Is the UK Suffering a Sovereign Debt Crisis?

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Last few days …

- After “mini”-budget announcement in UK
  - Tax cuts, ...

- British Pound dropped

- Interest rate of UK gov bond spiked
  - ⇒ floating mortgage rates spiked,
  - ⇒ no new mortgages

- Bank of England
  - From tightening mode with QT
  - To stepping in with “QE” as “Market Maker of Last Resort” (MMoLR)
What Dominance?

- Monetary vs. Fiscal Dominance

  - **Monetary Dominance**
  - **Financial Dominance** (Brunnermeier Baffi Lecture 2016)
  - Monetary tightening is limited since it would cause havoc in financial markets
  - Central Bank is “trapped”
Pension Funds, Liability Driven Investments (LDI)

- UK Pension funds
  - Invest in illiquid asset with higher returns
  - PV(Liabilities) decline/rise as \( i \) rise/decline
    - + accounting profit, but no immediate cash flow
  - Hedge with interest rate swaps
    (or holdgilts levered, funded short-term)
    - Exchange traded with margin calls
      - requires cash (not illiquid assets)
  - Done via Liability Driven Investments (LDI)
    - UK pension hold about £1.5 trillion in LDI
The Rise of Interest Rate Swaps

The notional amount of over-the-counter derivatives
Amplification

- Margin Spirals
  - Fire sales
  - Losses
  - tighter margins
  - volatility price

- Predatory Trading
  - Others are not stepping in
3 Interpretation of current events

1. UK gov. signals large future debt, fiscal dominance $\Rightarrow$ high inflation

2. Financial stability issue
   BoE acts as temporary MMoLR
   financial dominance if not temporary

3. UK is vulnerable: (current account)
   2. triggers/spills over to larger crisis + 1.
   - As mortgage freeze and rates rise
   - Loss of credibility/reputation
Poll

1. Is UK slipping towards a **sovereign debt crisis**?
   - Yes or No

2. Can UK get **sustainable growth** up to 2-2.5% over next 5-10 years?
   - Yes or No

3. Is the financial turbulence in UK markets likely to **spill over** to other markets?
   - Yes or No

4. Does this episode reveal "**shadow banking**" risks are as serious as they were before 2007?
   - Yes or No
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06. Oct. 2022
Markus Brunnermeier
IS UK FACING A DEFAULT PREMIUM IN CAPITAL MARKETS?

Paul Tucker, Research Fellow/MRCBG Harvard Kennedy School,
6 October, 2022
BANK RATE
SINCE BANK OF ENGLAND INDEPENDENCE (1997)

CUMULATIVE GILT PURCHASES VIA QE

Source: Office for National Statistics series FZIU, BoE: Asset Purchase Facility: Total gilt purchases: Em CPNSA.
£ NOMINAL 10, 20 AND 30-YEAR FORWARD RATES

Note: Data for 30-year forward rates unavailable prior to 2016. Shaded areas indicate periods when the Bank was undertaking QE. Source: Bank of England.
TERM STRUCTURE OF MARKET EXPECTATIONS FOR BANK RATE (OVERNIGHT INDEX SWAPS FORWARD CURVE)

10-YEAR FORWARD RATES, JANUARY 2018 TO PRESENT

10-YEAR AND 30-YEAR NOMINAL FORWARD RATES, SINCE MARCH 2022

10-AND 30-YEAR INFLATION FORWARDS

CUMULATIVE CHANGE IN LONG-TERM GOVERNMENT BOND YIELDS SINCE 1 SEPTEMBER

BEFORE AND AFTER OIS FORWARD CURVES

GILT FORWARDS TERM STRUCTURE

GILT/OIS SPREAD TERM STRUCTURE: PROXY TERM PREMIA

CHANGE IN GILT/OIS SPREAD TERM STRUCTURE
(9 SEPTEMBER TO 4 OCTOBER)

CUMULATIVE CHANGE IN EXCHANGE RATES SINCE 1 SEPTEMBER

STERLING EXCHANGE RATE INDEX

Source: Bloomberg.
UK 5 YEAR CREDIT DEFAULT SWAP FEE

Source: Bloomberg.