Better guidelines for growth

(written for the Telegraph)
I thought Liz Truss was right to want to break out of low growth and looming recession . I sent her some less expensive proposals for tax cuts and an energy package than she adopted along with some spending reductions and measures to boost our energy, food, transport and basic industrial capacities. I watched in horror as events unfolded as she tried to change economic policy in the face of a hostile establishment.
Monday 18th September saw the start of a fateful week for the government in the run up to the mini budget. UK ten year government borrowing rates usually of interest only to market specialists stood unremarked at 3.3%. US ten year rates were a bit higher at 3.5%. On the Wednesday the Bank of England hiked bank rate by 0.5% and the US Fed by 0.75% and sent bonds down. Just to make sure UK bonds tumbled the Bank of England announced a big reduction in its holdings by £80 bn including proposed sales of bonds at falling prices into an unhappy market. The ten year rate rose to 3.8% by the Friday in the UK and to nearly 4% in the USA.
Both the Bank of England and the Fed had made big errors in their money policy in 2021, keeping rates too low and pushing bonds to unsustainable prices by buying too many of them. This helped bring on a big inflation which started well before Putin's invasion of Ukraine. They were now fighting to control it by belated and fierce interest rate rises, triggering falls in the prices of the bonds they had previously paid too much for. Their language was tough because they wanted bond prices down.
So when the Chancellor stood up to announce tax cuts and a much larger energy package of support to business and households the bond market was already falling from Bank actions. It went down a bit more on his announcement with adverse comment on the extra borrowing needed to pay the energy subsidies and to cover any net tax revenue loss.
Things got out of hand in the UK government bond market on the following Monday and Tuesday, thanks to many large pension funds owning government bonds they had not paid for through funds that bought lots of claims on bonds. This was a problem specific to the UK They wanted to own several times the amount of bonds they could afford by just paying a margin and owning contracts to buy the rest. They now had to pay cash for more of the costs of these bonds as prices fell, forcing them to sell bonds in a market where no one wanted to buy. As they raised the money to pay for the calls for extra cash under the contracts the market dried up and fell sharply.
Belatedly on the following Wednesday the Bank of England announced it wanted bond prices higher and was even prepared to reverse its sales and drive them up with purchases if necessary. The market flipped upwards with the ten year rate falling from 4.6% to 4.1% and the thirty year from 5% to 4%. The Bank showed it did control the market and could stop the higher rates it had wanted a week earlier when that threatened to get out of hand. The Bank's own pension fund was a big holder of the levered funds and must have been sitting on big losses.
It suits many to spin all this as proof that some tax cuts to promote growth destabilised markets and were ill judged. This is a very partial and inaccurate account of the problems. To the extent that extra borrowing

worried the markets that was far more down to a generous energy subsidy policy than to tax cuts which would have produced more extra revenue from extra activity than official economic models allow for. It ignores the fact that the big falls on the Monday and Tuesday were dominated by worries about the pension funds in LDI geared bond funds, as the subsequent Bank actions and statements on the Wednesday made clear. It also ignores the way the Bank and the Fed deliberately drove bonds down prior to the Statement as they grappled with out of control inflation they had helped create.

It is good news that late in the day the Bank did what it took to sure up the very vulnerable LDI fund bond markets. They did not need to buy many bonds and were able to resell them at a profit a bit later . Just talking the market up would also have worked if they had done that earlier. Since then both the Fed and Bank have scrambled bank rates higher as they needed to do whilst allowing the longer rates to drift down again, with UK 10 year rates back to 3% and US to 3.5%. It looks as if they have now done enough to bring inflation down, which is reassuring markets.

It would be wrong looking at the state and forecasts for the UK economy to conclude from all this we need higher taxes. The growth rate is too low and the economy is very short of many types of capacity from energy to food production, from roadspace to water, from steel to chemicals. Expansion of capacity is needed to ease longer term inflationary pressures and to improve national security of supply. This needs more competitive business taxes and individual tax regimes on investment and income that encourage entrepreneurs and savers.

We cannot afford tax rises. They lower growth, stifle investment and in some cases even reduce tax revenues. We cannot afford to deter inward investment and home grown investment with higher business tax rates. We need to relax taxation on the self employed and small businesses, the potential source of much contemporary innovation, drive and good service. I hope the Chancellor learns the right lessons from last September and delivers a unifying growth budget for enterprise and success.