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Britain's Failed Attempt at Monetary and Fiscal Exceptionalism

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Abstract: The autumn 2022 economic upheavals that brought down British Prime Minister Liz Truss's government represented an ultimate extension of a high-risk exercise in British exceptionalism: the June 2016 referendum decision to leave the European Union. The ill-fated 23 September 2022 'mini budget' introduced by Truss and Kwasi Kwarteng, her chancellor of the exchequer – like the referendum outcome six years earlier – was a landmark gesture of national independence. 'The most ambitious and disastrous budget in modern British history' illustrated how the intertwining forces of politics and economics set limits on 'go it alone' policies. The lessons reverberate beyond the UK's borders.

Keywords: fiscal policy, monetary policy, financial stability, crisis

JEL Classification: E5, H3

1 Introduction

The autumn 2022 economic upheavals that brought down British Prime Minister Liz Truss's government represented an ultimate extension of a high-risk exercise in British exceptionalism: the June 2016 referendum decision to leave the European Union. The ill-fated 23 September 2022 'mini budget' introduced by Truss and Kwasi Kwarteng, her chancellor of the exchequer – like the referendum outcome six years earlier – was a landmark gesture of national independence. 'The most ambitious and disastrous budget in modern British history' (Parker, Payne, and Hughes 2022) illustrated how the intertwining forces of politics and economics set limits on 'go it alone' policies. The aftermath, and the Bank of England's entanglement in preventing disruption on the government bond market, provide a case study of central banks' difficulties in balancing two objectives – monetary stability and financial stability – that are often in serious conflict. The lessons reverberate beyond the UK's borders.

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2 Brexit, the Conservatives and the Political Economy of Exceptionalism

Truss was elected leader of the Conservative party at the beginning of September 2022 after a hard-fought contest with her rival Rishi Sunak. She is a former Liberal Democrat party member who voted to stay in the EU in 2016, but has since taken on the trappings of an ardent Brexiteer. Sunak had been chancellor of the exchequer (finance minister) under her predecessor Boris Johnson. He had raised taxes to their highest level in 70 years to try to correct imbalances after the Covid-19 pandemic. Truss wanted to do things differently. By the time she moved into the prime ministerial residence of 10 Downing Street, Truss regarded herself as bearing the tax-cutting heritage of Margaret Thatcher. Britain's first female government leader, fittingly for a politician who polarised the electorate like few before or after, was on separate occasions (2013 and 2016 respectively) voted both Britain's greatest and worst recent prime minister (Alberton and Stepney 2020). Truss neglected to recall that Thatcher's first budget, in 1979, raised rather than lowered taxes to balance the books (Margaret Thatcher Foundation 2023). After three weeks of financial market upsets Truss lost the confidence of Conservative MPs and announced her resignation on 20 October, triggering the second Tory party leadership contest in four months (Nevett and Whannel 2022). Sunak, not she, now sits in 10 Downing Street.

Britain, once a world leader, now a medium-ranked economy, still has pretensions of grandeur. A central repository of such beliefs is the Conservative party, in office (under five different prime ministers) since 2010. The party has been in power for 63 of the past 100 years. The Truss-Kwarteng budget and the referendum rejection of EU membership illustrate in different ways the ambitions for a country of Britain's size, standing and history to sidestep the conventional rules of mainstream economics. Both developments have had major negative results.

The first six post-referendum years produced an outcome well short of Brexit supporters' hopes. All available economic indicators underline that, in a generally difficult world economic environment, investment, productivity and growth have lagged behind most of Britain's peers among the major industrialised nations (Springford 2022). The Office for Budget Responsibility (OBR), the government's independent fiscal review body, has estimated that the post-Brexit trading relationship between the UK and EU, as set out in the 'trade and co-operation agreement' (TCA) that came into effect on 1 January 2021, will reduce long-run productivity by 4 % relative to the UK remaining in the EU (Office for Budget Responsibility 2023). The effect on long-term growth will be similar – in line with official projections before the 2016 referendum (Bank of England 2018a; PA Media 2021). The UK Treasury in April 2016 forecast the UK would register a GDP decline of 4.6 % to 7.8 % over 15 years if it left the EU and instead negotiated a bilateral agreement with the bloc, of the sort eventually agreed under the TCA (HM Treasury 2016).

