How (not) to run fiscal policy

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1. Outline

- Some basics on fiscal policy
- The Liz Truss 'mini-Budget'
- Rachel Reeves' first Budget
- Similarities and differences
- Some key messages
- Q&A

2. What I hope you will take from today

- Understanding of the fiscal framework
- Importance of ‘confidence’
- Links between financial markets, the public finances, and the ‘real’ economy
- Use of benchmarks and counterfactuals
- How to illustrate a point with a chart!

3. The UK fiscal framework

- Two good ‘fiscal rules’ (kudos to Reeves for these)
  1. current budget (revenues minus day-to-day spending) must be in surplus by 2029-30 (the ‘Golden Rule’)
  2. public sector net financial liabilities must fall as a share of GDP by 2029-30 (the debt rule)
- Progress against these targets is judged by the independent Office for Budget Responsibility
- OBR usually reports twice a year

4. How budget deficits are financed

- The government borrows by selling bonds (‘gilts’) which pay a fixed amount of interest regularly in the form of a ‘coupon’
- The interest rate on a bond is called the ‘yield’
- The average remaining life of conventional gilts is more than 10 years, so their yields are known as ‘long-term interest rates’
- The government also sells bonds whose value is linked to the RPI price index (inflation index-linked bonds, or ‘linkers’)

5. The role of QE

- The Bank of England bought gilts from commercial banks as part of Quantitative Easing (QE)
- It paid for these bonds using newly created money in the form of central bank reserves (deposits that commercial banks hold at the BoE)
- The BoE pays interest on these reserves at the Bank rate (currently 4½%) (the 'short rate')
- The BoE is part of the public sector so, in effect, QE has swapped borrowing via long-term gilts for borrowing in the form of short-term deposits

