UNITED KINGDOM: THE 'DASH FOR CASH', LEVERAGE AND THE NEED FOR ECONOMIC POLICY COORDINATION

Financial markets in the UK have recently been confronted with a 'dash for cash', whereby investors sell off even safe assets such as long-term government bonds to obtain cash. The catalyst was the announcement of an expansionary fiscal policy, which might force the Bank of England to hike interest rates more aggressively given the potential inflationary consequences. Leverage and the ensuing margin calls acted as an accelerator of the jump in Gilt yields. The events show the necessity for a coordination of economic policy. In case of elevated supply side inflation, this means monetary tightening to trigger disinflation, targeted fiscal policy support to those who suffer most from inflation and macroprudential policy that addresses the consequences from market volatility and large increases in bond yields.

Financial markets in the UK have recently been confronted with a 'dash for cash'. This describes a 'flight to safety' situation in which investors sell off even safe assets such as long-term government bonds to obtain cash.[1] This experience and its causes provide important insights in the need for coordination of economic policies.

The increased preference of British investors for cash may reflect a wish to reduce interest rate risk in their portfolios. The key driver however was the increase in liquidity demands of leveraged investors triggered by the need to meet margin calls on derivative positions that had suffered, directly or indirectly, from the jump in gilt yields.

Media reported forced selling of government bonds by pension funds to raise cash to meet the collateral requirements, a decision that amplified the increase in long-term interest rates. The rise in yields became self-reinforcing. According to the Bank of England's Financial Policy Committee, *"were dysfunction in this market to continue or worsen, there would be a material risk to UK financial stability. This would lead to an unwarranted tightening of financing conditions and a reduction of the flow of credit to the real economy."*[2] Consequently, the Committee decided to carry out temporary purchases of long-dated UK government bonds to restore orderly market conditions.[3]

The catalyst of the bond market turmoil was the announcement of a mini-budget on 23 September with GBP 45 bn of tax cuts, the biggest since 1972[4]. Gilt yields jumped (*chart 1*) because of the prospect of increased borrowing needs, against a background of a reduction of the Bank of England's balance sheet (quantitative tightening).

A second factor was the prospect of more rate hikes by the central bank, to counter the inflationary consequences in the medium run of the expansionary fiscal stance. Finally, the weakening of sterling, to an all-time low against the dollar (*chart 2*), created additional upside risks to inflation and contributed to the rise in bond yields. The drop in the currency reflected concerns about fiscal policy credibility -when

1. The definition is from The role of non-bank financial intermediaries in the 'dash for cash' in sterling markets, Bank of England, Financial Stability Paper 47, June 2021.
2. Source : Bank of England announces gilt market operation, News release by the Bank of England published on 28 September 2022.
3. It should be emphasized that this was a decision aimed at ensuring financial stability taken by the Financial Policy Committee, not a monetary policy decision, which is in the remit of the Monetary Policy Committee.
4. Source: Financial Times.

INTRADAY, 10-YEAR GILT VS GBP/USD

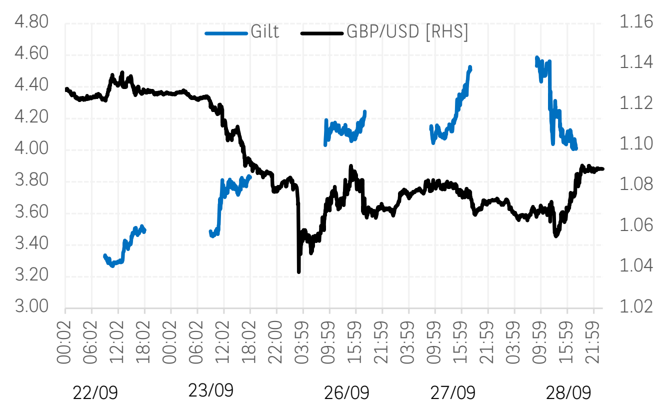

CHART 1 SOURCE: BLOOMBERG, BNP PARIBAS

GBP/USD

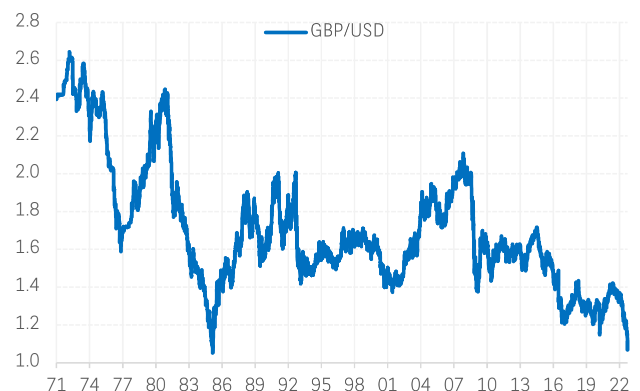

CHART 2 SOURCE: BLOOMBERG, BNP PARIBAS

> The more monetary liquidity is abundant, the higher the risk that market liquidity will be lacking in case of big movements in interest rates.

will the fiscal expansion be followed by a move in the opposite direction- as well as monetary policy credibility –will the Bank of England do what it takes to address the heightened inflation risks? Credibility is important in the conduct of economic policy, especially when, like in the British case, the country is running a current account deficit and depends on the willingness of foreign investors to cover the financing shortfall of the domestic sectors (households, companies and the public sector). Importantly, the jump in gilt yields pulled along bond yields abroad, including in the US (*chart 3*). Global bond markets are highly correlated in normal times and even more so in case of big moves as the ones seen in recent days.

