A briefing on the public finances: how deep a hole are we in?

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Summary

- This briefing looks at the impact of the pandemic on the UK's public finances and assesses the scale of the fiscal crisis. Some of the most common concerns are exaggerated. Others are not.
- The good news is that the increase in borrowing to pay for Covid does not itself have to be repaid; provided the government can continue to make the interest payments, debt can simply be rolled over.
- Of course, there are limits to how much debt can be serviced with comfort, but the UK is still a long way from these limits. UK public debt has been much higher in the past as a share of GDP, and is still lower now than in many other countries, including the US, France, Italy, and Japan.
- The health of the public finances is also not as dependent on the Bank of England as many seem to think. The Bank's purchases of government bonds have reduced the cost of borrowing, but the global economic slump and excess savings means that this cost would be low anyway. Interest is also still paid on the reserves created to buy the bonds. This is best seen as an asset swap which has shortened the maturity of public sector borrowing, rather than the printing of 'free money' to fund the deficit.
- The crunch may therefore come sooner if interest rates were to rise sharply and exceed the growth rate of the economy by a large amount. But it is more likely that interest rates will remain relatively low and that a rebound in growth will help to stabilise the debt-to-GDP ratio at a sustainable level.
- Indeed, recent better economic data and the rollout of the first Covid vaccine mean that the Office for Budget Responsibility's 'upside scenario' now looks closer to the mark. This would see a much faster recovery – and no significant long-term damage either to the economy or the public finances.
- Nonetheless, even if the government does not face the same financial constraints as a household, high public spending and borrowing has many other costs, including the misallocation of resources and the risk of runaway inflation. The state's ability to print money does not remove real resource constraints, which will start to bite again when the economy recovers.
- In summary, it is misleading to claim that the UK has already 'maxed out its credit card'. But it would be even more misleading to suggest that the government has a 'blank cheque' to spend or borrow as much as it likes, whenever it likes.

Introduction

The Covid-19 pandemic – and the government's responses to it – have led to a surge in public borrowing and debt. This briefing assesses the scale of the fiscal challenges that lie ahead.

The Office for Budget Responsibility's Fiscal Sustainability Report (OBR 2020a) also includes some longer-term scenarios where unchecked increases in public spending on health, social care and pensions could see debt balloon from about 105 per cent of GDP this year to more than 400 per cent in 2070. That would be a very different ballgame, requiring a much deeper analysis than is possible here. This briefing focuses instead on the medium-term outlook, or how to 'pay for Covid'.

Back to basics

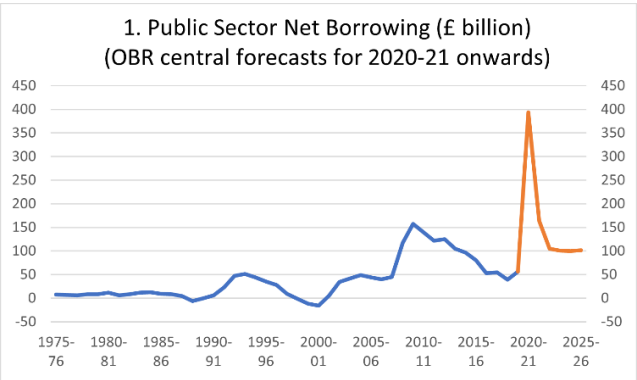
A good place to start is the difference between 'borrowing' and 'debt', which are frequently confused. In the words of the Office for Budget Responsibility (OBR 2016), 'when total spending in a year is higher than total receipts, the Government needs to borrow to cover the difference. This gap is known as the budget deficit or "public sector net borrowing". When receipts are higher than spending, the government runs a surplus.'

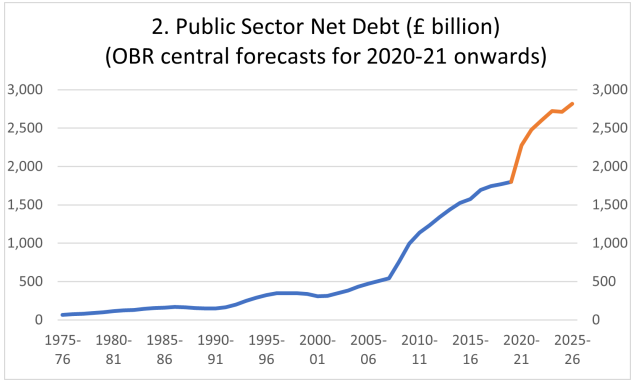
The deficit or borrowing is therefore a 'flow'. Debt, in contrast, is a 'stock'. Picking up from the OBR again, 'because governments run deficits much more often than they run surpluses, they have built up a significant stock of outstanding debt over time. Generally speaking, if the public sector runs a deficit in a particular year, debt will rise in cash terms'.