The £45bn Truss-Kwarteng 'plan for growth' (Maidment 2022) was an attempt to counter this adverse state of affairs. But it ended in spectacular failure. It prompted financial upheaval, a near-complete policy U-turn and the departure, first, of Kwarteng and then of Truss herself. She became (after just 49 days) the shortest-tenured prime minister in three centuries of British political history – giving way to Sunak, who was charged with clearing up the debacle. The chronicle serves up an extreme textbook case study of changing fortunes. As an example of government policy changes forced by financial market adversity, it ranks alongside US President Richard Nixon's 1971 departure from the gold exchange standard, French President François Mitterrand's emergency espousal of economy orthodoxy after a disastrous first 18 months in power in 1981–1983, and Britain's withdrawal from the exchange rate mechanism of the European Monetary System in 1992.

3 Repercussions of a Fiscal Mistake

The repercussions have been widespread. The events of autumn 2022 reduced the chances of the Conservative party winning the next general election, likely in 2024 (McElvoy 2023). They reset the fraught relationship between the government, the Treasury and the operationally independent Bank of England. At least in the short term, the influence of some central institutions in economic policy-making – particularly the Bank and the OBR (which was conspicuously sidelined in the 23 September announcement) – has been enhanced. This was precisely the opposite of Truss's and Kwarteng's intentions. The upheavals exemplified the power of financial markets to force a reappraisal of government policies, reinstating the principle of 'monetary dominance' in terms of policy-setting by the central bank. This has sent an international signal of the limitations to policies that try to move beyond conventional parameters – a particular lesson for members of Europe's economic and monetary union.

At the same time, the unrest in UK financial markets, and the way it was (at least temporarily) quelled, laid down an important warning about the position of independent non-elected institutions. Andrew Bailey, governor of the Bank of England since March 2020, a long-serving finance official who has spent most of his career at the Bank which he joined in 1985, was under pressure before the autumn unrest on account of poor relations with the government and a series of communications lapses. He has emerged from the affair with his reputation generally enhanced. But Bailey is aware that there could be a further backlash against the central bank unless it is seen to be doing its job properly in a working system of political responsibility and public accountability.

The post-mortem on the events of autumn 2022 is greatly complicated by the Bank's dual role as both a financial supervisor and the ultimate guardian of monetary and financial stability. There is strong belief that the Bank should have done more to monitor and control build-up of risks in the UK pension fund industry that burst suddenly into attention with the post-23 September volatility. This applies, in particular, to UK pension funds' use of liability-driven investment (LDI) strategies – contributing sizably to the financial upheavals and the ensuing political drama. Sharp increases in gilt yields placed particular pressure on the many pension funds which had invested in so-called LDI strategies. These schemes, sold by leading investment groups such as Blackrock and Legal and General – and deployed, too, by the Bank of England's own pension fund – use derivatives to smooth pay-outs to pensioners under defined-benefit pension systems, topping up returns that would otherwise lag behind requirements as a result of recent years' falls in interest rates (Roberts 2023). There had been no shortage of warnings that LDI investments could be storing up considerable risks of instability – but no one was paying much attention (Blake 2022a; Blake 2022b; Blake 2023).

The LDI uncertainties formed the backcloth to an exceptional series of events. The Truss-Kwarteng experiment foundered only a month after Truss became prime minister on 6 September, after winning an acrimonious Conservative party leadership context caused by the July resignation of her predecessor, Boris Johnson. Truss accepted an invitation to form the government from a seriously ill Queen Elizabeth II, who died two days later, on 8 September, plunging the UK into a period of mourning which acted as a sobering backcloth to the ensuing drama. On the day of her appointment as prime minister, Truss forced Kwarteng to dismiss from office Tom Scholar, the highly regarded permanent secretary at the UK Treasury, on the threadbare grounds that the Treasury's so-called 'economic orthodoxy' had been holding back UK growth. Had Truss been able to sack Bailey as Bank of England governor, she would have done so. Once she realised that the nature of Bailey's contract precluded this outcome (almost impossible to bring about in any other eventually other than if the governor had committed a criminal offence or become insane), she pressured Kwarteng into removing Scholar. Although legally a less complex issue, it turned out to be politically explosive.

The outcome of Truss's 'fairy-tale economics' (Hutton 2022) (the phrase used by her rival and eventual successor Sunak during the summer leadership campaign) sent reverberations around the world. The 23 September announcement of £45bn of debt-fuelled tax cuts, 50 % more than the £30bn Truss had proposed during the leadership fight, sparked an unusual rebuke on 28 September from the International

Monetary Fund in Washington.[1] It drew additional statements ranging from scepticism to direct criticism from a range of central bank and government officials, including the French, German and Spanish finance ministers and the US Treasury (Arnold 2022). According to several European commentators, the measures demonstrated the flawed thinking that had led to Brexit. One leading European central banker accused Kwarteng of 'fiscal hooliganism' (Marsh 2022).

