MACROECONOMIC *view*

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Five lessons from the UK bond market crash

Key highlights:

- The rise in interest rates is likely to expose the hidden fragilities of the global financial system.
- Central banks should continue to tighten, but they will have to be careful not to overdo it and risk causing financial instability.
- This episode of stress closes the debate on the merits of Brexit… but not to its advantage.

In the space of just a few weeks, the situation in the UK changed dramatically. After a 70-year reign, the much-loved and respected Queen passed away. Meanwhile, less than a month into the job, the new British government became a laughingstock. Its tax cut programme has been roundly criticised by the IMF and sanctioned by the financial markets. Two days after the plan was announced, the yield on 30-year Gilts jumped by 100 basis points, forcing the Bank of England to step in as lender-of-last-resort to prevent pension funds from succumbing to a liquidity crisis. **Is this episode the 'canary in the coal mine' foreshadowing similar fragilities elsewhere? Or is it a UK-specific problem?** In any case, there are lessons to be drawn for us, continental Europeans.

Lesson 1 – After the global financial crisis of 2008, regulators and financial authorities went to great lengths (regulation, capital buffers, stress tests) to prevent another crash, **yet dark corners remain in global finance**. Pension funds are not by nature reckless gamblers and the bond market of the world's sixth largest economy should be one of the safest and most liquid. **This episode of stress therefore raises questions about the ability of supervisory authorities to correctly assess market risks.** What applies to the UK certainly applies elsewhere, especially at a time when decentralised finance is developing.

Lesson 2 **– Be it households, companies or investors, no one is well-prepared to operate with permanently high interest rates, after so many years of low rates.** If the transition from one regime to the other is too rapid - the UK probably being an extreme case - it can cause damage both to the financial sector and the real economy. Housing markets, which are particularly sensitive to borrowing conditions, are bound to suffer across the board.

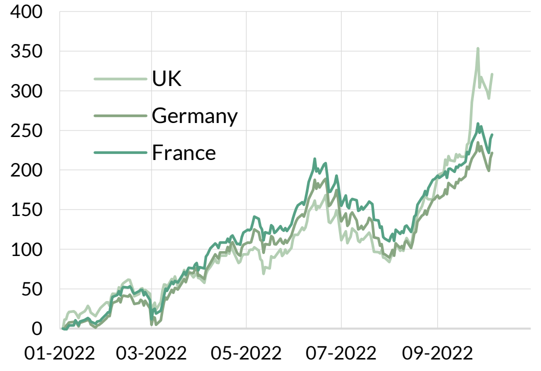
Lesson 3 – This should lead us to consider the conduct of monetary policy. The Bank of England has not given up on tightening monetary policy. In fact, it has more incentive than ever to do so, now that the government's fiscal choices are likely to fuel the inflation shock. However, a central bank may have to trade off its explicit mandate (ensure price stability) against its implicit mandate (ensure financial stability).

The outstanding question is whether aggressive monetary tightening almost everywhere in the world is likely to cause instability in the markets. This applies to both the Fed and the ECB. In any case, if central banks must give up one instrument of monetary tightening, it is more likely to be the reduction of their asset portfolios rather than the increase in key rates.

Lesson 4 – The sudden surge in UK rates can be seen as a classic case of market-imposed discipline. The bond vigilantes would have judged that the increase in budget deficits was not sustainable over time, and consequently demanded a much higher risk premium (graph). This is a bit of a crude interpretation in our view. What was sanctioned was as much, if not more, the lack of a credible assessment of the effects of fiscal measures. Bond markets may well accept higher deficits in response to specific shocks, for example the pandemic in 2020 or the energy crisis today. Countercyclical fiscal policy remains necessary. What is not (or no longer) tolerated in a high interest rate environment is inconsistent policy.

Lesson 5 – **Finally, there is a lesson to be learned about the pros and cons of belonging to the European Union.** In 2016, the UK chose to leave the EU. The Brexit adventure was supposed to free it from European shackles and unleash its potential. The result is not very exciting, to say the least. With the exception of a few staunch federalists, no one would claim that the EU is a flawless system. But it does have qualities. The EU's technocratic machinery is cumbersome, requiring each country to comply with procedures and rules, both economic (budgetary surveillance) and political (respect for the rule of law). Those who have tried to break away from it have suffered the consequences, from Greece to Hungary. **Those who play the game are rewarded: that is the philosophy behind the NGEU transfers in exchange for structural reforms**. It is notable that at a time when the UK was caught in financial turmoil, Italy, which had just elected a coalition with Eurosceptic roots, was not under attack. Without prejudging the future, this is an incentive to remain under the umbrella offered by the EU. It is not now that Brexiteers will be emulated on the continent.

10-YEAR GOVERNMENT BOND YIELD
(CUMULATED CHANGES SINCE JANUARY 2022)



Sources : Bloomberg

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