

Fiscal policy, the bond market and implications for monetary policy

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Main messages

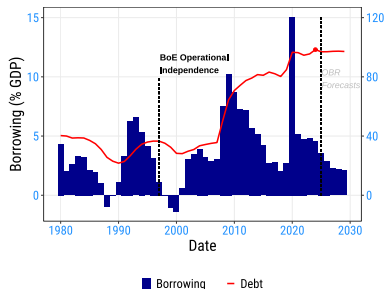
- ▶ **Markets** risk premium episodes suggest the UK's fiscal buffer is too small.
- ▶ **Macro** Risk of fiscal fatigue with more fiscal effort needed but lacking necessary support, absent risk premium episodes. Loosening the fiscal rules again in the Autumn Budget would be a symptom of fiscal fatigue.

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, risking too little near-term fiscal adjustment and too much monetary easing also risks a positive output gap, inflation persistence and recurring risk premium episodes.

A public debt ratchet and an expanded BoE balance sheet

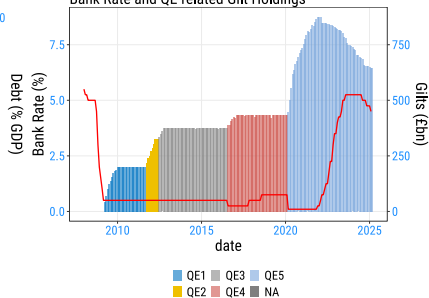
UK Public Debt and Borrowing since 1980



Source: OBR

BoE policy

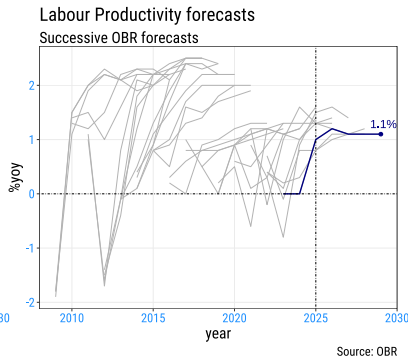
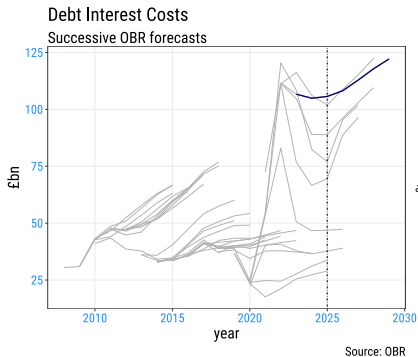
Bank Rate and QE-related Gilt Holdings



Source: BoE

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

$r \uparrow$, $g \downarrow$. $(r - g) \uparrow \uparrow$



- ▶ +50bp on market interest rates, +£7bn to public borrowing in 5Y.
- ▶ Fiscal and Monetary policies are not well co-ordinated when based on different views of future productivity growth.

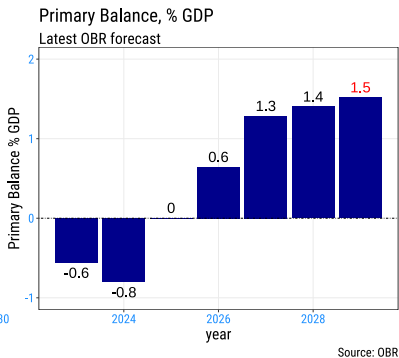
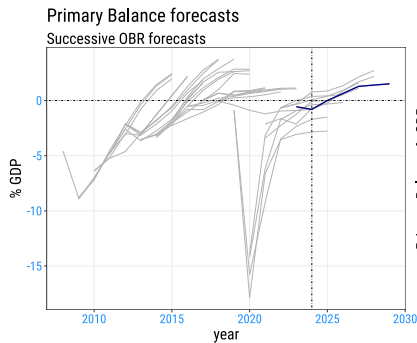
Stabilising debt. Fiscal space?