There was a major impact on the new Italian government of Giorgia Meloni which took power in November 2022, after her right-wing populist Brothers of Italy party won Italy's general election in September. The party has its roots in post-war incarnations of Italy's fascist movement, with supporters including some modern-day admirers of 1930s and 1940s dictator Benito Mussolini. There was general disquiet about the potential effect of her policies on international financial markets. The highly transparent nature of limits on British exceptionalism was an important factor damping the ardour of Meloni's inexperienced team for experimental measures to stimulate the Italian economy.

4 Test for Both Monetary and Financial Stability – Bank of England under the Spotlight

The biggest impact was seen on the UK itself. The turmoil led to sharp falls in government bonds and sterling. Soaring market interest rates forced the Bank of England into ground-breaking action. The central bank embarked on a £65bn exercise to shore up a highly volatile market in gilt-edged stock. The market at one stage threatened to 'blow up', according to Bailey (2023), Bank of England governor, or, as he put it more prosaically at the time, faced 'quite a serious crystallisation of risk' (Bailey 2022b).

The ultimately successful Bank action partly reflected timely contingency planning. Andrew Hauser, the Bank's markets director, a principal behind-the-scenes actor in the emergency programme, had helped lead preparatory work over the previous year at the Bank for International Settlements on designing 'backstop' measures for deployment when risk factors threatened to disrupt markets (Hauser and Logan 2022). In the period immediately prior to 28 September, the speed and scale of the moves in gilt yields were unprecedented, with two daily increases in

1 In rare public criticism of a leading global economy, the IMF said Kwasi Kwarteng's mini-budget risked undermining the efforts of the Bank of England to tackle rampant inflation amid the cost of living emergency. Through an internal oversight, an IMF comment in reply to a journalistic query became elevated to a 'statement' on the IMF website, focusing more attention than would otherwise have been the case.

30-year gilt yields of more than 35 basis points. Hitherto, the biggest daily increase (according to data going back to 2000) had been 29 basis points. Measured over a four-day period, the increase in 30-year gilt yields was more than twice as large as the largest move since 2000, which occurred during the ‘dash for cash’ in 2020. The 130-point rise was more than three times larger than any other historical move (Cunliffe 2022).

The Bank’s senior management lined up to explain to the public, financial markets and parliament what it termed a temporary, targeted programme of government bond purchases. It appeared a substantial reversal in Bank policy. ‘There may appear to be a tension here between tightening monetary policy as we must, including so-called quantitative tightening, and buying government debt to ease a critical threat to financial stability,’ Bailey said. ‘This explains why we have been clear that our interventions are strictly temporary and have been designed to do the minimum necessary’ (Bailey 2022a). Bailey and other senior officials made clear that the gilt-edged purchase scheme – formally decided by the Bank’s financial policy committee and not its monetary policy committee – showed the distinction between monetary policy and financial stability interventions. ‘As a central bank we have to be able to do both, and at any time. We cannot decline to do one because it appears to be at odds with the other’ (Bailey 2022a).

By the time the bond purchases ended, on 14 October, the Bank had succeeded in stabilising yields through purchases of £19.3bn of gilts, three-quarters of which took place in the final week of operations – a much lower figure than the maximum £65bn committed at the outset. An important role was played by the Bank’s market intelligence activities. Close-knit liaison with market practitioners helped spur the move from 11 October to extend Bank purchases to index-linked gilts, a major technical innovation involving fast-paced large-scale work by the Bank ‘s IT department. This turned out be a ’game-changer’ ensuring the success of the overall programme, according to Bailey.

In a major speech on 4 November to the European Central Bank’s money market conference, Hauser (2022) explained how the unrest forced the Bank to put on hold its plan for unwinding previous large-scale government bond purchases through quantitative easing. ‘Switching so rapidly from planned sales, to purchases, and back to sales again might appear to some to imply a confusing or contradictory policy stance. But through a combination of operational choices – clear communications, robust tool design, and following through on pre-commitments – it is possible to use the central bank balance sheet to support both monetary and financial stability, in ways that reinforce and complement, rather than undermine, either goal’ (Hauser 2022).