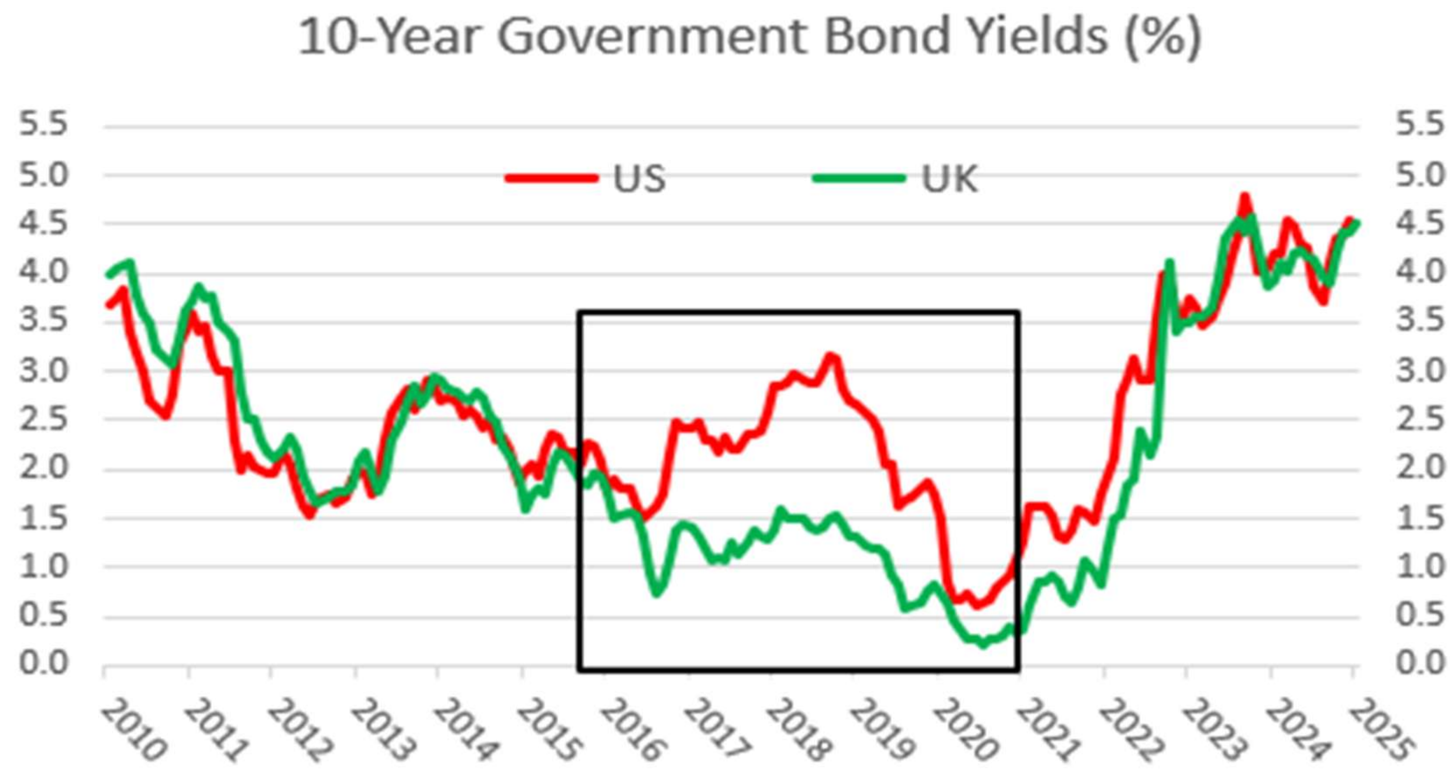
6. Why all this matters

OBR debt interest ready reckoner (£ billion)		
	2024-25	2029-30
1 percentage point increase in gilt rates	1.2	12.0
1 percentage point increase in short rates	8.1	4.7
1 percentage point increase in inflation	5.9	11.0
Increases are assumed to take effect at the start of 2024-25 and continue throughout the forecast.		

