Fiscal policy, the bond market and implications for monetary policy

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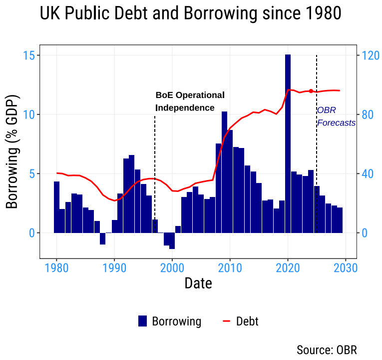
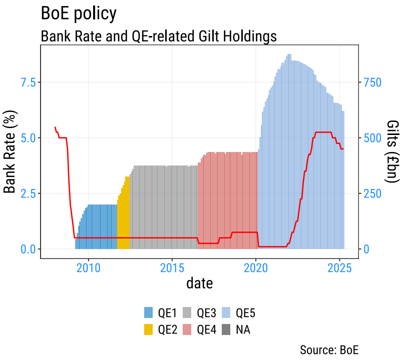
Main messages

- **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 if 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.

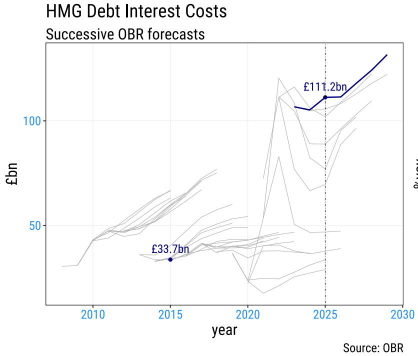
A public debt ratchet and an expanded BoE balance sheet

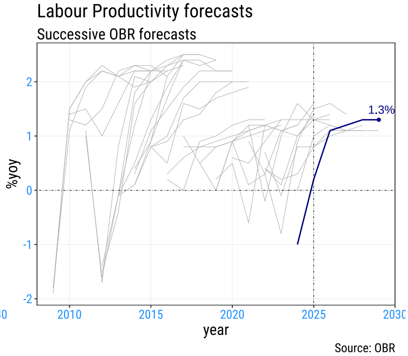




- Debt-to-GDP three times its average in MPC's first decade.
- QE shortened the effective maturity of public liabilities.

r↑, g↓. (r - g)↑↑





- +50bp on interest rates, ~£8bn to public borrowing in 5Y.
- Fiscal and Monetary policies are not co-ordinated when based on different views of future productivity growth.

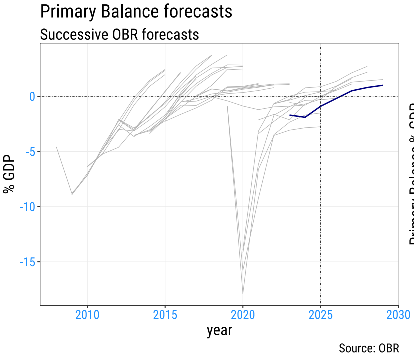
Stabilising debt. Fiscal space?

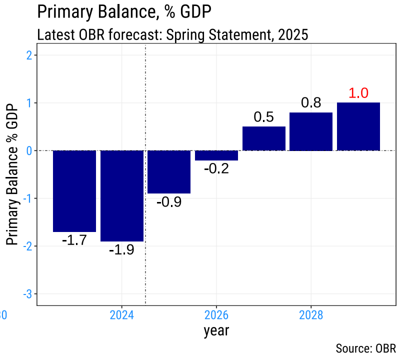
Required, Debt-stabilising, Primary Balance (% GDP)
effective nominal interest rate, r

g	1.5	2	2.5	3	3.5	4	4.5
2.0	-0.49	0.00	0.49	0.98	1.47	1.96	2.45
2.5	-0.98	-0.49	0.00	0.49	0.98	1.46	1.95
3.0	-1.46	-0.97	-0.49	0.00	0.49	0.97	1.46
3.5	-1.93	-1.45	-0.97	-0.48	0.00	0.48	0.97
4.0	-2.40	-1.92	-1.44	-0.96	-0.48	0.00	0.48

Note: Calculations assume Debt/GDP at 100% and no stock-flow adjustments, for different combinations of 'r' and 'g'.