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

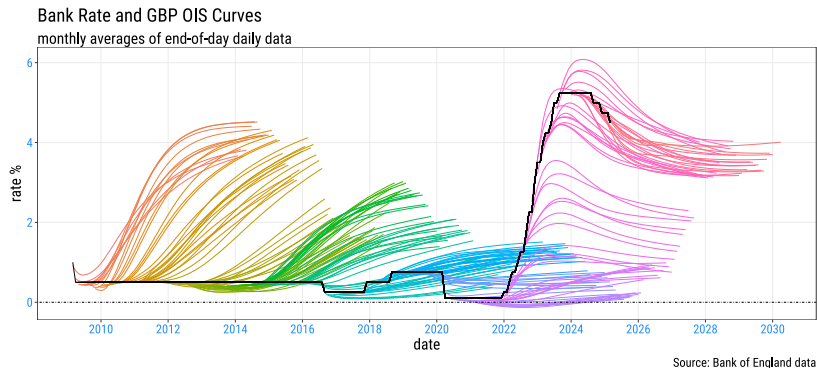
Note: Calculations assume Debt/GDP at 100% and no stock-flow adjustments, for different combinations of ' r ' and ' g '.

Delaying the fiscal effort



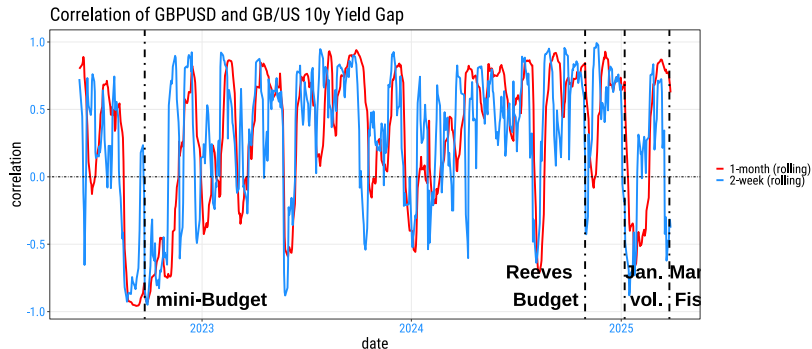
- ▶ Even excl. 2020/21, 't+4' forecast error on the OBR's primary balance forecast averages **-2.7pp**.

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).

Bouts of Sterling risk premium



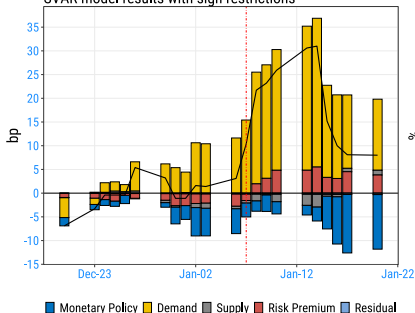
Source: Bloomberg

- ▶ 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.

Quantifying the risk premium effect

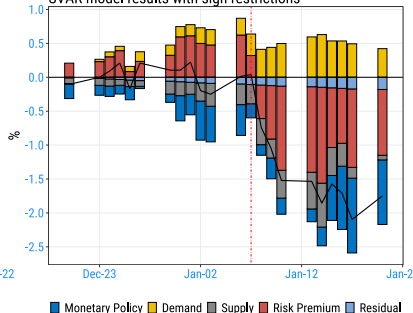
10y Gilt yield - historical decomposition (bp)

SVAR model results with sign restrictions



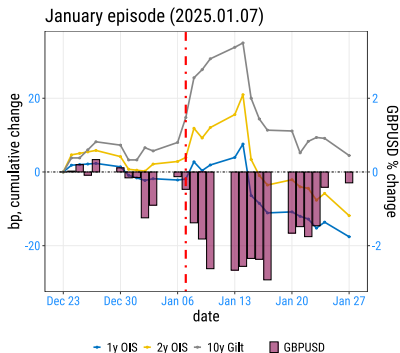
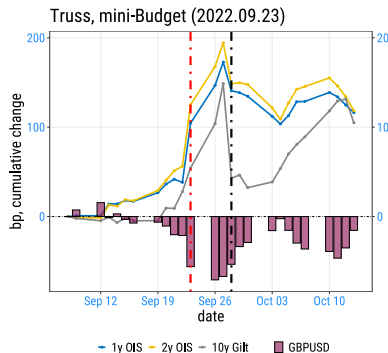
GBP Trade-weighted exch rate - historical decomp

SVAR model results with sign restrictions

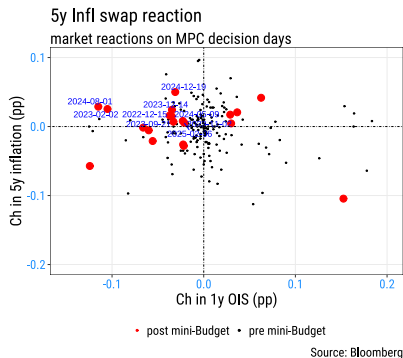
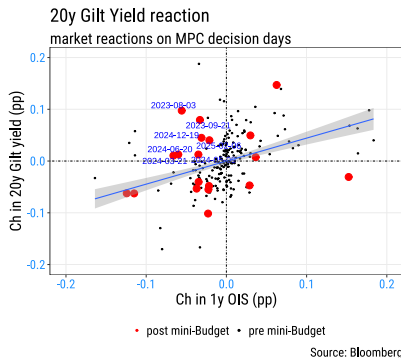


- ▶ A bigger risk premium contribution in foreign exch than Bonds.
- ▶ The fiscal buffer is **too small**, regardless of the source of shock.

