**BoE Watchers**

Thank you, Sam and good morning, everyone.

It’s a real pleasure to be back at BoE Watchers and especially to be part of such an excellent panel.

**[Main messages]**

I’d like to make three main points:

* First, risk premium episodes in Sterling markets show that the UK’s fiscal buffer is too small. We shouldn’t be distracted from that conclusion by a debate about whether those moves owe largely to developments at home or in the US.
* Second, fiscal fatigue is a major risk facing the bond market and the authorities – that being a scenario where a fiscal effort is still required to stabilise public debt but the country has reached the limits of its support for tax rises and public spending cuts. Loosening the UK’s fiscal rules again this Autumn and postponing fiscal adjustment would be a step towards that fiscal fatigue scenario.
* Third, a better UK policy mix would involve some added fiscal consolidation incl in the near-term. If that led to spare capacity opening-up, then the MPC could respond with additional rate cuts.
* But currently, we’re facing the risk of too little fiscal adjustment alongside too quick a withdrawal of restrictive monetary policy. That risks a positive output gap and above-target inflation persisting as well as a recurrence of the risk premium episodes that we had at the start of the year and in late October.

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

So, some context. Public net debt is almost 100% of annual GDP — three times the debt ratio in the first decade of the MPC.

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

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

The recent rate-hiking cycle exposed the heightened sensitivity of public finances to interest rate policy.

Interest payments now total £110 billion annually—up from £40 billion just a decade ago. Meanwhile, expectations for productivity growth have been repeatedly revised lower as shown in the right hand chart.

**[Chart 4 matrix] Primary deficit table**

The UK has gone from a primary deficit of around 2% of GDP being manageable to stabilise debt to GDP, to one requiring a surplus of 1.5% of GDP, to stabilise debt around its current level.

You can see that in these calculations for the required primary balance for different combinations of ‘r’ and ‘g’.

The UK hasn’t run a primary surplus since the year 2000.

**[Chart 5: Timing of fiscal adjustment delayed]**

The OBR expects the Treasury to engineer that 1.5% primary surplus within 5Y, as shown in the right-hand chart here. But two things stand out.

First, that adjustment is still quite back-loaded, having made little or no progress over the past year.

Second, we’ve been here before. Over-promising and Under-delivering versus the forecast has been a repeated pattern. It’s the pattern that led Charlie Bean to describe by quoting Saint Augustine’s maxim: “Lord, make me pure - but not yet.”

The average 4-year ahead forecast error on the OBR’s primary balance forecasts has been 2.7pp. That size of forecast error puts a premium on needing to make some progress in the near-term.

**[Chart 6: OIS Curves]**

As this audience will appreciate, market pricing of interest rates is subject to frequent and quite substantial revision. The revisions are serially correlated, as shown here.

Even if this source of interest rate risk is two-sided and we may get lucky, the risk of being forced to revise higher debt servicing costs is still very material, as the OBR has noted.

**[Chart 7] r-star**

Some of that interest rate risk relates to the level of neutral interest rate. I’m not going to say much about the neutral rate. I’II leave that to this afternoon’s session.

But the point I wanted to make is that if you believe that the output gap has been more positive than widely thought, then it’s natural to think that policy was less restrictive and the neutral rate has been somewhat higher.

In the next couple of charts, I’ll suggest that the output gap could still be positive and more so than the BoE has thought, that likely pushing up on a plausible estimate of r-star.

**[Chart 8] Output gap, [Chart 9] Beveridge curve**

Measuring capacity utilisation with a survey-based estimate shown here in the blue line points to CAPU above above-normal levels and the output gap being positive.

That approach aligned well with the OBR’s estimate of the output gap up until the financial crisis.

It also aligns well with the BoE’s latest view that the output gap in mid-2022 was +2% – although at the time the MPC was suggesting that the output gap was around zero. This blue line was already suggesting a firmly positive output gap approaching +2% at the time.

Measuring capacity utilisation is of course very imprecise. The Agents measure points to the possibility that it is marginally negative. But overall the longer track record of the BCC measure points to above-normal utilisation.

What of slack in the jobs market? Simple Beveridge Curve analysis suggests an outward shift in the Unemployment / vacancy curve since Covid and structural unemployment.

Traditionally, that risk of a slightly higher u-star would be further raised by increasing payroll taxes at a time when we’ve had real wage resistance. Higher U\* is easier to reconcile with recently sticky wage growth.

**Chart 10: BoE Forecast Errors**

The MPC has tended to be too optimistic on the economy’s supply-side capacity, under-estimating the output gap and inflation.

