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An end to the political chaos?

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The appointment of Rishi Sunak as the UK's new prime minister has been met with a positive market reaction as a line is drawn under the ill-fated 'Trussonomics' experiment. After a turbulent period for the UK we now expect a period of relative calm. For Sunak, the challenge will be to restore fiscal discipline amid dwindling public support and a faltering UK economy.

The new PM seeks to restore credibility

Liz Truss became the shortest-serving prime minister in UK history following her resignation after just 44 days in office. Her successor, Rishi Sunak, has been chosen in rapid time. Candidates needed to reach 100 nominations from Conservative MPs (there are 357). It became clear that Sunak's main rivals (Boris Johnson and Penny Mordaunt) could not muster enough support and both dropped out of the race. This meant that Sunak was selected as Conservative leader without the scheduled vote of party members to separate the two leading candidates.

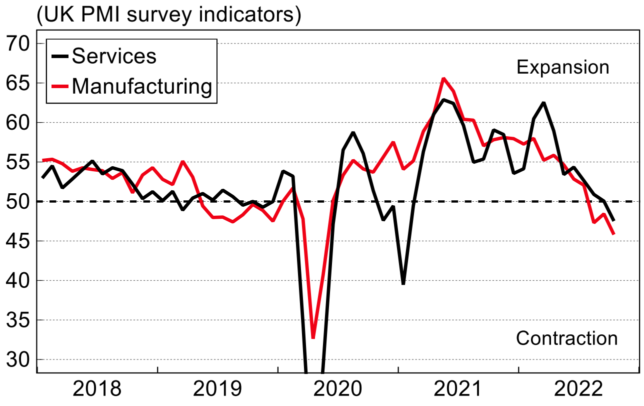
There should now be a period of relative stability after the turmoil of Truss. Sunak, previously UK chancellor, ran against Truss in the previous leadership election on a platform of fiscal discipline. His warnings that her plans were a 'fairy tale' and would drive up interest rates were vindicated (see here), and so he comes into his new role with credibility. The market reaction to the announcement he will be the new PM was clearly positive. He is pragmatic and can be seen as a safe pair of hands who will not pursue radical policies. Sunak supported Brexit but seems less likely to be needlessly antagonistic towards UK allies (in a way some of his predecessors may have been), which should reduce the chances of future bust-ups with the EU.

Political challenges will remain

While the change of prime minister is good news for UK financial stability, it is unlikely to be entirely plain sailing. Sunak has inherited an economy slipping into recession (Chart 1) and a deeply-divided Conservative Party. He has to immediately make significant tax and spend decisions (see below) and there may be internal opposition to some policies. The fact that Sunak achieved the support of a strong majority of the parliamentary party combined with the brevity of his predecessor's term in office means that he should be safe from leadership challenges for a while. However, there is a risk of an early election (the next is due to be held by January 2025) should he struggle to find support for his economic policies in parliament.

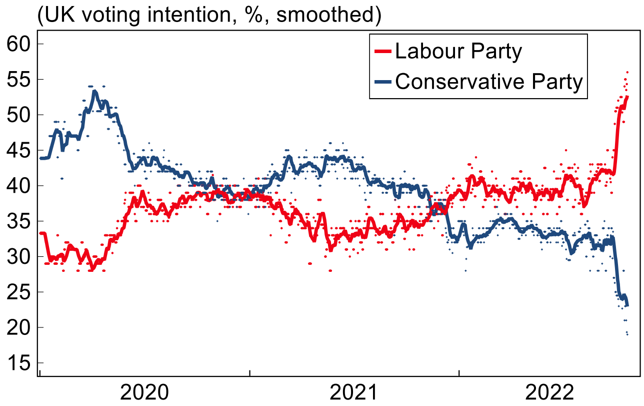
Sunak's profile increased sharply during the pandemic as he introduced the furlough scheme and subsidies for restaurant meals, but his electoral appeal with the wider public has not been tested. Nonetheless, we expect he will enjoy something of a honeymoon period in the polls. Frankly, it's hard to see how the figures can get much worse for the Conservatives. But it will be a big ask to overtake Labour's lead (Chart 2) as cost of living pressures mount. Households will increasingly feel the pain from more expensive mortgage payments as fixed term deals expire. Rates would have increased regardless as central banks tighten policy, but this will be indelibly linked in the minds of many to policy choices made by Conservative governments.

