How monetary policy triumphed over fiscal policy in the UK crisis

The Bank of England's inflexible stand was in direct opposition to the fiscal stance of the Liz Struss government, ultimately forcing her downfall

SASHI SIVRAMKRISHNA

OCTOBER 27, 2022 / 12:15 PM IST

The Bank of England in London, Britain. (File/REUTERS/Hannah McKay)

Highlights

- *The Bank of England had announced that it would go in for Quantitative Tightening to curb inflation*
- *The mini-budget of the Liz Struss government would have led to increased government borrowing*
- *The fiscal deficit was raising the expected inflation rate so that a hawkish BoE was expected to raise interest rates even further, accompanied by a more aggressive QT programme*
- *The bond and currency markets plunged*
- *Mortgage markets and pension funds were in trouble*
- *Although the BoE made emergency bond purchases, it announced a deadline for ending the programme*
- *The government caved in*

While Elizabeth Truss' resignation as UK Prime Minister has been attributed to misplaced priorities and even personal ineptitude, it is necessary to articulate the *essence* of what really happened over her short tenure in office: the assertive stance of an independent central bank (the Bank of England, BoE) that triumphed over the (UK) government's fiscal independence.

Globally, the Covid-19 pandemic compelled governments to intervene aggressively through fiscal spending supported by monetary policies that lowered interest rates and provided abundant liquidity through quantitative easing (QE) programmes. However, post-pandemic, the world experienced a sharp rise in inflation rates, triggered by several factors including release of suppressed demand, supply-side constraints, tight labour markets and profit-gouging. The Russia-Ukraine war added fuel to the inflation fire by severely disrupting energy markets, particularly in Europe and the UK.

A first step to bring inflation under control by central banks was to *taper* an existing quantitative easing (QE) programme, which may have been implemented during the pandemic to flood money markets with liquidity as interest rates were lowered. Governments in the normal course of spending, 'borrow' money by issuing new (on-the-run) assets (bonds or gilts) to 'fund' their spending. Central banks then ensure that there is adequate liquidity in the market by first buying back off-the-run assets issued in earlier periods. Under a taper program, the incremental asset purchases are less than incremental asset sales so that some excess liquidity in the market from an earlier QE programme is mopped up, making it easier for the central bank to achieve the interest rate target that is set to control inflation.

As inflation continued to accelerate in the UK, the BoE in **May 2022** indicated that it may elevate the taper programme into quantitative tightening (QT): 'We haven't actively sold any government bonds yet. But we have started to consider when and how we will sell some of the government bonds we have bought.' By **August**, the Monetary Policy Committee (MPC) of the BoE voted 'to reduce the stock of purchased UK government bonds held in the Asset Purchase Facility (APF), financed by the issuance of central bank reserves, by £80 billion over the next twelve months, to a total of £758 billion' while explicitly assuming that 'fiscal policy as a whole tightens over the projection.'

The risks of QT were, however, clear to the BoE: falling price of bonds or capital losses with rising yields. The impact of falling bond prices was to be minimized through proper communication between the BoE and major market players as well as by opening a special short-term repo window to prevent extreme volatility in market rates on account of QT and possible liquidity shortfall.

It was in the context of this monetary policy that Chancellor Kwasi Kwarteng under PM Truss announced the infamous mini-budget on September 23 wherein taxes on the richest were cut while government spending on energy subsidies were increased.

Some reactions to the budget were grossly flawed: the UK was on the verge of bankruptcy, Truss had not heeded Rishi Sunak's warning that there was 'no magic money tree', the bond vigilantes were back and that financial markets can tame governments. Without justifying or supporting the nature of the mini-budget, it is important to understand that a monetarily sovereign country like the UK, which issues its own fiat currency accepted as legal tender, cannot go bankrupt in sterling pounds. After all, the UK had run a fiscal deficit of over 15% of GDP in 2020-21, increasing its national debt to more than 100% of GDP with interest rates down to almost zero.

What then had led to the present crisis? With inflation accelerating and expected to touch 13% by the end of 2022, the Bank of England categorically announced in **August**: 'It's our job to make sure that inflation returns to our 2% target, and that is what we will do.' Kwarteng's mini-budget came in direct opposition to the BoE's monetary policy stand. The shortfall in government revenues required the BoE to sell off-the-run bonds in the market so that ample liquidity would be available for the sale of on-the-run bonds by the Debt Management Office. At the same time, the fiscal deficit was raising the expected inflation rate so that a hawkish BoE was expected to raise interest rates accompanied by a more aggressive QT programme, causing yields to rise from 3.6% to above 5% between September 22 and 28, resulting in substantial capital losses from the fall in price of bonds.

This set off a crisis in two contiguous financial sectors: the mortgage market and pension funds. The bank rate was expected to rise to 6% instead of 4.5% as previously anticipated. Many lenders began pulling mortgage deals. The default risk from additional annual mortgage payments also rose sharply. Meanwhile, pension funds resorted to fire sales in order to markup the value of their collateral to market prices, drawing the bond market into a vicious circle of falling prices.

The higher expected inflation along with uncertainty over the monetary policy response from the BoE led to a run on the sterling pound, taking it from £0.89/$ on September 23 to £0.94/$ on September 26.

Although the BoE reluctantly agreed to undertake emergency bond purchases to stabilize the financial and foreign exchange markets, Governor Andrew Bailey was unrelentingly hawkish in his **stand**: 'The MPC will not hesitate to change interest rates by as much as needed to return inflation to the two percent target sustainably in the medium term, in line with its remit.' He added: 'The BoE said it would sell back the gilts it buys once market conditions had stabilised, and that Britain's finance ministry had agreed to indemnify it against any losses.' On October 11, Bailey warned that BoE bond purchases would cease in three days. The government buckled. Kwarteng was asked to step down on October 14 and his successor, Jeremy Hunt, made a U-turn by scrapping the mini-budget on October 17.

The lessons from the UK crisis are stark: it is easier for central banks to accommodate the government's fiscal deficits in a crisis when aggregate demand and inflation are low by implementing cut in interest rates and flooding the money market with liquidity through QE programs. However, when inflationary pressures begin to build up along with supply-side constraints, it is far more difficult for the government to raise the fiscal deficit with an unsupportive and independent central bank that is inflexible in its decision to curb inflation by raising interest rates along with implementation of a QT program. Any increase in inflationary expectations on account of expansionary fiscal policies would lead to increasing yields and falling bond prices that could disrupt financial markets and send the exchange rate into free fall.

Paradoxically, the call for independent central banks, promoted by neoliberal economists and adopted in the Washington Consensus, ultimately destabilised the government of the Tories, a party that had always promoted neoliberal policies.

The UK government must now fight for fiscal independence from the BoE.

Sashi Sivramkrishna studies macroeconomics from a Modern Money Theory (MMT) perspective. Views are personal and do not represent the stand of this publication.

SASHI SIVRAMKRISHNA *is an economist, economic and environmental historian, and documentary filmmaker. Twitter: @Sashi31363.*