UK Macro:
A view from financial markets

Andrew Benito

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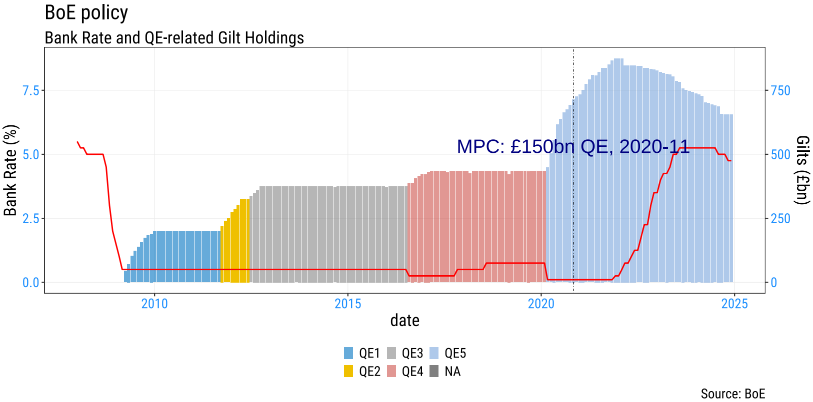
Key Questions

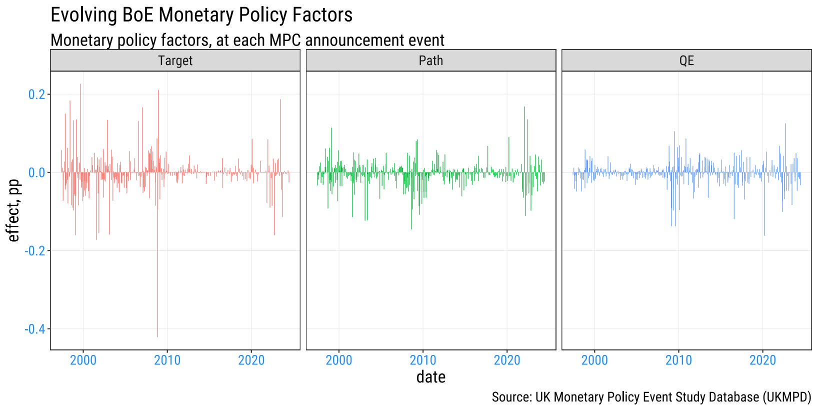
- How is the UK economy **evolving**?
- How is the UK's **policy mix** evolving?
- Where might we be going badly **wrong**?

BoE Policy Settings



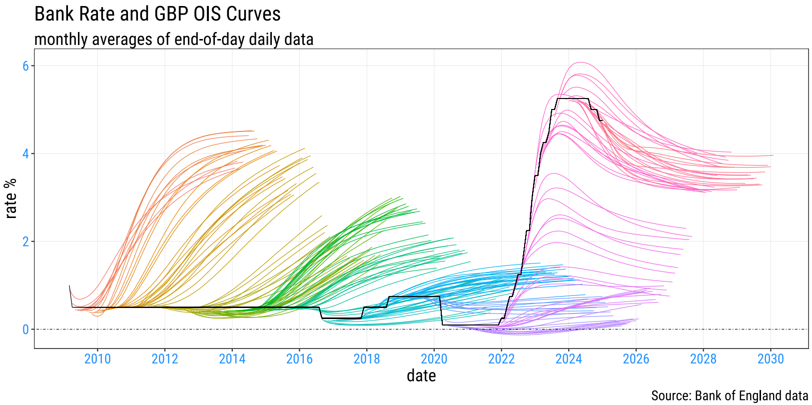
- Current rate-cutting cycle follows MPC's sharpest rate-hiking cycle.
- QT has reversed add'l Gilts held from the GBP150bn QE decision [Nov 2020].

