INVESTMENT MANAGEMENT

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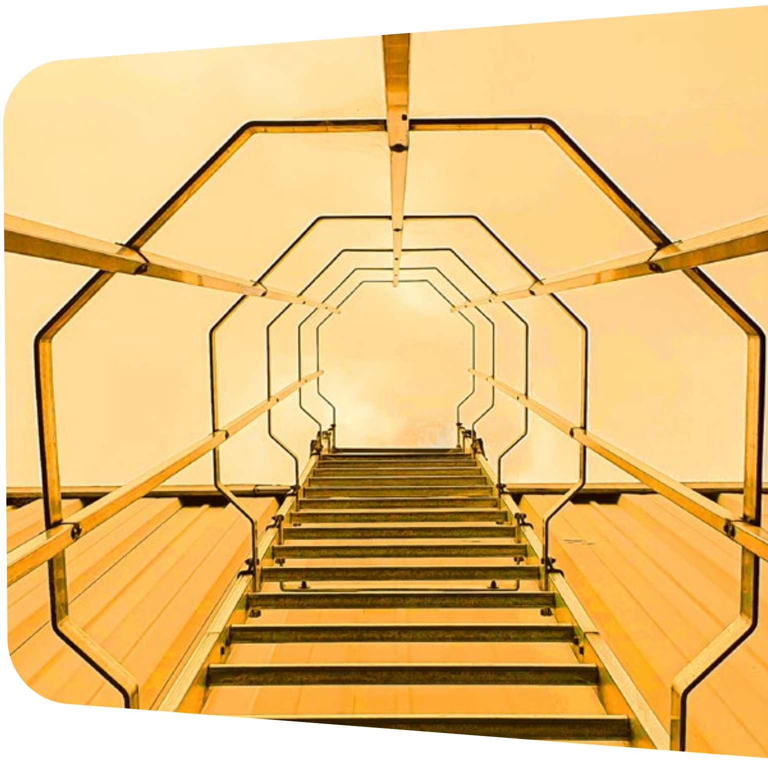
For Professional Investors only

Is the UK heading for bailout?

Gilt yields, the IMF and international comparisons

Recent commentary has sparked speculation that the UK could be heading for an International Monetary Fund (IMF) bailout. Some of this comes from respected economists, including a former MPC member and the ex-head of NEISR and deserves consideration. However, we think this commentary should be taken with a pinch of salt. The UK economy does face serious challenges that this or a future government need to take seriously, but an IMF intervention remains unlikely.

This paper examines the IMF's role and its relevance to the UK's current situation. It reviews lessons learned from the 1970s Sterling crisis and considers what is driving UK gilt yields compared to international peers. it also considers what a theoretical bailout might look like.



Background and role of the IMF

The IMF's most visible role is to assist countries that are unable to fund themselves. It gives them time to restructure their finances and implement economic reforms without the immediate pressure of rolling over debt. In the vast majority of cases to date, the need for assistance is due to the country in question borrowing in a foreign currency (normally US dollars) and then being unable to pay it back in $ terms. This is typically due to poor economic policy leading to lack of liquidity or currency depreciation, or natural disasters in several cases.

The IMF does not intervene in countries that can finance themselves in their own currency, such as the UK. It is usually summoned when chronic fiscal and balance of payments deficits have built up unserviceable foreign currency liabilities, or when banking systems buckle under the weight of external debt (as in Iceland in 2008).

Let's compare with 1976 – the Sterling crisis

The economic regime in 1976 was very different from today. Although sterling moved from a fixed to a floating exchange rate in 1971, it was still effectively a managed float, with HM Treasury and the Bank of England regularly intervening in currency markets.

What began as an attempt to weaken sterling spiralled into a full-blown currency crisis, that ultimately costing the BoE more than $5.5bn.

1975

Mounting inflation and economic instability

- Inflation peaks at over 25%.
- The pound weakens by 17% against the US dollar.
- Government introduces price and wage controls to reduce inflation with little success.

