**BoE Watchers**

I’d like to make three main points in what follows:

* First, that recent risk premium episodes in Sterling markets suggest that the UK’s fiscal buffer is uncomfortably small. It’s too small.
* Second, despite flatlining GDP, the UK output gap is likely still positive, which may explain some of the inflation persistence. The recent flatlining in GDP and falling levels of Employment appear partly driven by weak Supply-side factors rather than purely confidence-driven effects on Demand.
* The MPC is, therefore, running the risk that it under-estimates a positive output gap as well as the role of an impaired Supply-side.
* Third, and bringing these points together, a better policy mix would involve additional fiscal consolidation. That would bolster the UK’s fiscal buffer while helping address the positive Output gap and some of the inflation persistence.
* Whether this points to additional interest rate cuts would depend on where it would leave the Output gap and inflation. But this policy mix could at least ease some of the challenges that risk premium episodes pose for MPC communications.

**[Chart 1]: Public debt to GDP and [Chart 2] BoE Balance sheet**

By way of context, public debt has reached 100% of annual GDP—triple the debt ratio in the first decade of the MPC.

QE initially created fiscal space by securing lower interest rates and suppressing bond market volatility. But it also shortened the effective maturity of public debt as Gilt purchases were funded at Bank Rate, an overnight rate.

**[Chart 3]: Successive r and g forecasts**

The recent rate-hiking cycle exposed the government’s heightened sensitivity to interest rate policy on account of its higher debt ratio and QE. Interest payments now total well over £100 billion annually—up from £40 billion just a decade ago.

Interest payments are of course included in the Chancellor’s Current spending measure to be covered by tax receipts in the Chancellor’s first fiscal rule. It leaves open how much fiscal headroom to seek against that rule.

**[Chart 4: OIS Curves]**

As shown here, financial markets’ views for Interest rates over the subsequent 5 years frequently get revised, sometimes quite substantially.

So, even if this source of interest rate risk is two-sided and we may well get lucky, the risk of being forced to revise higher Interest Payments is still very material.

**[Chart 5 matrix] Primary deficit table**

The UK has moved from a situation where a primary deficit of around 2% of GDP was manageable to one requiring a surplus of 1-1.5% of GDP being needed to stabilise debt to GDP around its current level.

You can see that in these calculations for the primary balance needed to stabilise Debt to GDP for different combinations of nominal effective interest rate ( r)and nominal growth rate (g).

The UK hasn’t run a primary surplus since 2000 and most recently, its primary balance was almost -2%.

These calculations may not do justice to the risk that ‘r’ should be thought of as an increasing function of debt-to-GDP -- let alone the risk that ‘r’ could be a function of the US debt to GDP ratio.

**[Chart 6] r-star**

Neutral rate estimates, in principle, might give us some sense of where interest rates might settle as the output gap closes and inflation returns to target. These estimates taken from the BoE’s Market Participants Survey, have drifted higher from 2 years ago.

In the next couple of Charts I’d like to suggest that the output gap is slightly more positive than the BoE and OBR believe. If true, that could mean that interest rate policy has been less restrictive than widely thought and r-star is a bit higher than thought.

**[Chart 7] Output gap, [Chart 8] Beveridge curve**

The survey-based estimate of capacity utilisation shown here suggests the output gap is still positive perhaps at ½ - 1% of GDP.

Interestingly, this aligns quite well with the OBR output gap up until the financial crisis. It also aligns with the BoE’s recent acknowledgement that the output gap was +2% in mid-2022, even though the BoE had suggested at the time that the Output gap was zero back in mid-2022.

In its latest estimate for the current Output gap the BoE believes the Output gap is slightly negative, with some Demand deficiency.

Simple Beveridge Curve analysis suggests there has been an outward shift since Covid and structural unemployment may have increased, although not by more than the odd few tenths of a percentage point.

**Chart 9: BoE Forecast Errors**

The MPC has tended to be a bit too optimistic on the UK’s supply-side, thereby under-estimating the Output Gap and inflation.

