Economic Research Unit

Economics Weekly

Bank of Ireland

November 26th budget may well lead Bank of England to cut rates below 3.5%

Sterling remains under pressure today, at 88p against the euro, close to its weakest level since early 2023. The catalyst was yesterday's Bank of England decision to keep rates on hold at 4%, but with Governor Andrew Bailey's press conference seen as endorsing the market curve for two further 25bp rate cuts to 3.5% in 2026, most likely starting at the December 18th policy meeting. Crucially, however, the Bank of England's GDP and CPI inflation projections do not make any adjustment for the negative impact of the likely £30-£40bn (1%-1.3% of nominal GDP) package of tax rises and spending cuts expected in the November 26th budget.

Chancellor of the Exchequer Rachel Reeve's speech on Tuesday (November 4th) explicitly set out that the November 26th budget will aim to provide the Bank of England with further room to cut official rates. So painful, near-term, measures such as 1p increases in the key income tax rates are now more likely, depressing GDP growth next year. The political calculation seems to have been made it is better to have a difficult fiscal adjustment early on in the life of the UK parliament, which will also help to reduce borrowing costs and hopefully allow the Bank of England to cut rates faster than the 'gradual downward path' set out yesterday.

Sterling under pressure as December rate cut now seen as likely: Sterling is trading at 88.1p against the euro today, close to its weakest level in 2-years, following yesterday's decision by the Bank of England to keep rates on hold at 4%. However, the MPC's 5-4 split vote, dovish comments from Governor Andrew Bailey at the press conference and that the minutes indicated rates were on a '*gradual downward path*' led markets to price-in a cut at the next December 18th policy meeting. Options now imply a 70% probability of a cut in December, two cuts to 3.5% fully priced-in by July.

Bank of England endorses market curve: The Bank's updated forecast is for 1.4% GDP growth through 2026, with CPI inflation still expected to fall back to 2.5% by end-2026 and to the 2% target by end-2027. So the projections, based on the market curve, themselves reinforce market expectations for two rate cuts to 3.5% next year. In his press conference Governor Bailey was even more explicit, saying market pricing gave a '*reasonable view of a sensible path*' and were a '*fair description of my position at present*'.

But November 26th Budget is the elephant in the room: The minutes of the MPC's policy decision barely mentioned the upcoming budget. There was no analysis whatsoever of the likely negative impact of the expected £30-£40bn (1%-1.3% of GDP) package of tax rises and spending cuts onto the Bank's GDP and CPI inflation forecasts. When pressed, Governor Bailey demurred, highlighting the Bank's November projections are conditioned on existing budgetary policy. The Bank will reassess the (presumably weaker) economic outlook once the budget has actually been announced on November 26th.

Where and when will the Budgetary axe fall: There had been speculation Rachel Reeves might pursue various ruses to re-build the headroom vs her fiscal rule to balance the current budget over the next 3-years. For example, by assuming unspecified spending cuts in the 2029/30 budget year, or by extending the freeze on income tax bands beyond the currently planned end-date of April 2028. Whilst perhaps politically expedient, such measures would clearly be less effective in reducing the deficit in the near-term, carrying less credibility with gilt investors.

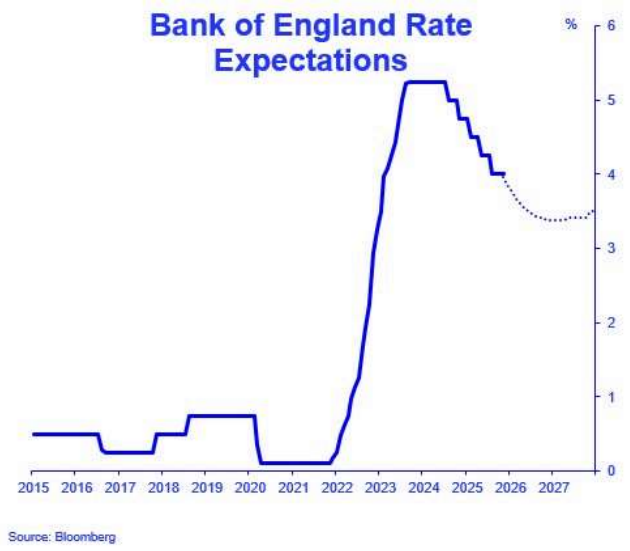
Rachel Reeve's speech on Tuesday (November 4th) signaled a decision has been made to grasp the nettle. Specifically, she said the Budget will focus on ''*getting inflation falling and creating the conditions for interest rate cuts to support economic growth*'. So, near-term painful measures such as the mooted 1p increases in the basic (20%), higher (40%) and additional (45%) income tax rates now look firmly on the agenda - that will depress household incomes and UK GDP growth in 2026 - and perhaps lead the Bank of England to cut rates below 3.5%.

Conall Mac Coille

Group Chief Economist

Bank of Ireland

conall.maccoille@boi.com



Contact Us at economics@boi.com