

UK Macro: A view from financial markets

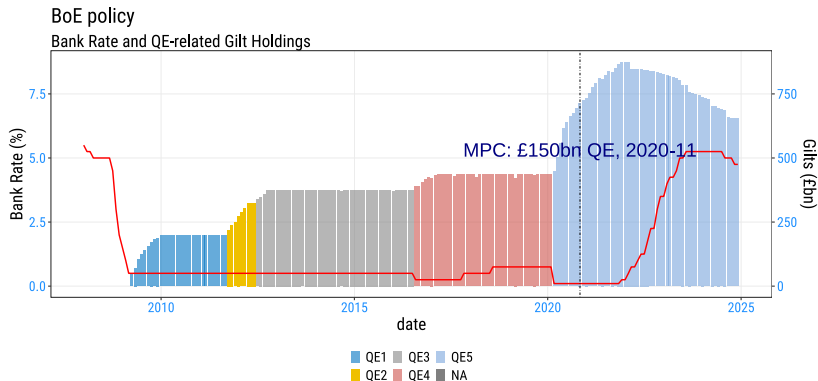
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January 13, 2025

Key Questions

- ▶ How is the UK economy **evolving**?
- ▶ How is the UK's **policy mix** evolving?
- ▶ Where might we be going badly **wrong**?

BoE Policy Settings



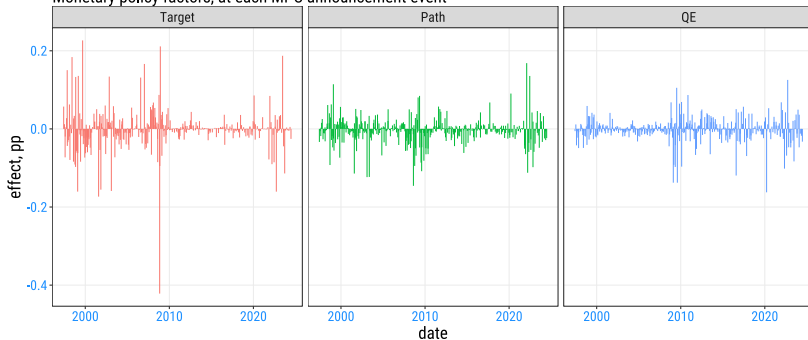
Source: BoE

- ▶ QT to date reverses the GBP150bn QE decision [Nov 2020], in terms of BoE Gilt Holdings.
- ▶ Start of rate hiking cycle delayed by the 12m and pre-announced QE programme.

