Market Bulletin

11 March 2020

UK monetary and fiscal stimulus – Unprecedented shock, unprecedented response

On Wednesday, the UK monetary and fiscal authorities provided a sizeable, coordinated package of measures to support the economy in the face of the COVID-19 outbreak. Such clear coordination between the Governor of the Bank of England and Chancellor of the Exchequer carried its risks. Central banks were made operationally independent to isolate them from the pressures of a government in search of cheap financing. However, the market accepted the announcement gracefully (sterling and Gilt yields were broadly flat on the day against most major counterparts). Clearly an unprecedented shock is seen to warrant an unprecedented response.

In terms of specifics, the Bank of England cut the base rate by 50 basis points to 0.25% and announced a comprehensive package to support bank lending. A term-funding scheme has been established with additional incentives for banks to increase loans to small businesses. In addition, the countercyclical capital buffer has been reduced to 0% for at least 12 months. The governor argued in his press conference that "in the last downturn the financial system was the core of the problem, now it can be part of the solution". For this reason he argued the Bank of England's central expectation was that this downturn is likely to be of a much smaller magnitude than the recession in 2008. Other points to note are that the Bank reasserted its view that the policy rate can get close to, but should remain slightly above, 0%. And that expanding the asset purchase scheme is very much a possibility should the need arise in the coming months.

A few hours later the chancellor announced a sizeable fiscal expansion—the largest sustained fiscal loosening since 1992. Real day-to-day spending will return to the levels seen before the Conservatives took office, thus entirely reversing the decade of austerity. The measures announced will increase the budget deficit by 0.9% of GDP on average over the next five years and add GBP 125billion to public sector net debt.

In terms of measures to directly support the economy during the COVID-19 shock, a package of GBP 7billion was announced to provide direct support for households and small businesses, including more widespread sick pay, reduction or exemption of business rates, a new temporary loan scheme with a government guarantee of up to 80%, and a GBP 3,000 cash grant to around 700,0000 eligible small businesses.

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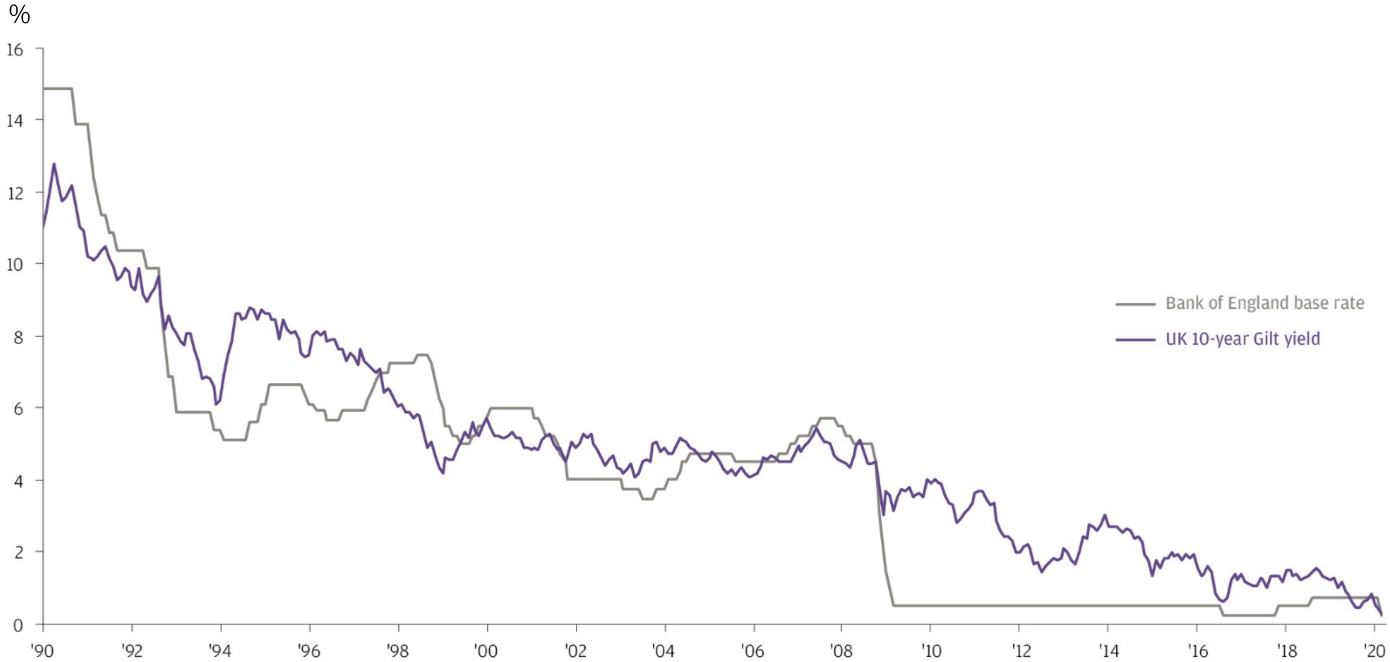
The chancellor indicated he will establish a new fiscal framework ahead of the next budget. While fiscal rules are often ripped up (the last set lasted less than four months) not having a defined framework leaves him exposed. Being a chancellor is much like being a parent of a teenager—constantly being asked for money and facing an almighty sulk when the answer is no. We suspect, therefore, that this budget represents just the tip of the iceberg in terms of the fiscal loosening we are likely to see in the UK in the coming years. Ambitions to balance the books have been abandoned.

Nevertheless, the Gilt market broadly shrugged off today's news. This reaction must mean that for now investors assume that the government will issue more debt, the Bank of England will buy more debt and, crucially, the end result will not be a resurgence in inflation. As the chart shows, however, the challenge for risk-averse investors in need of income is only getting harder.

UK Bank of England base rate and UK 10-year Gilt yield



Source: Bank of England, Refinitiv Datastream, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Data as of 11 March 2020.

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