UK: What the Chancellor's announcement means for the economy and sterling

The Chancellor's announcements are innovative but unlikely to completely change the game for either the UK economic outlook or the pound. We think the ongoing uncertainty surrounding UK-EU trade negotiations will dominate the story for sterling, and could push EUR/GBP to 0.92 over coming months

Source: Shutterstock

Chancellor unveils new job support amid rising unemployment

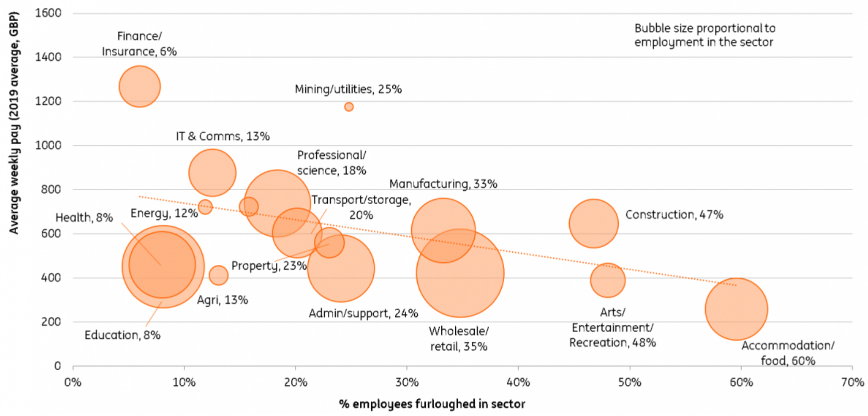
Ahead of Chancellor Rishi Sunak's summer economic update today, we set out four key challenges he faces as we enter the Covid-19 recovery phase. And by far, the biggest out of the four is linked to jobs. Unemployment is on the rise as firms grapple with the challenging new, socially-distanced operating environment.

The Chancellor has opted against extending the flagship Job Retention scheme beyond October, and don't forget that the state's contribution to wage bills will be gradually reduced until then. Clearly, removing such unprecedented government intervention in the labour market is going to bring about job losses. But the big announcement today is that the government will pay a £1000 bonus per employee that is brought back from furlough, and kept employed until January.

On the face of it this is a fairly generous policy. In the accommodation/food sector, one of the heaviest users of the furlough scheme, that would be enough to pay around a month of earnings, based on the average of 2019 weekly pay. Anecdotally, it also seems that those staff members being furloughed were often towards the lower end of pay brackets.

Will this change the course of the jobs market? Not entirely - clearly if you are a business that has either had capacity significantly reduced by the new safety measures, or have seen demand collapse due to changing consumer habits, it's unlikely to save jobs when the furlough scheme is unwound. But nevertheless this scheme should at face value help cushion some of the blow for firms more widely, and it's also worth noting that companies will get the bonus even if they've already brought staff back from furlough.

The job retention scheme by sector



Source: UK Government, ONS

Property/VAT tax cuts unlikely to significantly move the needle

The other key takeaway from the statement is that by-and-large, tax cuts were avoided. As we noted in our previous piece, involuntary savings will have dramatically increased for many who have been more fortunate to continue earning through the crisis. If demand remains low now that the economy has largely reopened, then it is therefore more likely motivated by safety concerns rather than financial contraints.

Admittedly, the government has opted to cut VAT for selected industries, and more interestingly the government will cover 50% of restaurant bills through August (Mon-Wed) up to a maximum of £10 per person. This seems to be an evolution of the voucher scheme proposed over the weekend, and probably stands a better chance of luring people back out to hospitality businesses, as it eliminates the risk of the equivalent cash injection being saved rather than spent. That said, the size of this measure is, in reality, fairly small.

There was also a fairly sizable change to stamp duty (a property tax), although our feeling is that the housing market will continue to be dominated by concerns surrounding job security, despite this new government support.

Controlling the virus much more critical for UK growth

In short then, there are some innovative policies in the Chancellor's latest statement, although for markets this is not a huge intervention, at least compared to the big numbers everybody has become accustomed to. It's unlikely the schemes announced will cost nearly as much as the £30bn (or roughly 1.5% of GDP) estimated by the Treasury.

It should though, at least at the margin, help cushion some of the turbulence in the jobs market over coming months. But more importantly, no amount of fiscal support can mask the fact that the UK recovery hinges almost solely on avoiding a return to repeated, widespread lockdowns.

Not only is it important to businesses, which will be looking for an operating environment that is as stable as possible until a vaccine or similar treatment is available. But consumer confidence in the safety measures is going to be absolutely key, and in many cases will probably be a bigger driver of spending over coming months than financial health.

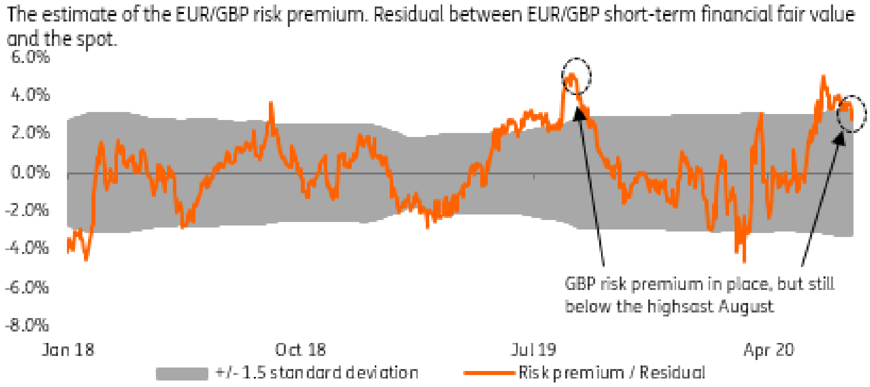
GBP: New announcements are no game changer, and will only provide short-term respite

The pound's reaction to Chancellor Sunak's fiscal announcement was fairly muted, given that sterling had already front-run the event yesterday (in terms of gains) after policy details started to emerge ahead of the announcement today.

While the size of the stimulus announced is modestly larger than expected, in our view it is not significant enough to prompt further GBP gains. The announced measures today do not significantly alter our UK growth outlook, and with the overriding GBP driver (UK-EU trade negotiations) still looking fairly uncertain, more gains in GBP are unlikely.

We see EUR/GBP moving towards 0.92 within three months as the lack of anticipated progress in UK-EU trade negotiations should translate into further risk premium being built into the currency. Based on our estimates, and following the recent GBP rebound, less than a 3% risk premium is currently built into GBP vs EUR (Figure 1). We think it's likely that the risk premium will increase above 5% (read GBP: The ongoing disappointment) if no meaningful progress in negotiations occurs this summer – which is our base case.

Figure 1: GBP risk premium



Source: Bloomberg, ING

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