- A 1 percentage point rise in interest rates and inflation could add about £28 billion to annual borrowing in year five – more than wiping out any 'fiscal headroom'
- That's equivalent to more than 3p on the basic rate of income tax, and is greater than the planned increases in NHS spending in 2024-25 and 2025-26 combined

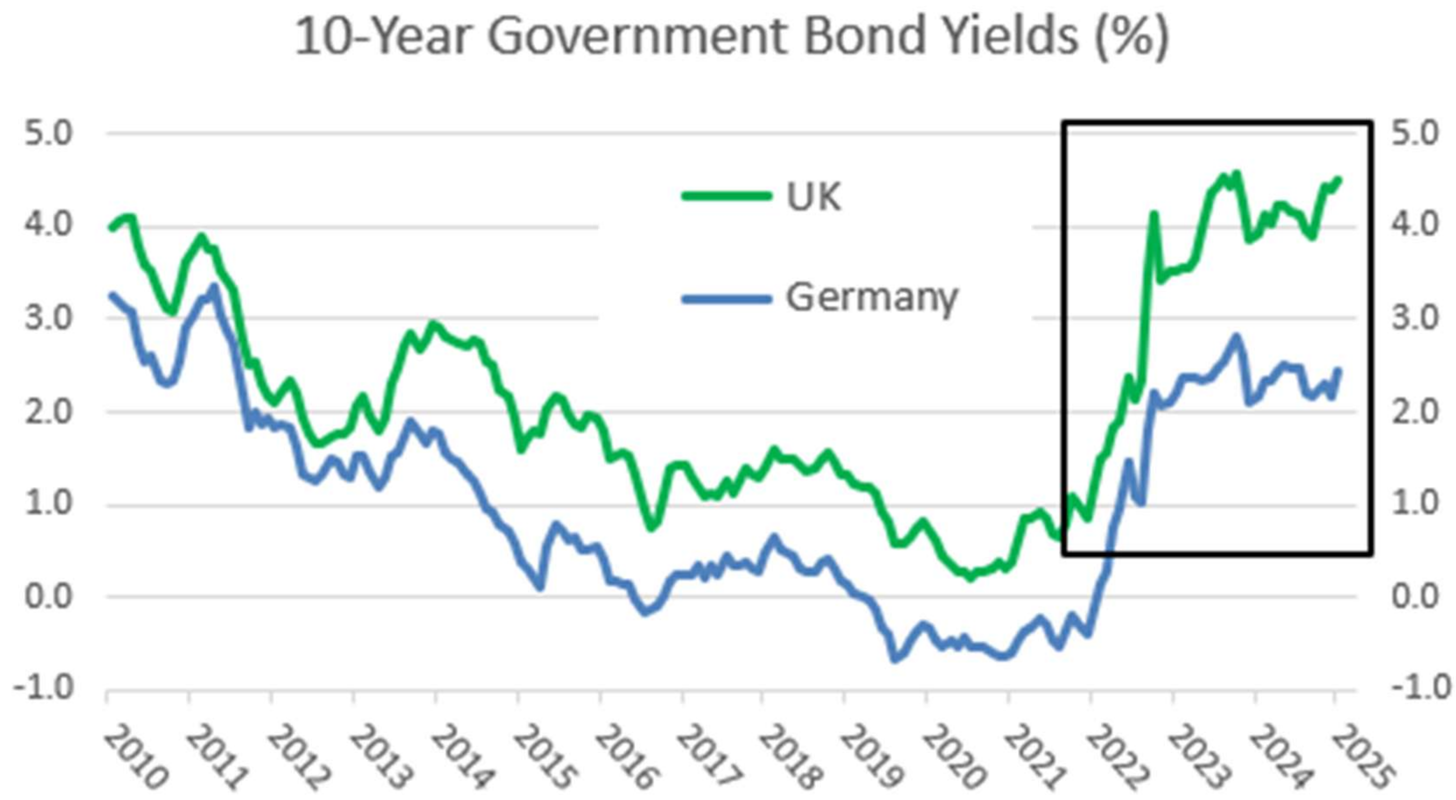
7. What determines bond yields?

