BoE Watchers: On monetary and fiscal policy interactions

Andrew Benito

Eisler Capital

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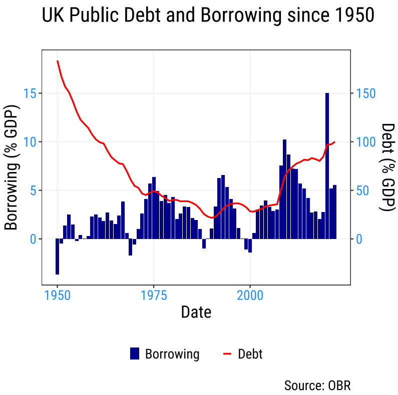
Main messages

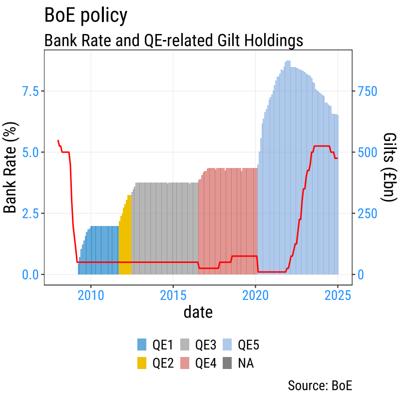
- **Markets**: risk premium episodes suggest the UK's fiscal buffer is uncomfortably small.
- **Macro**: (i) a need to restore fiscal space (ii) the UK output gap is still positive (iii) recent falls in Employment partly come from the Supply-side.

MPC again risks having under-estimated 'starting point' Output gap and role of Supply in recent economic weakness.

These point to an improved **policy mix** that would incorporate add'l **fiscal consolidation**. Whether **monetary policy** eases by more depends on where that would leave the Output gap overall, Inflation persistence and the incidence of Risk premium episodes.

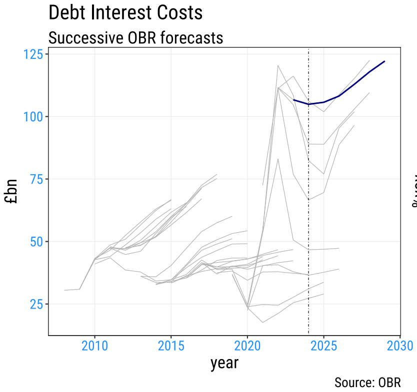
A public debt ratchet and an expanded BoE balance sheet

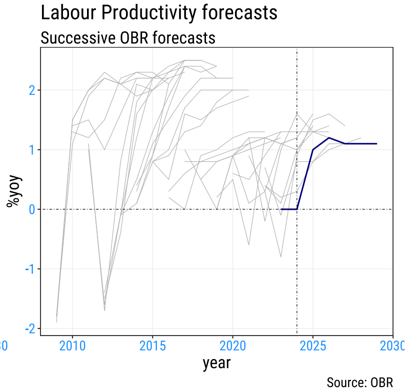




- Debt to GDP triple its average in MPC's first decade.
- QE shortened the effective maturity of Public liabilities.

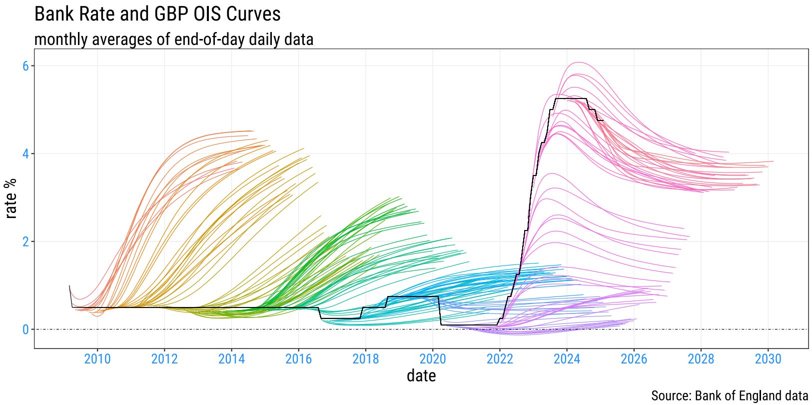
r↑, g↓





- +50bp on market interest rates now adds £10bn to public borrowing in 5Y.

