UK macro policy outlook - a case study

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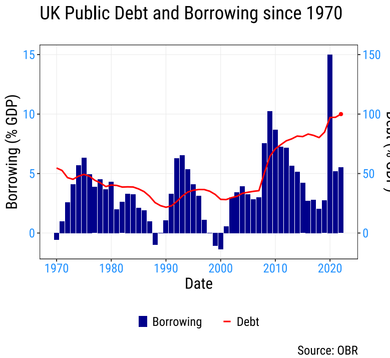
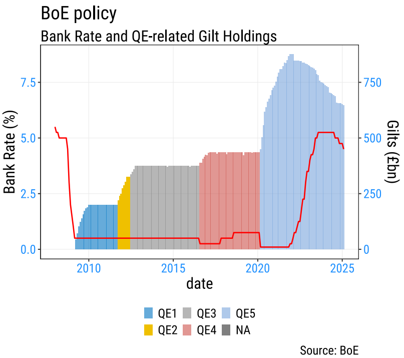
Main messages

- **Markets** risk premium episodes suggest the UK's fiscal buffer is too small.
- **Macro** (i) a need to restore fiscal space (ii) the UK output gap is still positive (iii) recent falls in employment partly come from the supply-side.

A better policy mix would incorporate add'l fiscal consolidation. If spare capacity opens up, monetary policy can ease by more. But the current policy mix, with too little near-term fiscal adjustment and too much monetary easing risks a positive output gap, inflation persistence and recurring risk premium episodes.

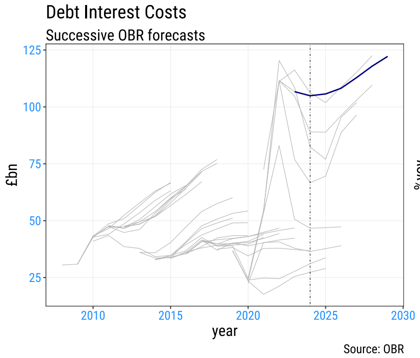
A public debt ratchet and an expanded BoE balance sheet

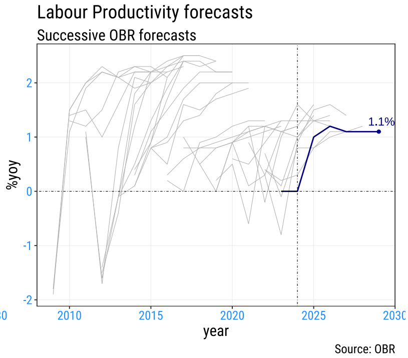




- Debt to GDP three times its average in MPC's first decade.
- QE shortened the effective maturity of public liabilities.

r↑, g↓. (r - g)↑↑





- $+50$bp on market interest rates now adds £7bn to public borrowing in 5Y.
- Fiscal and Monetary policies are not well co-ordinated when set with different views about future productivity growth.

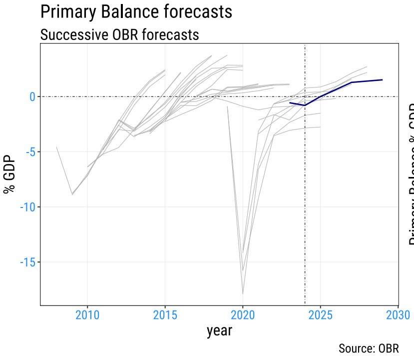
Stabilising debt. Fiscal space?

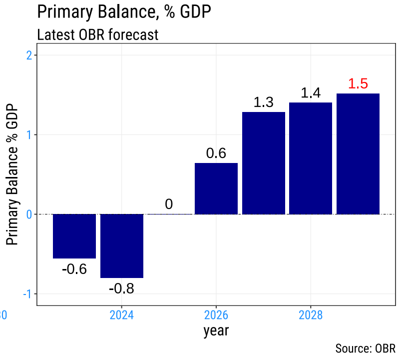
Required, Debt-stabilising, Primary Balance (% GDP)
effective nominal interest rate, r

g	0.02	0.025	0.03	0.035	0.04	0.045
0.010	1.01	1.52	2.02	2.53	3.03	3.54
0.015	0.51	1.02	1.52	2.03	2.54	3.05
0.020	0.00	0.51	1.02	1.53	2.04	2.55
0.025	-0.51	0.00	0.51	1.03	1.54	2.05
0.030	-1.03	-0.52	0.00	0.52	1.03	1.55
0.035	-1.55	-1.04	-0.52	0.00	0.52	1.04
0.040	-2.08	-1.56	-1.04	-0.52	0.00	0.52

Note: Calculations assume Debt/GDP at 100% and no stock-flow adjustments, for different combinations of 'r' and 'g'.

