR was sceptical about the growth-enhancing qualities of the government's recent announcements, or at least over the relatively short five-year horizon relevant for the fiscal rules.

Forget cuts; spending actually rises further than previously planned over the next two years

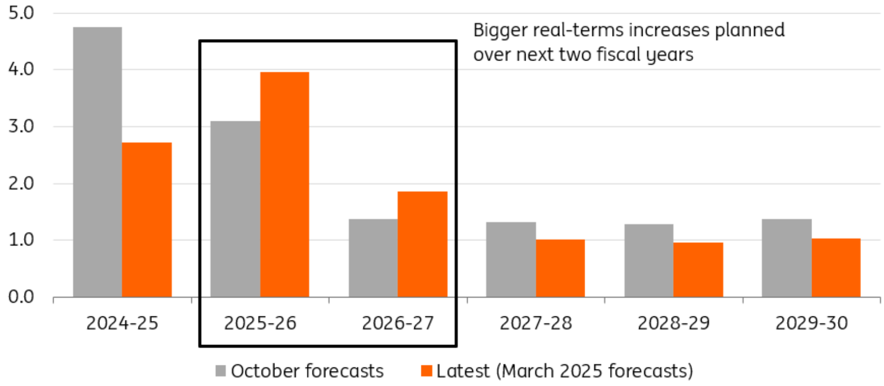
Then there's the spending cuts themselves – the small print reveals that all of the pain has been pushed back until later in the decade. Over the next couple of years, spending is actually set to be higher than previously planned. Departmental day-to-day spending will now rise by 4.0% in real terms in the next fiscal year, up from the previously announced 3.1%. Cuts to welfare budgets and wider government departments don't kick in in full for another four years.

This may well raise a few eyebrows in financial markets, though this creative accounting is far from new. The fiscal rules are centred around what happens to the public finances in the year 2029/30. And that has afforded successive chancellors with plenty of flexibility to push back painful spending cuts into the future, in the hope that improved economic fortunes would ultimately negate the need to implement them.

Admittedly, the numbers at play in the Spring Statement are not huge – overall spending is up by a couple of billion pounds a year over the next couple of fiscal years before falling thereafter. That's small fry compared to spending increases at the October budget, which exceeded £70bn/year, spread across both day-to-day and capital budgets.

The main comfort for investors is that debt issuance plans for the next 12 months haven't increased since October, despite those spending plans. The gilt remit, issued by the Debt Management Office, projects issuance of almost £300bn. And while that's still a huge number by historical standards, some had feared we'd see another significant rise versus October's plans. The DMO is also shortening the maturity of planned issuance, reducing the share of long-dated bonds to 13%, taking some of the pressure off the longer end of the market.

Growth in real-terms day-to-day departmental spending (RDEL)



Source: Office for Budget Responsibility

Debt issuance plans haven't risen, but tough decisions loom in the autumn

The Chancellor can breathe a sigh of relief that gilt yields haven't risen any further after these latest announcements. But the relief is likely to be short-lived; tough decisions are looming in the autumn.

The latest upgrade to Britain's medium-term growth forecasts may not stick for long. The OBR is still relatively optimistic about productivity growth, despite output per hour actually falling repeatedly over the past year or two. At some point, the OBR is probably going to have to throw in the towel and cut back its forecasts. And if it does this at the Autumn Budget, that will further reduce the money available under the fiscal rules. Bear in mind that the current level of "headroom" – £9.9bn – is a rounding error in the context of the UK's public finances.

The UK's public finances are operating on increasingly fine margins, and we don't think that defence will be the only department requiring fresh cash injections over the coming years. At the Autumn Budget, that may leave the Treasury with little choice but to boost government spending plans even further.

In the absence of further upgrades to GDP growth, or a fall in gilt yields (not our base case), we think this is likely to necessitate further tax hikes.

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