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Industry Voices

Commentary: Debt, currency and inflation crises — the U.K.'s object lessons for the G-7

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G-7 members share the dilemma of high inflation and slowing growth. This stagflation comes as parts of the European Union and United Kingdom face trade deficits (worsened by dependence on energy imports from Russia), debt burdens approaching 100% of GDP and expanding budget deficits.

In such a predicament, a sovereign state faces a choice. Together with its central bank, the government can make painful but needed structural change. That's the only way to attract inflows of offshore money to finance domestic consumption in the medium term while putting the economy on a sustainable long-term footing. Alternatively, the country might go on a currency-printing binge. That choice can fund imports and prop up growth, for a time, but ultimately money printing will accelerate inflation and scare away capital, jeopardizing economic sustainability.

The recent violent market swings in the U.K. show the risks of getting this policy choice wrong. The medium-term outlooks in terms of the value of the pound, the severity of domestic inflation, the country's ability to attract capital to fund its trade deficit and its credit rating are all negative. The rest of the G-7 would do well to learn from London's fiscal and monetary mistakes. Debt monetization is no longer a viable option. Inflation has made that playbook obsolete.

Fiscal blunder

With reason, investors are alarmed by the U.K.'s rising fiscal deficits and persistent current-account deficit in the face of high inflation. The confluence of this trio of challenges has been largely missing in the developed world, as inflation has been low for decades. However, this scenario is much more familiar in emerging markets, which is worth exploring as the U.K. tempts the same fate.

Inflation and policy credibility are closely linked. In the presence of high inflation, poor policy destabilizes financial markets. The natural adjustment valve in these situations is the exchange rate. As we've seen in emerging markets countries, the currency depreciates against so-called hard currencies. This segues into a vicious loop of accelerating domestic inflation, weakening growth and capital outflows. The solution is for the country's central bank to step up and raise interest rates beyond the prevailing level of nominal inflation — even at the risk of creating a severe recession. The country's fiscal authorities also must make sacrifices. Government must balance its budget to curb the sovereign debt trajectory to a sustainable path. Such actions are a precondition to winning back investment capital.

Unfortunately, London has moved the U.K. in the opposite direction, jeopardizing the credibility of the country's policy-setting institutions — the government and central bank — and the U.K.'s fiscal sustainability. The initial fiscal package introduced by new Prime Minister Liz Truss and now ex-Chancellor of the Exchequer Kwasi Kwarteng pushed the U.K.'s debt and equity markets and the pound to the breaking point because London offered no credible plan to fund the proposals. In response, investors unloaded their U.K. assets from bonds to equities and even FX. The resulting negative feedback loop from the currency to inflation to ever-more debt put that policy on a collision course with the markets. The government blinked, sacking its chancellor and redoing the budget proposal.

Photo: Jenna Schoenefeld

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The new plan advanced by Mr. Kwarteng's successor, Jeremy Hunt, still depends on additional deficit spending, albeit about half of that proposed by Kwarteng. At the end of October, the

U.K.'s fiscal watchdog, the Office for Budget Responsibility, will release its forecast of the government's medium-term fiscal hole. So far, Mr. Hunt has managed to calm the markets, but the jury is still out. We should closely watch the market for its verdict.

BOE compounds the government's mistakes

At its Sept. 22 policy-setting meeting, the Bank of England hiked its official bank rate 50 basis points despite many market participants expecting a 75-basis-point hike and set aside further tightening before the BOE's Nov. 3 meeting. That apparent dovishness puts at risk the BOE's inflation-fighting credibility. Markets panicked, prompting the BOE to intervene by purchasing gilts with a maturity of 20 years or greater to stop a sell-off that reportedly caused forced selling. This intervention achieved an immediate stabilization in the gilts market, although one of dubious sustainability. The BOE's bond buying effectively monetizes the debt finance of the deficit. Debt monetization fuels inflation and undermines the U.K.'s fiscal and monetary credibility. Furthermore, debt monetization is at odds with the need for, and market-priced expectations of, rate hikes: Bond purchasing is effectively a policy of monetary loosening, not tightening. The likely medium-term impact of this policy will be more currency weakness.

Balance of payments remains structural headwind

The United Kingdom has run a current-account deficit for many years as it has long imported most of its domestic consumption needs. The trade deficit in the U.K., which stood at -7% of gross domestic product at the close of the first quarter of 2022, was exacerbated in the past year by the spike in energy prices to 40-year highs across Europe. The imbalance poses a problem for the pound. To fund its large imports, the U.K. depends on attracting inflows of capital to prevent currency depreciation. Historically, London's position as a world financial center has helped the U.K. attract plenty of inflows, but that advantage has eroded in the wake of the Brexit decision. The recent policy actions by the British government and the BOE have dealt a comparable blow to confidence in the long-term outlook for the country, visible in capital flight and the falling pound.

Canary in the coal mine

This is a cautionary tale, especially for the EU, as the energy crisis over the Russia-Ukraine war pushes member countries into a trade deficit. The U.S. and Japan also run the risk of running afoul of markets, as these countries have run up debt loads on the seemingly free ride of debt monetization in the former days of disinflation. For over a decade (two decades in Japan), the binding constraint on such policies — inflation — remained contained to asset markets, a mixed blessing that stoked inequality but also the wealth of many households. The fiscal policies following COVID-19 opened the valve for inflation to spread beyond financial assets and flood into the real economy.

Ignoring this secular regime change, the U.K. has become the first developed economy to dare a reintroduction of debt-financed fiscal stimulus. The verdict of the markets signals the relatively free ride has ended for papering over fundamental imbalances with monetized debt. Policymakers worldwide should take notice, lest the U.K. be the canary in the G-7 coal mine.

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