THE TRAJECTORY OF UK PUBLIC FINANCES AFTER COVID-19

Before the onset of the Covid-19 pandemic, the United Kingdom had already begun to come out of the "age of austerity", to borrow a phrase from former Prime Minister David Cameron. The massive intervention of UK authorities to support the economy through the Covid-19 sanitary and economic crises has significantly strengthened this trend. The government deficit ran at almost 20% of GDP in 2020, and the ratio of government debt to GDP increased by twenty percentage points to nearly 100%. Once the crisis is over, some adjustments will be needed. That said, the Treasury's eagerness to bring public finances back under control rapidly could be counterproductive if it stifled the economic recovery. Moreover, long-term prospects, particularly demographic trends, suggest that balancing the government's books will be no easy task.

The Covid-19 crisis hit at a time when UK fiscal policy was beginning to be loosened after years of austerity. A combination of a massive increase in government spending, collapsing fiscal receipts and the measures taken by the Bank of England has pushed the UK's government debt sharply higher over the past months. This document attempts to analyse the past trends and future trajectory of public finances. The first section reviews the state of UK public finances before the Covid-19 crisis. The second examines the health crisis and its impact on the economy. The third details the measures taken by the UK authorities and the effect of the crisis on government spending, receipts, deficit and debt. The final section then considers the long-term outlook for the public finances, and discusses the government's strategies to ensure the sustainability of the country's sovereign debt.

The state of the public finances

The structure of public spending[1]

The total amount of government spending, known as Total Management Expenditure (TME), is split between the resource budget, covering current expenditure, and the capital budget, dedicated to investment spending. Each of these categories then splits into two sub-divisions. Departmental Expenditure Limits (DEL), set during Spending Reviews or, occasionally, Comprehensive Spending Reviews (CSR), set maximum spending over three years for predictable current and investment spending. This is the case for administrative costs, such as operational costs and payroll. The other subsection includes spending that is harder to control and thus to predict, such as welfare, tax credits and public sector pensions. This spending, known as Annually Managed Expenditure (AME), is reviewed annually.

Chart 1 shows the breakdown of UK government expenditure for the 2019-20 fiscal year[2]. Public sector current expenditure accounts for around 90% of total government spending. The remaining 10% is split almost equally between investment and depreciation, which together form public sector gross investment.

Where does public spending go?

Social protection is by far the main public expenditure item. Its stabilisation, and even slight reduction, in real terms since the beginning of the last decade is the main explanation for the slowdown in spending growth.

This trend has clearly reflected the spending cuts introduced under the austerity programme launched after the Global Financial Crisis (see next section). However, it has also been helped by the sharp reduction in unemployment since 2012, which has had the effect of reducing the government's benefits bill. UK unemployment fell from 8.5% in 2011 to 3.9% just before the onset of the Covid-19 crisis.

BREAKDOWN OF TOTAL MANAGED EXPENDITURE (TME)

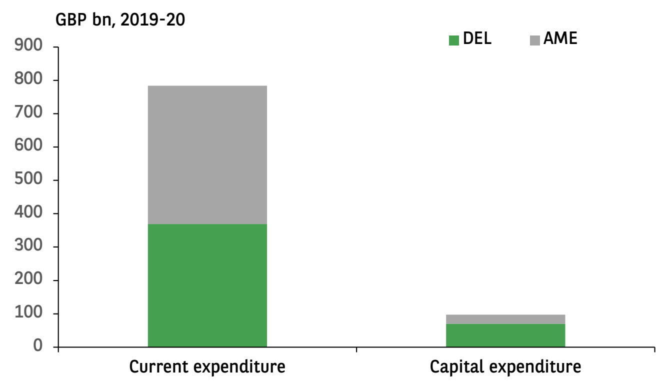

CHART 1 SOURCE: HM TREASURY

PUBLIC SECTOR EXPENDITURE FOR MAIN FUNCTIONS

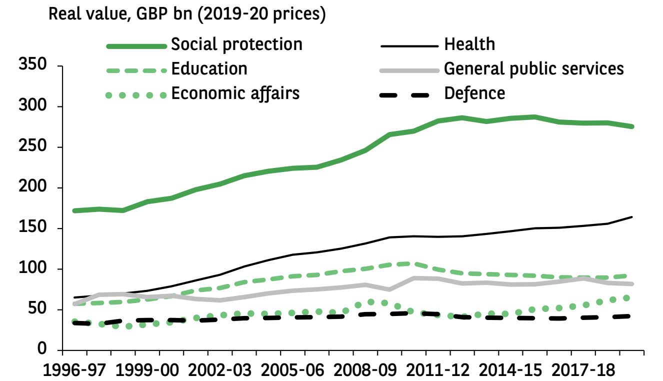

CHART 2 SOURCE: HM TREASURY

Healthcare is the second largest item of expenditure, followed by education, public services, economic affairs and defence (see Chart 2).

Pre-crisis trends

In 2018, UK public spending accounted for around 40% of GDP. This makes the UK government one of the lowest spenders among European OECD members (see Chart 3).

1 How to understand public sector spending, United Kingdom Government, 29 May 2013.
2 UK fiscal years run from April to March of the following year.

