Resolution Foundation

The Macroeconomic Policy Outlook

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It has been a bleak winter for the Government's hopes that the economy might turn a corner. Markets have been volatile, with the cost of government borrowing rising to its highest level since July 2008 with the pound falling sharply. And there are signs that growth has hit a brick wall, with GDP flat in Q3 2024. So in this edition of the *MPO* we take a closer look at what has been going on, and discuss how the Government should respond.

We find that recent changes in yields have been largely internationally driven, with UK-specific concerns playing a relatively small role. But there is little comfort for the Government here, as recent volatility suggests the UK has become more vulnerable to changes in investor sentiment. In any case, the rise in interest rates will hit both public and household finances. Government debt-servicing costs are still around 0.5 percentage points higher than the OBR forecast in October, representing an additional £7 billion of annual borrowing. And the 570,000 households that are due to roll-off five-year fixed rate mortgages in 2025 are set to see their annual costs rise by £2,700 a year, on average, £280 higher than if rates evolved in line with the OBR's forecast.

Data uncertainties cloud our understanding of the drivers of the slowing in GDP growth from an annualised rate of over 3 per cent at the start of 2024 to almost zero in Q3, but there has been a significant slowing in household spending as families become more cautious. It is welcome that the Chancellor has said that we need to go "further and faster" in efforts to boost long-run supply-side growth, but such efforts take time to bear fruit. This, along with stretched public finances, mean that, in 2025, it is down to the Bank of England to respond to the growth slowdown. Here, the data suggests there has been some progress recently in bringing underlying inflation back to levels consistent with the 2 per cent target. If that continues – and if wage growth, which has ticked up in recent months, also slows – then it should allow the Bank to cut rates more quickly than markets currently expect. That would also save the Government money on debt interest, helping the fiscal outlook.

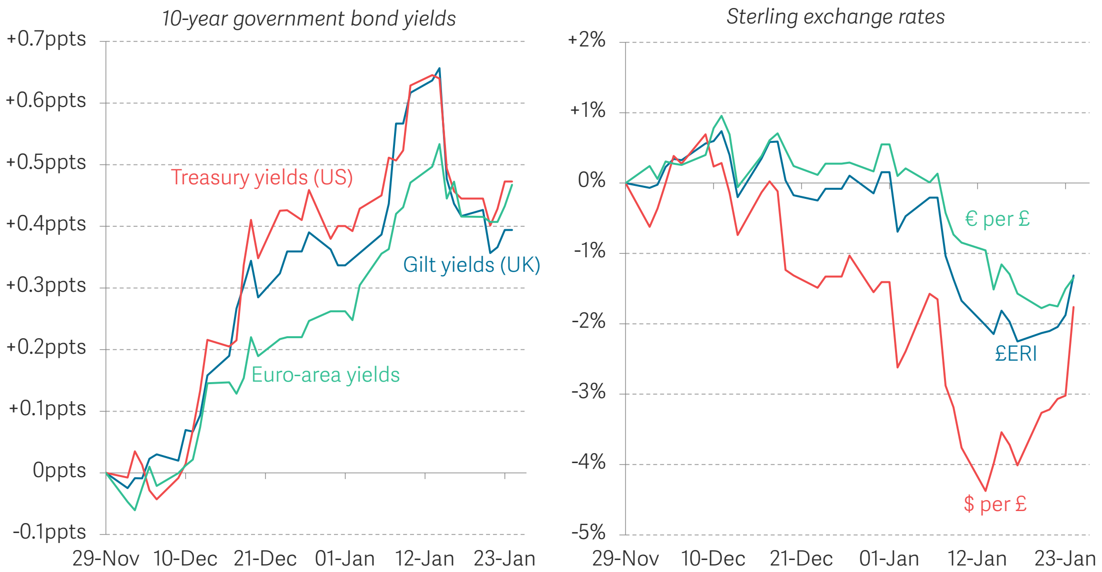
But, with the next official forecast due in March, the Government's commitment to bring borrowing for day-to-day spending to zero by the fifth year of the forecast stands on a knife edge, given higher debt-servicing costs. If the OBR finds that the Chancellor is in breach of her fiscal rules, then a decisive response would be needed to reduce risk of further market jitters. So the Chancellor should not rule out announcing tax rises in March, not least because these are likely to be needed in the medium term to address the UK's longer-term fiscal challenges.

