UK Financial Crisis of 2022: Retrospective Diagnosis and Policy Recommendations

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The UK government's "mini-budget" announcement on September 23, 2022 sent yields on UK government bonds soaring at a daily rate not seen since November 1988, brought the value of the pound to all-time lows, lead some mortgage providers to suspend lending, and dropped the UK pension system to a liquidity crisis.

This article, originally drafted in the midst of the crisis attempts to diagnose the nature of the crisis. The prevailing conventional wisdom at the time was--and still is today—that the UK was facing a sovereign debt crisis with the credibility of the UK macroeconomic framework and debt sustainability put into question. This article demonstrates that the data favour a different view. Markets never questioned the UK's commitment to its macroeconomic framework. Instead, asset prices indicate that markets viewed the "mini-budget" as a highly questionable policy within a solid macro framework.

This is demonstrated by comparing the prices of inflation protected and nominal gilts. Given that countries with independent monetary policy typically default on their debt through high inflation rather than outright default, increased sovereign risk would have translated into higher inflation expectations. Instead, yields on inflation protected gilts increases one-to-one with nominal gilts, implying no change in inflation expectations. Fears of outright default, on the other hand, would have led to larger increases in long-run interest rates, because the cumulative probability of default increases over time, by definition. Instead, there was a spike in short term yields with little change in longer (e.g. 20-year) horizons. These combined bond price shifts are more consistent with an expectation that the Bank of England would tighten policy to fend off inflation caused by the tax cuts and spending increases proposed by the government in September 2022.

The paper goes on to investigate the implications of the mini-budget crisis and rising interest rate more broadly. I argue that the main risk to the UK economy comes through the transmission of Bank of England rates to mortgage borrowing rate. While UK households are far less leveraged than they were prior to the financial crisis of 2008-9, the UK faces a mortgage affordability crisis that could lead to a substantial slowdown in economic activity. I predicted at the time that house prices would decline by roughly 10% in real terms.