



The UK's Triple Crisis: Currency, Gilts and Policy

By John Greenwood

Introduction and Overview

- Just as emerging markets (EMs) are sometimes faced with a triple crisis, the new UK government led by Liz Truss has been confronted with a triple crisis in its first month in office. Whereas EM crises typically comprise a currency crisis, a debt crisis, and a banking crisis, in the case of the UK the crisis has been comprised of a **currency crisis, a pension crisis arising from the plunge in the gilt market, and a crisis of credibility for the government's fiscal strategy.**
- **The currency crisis** has, at least in the short-term, been largely overcome thanks to the actions of the Bank of England in the gilt market. However, with the Fed still raising rates faster than other major central banks, the USD will likely continue to strengthen not only against the GBP but also against the JPY and the EUR.
- **The joint pension and government debt crises** are by no means over and will require significant overhauls of the regulatory framework for pensions, fiscal strategy, and – in my view – monetary policy before financial markets will acquiesce in the new regime.
- Against this background, the UK stock market should be viewed as vulnerable to further setbacks. In effect, equities have fallen due to interest rate concerns, but the depth of the coming slowdown and its implications for earnings growth are not yet reflected in stock market values.
- The combination of weak sterling and persistent domestic inflation through 2023 will raise gilt yields and borrowing costs right across the economy.
- When monetary and fiscal policy are working in opposite directions – as in the present UK tight monetary policy/easy fiscal policy mix – monetary policy invariably dominates. This implies that it will be several years before Liz Truss's growth ambitions for the economy can be realised.

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The IMM Newsletter offers economic research written by John Greenwood, founder and Chief Economist of International Monetary Monitor Ltd. John was also the publisher, editor and lead author of **Asian Monetary Monitor**, a bi-monthly publication that he operated for 20 years from Hong Kong between 1977 and 1996. He was a pioneer of monetary research in Asia. From 1999 to 2021 he was Chief Economist at Invesco, based in London.

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Introduction: Timeline of the UK Financial Crisis

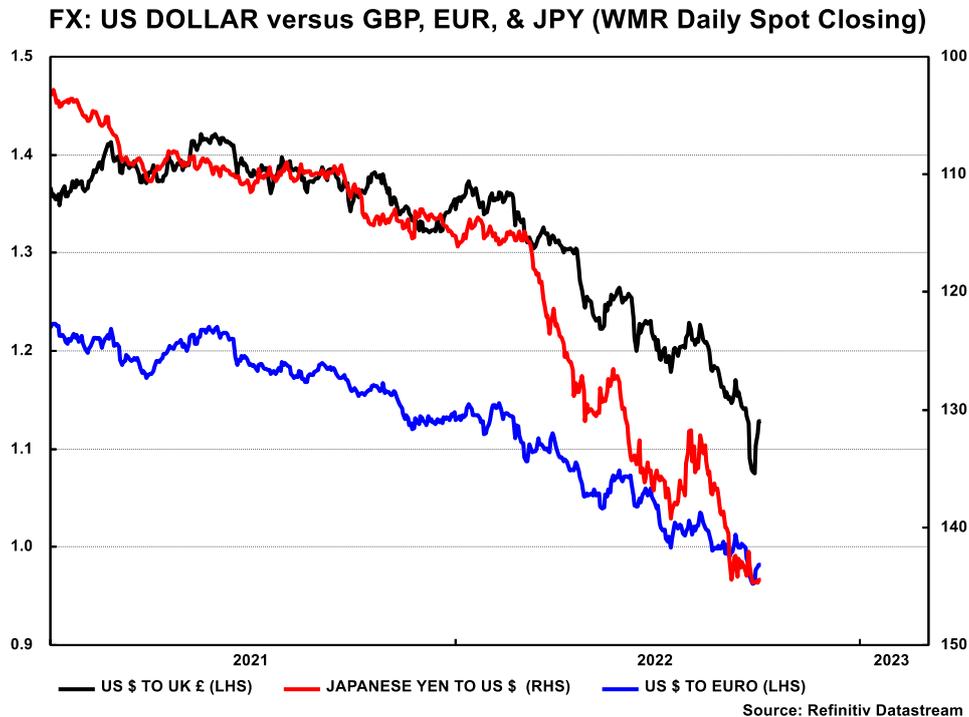
The recent UK financial crisis developed very rapidly, presenting a shock to analysts and investors alike. Before tackling the three parts of the crisis, here is the timeline that has unfolded since the last meeting of the Bank of England's Monetary Policy Committee (MPC).

