

Britain's economic crisis in Mini-budget perspective

Yuxuan Ye Li

Lingnan University, Hong Kong 999077, China

Abstract: In October 2022, former British Prime Minister Liz Truss announced her resignation in London, becoming the first prime minister with the shortest term in British history. Due to the current unstable economic and international situation, Lizzie Truss launched a "mini-budget" to trigger a violent reaction in the financial market. Severely tested the British market: the stock market plummeted, the bond market sold wildly, and the foreign exchange market collapsed. As a highly developed financial industry in the United Kingdom, the budget bill severely impacts its financial instrument pension plan. Mini-budget has been a cold winter for the British economy since Brexit in 2016, the new crown epidemic in 2019, and the Russian-Ukrainian war. This article examines the current British economic crisis and its consequences in the context of globalization, as well as analyzes and forecasts the future of the British economy based on Sunak's "Autumn Statement."

Keywords: Mini-budget; Economic Crisis; British Pension Plan.

1. The background of the British economic crisis

In economic globalization, it is difficult for economic actors to jump out of the framework of globalization and become isolated islands. More importantly, it is impractical for individual economies to achieve sustainable economic development in silos. Economic globalization has a history spanning more than 500 years. At the same time, we cannot ignore that the trend of anti-globalization has always existed in the process of globalization. "Reverse globalization" is a setback of the global economy, resulting in economic interdependence and integration among countries, which is concentrated on reducing global trade and investment, immigration flows, or obstacles to the cross-border flow of product elements (Wan & Zhu, 2020).

The 2016 Brexit referendum can be seen as a major setback for European economic integration, which means a setback for global economic globalization. Britain has historically played the role of an offshore balancer and held a negative attitude toward European integration. This neoliberal view of the E.U. has exacerbated divisions within the Conservative Party. Some politicians have called for a "global Britain" because British authorities see the E.U. as an obstacle to free trade. Historically, the U.K. practiced economic expansionism. Unlike other European countries, the United Kingdom and the United States adopted a neoliberal Anglo-Saxon form of capitalism. As a result, the United Kingdom held a strong position in the European integration process. It is an attitude of reluctance. In the six elections to the European Parliament in which the U.K. participated between 1979 and 2004, the U.K. had the lowest average turnout rate among E.U. member states (Martell, 2008).

Although the U.K. has the most developed financial center in the world, the U.K. is still a small, open economy in essence. It only has comparative economic advantages in the tertiary industry and relies heavily on E.U. trade. The E.U.'s exports to the U.K. accounted for 12% of the U.K.'s GDP, while the E.U.'s import rate from the U.K. only accounted for 3% of the E.U.'s GDP. However, the U.K.'s services sector accounts for 40% of its exports to the E.U., with financial services and other business services accounting for as much

as 50%. Therefore, Brexit will deal a heavy blow to the service industry and directly reduce the degree of economic integration in Europe.

To summarize, after the U.K. leaves the E.U., its resistance to external risks will be significantly reduced due to problems with the U.K.'s internal economic structure. One of the original intentions of Brexit was to eliminate the severe immigration problem within Europe. The hidden crisis is like a time bomb that may catalyze the collapse of the British economy at any time. The U.K.'s economic output has dropped to the lowest level since the new crown pneumonia epidemic, a sign that the British economy may have fallen into recession. According to the Bank of England database, the COVID-19 pandemic affected the international trade of British countries and regions in 2020. Since 2019, both total exports and total imports have declined. Total exports have dropped from 689 billion pounds in 2019 to 609.7 billion pounds in 2020, while total imports fell from 716.6 billion pounds to 603.4 billion pounds (Kevin, 2022).

In addition, the outbreak of the Russo-Ukraine war also sounded the clarion call for a soaring global food price. There is little development in planting in the U.K., and most of the food and fruits depend on imports. Therefore, when the Russia-Ukraine conflict broke out, food prices in the U.K. soared rapidly. Data show that in September 2022, the CPI rose from 9.9% in August to 10.1%. This represents a slight decline of 0.3% compared to the previous year in August-September 2021, so this increase represents the difference between the new inflation rate of 0.5% in August-September 2022 and the 2021 decline. The rise in inflation is in line with our forecast from last month (Huw, 2022).

When a country's economic inflation is too high and will cause social turmoil and an economic crisis, it can generally regulate it through a tight monetary policy and fiscal policy.

