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Lessons from the UK

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When assessing the state of the global economy, events in the US, Eurozone and China have dominated the news agenda. However, following the adverse market reaction to the now former Chancellor Kwarteng's mini-Budget, the UK has found itself in the spotlight.

The new government correctly identified that the UK has had a productivity problem over the past 15 years and, in a very ambitious Budget, announced a plan to "go-for-growth". This included income tax cuts, cancelling planned rises in corporation tax and cutting stamp duty, alongside generous energy subsidies for households and businesses.

The cost of the energy price guarantee will depend on what happens to energy prices this winter, but it will be a substantial cost. The plan has a wide degree of support because without it there would be material damage to the economy. The government is taking some of the higher energy cost onto its own balance sheet as it is better able to withstand the shock than the private sector. Many countries in Europe are offering similar energy support schemes to alleviate the near-term pain.

The more controversial aspect to the mini-Budget was the unfunded tax cuts amounting to around £45 billion, the biggest single package of tax cuts seen in the past 50 years. Parts of the budget were leaked beforehand but the size of the overall package announced took markets by surprise and the reaction in bonds and currency markets was vicious.

For much of the 30 years prior to 2020, fears around inflation risk, government budget deficits or "bond vigilantes" proved misplaced in most of the developed world. The implicit bet that policymakers took was that these fears would continue to be misplaced. The consequences of this miscalculation provide important lessons for policymakers and other countries.

To understand why this miscalculation happened, one has to look at the past. The story of why inflation has been dormant over recent decades is now well known; globalisation, technological advances, high debt levels and demographics all contributed to an era of low inflation. Fears about budget deficits in the aftermath of the Global Financial Crisis meant that the UK government pursued austerity policies and this tight fiscal policy kept growth and inflation subdued.

The combination of government support for both the pandemic and energy costs at a time of large economic disruption provided a difficult backdrop. The government's decision to remove the respected Permanent Secretary to the Treasury and to sideline the Office for Budget Responsibility further undermined financial market confidence.

The market had already begun to price in risk around fiscal policy in the run up to the Budget. Between August and September 5-year UK government bond yields jumped from 1.6% to 4.5% and sterling fell from 1.19 to 1.12 versus the euro.

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This then had a knock-on impact to the mortgage market and caused problems in the defined-benefit pension industry, which required the Bank of England to step in and stabilise markets. The Bank of England was left in an impossible situation where they had a conflict between fighting inflation (tighter policy) and supporting financial stability (looser policy).

In characteristic fashion, Larry Summers offered a particularly brutal assessment, saying that the UK “will be remembered for having pursued the worst macroeconomic policies of any major country in a long time”.

Financial markets are fragile as global inflation is elevated and interest rates were already on the rise. The UK had to reverse significant parts of the Budget and the Chancellor was relieved of his duties, with the Prime Minster explaining that “because of current market issues we realise that we need to do things in a different way”. The UK is not alone in facing challenges with low growth, high debt, energy costs and inflation, so there are important lessons to be learned from this episode.

Aiming to boost growth and incentivise investment are admirable aims. However, the ability of a country to increase deficits depends on the spare capacity in system. In the aftermath of the GFC unemployment was high, inflation was low and the private sector was paying down debt. This is a backdrop when governments can spend without driving interest rates higher and/or creating much inflation.

Unfortunately, the situation today is the opposite. This means policy measures must be thoughtful, well-calibrated and respect institutions, financial markets and real economic resource constraints.

Decades of low inflation lulled us into a sense of complacency, but the return of inflation reminds us that economics is ultimately about trade-offs. The UK’s economic crisis provides a painful lesson.

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