GENERAL GOVERNMENT SPENDING

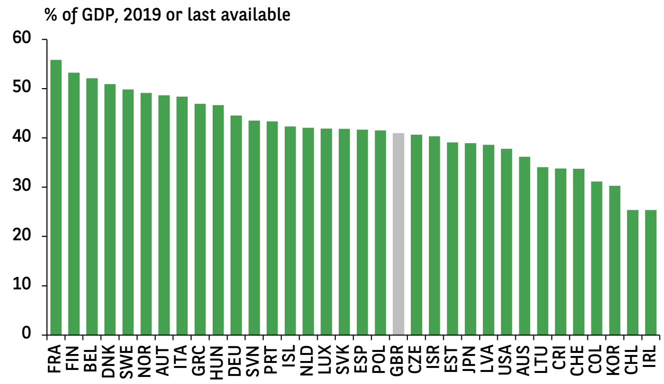

CHART 3 SOURCE: OECD

TOTAL MANAGED EXPENDITURE

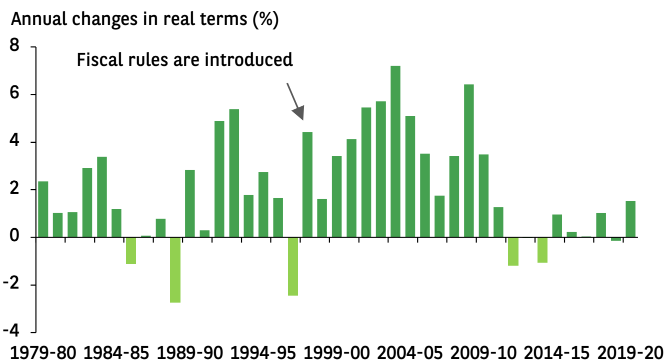

CHART 4 SOURCE: HM TREASURY

Successive UK governments over the past twenty years have sought to respect fiscal rules when drawing up their spending plans. These rules were first set out in 1997 by Gordon Brown, then Chancellor of the Exchequer. Initially, there were two rules. The first, the 'golden rule', stated that over the course of an economic cycle the government could only borrow to invest, and that current spending would be financed by tax receipts. The second sought to maintain government debt below 40% of GDP over an economic cycle. These rules have since been repeatedly dropped and replaced.

The three fiscal rules now in place were set out in the Conservative Party's manifesto for the 2019 elections[3], which led Boris Johnson to the prime ministership. The first stipulates that the current budget must be balanced no later than during the third year of the forecast period. The second limits net public sector investment – that is to say excluding depreciation – to 3% of GDP. The third calls for a reassessment of spending plans in the event that debt servicing costs exceed 6% of government revenue.

However, while the aim of the fiscal rules is to keep public spending in check, spending growth has accelerated in real terms after they were introduced nearly twenty-five years ago (see Chart 4).

It was only thanks to the austerity programme launched after the Global Financial Crisis that the government managed to rein in public spending. The programme, introduced by Chancellor George Osborne, aimed to balance the current budget over a moving five-year forecast period and to reduce the ratio of debt to GDP. As a result, growth in spending slowed significantly over the last decade. TME even fell by more than 1% in real terms in the fiscal years 2011-12 and 2013-14.

However, successive governments over the past three years have repeatedly promised to bring to an end what future Prime Minister David Cameron called the "age of austerity" in 2009. In her speech to the Conservative Party conference in October 2018, Prime Minister Theresa May announced that austerity would soon end, and this pledge was reiterated by Chancellor Philip Hammond in his 2018 Budget speech[4]. A few months later, when presenting the 2019 Spending Review, then Chancellor Sajid Javid stated being *"turning the page on austerity"*[5]. Lastly, Chancellor Rishi Sunak unveiled a budget in March 2020[6] that would have had the effect of stabilising, rather than reducing, the debt-to-GDP ratio. It should be noted that this budget contained only the premise of the recovery package later introduced by the government in response to the Covid-19 crisis. This package, detailed below, has clearly marked the end of the "age of austerity".

The Covid-19 crisis

The health crisis

Because the government was slow to introduce restriction measures, the Covid-19 pandemic initially spread rapidly in the UK. As a result, the country's first lockdown, which was finally imposed on 23 March 2020, was particularly long – non-essential shops only reopened in the middle of June, while the tourism and accommodation sectors had to wait until early July. Faced with a resurgence in the epidemic, a second lockdown was introduced in early November. While it was lifted after a month, a mutation of the virus, making it particularly contagious, led to the introduction of a third lockdown in early January. This will only start to be lifted in March, and some restriction measures will remain in place at least until mid-June. With a total of more than 100,000 deaths, the UK is the world's fifth most affected country, behind the United States, Brazil, Mexico and India, and thus the hardest hit in Europe. Moreover, according to the Government Stringency Index from the Oxford Covid-19 Government Response Tracker (OxCGRT)[7], the UK maintains restriction measures among the strictest in Europe.