The latest data

Figures 1 and 2 show the recent history of public sector net borrowing (PSNB) and debt in cash terms, along with the OBR's latest medium-term forecasts, published in November (OBR 2020b).

It is important to stress that these profiles are based on the OBR's 'central scenario' for the economy. This scenario assumes that the unemployment rate (currently about 5 per cent) peaks at 7.5 per cent and that long-term economic scarring means that GDP is 3 per cent smaller than it would otherwise have been in 2025 (though this would still be 5.6 per cent larger than it was in 2019, and probably 10-15 per cent larger than it is now).





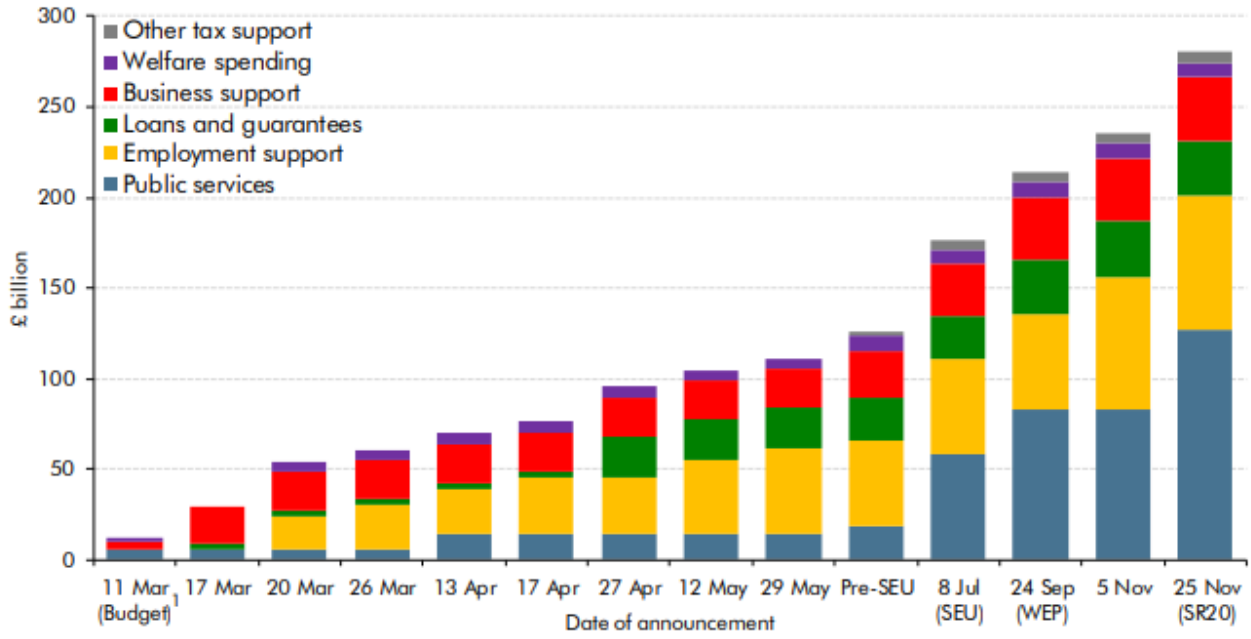
The government borrowed about £215 billion between April and October this year, with public sector net debt already reaching £2,077 billion (ONS 2020). Over the financial year 2020-21 as a whole, the budget deficit is expected to hit nearly £400 billion (£394 billion, to be precise), before dropping back as the economy recovers and the emergency fiscal support can be withdrawn.

In this central scenario, borrowing is still forecast to be £102 billion (3.9 per cent of GDP) in 2025-26. The OBR concludes that a 'fiscal adjustment' of £27 billion (1 per cent of GDP) would then be required to balance the budget on current spending, but given all the uncertainties this is little more than guesswork.

Indeed, the OBR's 'upside scenario' now looks more likely; in this case, GDP would be back to pre-Covid level by end-2021, unemployment would peak only a little higher than it is now, public debt could be back down to 90.5 per cent of GDP in five years, and there would be no need for any form of 'austerity'.