- The main driver of UK bond yields is the global interest rate cycle, but local factors play some part too. This divergence was due to the Brexit vote and Trump 1.0…



8. A fiscal risk premium?

- Investors usually expect higher rates for holding UK than German bonds, but this spread has widened since 2022…



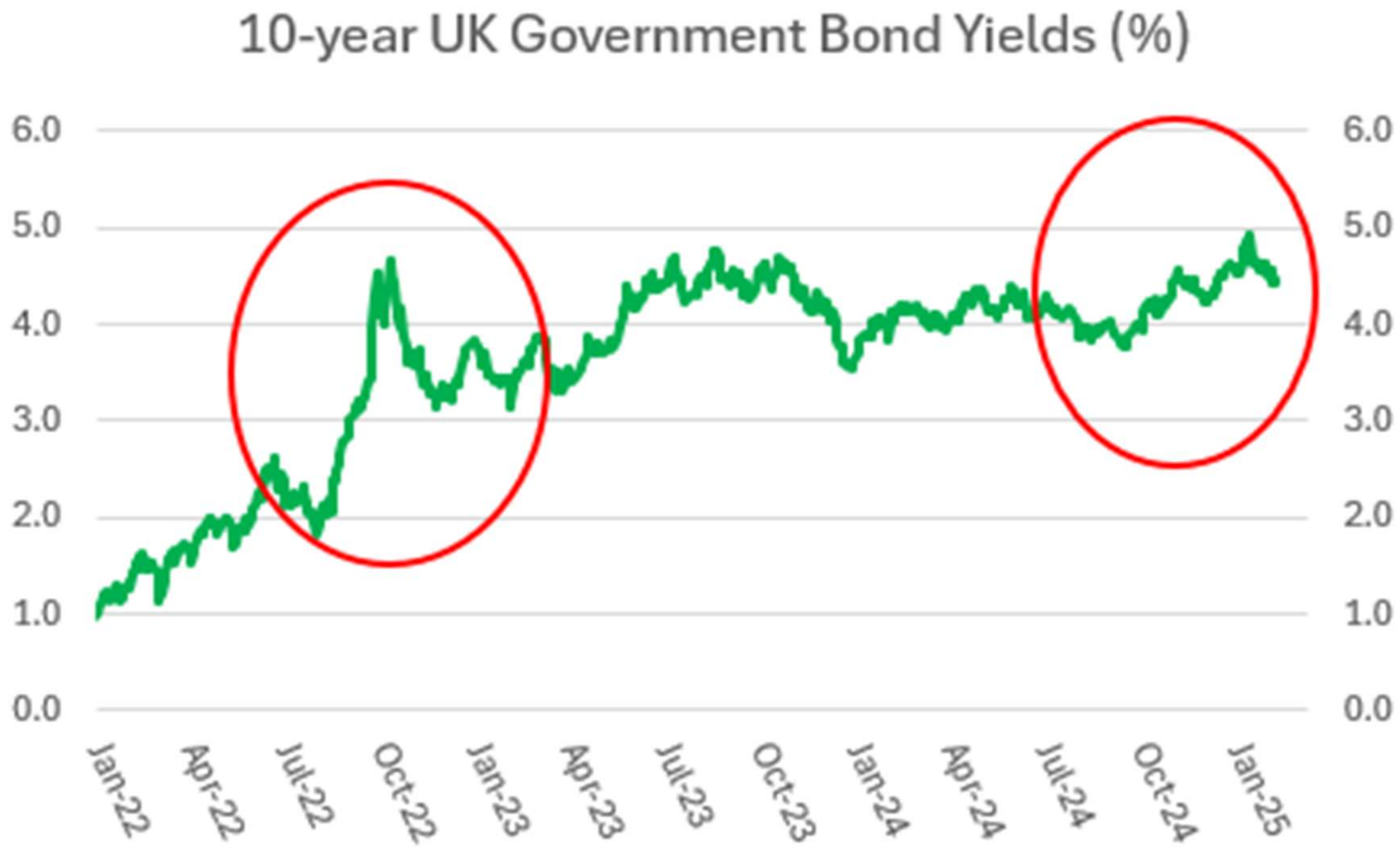
9. Why the gilt-bund spread has widened

- Investors are even more worried about the German economy and expect the ECB to keep euro interest rates low. But there is also a fiscal credibility problem in the UK.
- The UK is not expected to go bust (unlike Greece in 2012).
- However, investors are concerned about
  a) more government spending driving up inflation
  b) tax increases weakening growth and not raising as much revenue as expected ('the doom loop')
  c) more borrowing meaning a lot more bonds to buy (extra 'issuance')

