UK Watch

Room for fiscal easing squeezed by rising rates

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Macro
United Kingdom

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We expect fiscal easing next March

This year's Autumn Statement (22 November) seems likely to contain no major fiscal easing. Market conditions cut the room for easing next year considerably too. We estimate the fiscal rules give about £10bn headroom for fiscal measures in next year's Budget (in March), probably more if repurposed HS2 spending gets delayed after 2028. We expect most of the headroom to be used for fiscal easing in next year's Budget.

Supporting our call for no rate cuts until 2025

Chancellor's usually aim to meet their targets with room to spare to give confidence that forecast errors and shocks would not mean the rules are often missed ex-post. So we do not think the UK government has much economic room for tax cuts, despite some technical headroom within the rules. Uncertainty is high. Relatively small tweaks to potential growth or other assumptions by the Office for Budget Responsibility (OBR) can make a large difference to fiscal forecasts for five years' time. But our expectation of fiscal stimulus is one reason we expect the Bank of England to cut interest rates later than other major central banks.

Public sector finance: the story so far

The Gilt sell-off and the shift higher in the Sonia curve since April will mean that negative carry and crystalised losses on BoE's "active" Gilt sales – one of the UK's several macroeconomic fragilities - will translate into larger transfers from the Treasury to the APF than we were expecting at the start of fiscal year. So far, however, the likelihood that this will lead to an increased Gilt funding need has been reduced by an underlying improvement in the public finances. Gilt demand data fiscal year-to-date have been somewhat less daunting than expected also. Despite relative good news on public finance and supply/demand fronts, we continue to lean bearish UK rates (UK rates forecasts: taking stock of 2023 so far, 29 September). But the risk of the kind of Gilt turmoil we've seen before in response to a Spring fiscal easing seems low.

Abbreviations:

FY: Fiscal Year
DMO: Debt Management Office
BoE: Bank of England
APF: Asset Purchase Facility
CGNCR: Central Government Net Cash Requirement
OBR: Office for Budget Responsibility
ONS: Office for National Statistics
B&B: Bradford & Bingley
NRAM: NRAM Ltd
NR: National Rail
CCFF: Covid Corporate Financing Facility
NS&I: National Savings and Investment
MFI: Monetary Financial institution
LDI: Liability Driven Investment
HS2: High speed 2

Refer to important disclosures on page 5 to 7. **12608626**

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Heading for tax cuts

In our view the UK government does not have much economic room, if any at all, for tax cuts. But we expect fiscal easing in next year's Budget. It is hard to handicap the size of any easing but we would assume £10bn-£15bn a year. This is one reason we expect the Bank of England to cut interest rates later than other major central banks.

The Prime Minister and Chancellor have already signalled that the Autumn Statement, due on 22 November, will propose no fiscal easing while inflation remains elevated. This week's Conservative Party Conference repeated that message. But we think the Conference also drew attention to the pressure for tax cuts in the Budget due in March 2024, a potential election year.

Squeezed by yields

At the time of the March 2023 Budget the UK government was likely expecting to have considerable room to ease taxes in 2024. The Chancellors' fiscal rules require borrowing less than 3% of GDP and government debt-to-GDP falling in 5 years' time. These rules were met by a small margin in the Budget earlier this year. But crucially that 5-year horizon rolls forward every year. With relatively tight public spending plans cutting borrowing each year, we think rolling forward the targets one year would have left the government with considerable headroom vs. its fiscal rules in 2028/29.

The room for tax cuts has since been squeezed by rising debt interest costs and a weakening economic outlook. Government bond yields have risen since that 2023 Budget and inflation seems likely to continue running well above OBR forecasts. We estimate that debt interest costs could add approximately £30bn a year to government borrowing in the medium-term. Freezing fuel duty again, as the government has done since 2011, would add to borrowing. It's not all bad news as borrowing undershooting Budget forecasts this year through, in part, strong receipts should carry over to future years. Even so, we see only £10bn room for tax cuts based on the government's fiscal rules.

Exhibit 1: Government may have £10bn or more fiscal room by 2028/29
BofAf government borrowing and debt, £bns unless otherwise stated

	22/23	23/24	24/25	25/26	26/27	27/28	28/29
OBR forecast	152	132	85	77	64	49	35
Freeze fuel duty	0	0	5	5	5	5	5
Debt interest	0	18	37	38	29	31	27
Undershoot so far in 2023/24	0	-20	-10	-10	-10	-10	-10
Public sector borrowing	152	130	117	109	88	75	57
% GDP	6.1	5.0	4.4	4.0	3.1	2.6	1.9
Public sector net debt ex BoE, % GDP	88.9	92.1	94.5	96.8	98.2	98.7	98.5

Our assumption for what OBR forecast would have been for 2028/29, if forecast made in March 2023. **Source:** BofA Global Research, OBR.

