Investment*Update*

25 November 2020

Dealing with rising UK debt: not all options are bad

Rather than try to reduce it by austerity, inflation or default, the government should focus on keeping the rate of economic growth above the cost of servicing the debt.

The fiscal response to this year's unprecedented recession will drive the UK's net debt to a record £2.3 trillion by the end of March, according to the official projection from the Office for Budget Responsibility released today. Up from £1.8 trillion last year, it will exceed the size of the economy for the first time since 1963.

In the Spending Review, the Chancellor has not announced plans to pay down the debt in an accelerated manner. By 2023-24 the current budget deficit (day-to-day spending) will still be 1.2% of GDP compared to 0.6% in 2019-20. Net investment will be 2.9% of GDP, up from 1.9% in 2019-20. As investors, we are relieved, a premature – and, as we shall set out, misguided – tightening of the purse strings is one of the biggest risks to growth over the next few years, as was the case between 2010 and 2015.

Of course, many of you will be asking how will all this debt be paid for?

Choices, choices
After accumulating a large amount of debt, governments have four broad choices (in order of preference):

i. Promote economic growth
ii. Austerity (run budget surpluses)
iii. Inflate away the debt
iv. Default

Default: everyone gets hurt
Defaults are almost invariably accompanied by a currency crisis and/or a banking crisis. Governments need to manage the debt not for the debt's sake but to promote social welfare and/or to increase their chances of re-election. Both would take a rather large hit, to say the least.

Inflation: easier said than done
Inflating your way out of debt is easier said than done. High inflation would inflict considerable damage on the private sector, reducing the tax base. And once you've decided you've had enough inflation the almost intractable problem is getting it back down again. Most importantly, the cost of new debt rises with inflation, potentially offsetting all the benefits. Keeping interest rates artificially low amid high inflation could undermine the institutional credibility that anchors it and prevents deleterious spirals. As in 1920s Germany, inflating away the debt is a last resort, when there's no political or economic capital to do anything else.

Austerity: amplifying weaknesses
The corpus of empirical and theoretical evidence, greatly expanded since the financial crisis, is clear that austerity is highly likely to be counterproductive in developed markets with structurally low borrowing costs along with deficient demand/an excess of savings over investment (here, here, and here are the free versions of key papers).

In short, if the government retrenches as the private sector is also retrenching, there is likely to be a multiplicative effect. The decline in overall output may be so large that the government's finances end up worse than when austerity started, as fiscal gains are partly wiped out by the decline in output (and therefore tax revenues).

There's also a powerful political economy argument against austerity: reduced government services fall hardest on low income, and particularly BAME, communities. The worst health, employment and income outcomes from the pandemic are also felt by these groups. As one Conservative recently told Bloomberg, "Older MPs will remember 1997, when John Major and Ken Clarke went through agony to balance the books. The public said 'thank you very much,' and then handed Tony Blair a landslide." Social attitude surveys suggest that unlike in 2010 and 2015, austerity is no longer a vote-winning strategy.

To be clear, future budget deficits do need to normalise and that may entail *some* difficult decisions. We expect to see small rises in corporate taxes at some point during this parliament. Interestingly, even some of the more progressive think tanks, such as the Resolution Foundation, seem to suggest that additional household taxation is likely to fall disproportionately on working households rather than the older ones whose lives have been saved by anti-COVID measures.

Growing out of debt: the best way
The best strategy, however, is to concentrate on economic growth. It's important to remember that it's not the absolute amount of debt that matters so much as the amount of debt *relative* to the revenue-generating base that will be servicing it. As with everything in finance, we must consider both sides of the balance sheet. Annual output (GDP) is a good rough and ready denominator. In our opinion, the best way to ensure that the UK's finances are placed on a sustainable footing is for Whitehall to ensure that the organic growth of the tax base exceeds the cost of servicing and refinancing the debt.

Yes, there is some long-run evidence that low economic growth is associated with high public debt burdens. But '*associated with'* is not the same as '*caused by'*, and in fact the research points more towards deficient growth *causing* high debt (see here).

It's also worth noting that two of the most significant periods of Britain's economic development started with a much, much higher debt burden than the UK has today. Growth has never been better than during the 'Golden Age of Capitalism' between 1948 and 1972 which began with gross debt of over 200% of GDP. The pathbreaking increases in the standard of living that occurred between 1840 and 1890 also began when the debt-to-GDP ratio was over 150%. To be clear, we're not optimistic that we are at the beginning of a new golden era, but that's not because government debt burdens preclude it.

