LIZ TRUSS' FREE-MARKET EXPERIMENT IS NOT OFF TO A GREAT START

The new residents of No. 10 and 11 Downing Street had moved in just over two weeks before, and for much of that period the country, and many outside the country, had been caught up in mourning the Queen. Then last Friday, Prime Minister Liz Truss and her ideological kindred spirt, Chancellor of the Exchequer Kwasi Kwarteng, placed a massive bet on the British economy. Certainly bold, certainly highly risky. The markets delivered their unambiguous verdict on the Chancellor's "mini-budget" as sterling plummeted to its lowest level in recent memory (breaking $1.09 for the first time since 1985). This past Tuesday, in a highly unusual public rebuke of an advanced economy, the IMF, which had bailed out the UK in 1976, urged the UK government to reconsider its tax plans on the ground that the plans undermine the efforts of the Bank of England to get rampant inflation in the face of the cost-of-living crisis under control. Yesterday, Moody's delivered its verdict, characterizing the "large unfunded tax cuts [as] credit negative."

Today, the PM, in her first media appearances after the announcement of the mini-budget (eight seven-minute interviews to local stations across England, customary for a PM before the party conference), blamed the UK financial meltdown on Vladmir Putin and held firm: "I have to do what I believe is right, despite the mounting pressure to rethink the budget." The Chancellor, when asked to comment on the turmoil in the market, responded, "we're sticking to the plan." Over the previous days, the government response had been left to the Treasury financial secretary, who foreshadowed Putin's responsibility, citing volatility experienced by all "major economies" due to the Russians.

Commentators in the British media across the political spectrum have been scathing in their assessments.

The New Government

Let's review the context. Liz Truss won the election contest by garnering support from slightly over half the members of the Conservative party eligible to vote, who in fact cast votes, in the final round of the election contest (81,326 out of 141,725, or 57%). She had failed to attract the support of more than one-third of the parliamentary party (the Tory MPs). The ultimate tally represented less than 0.03% of the British electorate. (See my previous briefing note, available here.) So, hardly a mandate.

The dominant message during the divisive leadership contest was tax cuts to spur growth and a clear intention to challenge "Treasury orthodoxy," which the PM and her Chancellor blame for the sluggish performance of the British economy since the financial crisis. Expansionary fiscal policy and supply-side economics would turbo-charge the economy out of its stupor. The first shots were fired at the Treasury (on September 8) with the dismissal of Sir Tom Scholar, the Treasury Permanent Secretary (the top civil servant in the Treasury). His dismissal was viewed with concern given his long and deep experience (having worked with Chancellors George Osborne, Philip Hammond, Sajid Javid, Rishi Sunak and (briefly) Nadhim Zahawi).

The September 23rd Announcement

The country faces a massive cost-of-living crisis, and while the message on the hustings that a Truss government would lower taxes to stimulate growth, much of London was taken by

surprise by Friday's "mini-budget." There was nothing "mini" about it. The Chancellor announced, with some theatrical flair, not a cut in the top rate of 45p but rather its abolition. Caps on bankers' bonuses would be done away with, and the expected 1p general tax cut would be accelerated by a year to April 2023. He also announced, as expected, that the planned increase from 19% to 25% in corporation tax would be scrapped as would the recent increase in national insurance contributions.

Altogether this amounted to £45 billion of unfunded tax cuts, the largest in half a century, which in effect would be added to the country's debt burden. The last cut of this magnitude was in 1972 by then chancellor Anthony Barber, which led to significant inflationary pressures and a sharp drop in sterling. And speaking of debt burden (to which we need to add the costs to fund the energy price cap of £150 billion), that too would skyrocket given the inevitable rise in interest rates. Additional borrowings of £72 billion now are expected before next April, according to the UK Debt Management Office, raising the net financing requirement for 2022/2023 to £234.1 billion (which covers the energy price cap as well). The planned permanent tax cuts applicable next April will have a separate debt load.

The clear beneficiaries of the tax cuts are the wealthy, at a time when the country faces a palpable cost-of-living crisis, rising energy prices and industrial unrest. In themes foreshadowed in the book they co-authored (Britannia Unchained), the PM and her Chancellor laid out their vision of trickle-down economics. The Chancellor described tax cuts as providing incentives across the whole economy. High taxes, he said on Friday, "reduce incentives to work, deter investment and hinder enterprise." Lower taxes and less regulation would make Britain more competitive, reward enterprise and work, and drive growth. The pie grows even if its benefits are shared unevenly, or so the thinking goes. Incidentally, it is unclear what regulatory constraints (other than those imposed as a result of Brexit) stand in the way of economic growth.

According to a UK Treasury release, the Chancellor will set out medium-term debt-reduction plans on November 23, and has called on the Office of Budget Responsibility (OBR), the independent fiscal watchdog, to release its full forecast on the same day.

