Economic Research Unit

Economics Weekly

Bank of Ireland

Substantial fiscal consolidation a risk for UK and Sterling

UK Chancellor of the Exchequer, Rachel Reeves faces a range of headwinds that will make it harder to meet her fiscal rule for a current budget balance by 2029/30; recent Labour government reversals on planned welfare cuts, likely downward revisions to the OBR's projections for UK GDP growth, questionable plans for restrained spending from 2027 onwards and finally higher gilt yields and borrowing costs.

Hence, it is quite possible the November 26th Budget will be forced to set out a larger package of tax rises and spending cuts, exceeding the £20bn (0.7% of GDP) currently anticipated. If so, this poses a downside risk not only to our forecast for 1.3% UK GDP growth in 2026, but a more aggressive fiscal consolidation could also bear down on sterling, gilt yields and perhaps persuade investors the Bank of England has greater scope to cut interest rates.

Limited headroom against Chancellor's fiscal rule: Speculation Chancellor Rachel Reeves would be forced into additional tax hikes in this years' Budget have been mainly driven by the limited 'headroom' against her own fiscal rules. Specifically, that the UK will balance the current budget by 2029/30, only borrowing to invest. In March, the Office for Budgetary Responsibility (OBR) had forecast a current budget surplus of £10bn (0.3% of GDP) by 2029/30. However, since then the Labour government has largely reversed planned cuts to both the winter fuel allowance (£1.5bn) and disability and sickness welfare payments (£5bn) - effectively erasing most of the planned surplus. Higher gilt yields (see chart below) will also dilute the Chancellors £10bn headroom, although the Debt Management Office (DMO) can limit the impact by issuing shorter-term debt. In September, the 30-year gilt yield rose to 5.7%, the highest level since the late 1990s.

The OBRs forecasts for GDP will likely be revised down, hurting borrowing projections: In March, the OBR had forecast that UK GDP growth would average 1.8% per annum through 2026-2029. This would represent a marked acceleration in UK GDP growth, and the OBR has been criticised for taking too optimistic a view on an expected recovery in labour productivity (see chart below). The OBR's projections are also substantially more optimistic than the Bank of England, IMF, NIESR and other private sector forecasts - that do not see GDP growth exceeding 1.5%.

One justification by the Labour government for the late November 26th Budget date was to allow the OBR to consider the impact of '*pro-growth*' reforms, such as the new planning bill and reducing barriers to infrastructure investment. Nonetheless, the OBR's GDP projections will surely be revised down, hurting the forecast for public sector borrowing. For example, NIESR, who have taken a relatively gloomy view that GDP growth will average just 1.1% over the next five years, expect the current budget balance to be in deficit by £41bn in 2029/30 - which would necessitate a larger fiscal adjustment.

Spending plans remain questionable: The OBR's forecast for the current budget balance also assume the Labour government stick to the June spending review plans. However, the Institute for Fiscal Studies (IFS) has in the past said these plans are unrealistic, implying real cuts in expenditure for many 'non-ring-fenced' (i.e. excluding health and defence) government departments from 2027 onwards. For example, the schools budget will be frozen in real terms (excluding the expansion of free school meals). The IFS also estimate the budgets for Culture, Media and Sport, Environment, Food and Rural Affairs and the Home Office will fall in real terms by 2030. Of course, failure to achieve these spending cuts will squeeze the Chancellor's headroom against her fiscal rule even further.

Fiscal consolidation poses risk to UK outlook and Sterling: Through April-July, public sector borrowing was £60bn, almost exactly in line with the OBR's monthly projections and on track to equal £117bn (4% of GDP) in the full budget year 2025/26. Nonetheless, there appears to be some consensus a fiscal adjustment worth £20bn (0.7% of GDP) is required in November. The Chancellor has recently dismissed NIESR's estimate that a larger adjustment of £50bn is required.

Nonetheless, there is surely a risk the Labour government will eventually choose to impose a tougher package of tax rises and spending cuts than £20bn, early on in the life of the parliament. If so, this would pose a downside risk to our forecast for UK GDP growth of 1.3% in 2026, but would also bear down on gilt yields, sterling and perhaps persuade markets the Bank of England has greater scope to cut interest rates.

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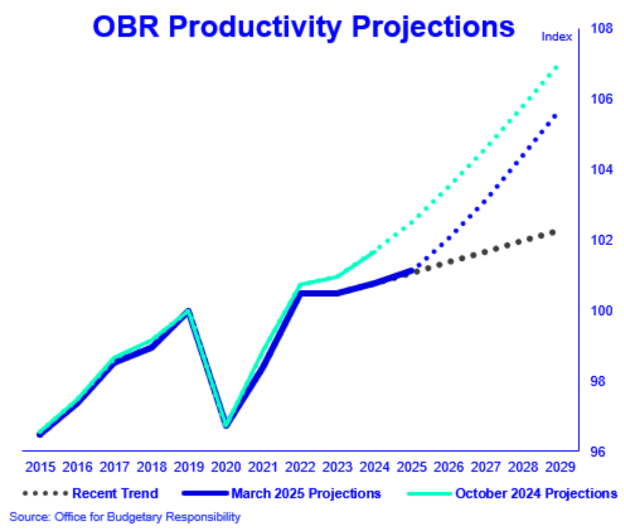

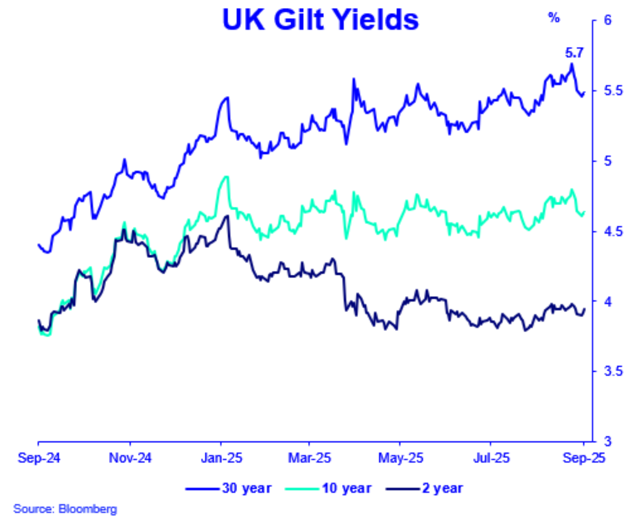

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