The Government is already under pressure on the economy

Just six months after a landslide election win, a period of market jitters has put pressure on the new Government over its handling of the economy. As shown in Figure 1, since the end of 2024 there has been a toxic combination of rising government borrowing costs (i.e. increasing gilt yields) and falls in sterling exchange rates that has drawn unnerving comparisons with the aftermath of Liz Truss's mini-budget. So in this edition of the *MPO* we take a closer look at what has been going on and discuss what the Government should do.

FIGURE 1: **Financial markets have been volatile in recent weeks**

Changes in 10-year government bond yields (left panel) and sterling exchange rates (right panel) since 29th November 2024



NOTES: Yields for the euro area are those on AAA-rated government bonds only.
SOURCE: RF analysis of Bank of England, Yield curves and exchange rate data; ECB, Euro area yield curves; and Federal Reserve Bank of New York, zero-coupon Treasury yields.

Government bond yields spiked in December and again in early January (Figure 1) with sterling falling sharply since the start of the year. Gilt yields rose to 4.9 per cent in January, their highest level since July 2008. That rise in the cost of Government borrowing is not confined to the UK: US Treasury and European yields have also been rising, with significant volatility ahead of Donald Trump's inauguration as more details of his economic agenda emerged. But although yields have retraced much of their most recent rises, it's striking that the pound remains weaker against the dollar *and* the euro. So the volatility may have started in the US, but the weaker pound suggests UK-specific concerns are also at play.

But market volatility is not the only worry for the Government: recent economic data has also raised concerns that we may be heading for a period of 'stagflation'. The UK was briefly the fastest-growing economy in the G7 in the first half of last year, but growth has since hit a brick wall, falling to zero in Q3, and there are signs that the stagnation has continued into 2025. Meanwhile, inflation data for October and November showed little progress on underlying inflation, with services inflation seemingly stuck at over 5 per cent and wage growth seemingly accelerating.

All in all, it’s been a tough winter for the Government’s hopes that the UK might turn a corner on its recent dire economic performance. So how worried should we be, and what can the Government do?

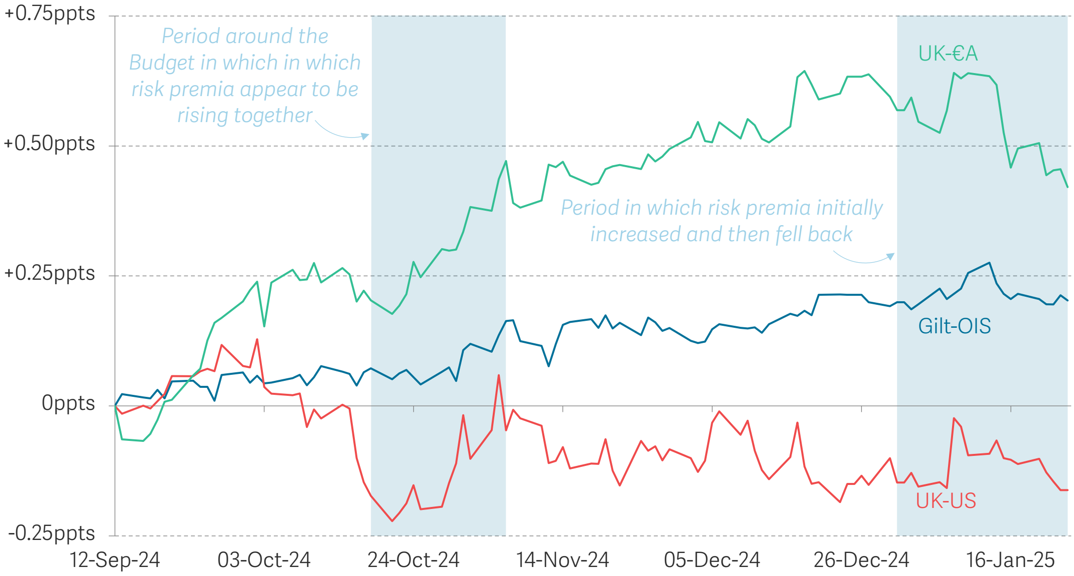
Market concerns about the UK’s fiscal position have been overdone…

