Is the UK becoming a ‘‘New’’ Italy?
The evolution of UK Public Debt since 2010

Dr Dimitrios Syrrakos
Manchester Metropolitan University
About the author

Since completing his PhD thesis on European Monetary Unification in January 2008, Dr Dimitrios Syrrakos has been researching on the topic of Eurozone debt crisis, fiscal and monetary policies and international monetary relations. At MMU he was the Economics subject leader for Combined Honours from 2004-2011, the first and third year tutor of the Economics Programme from 2011-2013 and 2013/2016 respectively and the Programme Leader for Economics from 2016-17. Currently he is the Deputy Head for the Department of Economics, Policy and International Business. He has been involved in the delivery of a number of units ranging from Introductory/Advanced Macroeconomics, to Economics of European Monetary Union, and is currently teaching Advanced Macroeconomics.

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Introduction

The paper assesses the viability of public finances and debt sustainability in the UK in the light of the pandemic lockdown and its suppressing influence on economic activity. The objective is to identify the pandemic’s impact on public finances and the likely consequences for discretionary fiscal policy. In section-1, the UK’s fiscal and monetary policies during the 2010s and their impact on debt evolution are evaluated. In section 2, the UK’s debt profiling characteristics by March 2020 are discussed with emphasis placed on planned fiscal expansion prior to the outbreak of the pandemic. In section 3, we draw on existing debt obligations, gilt issuance during the pandemic in order to address the immediate financial needs caused by the lockdown bailouts, and provide early forecasts of the government’s annual financing needs up to 2025. Finally, the main conclusions are drawn in section 4.

The analysis points to the UK economy moving to a new macroeconomic environment in the post-pandemic period. One that, in the absence of fiscal consolidation, is characterised by debt-to-GDP ratios permanently higher than 100 percent up to at least 2030. This will cause a substantial increase in the cost of financing overall debt obligations, thus placing an additional constraint to already stretched public finances. As a result, debt interest payments will absorb more than 1 in 10 pounds of government revenues for the next decade. Debt payments will thus raise to the fourth largest government expenditure behind social security, health and education despite having historically extremely low rates of interest. Consequently, debt financing will also become very sensitive to any future increases in the rate of interest.

Broadly, from a financing perspective, the UK does not run the risk of becoming a ‘new’ Italy in terms of its debt management obligations. By comparison, the fact that the UK is not party to a fixed exchange rate regime or a monetary union, like Italy is, and its lengthy average debt maturity, double that of Italy, ensure that short term refinancing needs will be easier to meet via increased tax revenue. It also means the BoE can assist with servicing debt at first instance, provided this does not cause any permanent deviations from its inflation targeting policy. In addition, the total UK debt liabilities are still a low rate (14 percent) of UK households’ net wealth, so that, in extremis, one-off wealth taxation could cover any shortfalls in public finances.

On the other hand, the UK is moving towards a new macroeconomic environment that resembles some key features of Italy -prior to the outbreak of the pandemic- as far as its debt stock is concerned. The UK’s debt-to-GDP ratio could reach 120 percent by 2022-3, whereas Italy’s stood at 135 by the end of 2019. A rebound of UK growth rates to 4 percent (as predicted by the IMF), could facilitate lower deficits as a percentage of GDP, but restoring a balanced budget would most likely be postponed for the second half of the 2020s. The increased costs of financing maturing debt will see to that. There are also significant institutional considerations. With the BoEs QE programme at £645 billion, and a recession of 6.5 percent as forecasted by the IMF, the Bank’s holdings of UK debt will exceed 30 percent in terms of the UK GDP in 2020 and 29 percent of total UK debt liabilities. The BoE will have to shift its emphasis on reserve management as well as setting short-term interest rates with
the two objectives being inherently contradictory in the case of upward deviations from the inflation target. Inflation above target would normally prompt the BoE to increase its base rate. However, in the new environment this will imply a higher cost for maintaining private sector bank reserves and thus significantly reduce the scope for aggressive monetary contraction. This could potentially lead to political intervention in the BoE’s policy in favour of positive output shocks. Such shocks could facilitate stabilising debt-to-GDP ratios but they will not suffice in terms of developing a balanced approach towards servicing debt, at low cost. It is proposed that the new fiscal framework includes two specific targets relating to debt financing.