Against this background, the 'dash for cash' acted as an accelerator of the move in bond yields. To the extent that it reflects the reaction of leveraged investors, it raises the question of what had been underpinning this appetite for leverage. An obvious answer is the investors' conundrum of, on the one hand, the ambition of achieving attractive returns -e.g. to meet the liabilities in a pension fund- and, on the other hand, (very) low expected returns after years of very expansionary monetary policy in the UK and abroad. It led to the, at first glance, awkward situation that bloated central bank balance sheets -a result of several years of quantitative easing- could not prevent that liquidity was lacking in other parts of the economy.

There is however nothing abnormal about this, because we are talking about two different things, respectively monetary liquidity -the size of the central bank's balance sheet, the excess reserves of the banking system- and market liquidity -the ability to trade big volumes with limited influence on market prices. The more monetary liquidity is abundant, the higher the risk that market liquidity will be lacking in case of big movements in interest rates. This calls for a coordination between monetary and macroprudential policies. For the former this means considering the financial stability implications of an accommodative or restrictive monetary policy stance. In terms of macroprudential policy, having a detailed view on the use of leverage would allow to better anticipate the reaction of leveraged market participants to interest rate shocks.

A better coordination between monetary and fiscal policy is also warranted to avoid huge interest rate shocks. Research shows that fiscal policy can enhance the effectiveness of monetary policy when interest rates are very low.[5] The boost to demand increases the likelihood that the inflation target would be reached earlier, enabling the central bank to normalize its monetary policy. This also reduces the risk of financial instability through the formation of asset bubbles. When inflation is above target, fiscal policy -a(n) reduction (increase) in the cyclically adjusted budget deficit (surplus)- can increase the effectiveness of a restrictive monetary policy. A fiscal expansion on the other hand would run into conflict with the ambition of the central bank to slow down demand growth. This is what happened in the UK. It would lead to a higher terminal rate -the cyclical peak in official interest rates-, which in turn would influence the dynamics of the public sector debt ratio due to higher bond yields.

INTRADAY, GOVERNMENT BOND YIELDS, 10-YEAR

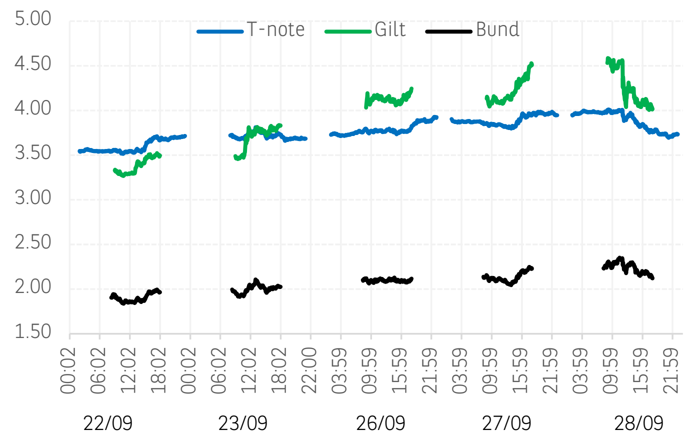

CHART 3

SOURCE: BLOOMBERG, BNP PARIBAS

High inflation that is caused by a negative supply shock -higher energy price, etc.- represents a challenge for monetary and fiscal policy. The former will tend to ignore it, based on the view that such a shock has a transitory impact on inflation. However, as we have been experiencing this year, faced with a risk of unanchoring of inflation expectations and the ensuing impact on wage demands and price setting strategies of firms, central banks have ended up raising rates anyhow. Governments will be inclined to cushion the impact of the negative supply shock on purchasing power of households. This in turn may fuel inflation, complicating further the task of the central bank and leading to higher interest rates.

Supply side inflation thus calls for targeted fiscal support to help those who suffer most. Such a policy is even more relevant considering that central banks are not equipped to address the distributional consequences of economic shocks. This necessity of a targeted approach was emphasized by the Eurogroup in July this year: *"the Eurogroup considers that supporting overall demand through fiscal policies in 2023 is not warranted, the focus being instead on protecting the most vulnerable, while maintaining the agility to adjust, if needed… thus also facilitating the task of monetary policy to ensure price stability by not adding inflationary pressures."*[6] Luis de Guindos, Vice-President of the ECB, made a similar remark recently: *"Fiscal policy should not stoke inflation. It needs to be temporary and tailored to the most vulnerable households and businesses, who are being hardest hit by high inflation."*[7]

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5. See in this respect: Unconventional fiscal and monetary policy at the zero lower bound, Keynote speech by Isabel Schnabel, Member of the Executive Board of the ECB, at the Third Annual Conference organised by the European Fiscal Board on "High Debt, Low Rates and Tail Events: Rules-Based Fiscal Frameworks under Stress", Frankfurt am Main, 26 February 2021.

6. Source: Eurogroup statement on fiscal policy orientations for 2023, 11 July 2022, www.consilium.europa.eu.

7. Source: Policy mix of the future: the role of monetary, fiscal and macroprudential policies, Remarks by Luis de Guindos, Vice-President of the ECB, at a panel at the conference "Future of Central Banking" organised by Lietuvos bankas and the Bank for International Settlements, Frankfurt am Main, 29 September 2022.