Investment Managers

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UK public debt sustainability: Post–Truss truths

UK debt on a stable, albeit narrow path, but difficult decisions will have to be made

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Key points

- UK public debt is projected to peak at 103.1% of GDP this financial year before declining to 96.9% in 2026-2027.
- UK borrowing costs have risen sharply recently – close to the levels seen in the fallout following September 2022's mini budget. We expect yields to ease, but if these moves are sustained, they will add to pressure on public finances.
- In our analysis there is no specific point at which debt becomes unsustainable, but we look at thresholds where markets may demand an increasing premium to hold UK debt.
- Other factors add to the challenges around public finances' sustainability including lower potential output because of Brexit and higher global interest rates.
- We think tough choices about how to deliver fiscal sustainability remain for the next government and are likely to constrain hopes of a large pre-election giveaway.

Public finances remain front and centre

United Kingdom (UK) government bond (gilt) yields have been steadily climbing over recent weeks on the back of fears that inflation is proving stickier than anticipated – and that the Bank of England (BoE) will be required to deliver more restrictive monetary policy for longer to restore price stability. Ten-year gilt yields rose to a peak of around 4.4% – close to levels last seen in the market turmoil under former Prime Minister Liz Truss. While the moves this time around are less dysfunctional – importantly accompanied by a strengthening in sterling – we believe UK public finances will under the microscope as government borrowing costs remain elevated.

In this paper we review the UK public finances and debt outlook, comparing it to limits implied by past trends. We argue the pressure on UK finances is not imminent and, following steps taken by Chancellor Jeremy Hunt to consolidate public finances, alongside the improvement in wholesale energy costs, the debt outlook remains on a stable path. We contrast this to the experience under Truss which pushed public debt close to its limits.

However, the UK still faces several challenges. First, longer-term economic trends are likely to add to the pressure already on the UK's public finances. Namely, Brexit's impact on potential growth and the prospect of rising global interest rates. Second, independent fiscal watchdog, the Office for Budget Responsibility (OBR) forecasts paint an optimistic picture of the UK economy and public finances. We are more cautious in our assumptions of longer-term growth and argue that the government's fiscal targets will be met with a much smaller margin than forecast by the OBR. This will make the fiscal consolidation needed to stabilise the public finances more difficult. This in turn leaves little scope for Chancellor Hunt to provide fiscal largesse in advance of 2024's General Election. It also means the next government will face tough choices around cutting spending or raising revenues to maintain fiscal rectitude.

Turmoil under Truss

In September 2022, then-Prime Minister Liz Truss and Chancellor Kwasi Kwarteng unveiled fiscal plans which pushed the UK to the brink of a public debt crisis. During the now infamous event on 23 September, Kwarteng announced the largest set of tax cuts since 1972 which were to cost £60bn (2.6% of GDP)[1] a year and included scrapping planned increases to National Insurance and corporation tax, and cuts to income tax. This all came without any indication of how the government would fund these policies and in the absence of official costing by the OBR.

In the following days, Kwarteng doubled down on the government's commitment to tax cuts stating there was "more to come" – a move that spooked already fearful markets. The pound fell to its lowest ever level against the US dollar and gilt prices collapsed as UK assets rapidly sold off in the days that followed. Gilt yields rose sharply – rising by around 120bp in the space of three days (Exhibit 1).

The sharp drop in gilt prices reverberated through markets; many mortgage products were removed from the market and defined benefit pension funds engaging in Liability Driven Investment (LDI) faced a crisis as they were forced to sell assets to raise collateral to meet margin calls. To prevent this dynamic from worsening, the BoE stepped in, purchasing long-dated gilts to put a floor on prices, stop the deteriorating dynamic and stabilise markets. The BoE bought £19.3bn of long-dated gilts between 28 September and 14 October[2].

Exhibit 1: Gilt yields have risen close to Truss peak

Source: BoE, Refinitiv and AXA IM Research, June 2023

The episode highlighted the risk of falling confidence, led by fears of an inability to service debts. The issue is key for the UK due to its reliance on overseas borrowers, which constitute around 30.5% of total gilt holdings, something former BoE Governor Mark Carney famously referred to as the "kindness of strangers". Moreover, the UK has in recent decades consistently run a current account deficit, funded by foreign inflows of capital, leaving the country exposed to shifts in investor sentiment.

