Paying for it – how to fund a budget deficit of £350 billion?

Economic commentary

6 August 2020

Key points

- The UK government is on track to post a budget deficit of around £350 billion in the current fiscal year. Yet at the same time, it is able to raise money in the bond markets more cheaply than ever before.
- Once the Covid crisis has passed, borrowing costs will inevitably rise. So, while running a huge deficit this year is not a problem, the Government will need to get a grip on the public finances during the next few years.
- If the economy doesn't get back on to its pre-Covid growth track, the Government will face tough fiscal choices. There seems little appetite for a second round of austerity, which implies that tax rises would be needed.

The British government, like many others around the world, is running its biggest ever peacetime deficit. Yet it is also raising money from the bond markets more cheaply than ever. Does this mean that there is no longer any need for fiscal discipline? Is there really a magic money tree of the kind that will just keep on giving, and giving? Or, on the other hand, are we just burdening future generations with even more debt, and won't there be, at some point, an awful day of reckoning?

Rishi Sunak's latest fiscal statement, delivered on 8th July, brought the total amount disbursed during the Covid crisis to a staggering £190 billion. He is perhaps the only Chancellor of the Exchequer who has spent more in the footnotes to his statement (£33 billion) than he did in the statement itself (£30 billion). When the Institute for Fiscal Studies (IFS) ran its customary slide-rule over the Chancellor's arithmetic the following day, they forecast a budget deficit for the current fiscal year of around £350 billion.

Indeed, since the crisis blew up in March, the government has been running bigger deficits in a month than it would usually rack up in a year, with its cash requirement coming in at an eye-watering £174 billion in the period from April to June. The shortfalls are now thankfully starting to come down, with June's cash requirement being a somewhat more modest £47.1 billion.

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An introduction to the bond markets

The obvious question that springs to mind, for anyone who isn't familiar with the world of government finances, is "how on earth does anyone raise such huge sums of money?" The answer is that the UK government, like many others, raises most of the money that it needs from the bond markets. It issues bonds of varying maturities (ranging from just a few years to as much as 50 years) which either pay a fixed interest rate ('coupon') or pay a return that is linked to the rate of inflation ('index-linked'). Governments have other options, for example selling investment products directly to the public; but in the UK, such products, which are marketed by National Savings and Investments (NS&I) and which include the famous Premium Bonds, account for only a tiny fraction of the money being raised.

Bonds issued by the UK government, which are often referred to as gilts, are bought by institutions and investors who seek a fixed income stream. Obvious examples are pension funds and insurance companies, as these firms need to meet predictable streams of liabilities that will arise in the future, for example payments to pensioners or payouts to policyholders. The advantage of buying gilts is that the investor knows, at the point when the purchase is made, what the flow of income will be if the bond is held until it matures. Government bonds are also attractive because they are liquid and (generally) safe, so that they are also held in large quantities by fund managers and commercial banks. They also feature in many countries' holdings of foreign currency reserves.

Looking at the table below, which analyses holdings of UK government gilts at the end of March this year, nearly a third (measured by value) was held by pension funds and insurance companies, while almost a quarter was held by the Bank of England's Asset Purchase Facility (APF) which is the vehicle through which it conducts its quantitative easing (QE) operations. About 30% of gilts are held overseas, which is a relatively high proportion by the standards of other advanced economies. It's gratifying that overseas investors are currently supporting the market for British government debt, but they are not under the same investment constraints as UK-based institutions and could easily put their money elsewhere if they were to lose faith in the credibility of the UK's public finances. Finally, it's clear that households, non-financial businesses, and non-profit institutions each hold relatively small amounts of gilts.

Who holds all the gilts?