Therefore, to change the current British economic downturn, Truss issued a "mini-budget." The main content of the bill is divided into two categories: energy subsidies and lower income taxes. On the one hand, the government plans to spend 100 billion pounds to subsidize the daily energy consumption of the people in response to the energy crisis triggered by the Russia-Ukraine war. On the other hand, personal income tax in the U.K. is taxed at progressive rates, and the higher the income, the more personal income tax that

needs to be paid. However, the lower income tax policy has lowered personal income taxes for the wealthy, including removing the top tax rate of 45% applicable to the highest earners and reducing the introductory tax rate from 20% to 19%. According to statistics, 45 billion pounds of personal tax will be progressively reduced or exempted.

As soon as the bill was introduced, it was questioned by all parties. The "mini-budget" is the most radical tax cut policy in the U.K. in 50 years. In its comments on the plan, the International Monetary Fund urged British authorities to consider more targeted support for households and businesses rather than significant tax cuts and big increases in government spending. An extensive and aimless fiscal program could increase inequality in the U.K. and undermine monetary policy.

After the "Mini Budget" was promulgated, the British financial market experienced severe turmoil. On September 22, the Federal Reserve and the Bank of England raised interest rates, triggering a pulse-like rise in U.K. government bond yields. On September 23, the Israeli government announced a 45 billion pounds plan to cut tax, which intensified the market sell-off of long-term British government bonds. The long-term British government bonds yield soared, and the British exchange rate plummeted. Due to the sharp rise in the price of government bonds, British pension funds have shrunk sharply on the asset side, requiring substantial additional margins. In order to meet the margin requirements, pension funds began to sell long-term British government bonds in stages, causing the price of long-term British government bonds to plummet.

2. U.K. pension plan

Strictly speaking, the origin of global financialization can be traced back to the free market concept advocated by neo-liberalism in the 1980s, which advocated the ideology of the market as the master. In the eyes of some liberal economists, the stagflation crisis of the 1970s was considered the best way to promote free markets. Like Milton Friedman and Friedrich Hayek, as well as politicians like Ronald Reagan and Margaret Thatcher (John, 2018).

Since the rise of financialization, various financial derivatives have emerged. In Western countries, social security benefit programs are often also a vital financial tool. Typical social security investment schemes are full or partial pay-as-you-go systems. However, in the U.K., pension schemes take the form of pre-funding future benefits by collecting and investing money first and returning benefits in the future. Therefore, pension funds are an essential financial product in the British financial market, and the management and supervision methods of the British government and financial institutions will significantly impact investors' retirement income and national welfare (Clark and Monk, 2017). That is to say, the U.K.'s welfare policy and assets are well protected, and it is challenging to be impacted by poor investment performance. However, this means that without undermining the promised future pension payments, the difference in assets must be borne by financial institutions. Margins to be paid by financial institutions become unpredictable. Therefore, the most common practice of financial institutions is to find other financial instruments to hedge their risks (Deborah, 2021).

In the U.K., there are two types of pension plans: defined benefit (D.B.) and defined contribution (D.C.). As of March 2021, the D.B. plan has 1.7 trillion pounds, and the D.C. plan

has 0.1135 trillion pounds. So what assets did the British pension buy? There are mainly two financial derivatives involved.

The first tool is called bond pledge repurchase. For example, if a person has 100 yuan and buys a bond with a face value of 100 yuan, the interest rate is 0.5%, and he can get 50 cents in interest every year, but he still wants to get more interest. A person can pledge the bond in his hand to the bank as collateral and loan out 100 yuan in cash but tell the bank that someone will redeem the bond one day when the loan expires. This process is called bond pledge repurchase. Then someone takes out 100 yuan in cash from the loan and buys the second bond. Finally, with 100 yuan, the effect of a 200-yuan bond can be achieved, and the interest of one yuan can be obtained every year. This operation is also called "leverage" in the bond market. The second financial derivative instrument is an interest rate swap agreement. Pension funds sign a VAM agreement with counterparties such as banks and securities firms. Interest rates in the market are floating, but pension funds like fixed rates. Therefore, the pension fund and the other party sign an interest rate swap agreement. Pension funds pay interest based on floating rates to counterparties, and pension funds receive interest based on fixed rates. The two sides net the difference to determine the profit and loss.

In the face of domestic inflation, the Central Bank of England adopts a tightening monetary policy by raising interest rates. However, the mini-budget introduced by the Truss government proposes an expansionary fiscal policy of tax cuts and energy subsidies to stimulate economic growth and achieve the goal of economic growth. The tax cuts caused the national debt to plummet, causing interest rates to rise. Since pension income is negatively correlated with interest rates, investment bank income is positively correlated with interest rates. From the perspective of the pension plan, when the interest rate rises, the user's income increases, and the investment bank's income decreases. At the same time, the user does not need to pay a deposit to the pension plan, while the investment bank needs to pay a deposit to support the transaction.