While most of Truss' policies were reversed even before her resignation just 45 days after she took office, the impact of the ill-fated policy approach remains, and the experience of the crisis is likely to see investors more closely monitor the outlook for the UK's debt sustainability.

How much is too much debt?

The limit to a country's borrowing should theoretically be determined by the relative ratio of future nominal interest and growth rates and the maximum primary public surplus an economy can sustain before public resistance to austerity demands a change, a point of so-called 'fiscal fatigue'[3]. We have recently published a similar analysis of the US debt outlook which explains the approach in more detail[4].

In the years since the global financial crisis (excluding the pandemic), the UK has seen nominal growth (g) exceed its nominal interest rate, the effective borrowing rate for the government (r). This can allow a country to reduce its debt as a proportion of GDP even whilst still running a deficit. However, the UK has also seen long periods from the 1980s to early 2000s where its nominal interest rate exceeded its growth rate (Exhibit 2). Many of these periods were accompanied with primary surpluses which limited the overall increase in debt seen over.

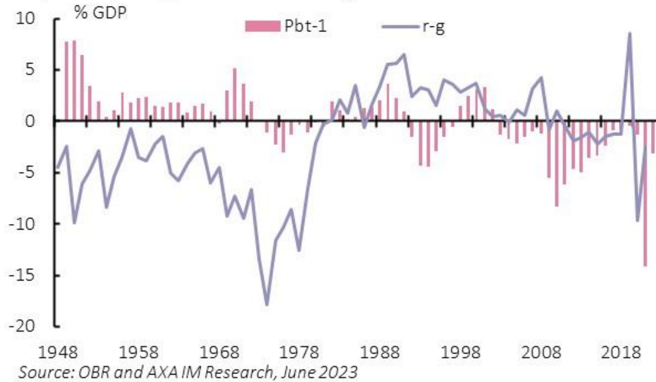
[1] HM Treasury, The Growth Plan 2022, 23 September 2022

[2] Of which £12.1bn were long-dated conventional gilts and £7.2bn were index-linked gilts. The BoE unwound all of these gilt holdings as of 12 January 2023.

[3] Page, D., "How governments can respond to the COVID-19 debt surge", AXA IM Research, 7 October 2020.

[4] Page, D., "US debt ceiling impasse: Unnecessary and unavoidable", AXA IM Research, 3 May 2023.

Exhibit 2: The primary balance and its relationship to r and g

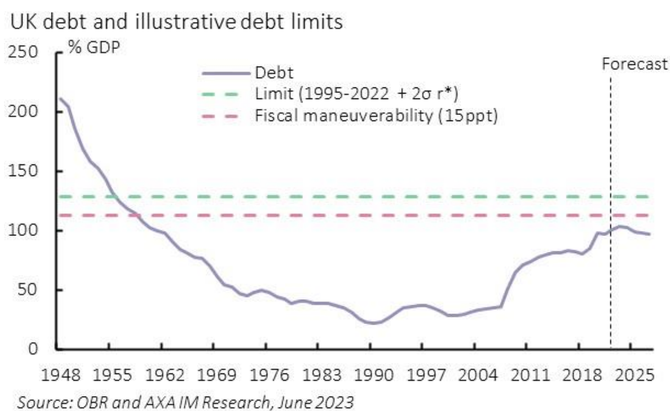


Source: OBR and AXA IM Research, June 2023

To determine a debt limit we need to make judgements on future nominal growth rates, the interest rate and the maximum primary surplus the UK can achieve. We take the average nominal growth rate from 1995 – 2019 of 4.1% and the interest rate of 4.8%. We also include to a two standard deviation shock to interest rates to account for the risk that the UK faces as a small open economy that rates rise exogenously. History gives some guidance as to where fiscal fatigue might occur. The UK has seen only two years in the last 25 when it experienced an overall budget surplus – in 1999 and 2000. However, it delivered primary budget surpluses (excluding debt interest payments) for five years over the early 2000s. We take the average of these primary surpluses (2.3% of GDP) as a guide to the maximum sustainable primary surplus. However, we also recognise that history can only tell us so much and see considerable uncertainty around this estimate.