- **Thursday, Sept 22** – Decision by BOE's MPC to raise rates by 0.5% (only) to 2.25%. This is to be compared with the decision of the FOMC in Washington DC the previous day to raise the range for the Fed funds rate by 0.75% to 3.0-3.25%. (The MPC's vote was split: 3 for +0.75%, 5 for +0.5%, 1 for +0.25%). Sterling against the US dollar GBP slipped to US\$ 1.1262; 10-year gilt yields closed at 3.491%.
- **Thursday, Sept 22** – At the same meeting, the MPC also decided (unanimously) to reduce the Bank's holdings of UK government bonds (gilts) by £80 billion over the next 12 months.
- **Friday, Sept 23** – Statement by Chancellor of Exchequer in parliament, cutting taxes by £45 billion. No Office of Budget Responsibility (OBR) assessment or forecast of government revenues, expenditure, the deficit or future debt levels – normally released alongside such fiscal statements – was issued with the statement. The pound sterling (GBP) fell to US\$1.0903, and 10-year gilts sold down to yields of 3.826%.
- **Monday, Sept 26** – Statement by the Bank of England Governor, Andrew Bailey. GBP fell to 1.0791; the 10-year gilt sold off again to close at 4.235%.
- **Wednesday, Sept 28** – In a reversal of the decision on September 22nd, the BOE announced that it would make temporary purchases of long-dated gilts (with maturities exceeding 20 years) of up to £5 billion per day for 13 days until Oct 14, "to restore orderly markets". The previously planned £80 billion sales of gilts were put on hold until October 31.
- **Wednesday, Sept 28** – Following the Bank of England's 1st auction (for £1 bn), 30-year gilt yields fell from 5% to 3.93%. GBP closed up at US\$ 1.0891.
- **Monday, Oct 3** – The Chancellor abandoned his earlier decision to scrap the 45% higher tax rate, saying that it was generating debate that was a distraction from the government's main agenda of reviving real economic growth.

1. Currency Crisis

In economies with floating exchange rates, and especially those like the British and Australian economies that maintain relatively low levels of foreign exchange reserves, any major crisis of monetary or fiscal policy, or any crisis affecting the banking system as a whole, it is typically the currency that takes the full force of the crisis. Sellers of shares, bonds or real estate must sell not only the specific asset class, but also the underlying currency in order to eliminate their exposure completely. For example, during the Brexit crisis in 2016 the pound was heavily sold. Similarly, during some episodes of unrest or political instability in Hong Kong, the currency has been driven to the weak side of its "convertibility undertaking" – i.e., the lowest level of the trading band for the currency.

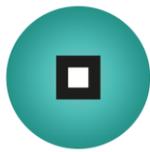
Figure 1: GBP weakness and USD strength reflect Fed rate rises greater than those of other central banks



The recent plunge of sterling was kick-started by the decision of the MPC on September 22nd **not** to follow the Fed’s FOMC (on September 21st) in raising interest rates by the 0.75% which had been widely anticipated by participants in financial markets. Until that point the Japanese yen had been falling more rapidly against the USD on the basis that Governor Kuroda was going to maintain the BOJ’s policy of yield curve control (YCC) with yields on 10-year JGBs as well as on overnight rates being maintained at close to 0%.

Looking ahead over the next several months, and particularly to the FOMC meetings scheduled for November 1-2 and December 13-14, the Fed will likely be raising rates faster than other major central banks. Current CME contracts for Fed futures (on October 3) show the greatest probabilities for rates of 3.75-4.00% at the Nov 2 announcement, and 4.25-4.50% at the Dec 14 announcement. These rate hikes (75 bps and 50 bps respectively) imply that the USD will likely continue to strengthen – not only against the GBP but also against the JPY and the EUR.