Evolving forms of Monetary Policy

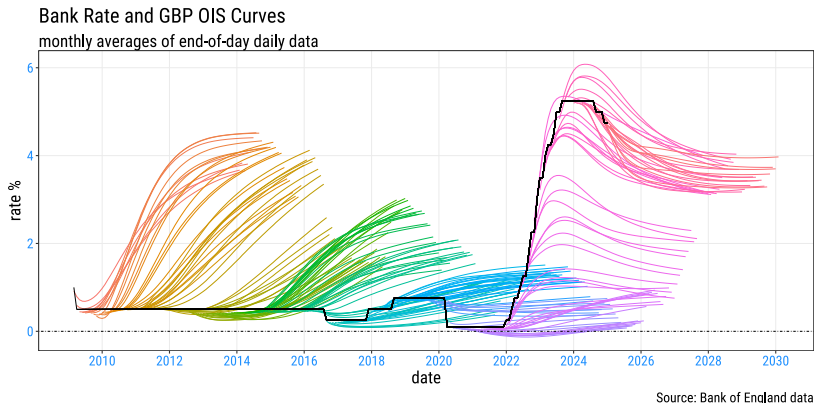
Evolving BoE Monetary Policy Factors

Monetary policy factors, at each MPC announcement event



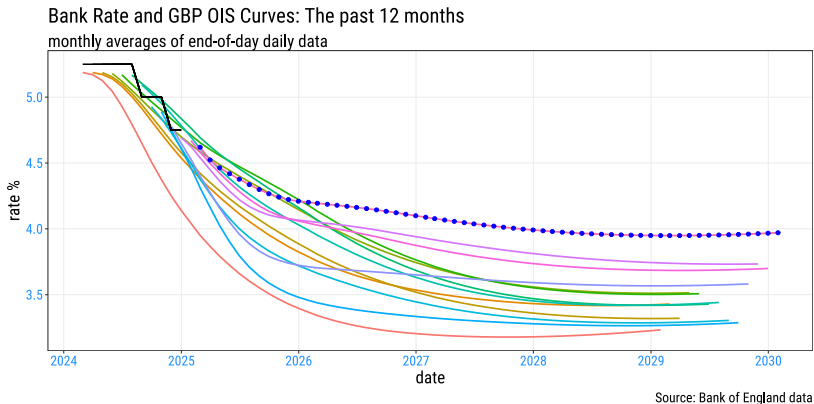
Source: UK Monetary Policy Event Study Database (UKMPD)

Evolving Market expectations



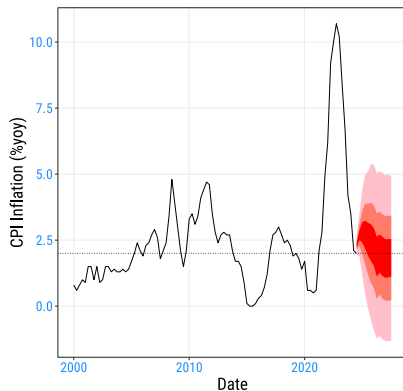
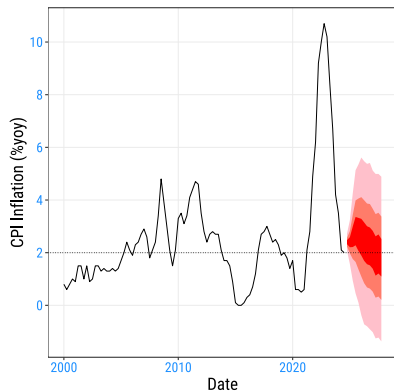
- Learning about hard-to-learn features of the economy (eg productivity and 'trend' growth) can be slow (Farmer *et al*, 2024).

Zooming in... the past year



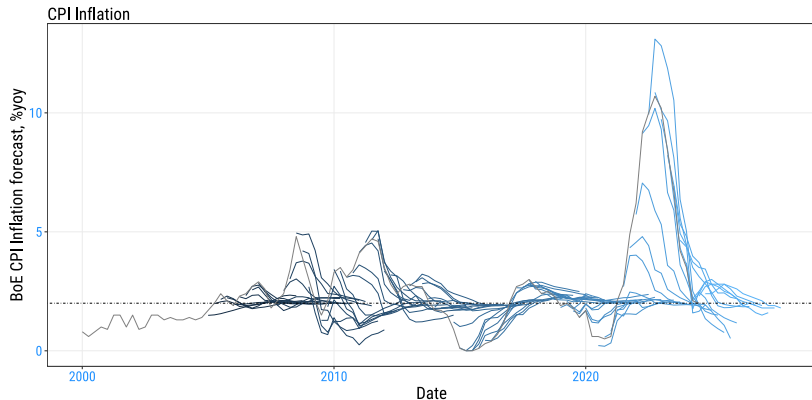
- Expected rate cuts have moderated... despite faster than expected disinflation in the past year.

An evolving inflation outlook?



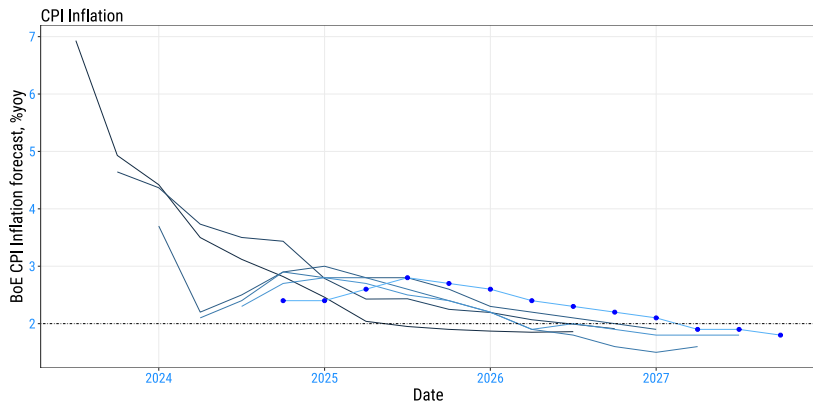
- ▶ BoE's Fan charts say little about the scale, persistence and source of macro news – about 'how is the economy evolving?'