Exhibit 3 then illustrates where a theoretic debt limit might exist. The limit defines the point at which debt interest costs, after allowing for nominal growth, exceed the primary balance resulting in debt to continue to rise. This may prove a level below which investors remain confident in UK debt stability, although investors may become increasingly cautious as an economy approaches such a limit, which underlines our strongly held conviction that there is no one point where finances begin to create tensions.

Exhibit 3: Debt remains well within theoretic limits



Source: OBR and AXA IM Research, June 2023

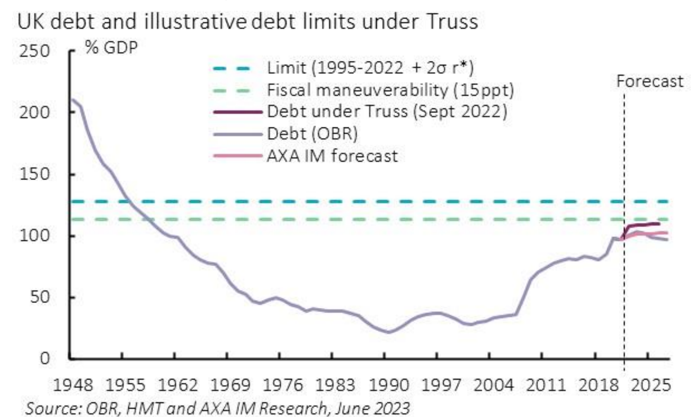
This assessment is sensitive to the assumption of fiscal fatigue. In addition, it does not allow for potential exogenous shocks. So, we also adjust our calculation to allow for risks of these shocks. The pandemic saw debt rise by 12.5ppt of GDP in one year, moreover the Great Financial Crisis (GFC) saw debt increase in 2008 and 2009 consecutively by 14.9ppt and 14ppt, respectively. This reminds investors that exogenous events can raise debt levels sharply and investors may be cautious of this margin before any actual limit is reached. It is plausible to assume that investors will demand a level of 'fiscal manoeuvrability' requiring a country to maintain some headroom that allows them to respond to potential exogenous shocks. To account for this, we reduce our calculated "debt limit" by a further 15ppt – the largest single year increase in debt on record – to reflect this margin. This brings UK debt closer to its effective limit, but overall debt still remains sustainable by this metric.

Nearing debt limits – the experience under Truss

The UK's Truss experience can be interpreted through the 'r-g' framework that we set out above. Exhibit 4 shows our debt limit projections based on previous assumptions for the primary surplus, nominal growth rates and interest rates and includes the UK's projected debt forecast under the policies that Truss and Kwarteng announced in the September Fiscal Event (Exhibit 4). This is estimated to have seen net debt on a rising path to above 109% of GDP closing in on the fiscal manoeuvrability limit we estimate around 113% of GDP.

We also include our own debt forecasts which see debt rising to around 102%. This remains below the fiscal manoeuvrability limit but moves debt closer than implied by the OBRs forecasts which sees debt declining to 97%.

Exhibit 4: Debt rising towards limit under Truss



Source: OBR, HMT and AXA IM Research, June 2023

This would appear to validate our framework's applicability: When debt was expected to reach these levels, markets increasingly questioned the sustainability of the outlook, and this led to an increase in borrowing costs that forced the government to review its plans. It also adds to our view that a fiscal outlook can trigger a crisis well before the actual moment a government's finances become unaffordable.

Domestic and global factors add to risk

While our estimates suggest the UK is currently on a sustainable path, they are sensitive to assumptions made about future interest and growth rates. This is particularly true when we consider structural shifts facing the global economy and some idiosyncratic developments the UK will face alone. Though difficult to quantify they warrant further discussion given their impacts on the UK outlook.