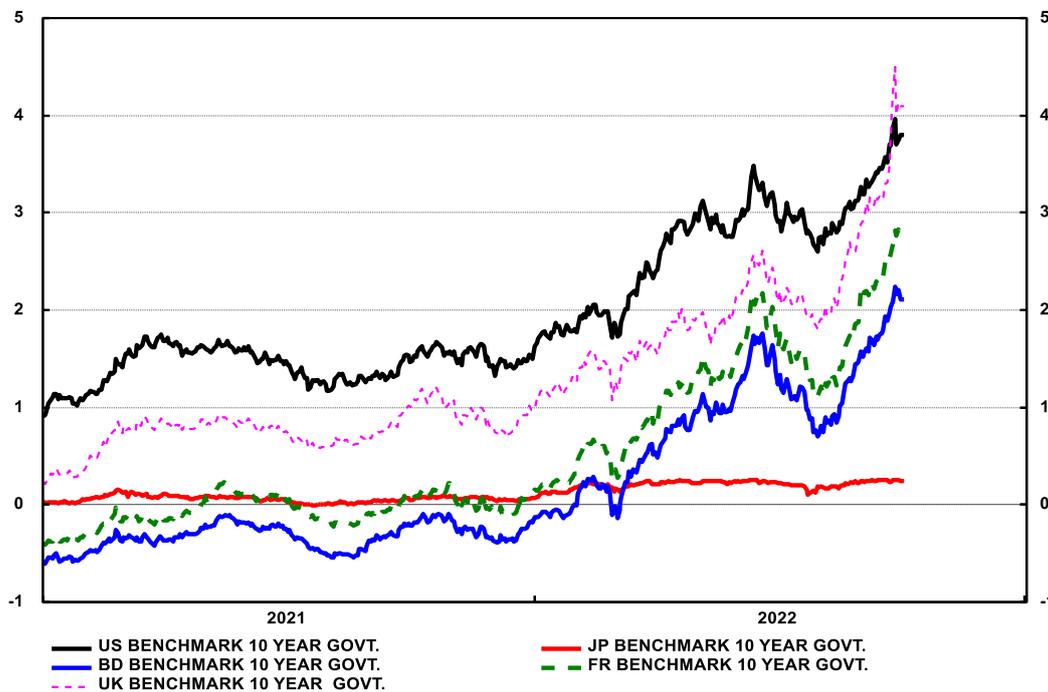
When should market participants reasonably expect the USD to peak? Only when the market starts to perceive a case for the Fed lowering interest rates. In the wake of (1) the market’s mistake between mid-June and mid-August of pushing equities up in anticipation of a Fed “pivot” towards an easier policy and (2) following the reaction of Chair Jerome Powell both at the Jackson Hole Symposium and at the Fed press conference on September 21st, it seems likely that markets will not become as exuberant any time soon. My guess is that it would not be until **next autumn at the earliest** that the Fed could start to be happy with the slowing of underlying inflation, and therefore be willing to embark on a series of easing steps.



2. UK Pension and Debt Crisis

Until September 28 the yields on 10-year US Treasury bonds had led the way when compared to yield on Japanese, German, French and UK government bond yields shown in Figure 2. However, the new Truss government's missteps catapulted 10-year UK gilt yields above 10-year US Treasury yields. Aside from the perceived lack of credibility in the government's overall fiscal strategy – to be dealt with in section 3 below – the crisis has exposed a serious regulatory problem in the market for UK defined benefit pensions.

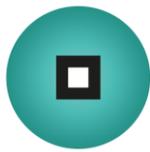
Figure 2: Until September 28, 10-year US Treasury yields led the way
GOVT BONDS: BENCHMARK 10-YEAR BOND YIELDS



Source: Refinitiv Datastream

In recent decades UK defined benefit pensions – those offering pensions relating to final salaries of employees – have been subject to a raft of new regulations, aimed primarily at ensuring “solvency” in relation to their liability to pay out benefits over a long period at dates in the relatively distant future. On the one hand this has led to regulations concerning the valuation of pensions which are onerous, requiring pensions to be invested in a narrow group of assets that will guarantee returns matching actuarial demands of the regulators. In practice this has meant that pension managers have been compelled to invest a substantial portion of pensions in long-dated government securities, including index-linked gilts. Given the extraordinarily low yields on gilts in recent years, especially since the GFC and the adoption of QE policies, the prospective returns on pensions have also dropped significantly.