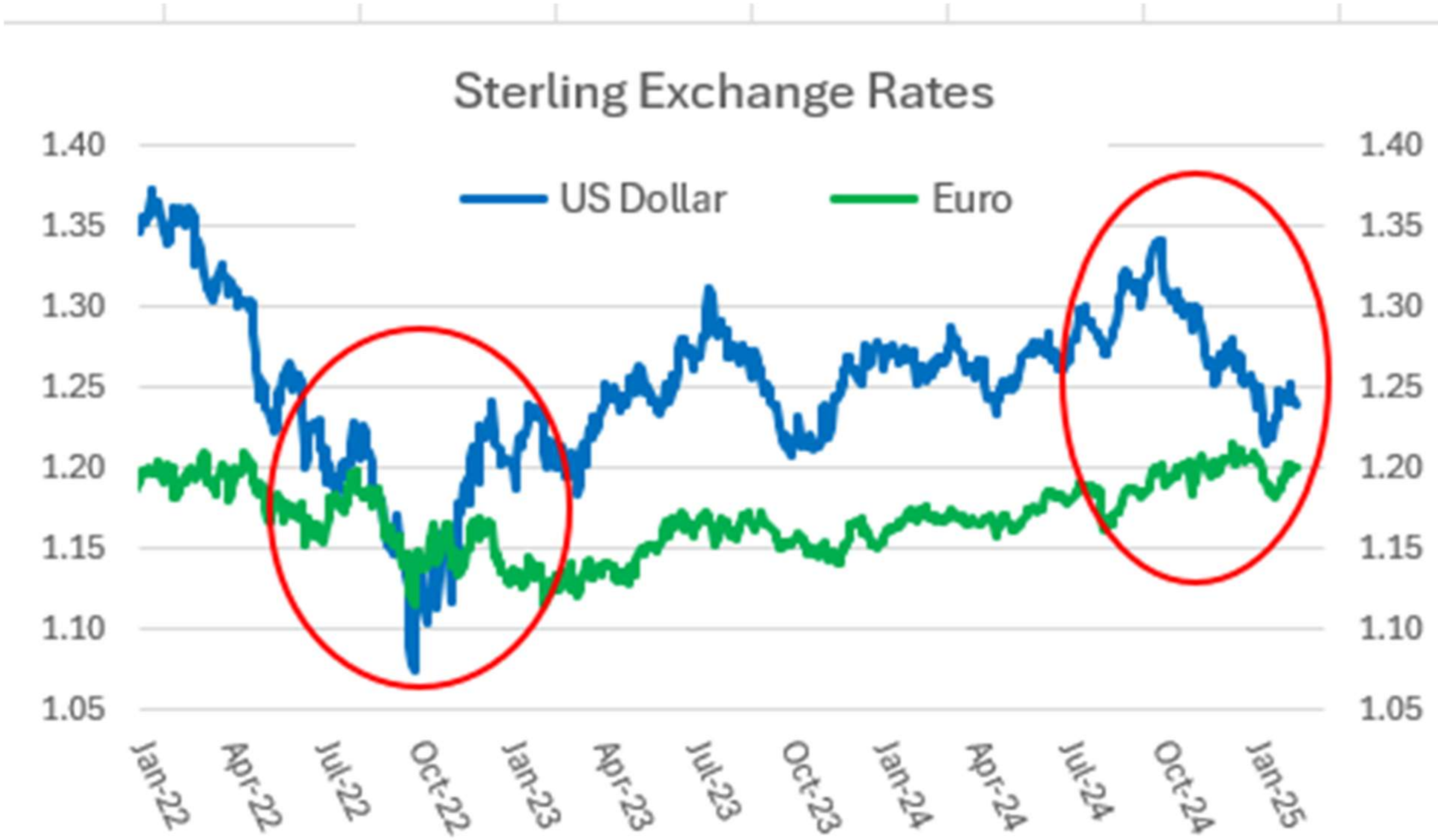
10. Liz Truss timeline

- 7th July 2022: Boris Johnson resigns as PM
- 5th September: Liz Truss wins Tory leadership, with a “bold plan” to cut taxes, grow the economy, and cap energy bills.
- 8th September: PM Truss announces a new Energy Price Guarantee. HM the Queen dies.
- 23rd September: mini-Budget. Markets react badly.
- 3rd October: U-turn on 45p rate of income tax.
- 14th October: Chancellor Kwarteng sacked. Hunt takes over.
- 20th October: PM Truss resigns.