Global factors could raise the pressure on UK debt. Interest rates in a country are determined by country-specific factors, but also influenced by global interest rates. From an r-g debt perspective, a country is at risk if other countries are investing heavily, driving international rates higher through a demand for capital, but in turn increasing their own potential growth rates. Countries not following suit risk seeing domestic interest rates rise as competition for funds increases, while their growth rate remains the same (deteriorating r-g). This would be the case if the global neutral interest rate (r*) were to increase.

r* is hard to determine ex-ante and the Federal Reserve's recent resumption of such estimates if anything points to recent falls in r* in the US and Canada, albeit a rise in the Eurozone. Broad economic, social, and demographic factors suggest that r* could well rise over the coming years, not least as investment increases for climate change transition and defence expenditure. An increase in global r* would have an impact on domestic markets, increasing the cost of borrowing.

While all countries face the risk of rising borrowing costs if international rates rise, the UK faces a unique problem with its own growth outlook. UK growth is likely to be lower compared to previous decades as the UK faces lower investment and higher trade barriers than would have been the case before Brexit. The OBR estimates that long-run productivity growth will be 4% lower compared to remaining within the European Union because of Brexit over the long term[5]. The slower productivity growth will weigh on long-term growth, in turn eroding the benefits of growing out of debt.

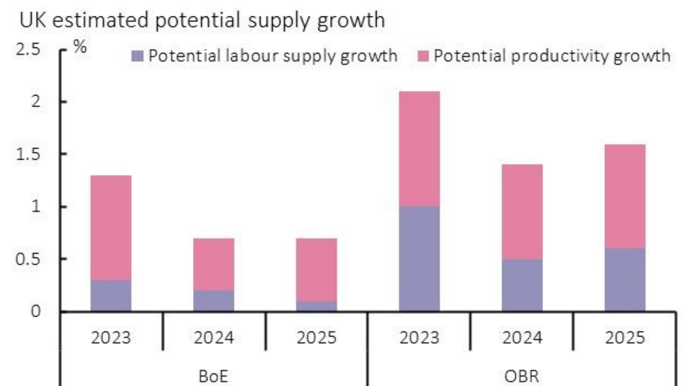
Therefore, we see a risk that both key metrics of debt dynamics have moved unfavourably against the UK. This creates a challenge for the UK at a time when expenditures are already coming under pressure from an aging population. Furthermore, this analysis underscores the strain that the public finances are likely to come under in the absence of fiscal consolidation.

Fiscal forecasts

So far, our analysis has taken the OBR forecasts for the debt outlook at face value; we now critically assess these projections. The OBR projections suggest debt rose to 103.1% of GDP in fiscal year 2022 and 2023 and is set to decline gradually from 2023 and 2024[6]. Additionally, the OBR projects the government will achieve its 'fiscal mandate' of seeing debt as a percentage of GDP fall by the fourth rolling year of the forecast.

The OBR's economic forecasts are underpinned by its expectations for a strong labour supply and, to a lesser extent, solid productivity growth. The OBR also assumes potential labour supply growth will continue to grow by around 0.7% a year. It also sees productivity growth averaging 1% over the next three years, a slight pick-up from the pace seen in the decade prior to the pandemic (Exhibit 5). Overall, it anticipates potential output growth to average 1.9% a year. In contrast, following its annual supply review in the February Monetary Policy Report, the BoE downgraded its expectations for potential output growth to 0.9% a year[7] – half the OBR estimates. The BoE sees labour supply growth markedly slower and expects that productivity growth will remain subdued rather than recover.