We don't need a new golden age for nominal growth to exceed debt servicing costs. For the most part, interest rates are not low because central bankers have decided they should be. They are low because of profound structural changes in the economy, such as ageing demographics or rising inequality, which have reduced the desire to invest and increased the desire to save (a low interest rate is required to bring these things back into balance). If it was central bankers' whims, we would have had much higher inflation since 2009.

Indeed, interest rates are so low that despite the incredible rise in government debt in 2020, interest costs are still likely to be lower in 2021 than in 2019 when they were about 2.1% of GDP. Of course, since the Brexit referendum, the trend rate of UK *nominal* growth (not adjusted for inflation) has fallen to around 3.0-3.5%, and as we noted in our previous Investment*Update*, the UK may suffer a little more economic scarring from COVID. Nevertheless, growth is still likely to keep ahead of debt servicing costs. Moreover, the government could raise potential growth by investing in productivity-enhancing projects.

The UK government has a self-imposed rule that requires net interest costs to be less than 6% of its primary revenue (measures of debt servicing costs and non-interest income respectively. Over the last 15 years, this ratio has averaged 5% but this year it will fall to 2.7%, levelling out at 2.2% between 2024 and 2026. Interest costs would have to rise considerably in order for this discipline to be breached.

Additional notes on affordability

This isn't an easy topic to get your head around. Government budget balances are frequently misunderstood. By politicians — sometimes wilfully — and even by some economists. It's no wonder then, if they're misunderstood by the public. An important point to note is that the government is not a household. For starters, it can create its own money. Its budget doesn't have to balance, and there are good reasons why it shouldn't.

The UK has had a "current account" deficit for about 35 years. That means that net trade, net investment income and a few other items add up to a negative number: the UK sends more money abroad than it receives. The 1990s aside, this gap has become steadily larger relative to the size of the economy, but there has never been a time when it hasn't been funded by overseas investors. The cost of funding it (the exchange rate and the interest rate) has changed, but the desire to fund it hasn't, even when the budget deficit has been huge and the economy has been in trouble.

Current account deficits exist largely because there is a global savings glut — an excess of savings over investment. This is a structural phenomenon that is unlikely to reverse without an extremely interventionist policy — even then it's not certain; America's deficit has continued to grow despite the protectionism of the Trump era.

Money coming in from overseas must be used by someone. Taking the current account deficit as a given, either the government, businesses or households must borrow. Over the last decade as the government has saved more (borrowed less) under austerity, households have saved less (borrowed more). A government in control of its own currency is in a better position to run a deficit than households. Households borrow to consume, not to invest like governments can.

That said, a government like the UK doesn't actually need to borrow. It can fund spending by creating its own money. Although we don't tend to think of it in this way, this is what governments do — they don't sit around waiting for a loan to clear. The government's ability to finance itself is ultimately constrained only by inflation.

For more information on why we do not think inflation will be a problem over the next 18 months or so, please see our Investment*Update* on inflation. If inflation expectations remain low, a government with its own currency can run deficits ad infinitum. Just look at Japan. Of course, Japan is no poster child for economic health, but it illustrates this point nicely: the sustainability of Japan's debt rarely gets mentioned these days, even though its gross debt ratio has risen to about 250% this year. What matters are credible institutions. Monetary and fiscal policy must make a credible commitment to attend to inflation expectations and not resort to currency debasement. But this credible commitment does not need to involve balanced budgets.

And that means that budget deficits should be used to make up for deficient demand, especially during a period of private sector retrenchment. Remember why government debt has risen by so much in the first place. Constraints on monetary policy mean a significant fiscal expansion is now necessary to avoid a protracted period of impaired demand and disinflationary pressure. Monetary policy is doing a great job at keeping the private sector liquid and solvent, but corporate and household balance sheets have taken on water.

The risk is that future balance sheet repair depresses demand, as it has been doing over the last 10 years, amplifying the effect of this sharp recession and recasting it as a long and deep depression. Preventing this will probably require both temporary *and permanent* extensions of fiscal policy. The current crisis is not a correction of previous imbalances, so we don't have to worry about moral hazard too much. Indeed, excess saving and a dearth of desired investment have been going on for years, a key factor in keeping inflation so low for the last decade. Government policy should make up for that lack of investment.

