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How market pressure can trigger fiscal consolidation: Some case studies

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With the recent rise in long-end bond yields, there've been growing questions about fiscal sustainability. After all, global public debt is forecast to keep rising, and many countries haven't run a budget surplus in decades.

Historically, a common pattern is that growing market pressure eventually leads to fiscal consolidation. Sometimes that's driven by intense market turmoil, as in the Euro Crisis. At other times policymakers have acted pre-emptively as pressure builds, particularly if interest rates are gradually moving higher. We saw that in the US in the late-1980s and early 1990s.

This note looks at several historic instances when fiscal consolidation occurred amidst growing market pressure. Although each scenario is different, it's noteworthy that when market pressure starts to build, what might seem politically impossible can quickly become a serious option. Indeed, much as spending cuts or tax rises might be painful, the alternatives of spiralling mortgage rates, capital flight, or a sharp currency depreciation (and therefore inflation), are often far worse scenarios for any government to face.

When have policymakers previously moved towards fiscal consolidation?

US deficit reduction in the late 1980s-early 1990s: Concern about the growing debt burden led to sustained surpluses by the late-1990s

Although the deficits of the 1980s under President Reagan might seem moderate by today's standards, they generated significant concern at the time. For instance, the 1983 deficit was the biggest since WWII. Moreover, average interest rates on the debt were much higher back then, so even a comparatively lower debt-to-GDP ratio could prove problematic from a debt sustainability point of view.

This backdrop led to growing calls to fix this. One of the first serious attempts came from Senators Gramm, Rudman and Hollings (GRH), two Republicans and a Democrat. They authored the Balanced Budget and Emergency Deficit Control Act of 1985, which included something called sequestration – automatic spending cuts if the deficit targets weren't met.

Although GRH didn't lead to a durable shift, the automatic spending cuts under sequestration meant that by 1990, politicians had to take action if they were to avoid major automatic cuts to spending that would happen under sequestration. This was under President George H. W. Bush, and a bipartisan agreement was reached that included spending cuts and tax rises. Specifically, that was done in the Budget Enforcement Act of 1990, which included discretionary spending caps, and a pay-as-you-go rule on both entitlement spending and taxes. So that meant that any proposal to lower tax receipts or increase spending on entitlements couldn't increase the deficit, so had to be accompanied by a way to increase revenue elsewhere or cut spending.

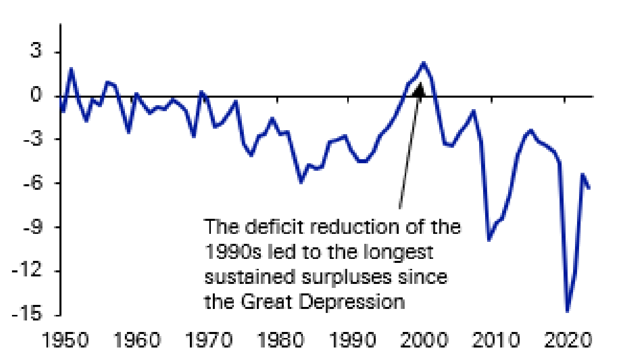
In retrospect, that agreement was a big turning point in reining in the deficit. Moreover, the political climate was also becoming more favourable to deficit reduction at this point. For instance, the independent candidate Ross Perot (who focused on the national debt) scored 19% in his 1992 presidential run, the highest for a third-party candidate since 1912. When President Clinton arrived in office in 1993, there was the further deficit reduction under the Omnibus Budget Reconciliation Act of 1993.

The deficit reduction of this period helped support a significant bond market rally in the early 1990s. Moreover, the moves were successful, and there were 4 consecutive budget surpluses over 1998-2001, which is the longest run of sustained surpluses since the Great Depression.

