MONTHLY ECONOMIC INSIGHT

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One event has dominated the economic and political agenda in the past month – the new chancellor's mini-budget, and its aftermath. This month's review looks at what was actually in it, as well as the market reaction. It will also take a look at what recent revisions to UK GDP data tell us about growth through Covid-19.

(MINI-) BUDGET ... WHAT WAS IN IT?

Before getting into the inevitable dissection of the market reaction to the statement, let's start with its contents – much of which was widely trailed ahead of time.

The headline measures were those set out by the new prime minister on the campaign trail – the reversal of national insurance rises for individuals and businesses and cancellation of the planned increase in corporation tax. And following Liz Truss' election as PM, the commitment to a lower energy price cap for households and a similar six-month support package for business energy bills was also confirmed in the statement.

The energy package is estimated to cost the Exchequer around £60 billion in 2023/23. In addition, the NICs and corporation tax measures are set to cost some £130 billion over the forecast period (to 2026/7). The chancellor also announced that he would bring forward the 1p cut in the basic rate of income tax to April 2023. The surprise move of cutting the top rate (45 per cent) of income tax, has since been cancelled.

For businesses, he made permanent the increase in the Annual Investment Allowance to £1 million, unwound previous changes to alcohol duties and increased Stamp Duty thresholds. The entire package, taken together with the previously announcement energy support measures, tops out at over £200 billion over the next five years.

A dispassionate assessment of the statement might be that there was something for everyone. The measures on energy prices are widely regarded as essential in supporting lower income households and businesses through the winter. And other tax measures align with the new government's commitment to lowering taxes and providing some support for businesses to invest.

However, the balance and scale of the measures have sparked significant concern about the overall plan. Starting with the balance – the Resolution Foundation analysis of the package shows the main beneficiaries of the tax package are those at the top ten per cent of the income scale. Scrapping the 45p tax cut doesn't change the distributional impact. At the other end of the spectrum individuals will see minimal benefit from tax changes and while the energy measures mean the hit from higher prices this winter won't be as large as feared, bills will still be higher and budgets will continue to be squeezed by rising inflation.

And in terms of scale, the National Institute of Economic and Social Research estimate that net borrowing will be nearly eight per cent of GDP in 2022/3 and will run at over £100 billion per year as result of tax cuts and increase interest payments.

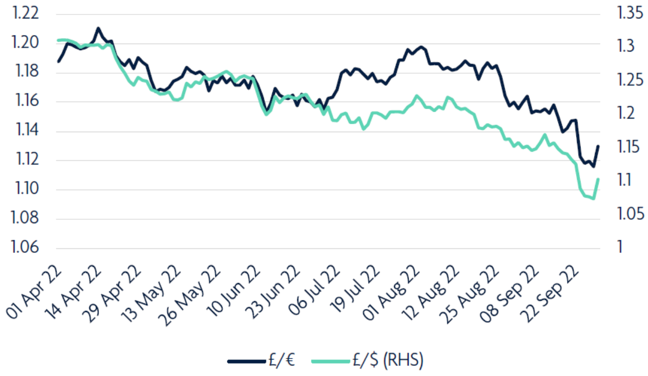
AND THE RESPONSE?

And it was those numbers that prompted the market response. The lack of any independent assessment of the economic and fiscal consequences of the measures from the OBR, which usually accompanies such announcements, didn't help.

Following the statement there was a sharp fall in sterling, hitting $1.03 (**chart 1**), and huge volatility in gilt markets. Long-dated government bond yields hit five per cent (compared with two per cent in August), prompting an intervention in the market by the Bank of England.

Markets also priced in a more aggressive pace of monetary tightening by the Bank, with interest rates expected to exceed five per cent in mid-2023.

Chart 1: Sterling exchange rate



Source: Bank of England

The ripple effects of these movements have hit mortgage lenders and pension funds. While sterling has rallied back to pre-statement levels against the dollar and the euro, renewed weakness would contribute to higher inflation.

What next? The government has rowed back on the tax cut for higher earners but this move, on its own, doesn't have much of a bearing on the overall borrowing numbers. The next action that markets are awaiting is a full fiscal plan in November (or likely sooner), together with a range of supply-side reforms intended to support the aim of higher long-run trend growth. Around the same time, the OBR will publish its updated assessment of the economic and fiscal outlook.

The expanded plan will need to demonstrate discipline in the managing the public finances as well as water-tight reform measures to avoid a repeat of the turmoil seen at the end of September.

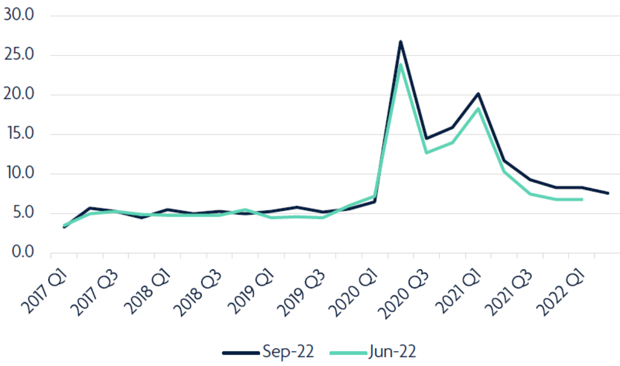
GDP REVISIONS – GOOD AND BAD NEWS

And speaking of growth, there was a bit of better news from the ONS in its GDP revisions. The economy was a touch stronger in the second quarter than previously thought, expanding by 0.2 per cent against a previous print of a 0.1 per cent fall. Services output was revised up, however there were offsetting downward revisions to production and construction (though the latter continued to report expansion).

The rather less positive news came from adjustments to 2020 and 2021 data. The UK economy is now thought to have fallen by 11 per cent during 2020 and despite a slighter faster recovery last year, current GDP levels are still below those reported pre-Covid-19.