The economic impact

Given the length and severity of restriction measures, it is hardly surprising that the UK economy has been hit particularly hard by the Covid-19 crisis. The collapse in consumption and output, notably resulting from restriction measures and the sharp slowdown in global trade, led to a massive drop in GDP in the second quarter of 2020

3 Our Plan, Conservative Manifesto 2019, Conservative Party.

4 Budget 2018: Philip Hammond's speech, United Kingdom Government, 29 October 2018.
5 Spending Round 2019: Chancellor Sajid Javid's speech, United Kingdom Government, 4 September 2019.
6 Budget 2020: What you need to know, United Kingdom Government, 11 March 2020.
7 Coronavirus Government Response Tracker, Blavatnik School of Government, University of Oxford.

(see Chart 5). Over 2020 as a whole, GDP fell by nearly 10%, the biggest contraction of any G7 country in real terms. Admittedly, this partly reflects how the volume of non-market output is recorded, and particularly how the provision of healthcare and education is captured. Nevertheless, even when accounting for this, the ONS estimates that the UK is the G7 country that suffered the biggest drop in GDP over the first three quarters of 2020[8]. According to the Bank of England, by the end of 2023 the supply capacity of the economy will be around 1.75% lower than it would have been in the absence of the pandemic.

Setting aside the level of economic activity, the authorities' response – detailed in the following section – was determined by the effect of the crisis on two other major economic variables. Indeed, these will continue to guide the authorities' response over the coming months, and could thus have an indirect but prolonged impact on the UK's public finances.

GDP OF THE UNITED KINGDOM

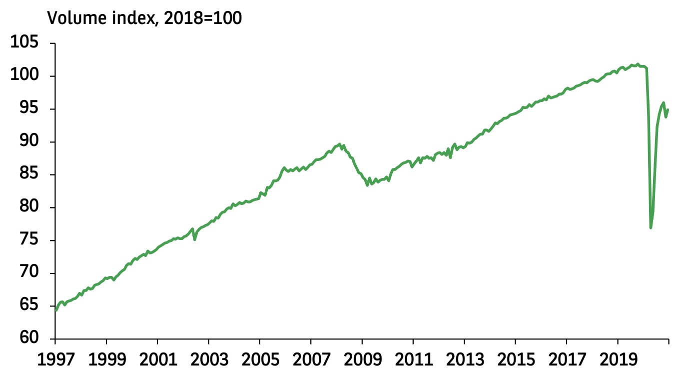

CHART 5 SOURCE: ONS

The first is the unemployment rate. In fact, it has not shot up as much as might have been expected given the abrupt and extended collapse of economic activity. This is thanks to the proactive response from the authorities, which rapidly introduced a furlough scheme to limit redundancies and a support programme for the self-employed (see following section). As a result, while the unemployment rate rose by more than three percentage points during the Global Financial Crisis, reaching 8.5% in late-2011, its increase since the beginning of the health crisis has so far been limited to only a little bit more than one percentage point. In the three months to December 2020, the unemployment rate was 5.1%. However, this limited rise can also be explained by an increase in the number of inactive people – those who are not employed but not looking for work either, and who are not included in the unemployment numbers. According to the Office for National Statistics (ONS) more than 700,000 jobs have been lost since early February 2020[9].

The second significant variable when looking at the official response to the current crisis is inflation. At the beginning of 2020, the annual rate of increase of the Consumer Price Index (CPI) was close to the Bank of England's 2% target. As a result of the pandemic's impact on demand, the collapse in oil prices in the first quarter of 2020, and some government measures such as temporary cuts in VAT for certain sectors, this rate fell to 0.5% in May and has not exceeded 1% since[10]. Against this background – and with its secondary objective of supporting the government's economic policy in mind – the Bank of England's Monetary Policy Committee (MPC) loosened its monetary policy significantly over 2020 (see following section).

The strong response from the authorities

The government has spent without limit...

To meet the challenges stemming from the sanitary and economic crises, the UK government has devoted substantial resources to support public services, companies and individuals.

First, nearly GBP130 bn have been paid out in 2020-21 to support public services, and around GBP60 bn have already been earmarked for 2021-22. These funds have notably been aimed at supporting the healthcare system through the sanitary crisis.

The government's measures targeted at companies have included subsidies, tax cancellations and deferred contributions. According to initial estimates from the Office for Budget Responsibility (OBR), which is responsible for providing independent forecasts to the Treasury, these measures will have a total cost of nearly GBP35 bn in 2020-21. On top of this, Chancellor Rishi Sunak has promised more than GBP300 bn in guarantees for loans to companies. To date, the various government programmes (Bounce Back Loans Scheme, BBLS; Coronavirus Business Interruption Loan Scheme, CBILS; and Coronavirus Large Business Interruption Loan Scheme, CLBILS) have provided more than GBP70 bn in financing. Meanwhile, nearly GBP85 bn have been approved for issuance under the Bank of England's Covid Corporate Financing Facility (CCFF). However, the impact of these programmes on the government's budget is likely to be inferior to these amounts, close to GBP30 bn in 2020-21 according to the OBR. That is because most of the loans will be repaid and therefore not need government intervention.