Evolving forms of Monetary Policy



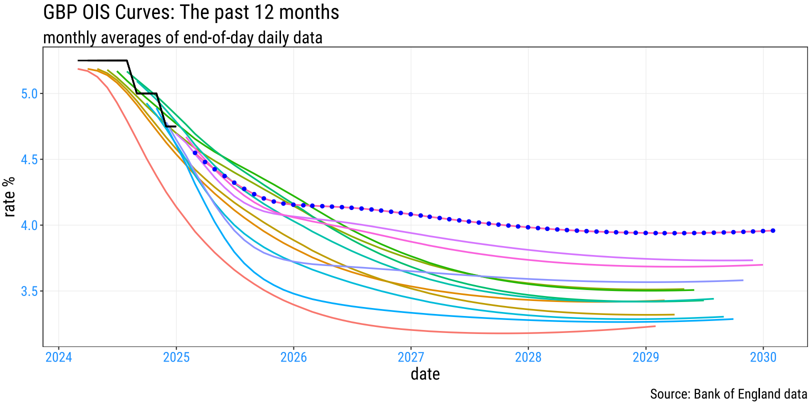
- Managing market expectations - medium-term path for monetary policy has a stronger and more prolonged effect on inflation.

Evolving Market expectations



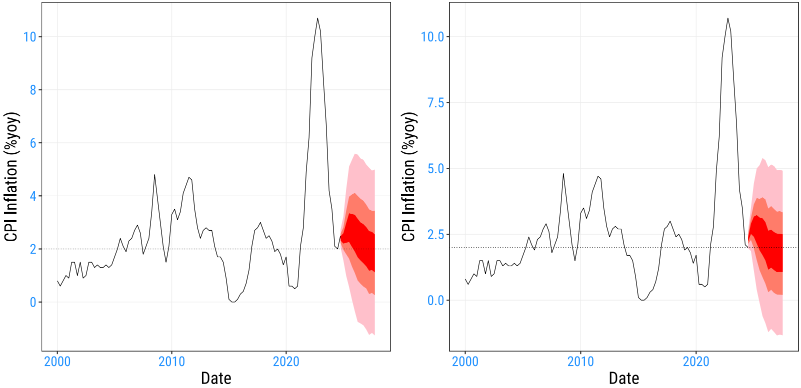
- Hard-to-learn features, eg productivity growth and r-star.

Zooming in... the past year



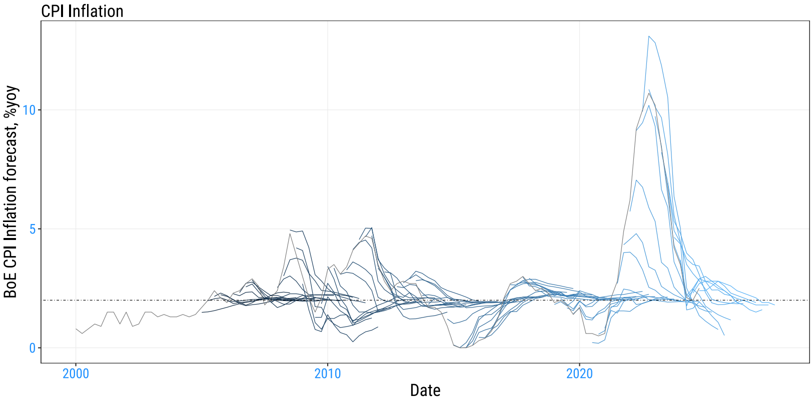
- Expected rate cuts have moderated, coinciding with US election, UK fiscal news and upward revisions to UK infl outlook.

An Evolving Inflation Outlook?



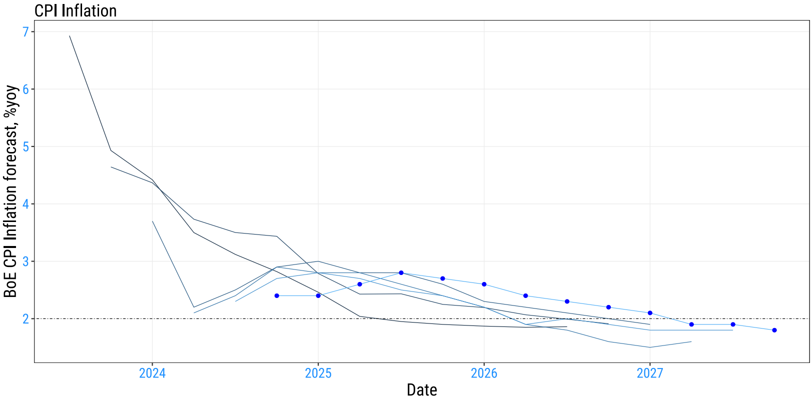
- BoE's Fan charts say little about the scale, persistence and source of macro news – about 'how is the economy evolving?'