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Funded by investment cuts

It is within this context that we viewed the changes to rail investment plans announced this week. While the Prime Minister suggested the funds allocated to HS2 would be repurposed to other investment schemes, we suspect the spending would be more backloaded beyond the five-year fiscal forecast horizon than under HS2. Planning new projects may take time, for instance. Lower investment within the five-year forecast period would generate more room within the fiscal rules for tax cuts next year.

Fiscal rules relatively loose

Over a longer horizon the same investment and lower taxes would worsen debt dynamics. The latest Fiscal Risks and Sustainability Report estimates that the UK government would rise to over 200% of GDP around 2050 and above 400% by the 2070s if similar shocks to the past 25 years are repeated. This is one reason we do not think the government has much economic room for fiscal stimulus.

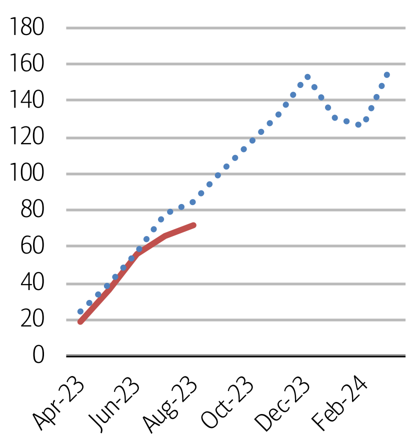
In the short term the fiscal rules allow fiscal stimulus for four years as long as in the fifth year of the forecast weaker spending, stronger growth or future tax rises are forecast to balance the tax cuts. The current fiscal trajectory relies on tight public spending plans in the second half of the forecast that we suspect would be difficult to deliver. So we see risks skewed heavily to borrowing overshooting the Budget forecasts. In this sense, while there may be headroom relative to the fiscal rules for easing next year, probably the more binding arbiter on stimulus will be whether those forecasts are seen as plausible by the market.

FY 2023/24 public sector finance: the story so far

The Gilt sell-off and the shift higher in the Sonia curve since April will mean that negative carry and crystalised losses on BoE's "active" Gilt sales – one of the UK's several macroeconomic fragilities (discussed recently in UK rates forecasts: taking stock of 2023 so far published on 27 September) - will translate into larger transfers from the Treasury to the APF than we were expecting at the start of fiscal year.

So far, however, the likelihood that this will lead to an increased Gilt funding need has been reduced by an underlying improvement in the public finances. According to the latest set of UK public sector finance data for August, CGNCR stood at £71.8bn fiscal year-to-August, some £12.7bn below OBR's projection of £84.5bn (Exhibit 2). The NS&I monthly flows amounted to £2.75bn in fiscal year-to-August, broadly on track to hit the DMO's FY 2023/24 Remit objective of £7.5bn if sustained (Exhibit 3). Looking at historical monthly fluctuations, CGNCR deviations from projections occurred in the months where OBR's monthly estimates were above historical averages (Exhibit 4). From here, October will be the next point of interest, with OBR's projection for £16bn differs meaningfully from average of no change on the month since FY 2010/11.

Exhibit 2: CGNCR ex. B&B, NRAM, NR and CCFF (GBPbn, cumulative)
Slightly better than projected so far



Source: BofA Global Research, OBR, ONS
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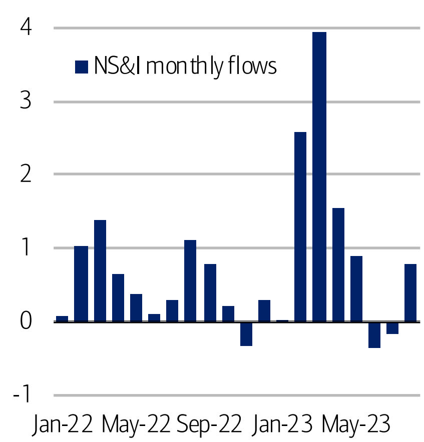
Exhibit 3: NS&I monthly and 3-month cumulative flows, £bn
Broadly on course to hit FY projection



Source: BofA Global Research, OBR, ONS
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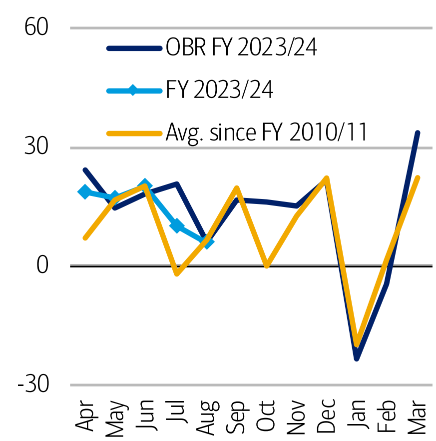
Exhibit 4: CGNCR ex. B&B, NRAM and NR monthly fluctuations, £bn
A few months of divergences ahead