As far as households are concerned, the government has put in place a furlough scheme (Coronavirus Job Retention Scheme, CJRS) and a support programme for the self-employed (Self-Employment Income Support Scheme, SEISS) in order to limit redundancies and protect workers' incomes. More than ten million people have benefited from these programmes, which are estimated to have cost the UK government more than GBP70 bn in 2020-21. Lastly, households have also benefited from an increase of around GBP8 bn in welfare payments.

All in all, the OBR estimates that these measures will have an impact of GBP280 bn (14% of GDP) on the 2020-21 deficit and of more than GBP50 bn on that of 2021-22 (see Table 1).

...while its revenues collapsed

In the meantime, government revenues have decreased significantly due to tax cuts and the contraction of economic activity, which reduced tax receipts. The OBR believes that the shortfall for 2020-21 will be more than GBP55 bn compared to 2019-20 receipts, a fall of nearly 7%. The drop in receipts from VAT, income tax, corporation tax, National

8 International comparisons of GDP during the coronavirus (COVID-19) pandemic, ONS, 1 February 2021.
9 Labour market overview, UK: February 2021, ONS, 23 February 2021.
10 Consumer price inflation, UK: January 2021, ONS, 17 February 2021.

Insurance Contributions (NICs), and taxes on non-residential property (business rates) should account for around three quarters of the shortfall (see Chart 6).

EFFECTS OF VIRUS-RELATED SUPPORT MEASURES ON PUBLIC DEFICIT

GBP bn

	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26
Public services	0.0	-127.1	-58.8	0.1	0.3	0.0	0.0
Employment support	-1.8	-73.3	2.5	0.0	0.0	0.0	0.0
Loans and guarantees	0.0	-31.4	-0.4	0.0	0.0	0.0	0.0
Business support	-0.2	-34.1	6.5	-0.6	0.0	-0.1	-0.1
Welfare spending	0.0	-8.3	-1.7	-1.3	-0.8	-0.5	-0.3
Other tax measures	0.1	-5.7	-0.8	-0.1	-0.2	-0.1	-0.1
Total	**-1.8**	**-280.0**	**-52.7**	**-1.9**	**-0.7**	**-0.7**	**-0.5**

TABLE 1 SOURCE: OBR

EXPECTED CHANGES IN CURRENT RECEIPTS BETWEEN 2019-20 AND 2020-21

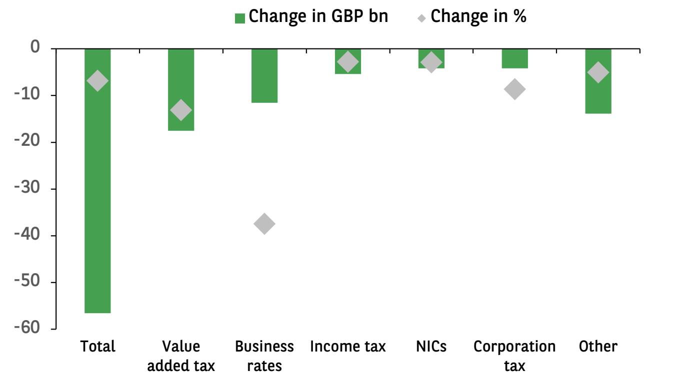

CHART 6 SOURCE: OBR

The Bank of England in support

In parallel, the Bank of England has also acted to limit the effects of the crisis on the economy. Although some measures have had no direct impact on the public finances[11], others have affected public sector net debt (PSND)[12] and the government deficit (public sector net borrowing, PSNB)[13].

This is notably the case for the extension of its quantitative easing (QE) programme, which the central bank manages through the Asset Purchase Facility (APF). Before the crisis, it had a target of GBP435 bn for its stock of UK government bonds (gilts), a figure that has now been raised to GBP875 bn. Similarly, the central bank has doubled its target for purchases of corporate bonds to GBP20 bn. All of these purchases have an instantaneous effect on net debt and a continuous effect on the deficit[14].

The instantaneous effect on government debt of the purchasing of gilts comes from valuation effects. While the APF purchases these from the private sector at market prices, as liquid assets they are recorded at face value in the calculation of net debt, that is to say at the level of the principal that will be repaid at maturity. As falling yields have pushed up gilt prices in recent years, their market prices are now higher than their nominal value. The value of reserves issued to finance the purchase of gilts is therefore greater than the accounting value of these liquid assets. Therefore, public sector net debt increases as a result of the APF's purchases. When it comes to corporate bonds, these are not recognised as liquid assets, so the increase in net debt is equal to the total amount of reserves issued, and thus to the bonds' market price.

The continuing effect on the deficit from bond purchases results from the fact that central government no longer pays interest on the gilts to the private sector but to the Bank of England, which is part of the public sector. The central bank, in turn, pays the banks that sold it the gilts at the rate it pays on the reserves that it has created on their accounts to finance these purchases. This is Bank Rate, the policy rate of the Bank of England. Overall, this is as if the government refinanced itself at Bank Rate. Since the global financial crisis, this rate has been lower than the average interest rate the government has paid on its debt stock. This means that the UK government's debt service costs are reduced by the APF's purchases, which therefore leads to a smaller deficit. The APF's purchases of corporate bonds also reduce the government's deficit, as the interest rates on these bonds are also generally higher than the base rate paid on the reserves created to buy them.