Macro news: scale, persistence of source of news



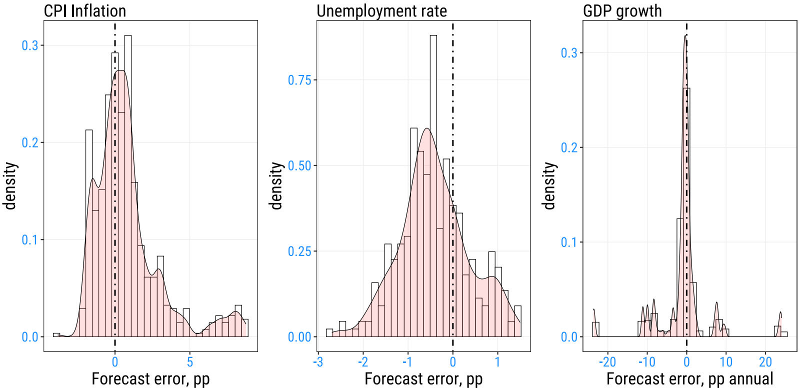
- Policy framework broadly robust to its largest inflation shock.

More recent disinflation news



- Some of the faster-than-expected disinflation of the past year is judged to be temporary. Inflation forecasts now evolving higher.

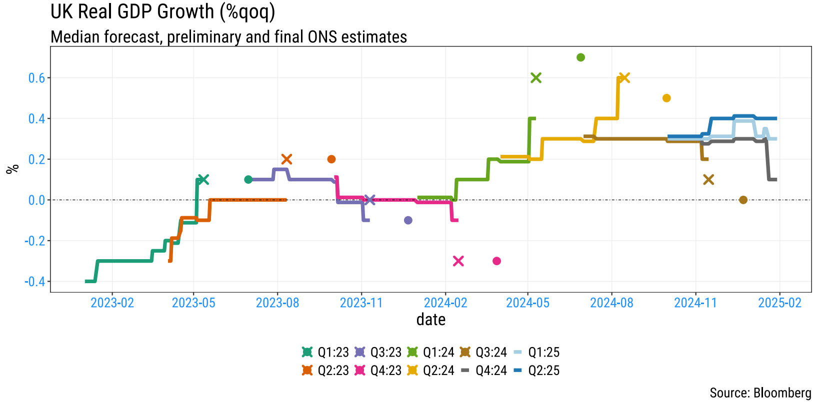
The pattern of BoE forecast errors



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

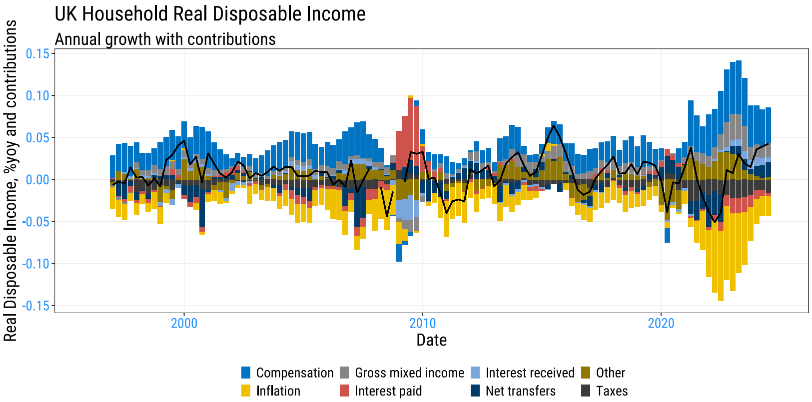
Growth agenda – Evolving expectations and out-turns

[1] "updating charts starting in 2022" [1] "updating charts starting in 2023" [1] "done"



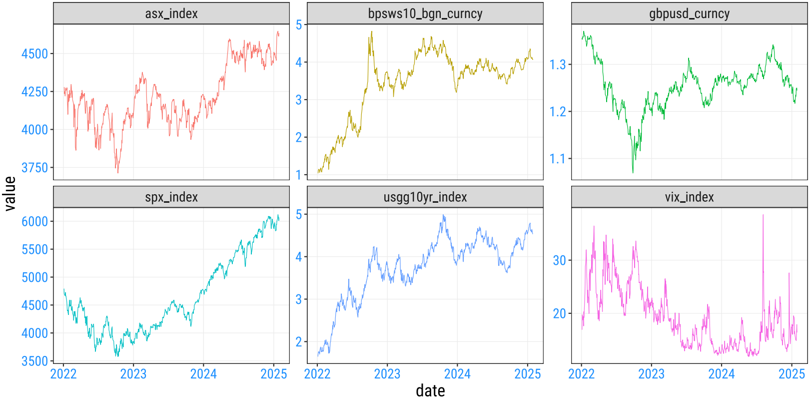
- Medium-term growth: innovation and reallocation effects dominate capital deepening.
- Is weak private investment a consequence rather than a cause of weak TFP and GDP growth? Easing planning rules can