Macro news: scale, persistence of source of news



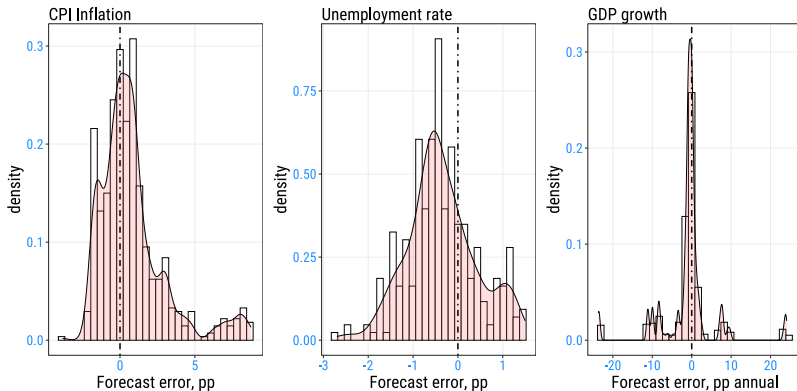
- Policy framework broadly robust to its largest inflation shock.

More recent disinflation news



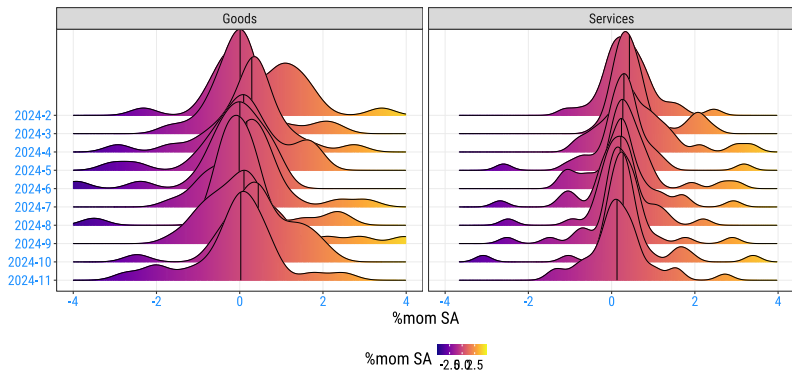
- Some of the faster-than-expected disinflation of the past year is judged to be temporary.

The pattern of BoE forecast errors



- Pattern of forecast errors points to repeated, negative supply shocks. (CPI: higher-than-expected; U: lower-than-expected; GDP: unbiased).

A disaggregated / distributional view of price changes



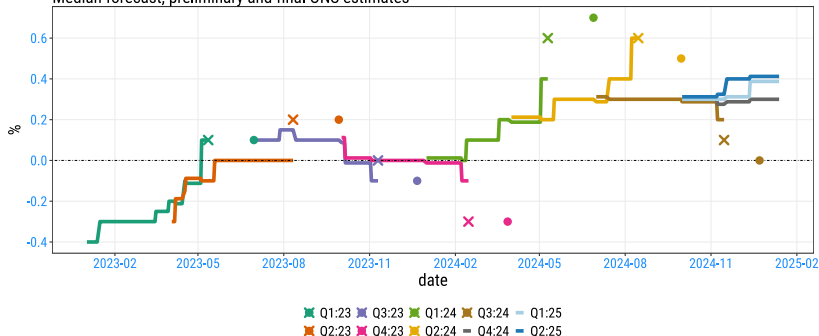
GDP Growth – Evolving expectations and out-turns

[1] “N:/Common/MACRO MARKETS/Team/AB/_TIDY/UK-Macro-Summary/scripts/05b_tracking_consensus_gdp.R” [1]

“updating charts starting in 2022” [1] “updating charts starting in 2023” [1] “done”