Revisions in market expectations of 'r'



- Hard-to-learn features, eg r-star and trend productivity growth (Leland *et al*, 2024).

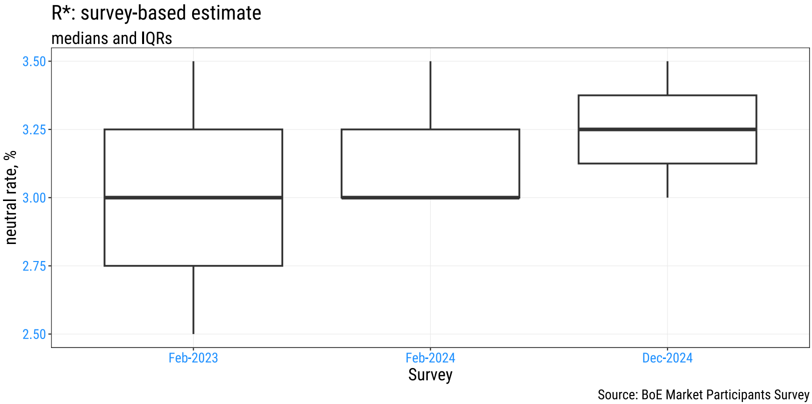
Stabilising debt, then restoring Fiscal Space?

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

g	0.015	0.02	0.025	0.03	0.035	0.04
0.010	0.51	1.01	1.52	2.02	2.53	3.03
0.015	0.00	0.51	1.02	1.52	2.03	2.54
0.020	-0.51	0.00	0.51	1.02	1.53	2.04
0.025	-1.03	-0.51	0.00	0.51	1.03	1.54
0.030	-1.55	-1.03	-0.52	0.00	0.52	1.03
0.035	-2.07	-1.55	-1.04	-0.52	0.00	0.52
0.040	-2.60	-2.08	-1.56	-1.04	-0.52	0.00

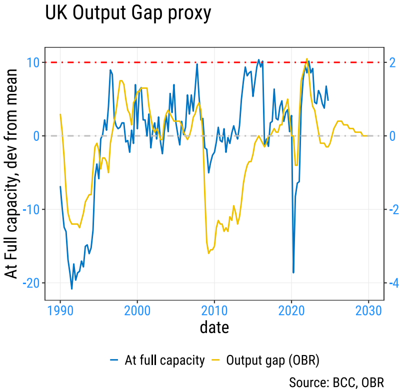
Note: Calculations assume Debt/GDP at 100% and no stock-flow adjustments, for different combinations of 'r' and 'g'.

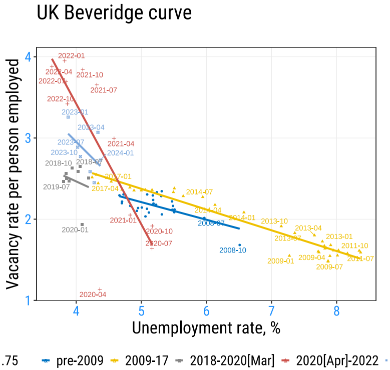
Estimates of neutral rates drifting higher



- If Output gap>0 (and Disinflation stalling), 'r' is closer to 'r*' than previously thought.

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



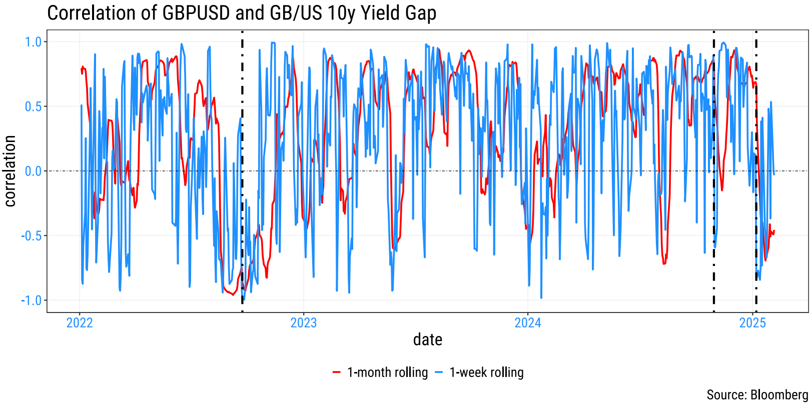


- Latest U/V curve suggests an outward shift in U* vs. pre-Covid. Sticky wage growth another symptom.