Household real incomes



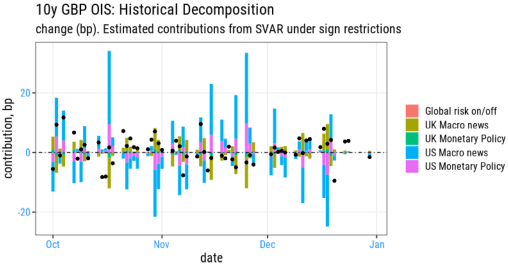
- The drag from elevated inflation and interest paid subsiding; household taxes a steady/persistent drag since 2023.

Sterling asset prices



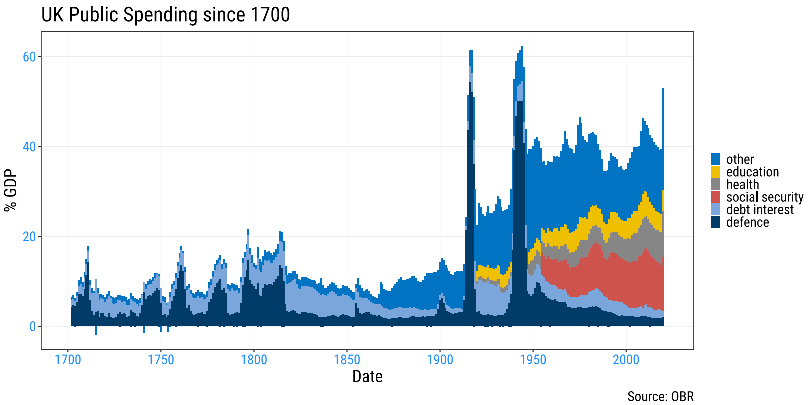
- Aim: distinguish sources of news: (i) UK macro (ii) BoE Monetary policy news (iii) US macro (iv) Fed policy and (v) 'Risk-on'.

Decomposing changes in asset prices into macro



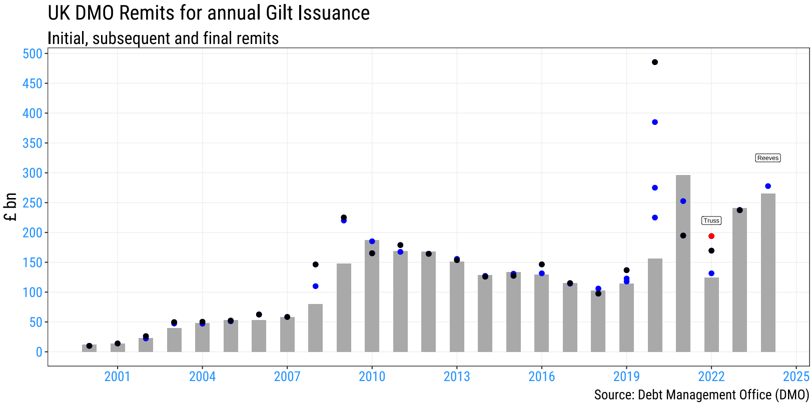
- Results from a Bayesian VAR estimated under sign restrictions on daily, financial market data.
- OIS higher on US spillovers.

Public spending shouldered by bond-holders + tax-payers

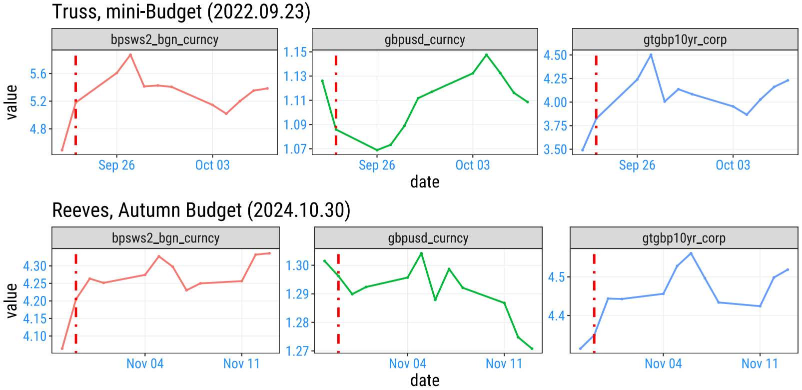


- The bond market recognises that politicians can be inclined towards making Bond-holders, not Tax-payers, shoulder Public spending.

