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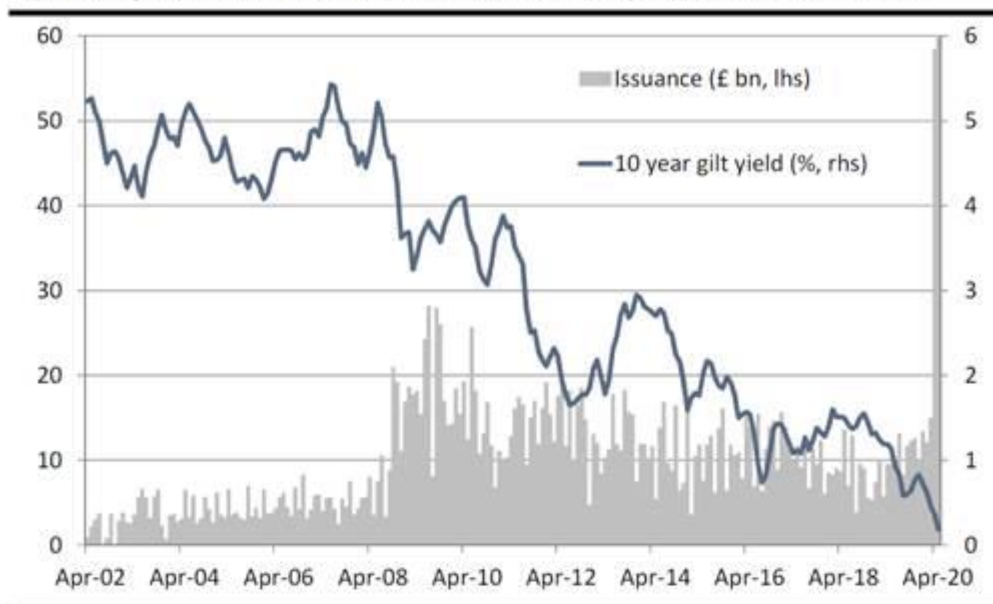
UK FISCAL POLICY: THE USUAL RULES DO NOT APPLY

Berenberg Macro Flash

Borrowing costs have fallen to near-record lows despite record debt issuance



Public sector debt issuance versus 10-year gilt yields. Monthly data. Source: DMO, BoE.

An expensive crisis: The UK government is borrowing at a record pace to finance its policies to tackle the COVID-19 pandemic and recession. The OBR (Office for Budgetary Responsibility) estimates that the government's coronavirus policies, which include generous employment subsidies and grants to businesses, will cost c£123bn for fiscal year 2020/21. Total borrowing for this fiscal year will be much higher, however. The OBR projects that public borrowing hit 15.2% of GDP (£298.4bn) in 2020-21 – the highest since 1945-46 (15.0% of GDP) – with public debt rising to 94.6% of GDP from 79.7% in 2019-20.

Record issuance: Data from the UK Debt Management Office shows a record surge in gilt issuance of c£60bn per month in April and May (see chart) – up from an average of c£13bn of debt issued per month in the six months to March and more than double the peak rate of issuance during the financial crisis. Given the current huge gap between spending and taxes, the pace of issuance is unlikely to slow anytime soon. However, despite the surge in public debt, the government's 10-year borrowing costs are hovering at near-record lows of 0.2%. The low rates on government debt in the UK and across the advanced world are being driven much more by economic fundamentals than the pace at which governments are increasing the supply of bonds on the open market.

Why are borrowing costs so low? The coronavirus recession has merely reinforced four interlinked factors that have caused bond yields in the advanced world to decline over time: 1) a rising glut of global savings seeking a safe haven in advanced markets; 2) declining inflation and inflation expectations; 3) weaker productivity growth in an age of growing economic and political anxiety (perhaps not for long); and 4) huge central bank balance sheet expansion.

Public and private debts are different: There are no hard and fast rules that limit government spending based on some arbitrary ratio of debt or deficit, especially in times of crisis like these. Unlike a household or firm, the government is a currency issuer with its own central bank. In principle, it can always meet its debt obligations in its own currency as long as people are willing to accept the pieces of paper with the Queen's face on that the BoE prints. Amid disinflation risks and with plenty of liquidity in the gilt market thanks to the BoE's aggressive asset purchases, HM Treasury will have no problem raising as much cash as it needs in the open market despite the high and rising public debt load.

The case for aggressive fiscal action: Judging by the developments in the UK debate, the bigger risk to worry about when it comes to fiscal policy is that deficit hawks persuade the government to pull back the economic policy support prematurely. When there are unused resources in the private economy and inflation expectations are well anchored, the government always has the fiscal capacity to spend until full employment is reached or inflation expectations start to rise too much for some other reason. Following the biggest contraction in economic output in modern times, providing for people who have fallen on hard times and promoting a recovery that returns people to work should be the immediate and overriding priority. If that involves persistent high borrowing for the next year until modern medicine wins the fight against COVID-19, then so be it. It is the lesser of two evils.

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