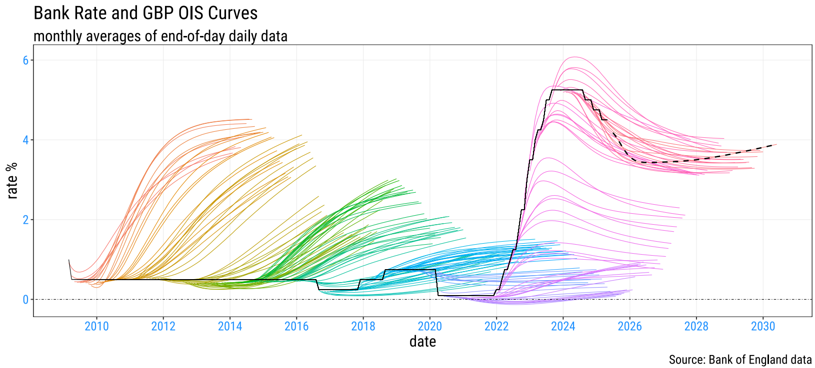
Expect delays





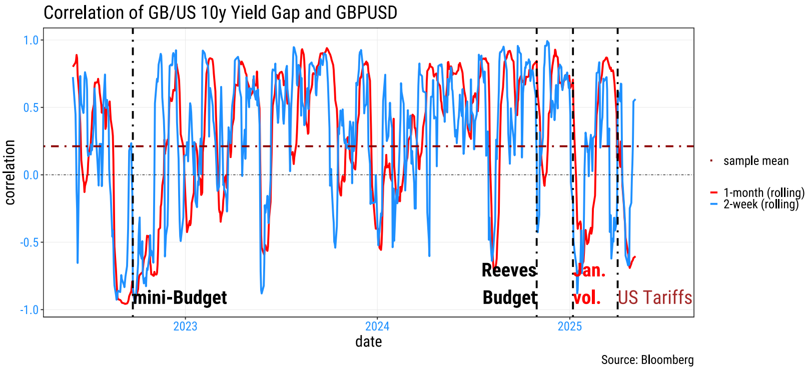
- Even excl. 2020/21, 't+4' forecast error on the OBR's primary balance forecast averages -2.4pp.

Market expectations of ‘r’



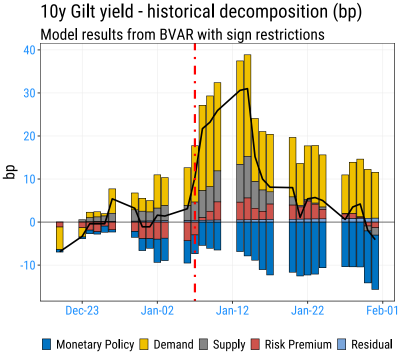
- Hard-to-learn, medium-term features, eg r* and trend productivity growth, lead to serially-correlated revisions (Leland *et al*, 2024).

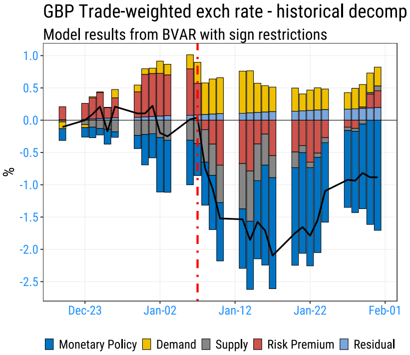
Bouts of (Sterling) risk premium



- Instability reflects changeable roles for different shocks.
- Demand news pushes Yields and Currency in same direction ($\rho > 0$). Risk premium news pushes them in opposing directions ($\rho < 0$).
- January episode a much smaller and more temporary bout of risk premium than Truss mini-Budget.

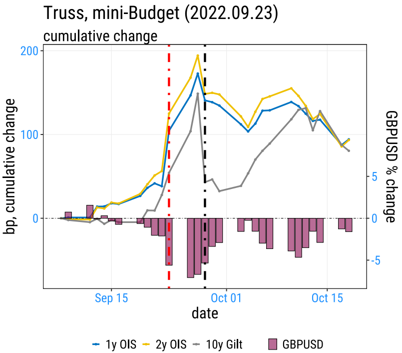
Quantifying the risk premium effect (in January)

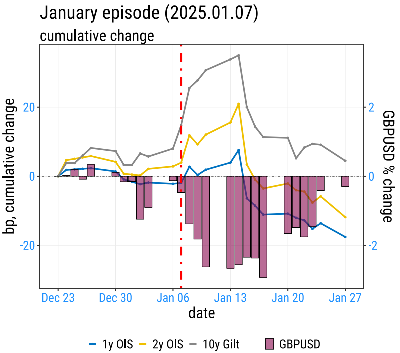




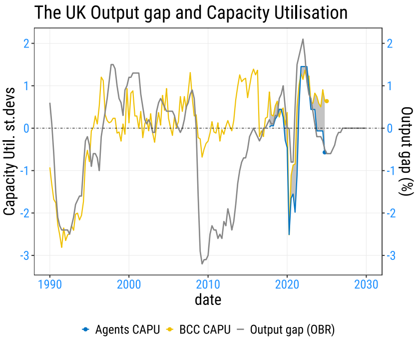
- Risk premium effect accounts for even more of the move in foreign exchange than in bonds.
- The fiscal buffer is **too small**, regardless of the source of shock.