You can see that in the distributions of the BoE’s past forecast errors for CPI, Unemployment and GDP shown here -- tending to be too low on inflation while being too high on the unemployment rate without any obvious bias on GDP itself.

**[Chart 11] Bouts of risk premium**

Let’s turn more directly to the bond market. This chart shows the correlation between the UK to US yield gap in 10y rates and Sterling-Dollar exchange rate.

Normally, this correlation is positive—imagine demand shocks pushing both UK yields and Sterling in the same direction. However, it’s highly unstable because its underlying drivers are so changeable.

And during risk premium episodes, the correlation turns to being negative, as higher UK yields coincide with a weaker currency.

January fit this pattern, though the precise trigger for the risk premium event was unclear and the move was clearly not as large or as persistent as the mini-Budget episode.

**[12. Quantifying the Risk premium effect]**

A related intuition can be used in a more formal statistical model here, as vector auto-regression (VAR) where the signs of the correlations among asset prices are used to identify the types of macro shocks.

Here a higher risk premium shock raises interest rates, lowers equity prices, weakens the currency and lowers 2y inflation.

The historical decomposition for 10y Gilt yields is shown in the left-hand chart and for the Sterling exchange rate in the right-hand chart. For the sake of this chart, I just focus on the risk premium episode in January.

On these estimates, a UK risk premium effect accounted for xxx bp of the XXX bp rise in 10y gilt yields in January, before subsiding.

That kind of calculation is useful and points to January being a sizable risk premium episode.

At the same time, we shouldn’t allow that to distract us from the conclusion that we need the public finances to be robust to other sources of interest rate risk that may originate in either UK or US.

**[Chart 13: Risk premiums complicate policy transmission and MPC Comms]**

**Market expectations for BoE policy change ‘hawkishly’ during the Risk premium episodes.**

**In the January episode, markets expected fewer rate cuts (on the right). More aggressive rate hikes were expected during the Truss mini-Budget (on the left) during what was a rate-hiking cycle.**

**Sterling came under pressure in both episodes, shown by the bars in the charts.**

Without the change in expected interest rates, Sterling would have had to weaken further – and overshoot to the downside -- to deliver the expected appreciation needed to compensate investors for the higher risk premium.

The better response, though, is to address the issue at source – with fiscal consolidation. That’s quite close to what we got after the Truss mini-Budget: the mini-Budget give-aways were quickly reversed. BoE asset purchases were targeted and temporary before the MPC reverted back to its QE plans. In January the Bank was careful to downplay the implications of the risk premium episode for the BoE.

The two main implications are: first, greater fiscal headroom would support steadier policy transmission including in the swaps market; and second, it would make more predictable MPC communication easier.

**[Chart: Dovish Comms less Credible]**

If the output gap were positive with added inflation pressures, we might expect the bond market to doubt any Dovish policy message at an MPC event.

I don’t want to overstate this. But there’s a hint of that in some of the market reactions since mid-2022 when the output gap was positive.

Typically, at MPC events, there’s been a solid positive relationship between the reaction in 1y OIS and longer-term gilt yields. But since mid-2022, that has been weaker and we’ve been as likely to see Gilt yields rise as fall in response to a decline in 1y OIS at an MPC event.

If any Dovish MPC Comms were in future to follow tighter fiscal policy, I would not expect doubts about credibility of monetary easing. The rate cuts then would be for the right reasons.

**[Chart 14] The Fiscal reaction**

A modest added fiscal consolidation would reduce some of these risks and help lean against a positive output gap.

The norm since 2010 has been for fiscal policy to give away half of any positive fiscal news through higher spending or tax cuts, as shown in the chart as a type of fiscal reaction function. The October Budget deviated from that norm, increasing spending by 2% of GDP while raising taxes by 1% of GDP, alongside little macro news.

A modest tightening in a future Budget would be represented by a point lying below the estimated regression line shown in this Chart.

By contrast looser fiscal rules would point to more of a fiscal fatigue scenario, encouraging markets to believe that the UK is approaching the limits of public and political appetite for higher taxes or public spending cuts even though more fiscal effort is needed to stabilise debt.

**Conclusions**

Overall, then, being too optimistic about the economy’s supply capacity remains a risk for both monetary and fiscal policy in the UK.

A better policy mix would be more robust to that risk and would point to some additional fiscal consolidation.

This would also help reduce the incidence of risk premium episodes that complicate monetary policy transmission and MPC communications.

I’ll stop there. Thanks a million.