(outstanding value of UK central government securities as at 31 March 2020)

	Amount £ billion	**Share** %
Insurance companies and pension funds	698.0	32.4
Bank of England	526.5	24.4
Non-bank financial institutions	152.8	7.1
Banks and building societies	117.2	5.4
Households	3.8	0.2
Non-profit institutions	3.6	0.2
Private non-financial companies	1.0	0.0
Public companies	0.5	0.0
Local government	0.3	0.0
Total held in the UK	1,508.5	69.9
Foreign holdings	648.9	30.1
of which: Foreign central banks	97.1	4.5
Total	**2,157.3**	**100.0**

Source: ONS, UK Economic Accounts; Bank of England, BankStats

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Lower and lower

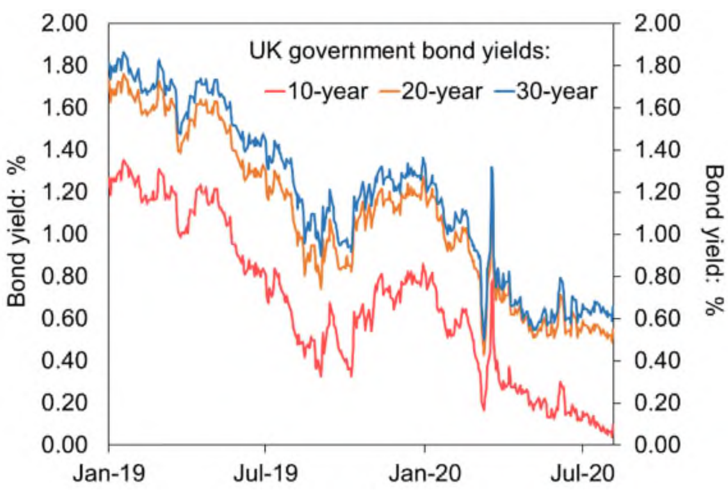
It is fortunate that the government's huge need for cash has been greeted with equanimity in the bond markets. Since the start of the financial year in April, the Debt Management Office (DMO), the agency which issues these bonds, had raised £225 billion by the end of July; and it expects to raise a further £50 billion in August.

Far from buyers throwing up their hands in horror and demanding higher yields to take all these bonds off the government's hands, the cost to the government has continued to fall. At the time of the Chancellor's March Budget, the Office for Budget Responsibility (OBR) forecast that the cost of servicing the national debt would amount to £34.5 billion during the current financial year. This was on the basis of an expected average yield on typical ten-year gilts of 0.9%. This was viewed at the time as a remarkably low rate; and by historical standards it was. But it was nothing compared to what has happened since.   With many investors craving safe assets, and with the Bank of England having cut Bank Rate to just 0.10% and launching two more rounds of quantitative easing (QE), yields on government bonds have fallen right across the maturity spectrum. By 4th August, the yield on 10-year gilts had fallen to an all-time low of just 0.04%, while that on 20-year varieties was just under 0.5%, with gilts maturing in 30 years commanding a yield of just under 0.6%.

In other words, there has never been a better time in history for the British government to fill its coffers with cash from the bond markets. It's not only that the government can fund itself very cheaply, but it can spread the cost out over many years, ensuring that large slugs of debt won't fall due for repayment at the same time. Indeed, it's quite likely that when Mr Sunak delivers his next Budget in the autumn, he may be able to announce that the debt servicing cost for this year is lower than predicted in the OBR forecast in March.

The decisions by the Bank of England, in March and June, to launch additional rounds of asset purchases (another name for QE) have helped to keep gilt yields on the floor. As the government has been issuing new bonds into the primary market, the Bank of England has been sucking them out of the secondary market. When the second round of QE is completed, which is expected to be towards the end of this year, the Bank's Asset Purchase Facility will have increased its holdings of gilts by a further £300 billion, taking the total to £745 billion. The Government will get a truer sense of the appetite of investors to buy and hold its bonds once the QE programme is completed. By that stage, the Bank of England, which is technically a state-owned entity, will be sitting on about a third of the national debt.

UK bond yields hit historic lows



Source: Thomson Datastream

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While the Bank of England could do more QE, if it was really needed, the mood music coming from members of the Monetary Policy Committee (MPC) suggests that they are not inclined to do so. Indeed Andy Haldane, the Bank of England's Chief Economist, voted against the latest round of asset purchases when it was put to the vote at the meeting in June. From the Government's perspective, most of the money that it needs to cover this year's extraordinary budget deficit is expected to have been raised by the time the QE purchases are completed; and the hope will then be that, as the economy recovers, so the need for cash will diminish.