UK Real GDP Growth (%qoq) - Consensus Forecasts

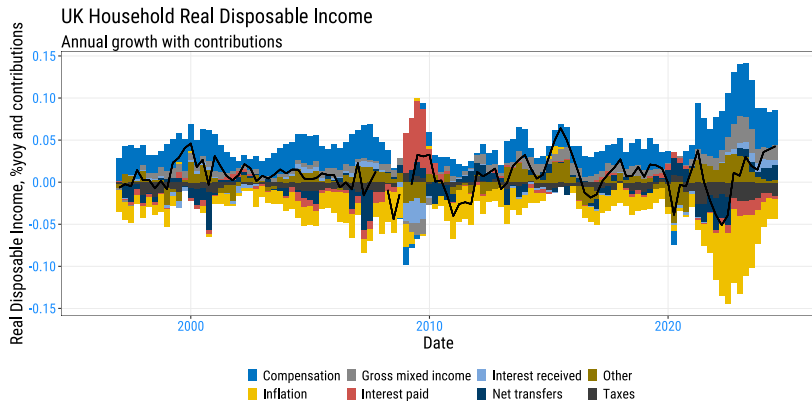
Median forecast, preliminary and final ONS estimates



Source: Bloomberg

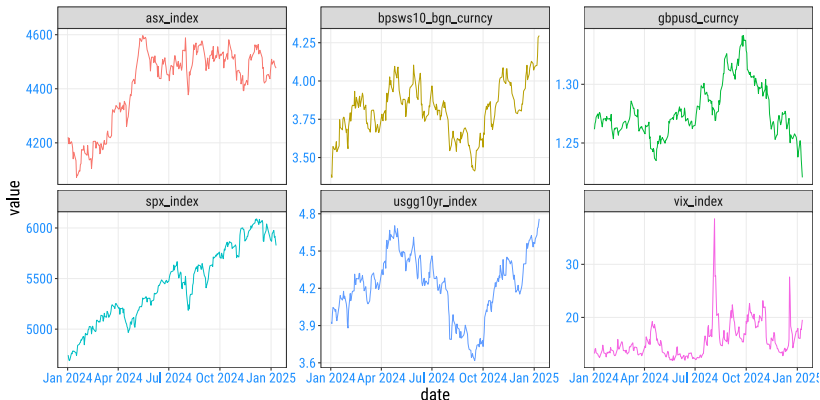
- ▶ Medium-term growth: innovation and reallocation effects dominate capital deepening.

Household real incomes



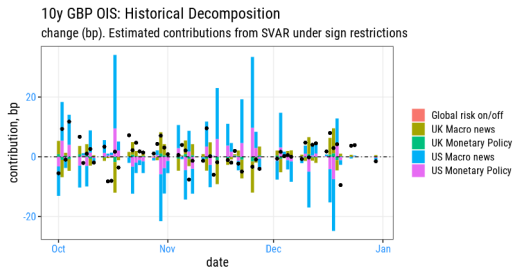
- The drag from elevated inflation and interest paid subsiding; household taxes a steady/persistent drag since 2023.

Sterling asset prices



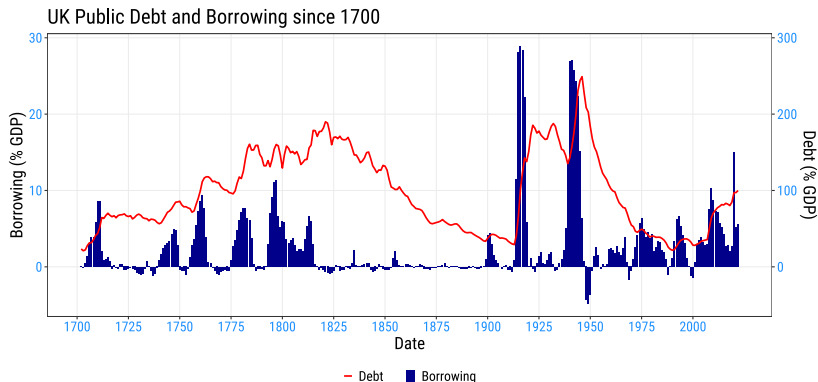
- Aim: distinguish sources of news: (i) UK macro (ii) BoE Monetary policy news (iii) US macro (iv) Fed policy and (v) 'Risk-on'.

Decomposing changes in asset prices into macro



- ▶ Results from a Bayesian VAR estimated under sign restrictions on daily, financial market data.
- ▶ OIS higher on US spillovers.