In turn, this has led pension managers to seek out higher return instruments, while satisfying the demands of the regulators with a part of their portfolio that is committed to Liability Driven Investment (LDI). LDIs are used primarily by pension



funds to match long term liabilities they have to retirees with less capital than they would by owning regular long-dated government bonds alone. While in principle LDI products aim to help pensions close the gap between their liabilities to retirees and the funds they have on hand by enabling them to invest less in hedging interest-rate risk and more in high-growth assets such as stocks or property, at the same time they expose the funds to losses if interest rates rise rapidly – as they have done recently.

The problem is that to cover their liabilities, investment managers in the LDI pension market have used derivative instruments which have embedded leverage. It is this which has triggered the crisis following the recent big moves in interest rates. In the Covid market panic of March 2020, for example, the Bank of England noted that LDIs had contributed significantly to the instability. To give a sense of the magnitude, of the LDI market, pensions and others like insurance companies had invested £1.6 trillion in LDIs by 2021, up from £400 billion in 2011, according to trade group the Investment Association.

The process works something like this. A pension fund invests money with an LDI manager. The LDI enters into trades that try to match a pension fund's liabilities through a combination of bonds and derivatives such as interest-rate swaps and repo trades. According to one consultant, derivatives allow a pension fund to “invest £1, and get £3 in exposure.” The same consultant estimated that of the 400 pension plans his firm advises, roughly two-thirds had been affected. As interest rates rose, the value of the LDIs fell, requiring the pension funds to post more collateral to back the investments. Pension managers therefore sold government bonds—as well as stocks and corporate bonds—to generate the cash to meet the collateral calls. These sales drove bond prices even lower, sparking a feedback loop that led to more losses in the LDIs.

Reflecting the losses likely to have been suffered in LDIs, shares in UK insurers and pension-fund managers were among the biggest losers in the stock market on September 28th, the day of the steepest losses, with some losing more than 6% despite the Bank of England bidding for gilts on the same day.

Ironically, the surge in gilt yields will ultimately benefit pension funds because the value of their liabilities will decline. But in the meantime, the magnitude of the crisis will oblige pension funds to rethink the level of leverage they use. Nevertheless, the LDI crisis points to the need for an overhaul of pension fund regulation away from overly prescriptive methods of valuation on the one side or usage of unwarranted leverage on the other.

3. The Credibility Crisis for the Government's Fiscal Strategy

The spill-over of the debacle in the markets for pensions and gilts extends to fiscal strategy, and – in my view – monetary policy. Undoubtedly one of the triggers for the crisis was the announcement by the newly appointed Chancellor of the Exchequer, Mr Kwasi Kwarteng, on Friday, September 23rd of unfunded tax cuts to the tune of some £45 billion. At the best of times such a bold set of tax cuts, designed to improve



the “supply side” of the economy, would have faced considerable scepticism both in the financial markets and amongst academic, government and business economists. But to attempt such a far-reaching fiscal reset in the teeth of the Bank of England tightening monetary policy was truly astonishing.

The details of the Truss/Kwarteng fiscal plan need not detain us here. The essential point to grasp is that, **contrary to conventional analysis, fiscal and monetary policy are not equivalent levers for economic stimulus or restraint.**

The reason is that there are only three ways to finance a budget deficit.

- 1. First**, the authorities can raise taxes. Taxes take money (income) from the private sector and put it into the hands of government to spend. There is no net stimulus because the spending by the government is offset by less spending by the private sector.
- 2. Second**, the funds for a larger budget deficit can be borrowed from the private sector¹. But if the private sector lends the funds to the government, those funds are no longer available to lend to private sector investors to build homes or factories or invest in other businesses. Again, there is no net stimulus to the economy from government borrowing.
- 3. The third** and only other way to finance a larger budget deficit is to create new money to fund the incremental spending—i.e., to “print the money”. In the normal case this happens when the central bank keeps interest rates too low for too long, generating a large demand for loans and expanding the money supply as a consequence, or if it keeps the exchange rate too low and generates a large inflow of foreign currency that gets converted at a fixed rate, creating new domestic currency in the process. In both these cases, the banks are creating the new or excess money.