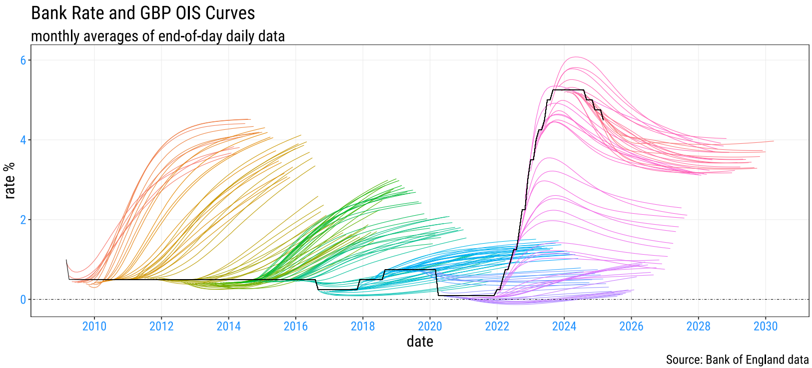
Delayed timing of fiscal consolidation





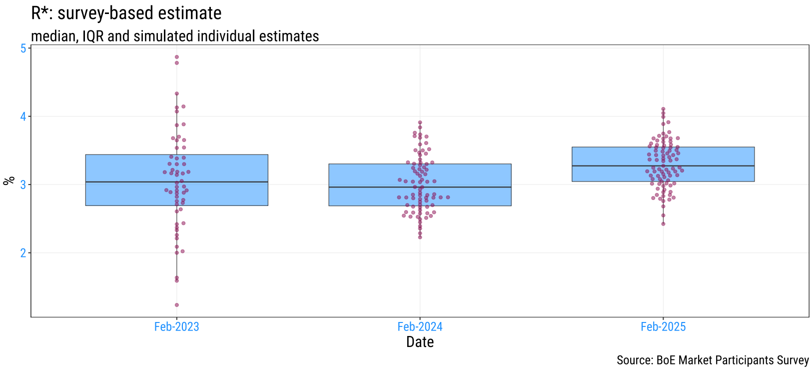
- Even excl. 2020/21, 't+4' forecast error on the OBR's primary balance forecast averages -2.7pp.

Market expectations of ‘r’



- Hard-to-learn medium-term features, eg r* and trend productivity growth lead to serially-correlated revisions (Leland *et al*, 2024).

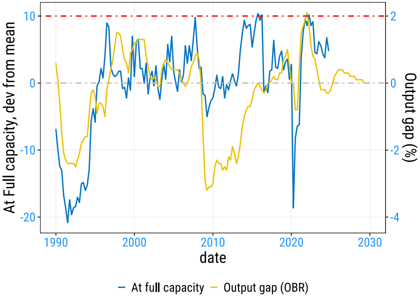
Estimates of neutral rates drift higher



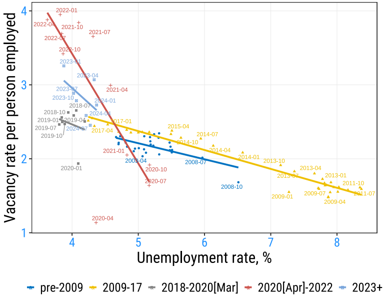
- If the output gap > 0, and disinflation is stalling, ‘r’ is closer to 'r*' than previously thought.

y* may be lower than thought, incl on U*↑

UK Output Gap and Capacity Utilisation



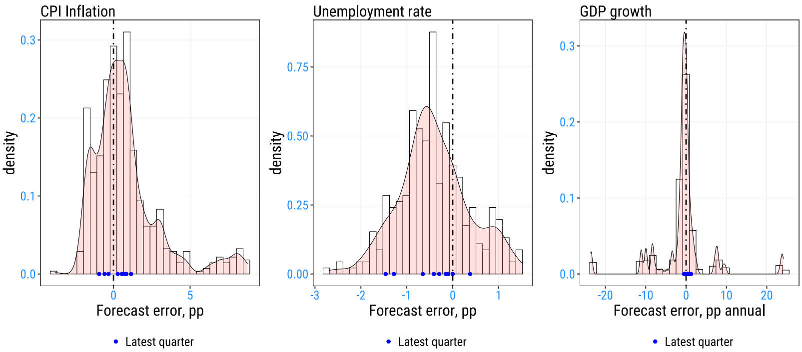
UK Beveridge curve(s)



