The Rise And Fall Of Trussonomics – Analysis

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On July 8 this year, UK prime minister Boris Johnson resigned as Conservative Party leader after a Cabinet revolt over a series of ethics scandals had made his position untenable. A leadership election was then set in motion to allow party members to elect the next party leader who would succeed Johnson as PM. The result was announced on September 5: the winner was would-be Margaret Thatcher, Liz Truss.

The queen invited Truss to become PM on September 6. Truss immediately announced a "bold plan to grow the economy through tax cuts and reform" and "action [i.e., a price cap] this week to deal with energy bills." The same day, she appointed Kwasi Kwarteng, a free marketeer with a Cambridge PhD on the Great Recoinage of 1696, as her new chancellor of the exchequer.

Government business then came to a stop after Queen Elizabeth suddenly died two days later. The country went into a period of national mourning that ended on September 20. It was then announced that there would be an emergency "mini-budget" to set out the new government's economic program.

What followed can best be described as a case study in how *not* to promote a free-market agenda, and it deserves close study lest policy makers elsewhere repeat the mistakes that Truss and Kwarteng made, which ultimately brought them both down. Their fundamental failure was a simple one. Yes, tax cuts were reasonable, but those needed to be *more than matched by large cuts in government spending to reduce the fiscal deficit*and establish that the new government would be fiscally responsible.

Granted, the notion of fiscal responsibility had long been honored in the breach by successive UK governments, but even so, it was reckless to ignore the issue—especially for a government that promoted free markets. And so the gods of the copybook headings had their revenge on a government that ran off a fiscal cliff that it should have but didn't realize was right in front of them.

In this posting, I shall give an overview and timeline of events leading up to the reversal of the mini-budget and Truss's fall from office, and I shall follow up on what should have been done in a later posting.

The Mini-budget and the Market Response

Kwarteng gave his mini-budget statement to Parliament on Friday, September 23. It consisted mainly of an expensive energy price cap and a package of tax cuts designed to promote a dash for economic growth.

The financial markets hated it. To quote Bloomberg commentator Simon White:

Today's UK "mini budget" has triggered a rout in sterling and gilts [UK government bonds]…. A combination of huge government-spending pledges and tax cuts will require a significant increase in UK borrowing.

The BoE is now in an EM-like dilemma….

The twin deficit (budget + current) currently sits at over £250 billion—a huge amount of capital…. Fine in normal times, but when growth is weak and macro-economic volatility is elevated, it is deeply problematic….

…. The UK government and Bank of England need to think fast so that it does not lead to yet another sterling crisis.

They didn't and on the following Monday the pound crashed to a record low against the dollar, just over three cents above parity.

The reaction to the mini-budget from the commentariat and many politicians was, with exceptions, hostile and so ill informed that I wonder whether the UK has become an idiocracy. There were the predictable leftist howls that the tax cuts only benefitted the rich, but the most bizarre criticism came from former Goldman Sachs investment banker and Davos acolyte Rishi Sunak, a former Conservative chancellor and the runner-up to Truss in the leadership race. He maintained throughout his leadership campaign that the tax cuts Truss was proposing were bad because they were "not funded."

Think that through for a moment: the government should only cut taxes if it has previously accumulated a fund with which to finance those tax cuts! And since Sunak hadn't built up such a fund, the implication was Kwarteng shouldn't cut any taxes at all. This pearl of brain-hurting fiscal wisdom came from the same former chancellor who had spent like a drunken sailor on his covid watch and left the public finances in the ruinous state that Truss and Kwarteng inherited, as if his own profligacy had not left the UK economy primed for a fiscal confidence crisis. Pot, meet kettle.

"The media's Overton window is [now] so narrow that tax-cutting Conservatives are considered deranged," observed Tim Stanley in the October 3 *Daily Telegraph*. He continued:

The biggest price tag was the energy price cap (£60 billion), while National Insurance and Corporation Tax were not cuts but reversals. The shock was abolishing the highest rate [the 45 percent maximum income tax band, was] a drop in the ocean at just £2 billion. That's about two Gary Linekers and a royal yacht.

He went on to criticize “political compasses [that] exist not to show where politicians stand but to mark out a zone of acceptability in our discourse…. Step an inch away … and you are labelled a lunatic.”

The gilts market then became increasingly unsettled over the first half of the next week. Matters came to a head on the morning of Wednesday, September 28 when the long-term gilts market collapsed. To quote the *Financial Times*:

“At some point this morning I was worried this was the beginning of the end,” said a senior London-based banker, adding that at one point on Wednesday morning there were no buyers of long-dated UK gilts. “It was not quite a Lehman moment. But it got close.”

The most directly affected groups were final-salary pension schemes that have hedged to ensure their ability to make future payments—so-called liability-driven investment (LDI) strategies that are very sensitive to fast-moving gilt yields.

It also became clear that if nothing was done, most UK pension plans would default on their LDI swap positions by the *end of the day*, the consequences of which would be catastrophic. The bank responded by temporarily suspending quantitative tightening and announced a £65 billion quantitative easing package to buy long dated gilts and bring their rates down.