BoE: Risk premium episodes complicate policy transmission + 'predictable' MPC Comms



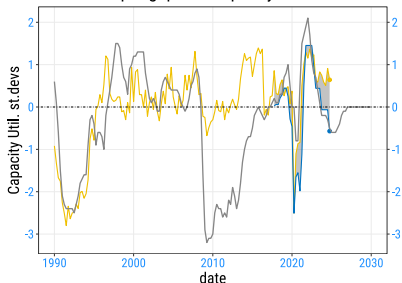
BoE: Are Dovish MPC Comms becoming less credible?



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

The Output gap still positive?

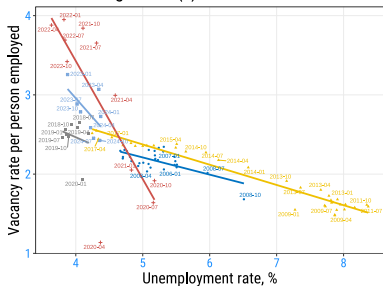
The UK Output gap and Capacity Utilisation



◆ Agents ◆ BCC — Output gap (OBR)

Sources: BCC, BoE, OBR

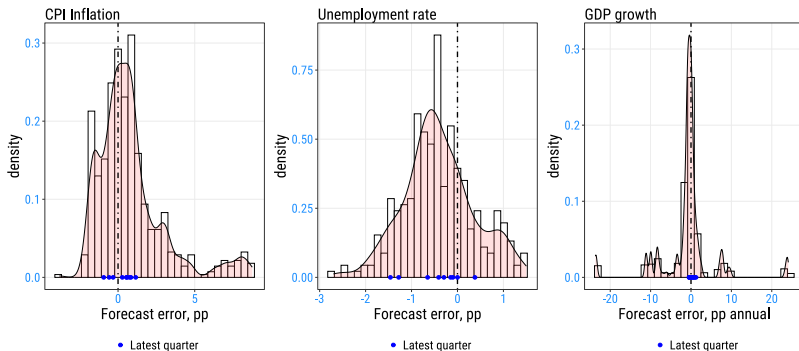
UK Beveridge curve(s)



◆ pre-2009 ◆ 2009-17 ◆ 2018-2020[Mar] ◆ 2020[Apr]-2022 ◆ 2023+

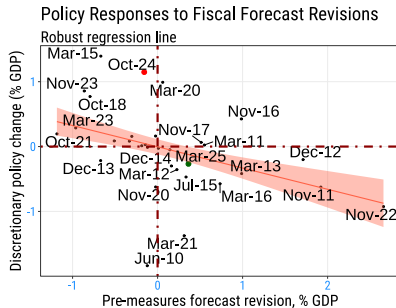
- ▶ Latest U/V curve suggests an outward shift in U^* vs. pre-Covid. Sticky wage growth another symptom.

BoE: the past pattern of forecast errors



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

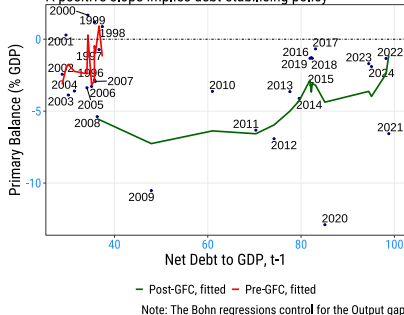
The fiscal reaction. Fiscal fatigue?



Source: OBR

A Weaker Fiscal Response, amid Higher Debt

A positive slope implies debt-stabilising policy



► **Looser fiscal rules** would reinforce a sense of UK fiscal fatigue.

Conclusions

- ▶ **Markets** risk premium episodes suggest the UK's fiscal buffer is too small.
- ▶ **Macro** risk of fiscal fatigue with more fiscal effort needed but lacking necessary support, absent risk premium episodes. Looser fiscal rules in the Autumn Budget would be a symptom of fiscal fatigue.

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