Figure 1: Average interest rate (%) on interest-bearing US Public Debt

Source: Haver Analytics, Deutsche Bank

Figure 2: Federal Surplus/Deficit (% of GDP)



Source: Haver Analytics, Deutsche Bank

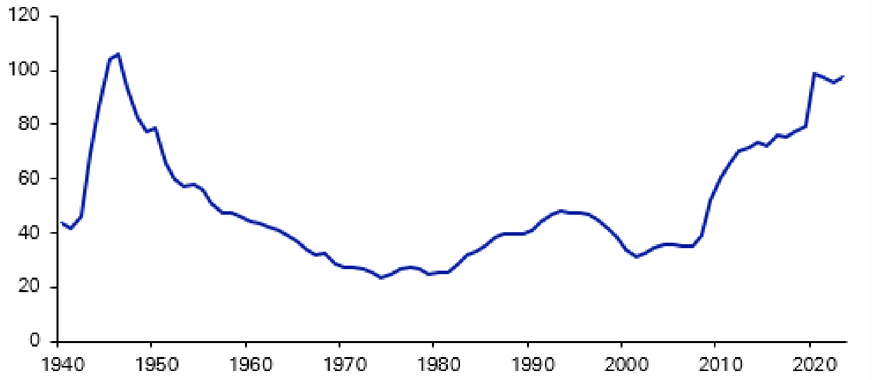
US deficit reduction after WWII: The record debt burden and need to maintain investor confidence led to consistent primary surpluses that significantly lowered debt

After WWII, the US national debt stood at an all-time high, reflecting the surge in borrowing necessary to finance the war. Once the conflict was finished, attention swiftly turned to reducing this. After all, balanced budgets were still part of the economic orthodoxy at the time. And memories were still present of WWI's aftermath, when many countries fell into severe problems like hyperinflation, in part because of unsustainable debt levels and investors losing confidence. Moreover, the new Bretton Woods system (tying the dollar to gold) required that investors maintain their confidence in the US Dollar.

In light of this, there was a huge push towards reducing the debt, and the federal government ran a broadly balanced budget throughout the late-1940s and 1950s. To be fair, there was also a helping hand from a surprise burst of inflation, so that reduced the debt's value in real terms. The government also still used financial repression at this point, and from 1942-51, the Fed maintained an interest rate peg on short-term Treasury bills. Meanwhile, economic growth was also very strong in the post-war era, aided by favourable demographic trends and new technological advances.

Thanks to all these various measures, including the balanced budgets that were run, the US debt plummeted from 106% of GDP in fiscal year 1946, down to 27% by fiscal year 1970.

Figure 3: US Federal Debt Held by the Public (% of GDP) – after reaching an all-time high, public debt plummeted after WWII



Source: Haver Analytics, Deutsche Bank

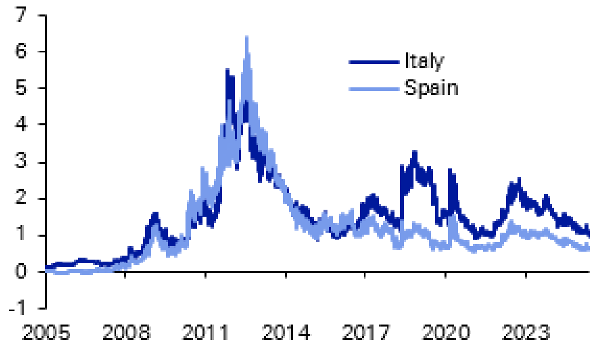
Euro crisis in the early 2010s: Market turmoil forces rapid fiscal tightening

The Euro crisis represents a classic example where fiscal tightening was directly in response to market turmoil. Greece was the initial focus, facing intense scrutiny after they said their deficits had been higher than previously thought. That triggered a significant rise in bond yields that led to a bailout in May 2010. But contagion quickly spread to other countries, including Ireland and Portugal (who also received bailouts), as well as larger countries like Italy and Spain.

This was a classic vicious circle, where concerns about debt sustainability led to a rise in bond yields, which in turn made investors more fearful about the debt trajectory, triggering a fresh rise in bond yields. So it was difficult to break out of that dynamic once it started. Lots of countries, including those well away from bailout territory, moved to tighten fiscal policy to alleviate market concerns. So the overall Euro Area deficit went from around 7% of GDP at the height of the turmoil, to almost balance by the late-2010s.