The gilts markets recovered sharply after the announcement and by the end of the day the pound had risen to $1.088 against the dollar. The events of September 28 had exposed a hitherto unappreciated risk exposure in the UK pension system, itself the result of a string of earlier regulatory failures.

The Political Crisis Spirals Out of Control

The financial crisis had stabilized, but the political crisis was only getting started. Sunak and his supporters then boycotted the Conservative Party annual conference that started on October 2 so that “Liz could own the moment.” Amongst those who did attend there was an open revolt by disaffected Conservative MPs, the opposition were clamoring for Truss and Kwarteng to resign, and the polls showed Labour way ahead of the Conservatives (LAB 54 percent versus CON 21 percent), suggesting that if a general election were held the next day, then Labour would win by a landslide.

At this point, a strong PM would have told her rebels that if the mini-budget was rejected by Parliament, then she would call a general election and they could all take their chances with the electorate. But Truss didn’t.

In an interview on Sunday morning, October 2, Truss was still insisting that the tax cuts were essential to get the economy growing again. She was “committed” to scrapping the 45 percent maximum tax rate, she reassured her audience. There would be no U-turn. The allusion was to Margaret Thatcher’s famous “the lady’s not for turning” speech in 1980, when Thatcher stood firm against those then calling for her to make a U-turn on her controversial economic policies.

But by the end of the next day, the plan to scrap the 45 percent rate had been scrapped. “The lady *is* for turning,” gleefully wrote Sean O’Grady in *The Independent*. “Whatever reputation she had for being a potentially strong Thatcheresque leader has been destroyed." "It's a very painful decision but we had no choice," said a cabinet minister. "There was no way we were going to get the budget through."

In that same interview she also made it clear that scrapping the 45 percent tax rate was Kwarteng's decision, not hers, and hadn't been discussed with Cabinet. Ouch! The next day, Truss repeatedly refused to confirm that she had confidence in him and it was obvious to all that Kwarteng was now a dead man walking, politically speaking.

In the meantime, the pressure on Truss and Kwarteng continued to intensify and came to a head in mid-October. "On October 13 and 14 we were being briefed that the UK was about to become a Third World country by the Treasury," a Downing Street source was reported to have said. Senior Treasury and Cabinet Office officials

all sat around the Cabinet table and said to the PM, "Unless you junk [your plans for] corporation tax, we are going to have the most catastrophic meltdown; it will take 20 years to recover." They scared the s**t out of her basically…. They said the Pound was basically going to crash to such a level that we would struggle to sell our debt, in the way a Third World country does. Basically, Britain was going to become like rubble.

It was apocalyptic nonsense—the Treasury has a track record for risibly poor modelling of this nature—but it had the desired effect.

It was also made clear to her that if she was to any chance of remaining as PM, then Kwarteng would have to go, and she reluctantly fired him on October 14. By this point, she had the support of just 9 percent of the electorate, essentially Prince Andrew territory.

Kwarteng's replacement was Jeremy Hunt, a "safe pair of hands" establishment type who had supported China's "zero Covid" quarantine policies and called for similar policies in the UK. Hunt then proceeded to roll back almost all the remaining tax cuts in the Kwarteng mini-budget and in the process destroyed whatever was left of her authority.

On October 20, Truss received the presumably dreaded visit from Sir Graham Brady, the chair of the 1922 Committee of backbench (i.e., nonministerial) Tory MPs, who is responsible for leadership elections. He is believed to have told her that he had enough letters from MPs to warrant a new leadership contest: the jig was up. An hour later, Truss announced that she would resign as party leader as soon as a successor had been found. She had been in office for only forty-five days, the shortest ever for a UK PM.

Under new leadership selection rules, Sunak rapidly emerged as the MPs' favorite—with Boris Johnson (of all people!) In second place, Tory MPs being a fickle lot—and party members were not consulted. Sunak became party leader on October 24 and was appointed PM by the king the next day.

The defenestration of Truss and installation of Sunak as the new PM amount to nothing less than a "Remainer coup [that] has taken control of UK economic policy," observed my friend and coauthor David Blake and I agree. "The real risks to the economy now come from the Remainer elite both at home and abroad." The radicals had been beaten by the elite, and yet it is radical reform that the UK economy desperately needs now more than ever. Instead, Sunak supporters are now calling for "right wingers" to be purged—i.e., advocates of low taxes and small government are no longer welcome in the Conservative Party.

*About the author: Kevin Dowd is professor of finance and economics at Durham University in the United Kingdom. He is a lifelong libertarian and his thinking is heavily influenced by Austrian and Public Choice economics. His main areas of interest are free banking, central banking and private money. Dr. Dowd is an adjunct scholar at the Cato Institute, research fellow of the Independent Institute, senior fellow of the Adam Smith Institute (London) and of the Cobden Centre for Honest Money and Social Progress, and member of Economists for Free Trade (formerly Economists for Brexit). Among his books, he is editor (with Richard Timberlake) of the book, *Money and the Nation State: The Financial Revolution, Government, and the World Monetary System*.