With much hype around recent market moves, it’s important to get an accurate sense of how much is down to investor concerns about the UK fiscal position, and how much is about what is happening elsewhere. To zero in on that, Figure 2 shows changes in proxies for the risk premium demand by investors for holding UK Government debt since the OBR’s market-data cutoff for the Autumn Budget in September 2024. By comparing gilt yields to those for other rich countries (specifically: the US and euro area), we can get a sense of how much of the rise is UK-specific. In addition, by comparing gilt yields to expectations for future Bank of England policy rates – captured by rates on Overnight Index Swaps (OIS) – we can get a sense of how much relates to concerns about the debt position specifically. Figure 2 shows there have been some periods (shaded in blue) during which UK-debt-specific moves have been the key driver (these are period when international and OIS spreads moved together). Much of the move upwards in spreads happened immediately after the Autumn Budget. Since then, though, there has not been much UK-specific action, except during the first two weeks in January, when spreads increased and then fell back. Consistent with that, US Treasury yields have risen by more, while euro-area yields have risen by less reflecting weaker economic data which have led to expectations of faster rate cuts by the European Central Bank.

Taking the period since September together, then, gilt yields are up around 0.75 percentage points, with most of the rise seemingly related to international factors, and only around 0.1-0.2 percentage points of the rise in UK yields seemingly related to specific worries about UK debt (as measured by the rise in gilt-OIS spreads).

FIGURE 2: **Recent changes in gilt yields appear to be almost entirely driven by international factors**

Changes in measures of the risk premium on 10-year gilts since 12th September 2024



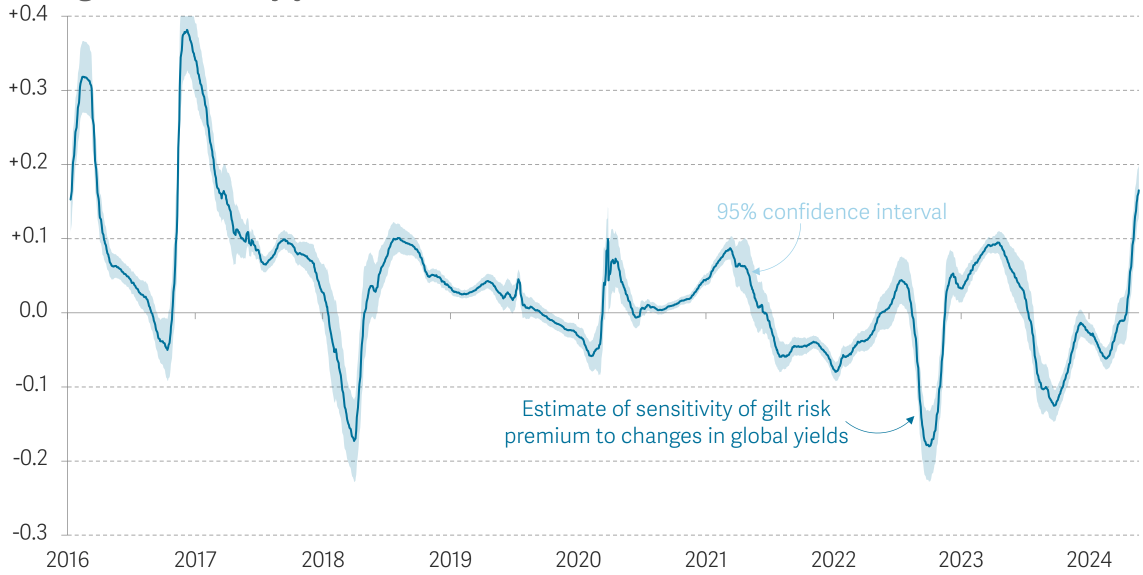
NOTES: The chart shows three measures of the risk premium demanded by investors for holding gilts, i.e. 10-year gilt yields compared with 10-year euro-area AAA-rated sovereign bond yields; 10-year US Treasury yields; and Overnight Index Swap rates. The blue shaded areas show periods in which all three measures changed in the same direction.
SOURCE: RF analysis of Bank of England, Yield curves and exchange rate data; ECB, Euro area yield curves; and Federal Reserve Bank of New York, Treasury yields.