The Bank of England's financing scheme for banks (Term Funding Scheme with additional incentives for SMEs, TFSME) also has an instantaneous effect on public sector debt. Through this programme, the central bank provides commercial banks with loans financed through the issue of reserves. As with purchases of corporate bonds, the loans added to the Bank of England's assets are not recognised as liquid assets. In the calculation of net debt, the increase in reserves on the liabilities side of the central bank's balance sheet is therefore not offset by a simultaneous increase in liquid assets. The effect of the programme on the deficit is virtually inexistent, as the average interest rate on these loans is very close to Bank Rate.

The OBR's estimates of the impact of the Bank of England's measures on public sector debt are summarised in Table 2.

SOURCES OF YEAR-ON-YEAR CHANGES IN PUBLIC SECTOR NET DEBT

GBP bn, OBR forecasts

	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26
Year-on-year change in PSND	473.4	204.6	123.8	118.7	-6.8	102.6
Public sector net borrowing	393.5	164.2	104.6	100.4	99.6	101.8
Financial transactions	66.8	43.3	29.1	16.3	-97.2	-1.1
Bank of England schemes	**54.7**	**30.2**	**0.1**	**1.7**	**-117.1**	**-16.8**
Term funding scheme	**42.9**	**20.0**	**0.0**	**0.0**	**-125.0**	**-20.0**
Other effects	**11.7**	**10.2**	**0.1**	**1.7**	**7.9**	**3.2**
Other financial transactions	12.1	13.1	29.1	14.6	19.8	15.7
Valuation effects	13.0	-3.0	-10.0	2.1	-9.2	1.8

TABLE 2 SOURCE: OBR

11 Among these, the Bank of England cut its policy rate (Bank Rate) by 65 basis points to 0.10%, its lowest ever level. It also launched a scheme to provide liquidity to market participants (Contingent Term Repo Facility, CTRF) and, in cooperation with the Treasury, a programme to finance businesses (Covid Corporate Financing Facility, CCFF). Lastly, the central bank has expanded the use of the "Ways and Means facility", which provides direct short-term financing to the government, and has entered into swap agreements with the US Federal Reserve.

12 Net debt = Debt - Liquid Assets

13 The public sector includes the Bank of England; PSND ex BoE and PSNB ex BoE are the measures of debt and deficit, respectively, that exclude it.

14 The direct fiscal consequences of unconventional monetary policies, OBR, 13 March 2019.

The impact on the government's deficit and debt

All in all, the crisis will have a significant effect on government deficit and debt. In 2020-21, the deficit has increased due to higher spending and lower receipts, which have largely overweighed the relief provided by the reduction in debt service costs stemming from both lower interest rates and the continuing effect of the BoE's QE programme. In the central scenario of its latest Economic and Fiscal Outlook (EFO) report[15], published in November, the OBR predicted a deficit of nearly GBP400 bn in 2020-21, which would be equivalent to 19% of GDP (the forecasts in the rest of this section are also based on that scenario).

This increase in the deficit and the instantaneous effect of the QE programme have raised public sector net debt. For the first time in history, this debt has exceeded GBP2,000 bn. Moreover, the steep drop in GDP has contributed to pushing up the ratios of deficit and debt to GDP (see Charts 7 and 8). In January, the ratio of public sector net debt to GDP stood at nearly 100%[16]. The OBR predicts that it will exceed this threshold over the next few months, and remain above it for the next five years at least.

The future of the public finances

Adjustments will be needed...

Given the significant deterioration of the public finances, a tightening of fiscal policy will at some point become necessary. The improvement will at first be mechanical. As the sanitary situation will improve, the authorities will be able, on the one hand, to restart the economy by loosening restriction measures and, on the other hand, to gradually withdraw its support measures. The deficit will thus automatically shrink as spending falls and receipts rise.

However, this will certainly not be enough. First, the Covid-19 crisis has resulted in a smaller economy, and will therefore lead to lower tax revenues in the coming years. The Institute for Fiscal Studies (IFS) estimates that tax rises of over GBP40 bn a year will be needed by 2025 to "stop debt spiralling upwards"[17].

Second, OBR projections produced before the Covid-19 crisis were already pointing to an unsustainable rise in the deficit and public debt over the next decades. This is due to the fact that, like most developed nations, the UK will be confronted with the ageing of its population. The baby boom that followed World War II contributed to strong economic growth in the following decades. However, baby boomers are now reaching retirement age, and the birth rate in the UK has stagnated since the 1980s below the generational replacement rate[18].