Equally, this is what happened under QE when the central bank purchased securities from non-banks with new reserves created out of thin air. The act of purchasing securities from non-bank holders by the central bank placed newly created deposits in the hands of the sellers of those securities. In other words, instead of the banks creating new money (as in the normal case), the central bank created the new money.

But these last two instance (both part of 3) — money creation by the banks or money creation by the central bank — are not acts of fiscal policy; they are monetary policy actions. In short, (1) and (2), which are fiscal policy actions, are non-stimulative whereas (3), a monetary policy action, is stimulative.

¹ In addition to the domestic private sector, the deficit can be financed from abroad by non-residents, foreigners, or foreign financial and non-financial institutions. But all these entities must first obtain domestic currency, which in practice they will purchase from the private sector, which in turn acquires foreign assets. In this case, the funds available to lend to the government are unchanged; only their ownership has changed.



The importance of this discussion in the context of the UK situation today is that for the next year or more monetary policy is set to be restrictive if not actually contractionary. Fiscal policy, on the other hand, is set to be “expansionary”. Since we know, from the discussion above, that fiscal policy on its own cannot be either expansionary or contractionary, it is meaningless to talk of the Truss government stimulating the economy with tax cuts.

More generally, as illustrated in Figure 3, whenever monetary and fiscal policy are operating in opposite directions it is always monetary policy that dominates – for the same reason that I have put forward above i.e., that fiscal policy is never stimulatory unless financed by the creation of new/excess money growth.

Figure 3: The Interaction of Monetary and Fiscal Policy

		MONETARY POLICY	
		Expansionary	Contractionary
FISCAL POLICY	Expansionary	Case A Both Monetary & Fiscal Policy Expansionary	Case B Monetary Policy Contractionary, Fiscal Policy Expansionary
	Contractionary	Case C Monetary Policy Expansionary, Fiscal Policy Contractionary	Case D Both Monetary & Fiscal Policy Contractionary

The matrices in Figure 3 provide an overall framework for analysing the interaction of monetary and fiscal policy. In the case of both monetary and fiscal policy there are two options in each case: expansionary and contractionary monetary and fiscal policies. The cases that interest us most are those where the policies are operating in opposite directions -- i.e., Case B where monetary policy is contractionary or tight but fiscal policy is expansionary, and Case C where monetary policy is expansionary but fiscal policy is tight or contractionary².

² NB In each case, monetary policy should be measured *not* by the direction of interest rates but by the direction of change in the rate of growth of broad money. Ideally, the fiscal stimulus is measured by the

Since the Bank of England will necessarily be tightening monetary policy (to correct the errors resulting from “Going big in 2020-21” – see IMM Newsletter #3), but the government is lowering taxes and likely to be enlarging the budget deficit, the situation faced by the UK today is that depicted in Case B. Can such a policy combination succeed in reviving the economy in the short to medium term?

To answer that question, it is useful to populate the matrix with real world cases as shown in Figure 4.

Figure 4: The Interaction of Monetary and Fiscal Policy – Some Cases from International Monetary Experience³

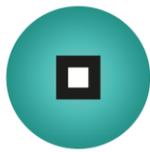
		MONETARY POLICY																																	
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FISCAL POLICY	Expansionary	<p>Case A</p> <p>China's 4 tr Yuan Stimulus, 2008-10</p> <p>Change in Budget Balance (% of GDP)</p> <table border="1"> <tr> <th>2008</th> <th>2009</th> <th>2010</th> <th>2011</th> </tr> <tr> <td>-0.2</td> <td>-1.5</td> <td>+1.4</td> <td>+0.3</td> </tr> </table> <p>M2 Growth (% year-on-year)</p> <table border="1"> <tr> <th>2008</th> <th>2009</th> <th>2010</th> <th>2011</th> </tr> <tr> <td>14.7</td> <td>29.6</td> <td>19.5</td> <td>16.2</td> </tr> </table>	2008	2009	2010	2011	-0.2	-1.5	+1.4	+0.3	2008	2009	2010	2011	14.7	29.6	19.5	16.2	<p>Case B</p> <p>UK after the GFC, 2007-10</p> <p>Change in CABB* (% GDP):</p> <table border="1"> <tr> <th>2007</th> <th>2008</th> <th>2009</th> <th>2010</th> </tr> <tr> <td>-0.7%</td> <td>-2.0%</td> <td>-1.6%</td> <td>+1.5%</td> </tr> </table> <p>M4 Growth (% year-on-year)</p> <table border="1"> <tr> <th>2007</th> <th>2008</th> <th>2009</th> <th>2010</th> </tr> <tr> <td>10.6%</td> <td>3.7%</td> <td>1.6%</td> <td>2.5%</td> </tr> </table>	2007	2008	2009	2010	-0.7%	-2.0%	-1.6%	+1.5%	2007	2008	2009	2010	10.6%	3.7%	1.6%	2.5%
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Contractionary	<p>Case C</p> <p>Britain's 1931 Budget (Philip Snowden)</p> <p>Britain's 1981 Budget (Geoffrey Howe)</p>	<p>Case D</p> <p>Japan's <u>Matukata</u> Deflation 1881-85</p> <p>Japan's “Dodge Line” Squeeze, 1949-50</p>																																	