…but interest rates are still higher and the recent episode shows how vulnerable the UK is to the 'kindness of strangers' drying up

Even if recent market moves don't represent a large-scale loss in confidence in the UK fiscal position, that doesn't mean all is well. Recent weeks illustrate how sensitive sentiment towards UK Government debt has become. As past research has shown, the costs of borrowing faced by large, rich countries tend to move together. This is to be expected given large, global shocks and synchronised changes in policy rates. But, as shown in Figure 3, the sensitivity of the UK 10-year gilt *risk premium* now seems to be moving more strongly with global developments. Normally, we would expect such a measure to be largely uncorrelated with global developments (here proxied by changes in 10-year US Treasury yields), which is why the sensitivity is generally around zero. But the sensitivity has increased in recent months to its highest level since the Brexit referendum. This is consistent with the idea that continued weak macroeconomic performance and high debt have increased the UK's exposure to changes in global financial conditions, given our reliance on borrowing from abroad (or the 'kindness of strangers') to finance our debt. All this suggests that any further loosening in fiscal policy would come with a significant risk of more market volatility.

FIGURE 3: **The risk premium on UK gilts has become more sensitive to global yields**

Rolling regression sensitivity of 10-year gilt-Overnight Index Swap spreads to changes in Treasury yields: UK



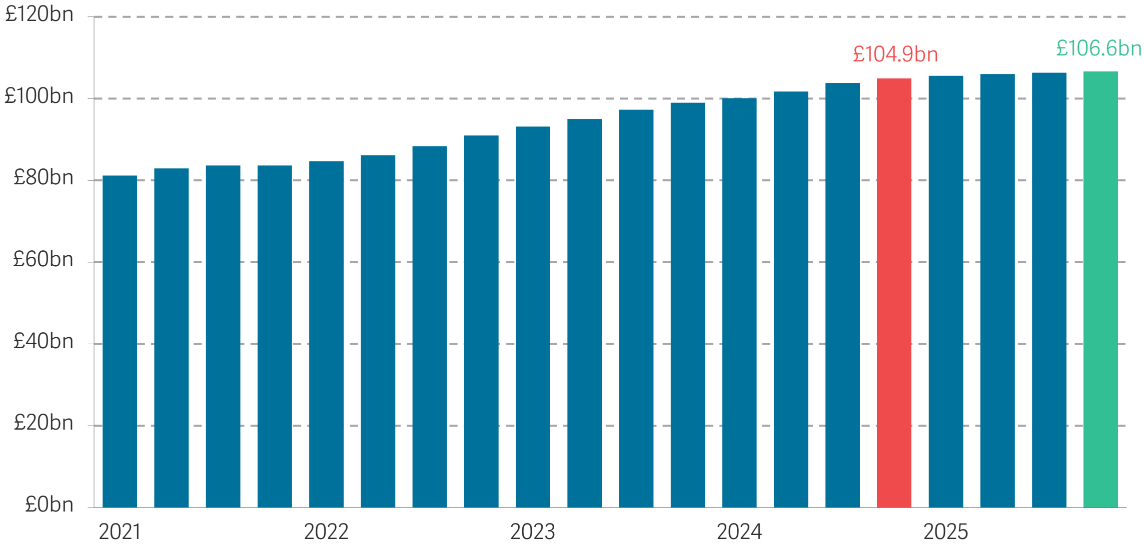
NOTES: Dark blue line depicts rolling 180-day regression estimates of the sensitivity of UK gilt-OIS premia to changes in US Treasury yields. Light blue swathe shows a 95 per cent confidence interval.
SOURCE: RF analysis of Bank of England, Yield curves; and Federal Reserve Bank of New York, zero-coupon Treasury yields.