Debt Issuance approaching its limits?

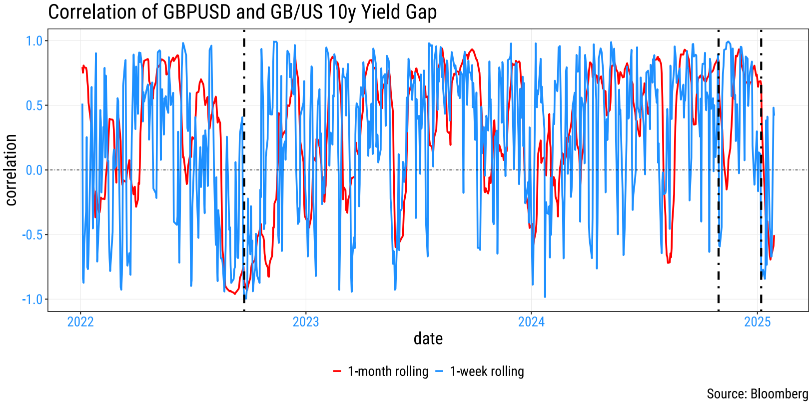


Truss vs Reeves: financial markets' (15day) assessment



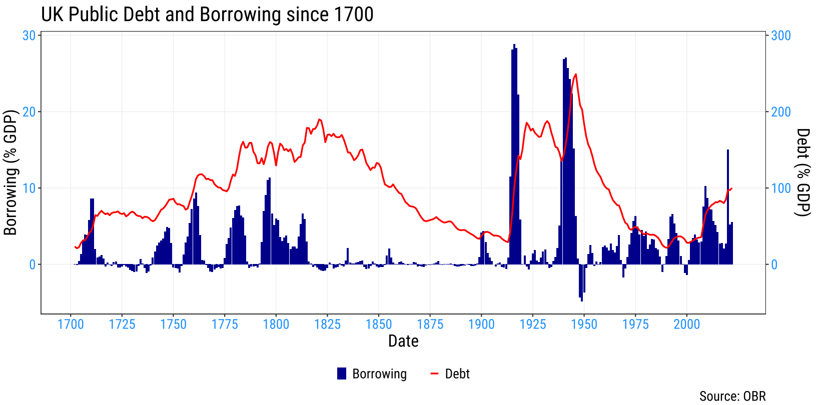
- **Truss**: a loss of (foreign) **investor confidence**, exacerbated by long-term investors (LDI). BoE interventions stabilised.
- **Reeves**: a more standard injection of **aggregate Demand**, met with higher ST interest-rates. A subsequent deterioration in aggregate Supply or Risk premium?

Bouts of risk premium



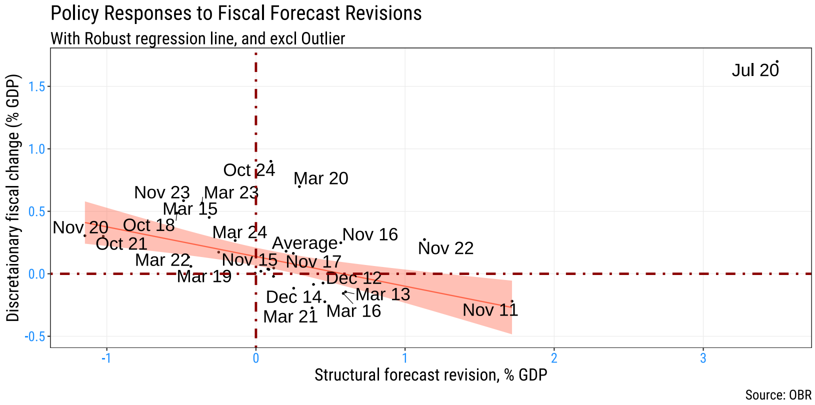
- Instability reflects time-varying roles for different shocks.
- ‘normal’ $\rho > 0$ consistent with Demand news pushing Yields and Currency in same direction. Risk premium => opposing directions and $\rho < 0$.
- Reeves episode a much smaller and more temporary bout of risk premium than Truss mini-Budget.