CHART 1: UK SLIPPING TOWARDS RECESSION



Source: IHS Markit, MUFG Bank Economic Research Office

CHART 2: LABOUR HAVE OPENED A LARGE LEAD



Source: Europe Elects, MUFG Bank Economic Research Office

Prediction markets are currently suggesting that Labour have a 62% probability of winning the most seats at the next UK general election. Our takeaway from the recent party conference was that Labour would take a more moderate approach to fiscal policy in power, at least initially, than may have been the case in the past. The Truss experience also will serve as a strong deterrent against big spending pledges. However, the fact that a change in government within two years is plausible may weigh on areas such as business investment, which has seen anaemic growth for some time, given the prospect of significant regulatory shifts.

A tough balance between spending cuts and tax increases

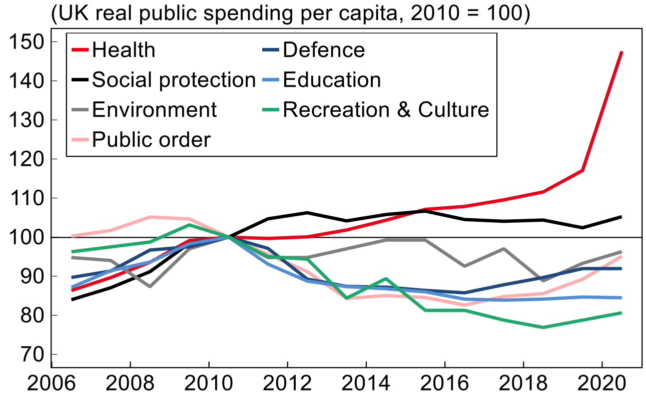
During his period as chancellor (February 2020 – July 2022), Sunak did not introduce any notable cuts to government expenditure. As well as the pressures of the pandemic, that was probably due to reluctance from Boris Johnson to make unpopular decisions. Sunak was then criticised from within his own party for putting the UK on course to have a historically high tax-to-GDP ratio of 36% as he sought to balance the books. Despite this, Sunak's natural instinct is probably to cut taxes when possible. But, he will be wary of the inflationary effect of doing so and conscious of the immediate need to put the UK on a sustainable fiscal footing after the market reaction to 'Trussonomics'.

With the next election looming, and the Conservatives trailing in the polls, it will again be tempting to kick politically painful decisions on spending down the road. There are few obvious targets for cuts after post-GFC austerity (Chart 3), and any reductions in capital spending or services should be considered alongside the UK's longstanding issues with productivity growth.

In the absence of swingeing spending cuts, we think it will be hard to bring down the tax-to-GDP ratio (Chart 4) in the medium term. One of the few measures announced by Truss that was not reversed by new Chancellor Jeremy Hunt (see here) was the cancellation of the 1.25pp increase in National Insurance contributions. This increase was actually introduced by Sunak when chancellor to help support health and social care funding, and so he may be keen to see it go ahead. Another option will be to introduce 'stealth' tax increases – the freezing of income tax thresholds despite high inflation – to increase government revenues.

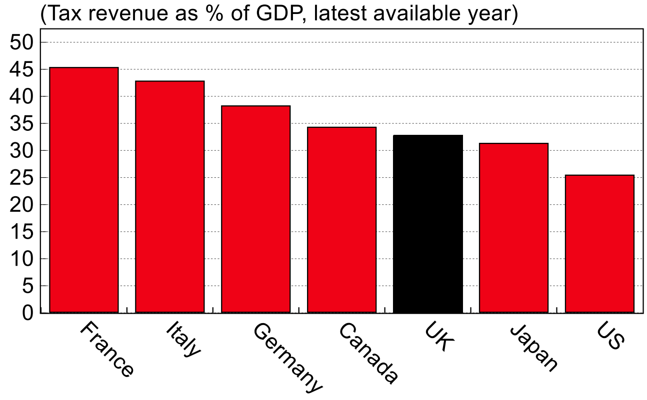
Sunak's fiscal priorities should be revealed next week. As it stands, a medium-term fiscal plan announcement is scheduled for 31 October, and this is to be accompanied by new OBR forecasts. The market reaction is likely to be minimal – a stark contrast to the fallout from the Truss 'mini' Budget.

CHART 3: THERE ARE FEW OBVIOUS TARGETS FOR SPENDING CUTS



Source: UK Treasury, MUFG Bank Economic Research Office

CHART 4: UK TAX-TO-GDP IS STILL LOW BY EUROPEAN STANDARDS



Source: OECD, MUFG Bank Economic Research Office

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