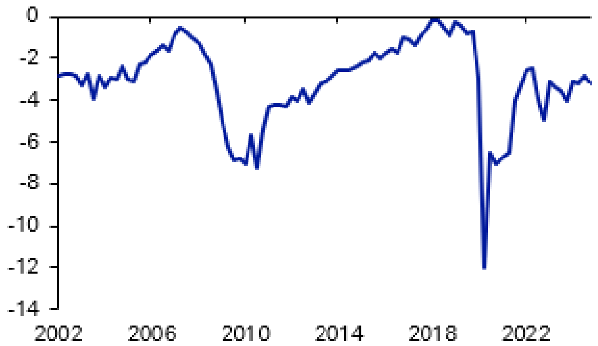
In retrospect, the most important turning point came with ECB President Mario Draghi's pledge in July 2012 to do "whatever it takes" to save the euro. They outlined a programme called Outright Monetary Transactions, which was never actually used, but which markets saw as credible. There were still periodic bouts of turmoil after this, most notably with Greece in 2015, but there was no repeat of the wider contagion across the Euro Area seen at the height of the sovereign crisis.

Figure 4: 10yr Yield Spread (%) over German bunds



Source: Bloomberg Finance LP, Deutsche Bank

Figure 5: Euro Area Surplus/Deficit (% of GDP)



Source: Haver Analytics, Deutsche Bank

UK 2022 mini-budget/LDI crisis: Intense market turmoil led to a swift policy reversal

In retrospect, the turmoil of September-October 2022 was incredibly brief, and many of the announced policies were never even implemented. But it offers a stark case study for how governments can rapidly back down under market pressure.

The context was a significant package of tax cuts, the biggest in half a century, which was announced by the new UK government under Prime Minister Liz Truss. Technically, it wasn't a formal budget, hence it was widely dubbed the "mini-budget". The backdrop was a tough one of sharply rising market interest rates, alongside double-digit inflation, and the new government had also just announced substantial support to pay people's energy bills, which were surging across Europe.

The tax cuts announced were substantial, including a cut in national insurance of 1.25pp, cancelling the planned Corporation Tax increase, and abolishing the top 45% rate of income tax. However, there was quickly a negative market reaction, and the pound sterling fell to its weakest level against the US Dollar on record, just above parity at $1.035. Moreover, gilt yields catapulted higher, with the 10yr yield up more than +100bps in the three sessions after the mini-budget. That in turn quickly filtered through into mortgage rates, which were a significant issue given the number of people in the UK on short-term rate fixes of 2 or 5-years.

With the government under intense pressure, they initially announced that the top 45% rate of income tax would remain in place. Then they confirmed that the previously planned rise in corporation tax would still go ahead. And then the bulk of the other measures were reversed by the new Chancellor of the Exchequer Jeremy Hunt. So even before being implemented, there was a huge policy reversal under market pressure.

Figure 6: 10yr gilt yields (%) in late-2022 – after the mini-budget they spiked by over 100bps in just three sessions

Source: Bloomberg Finance LP, Deutsche Bank

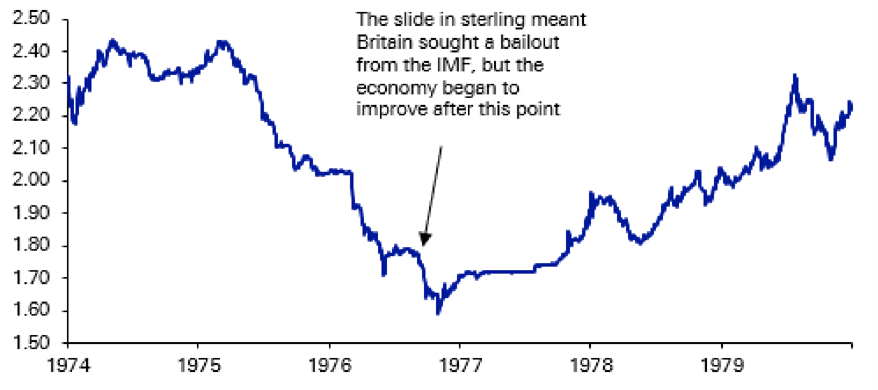
UK 1976 sterling crisis: Britain gets a $3.9bn IMF bailout that commits to significant spending cuts

2022 wasn't the first time the UK had faced intense market pressure that forced a policy shift. In the 1970s, the country had an IMF bailout that required them to commit to significant spending cuts and tax rises to cut the deficit.

Similar to the 2022 case, the backdrop was one of incredibly high inflation and growing budget deficits. The Western world had faced high inflation since the 1973 oil crisis, which saw the oil prices almost quadruple. The UK economy had been stagnant for three years, whilst inflation was also raging, with CPI peaking at 24.5% in August 1975, more than double the most recent peak of 11.1% in October 2022. The budget deficit was above 5% of GDP, the largest since WWII at that point, and there was a sustained current account deficit as well.