Whatever the cause, interest rates are still up, and this will have a real impact on the economy. For starters, higher rates represent a deterioration in the fiscal position. A higher cost of servicing the UK's debt means that there will be less to spend on public services and investment. At their peak in mid January, 10-year gilt yields were up around 0.75 percentage points relative to the market pricing used in the OBR's forecast for the Autumn Budget (after taking account of the expected rise in interest rates assumed by the OBR). That would increase borrowing by around £11 billion a year by the end of this Parliament – more than enough to wipe out the £10 billion in headroom the Chancellor had against her binding fiscal rule at the Autumn Budget. Falls since then mean this number is now around £7 billion – still a chunky deterioration in the fiscal position, but not quite enough to wipe out all the headroom that the Chancellor had at the Autumn Budget.

Higher interest rates will also increase families' mortgage bills. Although the Bank of England is expected to cut rates at least twice this year, this won't feed through into lower mortgage bills. This is partly because the pricing of new fixed-rate mortgages is not tied to the current level of Bank Rate: instead, it depends on its *expected* future level. Despite the Bank cutting rates in November, OIS rates (a proxy for expected future Bank rates) are actually somewhat higher than they were before the Autumn Budget. Moreover, the popularity of fixed-rate mortgages means that, even as rates on new mortgages follow Bank Rate down, families' average bills are still set to rise in 2025, driven by an estimated 570,000 households rolling off cheap five-year fixes secured in 2020. Based on the current outlook for interest rates, Britain's aggregate annual mortgage bill is estimated to rise by around £1.5 billion over the course of 2025, as shown in Figure 4. Households coming to the end of a five-year fix are set to see their annual bill rise by £2,700 on average, about £280 more than if rates had evolved in line with the OBR's forecast.

FIGURE 4: **Rising interest rates will add to families' rising mortgage costs**

Estimated aggregate annualised owner-occupier mortgage repayments: UK



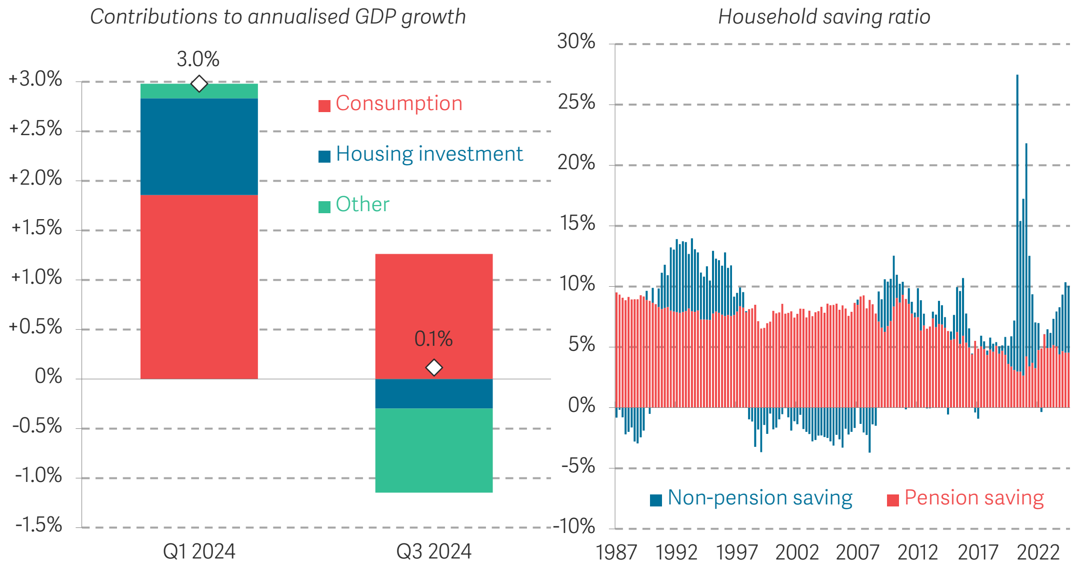
NOTES: Repayments include both interest and capital repayment. Mortgage repayments are projected for mortgagor households in the 2018-20 wave of the Wealth and Assets Survey (WAS), using the methodology outlined in L Judge, J Leslie & K Shah, Interesting times: Assessing the impact of rising interest rates on mortgagors' living standards, Resolution Foundation, October 2022. Future mortgage rates are estimated using market interest rates on 21st January 2025.
SOURCE: RF analysis of Bank of England, Bankstats and Yield curves; ONS, Wealth and Assets Survey; FCA, Mortgage lending statistics.

