

The U.K. Takes A Pounding

Uncoordinated policy caused turmoil across British assets.

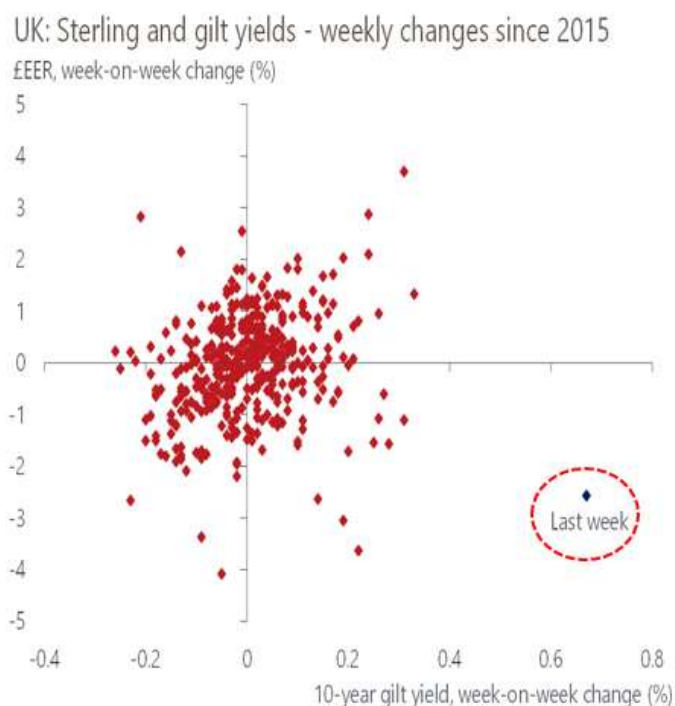
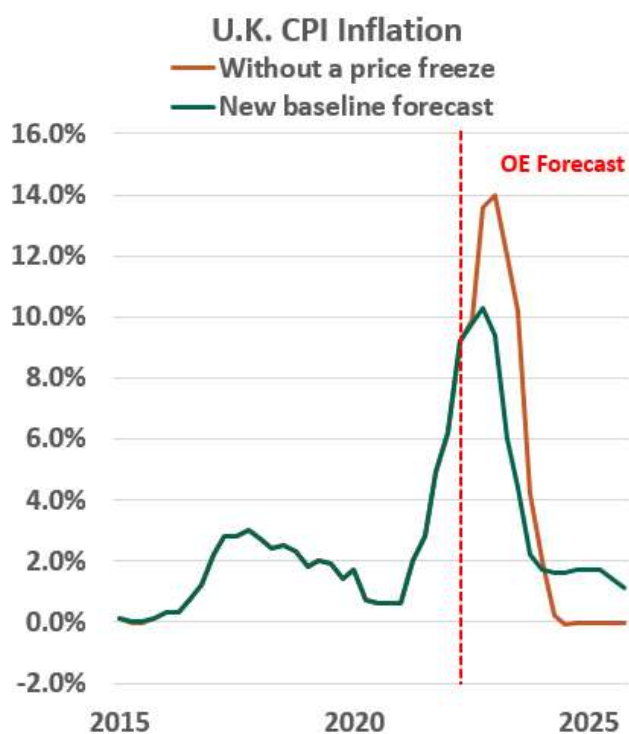
By Vaibhav Tandon



On Wednesday, September 16, 1992, John Major's British government was forced to withdraw sterling from the European Exchange Rate Mechanism after the value of the currency fell below the established minimum level. It was an event from which Major never recovered. On the 30th anniversary of that event, the ghost of “Black Wednesday” has returned to haunt the British economy and the Tories all over again.

Current Prime Minister Liz Truss entered Downing Street earlier this month at a very challenging time, with inflation hovering in the double digits and a recession on the horizon.

To respond, Truss capped the cost of energy for a household with typical consumption at an annual level of £2,500 for the next two years. This is likely to provide much-needed reprieve to struggling households.



Source: Oxford Economics

Given the inflation picture, the energy price cap wasn't entirely misdirected. But from there, Truss doubled down, proposing a Margaret Thatcher-esque tax cut package for **businesses and high earners**, worth £45 billion. This would be the largest such reduction in Britain since 1972. The new Chancellor of the Exchequer, Kwasi Kwarteng, said that "the heavy price of inaction would have been far greater than the cost of these schemes."

Unfortunately, what was termed a "mini budget" caused maximum discomfort for the financial markets, leading to a tumultuous week. The pound slumped and U.K. interest rates surged on fears of much deeper debt and deficits. The currency fell to a record low of 1.035 against the dollar. The cost of borrowing soared, with the yield on 10-year gilts rising by more than 100 basis points in a matter of days.

The sell-off in the U.K. bond markets led to calls for cash from pension funds, forcing them to slash positions. According to the Pension Protection Fund, of the £1.5 trillion in assets held by British pension funds, 72% were invested in bonds last year. As a result, movements in government bonds tend to have a significant impact on pension assets. A 0.3 percentage point rise in gilt yields reduces assets by 2.7%.