This situation meant sterling came under significant pressure, falling from around $2.40 in early-1975 to around $1.80 by mid-1976. This saw the government request a loan from the IMF that September. However, they demanded more spending cuts in return, which caused significant political difficulties for the Labour government at the time. After the bailout, the economy began to improve and sterling gradually strengthened again. So the market turmoil abated. However, ongoing industrial unrest, culminating in the "Winter of Discontent" in 1978-79, contributed to the Labour Party's fall from power in the 1979 general election, with Margaret Thatcher becoming PM.

Figure 7: GBP/USD in the 1970s



Source: Bloomberg Finance LP, Deutsche Bank

UK in 1931: Facing intense market pressure, the government collapses and the UK ends up leaving the Gold Standard

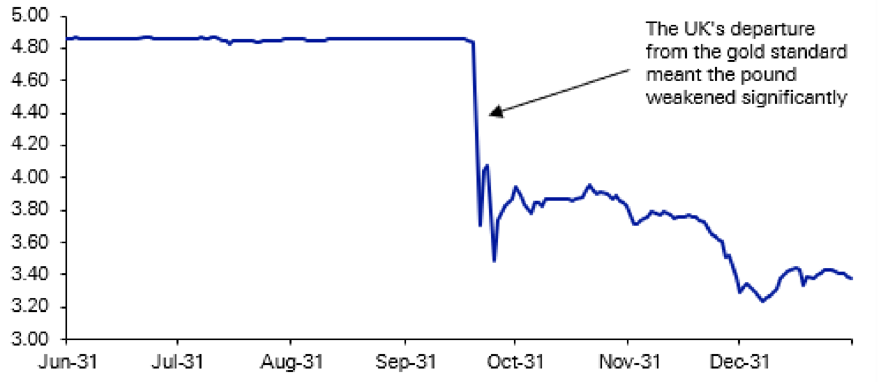
In 1931, the UK was suffering the effects of the Great Depression, and there was growing doubt in financial markets about sterling's position on the Gold Standard. The problem was that the growing need to support unemployed workers meant it was an increasing struggle to balance the budget and keep sterling on the gold standard. Under pressure, the then-Chancellor of the Exchequer Philip Snowden set up the Committee on National Expenditure, which was set up to examine the public finances and chaired by George May.

This committee published the May Report that called for significant public spending cuts (including to unemployment benefits), as well as public sector wage cuts. However, this caused a huge split in the cabinet of the then-minority Labour government, which voted by just 11-9 in favour of the spending cuts. The Prime Minister Ramsay MacDonald was seeking to avoid a financial crisis, but many cabinet ministers were threatening to resign if the cuts went through, so the government fell.

In its place, MacDonald agreed to form a "National Government" that was also comprised of Conservative and Liberal politicians, whilst MacDonald himself was expelled from the Labour Party. However, as the new government sought to cut spending, this produced a naval mutiny, where sailors on the ships at Invergordon started to refuse orders. This led to further pressure on the pound, as it eroded market confidence in Britain and the government's ability to cut spending, at a time when the country was experiencing gold outflows. With the pressure mounting, this saw Britain come off the gold standard altogether.

Ultimately, Britain coming off the gold standard was seen in a more positive light. With the pound now floating, British exports became more competitive, and monetary policy was then eased in 1932 as well. So that set the stage for a stronger economic recovery, and the evidence has since shown that the countries which came off the Gold Standard earlier performed relatively better in the Great Depression.

Figure 8: GBP/USD after Britain came off the Gold Standard in 1931



Source: Finaeon, Deutsche Bank

Conclusion

These case studies are wide-ranging, but they show how the political environment can quickly shift towards deficit reduction under market pressure. Much as spending cuts and tax rises can be painful, on both an economic and a political level, the alternatives of intensifying market turmoil or a financial crisis have often forced decisions that might have looked impossible just beforehand.

In today's context, the hope is naturally that faster economic growth can help reduce these debt burdens in a relatively pain-free way. Indeed, in all the instances mentioned above, the fiscal tightening went alongside an economic recovery that was crucial to getting debt lower. But without an acceleration in growth, many countries remain on unsustainable fiscal trajectories. So if bond yields do continue to creep higher, policymakers will have to confront much tougher fiscal choices over the years ahead.

Appendix 1

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