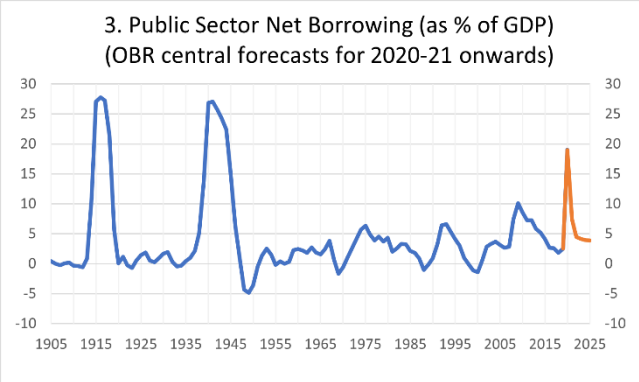
We can at least be confident that annual borrowing will fall back in almost any scenario. By far the largest part (£280 billion) of the jump in expected borrowing this year reflects temporary policy interventions which should no longer be required once the crisis is over. Chart 1.7 below, from the OBR (2020b), summarises the cost of these measures. The bulk is made up of additional funding for public services, especially health, and employment support, including the furlough scheme.

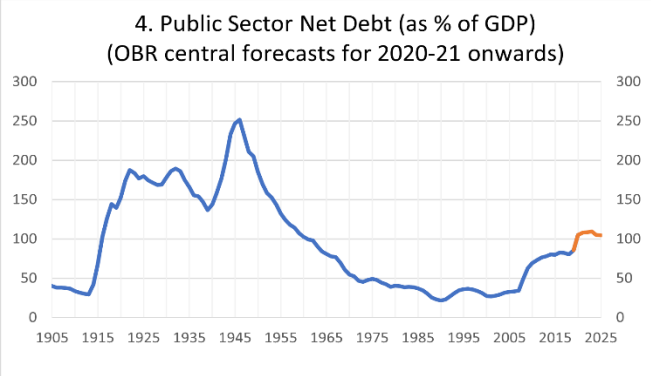
Chart 1.7: The evolving cost of the coronavirus policy response in 2020-21



[1] Cost based on figures announced by the Chancellor in the Budget. All other costs based on our November forecast estimates.
Source: OBR

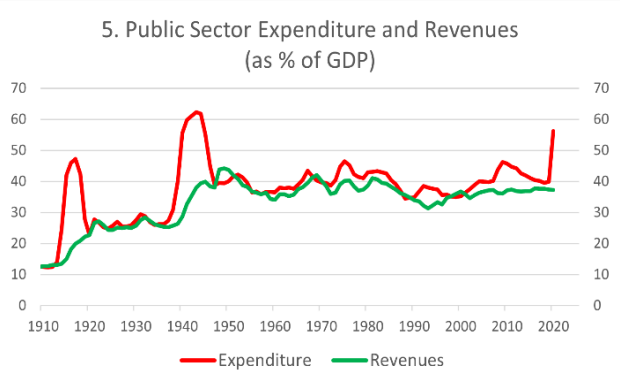
What is more, looking solely at the headline figures in cash terms can give a misleading impression of the economic burden. Figures 3 and 4 show borrowing and debt as a percentage of nominal GDP, thus reflecting the combined effects of real economic growth and inflation.





These graphs show a large but temporary increase in annual borrowing and a one-off step increase in the level of debt. They also show that both borrowing and debt have been much higher as a share of GDP in the past, specifically during World Wars I and II. Indeed, the debt-to-GDP ratio (Figure 4) peaked at 252 per cent in 1946 – more than twice as high as it is now.

This may prompt the question of how borrowing and debt were brought back down again. As Figure 5 shows, the key driver of the surge in borrowing during each of the World Wars was a jump in public spending, which then fell back sharply as the emergency passed and exceptional levels of state intervention were no longer required. Note, however, that neither spending nor taxation fell all the way back to their earlier (peacetime) levels.



What is more, with the exceptions of a few years in the late 1940s, annual budget deficits remained the norm. Nonetheless, the debt-to-GDP ratio still fell sharply again after World War II.

The key driver here was the relatively rapid growth in nominal GDP, reflecting both the post-war economic boom and (less positively) the impact of inflation. A detailed study by Ellison and Scott (2017) suggests that inflation played the biggest part.

This is what happened in other countries too. For example, the Federal debt-to-GDP ratio in the US fell from 121 per cent in 1946 to 32 per cent in 1974, despite the persistence of budget deficits.