Worsening fiscal arithmetic: a public debt ratchet



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

Fiscal choices based on Macro news



- Spending some of proceeds of good news rather than ‘paying-down’ debt. Oct’24 Budget loose relative to that pattern.
- Fiscal policy tightened at only 2 out of 21 fiscal events since 2015. Estimates of ‘Headroom’ small.

A plan to restore Fiscal Space? No.

Required, Debt-stabilising, Primary Balance (% GDP)

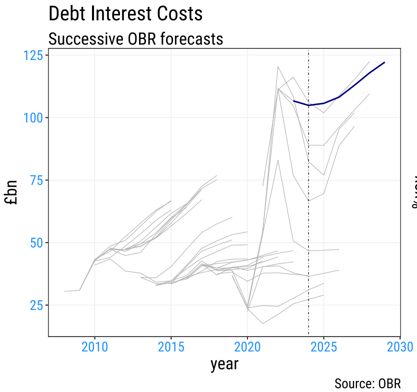
effective nominal interest rate, r

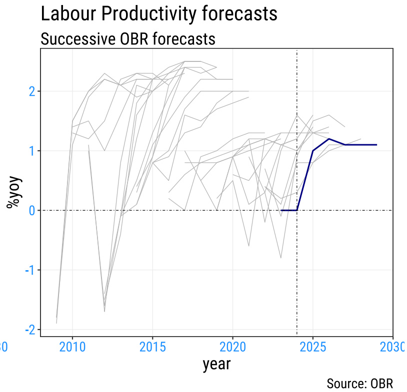
g	0.015	0.02	0.025	0.03	0.035	0.04
0.010	0.51	1.01	1.52	2.02	2.53	3.03
0.015	0.00	0.51	1.02	1.52	2.03	2.54
0.020	-0.51	0.00	0.51	1.02	1.53	2.04
0.025	-1.03	-0.51	0.00	0.51	1.03	1.54
0.030	-1.55	-1.03	-0.52	0.00	0.52	1.03
0.035	-2.07	-1.55	-1.04	-0.52	0.00	0.52
0.040	-2.60	-2.08	-1.56	-1.04	-0.52	0.00

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.

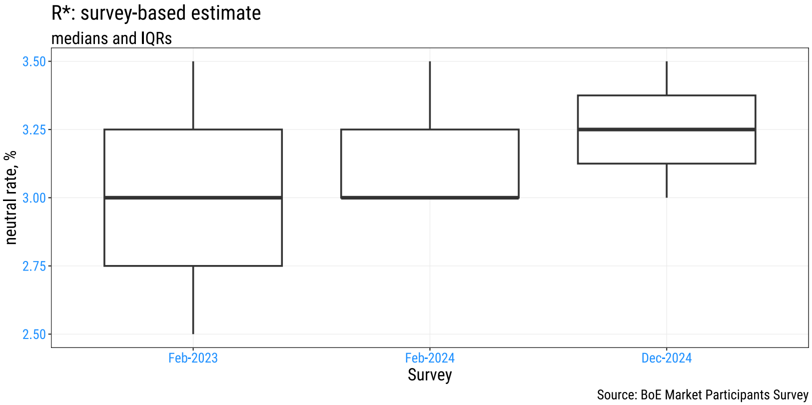
r↑, g↓





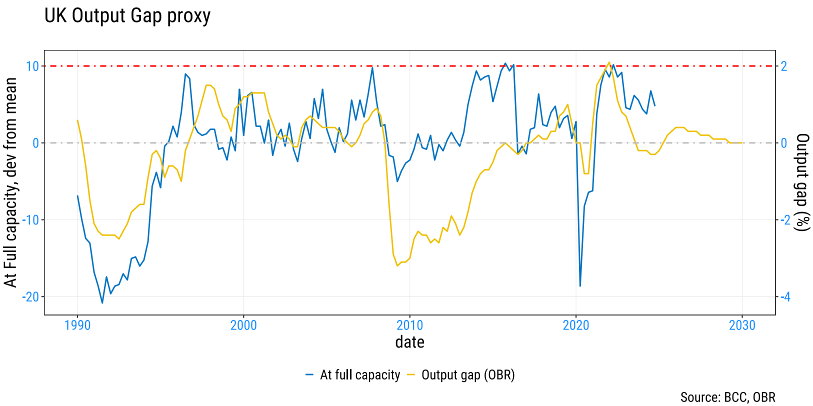
- +50bp on market interest rates adds £10bn to public borrowing in 5Y.
- -1% from level of productivity adds c.£10bn to public borrowing in 5Y.