³ *In UK, fiscal stimulus is measured as percentage change in cyclically adjusted budget balance (CABB).

The most relevant past case study for the UK is what happened in the immediate aftermath of the GFC when the budget deficit ballooned to 10% of GDP and the cyclically adjusted negative budget balance (CABB) grew progressively by 2.0% of GDP in 2008 and 1.9% in 2009. Admittedly this policy was abandoned in 2010 when the Conservative government of David Cameron came to power (in coalition with the Liberal Democrats under Nick Clegg), and a subsequently much-reviled policy of

change in the cyclically adjusted budget balance (CABB), but in historical cases this may not be possible so alternative measures must be found.

³ The author has written a paper for the Institute of International Monetary Research at the University of Buckingham, “Milton Friedman on the interaction between fiscal and monetary policy” (2019) which explores the topic more fully. Copies are available from the author.



fiscal austerity was implemented. However, as Case B above reveals, at least as important was the tightening of monetary policy. Broad money growth as measured by M4 slowed from 10.7% in 2007 to 3.7% in 2008 and only 1.6% in 2009. Under any circumstances such a squeeze on monetary growth was bound to have serious consequences for the economy, as indeed it did.

Returning to the present case, a tightening of monetary policy (i.e., slower growth of broad money, M4x nowadays) will far outweigh any possible fiscal “stimulus” from the Truss/Kwarteng-led Conservative government since the relation between money growth and spending in nominal GDP is direct, generally stable, and trend-reverting in the medium term, whereas the relation between fiscal expenditures or the size of the budget deficit and spending on nominal or real GDP is highly unreliable.

Summary and Conclusions

- The new UK government led by Liz Truss has been confronted with a triple crisis in its first month in office, comprising a **currency crisis, a pension crisis arising from the plunge in the gilt market, and a crisis of credibility for the government’s fiscal strategy.**
- **The currency and gilt market crises** have, at least in the short-term, been largely overcome thanks to the purchases by the Bank of England in the gilt market. However, with the Fed still raising rates faster than other major central banks, the USD will likely continue to strengthen not only against the GBP but also against the JPY and the EUR.
- **The joint pension and government debt crises** are by no means over and will require significant overhauls of the regulatory framework for pensions, fiscal strategy, and – in my view – monetary policy before financial markets will acquiesce in the new regime.
- **Critically, based on past experiences, the interaction of tight monetary policy (in the sense of slower M4x money growth) and easier fiscal policy is highly unlikely to be favourable to the new Truss administration.**
- Against this background, the UK stock market should be viewed as vulnerable to further setbacks, while the country at large will likely experience considerable social unrest as firms and households adjust to the higher prices caused fundamentally by the Bank of England’s excessive monetary growth in 2020-21.
- In financial markets, equities have fallen due largely to interest rate concerns, but the depth of the coming slowdown and its implications for earnings growth are – in my view – not yet reflected in stock market values.
- The combination of weak sterling and persistent domestic inflation through 2023 will raise gilt yields and borrowing costs right across the economy.
- When monetary and fiscal policy are working in opposite directions – as in the present UK tight monetary policy/easy fiscal policy mix – monetary policy invariably dominates. This implies that it will be several years before Liz Truss’s growth ambitions for the economy can be realised.



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