How you spend it matters
For this approach to be successful, it's important that the government directs its budget to where it is most likely to *permanently* boost GDP. In other words, it needs to invest in areas the private sector isn't allocating to efficiently, where there's market failure. The composition of spending is crucial. Educational and infrastructure investments are two obvious examples, or schemes to encourage more private sector investment and R&D.

Accordingly, we are very pleased to see the government getting a handle on current expenditure in the Spending Review, while greatly increasing public net investment from £42 billion last year to an average of £73 billion per year between 2023 and 2026, targeting digital and transport infrastructure and regional "levelling-up".

History suggests that this approach can be very effective. Public works programmes during the Great Depression re-employed many of those hardest hit by the downturn and made lasting improvements to the nation's infrastructure that boosted the US economy's potential GDP. The 1944 GI Bill helped veterans and their family members pay for university education following World War II facilitating the education of a whole generation and contributing to the rapid growth that lasted to the 1970s.

Other borrowers "crowded out"?
The most common pushback against government borrowing is that it "crowds out" private sector borrowing, which is more likely to be allocated efficiently. The idea is that there's a finite amount of capital – or loanable funds – and so if the government borrows more money, the price of capital (interest rates) goes up and the private sector borrows less in turn. But the evidence for this is very mixed. It depends on why governments are borrowing more. Broadly speaking, there's evidence of crowding out if governments borrow to fund day to day expenditure at a time when the economy is operating at full capacity – no deficient demand. Borrowing to run state-owned companies is usually found to crowd out private enterprises in the same industry sector. But there's also lots of evidence of the opposite – "crowding in" – if the government borrows from a glut of savings looking for a home at a time of deficient demand.

Financial repression
As the economic recovery matures and private sector demand for debt returns, it's quite possible that government borrowing costs may face some upward pressure. We expect central banks to combat this with 'financial repression'. This could – and indeed already does – entail central bank purchases of bonds and regulatory requirements for financial institutions to hold more government debt. Some may worry that this amounts to central banks losing their independence, which could cause inflation expectations to rise. However, we take the alternative view: if the only way for a central bank to reach its inflation target is to stimulate demand, and if the only way to raise demand is to support fiscal policy, and if the only way to do this is through financial repression, then "monetisation" of the debt is not just allowed under the mandate of an independent central bank but required by it.

Financial repression has proved to be a powerful tool in reducing governments' debt burdens in the past, most notably after the Second World War. Financial repression weighed on bank profits during that era, but it facilitated financial stability. Indeed, during the Golden Age advanced economies experienced fewer years of banking crisis than other periods before or since – nothing depresses GDP and raises public debt ratios like a banking crisis.

The 'So what?' for UK investors
What does this all add up to? We believe a substantial portion of the extraordinary increase in debt will be paid for by current and future creditors of the government via suppressed interest rates. That means a meagre outlook for the yields from relatively low-risk bonds. At the same time, lower bond yields raise the relative attractiveness of riskier assets such as equities, as well as mechanically raising their valuations (such as prices relative to earnings). That's because future cashflows are discounted into today's prices at a lower rate (those lower yields). Holding all else equal, this would benefit the valuation of so-called growth stocks whose cashflows are projected to be much larger in the future. Growth-oriented portfolios also tend to have less exposure to financial companies, such as banks and insurers, whose profit margins are vulnerable to suppressed interest rates.

We do not expect government debt to weigh on the pound. An exchange rate is the price of one currency relative to another. The increase in the UK's debt this year is comparable to other major economies, and it is still on track to have the second lowest debt-to-GDP ratio of the G7 group of the largest developed economies. If government debt influenced the exchange rate there should be a statistically significant correlation with the amount of UK government debt relative to the government debt of other countries. We find none when looking over various timeframes.

Important information

Contact us

If you would like further information or to arrange an initial meeting, please contact us on 020 7399 0000

Head Office
8 Finsbury Circus, London, EC2M 7AZ

For ethical investment services:
Rathbone Greenbank Investments
0117 930 3000
rathbonegreenbank.com

For offshore investment management services:
Rathbone Investment Management International
01534 740 500
rathboneimi.com

@Rathbones1742
Rathbone Brothers Plc
Rathbone Brothers Plc