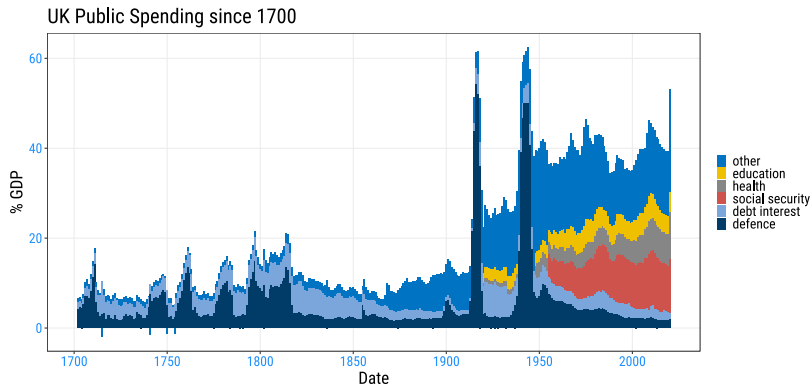
Worsening fiscal arithmetic: a public debt ratchet



Source: OBR

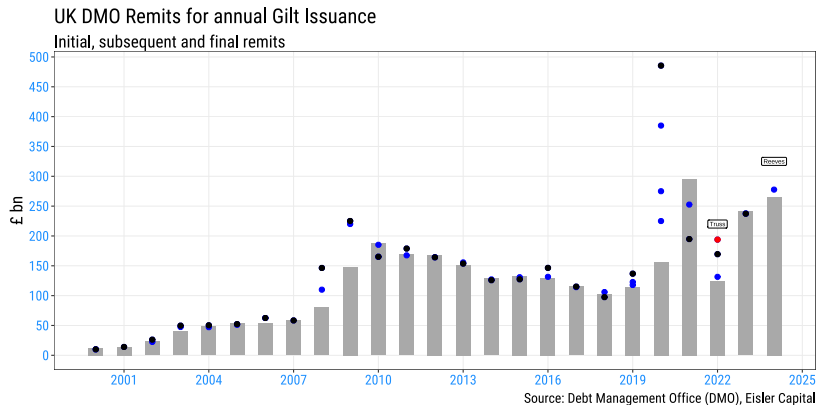
- ▶ One-off Supply shocks should be met with *higher* Public Debt, worked-off gradually.
- ▶ Yet: $r \uparrow$, $g \downarrow$ imply a *lower* optimal Debt/GDP ratio.

Public spending shouldered by bond-holders + tax-payers



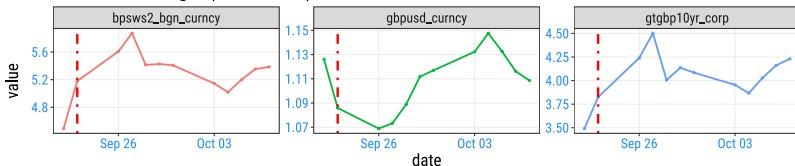
- ▶ The bond market understands that politicians can be inclined towards making Bond-holders, not Tax-payers, shoulder Public spending.

Debt Issuance approaching its limits?

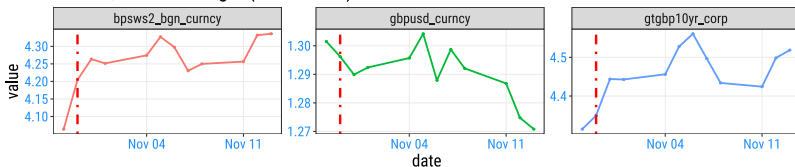


Truss vs Reeves: financial markets' assessment

Truss, mini-Budget (2022.09.23)

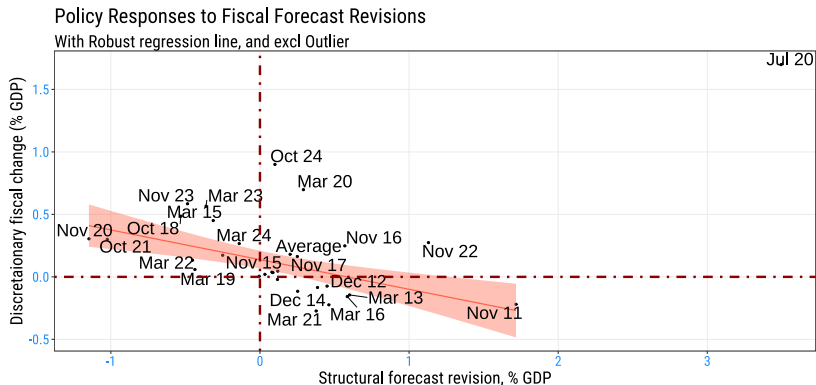


Reeves, Autumn Budget (2024.10.30)



- ▶ **Truss:** a loss of (foreign) **investor confidence**, exacerbated by long-term investors (LDI). BoE interventions stabilised.
- ▶ **Reeves:** a more standard injection of **aggregate Demand**, met with higher ST interest-rates. A subsequent deterioration in aggregate Supply?