Estimates of neutral rates drifting higher

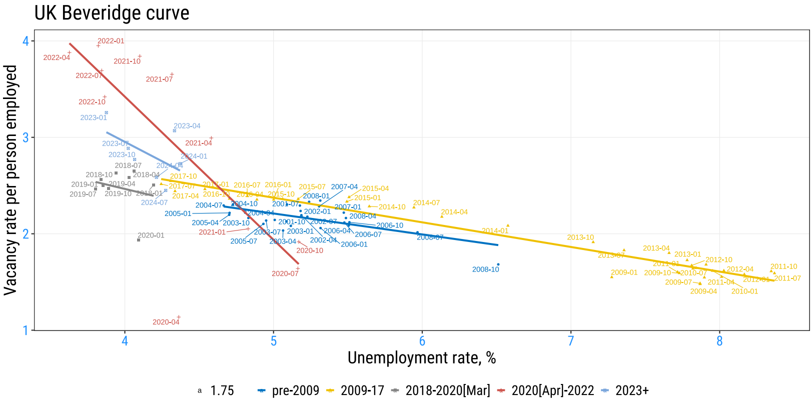


- Risk of US fiscal policy pushing up on global neutral rates (r*).
- If Output gap>0 and Disinflation stalling, ‘r’ is closer to ’r*’ or neutral than thought.

g↓and y* may be lower than thought

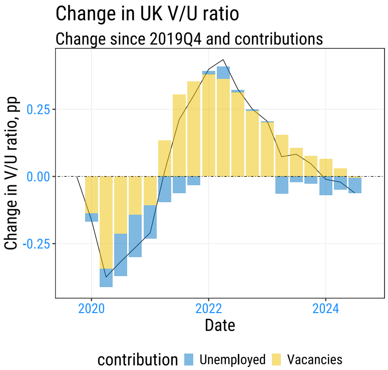


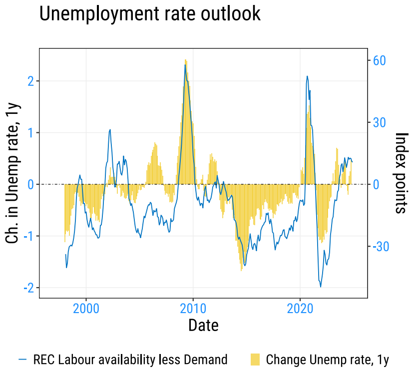
U*↑



- Pre-Covid vs. latest U/V curve suggests an outward shift in U*. Sticky wage growth is another symptom.

Rising unemployment





Sources: REC/KPMG

- Risk: U*↑is mis-interpreted as a cyclical effect.
- Would imply some additional inflationary pressure, keeping ‘r’ higher than otherwise.

What have we learned?

- **Learning** about how the economy is evolving, while still **reassessing the starting point** of what we thought we cld take as given.
- **Bayesians**: learning is continuous. But might we have to ‘unlearn’ something, previously taken as given? Imagine: jumping to a different branch of a decision tree.
- **Policy**: the misdiagnosed ‘starting point’ origin of large 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? Disinflation that still depends on a restrictive monetary policy stance. Supply-side constrains GDP growth.

How is the UK policy mix evolving? Withdrawal of both monetary restriction and fiscal support slower than expected a year ago. Fiscal policy as a driver of Monetary policy outlook, as well as Global news.

Where might we be going badly wrong?
- Both Debt sustainability and Inflation persistence are sensitive to over-stating supply capacity and its trend.
- Added risk that higher U is mis-diagnosed as slack (U-U*) when it owes to higher structural U*. Bouts of risk premium.
- Cyclical: Consumers may discount fiscal consolidation, while mon pol eases (Hawkish/Infl). Or, transmission of past monetary tightening delayed (Dovish/Growth at risk).