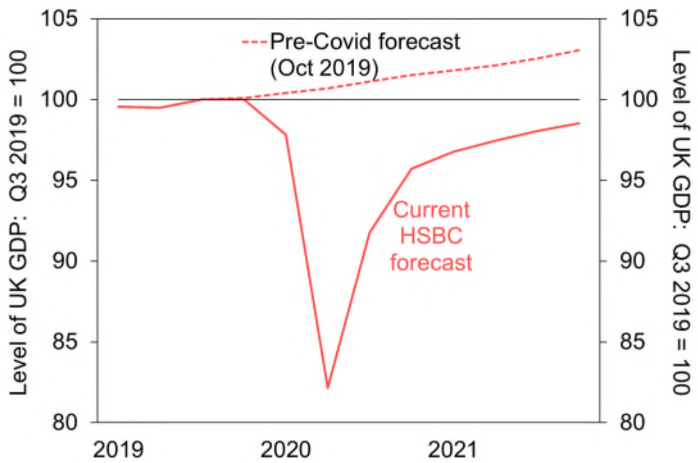
Pressing the accelerator

With the government being able to borrow so cheaply, does this mean that we can stop worrying about the size of the budget deficit and the accumulated burden of debt? Well, yes and no. The short-term answer is that we probably needn't concern ourselves unduly this year, and maybe even next year. But not even governments can run up debts *ad infinitum*, despite what some siren voices among exponents of Modern Money Theory (MMT) may say. In any case, there is no appetite, neither in the Government nor at the Bank of England, to embrace such unconventional approaches. That being the case, the question is how to ensure that there isn't a painful and disruptive fiscal day of reckoning at some point in the future.

Rishi Sunak's recent fiscal statement marked the point where the Government began to shift gear from support to stimulus. The Budget, due in the autumn, will take this process further, with the Chancellor likely to set out the Government's approach to pump-priming economic growth in the years to come. One thing is abundantly clear: getting the deficit down to manageable proportions will not be quick if the economy can only muster the modest annual growth rates of around 1.5% seen in the past couple of years.

The immediate challenge is to restore the level of GDP to its pre-Covid level. But even then the job is only half done. If the rate of unemployment is to be brought back to where it was in the early months of this year, and if the government revenues are to be restored, then the economy must get back onto its pre-Covid growth track by making good the growth that had previously been expected during what has turned out to be a period of recession. On the basis of the latest HSBC forecasts, by the end of 2021 the economy will still be around 1.5% smaller than it was before the pandemic; but it will be around 4% smaller than it would have been had none of this happened.

Mind the gap: Covid leaves the economy appreciably weaker



Source: ONS, HSBC Global Research

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Any government can make a case for borrowing to invest. This was the basis of Gordon Brown's 'Golden Rule", which was in place from 1997 until the financial crisis. It implies that the government should cover its day-to-day expenditure from its revenues, if not in a single year then at least over a period of time. Rishi Sunak is likely to announce a new fiscal framework for the post-Covid era in his next Budget. He will clearly want the debt-to-GDP ratio to begin falling as soon as possible, and he will also want the current budget to move closer to balance.

But this Government, and a Conservative one at that, recognizes that this will only happen if the economy grows, and that this in turn will only happen if the Government continues to lend a hand. For all the assistance that the Government has provided, the private sector will emerge from this crisis badly scarred. The Government will hope that by pressing ahead with spending on infrastructure, community improvements (especially in 'left behind' towns) and investment in 'green' projects, the economy will not only achieve better-balanced growth than has maybe been the case in recent years, but that it will also expand at a faster rate.

During his brief tenure as Chancellor of the Exchequer, Sajid Javid expressed an intention to double the economy's growth rate, implying that GDP would expand at an annual rate of between 2.75% and 3% a year. This has now become Rishi Sunak's imperative. If the Government can propel the economy into a faster growth mode, then the public finances will gradually repair themselves; if it can't, then other measures will have to be taken to plug the gap. There appears to be little appetite for further rounds of austerity, neither among the general public nor within the Government. This implies that taxes would have to be raised. Levies on wealth would likely be the first to be wheeled out. But if the Government finds itself needing to raise substantial sums, then it would have little choice but to raise the traditional headline rates of tax.

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