

# Fiscal policy, the bond market and implications for monetary policy

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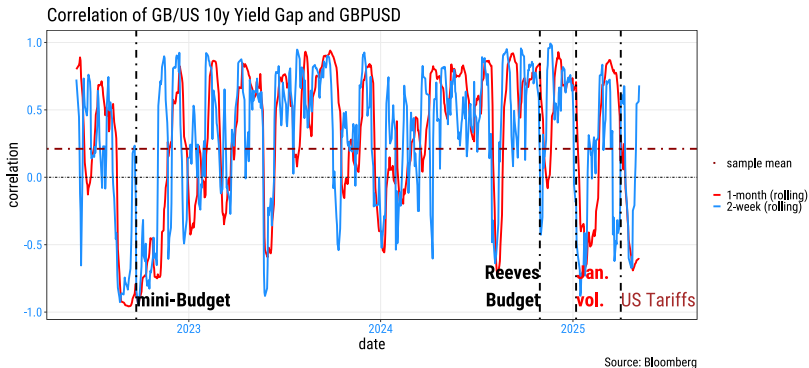
Remarks at BoE Watchers Conference

May 12, 2025

# Main messages

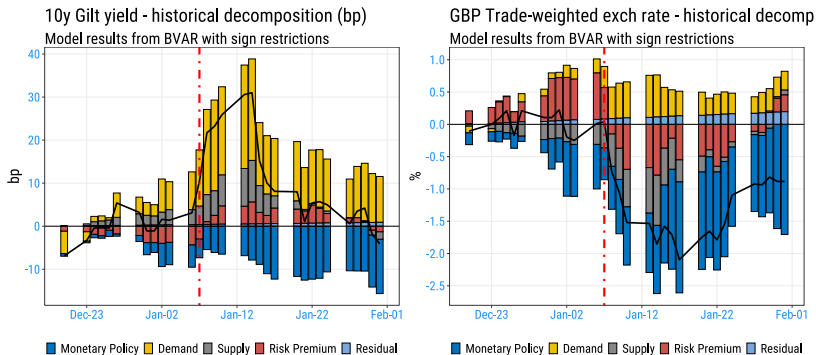
- ▶ **Markets** Risk of **fiscal fatigue**: more fiscal effort is needed but may lack political support, absent risk premium episodes.
- ▶ **BoE and Monetary policy**
  - **Risk premiums** complicate policy transmission and effectiveness.
  - Ease **monetary policy** as spare capacity opens-up (on fiscal consolidation or US Tariffs), not on fiscal risk premium.
  - Market liquidity: DMO changes preferred. QT changes and capacity to support **market functioning** facilitated by confidence in the fiscal path.
- ▶ Loosening the **fiscal rules** again would be a symptom of fiscal fatigue. More flexibility can come after more of a **track record**.

# Bouts of (Sterling) risk premium



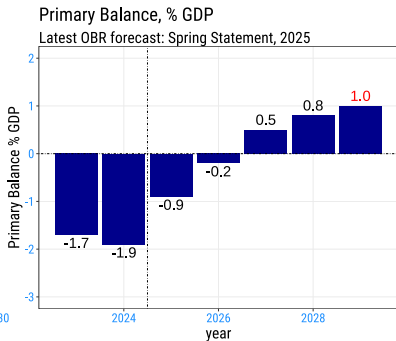
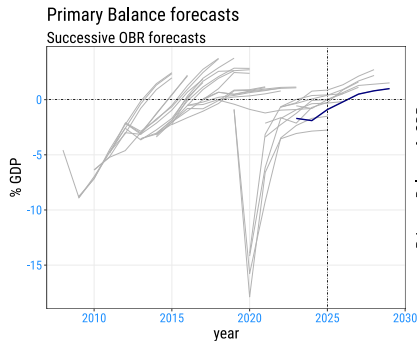
- ▶ Instability reflects changeable roles for different shocks.
- ▶ **Demand** news pushes Yields and Currency in the same direction ( $\rho > 0$ ). **Risk premium** news pushes them in opposing directions ( $\rho < 0$ ).
- ▶ 'Case studies': January episode and US tariffs.

# Quantifying January's risk premium effect



- Risk premium effect accounted for more of the move in foreign exchange than bond yields.