History therefore provides several examples where borrowing falls back sharply after a crisis as public spending corrects to more normal levels, and where the burden of higher debt is reduced by faster economic growth and inflation. Of course, circumstances change – the demographics are now less favourable and potential growth is generally lower – but clearly 'austerity' is not the only way out.

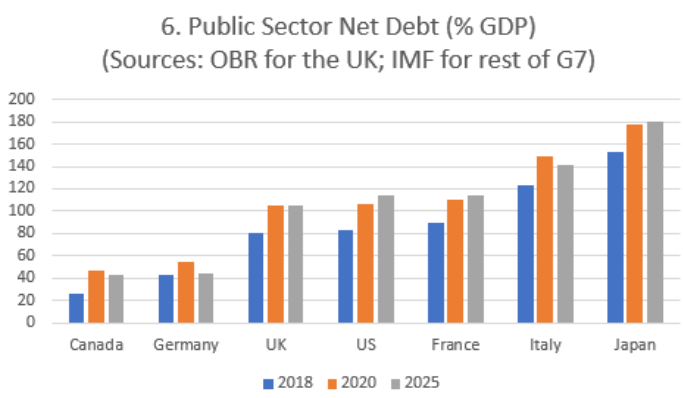
What happens next?

Some of the most common concerns are exaggerated. For a start, the increase in public borrowing to pay for Covid-19 does not itself have to be repaid, only serviced. Provided the government can meet the interest payments (more on the risks here later), maturing debt can be 'rolled over' effectively in perpetuity. When one government bond matures it can be replaced by selling another, either to the same investor or someone else.

Indeed, this is what usually happens. The last time that the UK government ran an annual budget surplus was in 2000-01. Public sector net debt had already increased from £307 billion to £1,800 billion in 2019-20, before the pandemic struck.

The key to fiscal sustainability is to avoid a vicious spiral where higher interest payments require more borrowing, adding to debt and thus driving up interest payments even further. A higher stock of debt obviously increases this risk. For this reason, it is usually considered desirable to stabilise the debt-to-GDP ratio, or to reduce it, and big jumps in debt are worrying.

Nonetheless, there is no particular threshold for the ratio of debt to GDP at which debt sustainability becomes a problem, either in theory or in practice. In the early 2010s, the US economists Carmen Reinhart and Kenneth Rogoff (2010) argued that economic growth tends to slow sharply once debt exceeds 90 per cent of GDP. But this has been widely challenged, not least because the conclusion appears to have the direction of causation the wrong way around: it is slow growth that leads to higher debt, not vice versa.

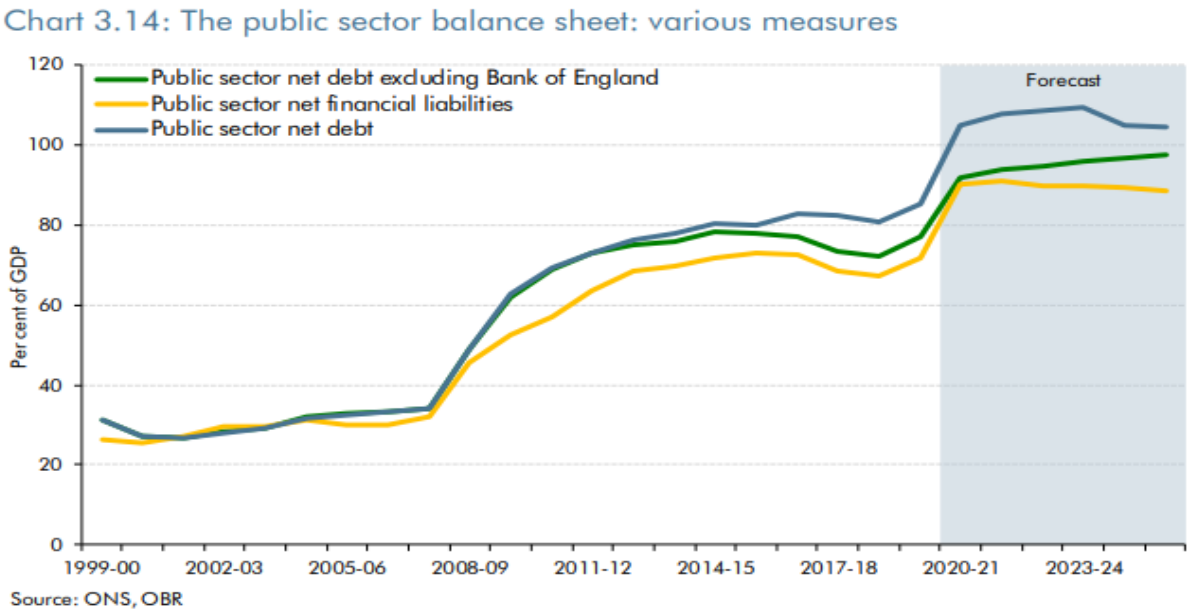


Of course, there must be some limit, but these limits seem to be a long way off.