UK fiscal and monetary policies in the 2010s

The macroeconomic framework adopted in the UK in the 2010s as a means of countering the implications of the economic downturn during the Great Recession (2008-10), was based on expansionary monetary and contractionary fiscal policies. The need to bailout major financial institutions (RBS and Lloyds TSB) and maintain liquidity for all systemic banks led the Bank of England (BoE) to unprecedented monetary policies that went beyond orthodox monetary expansion (e.g. reducing the rate of interest to 0.5 percent) to unconventional ones including Quantitative Easing (QE). From November 2009 to July 2012, the BoE injected £375 billion in the UK economy. To put into perspective this was approximately a quarter of the 2012 UK GDP. A further £60 billion were injected in August 2016, following the leave outcome of the UK’s referendum on EU membership in June of the same year. Apart from providing a vital, immediate remedy to the extremely low reserve ratios of private sector banks and maintaining sufficient liquidity across the entire financial sector, QE also offered an essential stimulus to the UK economic recovery, despite it being the slowest on record. In the domestic economy, it substantially reduced the cost of borrowing money and boosted demand via the interest rate transmission mechanism. It also stimulated demand via the depreciation in the value of the pound and the exchange rate transmission mechanism, reversing (but not restoring) the downward trend in the balance of payments by 2011. The slow recovery had, in part, to do with the nature of the crisis that originated in the financial sector, which subsequently transmitted to the real economy. Figure-1 below, presents the private sector banks’ reserves held with the BoE. As it can be observed, by March 2009, UK banks held less than £50 million as reserves with the BoE. An exceptionally low amount, given the size of the UK economy and its financial sector. Banks’ response to the Great Recession was to increase their reserves to over £150 million pounds by July 2009, an increase of £100 million in a very short time, thus reducing loans to the private sector. QE was thus implemented in November 2009 (£200 billion) as a means of purchasing government bonds and providing liquidity to the UK financial system. A similar trend is observed from September 2011 to December 2012, when there was speculation about a double-dip recession and the UK’s fiscal policy based on austerity started taking its toll on economic growth. This led to the second round of QE.
Eventually, once trust was recovered, non-banking private institutions resumed their investment programmes in the beginning of 2013. Overall, the BoE’s interventionist monetary policies provided much needed support and played a major part in the growth rates achieved from 2013-2019. However, it has to be noted that monetary policy in the UK has not been ‘normalised’ to date. Normalisation would involve a return of the base rate to a minimum range of 2-3 percent and a reversal of QE, i.e. the BoE to start selling its gilt holdings accumulated during the last 11 years.

Apart from its positive impact on economic activity, QE also had two side effects. First, it led to significant change in the composition of UK’s debt post-2009. Prior to Great Recession pension funds and insurance companies held approximately 60 percent of UK debt. The high rates of return, ensured by the high rate of interest (4.5 percent base rate in 2007) rendered UK debt investments very attractive. Furthermore, in the post-2010 period not only did the BoE start purchasing UK debt, but private sector banks and building societies started doing so as well. As a result, of this readjustment process, the four largest holders of UK debt by 2018-19 were insurance and pension funds (30 percent), foreign investors (25 percent), private sector banks and building societies (22 percent) and the BoE (20 percent).\(^1\)

The second major implication of QE is its ‘lock-in’ effects. As the deficit elimination process that started in the second half of 2010, based on draconian fiscal contraction, was not as successful as initially envisaged, it was extended from 2015 to 2017. It was then, further extended due to Brexit to 2019. This implies that despite deficit reductions taking place at a satisfactory pace, until the UK economy generates budget surpluses, the absolute value of debt keeps increasing and so does maturing debt. This necessitates further rounds of guilt issuance at increasing pace. As a result, whereas maturing debt in 2011-12 stood at £49 billion, it increased to £99.1 billion by 2019-20. It also means that in order for refinancing costs to be maintained low, the BoE will have to commit to further rounds of QE.