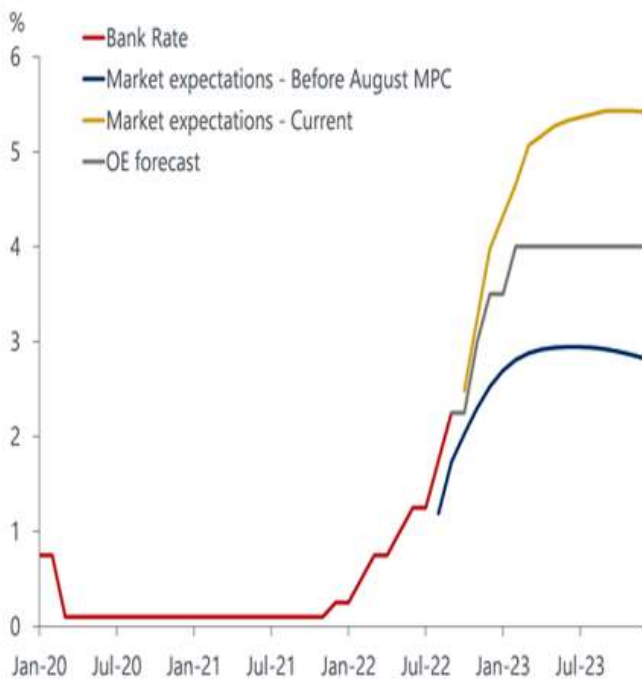
The turmoil put the Bank of England (BoE) in a difficult position. The central bank initially issued an emergency statement indicating its willingness to lean against fiscal excess by raising interest rates further, but refrained from making an out of schedule policy decision. Later in the week, with risk to financial stability increasing, the central bank announced temporary purchases of long-dated U.K. government bonds until the middle of October. In essence, the BoE was forced into quantitative easing.

U.K. monetary and fiscal policy are on a collision course.

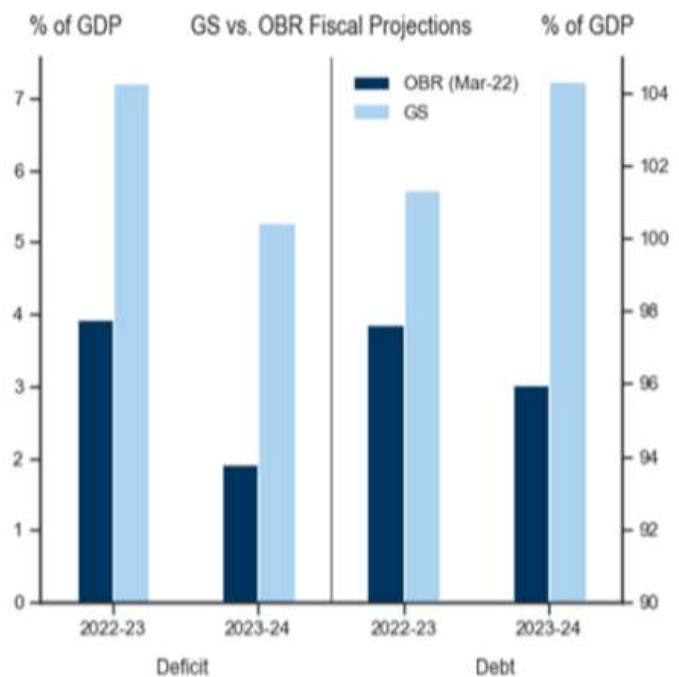
U.K. inflation is at its highest level in decades. The central bank has been trying to restrain the price level by squeezing demand. But recently-announced measures are likely to spur renewed demand for non-energy spending. Furthermore, sterling devaluation will lead to higher import prices, raising the costs of energy, food and other items.

The weaker currency combined with a large fiscal expansion will likely intensify the BoE's tightening program. Estimates of the peak overnight interest rate were increased sharply this week; if those levels are realized, they would undermine an already **unsteady economy**. At least six U.K. mortgage companies have paused new mortgage lending amid an increasingly uncertain interest rate outlook.

UK: Forecasts for Bank Rate



U.K. Fiscal Balances



Sources: Oxford Economics, GS

Despite widespread criticism from within and outside of Britain, the Truss government remains undeterred in its drive to cut taxes. This places it on a collision course with the Bank of England (which, interestingly, Truss has proposed bringing closer to government control). The battle could be played out in volatile financial markets.

Failure to address market turmoil will not only erode confidence of the market participants in the government, but could also trigger a vote of **no confidence** in Liz Truss's leadership. While fancying herself as an heir to Margaret Thatcher's legacy, Truss may more closely resemble John Major.

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Vaibhav Tandon

Vice President, Economist

Vaibhav Tandon is an Economist within the Global Risk Management division of Northern Trust. In this role, Vaibhav briefs clients and colleagues on the economy and business conditions, supports internal stress testing and capital allocation processes, and publishes the bank's formal economic viewpoint. He publishes weekly economic commentaries and monthly global outlooks.