PUBLIC SECTOR NET BORROWING (PSNB)

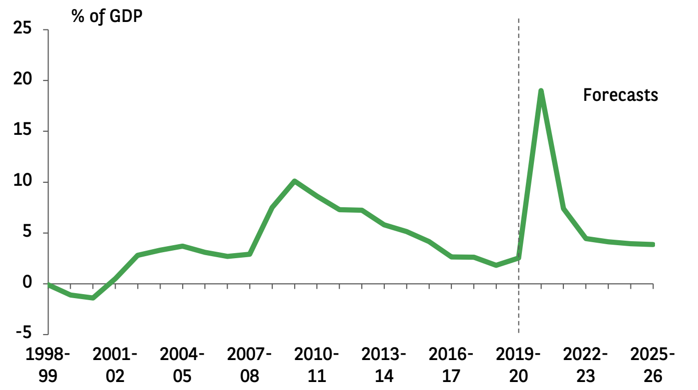

CHART 7 SOURCE: ONS, OBR

PUBLIC SECTOR NET DEBT (PSND)

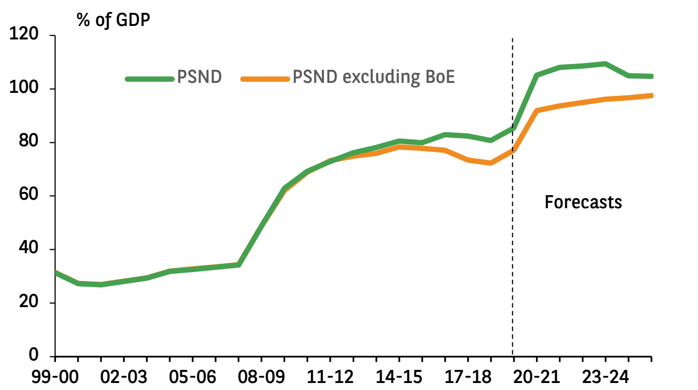

CHART 8 SOURCE: ONS, OBR

EXPECTED CHANGE IN POPULATION BY LIFE STAGE (%)

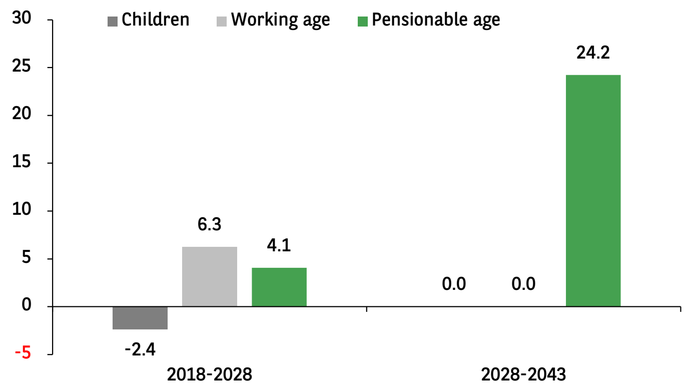

CHART 9 SOURCE: ONS

15 Economic and fiscal outlook – November 2020, OBR, 25 November 2020.
16 Public sector finances, UK: January 2021, ONS, 19 February 2021.
17 Current, necessary, fiscal largesse will need to be followed by tough decisions as we deal with a smaller economy, rising demands on government and elevated debt, IFS, 13 October 2020.
18 Remplacement des générations, INED.

According to ONS projections[19], the gap between births and deaths will close over the next twenty years. From the end of the 2030s, immigration will be the sole engine of population growth in the UK.

This major demographic challenge could start to weigh heavily on the public finances and the trajectory of debt at the end of this decade. Between now and 2028, it is expected that the working age population will grow at a rate slightly faster than that of the pensionable population[20]. However, between 2028 and 2043, the former category should stagnate while the latter grows by nearly 25% (see Chart 9).

In light of these demographic trends, spending on healthcare and adult social care will be the two main factors driving growth in public spending according to the OBR, the third being state pensions spending[21].

GOVERNMENT RECEIPTS

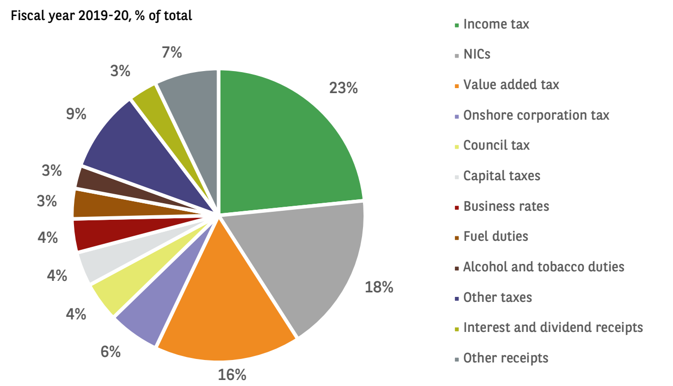

CHART 10 SOURCE: OBR

CORPORATE, INCOME AND VALUE-ADDED TAX RATES (%)

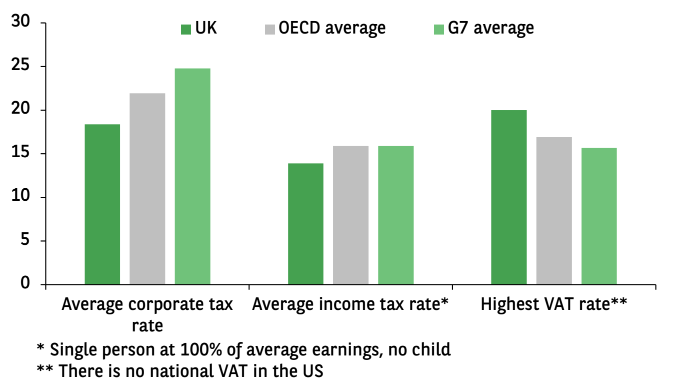

CHART 11 SOURCE: OECD, USCIB

Moreover, the Covid-19 crisis could result in an increase in financing for the National Health Service, which would further weigh on the government's budget in this area. Given that welfare and healthcare are the two main items of government spending – accounting for more than half of total spending – a reduction in total public spending will be hard to achieve.