As this Chart shows, the general pattern of BoE forecast errors since 2014 has been for forecasts that have tended to be too low on inflation yet too high on the unemployment rate without any obvious bias on GDP itself – a tell tale sign of being too optimistic on Supply.

In a past speech, Paul Tucker described a persistent Current Account deficit as indicating a country was borrowing capacity from abroad and that being a symptom of repressed inflation. That type of view would also indicate additional supply-side weakness that may not be widely taken into account.

**[Chart 10] Bouts of risk premium**

Risk premium episodes like that in early-January give a hint of UK’s fiscal vulnerability, even if this was far less extreme than the mini-Budget turmoil.

Here, I show a proxy for a Risk premium event based on the direction of the correlation between the UK’s yield gap versus the US in 10y rates and the Sterling-Dollar exchange rate.

On this indicator, January was a risk premium event even if its trigger was far from clear and this was by no means as large or as persistent as the mini-Budget. In case you think this point in August 2024 is a false positive of a risk premium, this was last the volatility spike associated with a hawkish BoJ and weak US payrolls data. So, while it originated outside the UK, that episode was also a risk premium event amid a large volatility spike.

The UK focused episodes limit the MPC’s ability to act decisively on rate cuts as well as complicating its communications.

**[Chart 11: OIS curve in aftermath of 07.01.25 and 22.09.22]**

When confronted with an added risk premium, OIS markets expect fewer BoE rate cuts, or even substantial policy tightening after the Truss episode.

The Truss mini-Budget episode was an extreme. But more generally it points to the OIS market expecting the MPC having to act to avoid a Sterling overshoot to the downside in any risk premium episode.

If the MPC hadn’t been expected to tread more carefully towards expected rate cuts in January then the Currency would have depreciated further, the overshoot being necessary to produce the expected appreciation needed to compensate investors for the added risk premium.

Even the modest and temporary risk premium episode in January therefore can complicate MPC communications. A steadier, more predictable set of Comms would be more likely with larger fiscal headroom.

**[Chart 12] Fiscal reactions.**

A modest fiscal consolidation would mitigate some of these risks while leaning against inflation pressures that come from a positive Output Gap.

Historically, fiscal policy has tended to "give away" around one-half of any positive fiscal news at a fiscal event via additional Spending or lower Taxes. That’s basically what this Chart shows, plotted across each of the OBR forecasts since the OBR was formed in 2010.

The October 2024 budget deviated from this norm, raising Spending by 2% of GDP, raising Taxes by 1% of GDP, to net off at a 1% of GDP easing, as shown above the plotted line. That was despite little pre-measures fiscal news.

What’s more, only 2 of the UK’s 21 fiscal events in the past decade have seen any net fiscal tightening on this measure.

**[Chart 13: DMP responses to payroll taxes]**

What about the Budget’s impact on the real economy?

The MPC has been tracking how businesses respond to higher national insurance, alongside a 7% minimum wage hike. Surveys show mixed reactions—some firms absorb costs via lower profits or wages, but nearly half are raising prices or cutting jobs, adding to the MPC’s policy trade-off.

Surprisingly, the MPC sees job losses as a reflection of weak demand. But given the tax-driven rise in employment costs, coinciding with a significant rise in the minimum wage and soon after an instance of real wage resistance it likely reflects some supply-side effects, including higher structural unemployment.

If so, falling employment is far less dovish for monetary policy.

**Conclusions**

Misjudging the economy’s starting point, particularly in its supply-side conditions, remains a key risk for the MPC. That could apply including on account of misinterpreting the employment declines since the Budget as having been demand-driven, rather than supply-side effects.

Further fiscal consolidation could help mitigate disruptive risk premium episodes, ease MPC communications, help address the positive output gap, and support the goal of returning inflation to target 2.0. Whether this suggests more rate cuts depends on how the fiscal measures and revised starting point affect the output gap and inflation outlook and those risk premium episodes.