Britain's Minsky Moment

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"Stability leads to instability. The more stable things become and the longer things are stable, the more unstable they will be when the crisis hits."

- Hyman Minsky

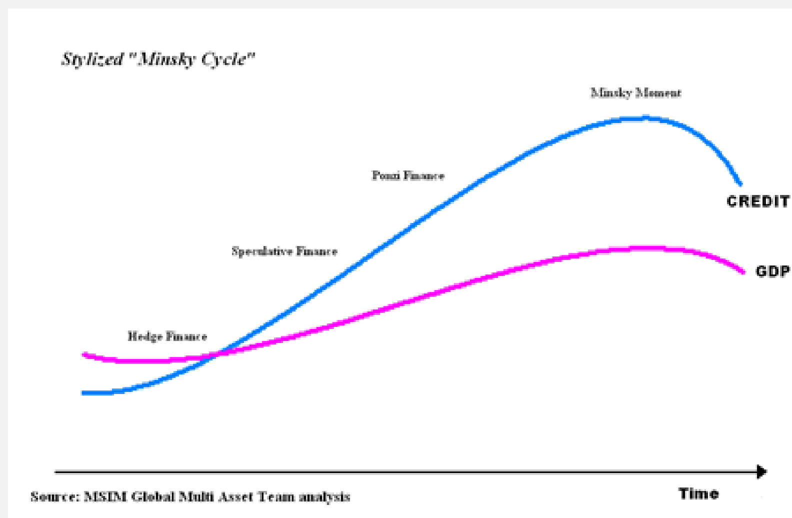
On September 28, the Bank of England (BoE) backstopped the gilt market, the British government debt market equivalent to the United States Treasury market. While the BoE pointed to "a specific problem" in the longer-termed gilt market, the reality is that this was a necessary liquidity operation. It is difficult to tell how big of a problem this will be for the United Kingdom, but for U.K. pension investors, it is a Minsky Moment.

The phrase Minsky Moment is named after Hyman Minsky, an economist who focused on linking the fragility of financial markets with speculative investment bubbles. "A fundamental characteristic of our economy is that the financial system swings between robustness and fragility, and these swings are an integral part of the process that generates business cycles," wrote Minsky.

The Minsky cycle is described as having three main phases.

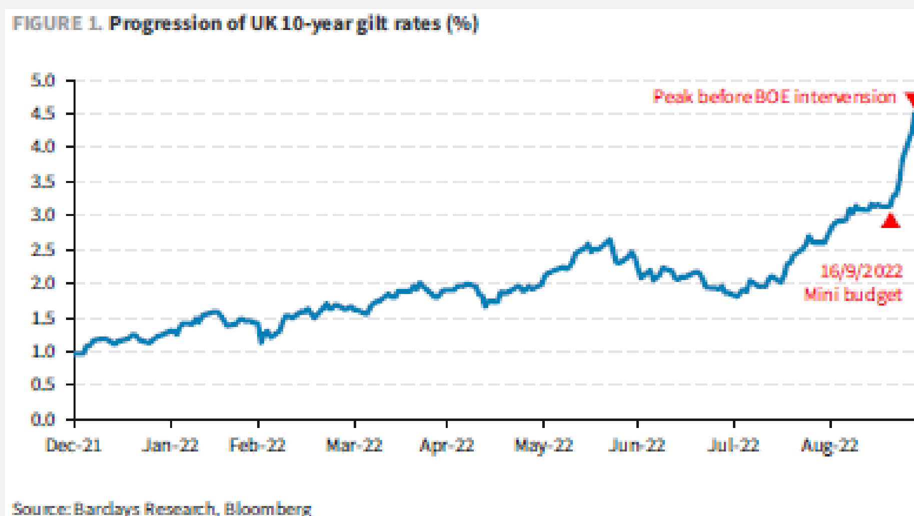
- **The Hedge phase** is characterized by lenders being overly cautious. It usually begins after a crisis during the initial recovery.
- **The Speculative phase** occurs when lenders gain a renewed confidence in the banking system and begin to extend credit to borrowers who can repay interest but who may have principal risk.
- **The Ponzi phase** sees exuberance in lending and borrowing, typically to the point where interest cannot be paid unless asset prices continue to rise. This ends with the Minsky Moment, where both lenders and borrowers realize a default or loss is inevitable.

Many of Minsky's theories focused on the concept of unknown risks in the private sector pushing the economy into recession. The economist favored government intervention, both through regulation and monetary policy, to smooth the business cycle. Minsky's theories were not popular during his lifetime, although he received more recognition following the 2009 housing crisis in the United States.



But back to England. The problem appears to be within the U.K.'s defined benefit pension plans. These are older plans, as almost all current British pension plans are defined contribution (i.e., U.S. 401(k) plans). The defined benefit pension scheme in the U.K. is about £2.0 trillion. These plans can leverage up to four times and often buy long-term gilts in order to match the money needed to be paid in the future.

Over the last several years, pension plans have tried to gain incremental income and remove volatility from their long-term gilt holdings by hedging through vehicles called Liability Driven Investment funds (LDI). As long as volatility was low, such as less than 2% annually, the contracts would have expired in the pension plan's favor. Volatility spiked, increasing 3.6% from the start of the year until September 28, resulting in a capital call. Providing capital forced the pensions to sell gilts at depressed values, which drove down the value of gilts even further, exacerbating the very problem.



The BoE's intervention attempted to provide stability to the gilt market. Rarely does a developed country see the yield of its sovereign debt increase from 3.2% to 4.5% (+1.2%) in a seven-day period. However, these liquidity injections could be detrimental to the inflation outlook and the BoE's attempt to fight inflation through raising interest rates. Hopefully, the BoE bought enough time for the pension plans to stabilize their books and not require any further emergency liquidity.

Normally, the Bank of England's purchase of gilts would not be of concern, but the announcement was likely the catalyst for some near term moves in global markets, including a decline in the rates for U.S. Treasuries. The current higher rate policy by Central Banks, both in the U.S. and abroad, is starting to show some strains on the global financial system. Other global macro instabilities include energy shortages in Europe, the war in the Ukraine, China's rolling Covid lockdowns, and the negative impact of a stronger U.S. dollar to other currencies. There is no shortage of events to track.

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