1976

Early 1976:
Crisis deepens

- Harold Wilson resigns and James Callaghan becomes PM.
- The pound falls a further 14% against the US dollar.
- Foreign exchange reserves run short and government struggles to fund its deficit.

1976

Mid-1976:
Speculative pressure and IMF negotiations

- Heavy speculative attacks on the pound force Bank of England intervention with the pound now have fallen 33% since early 1975.
- UK government begins secret negotiations with the IMF for a loan.

September-December 1976:
IMF bailout

- September 1976: Chancellor Denis Healey formally requests a loan from the IMF.
- IMF agrees to lend $3.9 billion, the largest loan it had ever made at the time.
- UK agrees to cut public spending and implement deflationary policies.
- December 1976: IMF loan approved; UK begins implementing austerity measures.

Table 1: Key financial and economic indicators through 1970 crisis

Inflation peaked at 27% in August 1975

	1-Jan-1972	1-Jan-1975	1-Nov-1976	1-Jan-1980
GBP to USD	2.55	2.33	1.57	2.21
FTSE All-share	193	66.9	122	227
Bank of England Rate	5%	11.5%	15%	17%
Inflation Rate*	9%	19.9%	14.7%	17.4%

*Source Bloomberg

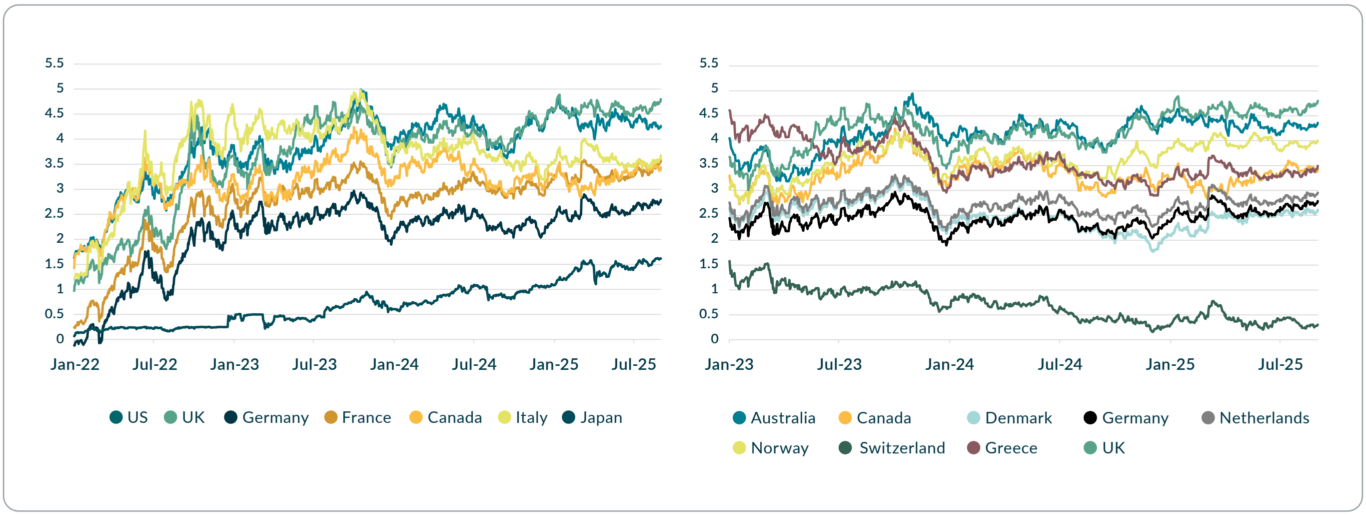
There are many differences between 1976 and now that mean a repeat of the above is unlikely.

1. We have a truly free-floating currency that would bear the brunt of any 1970s style events.
2. We have an independent central bank which should keep inflation expectations anchored.
3. We have a central bank that has become less opposed to intervening in the gilt market should it be required.