The outlook for growth has also deteriorated, in large part because families have become more cautious with their spending

Meanwhile, although the Government has made boosting growth its highest priority, this is not yet reflected in outturn data. The left panel of Figure 5 shows that growth slowed sharply between the start of 2024 and the third quarter. There is significant uncertainty here, with large adjustments to align the data on industrial output, which is the main data source for early vintages of GDP, to data on expenditure across the economy. But it is clear that household spending has slowed sharply. The contribution of such spending to annualised GDP growth in Q1 2024 was 2.8 percentage points, the highest since the pandemic recovery in 2022; but in Q3 this had slowed to just 1 percentage point. This slowing has coincided with a period of apparently more cautious spending on the part of households, with the saving ratio rising in recent quarters (Figure 5, right panel).

FIGURE 5: **Growth has slowed sharply, with households becoming more cautious**

Contributions to annualised GDP growth (left panel) and the household saving ratio (right panel): UK



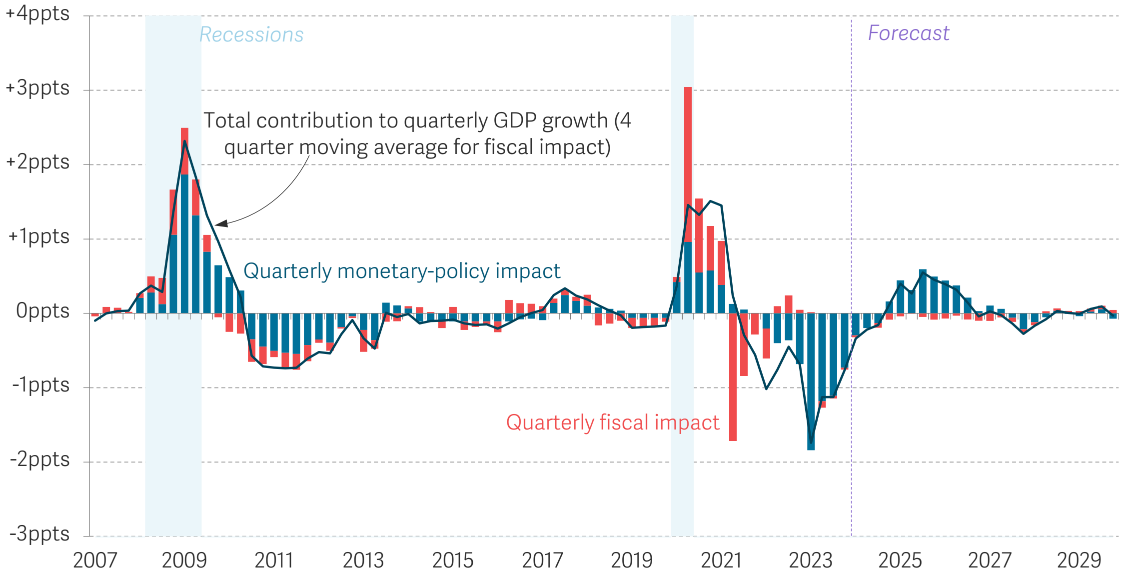
NOTES: Consumption includes household, non-profit institutions serving households.
SOURCE: RF analysis of ONS, National Accounts.