Thus, any improvement in the public finances will almost certainly have to come through an increase in government receipts. An increase in taxes, the main source of revenue for central government (see Chart 10), therefore seems unavoidable.

With that in mind, the average corporate tax rate looks fairly low compared with the rest of OECD and particularly the other G7 nations (see Chart 11). Similarly, the average personal income tax rate is somewhat lower than in other developed countries, and a recent poll suggests that UK households would be willing to accept tax rises to help finance the response to the Covid-19 crisis[22]. One other possibility would be to increase VAT. The broad base of this tax – the net price of all goods and services exchanged – means that a small increase could give a substantial boost to government receipts. However, the poorest households – who spend a greater share of their income on consumption – would be the most affected by this measure, after having been among the hardest hit by the Covid-19 crisis. What's more, the VAT rate is already higher in the UK than in most other advanced economies. There could also be an increase in employer and employee National Insurance contributions (NICs), which represent a fifth of government revenue (see Chart 5 again). This would be the logical consequence of an increase in the cost of funding pensions.

However, on the first page of his manifesto for the 2019 general election, Boris Johnson pledged not to increase income tax, VAT or NICs. Although the Covid-19 crisis would certainly give him some leeway to renege on some of his promises, he seems determined to keep this one. This means that, among the possibilities discussed above, only an increase in corporation tax would appear possible. Indeed, this would fit with the change of tack that began prior to the Covid-19 crisis. At the end of 2019, Boris Johnson announced the cancellation of a corporation tax cut, from 19% to 17%, that had been due to take effect in April 2020. What's more, Chancellor Rishi Sunak is reported to be considering an increase in the corporate tax in the 2021 Budget, which will be presented on 3 March. Other options could also be considered, such as raising tax rates for Internet giants, establish a carbon tax, or even institute a wealth tax[23].

... but there is little immediate danger

Against this backdrop, the Chancellor appears to be willing to restore the UK's public finances quickly. In a speech during the Conservatives' annual party conference in October 2020, he vowed to always balance the government's books. However, tightening fiscal policy in 2021 could be premature. After all, England will still be locked down when the 2021 Budget will be announced, and the country's GDP will probably contract in the first quarter of 2021. In fact, tightening too quickly could be counterproductive. This is because any reduction in spending or increase in taxes could delay the economic recovery, which could already be hindered by the UK's exit from the EU's single market[24]. In its

19 National population projections: 2018-based, ONS, 21 October 2019.
20 The working age and pensionable populations are determined by the State Pension age (SPA). Under current legislation, this will be 67 for both men and women between 2028 and 2043.
21 Fiscal sustainability report – July 2020, OBR, 14 July 2020.
22 UK workers prepared to pay extra 4% income tax to fund £300bn pandemic bill, AJBell, 3 June 2020.
23 Report of the UK Wealth Tax Commission, LSE, 9 December 2020.
24 United Kingdom: What will be the economic consequences of a hard Brexit?, BNP Paribas, 20 November 2020.

October 2020 report discussed above, the IFS warned that it was *"not the time for tax increases or any other form of fiscal consolidation"* and that, over the following eighteen months, the government needed to be *"focussed on supporting the economy almost irrespective of short-term impacts on borrowing"*.

Moreover, the government is under no pressure from financial markets. There are several reasons for this.

First, First, the massive rise in government borrowing has been largely covered by additional purchases from the Bank of England. And while the UK went into the crisis with a fairly high debt-to-GDP ratio – around 85% in March 2020 – its position is not particularly worrying compared to other developed economies. According to OECD data, only Germany and Canada had lower levels of government debt among G7 countries[25].

Furthermore, the debt stock is not a comprehensive indicator of solvency. Debt service costs also need to be taken into account, as they measure the weight of debt repayments and interest charges on the government's finances. Also, while the ratio of debt to GDP compares a stock to a flow, the ratio of debt service to GDP compares two flows.

Admittedly, the stock of government debt has increased sharply since the late 1980s, both in nominal terms and relative to GDP. However, over the same period the cost of this debt – the weight of interest charges[26] – has fallen steeply as the result of lower real interest rates and inflation. Over this period, the interest burden has fallen from nearly 4% of GDP to 1.5% (see Chart 12). According to the OBR, this trend has accelerated over the course of the crisis, as the increase in debt has been overshadowed by the falls in real interest rates and inflation that followed the Covid-19 crisis. One of the main reasons for these falls is that global central banks have loosened monetary policy even further. The Bank of England has notably cut its policy rate by 65 basis points, to 0.10%, and extended its QE programme (see previous section). According to the minutes of its last meeting, the Monetary Policy Committee has no intention to tighten policy "at least until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% inflation target sustainably"[27]. Admittedly, in its Monetary Policy Report for February[28] the Bank of England forecasts a rapid rise in inflation in 2021. However, it expects it to stabilise at around 2% until at least 2023, which would allow the MPC to maintain an accommodative monetary policy during this period.