In the OBR's central scenario, UK public debt jumps to 105 per cent of GDP this year and then stabilises close to this level. But this ratio has been much higher in the past (see Figure 4).

It is also expected to remain lower in the UK than in four other members of the G7, namely the US, France, Italy and Japan (see Figure 6).

Incidentally, this measure of net debt includes loans made by the Bank of England to the private sector under its 'Term Funding Scheme', which are not netted off as assets because they are illiquid. If these are excluded, UK public debt is still below 100 per cent of GDP. This is the green line in the OBR (2020b) chart below. (Public sector net financial liabilities are lower still, mainly due to the build-up of student loan assets.)



What is more, the cost of financing this debt has actually fallen, both in cash terms and relative to other metrics. For example, the debt interest-to-revenue ratio is forecast to drop from 3.5 per cent in 2019-20 to a new post-war low of 1.7 per cent in 2021-22 before rising back to a (still low) 2.2 per cent by 2025-26. This is because the increase in the stock of debt has been more than offset by a fall in the average interest rate paid on this debt.

But what happens if interest rates take off?

A significant rise in the interest rates on a high stock of debt could be a game-changer and it is right to worry about this. But there are three reasons not to panic.

First, the average remaining life of UK government borrowing on the gilt market is around 13 years. This means that even if interest rates in the bond markets do rise soon, it will be a long time before this is reflected in the overall cost of borrowing. Indeed, many economists, such as Blanchard (2019), expect interest rates to remain relatively low for the foreseeable future.

Box 1: The role of 'quantitative easing'

'Quantitative easing' (QE) is widely misunderstood. Some claim (wrongly) that it is a means either to 'bail out the banks or to 'write off' government borrowing. Others claim (perhaps just as wrongly) that is only delaying an inevitable day of reckoning.

In a nutshell, QE involves the purchase of assets, or the making of loans, using newly-created money. This money takes the form of central bank reserves, which are electronic IOUs from the central bank to commercial banks (Bank of England 2014).

Typically, the assets bought are government bonds. This is because the markets for these bonds are relatively large and liquid, and their yields set a benchmark for asset prices more generally. Crucially, central banks do not buy these bonds directly from the government, nor is the money being 'given away' to 'fund the deficit'.

Instead, central banks buy the bonds from private financial institutions by crediting their accounts at the central bank itself. These accounts are interest-bearing deposits (reserves). In the UK, the Bank of England pays Bank Rate (currently just 0.1 per cent) on these reserves.

As the Bank of England is itself part of the public sector, this is effectively an asset swap which shortens the maturity of public sector borrowing. Rather than the government having to pay the usual long-term rates of interest in the bond market, the cost of serving the debt is determined by the short-term rate set by the central bank.

This may reduce the cost of borrowing, at least while short-term interest rates are relatively low, but borrowing still takes place and the stock of public debt still increases. The health of the public finances is therefore not as dependent on the intervention of the Bank of England as many seem to think.

This is not just kicking the can down the road for future generations, because in ten to fifteen years the economy should be larger, and the burden of a given stock of debt therefore much smaller. (Alternatively, if the economy is still as weak as some fear, it seems even more likely that interest rates would remain low.)

Second, the Treasury now gets a large chunk of the interest back anyway from the Bank of England, which refunds profits from its gilt holdings, minus the interest – currently just 0.1 per cent – that the Bank itself pays to commercial banks on the reserves created to purchase them (see Box 1).

Admittedly, this creates some new risks. At some point the Bank of England may want to sell its gilts back onto the open market. This is a double threat, both because it could drive up bond yields and because the Treasury will then lose the repaid profits. Even if the Bank of England keeps the gilts on its books and they are rolled over when they mature (as seems more likely), there is the risk that the interest rate that it pays on the reserves (the Bank Rate) increases from its current very low levels.