The 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).

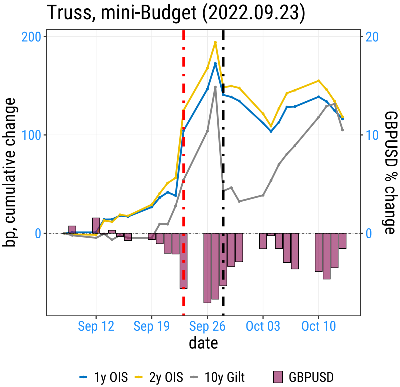
Bouts of Sterling risk premium

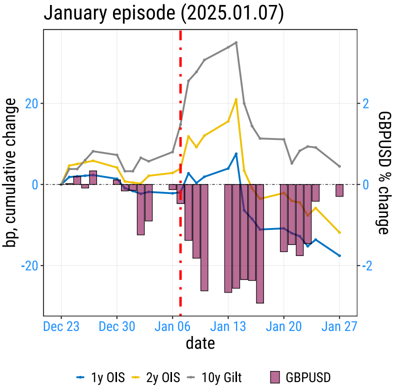


- Instability reflects time-varying roles for different shocks.
- 'normal' $\rho > 0$ consistent with Demand news pushing Yields and Currency in same direction. Risk premium news $=>$ opposing directions and $\rho < 0$.
- Cx Reeves episode a much smaller and more temporary bout of risk premium than Truss mini-Budget.

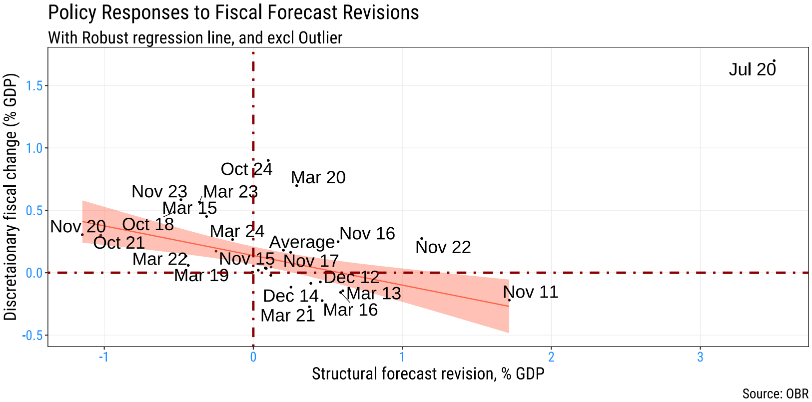
Some quantification of Risk premium vs. Demand effects

Risk premium episodes complicate predictable MPC Comms



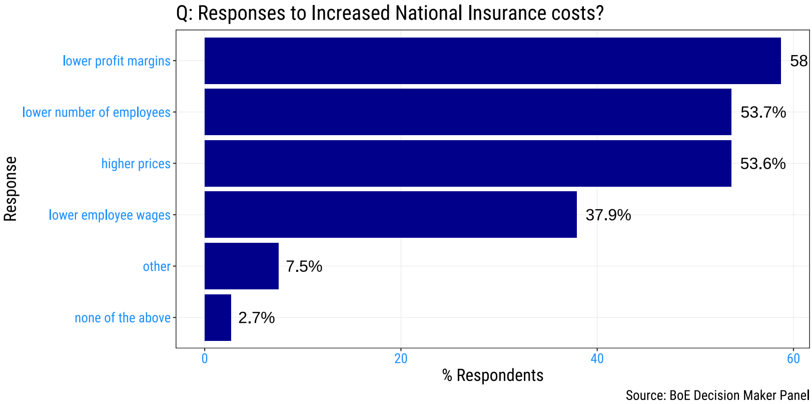


Fiscal reactions to macro news. More fiscal consolidation?



- Fiscal policy tightened at 2 out of 21 fiscal events since 2015.
- A quicker pace of consolidation to recognise a still positive Output Gap and provide a larger buffer against risk premium.

How MPC interprets company responses to higher payroll taxes.



- Employment cuts owe to weaker Supply-side, as much as aggregate Demand, and $U* \uparrow$.

Conclusions

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