Source: BofA Global Research, OBR, ONS
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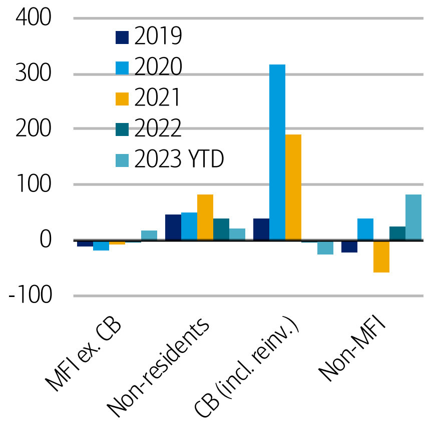
Some encouraging data on "who will buy Gilts" front

Despite slightly better than expected public sector finances so far this year, the call on investors to absorb Gilt supply from the DMO and BoE will remain substantial. But the latest BoE Bankstats data revealed that the situation has been less dire than feared at the start of the year. In Gilt buying in August: foreigners (29 September) we highlighted:

- As feared in late 2022, overseas investor demand for Gilts has been weak year-to-August vs. prior years, with domestic non-bank investors the dominant buyer (Exhibit 5 and Exhibit 6). But quarterly dynamics seemingly remain seasonal (Exhibit 7). Q4 tends to be a strong quarter for Gilt buying by foreigners (at least partially due to a slowdown in GBP SSA primary issuance into year-end, we think) - foreign demand for Gilts could catch up to non-banks' into year-end. Oil price strength, if sustained, could aid demand further.

- Perhaps more encouraging was the £18.6bn buying of Gilts by domestic banks year-to-August, after selling of Gilts every year since at least 2019. While still relatively marginal in size compared to Gilt issuance from the DMO and Gilt selling from the BoE, it is an important development for the Gilt market.

Exhibit 5: Net buying of Gilts per investor type, £bn
Non-MFIs the dominant Gilt buyer so far this year



Source: BoE, BofA Global Research

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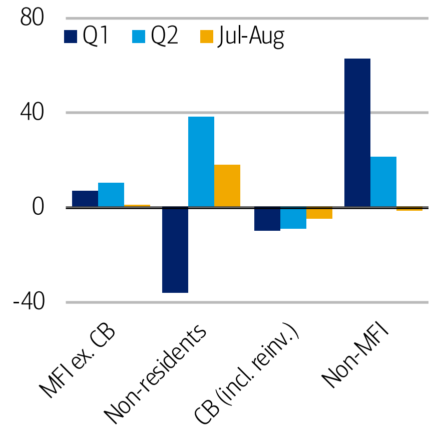
Exhibit 6: Net buying of Gilts per investor type per quarter, £bn
A rebound in foreign demand for Gilts



Source: BoE, BofA Global Research

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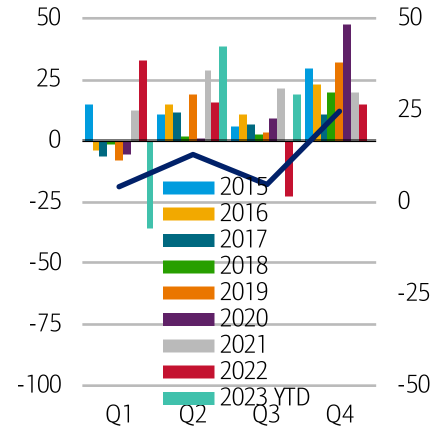
Exhibit 7: Quarterly overseas investor net buying of Gilts, £bn
Seasonality implies strong Q4



Source: BoE, BofA Global Research

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Could the market get spooked by fiscal again next spring?

This year's Autumn Statement seems likely to contain no major fiscal easing. But we estimate the fiscal rules give about £10bn headroom for fiscal measures in next year's Budget in March (potentially more if switching investment spending from HS2 to other projects backloads more of the spending beyond the five-year fiscal rule horizon). We expect most of the headroom to be used for fiscal easing in next year's Budget. The key question we have received from investors this week was around chances of last Autumn's Gilt turmoil repeating next spring.

While anything is possible, we think the chances of an extreme market reaction next spring is small for a number of reasons. These include LDI having taken steps to ensure resilience to fast and sharp yield moves, and supply and demand conditions appearing less difficult than perhaps expected at the start of the year. One potential development worth keeping in mind: Moody's and Fitch continue to hold "negative" outlooks alongside their ratings, and adverse fiscal developments could induce them to act on the outlook. As argued in the past, however, the market impact in such an instance should be relatively small: while some investors might favour "high grade" to "upper medium grade", a bigger problem would obviously be ratings dropping out of "investment grade" territory (a very remote risk for the UK).

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