While the quarterly profile of growth isn't materially different, the revised data does show a slower recovery in 'contact-intensive' sectors (e.g. wholesale and retail, and health) and a stronger rebound in manufacturing.

Chart 2: Household saving ratio, percentage



Source: ONS

One notable change in the data is that relating to household saving (**chart 3**). The ONS note that households have saved more of their incomes during and after the coronavirus pandemic than previously estimated.

At the peak of the pandemic households were saving more that a quarter of their income. The last full quarter of data unaffected by Covid-19 (2022 Q2) the saving ratio stood at 7.6 per cent compared with 5.6 per cent at the end of 2019. ONS point to household consumption growing more slowly than nominal incomes as the driver.

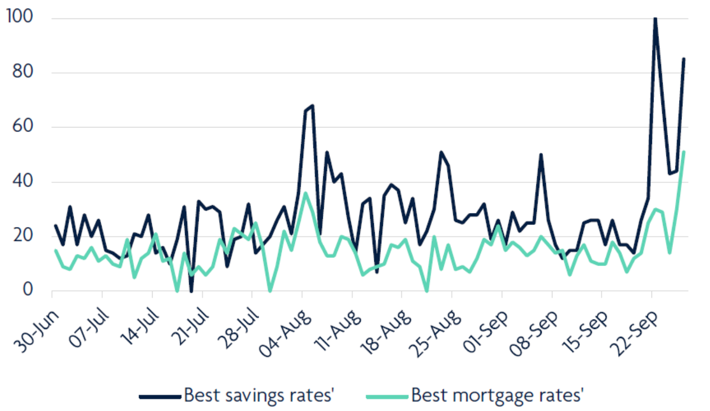
'BEST RATES'

As noted above, events in financial markets at the end of September and expectation of higher interest rates has led to a re-pricing of mortgage products and has prompted some concern about the impact on mortgage borrower rolling of fixed-rate contracts in the next year.

Chart 3 shows some spikes in internet searches for the 'best mortgage rates' as the prospect of higher mortgage rates hit the headlines at the end of September and indeed, in August, when the Bank of England announced its first 50 basis point rise in Bank Rate.

Somewhat less attention is given to savers, but as the chart illustrates there had also been a rush to research saving rates options as the outlook for interest rates has increased. While the accumulation of savings has been larger than first thought, **UK Finance data** shows that the vast majority of household deposits are held in instant access accounts. With the prospect of better returns consumers appear to be looking around for better options. We shall see if this translates into some growth in ISAs or other accounts in our data in the coming quarters.

Chart 3: Google searches, 100 = peak popularity of search term



Source: Google trends

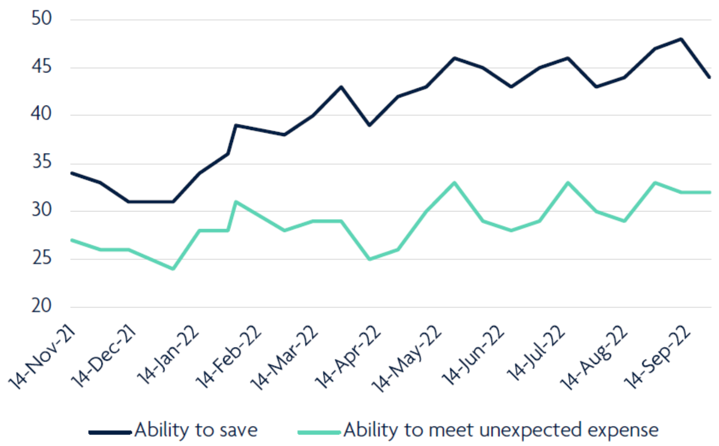
HOUSEHOLD PRESSURES

In recent months we and others have had a focus on the cost-of-living challenges facing households. Despite the government's recent announcements, consumers will be facing higher energy costs this winter in addition to rising food and other prices. The ONS's regular Opinions and Lifestyle survey shows no signs that pressures are abating, with nine in ten respondents reporting a rise in their cost of living compared with a year ago while three-quarters say the cost of living has increased over the past month.

As a result, the proportion of consumers who believe they will be unable to save in the next twelve months has been gradually increasing since the start of the year and by demographic, older households are more likely to think they will be unable to put any money aside in the coming year.

Similarly, the proportion of household unable to meet an unexpected £850 expense has also edged up slightly, but younger respondents are more likely to say this would be a struggle.

Chart 4: Household finances, percentage of respondents replying 'no'



Source: ONS

The direction of travel of the survey suggests that the build up of savings seen in recent years is likely to hit the buffers as cost pressures continue to increase.

ROUND UP

To say it's been a difficult first month for the new government is an understatement. While the moves to minimise energy price rises for households and businesses were critical, further announcements on the public finances, spending decisions and growth policies will need to tread a careful line, given market jitteriness.

October should be a quieter month, with the government's fiscal plan, OBR forecasts and the next Bank of England MPC meeting all pencilled in for November.

Households will be aware that October sees the start of the higher energy price cap, so the indicators to watch will be confidence, indicators of credit demand and what's happening in the retail space.

Indicator	Period	Value	Change	2022 Forecast*
GDP	Q2 2022	-0.1%	↓	3.6%
CPI inflation	Aug 2022	9.9%	↓	10.6%
Unemployment rate	Jul 2022	3.6%	↓	4.1%
Average earnings	Jul 2022	5.5%	↑	5.9%
Brent crude	Aug 2022	$100.45	↓	-
$ Exchange rate	Aug 2022	$1.20	↓	-
PSNB	Aug 2022	£11.8 bn	↓	£117.5 bn

Source: ONS, HM Treasury, Bank of England,