Source: BCC, OBR

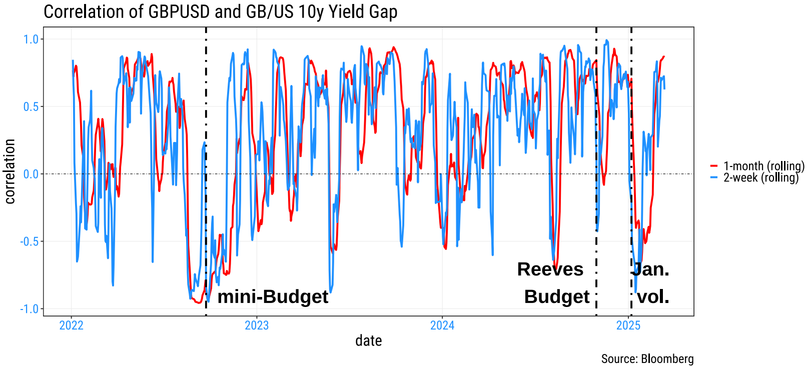
- Latest U/V curve suggests an outward shift in U^* vs. pre-Covid. Sticky wage growth another symptom.

The past pattern of BoE forecast errors



- Pattern points to repeated, negative supply shocks under-estimated by BoE. (CPI: higher-than-expected; U: lower-than-expected; GDP: unbiased).

Bouts of Sterling risk premium



- Instability reflects changeable roles for different shocks.
- Demand news pushes Yields and Currency in same direction ($\rho > 0$). Risk premium news pushes them in opposing directions ($\rho < 0$).
- Cx Reeves January episode a much smaller and more temporary bout of risk premium than Truss mini-Budget.

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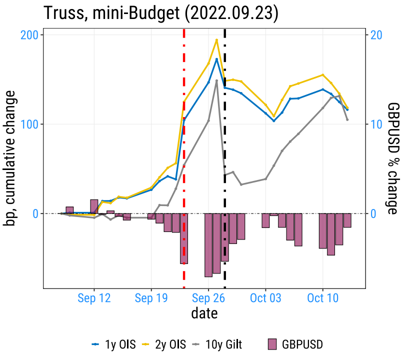
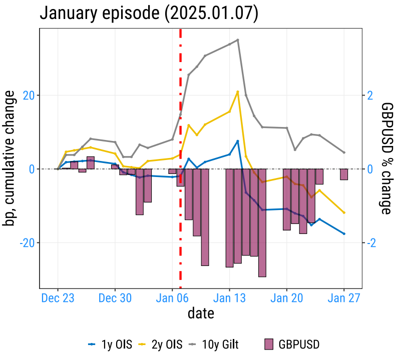
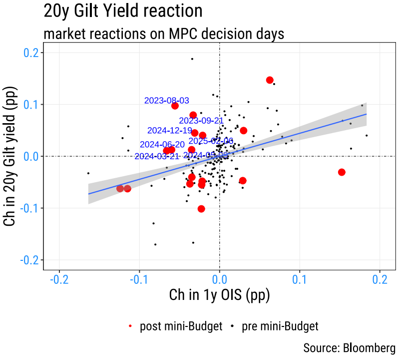
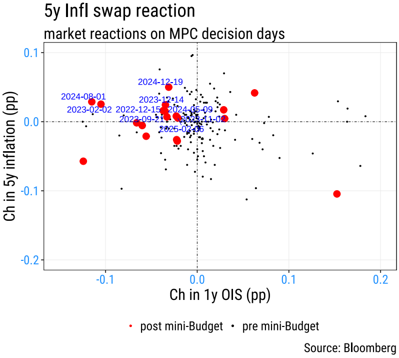
Risk premiums complicate policy transmission + ‘predictable’ MPC Comms





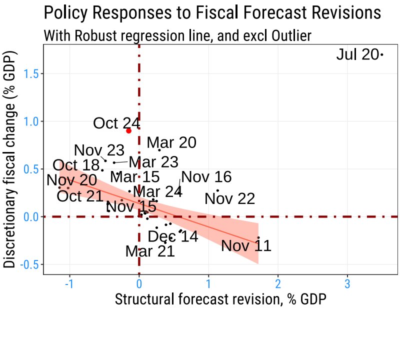
Are Dovish MPC Comms becoming less credible?



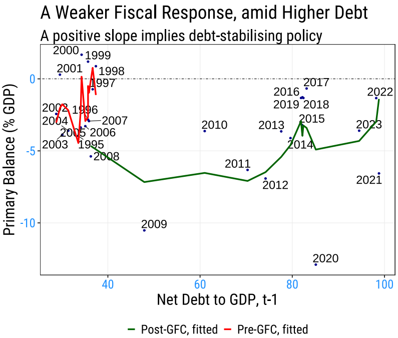


- Lower 1y OIS on MPC days as likely to push up on Gilt yields, and more so than before the mini-Budget.

The fiscal reaction. Fiscal fatigue?



Source: OBR



Note: The Bohn regressions control for the Output gap

- Fiscal policy tightened at 2 of 21 fiscal events since 2015.

Conclusions

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