Threadneedle Street Responds

Yesterday, shortly after the IMF statement, the Bank of England swung into action to calm the turmoil in the financial markets amid the sharp increase in government borrowing costs and the collapse of sterling. The message was blunt: "[w]ere dysfunction in [the gilt] market to continue or worsen, there would be a material risk to financial stability." The statement issued on Monday by the BoE governor had not been enough to calm the markets. The BoE undertook to buy in long-dated government bonds (quantitative easing billed as temporary and targeted – through October 14; this being the fourth round of QE initiated by the BoE) in a U-turn from its position barely a week earlier that it would reduce its holdings of government bonds. The yield (which moves inversely to prices, in this case a rout in bond prices) increased to 5%, a level not seen since the global financial crisis, prompting concerns that the "doom loop" would tigger a crisis akin to 2008.

The BoE move was designed in part to forestall forced sales of government bonds by pension funds that were facing margin calls under hedges taken out in "liability driven investment" (LDI) schemes (the collateral for which are long-term UK government bonds). As interest

rates shot up, the LDIs required more collateral, triggering sell-offs of government bonds as cash ran low. The market dysfunction triggered by last Friday's announcements, were it to continue, would pose a direct threat to financial stability. Many expect the BoE to raise rates closer to 6%, which could lead to massive turmoil in the housing market (as mortgages in Britain typically are fixed for two-to-five years, followed by variable rate options or refinancings).

Looking Ahead

MPs return to Westminster on October 11 following a recess that ironically began last Friday. A growing chorus of MPs has suggested recalling Parliament so that the government can spell out its plans in greater detail, rather than wait until November 23. A recall can only happen if the government requests the Commons Speaker to do so. There appears to be little likelihood of that happening. Others are urging that the Chancellor accelerate his plans to bring forward the date for releasing the government's plans and for OBR to issue its report. It was reported this evening that the PM and the Chancellor will hold emergency talks with the OBR chair tomorrow.

Weighing heavily on the minds of many Tory MPs anxious to maintain the red wall/blue shires coalition is whether the Tories would trigger a political crisis on top of the economic crisis. The Truss-Kwarteng vision is a marked departure from Boris Johnson and from the party manifesto, but another leadership contest (necessitating a change in party rules, if it is to happen within 12 months) is unlikely to reverse the damage. Tory MPs might also bring down the government by voting down the finance bill.

In the meantime, the party will head next week to Birmingham for its annual conference. Labour has a comfortable, and widening by the day, lead over the Tories in terms of voting intention (ITV polling just before the Labour Party conference showed a 12-point lead, with multilevel regression analysis suggesting a 56-seat Labour majority; following the announcement of the mini-budget, YouGov polling showed the lead widening to 17 points (45% - 28%), and to an astonishing 33-point lead (54-21) today). YouGov polling shows 47% of Britons believing Labour will win the next general election, compared to 26% who believe the Tories will win. Two weeks ago, Labour was at 37%, the Tories at 35%.

The polling may confirm for the PM and her Chancellor that their bet is worth the risk. After all, it appears they do not have much to lose, from a purely self-interested political perspective.

Concluding Thoughts

In the short term, the tax cuts and borrowings could boost the economy, but what will they do to inflation, interest rates to combat inflationary pressures, and the levels of debt relative to GDP? So we go back to the driver – growth: yes, businesses will have more to invest with lower corporate taxes, but they will be paying far more to service their debt and may well lack the confidence to invest.

The financial market turmoil of the past few days may be a harbinger of things to come. It would be a mistake to view all of this in isolation. Admittedly, the markets reacted to the mini-budget announcement, but that announcement has a deeper and broader context, with implications for Britain, those considering investing in Britain, and Britain's allies. Yes, the

dollar goes from strength-to-strength and the cost of living crisis has multiple causes, not the least of which is Ukraine.

But something more fundamental appears to be afoot, and that is the promise of a low-tax, low regulation jurisdiction (think Singapore) unleashed by the ideology that begot Brexit. The damage to the economy caused by Brexit was masked in part by the pandemic, at least as far as public and media perception were concerned. However, in 2021, the chairman of the OBR had said that the impact of Brexit on the UK economy would in the long run be worse than the impact of the pandemic, reducing GDP "by about 4% in the long term." (As an aside, OBR had, back in July as the election contest was kicking off, said that Britain's public finances were "on an unsustainable path in the long term.")

None of the underlying dynamics has improved. And, incidentally, the Northern Ireland Protocol remains a flashpoint for the European Union and the United States. Brexit demonstrated a willingness for Britain to opt to go it alone at a time when uniting for a common cause has so much going for it. Brexit boiled down to "taking back control," but the effort to do so seems to have very little to show for it.

Economics appears to have gotten lost in conversations now driven by ideology, which begs the question: where will that lead Britain's leaders over the coming weeks and months. (Incidentally, senior Tories were not united in their outlook – Rishi Sunak had predicted the very consequences of the "tax fairy tales," as he labelled them over the summer, that have come to pass, and he was roundly criticized for it at the time.)

In the meantime, the markets have rendered their own verdict on where they think things are headed. We stay tuned.

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Mark S. Bergman
7Pillars Global Insights, LLC
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