11. Compared to 2024, gilt yields rose relatively sharply in 2022 over a much shorter period



12. The pound also fell in 2022 against both the US dollar *and* the euro

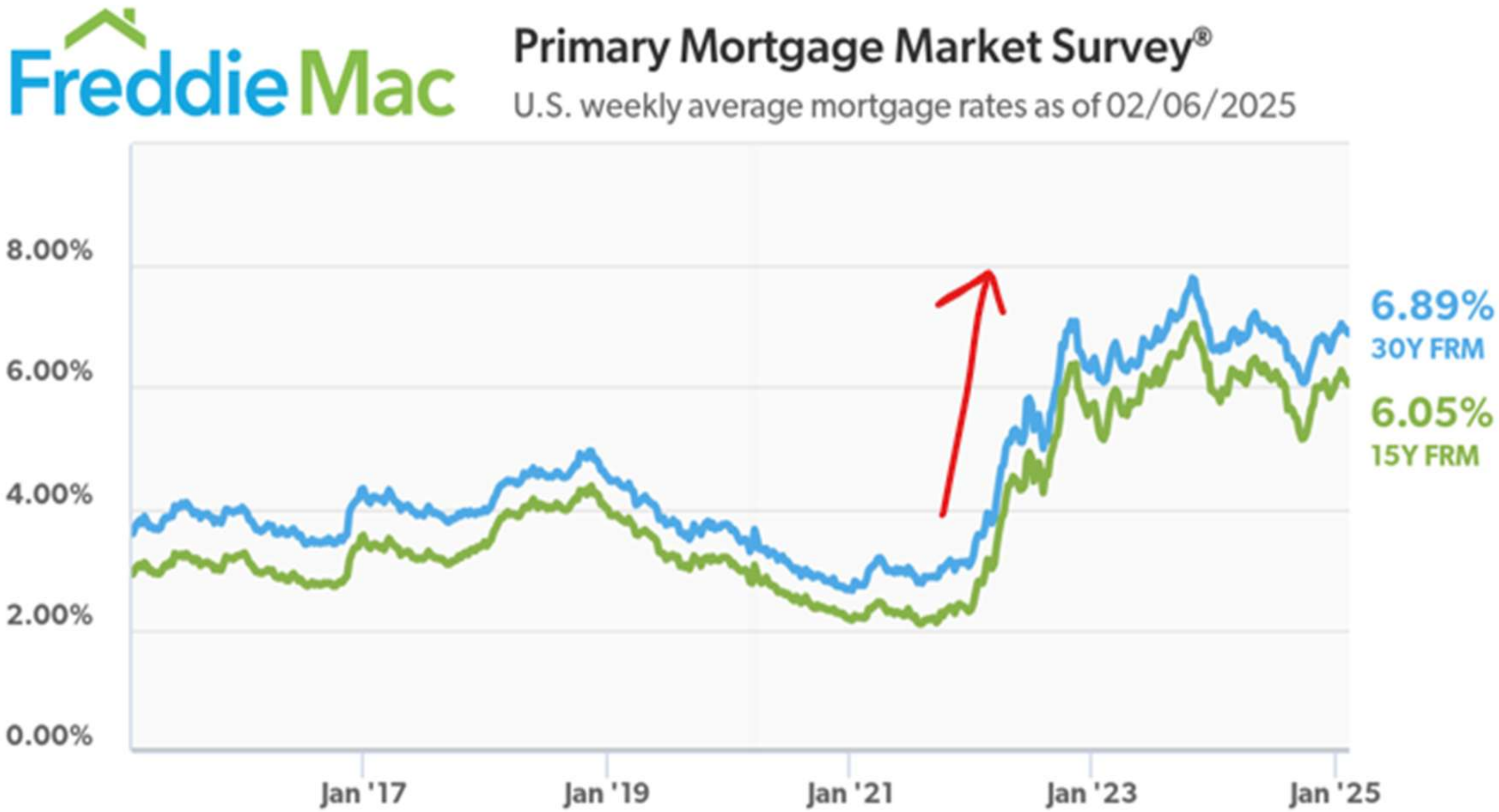


13. What went wrong?

1. Leadership debates focused on tax cuts, without any serious discussion about which taxes to cut, why and when
2. Truss wanted to challenge 'groupthink', but this was interpreted as 'trashing' the institutions themselves, including the Treasury, Bank of England and the OBR