BoE: Risk premium episodes complicate policy transmission + 'predictable' MPC Comms

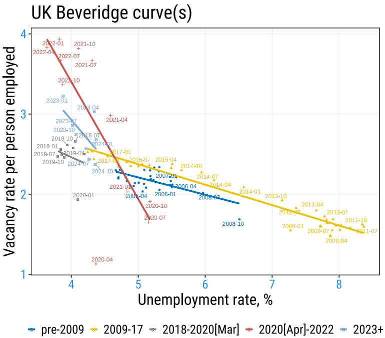




The Output gap still positive, for now?

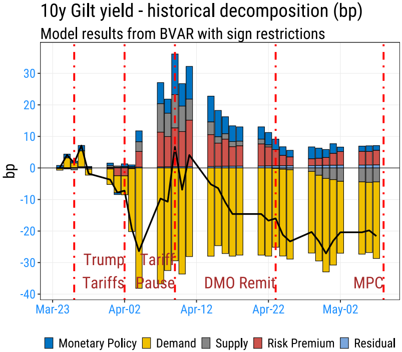


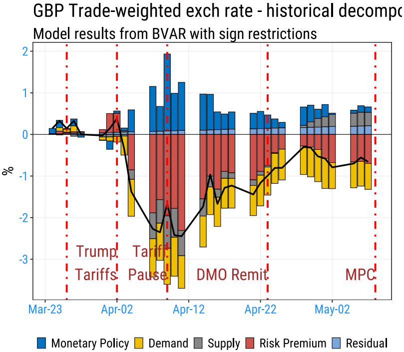
Sources: BCC, BoE, OBR



- Sticky wage growth a symptom of U/V curve's shift outward and (slightly) higher U^* vs. pre-Covid.

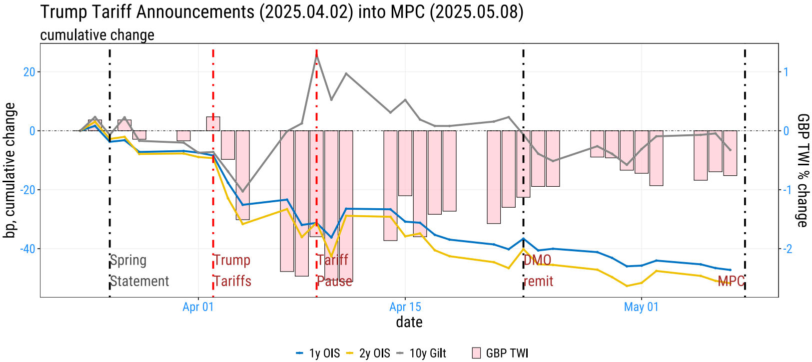
US Tariffs: Decomposing GBP market reactions





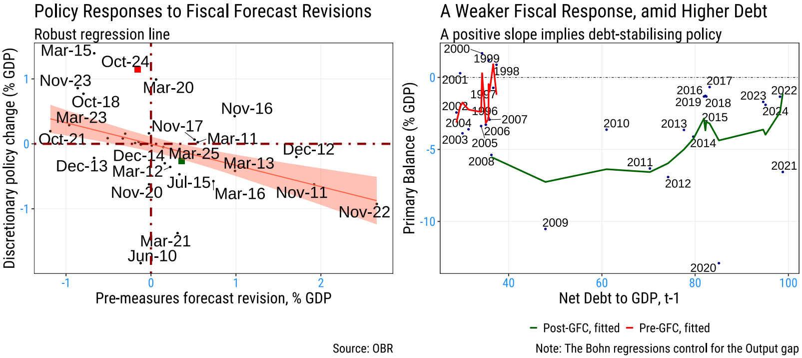
- Predominantly, a negative Demand shock, with some Risk premium effect.

BoE: weak Demand effects are more Dovish than Risk premium effects



- ‘Weaker demand’ is Dovish in a way the ‘risk premium’ is not.
- Needed: allowance for a US risk premium and its spillovers.

The fiscal reaction. Fiscal fatigue?



- Needed: a positive reaction in the primary balance to higher net debt, amid higher ‘r’ and lower ‘g’.
- Looser fiscal rules would reinforce a sense of UK fiscal fatigue.

Conclusions

- **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 hinder policy transmission and effectiveness.
  - Ease monetary policy if spare capacity opens-up (on fiscal consolidation or US Tariffs), not on fiscal risk premium.
  - Interventions to support market functioning or QT changes also 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.