Exhibit 5: Comparison of OBR and BoE estimated potential supply growth



Source: BoE, OBR and AXA IM Research, June 2023

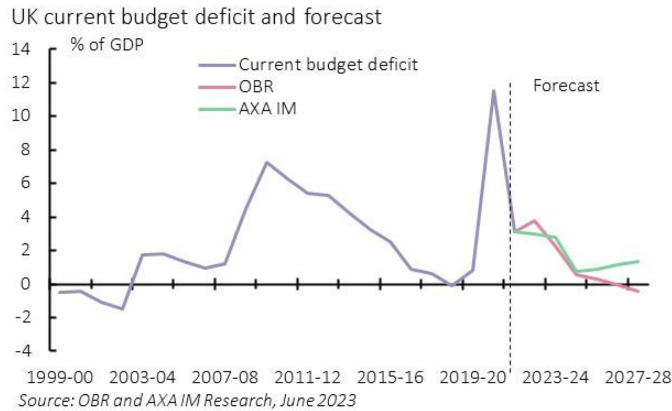
The stronger outlook for potential output means the OBR expects government revenues to pick up considerably over the forecast horizon. We see a significant risk the recovery will not be as rapid as the OBR expects and this will leave debt higher than it currently projects. In our own outlook, we project slower GDP and revenue growth to push the current budget deficit and overall borrowing higher (Exhibit 6).

[5] Economic and fiscal outlook – March 2020, Office for Budget Responsibility (OBR), 11 March 2020

[6] Economic and fiscal outlook – March 2023, OBR, 15 March 2023

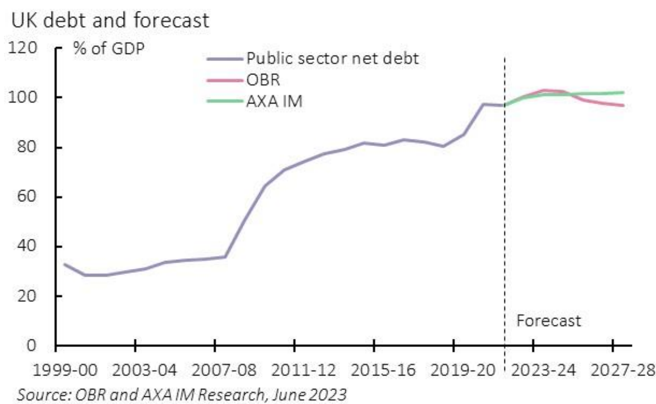
[7] Monetary Policy Report – February 2023, Bank of England, 1 February 2023

Exhibit 6: Current budget deficit forecasts



This also means for public debt, our own forecasts are also less rosy, and while we do forecast debt to stabilise, we see this happening on a much slimmer margin (Exhibit 7). We forecast debt to rise to around 102.2% by the 2027-2028 fiscal year compared to the 96.9% forecast by the OBR.

Exhibit 7: Debt to stabilise at a higher level than OBR forecast



We also looked at the impact of rising borrowing costs on our model. In the baseline, our model also assumes that government borrowing costs benchmarked by 10-year gilt yields decline to around 3% in five years' time. The recent rise in yields – if sustained – would add to pressure on government borrowing costs. The OBR estimated that a 1ppt rise in gilt yields would lead to an increase of £7.1bn in annual debt interest costs.[8] A rise of 50bp in the long-term borrowing cost would leave our estimates of debt on a rising path.

We believe the OBR's optimistic forecasts understate the challenges that government will face in delivering the fiscal consolidation needed to stabilise public finances. The current government has already indicated its plans to cap public spending in real terms and increase taxation, but at present these leave the government achieving its fiscal mandate with an already slim margin of £6.5bn – the smallest ever headroom excluding during the pandemic – with much of the projected fiscal tightening taking place after 2024, when the next General Election is due. This likely deprives Chancellor Hunt of the ability to provide an economy-boosting pre-election Budget giveaway. It also presents the next government with difficult choices around the balance of public spending and taxation.

The narrow path ahead

The recent rise in gilt yields, in the wake of last year's Truss crisis, reminds us of the pressure on UK public finances. UK public debt is forecast to remain on a sustainable path, but we think the path to delivering that sustainability is narrower than the OBR's central projections suggests.

This is driven by domestic and global factors which are likely to weigh on debt. The impact of Brexit on potential output means UK growth will be lower than it otherwise would have been. In addition, we think the cost of borrowing globally is probable to be higher as global interest rates are likely moving higher than they were prior to the pandemic.

Given this, we believe the next government will face tough choices on how to deliver the fiscal restraint needed to ensure debt remains stable.

[8] Tax and spending ready reckoners, OBR, 9 December 2021

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