Government efforts to boost growth are welcome, but continued falls in underlying inflation should allow interest-rate cuts to contribute

In response to the weaker outlook, the Chancellor has said that the Government will go "further and faster" with its growth plans. This is laudable (and certainly needed), but research shows that the kind of structural policy changes that the Government has in train (around planning, industrial strategy and changes in regulation) will take several years to design, implement and have their effects. And to the extent that the recent slowing has been driven by greater caution on the part of households, macroeconomic policy tools can, and should, also be used in response. Here, despite looser fiscal policy announced at the Autumn Budget, and cuts to Bank Rate, indicative estimates of the impact of policy, shown in Figure 6, suggest that policy is likely to be detracting from growth in the coming quarters and only turn positive later this year as the effect of rate cuts start to have an impact.

FIGURE 6: **Macro policy looks set to be detracting from growth in the coming quarters**

Estimated impact of macroeconomic policies on GDP growth: UK

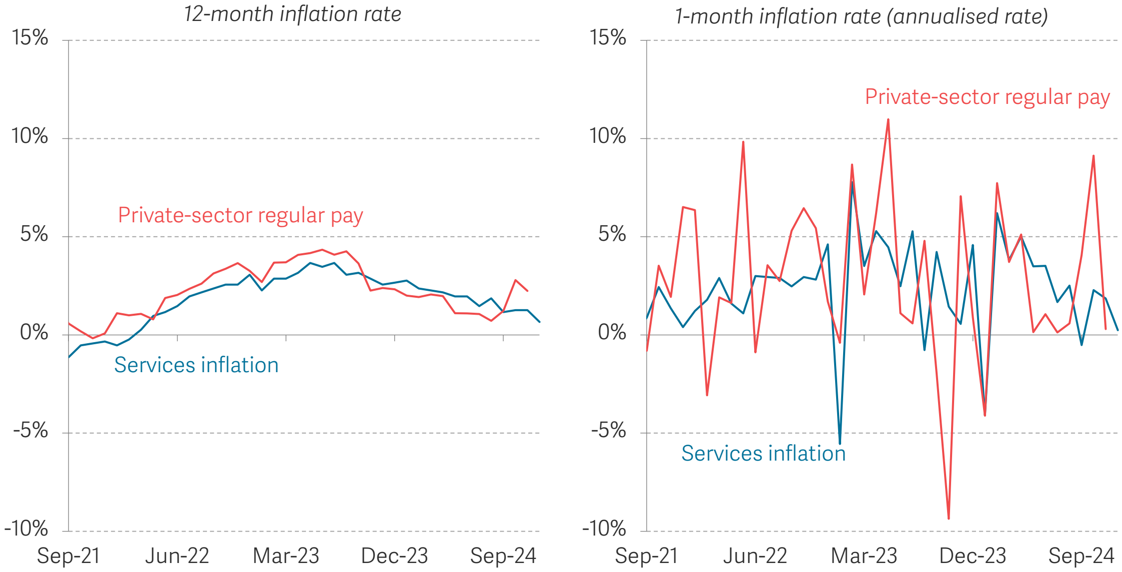


NOTES: Monetary policy impact is calculated using estimates from P Bunn, A Pugh & C Yeates, 'The distributional impact of monetary policy easing in the UK between 2008 and 2014', Bank of England Working Papers no.720, Bank of England, March 2018. This covers the Bank of England stimulus during the financial crisis. Subsequent changes in Bank rate and quantitative easing purchases are incorporated using equivalent scaling factors between policy changes and GDP. The fiscal policy impact is calculated based on a UK version of the Hutchins Center Fiscal Impact Measure, adjusted for the OBR's estimate of fiscal multipliers. More recent changes in Bank Rate are calculated using the Overnight Index Swap forward curve to 21 January with their growth contributions estimated using multipliers contained in S Burgess et al., The Bank of England's forecasting platform: COMPASS, MAPS, EASE and the suite of models, Bank of England Working Paper No. 471, 2013.
SOURCE: RF analysis of OBR, Economic and fiscal outlook, various; and Bank of England, Yield curves.