3. Energy Price Guarantee was potentially hugely expensive (an estimated £60bn for the first six months)
4. Mini-Budget surprised the markets by bringing forward a 1p cut in basic rate of income tax (even though was costed at just £5bn) and abolishing the upper 45p rate (just £2bn)

14. Some bad luck (or bad timing) too

- Markets were already on edge because of worries about rising interest rates in the US – including mortgage rates



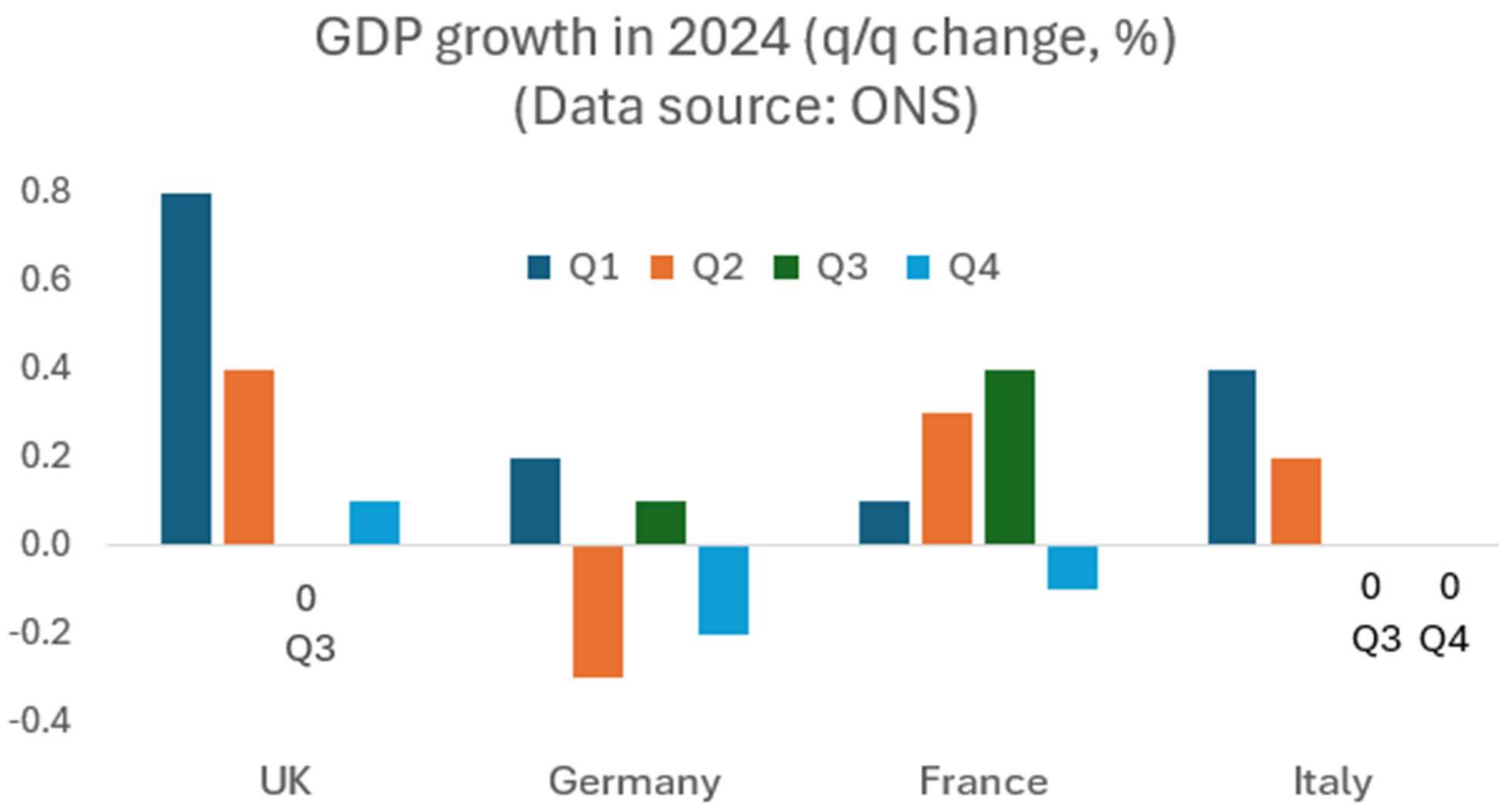
15. Was the Bank of England also to blame?