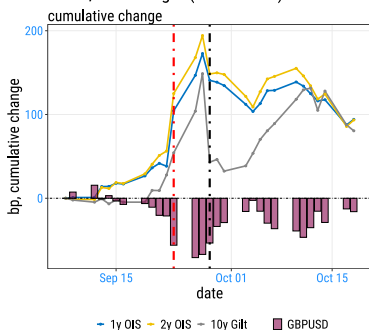
# The fiscal effort: expect delays?



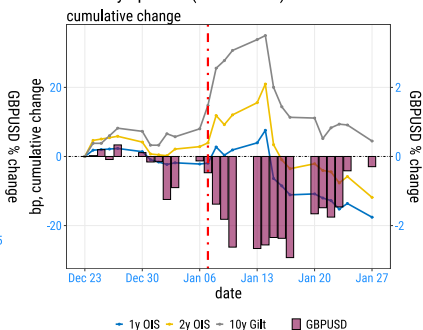
- ▶ Required, Debt-stabilising primary balance has increased from -2.0% of GDP to +1.0% (on  $r\uparrow$ ,  $g\downarrow$ ).
- ▶ Excl. 2020/21, 't+4' forecast error for the primary balance averages -2.4pp.

# BoE: Risk premium episodes complicate policy effectiveness + predictable MPC Comms

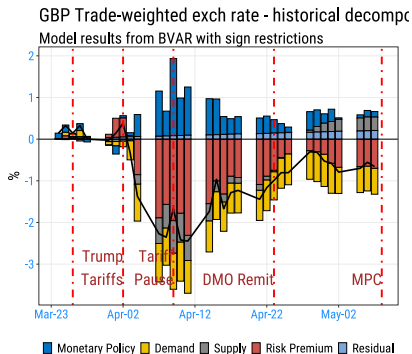
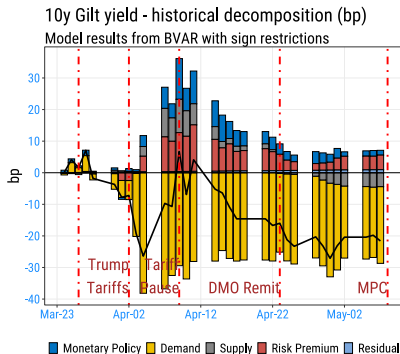
Truss, mini-Budget (2022.09.23)



January episode (2025.01.07)

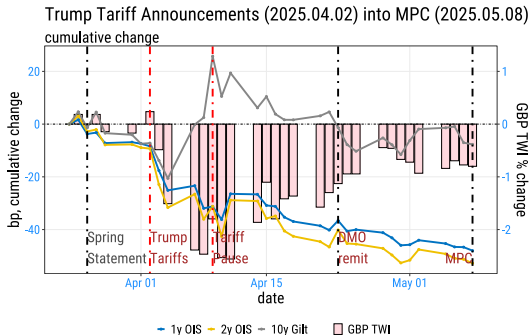


# US Tariffs: Decomposing GBP market reactions

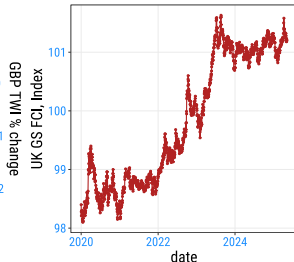


- ▶ **US Tariffs** as a negative Demand shock (for the UK), with a temporary Risk premium effect.
- ▶ Needed: allowance for a US risk premium and its spillovers.

# BoE: weak Demand effects are Dovish. (Fiscal) Risk premium effects not so much



Financial Conditions Index: UK



Sources: Goldman Sachs, Bloomberg

- ▶ Commitment to fiscal rules gives BoE greater flexibility to adjust **QT** (eg.10/04). A high bar on temporary and targeted interventions. **DMO** response (eg.23/04) preferred.



# HMT: The fiscal reaction

## A Weaker Fiscal Response, amid Higher Debt

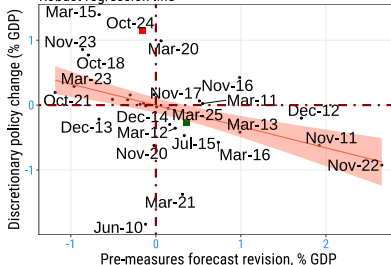
A positive slope implies debt-stabilising policy



Note: The Bohn regressions control for the Output gap

## Policy Responses to Fiscal Forecast Revisions

Robust regression line



Source: OBR

- Suspending or revising fiscal rules would reinforce a sense of UK fiscal fatigue.