Eriswell Market Insights

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> Whatever one thinks about her, the way the Truss Government fell should concern all who care about democracy. We're not denying that Liz Truss and her erstwhile Chancellor Kwasi Kwarteng made serious mistakes, they did, but they nevertheless had a mandate of sorts for their manifesto.
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> Contrary to popular opinion, Truss was sunk, not by financial markets, but by poor financial regulation, poor crisis management, and the errant implementation of monetary policy. Perhaps markets would have ultimately destroyed her, they probably would in the end, but that would have taken months, if not years had the Bank of England retained control. Just look at the Euroarea's mistakes!

It is surreal watching the Bank of England (BoE) trying to land the British economy in a manner no sane central bank would wish to attempt.

To put this in context, most commercial airlines require a fully stabilised approach at 500ft for a landing to be attempted. Meanwhile the Bank of England approached rising inflation at the speed of heat, too fast to deploy either flaps or undercarriage, as the Monetary Policy Committee (MPC) half-activated the brakes in a desperate attempt to slow the economy.

Only to find its FPC co-pilot (Financial Policy Committee) had simultaneous lost control of the LDI pension fund sector requiring an emergency Gilt buying rescue. Which of course acts in the opposite direction to MPC tightening.

Whatever its failings, the UK Government was rightly concerned about this loss of control. Which prompted a coordinated attack on Rishi Sunak's proposal for a new power to allow the elected Government to overrule the BoE's decisions in certain circumstances. Sam Woods, a deputy governor at the Bank of England and Nikhil Rathi, head of the FCA, both used speeches at the Mansion House to warn that the proposal would undermine their independence.

Which it would do.

So, at what point should an elected government intervene to overrule the actions of a BoE that appears to be prioritising self-interest over that of the UK body public? It has to be a concern if the BoE is seen to be Interfering in the democratic process while failing to explain wild deviations from its given mandate.

BoE must engage with the nature of the problem it is facing

The BoE has for whatever reason failed to correctly identify the true enemy the UK economy has been up against since 2008 – stalled labour productivity growth. And the profound effect this has on the operation of monetary policy.

This productivity stall bounced the UK economy into a complex zero-r* world – when the natural real rate of interest (r*) falls to zero or below.

A world, in which the BoE's forecasting models and idea frameworks are entirely unsuitable for safe navigation.

Opening the door to predictable and predicted mistakes with both UK inflation and growth. Including Eriswell's March 2021 prediction of an inflationary firestorm up ahead.

'FOUR MUSTS' now Required for UK to Thrive

1. The BoE MUST finally get on top of UK inflation and stop it winging around like it is. To do this it must belatedly embrace the new ideas and models which would have enabled it to act swiftly and firmly to rising inflation. As mentioned, these new models correctly predicted the ongoing inflation storm back in March 2021, alongside the fact that the UK's predicament was worse than most Western countries.

   Other central banks face similar predicaments – the Euroarea in particular – but that is another matter. Whatever way one looks at it, the BoE's policy decisions have been egregious.

2. Tasked with ensuring financial stability, the BoE's Financial Policy Committee (FPC) mandated the recent Gilt buying package to rescue UK LDI pension funds which had blundered in the face of rising bond yields. Henceforth, the FPC MUST better understand the plumbing of UK financial markets. Otherwise, a repeat of 2008 beckons when misunderstandings surrounding the shadow banking system (CDOs, CLOs, etc.) became deeply problematic.

   For the FPC to be pulling against the MPC at a critical time like this is unwelcome and suboptimal to say the least.

3. The UK Government MUST redouble its focus on the UK's labour productivity problem. It is only faring better than Italy amongst its G-7 stablemates! To be fair, France and to some extent the US are not doing much better, but the US is doing much more about it and making valuable progress.

4. The Government MUST better communicate its policies to financial markets and the public at large. Social pressures are unlikely to be amenable to significant austerity for some time. According to our models, it is sub-optimal in the extreme to try and establish sweeping austerity programmes until a state of stable growth and steady inflation has been attained.

   At that point fiscal policy can be gradually tightened as the BoE is free to ease once more to accommodate any secondary shocks to employment and growth.

   Finally, for this to work, financial markets must understand and buy-in to the new and credible fiscal trajectory.

Conclusion

The good news is that an escape route from this turmoil remains available – just! Moreover, the UK is ultimately in a better position to engage with the underlying labour productivity issue than its European counterparts.

If, however, the BoE fails to get the economy back onto a stable track, UK inflation will likely begin to balloon downwards later in 2023 during what is now all but certain to be an unnecessarily severe recession.

Leading to yet more knee-jerk monetary policy moves on the part of the BoE, inflicting needlessly severe damage upon the UK economy.

Make no mistake about it, under such an outcome the Bank of England's independence will most definitely come under public scrutiny. Whether it likes it or not.

For any enquiries or comments, you may have, please contact us at info@eriswell.com. We look forward to hearing from you.

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