**UK Debt Profiling Features 2019-20**

The new government’s decision to engage in expansionary fiscal policies prior to the pandemic aimed at mitigating the impact of a potentially hard Brexit that could materialise as early as the summer of this year. Overall, the planned fiscal expansion was going to add 0.9 percent of GDP on annual deficits on average for a period of 5 years, i.e. up to 2024-25. In net terms, the expansion was going to add 4.6 percent to debt-to-GDP ratio, approximately £125 billion. Effectively, this policy decision was putting on hold the process of fiscal consolidation for at least up to the middle of the decade, despite optimism in the budget calling for a balanced budget to materialise by 2022-23. As a result, the UK government’s fiscal policy reflects a significant departure from the past. It is a fiscal policy that instead of focusing on deficit elimination (balanced budget) and a gradual but steady decline in the debt-to-GDP ratios, it is rather based on continuous borrowing and just maintaining debt-to-GDP levels at a steady state i.e. about 85 percent of GDP in grossed terms.

This approach would have been financially sustainable in the medium to the long-run, for as long as interest rates on refinancing debt remained low. On the other hand, the debt-to-GDP levels remain double of the pre-Great Recession period, the volumes of index-linked debt is now much larger than 2010 and the governments’ annual financial needs would have been maintained at about £150 billion up to 2024-25. Despite being sustainable therefore, given the assumptions that underpin that sustainability, the question that was raised is whether the government’s revised fiscal policy was prudent. Be it as it may, the fiscal needs of dealing with the lockdown have rendered this debate obsolete. What is essential though is that the annual financing needs of the government prior to the lockdown would have been around £150 billion pounds up to 2024-25.

Overall, prior to the pandemic, the UK’s debt profiling features was a mixed picture, with major advantages and disadvantages against other advanced economies. The UK’s total liabilities of debt issuance stood at £1.9 trillion for the financial year 2019-20. Relative to the UK GDP of £2.21 trillion, this made the gross debt-to-GDP ratio reach **86 percent**. This compares to €2.45 trillion for Italy (**135 percent** of Italian GDP), $23.2 trillion for the USA (**107 percent** of American GDP).

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percent of USA GDP), €2.38 trillion for France (98 percent of French GDP), €1.2 trillion for Spain (98 percent of Spanish GDP), and €2.05 trillion for Germany (60 percent of German GDP). So, overall, with the exception of Germany, the UK’s debt-to-GDP ratio, prior to the pandemic, was faring reasonably well by international comparison³.

In terms of debt maturity (i.e. number of years it will take for the country’s debt to mature on average), for the UK it exceeded 14 years, which is far the lengthiest in G-7. This places the UK into a considerable advantage in relation to its debt servicing costs. For example, the average debt maturity is less than 6 years for the USA, 7 years for Italy and Germany and 8 years for France and Japan⁴.

Another debt-profiling characteristic is the percentage of front-loaded debt obligations (i.e. the ratio of the value of debt that matures during the next 5 years, over the absolute value of debt). The ratio is a major determinant of the government’s borrowing needs to finance national debt for the duration of the new parliament. The maturing debt during the next 5 years comes to 23.4 percent of total debt liabilities. International comparisons on this debt-profiling feature are difficult to make due to the differences in the average debt maturities.

In terms of the internal-to-external debt ratio (the ratio of debt that is held by domestic residents and institutions over the debt that is held by foreign residents and institutions). In the UK, the ratio has fluctuated around 2, reflecting that approximately two thirds of the debt is purchased by domestic institutions. This makes UK debt very safe investment market, as it is only marginally dependent on foreign exchange volatility.

In its current form, the UK’s debt structure -a histogram that demonstrates debt issuance and maturity in each year- reached its peak during 2009-12 and consequently debt maturity would reach its peak during 2019-2022.