These two tools are leveraged transactions. Once interest rates rise sharply in the short term, pension funds will face losses magnified by leverage. Moreover, in the bond pledge repurchase transaction, the market price of the bond used as collateral has dropped sharply, and the assets pledged to the bank brokerage have shrunk sharply, and the bank brokerage will force the pension fund to pay the collateral or margin. Similarly, a sharp rise in interest rates will also cause the pension fund to pay the counterparty the interest calculated based on a higher floating rate, lose money in the "interest rate swap agreement," and be required to pay a margin. In order to make up the margin and supplement the collateral, the pension fund can only sell the bonds in exchange for cash, which further causes the bond price to fall. The loss of the pension fund will continue to expand, and the pension fund will be called upon for more guarantee deposits.

However, the market has questioned the British government's efforts to control inflation and even its sovereign credit. The three major international rating companies downgraded the outlook on the U.K.'s sovereign debt rating from stable to negative. Finally, long-term Treasuries were the most volatile and suffered the most damage as the market sold them off. The 50-year British national debt dropped by more than 40% in a month, causing

pension funds that held the British state to liquidate their holdings.

3. The impact of the U.K. economic crisis

The Conservatives are losing credibility after the tax cuts. The poll by market research firm YouGov showed the Conservatives trailing Labor by 33 percentage points. With the political changes in the U.K. and the new Prime Minister taking office, the uncertainty of the U.K.'s economic policy has risen in the short term, which is not conducive to economic recovery and restoring confidence in the financial market. In the long run, it will depend on the new government's policies. At the same time, after Brexit, trade frictions between the U.K. and the E.U. continued, and negotiations on regional trade arrangements in Northern Ireland were pending. If the trade dispute between the two sides intensifies, the UK-EU free trade agreement is at risk of being interrupted, which is not conducive to the recovery of the U.K. economy. In addition, the U.K.'s domestic economy is being affected by increasing downward pressure on the economy, structural labor shortages, short-term inflation, rising energy prices, and the low consumption willingness of residents. ONS figures show that the CPI annual inflation rate in October 2022 is 11.1%, which is higher than 10.1% in September 2022, which is the highest annual inflation rate in the statistical data of this indicator. Despite the relevant energy subsidy measures (Energy Price Guarantee), the government will not be able to change the gas and electricity prices increase in September–October 2022, contributing to the two indicators of CPIH and the CPI annual inflation rate (Andy, 2022).

The sharp drop in sterling showed distrust of the British economy and triggered panic in the market. Since the British pension system is related to the lives of all British people, to avoid further losses, the Bank of England bought a large number of British government bonds on September 28 to lower market interest rates and help stabilize bond prices. Former British Prime Minister Truss also fired the Chancellor of the Exchequer, who had only been in office for 30 days, and withdrew the tax cut plan to stabilize the market's confidence in the British government.

After the Bank of England and the government took action, the price of British government bonds rebounded, and the pension fund crisis was temporarily eased. Some analysts believe that the turmoil in the U.K. financial market this time will ignite a future global financial crisis. However, in my opinion, compared with the financial crisis in 2008, this time can be said to be a "liquidity risk," only causing short-term global financial market turmoil and not causing a large-scale global economic crisis. Looking back, the global financial crisis of 2008 manifested as the global economy's Great Recession and the financial market's collapse. The reason is that loose monetary policy created the eventual bubble economy, with subprime mortgages, poorly regulated financial markets, and highly high bank leverage (Allen & Carletti, 2010).

In 2007, the U.S. Federal Reserve and global financial markets found themselves confronted with underlying financial risks, with banks and other financial institutions suffering disastrously from their exposure to subprime mortgages. From the liquidity risk perspective, the Federal Reserve faced severe credit constraints and the danger of a

sharp contraction in bank lending. The central bank has to provide the necessary reserves to support the daily operations of financial institutions, so the central bank has a large amount of liquidity for transfer payments. Bank loans are closely related to bank capital or net assets. According to relevant regulatory requirements, bank loans cannot exceed a certain multiple of capital. In the run-up to the economic crisis, well-capitalized banks were suddenly forced to lend more than their previously committed lines of credit. Traditionally, central banks have been able to ease liquidity constraints by providing banks with the funds they need in the short term. However, continuing into the fall, the Federal Reserve continued to provide short-term funding liquidity, effectively allowing banks to swap their holdings of U.S. Treasury bonds for cash. This policy enables banks to honor their outstanding credit line commitments.

