

Who's afraid of fiscal dominance? Gilt markets are bracing for a crisis

- In the aftermath of the euro area debt crisis, Jean-Claude Juncker, then Prime Minister of Luxembourg and subsequently President of the European Commission, summarised the dilemma for politicians as: “We all know what to do, but we don’t know how to get re-elected once we have done it.”
- The same words now ring true in UK politics. The recent government U-turn on welfare reform highlighted this point. One of the most significant issues facing this government is rising interest costs against a backdrop of spiralling debt. Central to their response has been to try to cut day-to-day spending to make room for investment spending, to kick-start growth.
- The fact that the government was unable to pass such an important set of reforms suggests that the Prime Minister has no effective majority. In this respect, the UK situation is more extreme than Juncker’s: the Prime Minister and Chancellor know what they must do but cannot get the required legislation through Parliament. This is a difficult situation to be in. The behaviour of yields on long-term gilts – the government’s cost of finance, a proxy for market confidence in public finances – suggests a fear that fiscal dominance, where interest rates are dictated by the budgetary needs of government, is a real threat.
- At the heart of the issue is that perceptions have shifted on what acceptable public financing looks like. John Maynard Keynes’ original idea that activist fiscal policy should be countercyclical. Fiscal deficits were aimed at preventing a recession from turning into a depression. However, we are now confronted with a situation where the UK economy continues to grow in real terms, and yet the government operates a fiscal stance traditionally consistent with recession. Indeed, the fiscal rules that the Chancellor has set for government do not make any explicit reference to the economic cycle.
- We have written about the risks of elevated government debt and unsustainable fiscal policies for some time. The UK’s public finances are widely acknowledged to be reaching this situation, alongside other developed markets such as the US, France and Japan. Our initial view was that the UK needed fiscal reform to avoid a debt crisis. After the events of the past weeks, our revised view is that the UK will not see fiscal reform until there is a crisis.
- What should the reforms look like? We are close to the limit of the practical ability to extract more tax. The government’s repeated pledges not to increase taxes on working people concede this point. So, the bulk of the adjustment will have to come from public expenditure. Social security reform was the first chapter of the OBR’s latest report on the UK’s fiscal risks and must surely be the first candidate for consolidation.
- There will also need to be decisive supply side reform. The planning regime must change to ensure that housing and infrastructure delivery is more efficient and lower cost. And we must take steps to address poor labour productivity, particularly in the public sector. There are many possible reasons for low productivity, but the reluctance of the civil service to return to the office stands out as an issue which is easily addressed.
- There are very few responses to the current situation that will not require pain to be felt by an increasingly wide segment of society. The least painful way is through growth. However, we fear that some of the responses being proposed – most recently, a wealth tax – do the opposite, disincentivising economic activity for an uncertain impact on revenues.
- Ultimately, whether and when we see a crisis will depend on how close we are to the breaking point of bond markets’ confidence. The timing of this is difficult to predict. The long end of the gilt curve – the government’s cost of finance – will ultimately rest on shoring up and maintaining this confidence. Unlike the US or the euro area, the UK is a small open economy and does not have the exorbitant privilege of global reserve currency status, meaning that confidence in sterling markets may be quicker to evaporate, in a replay of the Truss moment.
- Informed by these developments, our overall positioning is defensive. We are underweight risk assets as we remain concerned about stretched equity valuations in the US against a deteriorating macroeconomic outlook. Our multi-asset funds’ allocation emphasises dry powder and index-linked government bonds, to lower volatility and provide inflation protection. Until we see fiscal reform, our view is that portfolio positioning must incorporate the increasing possibility of a breakdown in the gilt market.

Peter Spiller & Emma Moriarty