Current gilt yields vs international comparators

The two charts below show G7 yields and the yields from AAA rated countries + Greece. There does not appear to be any direct relationship between gilt yields and solvency. Japan has the lowest yields despite the highest debt-to-GDP, while the US has lower yields than the UK despite higher debt-to-GDP and a larger deficit. Greece, meanwhile, has a lower cost of government debt than a number of AAA rated countries.

Chart 1: Change in G7 10-year bonds and change in AAA rated country 10-year bonds (+ Greece and UK)

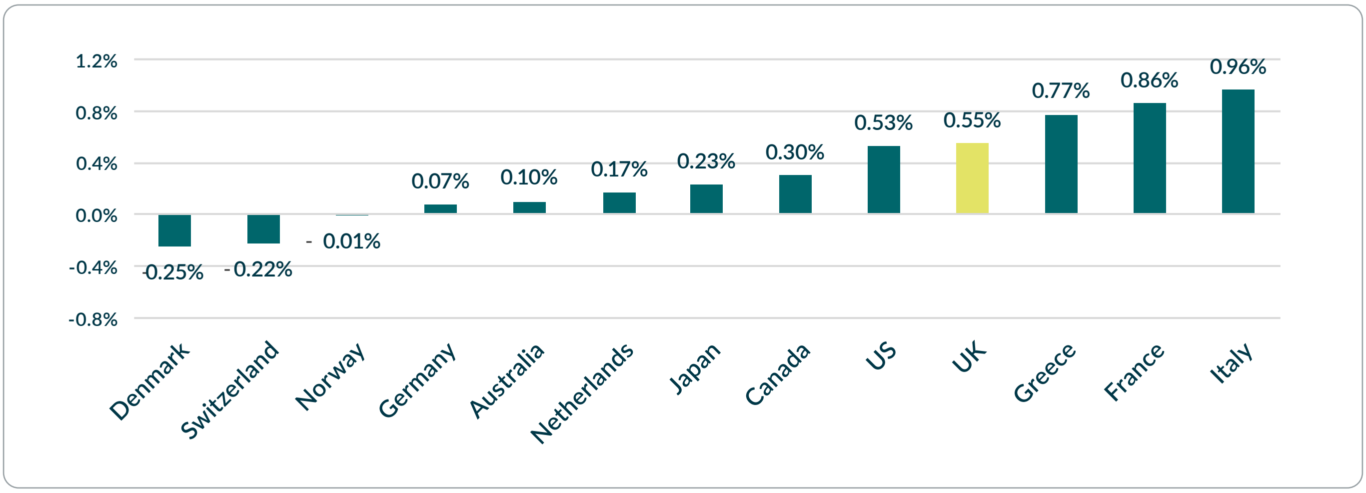


Source: Bloomberg

We need to look at an alternative measure to determine how markets view fiscal sustainability. Fortunately, markets provide a suitable benchmark which strips out the various risk premia, the overnight index swap. It measures where markets expect central bank policy rates to average over the next 10 years, showing how much more or less governments are paying relative to this 'risk free' rate.

The chart below shows this for all G7 countries and those with AAA ratings.