5 'Asleep at the Wheel' over the LDI Upsets – Charge of Failure by Bank of England

Another less benign explanation holds that the Bank of England itself bears part of the blame for the autumn drama. According to Narayana Kocherlakota, former president of the Federal Reserve Bank of Minnesota, rather than demonstrating 'the objective discipline of financial markets', the episode illustrated the Bank of England's 'poor financial regulation and highly subjective crisis management' (Kocherlakota 2022). He pointed out that over the three days starting 23 September, when the Truss government announced its mini-budget, the pound fell by 2.2 % relative to the euro, and the FTSE 100 stock index declined by 2.2 % – 'notable movements, but hardly enough to bring a government to its knees' (Kocherlakota 2022). The big change, he said, came in the 23 % fall in the price of 30-year UK government bonds – which he blamed on the repercussions of LDI strategies. 'Most of this decline had nothing to do with rational investors revising their beliefs about the UK's long-run prospects. Rather, it stemmed from financial regulators' failure to limit leverage in UK pension funds. These funds had bought long-term gilts with borrowed money and entered derivative contracts to the same effect – positions that generated huge collateral demands when prices fell, and yields rose. To raise the necessary cash, they had to sell more gilts, creating a doom loop in which declining prices and forced selling compounded one another. The Bank of England, as the entity responsible for overseeing the financial system, bears at least part of the blame for this catastrophe' (Kocherlakota 2022, para. 5).

As long ago as in November 2018, in its financial stability report, the central bank identified the hazard of 'potential calls on collateral that could arise in a stress' (Bank of England 2018b) from LDIs. It added: 'It is not clear whether pension funds and insurers pay sufficient attention themselves to liquidity risks (…) Initial work by Bank staff has found that some insurers may not be recognising fully all the relevant liquidity risks' (Bank of England 2018b). Clearly, few funds took note of the Bank's strictures. The Bank in 2018 said it intended to work with the Prudential Regulation Authority, the Financial Conduct Authority and the Pension Regulator to enhance the monitoring of potential liquidity demands and losses from 'non-bank leverage' (Bank of England 2018b). A survey was conducted for the pensions regulator, published in December 2019 (OMB Research 2019). According to Con Keating, head of research at Brighton Rock, an insurance company for pension schemes, 'This contained a number of findings which should have been served as alarm calls. It sank into obscurity. The pensions regulator continued promoting LDI – indeed it was still promoting LDI to schemes as late August 2022 and up to the eve of the Budget' (Keating 2023).

Subsequent revelations about pension funds' widespread use of more complex variants of LDI have added to the belief that the Bank should have done more to supervise a relatively under-regulated part of the financial system. LDI spread well beyond straightforward measures to match pension assets and liabilities, involving switching from equities to long-dated bonds, as well as taking out interest rate swaps to receive regular index-linked payments. Under 'leveraged LDI', a pension scheme borrows to buy assets which do not match liabilities, in areas such as public and private equity, hedge funds, and real estate, wagering that assets will be revalued faster value than liabilities. As Sam Woods, one of the Bank's deputy governors, subsequently put it, 'There is a bit of having your cake and eating it: you keep the returns from the higher returning assets you have and you leverage for the gilts part that you need for matching purposes' (Woods 2023).

According to Keating, 'A large move in gilt yields was certain to trigger cash collateral calls under the terms of the repo and interest rate swap contracts held by pension funds and result in sales of assets by schemes. The speed and scale were baked into the instruments being used.'

'There is a common misrepresentation promoted by the Bank, among others – that LDI is 85 % segregated account and 15 % pooled LDI fund. This is a comparison of apples with pears. At the beginning of 2022, scheme segregated accounts had interest rate exposure of about £1.5tn through cash bonds, repo and IR derivatives. Pooled funds had equity of £230bn. Comparison of these produces the 85 %–15 %. But the pooled funds were levered three or four times to give an interest rate exposure of around £1tn, so the true reality was 60 %–40 %.' Pooled funds were the most prominent sellers of gilts, Keating says: 'They had to be, as they had no other assets' (Keating 2023).

Pointing to allegations that, in his previous role as head of the Financial Conduct Authority, Bailey had 'dozed off' during meetings over a steelworkers pensions scandal, John Moynihan, one of the Bank's most severe critics and a supporter of Truss, has accused the Bank 'of being asleep at the wheel on LDI pension funds, not to mention on inflation, the currency, the stability of markets' (Moynihan 2023). This, he says, is a matter of weighty democratic significance. 'All that led to the end of a government, in a way that will continue to reverberate, to the detriment of many people's view of democracy in this country, for decades to come' (Moynihan 2023).

John Redwood, a veteran Conservative MP and former adviser to Margaret Thatcher when she was prime minister in the 1980s, points to wider failings in the Bank's erratic policies on first expanding and then tightening its balance sheet. 'They deliberately drove bond prices down by announcing and commencing a large bond sale programme. This led to big losses in pension funds, and more calls for cash on the geared positions in government bonds LDI funds were running. LDI funds then also sold bonds to meet calls making their positions worse and increasing the losses.