At the same time, the 2008 financial crisis faced severe credit risks. The credit default swap market needs to be better regulated. It is difficult for investors to discern whether the credit ratings of insurance companies, such as banks, the Federal Mortgage Agency (FNMA), and the insurance company AMBAC, are generally assigned a high credit rating. In the eyes of the market, the hedging position of debt and credit default insurance is a risk-free financial product, which can provide investors with a lower cost to reduce their investment risk. Hence, investors tend to use credit default to hedge their Investing in bond markets, and loans ultimately create credit risk due to poor regulation.

More importantly, this pension crisis reminded us of the enormous risks of using derivatives. High leverage and the excessive use of derivatives partly contributed to the Great Crisis of 2008, with Moody's warning that the mini-budget was a "credit-negative" event for the U.K. However, pension funding ratios improved during the U.K. market turmoil, as liabilities fell more than assets. Furthermore, the initial impact of the crisis was mainly contained, with almost all politics withdrawn in the mini-budget plan. In addition, leverage ratios for pensions and life insurance remain moderate. Finally, for other countries with D.B. pension systems, such as Japan, unlike the U.K., there are meager accurate interest rates and unbalanced trade accounts, indicating that the risk of a global sell-off is lower and more of a liquidity crisis than a systemic risk.

In addition, the actions of the Bank of England to intervene in the bond market have also created a severe but easily overlooked problem, namely, moral hazard. First, it rescued the British government from taking full responsibility for its chaos. The U.K. government has thrown markets into disarray by rolling out a massive tax cut package without adequately considering the market reaction. Without the help of the Bank of England, the British government would have suffered a lot. The Bank of England's rescue operation gave the British government a respite from taking full responsibility for its actions, likely motivating the British government to continue to do such things in the future since the Bank of England is behind it. Second, it rescued investors who took aggressive risks in the financial markets, giving them a greater incentive to take more significant risks.

Take the current crisis in the U.K. government bond market as an example. If the Bank of England does not rescue the government bond market, investors who have previously operated aggressively may lose their money. Therefore, the Bank of England's rescue operation not only rescued investors in the government bond market but also indirectly rescued

investors in other markets, which created a moral hazard on a larger scale. For example, Lehman during the 2008 financial crisis Lehman Brothers was the fourth largest investment bank on Wall Street at that time, and it was inextricably linked with the entire financial system. It was a very obvious institution with systemic risks. At that time, the U.S. government and the Federal Reserve discussed the rescue of Lehman many times but finally rejected the rescue because they had no power. Soon, Lehman went bankrupt, the financial crisis reached its climax, and the entire market panicked. The collapse of Lehman was like bank runs in the past. Not only did Lehman go bankrupt, but investors also turned their attention to other banks, such as Goldman Sachs and Morgan Stanley. The financial market is precisely a market that needs trust to maintain its operation. American decision-makers refused to rescue Lehman because they had no power. However, the more important reason was that they feared the moral hazard that would arise from it.

4. UK economic direction forecast

On November 17, 2022, the British Ministry of Finance issued an "Autumn Statement," which contained a complete plan for the medium-term financial plan. A *statement* is the first budget plan released by the new government after it came to power. The purpose is to clarify the tax increase plan and restore the balance of public finances. ONS figures show: Following a 0.1% fall in August 2022, actual gross domestic product (GDP) is estimated to have fallen by 0.6% in September 2022 and is now estimated to be lower than pre-COVID-19 levels (February 2020) by 0.2%(Ben ,2022).

Since the beginning of this year, affected by factors such as the new crown pneumonia epidemic and the conflict between Russia and Ukraine, the British economy has fallen into high inflation, an aggravated energy crisis, and an accelerated economic recession. In addition, the tax cut policy and energy subsidy plan of former Prime Minister Truss's government caused the British fiscal deficit to expand rapidly. The Sunak government has to face the double pressure of raising taxes and reducing government spending. According to the Office for Statistics, public sector spending in the United Kingdom far outstrips income in tax and other revenue figures, which are the fourth highest on record since 1993. Among them, the net borrowing of the public sector is 13.5 billion pounds, which is 4.4 billion pounds more than in 2021 will undoubtedly make the British economy worse, and a long-term recession is inevitable. At the same time, according to the National Institute of Economic and Social Research (NIESR) assessment, by April 2024, there will be a large number of residents with little or no savings, accounting for one-fifth of British households. Facing a triple shock of soaring energy, food, and mortgage or rent rates, savings for nearly 6 million households will drop to negligible levels, despite the Energy Price Guarantee (EPG) and other support measures (Fraser ,2022).