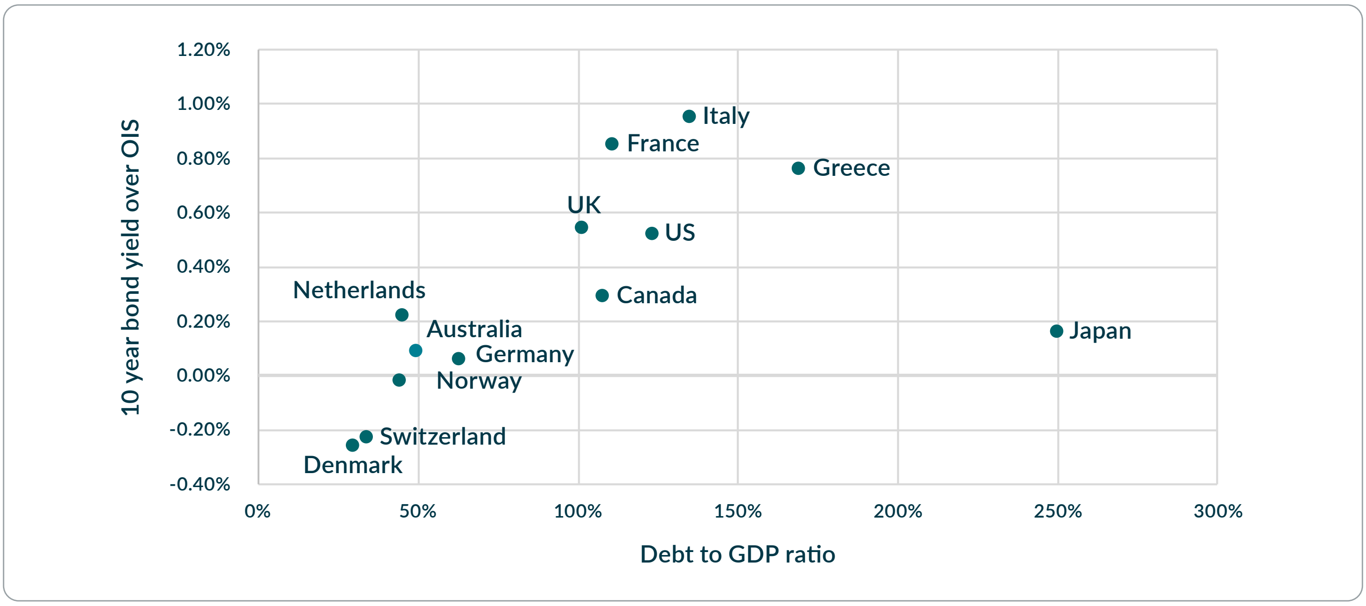
Chart 2: Spread over long-term risk-free rate (OIS) for 10-year government bonds



Source: Bloomberg and Van Lanschot Kempen calculations

This provides a more useful comparison. The majority of AAA-rated countries have low borrowing costs above their respective interest rate expectations and are to the left of the chart. On the right are countries that we might intuitively expect to see; those with past debt issues or currently running high debt and deficit levels. The UK is towards the right, but at a similar level to the US. The UK is not unique in its current situation and actually has the second lowest debt-to-GDP of the G7 countries. The relationship between these OIS spreads and debt is shown in Chart 3.

Chart 3: Relationship between OIS and debt to GDP



Source: Bloomberg and IMF

IMF bailout – when and at what cost

While the UK has not intervened in foreign exchange markets for domestic policy reasons since 1992 (the trade that made George Soros famous), it retains the ability to do so through the UK Exchange Equalisation Account (EEA), managed by the Bank of England on behalf of the government. It is therefore not impossible that the government could intervene to manage the value of the pound.

For the UK to seek an IMF bailout, several conditions would need to align: failed currency interventions (as in 1992), a sharp sterling devaluation, followed by a series of unsuccessful gilt auctions causing a funding crisis, and finally the Bank of England refusing to stabilise conditions.

The cost of an IMF bailout is always austerity. The government would be expected to reduce spending rapidly and significantly. With social security and health accounting for around 50% of total expenditure, these areas would face the deepest cuts. In 1975, government spending was 45% of GDP; by 1977 this had fallen to 42%. Applying similar reductions today would amount to cuts of at least £90bn, assuming GDP remains unchanged, which is highly unlikely.

To illustrate the potential severity, consider Greece. Although not an IMF bailout, Greek GDP in 2010 was $296bn (in current prices) with government spending at $157bn. By 2023, Greek GDP had fallen to $243bn and expenditure was $121bn; a 22% reduction over 13 years.

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