Mainly as a result of the swapping of gilts for floating-rate central bank reserves, the sensitivity of debt interest to a one percentage point rise in short-term interest rates has doubled from £6 billion (0.2 per cent of GDP) to (a still low) £12 billion (0.5 per cent of GDP).

But this is where the third point comes in. If interest rates do rise, we also need to know *why* they are rising**.** Presumably, it would either be because the economy is recovering more quickly than expected, or because inflation is higher, or both. (Another possibility is a collapse in investor confidence in UK assets, but there is no sign of this happening either here or in other countries where debt is already much higher.)

In either case, nominal GDP would also be higher, thus reducing the budget deficit (excluding interest payments) and the burden of debt as a share of GDP. This is likely to more than offset any increase in debt interest payments.

The crucial factor in the debt dynamics here is the difference between the interest rate paid on debt, and nominal GDP growth (see Bangham et al. 2020). In brief, the debt-to-GDP ratio is more likely to fall if interest rates are lower than GDP growth. If interest rates are a lot lower than GDP growth, the debt-to-GDP ratio can still fall even if the government is still running a large primary deficit (the budget balance excluding interest payments).

Box 2: What about Modern Monetary Theory?

None of this, by the way, is a nod to 'Modern Monetary Theory' (Kelton 2020). MMT is based on the truism that a sovereign government issuing its own currency can never 'run out of money'. But MMT takes this further by arguing that the only significant constraint on government spending is the risk of inflation, which can be countered by raising taxes.

This is nowhere near as insightful as some seem to think. For a start, the policy outcome might well be the same: higher spending would still have to be offset by higher taxation, even if in MMT-world the tax increases are notionally required to control inflation rather than fund the spending.

What is more, you do not need MMT to argue that it makes sense to run an expansionary fiscal policy during a recession. When the economy is depressed, as it is now, consumers and businesses are building up savings which they are happy to park in government bonds (or deposits at the Bank of England). But most of the time, the public and private sectors are competing for a limited pool of resources, including savings.

The more the government borrows, the higher the real rate of interest it will have to pay. If the government tries to borrow at anywhere near the current levels when the economy recovers, and consumers and businesses want to spend again, interest rates may then need to rise sharply.

In short, the ability to print money will not prevent higher public spending from crowding out private spending and investment, as and when the economy is operating close to full capacity again.

This is crucial. It seems very likely that nominal interest rates will remain low for the foreseeable future, or at least lower than the growth rate of nominal GDP. This emphasises the importance of focusing on economic growth as the best way to keep borrowing and debt under control.

No such thing as a free lunch

This briefing has explained how some of the concerns about the public finances are wrong, or at least exaggerated. Nonetheless, even if the government does not face the same financial constraints as a household, high public sector spending and borrowing still has other cost and risks, including the misallocation of resources – and the potential for runaway inflation (especially if it is indeed paid for by money printing).

Public sector spending has already averaged around 40 per cent of UK GDP since World War II, which is surely more than enough to fund good public services and a decent welfare safety net. It must be possible to find substantial savings by pulling back from activities that can be done at least as well by the private sector and still have room to increase public investment in the limited number of projects that cannot be left to the markets.

This is a very different way of thinking to many commentators, who take the path for public spending as a given and search instead for ways to raise the tax burden (also to 40 per cent of GDP) to meet it.

It is also important not to undermine the independence of the Bank of England. The central bank's main job is to 'maintain price stability'. Supporting government policy more generally is a secondary objective (Bank of England 2020).

At the moment there is no contradiction between these objectives: the Bank's Monetary Policy Committee has judged (rightly or wrongly) that additional monetary stimulus has been required to prevent inflation from becoming too low. Implementing this via the purchase of government bonds using newly-created money has had the welcome side-effect of keeping government borrowing costs down.

But this balance could change in future. Facilitating a temporary increase in government borrowing to support the economy during a once-in-300-years recession is one thing. Subverting monetary policy to underwrite a permanent increase in the size and role of the state would be quite another (see Box 2).

Last, but not least, issuing unlimited amounts of debt is likely to drive up interest rates and threaten debt sustainability. That this has not happened in recent years is due to the weakness of the economy. If the government continued to rack up huge debts even in better times, the outcome could be very different.

In summary, it is misleading to claim that the UK has already 'maxed out its credit card'. But it would be even more misleading to suggest that the government has a 'blank cheque' to spend or borrow as much as it likes, whenever it likes.

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