In terms of the interest rate paid on debt (debt yield curve), this is the rate of interest payable by the UK government to bond holders, when their gilt holdings mature and they are not interested to exchange them with new debt (roll them over), i.e. they want to exit the country’s debt market. Currently, it is at historically low levels, with the yield of 30-year gilts at 0.6 percent, the yield of 10-year gilts at 0.3 percent and the yield of 5-year gilts at just 01 percent. The low levels of yield are facilitated by the BoE’s QE programme, as private sector debt investors have to compete with the BoE in gilt auctions. It is also one of the main advantages of retaining monetary independence, as the BoE maintains its status of lender of last resort⁵.

Despite the BoE’s intervention to ensure borrowing costs are maintained at low levels, the debt market is competitive. As such, debt financing needs also depend on the alternative debt

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Markets to the extent they provide alternative investment opportunities. Asian markets aside, the UK’s main debt market competitors are the USA and Germany. UK debt is considered a safe asset hence attracting international investors. In addition, as the Federal Reserve and the European Central Bank have also engaged in their own QE programmes, their yields are also maintained at historically low levels. As a result, the low gilt price differentials combined with the fact that Eurozone and the USA economies are also amidst severe recessions, imply that the American and the German gilt markets are not substitutes for UK gilts, at least in the short and medium term.

The demand for UK gilts by international investors is also vital. It reflects the confidence the UK economy enjoys world while. During the last two decades, the demand has shifted from European, American and Japanese investors to Asian ones. Largely, the demand for gilts by international investors highlights the confidence over the UK’s long run growth prospects and the pound’s volatility. Debt holdings by international investors of UK debt has ranged between 24-28 percent during the last 15 years. This despite the considerable exchange rate volatility in the value of the pound, which could impact returns and profits when debt holdings mature and investors decide to exit the market and translate gains into their local currencies. Debt holdings by international investors were also, marginally increased during 2017-19, which implies that the process of Brexit did not have a material impact on the appetite of foreign investors for UK debt.

Bank of England’s Asset Purchasing Programme

The Bank of England’s Quantitative Easing programme has led to purchases of £645 billion pounds since 2009. This is the equivalent to 31 percent of the UK’s £2.15 trillion debt. Excluding the BoE’s holdings, the ratio of internal-to-external remains at 2. However, if we include the BE (and assume the BE is a domestic institution) then the ratio increases to 3 (75:25). QE has also led to a lengthening of the average debt maturity of the UK debt from 11 years in 2009 to 15 years in 2019.

The UK’s Post Pandemic Debt Evolution

The financial cost of the pandemic and the lockdown is unprecedented and it will surpass the hit from the Great Recession. The Office for Budget Responsibility (OBR) estimated the economic cost of the lockdown bailouts to £103.6 billion by the end of April alone. The Debt Management Office (DMO) confirmed in April that gilt issuance during May - July will reach £180 billion (with a range of short/medium/long dated sales). This is on top of £45 billion sold during April sales. This brings the total to £225 billion only for the April-July period.

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6 Inman, P. (2020) ‘UK coronavirus business bailouts have already cost more than £100bn’ 08/05/2020. https://www.theguardian.com/world/2020/apr/30/uk-coronavirus-business-bailouts-have-already-cost-more-than-100bn 30/04/2020

7 Debt Management Office (2020) ‘April 2020: Revision to the DMO’s 2020-21 Financing Remit for May to July 2020’
This is more than the 10.2 percent deficit reached during 2009-10 but covers only a third of the financial year. The calculation relative to GDP, also assumes a Gross Domestic Product of £2.21 trillion pounds, the one prior to the lockdown contraction at the end of 2019. In addition, the economy will not reach full capacity/speed any time soon.

In order to calculate the government’s Net Financial Requirement (NFR) from 2020 to 2025, not only the new debt issued needs to be taken into consideration but also the fiscal expansion that the government planned prior to the pandemic and the refinancing needs of the 10-year gilts issued during 2009-12, a process that is already under way. Excluding bailouts (B&B, NR etc.) the debt refinancing needs for 2020-21 are about £98.9 billion. This includes repayment for most of the 10-year gilts issued back in 2010-11, to cover that year’s deficit. As a result, there is bound to be more gilt issuance in the second half the year, even if the lockdown is fully lifted. Given that, the entire debt issuance from May to July will cover short-term financing needs (e.g. enhanced NHS emergency funding, lockdown bailouts etc.), at least £98.9 billion have to be issued from August 2020 to March 2021, in order to meet debt refinancing needs. This brings the total gilt issuance for 2020-21 to £323.9 billion pounds. It also raises the total value of debt by £225 trillion to £2.125 trillion. This is a good case scenario, in which the UK economy returns to normal by August and the recession is not extended for more than three quarters.