Fiscal choices with macro news



- ▶ Spending proceeds of good news rather than 'paying-down' debt in good times, despite ratchet higher in Debt/GDP.
- ▶ Estimates of 'Headroom' (vs. loosened fiscal targets) are small.

A plan to restore fiscal space?

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

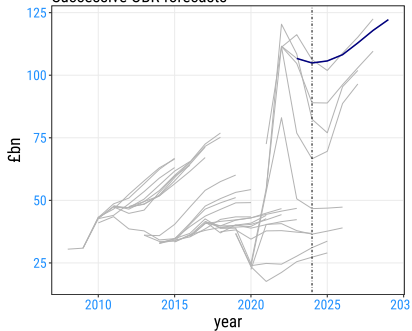
g	0.015	0.02	0.025	0.03	0.035	0.04
0.010	0.51	1.01	1.52	2.02	2.53	3.03
0.015	0.00	0.51	1.02	1.52	2.03	2.54
0.020	-0.51	0.00	0.51	1.02	1.53	2.04
0.025	-1.03	-0.51	0.00	0.51	1.03	1.54
0.030	-1.55	-1.03	-0.52	0.00	0.52	1.03
0.035	-2.07	-1.55	-1.04	-0.52	0.00	0.52
0.040	-2.60	-2.08	-1.56	-1.04	-0.52	0.00

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

- ▶ A plan to stabilise “net financial liabilities” does not (i) allow for more negative supply shocks or (ii) restore fiscal space.

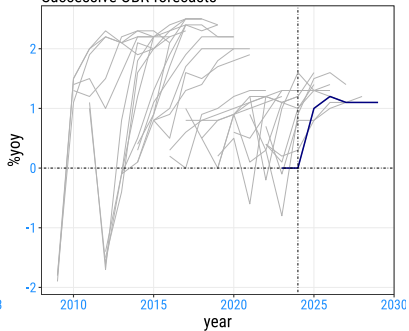
$r \uparrow, g \downarrow$

Debt Interest Costs
Successive OBR forecasts



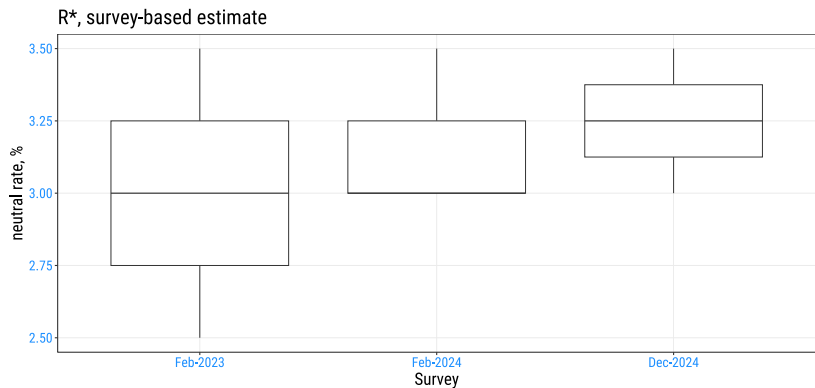
Source: OBR, Eisler Capital

Labour Productivity forecasts
Successive OBR forecasts



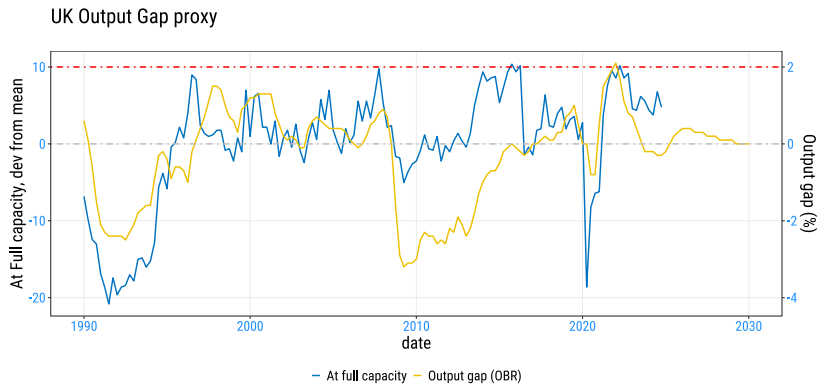
Source: OBR

Estimates of neutral rates, drifting?