The Bank then bought up some bonds to reverse some of the price falls it had helped create.' Redwood adds, 'The Fed and the Bank of England printed too much money and kept rates too low in 2021. In the last year they rushed to tighten, causing tremors in UK pension funds and some US regional banks. When financial instability appeared they both eased by supplying money to markets offsetting the severe quantitative tightening they were still executing. They should both take money and credit growth more seriously and stop lurching from too easy to too tight' (Redwood 2023).

There are wide implications for financial markets. John Nugée, a former chief manager of the reserves at the Bank of England, told the Financial Times in December, 'The problem with LDI is not that it makes any one pension fund safer or less safe, but that if everyone employs it, it makes the market overall less safe because when it moves, it all moves in the same direction.' Nugée noted how efforts to secure one financial sector can transfer risk to other parts of the financial ecosystem (Nugée 2022). After the 2007–2008 financial crisis, regulators succeeded in strengthening the banks, partly by constraining their willingness to take risk. This both reduced market liquidity and shifted risk to less regulated and less well capitalised parts of the non-bank financial sector, including pension funds. The LDI flare-up in the UK in September–October 2022 provided just one case-study of how this can break through into public consciousness. Other examples are almost certain to follow.

6 Conclusion: Amid the Blame Game, Treasury Orthodoxy Back with a Vengeance

The success of the Bank's emergency operation helped to buttress, at least temporarily, the central bank's standing at a time when its independence had been under threat. How long that will last is a matter of conjecture, given the scale of problems affecting the British economy. Macpherson (2022), Scholar's predecessor as head of the Treasury, in possibly the most stringent tones adopted in modern times by a former civil servant against a recently departed prime minister, forcibly criticised Truss in a speech in Edinburgh on 1 November. Macpherson was Treasury permanent secretary in 2005–2016 under three chancellors, one of the longest spells of service since the post was established in the 1860s. He said Truss had taken aim against the Treasury as 'an easy target' (Macpherson 2022, p. 1), part of an effort by the Conservative party to seek 'new dragons to slay to explain why it has yet to build a new Jerusalem'. At the Conservative party conference on 5 October – just a fortnight before she resigned as prime minister – Truss had associated the Treasury with an alleged 'anti-growth' coalition she blamed for slowing Britain's economic dynamism.

After her forced departure, she returned to the theme in a widely publicised 4000-word newspaper article assailing UK economic ‘establishment’ which she accused of a ‘left wing drift’ (Turner 2023).

After the rollercoaster ride which unseated her from the prime ministership, these statements read like little more than special pleading. Measured against Truss’s initial ambitions, her actions were counterproductive. As Macpherson said on 1 November, ‘failed Treasury orthodoxy’ appeared to be back ‘with a vengeance’ (Macpherson 2022). His message was that British government incompetence would exert an overall negative effect on the UK economy because of the need to recover credibility – ‘hard won and easily lost’ – on international financial markets. Yields on 10-year government bonds had returned to around 3.5 %, the level before the government’s largely reversed 23 September tax cuts. But the UK was effectively paying a premium on its debt because of continuing uncertainty. Policy was now being tightened ‘more than necessary than if [the ‘mini-budget’] had never taken place’ (Macpherson 2022). Unlike the US, Britain did not possess an important reserve currency. Macpherson said: ‘America could draw in international funds at will, but ‘no one has to fund Britain’s deficit.’ He said the ‘disaster’ of the September measures was ‘etched into the collective consciousness of the Treasury’. It ranked along with post-second world war British monetary mishaps including the 1967 sterling devaluation, Britain’s 1976 recourse to the International Monetary Fund, the 1992 retreat from the exchange rate mechanism and the 2008 financial crisis.

Opinions will remain divided in the UK and elsewhere as to the apportionment of responsibility for the autumn 2022 crises. Truss and her supporters are unlikely to back down from the view that the Treasury and Bank of England should take part of the blame from the upsets. It is worth noting that, if the UK had not left the EU, this exercise in British exceptionalism may never have happened. Kim Darroch, a former UK ambassador to the European Union and to the US, has pointed out that the arrangement with the EU which the UK chose to leave in 2016 was a highly advantageous special deal.’ We had negotiated for ourselves a privileged form of EU membership, full of British exceptionalism: Mrs Thatcher’s rebate, our unique permanent exclusion from for the euroland, and our partial exclusion from those bits of Schengen, “Europe without Frontiers”, that we didn’t like. We had managed to get ourselves effectively the best of both world: the advantages of membership, absent the obligations we didn’t like, and with a special discount on costs’ (Darroch 2020). That is a potent reminder that the 2022 political-economic upheavals were avoidable. All those involved in the drama will bear the consequences – with repercussions that will echo in politics and on financial markets for years to come.

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