The Make-Believe Logic of Brexit Runs into the Buffers of the Bond Markets

On 23 September 2022, the new British government led by Liz Truss announced a "**fiscal** event", which has also been called a "mini-budget". Although the policies presented by the new Chancellor of the Exchequer, Kwasi Kwarteng, contained substantial tax and spending measures, it was not officially called a Budget, in order to avoid scrutiny by the Office for Budget Responsibility. This public body was created in 2010 to provide "independent and authoritative analysis of the UK's public finances". The new government's action was a therefore **blatant sleight of hand**.

In fact, far from being minor, the policies announced by the Chancellor were substantial. The government had already **trailed** that it would provide a £60 billion to cap household energy bills, to support incomes and hold down inflation. More surprisingly, the government announced that it was planning to cut taxes **to the tune of** £45 billion. While these tax cuts included a cut in the **basic rate** of income tax from 20% to 19%, the biggest cuts were for top earners, as the top marginal tax rate was planned to come down from 45% to 40%, and the limits on bankers' bonuses were to be scrapped. Significantly, these tax cuts were to be paid for by extra government borrowing.

The economic philosophy behind the "mini-budget" was that a supply-side shock would help boost Britain's slow growth rate to 2.5%: the trend that had existed before the global financial crisis (CFC) in 2007-2009. To some extent, the new government team hoped to imitate the policies of Ronald Reagan, when he came to power in the United States in 1981, and cut taxes while boosting defense spending. This led to strong growth from 1983 onwards. Truss and Kwarteng were even **lauded** by Arthur Laffer, the original tax-cut theorist, who had inspired Reagan by arguing that cuts in tax rates ultimately lead to higher tax revenues as the economic pie expands.

But the United Kingdom in 2022 is not the US in 1980: it is not the world's largest economy, issuing the world's reserve currency. Global financial markets and bond vigilantes were not impressed. They began selling the pound sterling, and also British government **bonds** (called gilts): as bond prices fell, interest rates in bonds began to rise, because there is an inverse relationship between bond prices and yields.

With a few days, Britain started entering a financial crisis, because lower bond prices meant that pension funds had to sell assets (including bonds) in order to provide collateral on derivative positions they were using to protect their investments. This led to a snowball effect, as lower bond prices forced pension funds to sell more assets, prices fell and so on. A financial **meltdown** was on the cards, causing the Bank of England to step in with new quantitative easing: i.e. to buy up bonds, to push up bond prices. The Bank stated that it would spend up to £65 billion until 14 October to make such purchases, and then stop, because it wants to reduce its **asset holdings** and fight inflation.

In the face of such violent market reaction, the Truss government was first obliged to cancel its announced tax cuts (especially the top rate). It was also obliged to say that it would announce full a Budget in November, to explain how tax cuts would be funded by spending cuts, and not borrowing. This idea however has been very unpopular, especially with Brexit-supporting working-class voters who helped Boris Johnson and the Conservatives win the 2019 elections, to "get Brexit done". More spectacularly still, on Friday 14 October, in a sign that Liz Truss needed to confirm her policy **U-turn**, she sacked Mr Kwarteng, and replaced him with a moderate politician.

In many ways, the present economic and political crisis in the UK reflects the contradictions of Brexit and the wi**shful thinking** of its supporters. Creating "Global Britain" while significantly worsening the UK's trading relationship with is nearest partners is nonsensical. Believing that Britain can implement a low-tax, low-regulation model – become a "Singapore-upon-Thames" – shows little understanding of how a stable regulatory environment supports the market economy. Thinking that a medium-sized economy can rely on international investors to buy government debt, when policies seem irresponsible, is foolish optimism at best. Stating that the government will raise the growth rate simply by saying it wants to is naïve in the extreme. Yet the crisis in the UK also reveals the significant risks global finance and the world economy face as inflation and interest rates arise worldwide.

Make-believe = pretending something is real; fiscal (policy) = taxation (T) and government spending (G); blatant = noisy, loud, shocking; sleight of hand = a trick by a magician; to trail = to mark a course, to drag; to the tune of = to the level of, indicating much spending; basic rate = the main, minimum rate; laud = to honour, to compliment; bonds = financial instruments sold by governments (and large companies) to borrow money, and usually repurchased (redeemed) at a time in the future; meltdown = overheating and collapse; asset holdings = assets owned, on books; U-turn = a complete change of direction; wishful thinking = hoping something unlikely will happen.