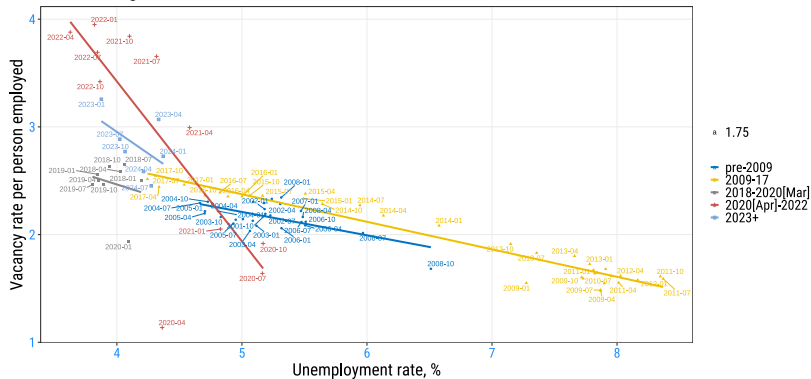
Source: BoE Market Participants Survey

g_{\downarrow} and y^* may be lower than thought



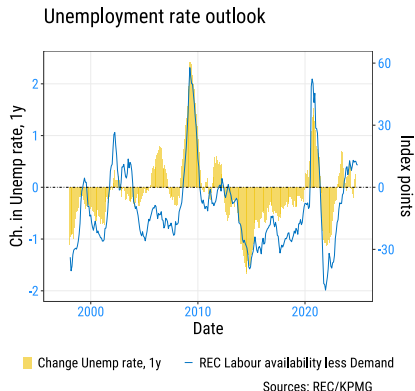
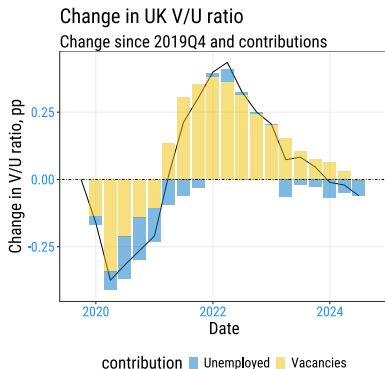
Source: BCC, OBR

UK Beveridge curve



► pre-Covid vs. latest U/V curve suggests an outward shift.

Rising unemployment



- Risk: U^* is mis-interpreted as a cyclical effect.
- Would imply some additional inflationary pressure, pushing up on 'r' over time.

What have we learned?

- ▶ **Bayesians:** learning is continuous. But when might we have to 'unlearn' something, previously taken as given. Imagine: jumping to a different branch of a decision tree.
- ▶ **Learning** about how the economy is evolving, while still **reassessing the starting point** of what we thought we cld take as given.
- ▶ **Policy:** the origin of larger policy mistakes. In **Markets:** opportunities from these discontinuities (a la *Big Short*).
- ▶ *UK Examples:* (i) BoE underestimating a positive output gap, post-Covid in 2022, with 'incrementalism' since then. (ii) BoE and markets assuming unrealistic fiscal tightening in 2024H1. Forward curves drift higher since then.

Conclusions

How is the UK economy evolving? Ongoing disinflation, still depends on a restrictive monetary policy stance.

How is the UK policy mix evolving? Withdrawal of both monetary restriction and fiscal support slower than thought a year ago. Fiscal policy as a driver.

Where might we be going badly wrong?

- Both Debt sustainability and Inflation persistence are sensitive to over-stating supply capacity and its trend.
- Excess demand applies if improved terms of trade and labour supply boost Demand more quickly than Supply; more so, if this is mis-diagnosed as a boost to Supply, as U rises (for structural reasons). Consumers may already discount fiscal consolidation, while monetary policy eases (Hawkish). Or, has transmission of past monetary tightening been delayed (Dovish)?