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Government borrowing, debt definitions and gilt yields

Synopsis: The questions of how much the Government can borrow and what it will cost, which have arrived in the headlines from different directions.

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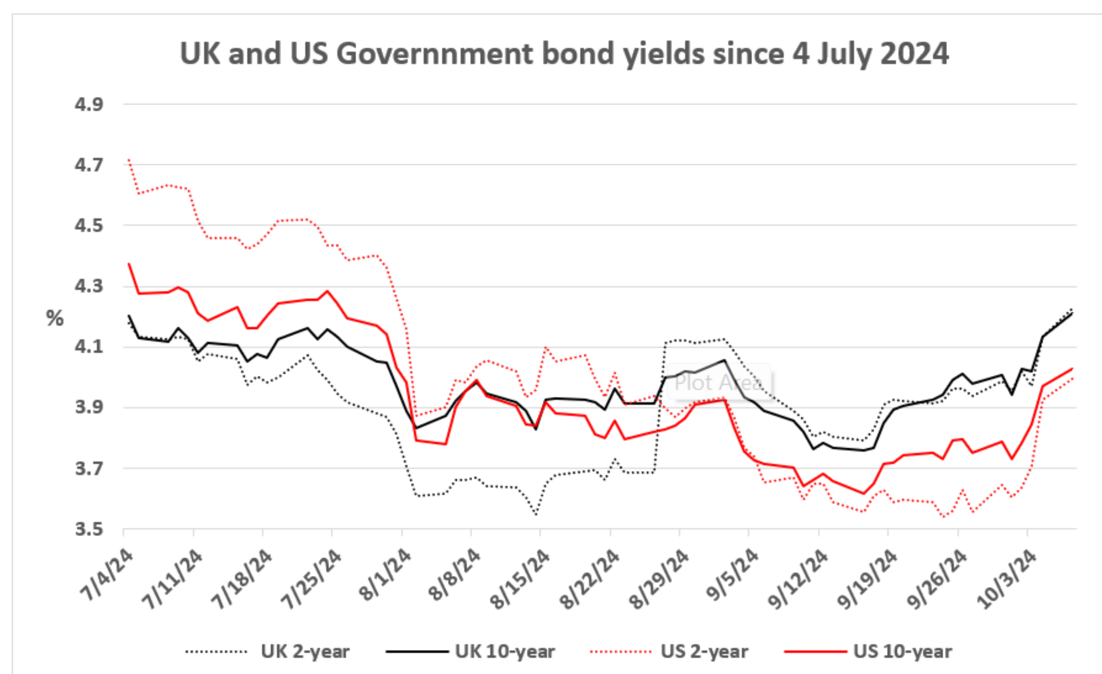

Source: Investing.com

The past couple of weeks have seen discussions grow about how debt could be redefined by the Chancellor to give herself more wiggle room on the borrowing front. The choice was set out by the ONS in a paper published in June 2021.

There are basically two options if she moves on from the current debt definition...

Public sector net financial liability (PSNFL) This is an extended version of the current public sector net debt (PSND) yardstick which includes illiquid financial assets (e.g. student loans and equity investments in Government entities) and, on the other side of the balance sheet, other financial liabilities (e.g. financial guarantees) and *funded* public sector pension liabilities. In the Treasury, this measure is referred to as 'The Snuffle'.

Public sector net worth (PSNW) As its name suggests, this is the broadest measure, but confusingly there are two versions. The European System of Accounts version (ESA) adds non-financial assets to the PSNFL, e.g. the (estimated) value of roads, buildings and other infrastructure.

The International Monetary Fund (IMF) definition is the full fat version, including assets and liabilities associated with public-private partnerships and, most painfully, *unfunded* public sector scheme liabilities.

Calculations by the IFS suggest that a switch from PSND (ex BoE, ex private sector banks) falling between year four and five and PSNFL falling over the same period would give the Chancellor £53bn additional headroom while a move to the ESA PSNW would yield an extra £58bn.

On Tuesday the Institute for Public Policy Research (IPPR) published a paper, with a foreword by Lord Jim O'Neill, calling for a move to using the PSNW yardstick as 'a "more honest" measure when assessing the government's financial position, including its ability to borrow to invest'.

The IPPR puts the extra headroom this would offer at £57bn, but 'advises that some of this should be held back as a buffer against uncertain economic forecasting.'

In the longer term, the IPPR wants a reworking of the fiscal framework, including...

- **Rethinking the timeframe of the debt rule** to end its sole focus on the difference between years four and five of the economic forecast.
- **Putting greater emphasis on debt servicing costs** which have little weight under the present system, despite the impact of higher interest rates on the Government's day-to-day spending. Net interest costs in 2024/25 are projected to be £73.5bn.
- **Developing metrics that better reflect the future impact** of today's fiscal policy choices (such as infrastructure investment versus tax cuts).
- **Reflecting the benefits of making the economy more resilient** against future shocks (such as an energy crisis).

Ironically on the same day that the IPPR paper was published encouraging the Chancellor to borrow more, the *Financial Times* ran a story on its front page referring to the mounting cost of borrowing and Rachel Reeves having to walk a 'tightrope' over spending plans.

The FT highlighted that borrowing costs had risen sharply since the middle of last month. For instance, between 16 September and 7 October, two-year yields were up by 0.43% and ten-year yields by 0.45%.

It is worth putting this into context. As the graph above shows, rates are now virtually at the same level as on election day and over the same period US two-year and ten-year rates have risen by 0.44% and 0.41% respectively.

The Bank of England has also thrown a small lifeline to the Treasury by deciding not to increase the pace of quantitative tightening (QT). This reduces the debt on QT shortfalls which hits the PSNB and lowers the volume of gilts coming to the market.

At 2 October, the Debt Management Office had £126bn to sell in the remainder of the current fiscal year, a figure which some commentators expect to rise given the current state of the public finances.

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Comment

For now, the rising yields of the last few weeks appear more of a concern in terms of keeping financing costs high rather than a warning on increased borrowing. However, it is unclear how much of any newly created fiscal headroom the Chancellor could use before encountering the bond vigilantes.

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