**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 financial 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 abroad.
* Second, fiscal fatigue is a major risk facing the bond market and UK 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 or public spending cuts. Loosening the UK’s fiscal rules again 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 an easing in 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 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 labour productivity growth have been repeatedly revised lower.

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

The UK has gone from being able to stabilise net debt to GDP with a primary deficit of around 2% of GDP to requiring a primary surplus of 1.5% of GDP.

You can see that in these calculations for the required primary balance needed to stabilise Debt to GDP at 100% for different combinations of ‘r’ (across the columns) and ‘g’ (across the rows). We’ve gone from the bottom left part of this table to the middle right section.

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 reach that 1.5% primary surplus within 5Y. But two things stand out.

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

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 phrase: “Lord, make me pure - but not yet.”

In fact, the average 4-year ahead forecast error on the OBR’s forecasts for the primary balance has been 2.7pp. That scale of forecast error puts a premium on making near-term progress.

**[Chart 6: OIS Curves]**

As this audience will appreciate, market pricing of interest rates is subject to frequent and sometimes quite large 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 forecast errors can persist and the risk of being forced to revise higher debt servicing costs is still very material, as the OBR has noted.

I don’t have the time to cover the BoE’s Balance Sheet here. But it’s worth recalling in the context of this chart that some of that interest rate chart occurs through the BoE’s balance sheet, as well as the earlier chart we saw about rising debt servicing costs.

**[Chart 7] Bouts of risk premium**

Let’s turn more directly to the bond market and some occasions when interest rate risk crystallised.

This chart shows the correlation between the UK to US yield gap in 10y rates and Sterling-Dollar exchange rate.

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

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

The early January episode 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.

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

We can use a related intuition exploiting the co-movement in asset prices in a more formal statistical model to quantify the risk premium effect.

In this vector auto-regression (VAR) model, a higher risk premium raises interest rates, weakens the currency as before while also lowering equity prices, and lowers 2y inflation. We can distinguish that from the other macro shocks labelled in the decomposition.

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. Here, I just focus on the risk premium episode in January.

On these estimates, a UK risk premium effect accounted for 5bp of the 30 bp rise in 10y gilt yields in January, before subsiding. The risk premium made a bigger contribution to the moves in FX, almost fully accounting for the 1.5% weakening in the currency in just a few days.

On this decomposition, more of the moves in the bond market owed to Demand effects which likely included spillovers from US markets.

But we shouldn’t allow that to distract us from the broader 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.

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

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

**In the January episode, markets expected fewer rate cuts [right]. Much more aggressive rate hikes were expected during the Truss mini-Budget episode [left] during what was already 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 by even more – and overshoot to the downside -- to deliver the expected appreciation needed to compensate foreign investors for the higher risk premium on Sterling assets.

The better response, though, is to address the issue at source – with fiscal consolidation. That’s essentially what we got after the Truss mini-Budget: the Budget give-aways were quickly reversed. The BoE also responded but the asset purchases were strictly targeted and temporary before the MPC reverted back to its QT plans.

In January, the Bank was also 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 interest rate markets; and second, it would make more predictable MPC communication easier.

**[10: Dovish Comms less Credible?]**

If inflationary pressures are still quite persistent, we might expect the bond market to doubt a 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.

Typically, at MPC events, there’s been a 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. That what the red dots since mid-2022 show.

The bond market has been a bit more sceptical of whether Dovish front-end market reactions also apply further along the yield curve.

Looking ahead, if the case for rate cuts would be stronger following a fiscal tightening, I’d expect this Gilt yield reaction to revert back to being closer to the traditional positive one shown in this left hand chart, being less sceptical about the case for rate cuts in that context.

**[Chart 11a] Output gap, [Chart 11b] Beveridge curve**

One critique of more fiscal tightening is that UK growth is simply too weak.

But thinking in terms of levels rather than growth rates, it’s still quite plausible to think that the UK’s Output gap is positive.

That’s the message from these two charts. Capacity utilisation is still above normal, at least on the BCC measure. Slack in the jobs market may also be below normal.

The recent rise in payroll taxes at a time when we’ve had some wage resistance would normally push up on equilibrium unemployment further limiting slack in the jobs market or pointing to a positive output gap.

**Chart 12: BoE Forecast Errors**

We have also repeatedly seen the BoE and OBR be too optimistic about the UK economy’s supply capacity.

That’s the message from this Chart. The pattern of the BoE’s past errors has been to tend to underestimate inflation and over-estimate a rise in unemployment. That’s a pattern best explained by having been too optimistic about the supply-side and under-estimate a positive output gap.

**[Chart 13] The Fiscal reaction**

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

It would be represented by a point lying below the estimated regression line shown in this Chart, say in the upcoming Autumn Budget.

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 here.

October’s Autumn Budget deviated from that through a net fiscal easing of 1% of GDP by raising spending by 2% of GDP partly offset by 1% of GDP in higher taxes.

The recent March Statement involved a modest, back-loaded tightening that generated significant political pressure.

This year’s Autumn Budget might have to return to tax rises as well as spending restraint.

But loosening the fiscal rules later this year would point to more of a “fiscal fatigue” scenario, encouraging the bond market to believe that the UK is approaching the limits of its tolerance for higher taxes or public spending cuts even though a further fiscal effort is still needed to stabilise debt.

To avoid the fiscal fatigue scenario, we need the line in this RH chart to steepen back up and show a reaction in the primary balance to higher public debt. We could only get away with this flat line since the financial crisis because of low interest rates.

**Conclusions**

Let me conclude. The UK should look at the risk premium episodes in January or after last October’s Budget as warnings about the underlying fiscal effort still needed amid uncertain public support and a lot of interest rate risk.

If the world has changed on account of geopolitics including a necessary rise in Defence spending then that should be tax-financed, or financed from reallocated Spending, not deficit-financed.

Revising and weakening the fiscal rules again would be seen by the bond market as another symptom of “fiscal fatigue” setting-in.

And limiting risk premium episodes would have the further benefits of smoothing monetary policy transmission and supporting more predictable MPC communications.

I’ll stop there. Thanks a million.