

What next after UK markets jolted by doubts over Chancellor's future

UK markets are beginning to price in the possibility that a new Chancellor could change the fiscal rules and loosen Britain's purse strings, at a time when annual debt issuance is already perilously high. That seems like a bit of a leap at this stage, but once again, Gilts are dragging UK asset markets lower



UK Chancellor Rachel Reeves' future is in question

UK markets are under pressure today on doubts about the future of Chancellor Rachel Reeves. This follows an exchange in Parliament today between Prime Minister Keir Starmer and opposition leader Kemi Badenoch, where the PM skirted a question about the Chancellor remaining in her position until the next election.

It's worth saying that this all looks hugely speculative at this stage, and a spokesperson for the prime minister has since confirmed the Chancellor has his backing. But this episode comes at a time when the government's own MPs are increasingly critical of its economic strategy – a strategy which has recently favoured spending cuts over tax rises as a means to bolster the public finances.

UK 30-year bond yields were up almost 20 basis points on Wednesday, presumably on the view

that a new Chancellor would be more likely to loosen the purse strings via a less stringent set of fiscal rules, and increase borrowing.

That feels like a bit of a leap right now. But what might that scenario look like in practice?

An obvious tweak to the fiscal rules could unlock £17bn/year

The present fiscal rules require the current budget – that's day-to-day spending versus tax revenues – to be forecast in surplus at the end of this decade. Currently, the Office for Budget Responsibility projects the government will generate a £10bn current surplus in fiscal year 2029/30. That's what's known as 'headroom' – money the Chancellor could theoretically spend and still meet her rules. In the context of more than £1.5 trillion of forecast government spending in that year, that really isn't much room for error.

[We've recently argued](#) that this headroom is likely to have completely disappeared by the autumn, where a combination of economic forecast downgrades and mounting spending pressures means that the Chancellor may need to find an extra £20bn. That's why tax rises have been looking increasingly inevitable.

The alternative is to simply move the fiscal goalposts again. That looks challenging, given the Chancellor already made big changes last October. Buried in that update was a piece of small print, making things a little more flexible from April 2026, when the Chancellor will be permitted to run a deficit of up to 0.5% of GDP (rather than an outright surplus). Were the Chancellor to bring that forward to this autumn, it would give the Chancellor an extra £17bn in wiggle room. That would just about mean tax rises could be avoided.

We doubt the Chancellor (current or new) would make drastic rule changes

But that still means more borrowing. And the reaction in financial markets to all of this shows that investors are still highly sensitive to the UK's public finances. The Debt Management Office's gilt issuance remit is just shy of £300bn this year – as it was last year. And that's seen as a big number.

The scars of the 2022 'mini budget' crisis still appear to be deeply etched into the political memory in Westminster. And we still suspect the Chancellor – be it Rachel Reeves or any successor – will be reluctant to make major changes to the fiscal rules, amid fear of provoking an adverse reaction in markets. Our base case is still that tax rises will do the heavy lifting this autumn.

Gilts and sterling marked lower

The uncertainties surrounding the UK's fiscal policy have hit UK asset markets today. While we had felt the welfare vote would pose a modest risk to sterling, the speculation over the future of the Chancellor has now triggered a significant market reaction.

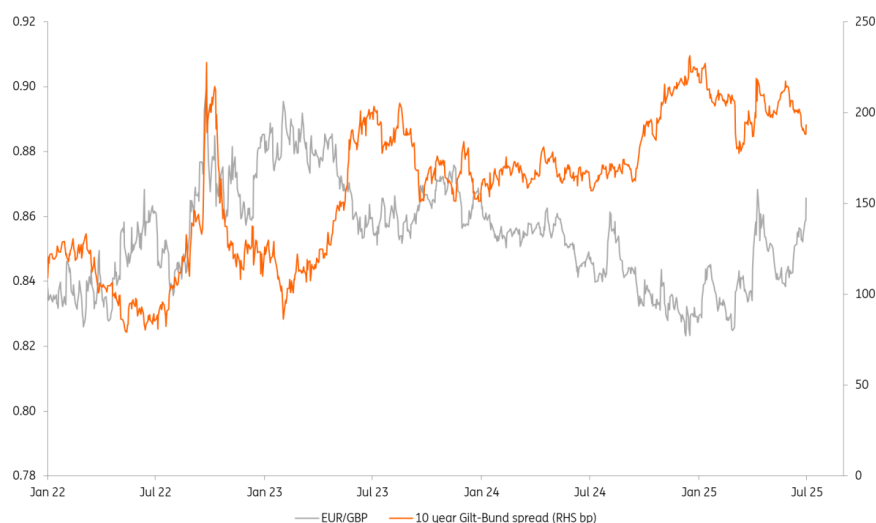
In the bond market, 10-year Gilt spreads have widened by 8 basis points over German Bunds and by 10 basis points over US Treasuries, to which Gilt yields have been more closely correlated this year. This movement reflects the market's anticipation of potentially looser fiscal policy, which could limit the Bank of England's room to cut rates. Consequently, the policy rate for summer 2026 is now priced around 3.50%, some 5-8 basis points higher than before.

In the foreign exchange market, sterling has experienced nearly a 1% sell-off against the euro, mirroring some of the larger swings seen during the market unrest in April this year. Since 2022, fiscal policy has been sterling's Achilles' heel, and FX traders are once again taking their cues from Gilts. Speculation will inevitably build that the BoE may rein in its £100bn of Gilt sales via quantitative tightening when its next decision on the programme is taken in September.

Traders are also recalling the BoE's month-long gilt-buying programme in September 2022, which was undertaken to restore market order. Currently, the 10-year Gilt-Bund spread is around 192 basis points, substantially off the extremes of 220/225 basis points seen as recently as January this year. Should the Labour government fail to restore fiscal confidence, the 220/225 basis point area could become the target, prompting the BoE to intervene again should the move prove disorderly.

Elsewhere, we estimate that sterling already trades with a 2% risk premium. An extreme move could potentially add 1-2% to EUR/GBP, making the April high of 0.8750 a very visible near-term target. We are already somewhat bullish on EUR/GBP, anticipating that the BoE will need to catch up with the ECB's easing cycle. It seems we might reach our 0.88 EUR/GBP 2026 forecast much sooner than expected.

EUR/GBP versus the Gilt-Bund spread



Source: ING, Refinitiv

Author

James Smith

Developed Markets Economist, UK

james.smith@ing.com

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

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