Further fiscal loosening appears risky given recent market developments, but the Bank of England may have space to respond to the deterioration in the outlook. So far, the Bank has been cautious in cutting rates, reflecting concerns about the stickiness of inflation. As shown in the left panel of Figure 7, annual inflation rates for the key measures of underlying domestic inflationary pressure emphasised by the Bank – services inflation and private-sector regular pay growth – remain elevated. This creates a dilemma for interest-rate setters wanting to support a slowing economy but also worried about higher inflation becoming entrenched. Encouragingly, high-frequency measures of services inflation – although volatile – appear close to levels that in the past have been consistent with meeting the inflation target. Developments in wage growth have been more worrying, with an acceleration in monthly private-sector regular pay growth in September and October. Monthly wage inflation in November was, however, more encouraging. If this continues, it should allow the Bank to cut rates more quickly than markets expect.

FIGURE 7: **Measures of underlying inflation are close to levels consistent with the 2 per cent target**

Deviation of 12-month (left panel) and 1-month (right panel) inflation rates from their 2000-2008 average



NOTES: Chart shows deviation of inflation from its 2000-2008 average which for both services inflation and private-sector regular pay is around 3.7 per cent, a period during which CPI inflation averaged 1.8 per cent. 1-month services inflation rate is calculated by seasonally adjusting the price index using X-13.
SOURCE: RF analysis of ONS, consumer price statistics.

An indecisive response to higher interest rates at the March OBR forecast risks further market jitters

Overall, then, although much of the rise in gilt yields in recent months has been driven by international factors, this is little comfort to the Chancellor, as the rise in interest rates since the Autumn Budget will matter for both public and family finances. And although concerns may have receded for now, the higher sensitivity of UK risk premia to changes in investor sentiment suggests there is a significant risk that they reemerge. With the next official forecast due on 26 March, the Government's commitment to bring borrowing for day-to-day spending to zero by the fifth year of the forecast stands on a knife edge given the rise in debt-servicing costs since the Autumn Budget. That rise adds around £7 billion to borrowing annually, nearly wiping out much of the thin £10 billion margin the Chancellor allowed at the Autumn Budget. If yields rise again, or if there are other changes to the OBR forecast, this could easily leave the Government in breach of its fiscal rules. If that happens in March, there is a question about how the Government should respond.[1] Recent market jitters and increased sensitivity to investor sentiment suggest that doing nothing would increase the risk of further volatility, even if, as we have previously argued, tightening policy would worsen the already grim growth outlook. Indeed, having committed to a set of fiscal rules, there is a strong argument for taking action to meet those rules, not least because this would reduce the risk of further increases in the cost of borrowing. Such an approach should be seen in the context of a longer-term need to rebuild fiscal space: unless fiscal pressures – such as those from health and defence spending – recede dramatically in the coming years, it is likely that higher taxes will be needed at some point during this Parliament, and so the Chancellor should not rule them out if they become necessary in March.

[1] In this context it is unfortunate that the extra buffers built into the fiscal framework for just this sort of situation won't apply until the third year of this Parliament, at which point a current deficit of up to 0.5 per cent of GDP in the third year of the forecast will be deemed consistent with the Government meeting its fiscal rules.

Resolution Foundation

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We do this by undertaking research and analysis to understand the challenges facing people on a low to middle income, developing practical and effective policy proposals; and engaging with policy makers and stakeholders to influence decision-making and bring about change.

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