- Two other factors compounded the jump in bond yields
- First, the Bank of England launched Quantitative Tightening (QT) – selling back some of the bonds it had bought under QE
- Second, officials seemed unaware of a ticking time bomb in the pensions market caused by the increased use of liability-driven investment (LDI) strategies
- In short, this set off a vicious spiral of margin calls and forced gilt sales, driving up yields further and requiring the Bank to intervene by buying gilts back again

16. Rachel Reeves timeline

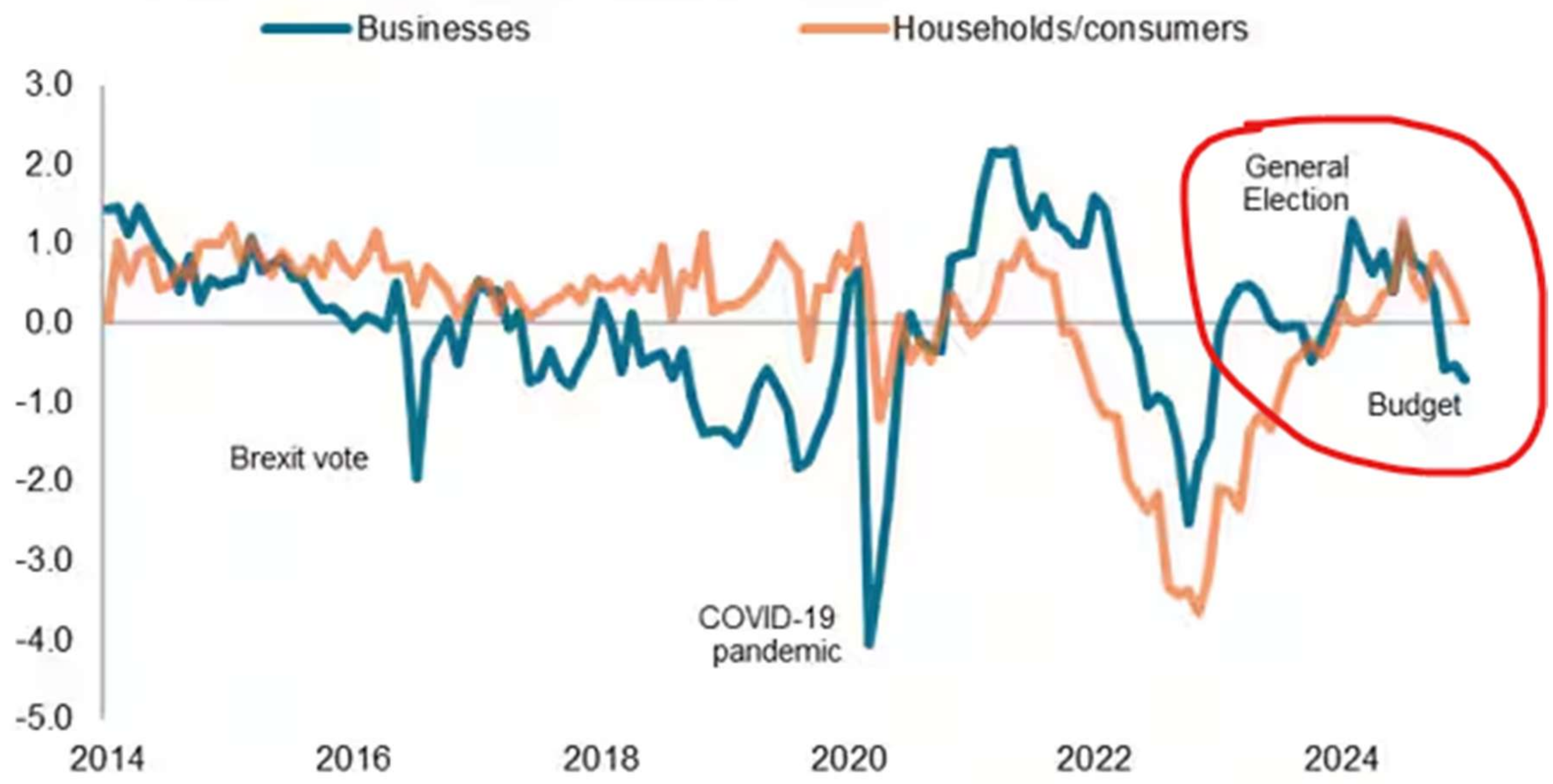
- February 2024: the then shadow Chancellor warns of "the worst inheritance any incoming government will have had since the Second World War"
- 4th July: Labour win General Election on a manifesto promising not to raise taxes on 'working people'
- 24th July: Chancellor's statement on public spending, including claims of a £22bn 'black hole' and the announcement that Winter Fuel Payments will be restricted
- 30th October: Budget includes large and sustained increases in spending, tax, and borrowing, including big increases in employer's National Insurance (NI) contributions

17. The UK economy has weakened relatively sharply since the general election



18. Confidence has fallen too

UK confidence indicators for the year ahead



Data to January 2025.

Business confidence measured by S&P Global flash PMI future output expectations covering manufacturing, services and construction. Consumer confience measured by S&P Global CSI survey. Both shown as z-scores whereby 0 = long run average.

Source: S&P Global PMI, S&P Global Market Intelligence.

19. Truss and Reeves – some similarities

1. Both prioritised growth and supply-side reforms (though with different approaches to spending and tax)
2. Both lost the confidence of bond market investors (despite Reeves' far more orthodox approach)
3. Both hit by bad luck, or at least bad timing (in Reeves' case, Trump 2.0 and a sharp slowdown in the euro area)
4. Reeves' "Securonomics" doesn't appear to be working any better than "Trussonomics"
5. But both also unfairly lampooned ('the Lettuce' vs. 'Rachel from Accounts')

20. Truss and Reeves – some differences

1. The adverse reaction in the markets was much worse in 2022 than in 2024 (but this was not just down to Truss)
2. The 2024 Budget has gone down much worse with business and consumers, and increased recession risks. The jury is still out on the longer-term impact
3. Truss did not 'crash the economy', because the economy did not crash. Arguably it is 'crashing' now, with the private sector cutting jobs in response to higher costs
4. Rachel Reeves' position still looks secure. Recovery in Europe, lower UK interest rates, and the benefits of higher public investment could all come to her rescue.

21. Some key messages

- Condolence is important: consumers and businesses like certainty and positivity, and markets hate surprises
- With public debt this high, even a small premium on interest rates can hurt the public finances – and drive up borrowing costs in the rest of the economy too
- Balance is important as well: overly-tight fiscal rules and broken tax promises can be just as damaging as having no rules at all (or appearing to ignore them)
- Chancellors are still at the mercy of external factors
- A credible plan for growth is essential to reduce borrowing and debt

Questions and discussion

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