Meanwhile, there aren't any particular concerns when it comes to the repayment of principal over the short and medium terms. The repayment schedule for UK government debt is largely spread over the next decades (see Chart 13).

In fact, the UK's government debt has an average maturity that is very high relative to those of other G7 countries, according to the Treasury's Debt Management Report[29], the Debt Management Office and the National Savings and Investments (NS&I) (see Chart 14).

CENTRAL GOVERNMENT DEBT INTEREST (NET OF APF)

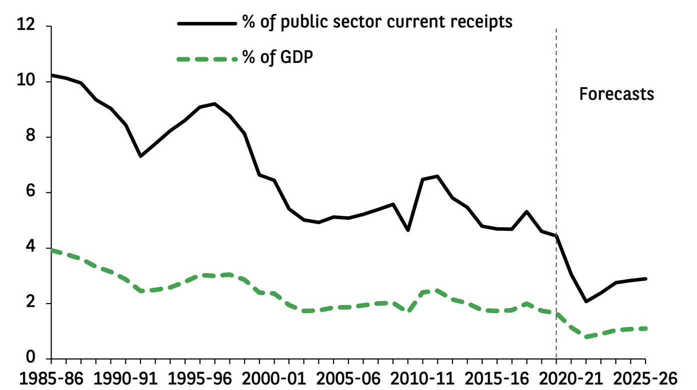

CHART 12 SOURCE: OBR

OUTSTANDING GOVERNMENT DEBT BY MATURITY

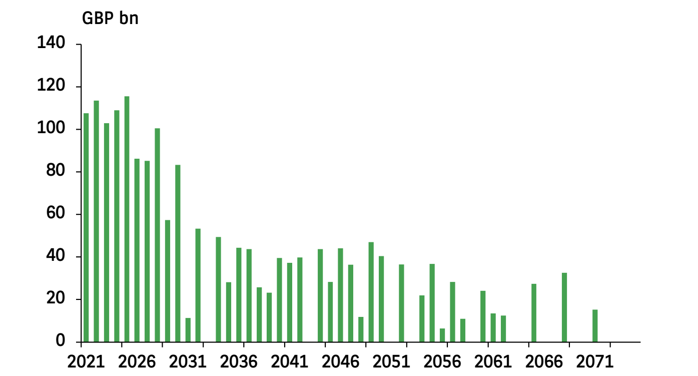

CHART 13 SOURCE: REFINITIV

AVERAGE MATURITY OF THE PUBLIC DEBT STOCK AT END 2019

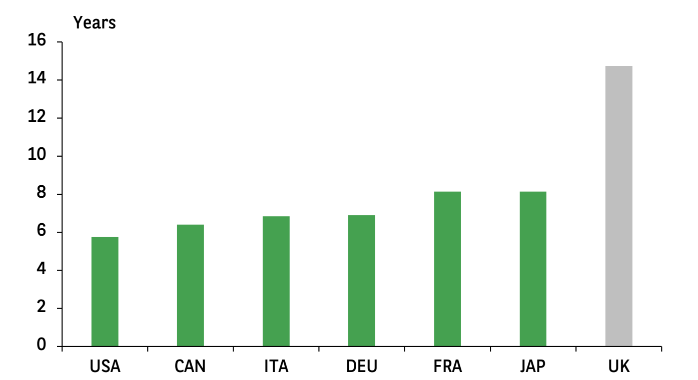

CHART 14 SOURCE: BLOOMBERG, DMO

25 General government debt, OECD.
26 Debt service = Principal + Interest
27 Bank Rate maintained at 0.1% - February 2021, Bank of England, 4 February 2021.
28 Monetary Policy Report - February 2021, Bank of England, 4 February 2021.
29 Debt management report 2020 to 2021, UK Government, 11 March 2020.

This indicates that UK government debt will mature much later, and therefore that its refinancing requirements over the next few years will be lower. All in all, there is little reason to be concerned by UK public debt at the moment.

* * *

Like many developed countries, the UK will be confronted to the ageing of its population over the next decades, which will probably put a big strain on public finances. What's more, addressing this challenge has been made more complex by the pandemic. In fact, the UK government is now facing a dilemma. On the one hand, failing to maintain control over its books could have serious implications. That is because a larger debt stock is more sensitive to changes in interest rates, and a rise thereof can never be entirely ruled out. Moreover, should investors become worried about the state of the public finances during a future crisis, the government's ability to support its economy could be inferior to what it has been during the Covid-19 pandemic. On the other hand, tightening fiscal policy too quickly could delay the recovery from the current crisis, which could already be hindered by Brexit. The European Union made this mistake after the global financial crisis, and payed it with years of depressed growth afterwards. Overall, the UK government is facing a difficult balancing act in order to keep its finances on a sustainable track. Some hints on how it will solve this puzzle could be given when the 2021 Budget is presented on 3 March...

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