The "Autumn Statement" is the first budget plan of the new British government, which is related to taxation and spending plans for the next few years. The main measures include increasing taxes and reducing government spending to restore market confidence in the U.K.'s economic development and convincing investors that the U.K.'s debt situation is controllable and sustainable. Reduce inflation while maintaining a healthy balance of economic growth.

Since the United Kingdom prepared for "Brexit," the British Prime Minister has frequently changed, which has

severely impacted the British economy and financial markets. The division of the financial market has also had a significant impact on the City of London. Secondly, the frequent change of British prime ministers led to the frequent emergence of immature economic policies. The tax cut policy after Truss took office ran counter to the central bank's policy, and the financial market experienced significant turmoil, which led to the central bank having to intervene urgently. The new Prime Minister Sunak launched a fiscal policy opposite that of Truss. Against the background of the Federal Reserve's substantial interest rate hikes and the cyclical strength of the U.S. dollar, it was still difficult to avoid the pound's decline, the sharp drop in bond prices, and the intense turmoil in the stock market.

Fang Ming, director of the Global Financial Strategy Laboratory of the Southwestern University of Finance and Economics in China, predicts that the British economy may first experience a technical recession, that is, a quarter-on-quarter decline in the next two to three quarters. Zhao Xueqing, a researcher at the International Monetary Institute of the Renmin University of China, predicts that the U.K. will enter a technical recession in the fourth quarter of 2022 and achieve positive growth throughout the year. However, the economic growth rate will drop to near zero in 2023. According to the International Monetary Fund (IMF) forecast, the real GDP growth rate of the U.K. will be 3.2% in 2022, and the economic aggregate will fall out of the top five economies in the world. In 2023, the GDP growth rate will slow down to 0.5%(Xiang, 2022).

To sum up, the British economic structure had a structural imbalance, and the problem of industrial hollowing appeared very early. Only the service industry has certain comparative advantages, but they only exist in the financial industry. Although the British government wants to adjust the economic structure and try to balance the real and virtual economy, it has yet to thrive under the influence of Brexit, the new crown pneumonia epidemic, and the conflict between Russia and Ukraine. The mini-budget has alarmed the British government: winter is coming. In the short term, Sunak's "Autumn Statement" still makes it difficult to make substantial changes to the British economy, which will remain in a crisis.

References

- [1] Allen,F.,& Carletti,E.(2010).An overview of the crisis:Causes, consequences,and solutions.International Review of Finance,10(1), 1-26.
- [2] Andy King,(2022).Consumer price inflation, UK: October 2022.<https://www.ons.gov.uk/>.
- [3] Balder,J.M.(2018).Financialization and rising income inequality: connecting the dots.Challenge,61(3),240-254.
- [4] Ben Graham,(2022).GDP monthly estimate, UK: September 2022.<https://www.ons.gov.uk/>.
- [5] Bulmer,S.,& Quaglia,L.(2018).The politics and economics of Brexit.Journal of European public policy,25(8),1089-1098.
- [6] Cecchetti, S. G. (2008).Crisis and responses: the Federal Reserve and the financial crisis of 2007-2008 (No. w14134). National Bureau of Economic Research.
- [7] Clark GL and Monk AHB.(2017) Institutional Investors in Global Markets. Oxford: Oxford University Press.
- [8] Fraser Munro,(2022) .Public sector finances, UK: October 2022.<https://www.ons.gov.uk/>.

- [9] Hull, J.C. (2003). *Options futures and other derivatives*. Pearson Education India.
- [10] Huw Dixon, (2022). *Food and Energy Continue to Drive UK Underlying Inflation*. <https://www.niesr.ac.uk/blog>.
- [11] Kevin Sharp, (2022). *International trade in UK nations and regions: the impact of coronavirus (COVID-19): 2020*. <https://www.ons.gov.uk/>.
- [12] Mabbett, D. (2021). *Reckless prudence: financialization in UK pension scheme governance after the crisis*. *Review of International Political Economy*, 28(4), 926-946.
- [13] Martell, L. (2008). *Britain and globalization*. *Globalizations*, 5(3), 449-466.
- [14] Murphy, A. (2008). *An analysis of the financial crisis of 2008: causes and solutions*. *An Analysis of the Financial Crisis of*.
- [15] Wan Guanghua, & Zhu Meihua. (2020). *"Anti-globalization" Characteristics, Causes and Prospects*. *Beijing: Academic Monthly*, 7(33), r47.
- [16] Xiang mengxi, (2022). *With high inflation and a succession of prime ministers, how close is the UK economy to recession*. <https://mp.weixin.qq.com/s/YidQvjNfuSHXBnxMhngjDg>.