However, according to the BoE’s forecasts the recession could be double the one predicted by the IMF, reaching a staggering 14 percent of GDP. As a result, the UK’s GDP could be reduced from £2.21 trillion to £1.9 trillion and the debt-to-GDP ratio could accelerate to 112 percent for 2020. The Bank anticipates an expansion of 15 percent for 2021 and 3 percent growth for 2022. Notwithstanding the Bank’s very optimistic view over the return to normality and the rebound in growth in 2021, the forecast’s severity of the recession is astonishing. Furthermore, despite recovering most of the output loss in 2021, the UK economy would only recover its output loss by the end of 2022.

**Policy Implications**

The macroeconomic framework adopted in the UK (and abroad) to combat the lockdown deflationary pressures is based on expansionary fiscal and monetary policies. Fiscal policies provide short-term bailouts so that when the lockdown is relaxed the increase in...
unemployment to be contained. Monetary policy based on further QE ensures that liquidity is maintained at appropriate levels. Fiscal and monetary expansion taking place in tandem, are inherently inflationary and they will assist preventing a prolonged deflation. Their impact, could potentially lead to inflationary pressures in the medium to the long run\textsuperscript{12}, especially if combined with broken international supply chains\textsuperscript{13}. This is not however a concern for policy makers at present\textsuperscript{14}.

Expansionary monetary policy based on QE however is already having profound implications for institutional policy in the UK. The BoE in particular, apart from focusing its policy on determining short-term interest rates it will also have to shift its attention to reserve management too\textsuperscript{15}. Put differently, the BoE’s objective of setting short-term interest rates will be constrained by the need to manage its expanding balance-sheet. Overall, in the post-pandemic era the BoE would have an additional constraint. On top of preserving financial stability in the UK financial sector by meeting the high demand for reserves of private sector banks, it would have to pay for them. This would create a new profitability constraint. This process has started in 2009 and has gradually evolved to reach a pandemic peak. However, the implications of the additional constraint do not end with its inclusion in the BoE’s policy considerations. That is, reserve management is not just another variable the BoE would have to review when reaching decisions. When for example, at some point in the future inflation deviates from target and the BoE considers to increase its base rate, the increases could only be limited, as they would significantly reduce its profitability.

At the same time, they will also reduce the government’s profitability from QE. As a result, the process of reversing QE and pursuing contractionary monetary policies would inevitably attract political intervention. Overall, this will reduce the magnitude of contractionary monetary cycles with the base rate reaching a maximum of 2.5-3 percent. As a result, there would be/is a bias towards easing and in favour of prolonged positive output shocks (that could be precipitated by the government). Consequently, there are bound to be implications for the BoE’s inflation targeting. Deviations from the 2 percent target will be tolerated for longer as long as growth is maintained at high rates. In effect, this would lead to a de facto revision of the target. We anticipate a return to inflation rate bands e.g. to a range from 2-4 percent. After all, inflation above target is very helpful in terms of reducing the real value of debt and consequently the debt-to-GDP ratio, a process that would be very helpful to all UK governments, as it reduces the need for adopting discretionary fiscal policies i.e. increasing taxes.


\textsuperscript{13} Roach, S. (2020) ‘A return to 1970s stagflation is only a broken supply chain away’ FT, 06/05/2020, https://www.ft.com/content/5f4e64f6-8ad6-11ea-a109-483c62d17528


UK authorities however are not simply going to inflate their way out of excessively high debt-to-GDP ratios without having to utilise contractionary tax policies. As we embark on a new era of macroeconomic policy, one that does not focus as much (if at all) on the quantity of debt, but on its price a new fiscal framework has to be devised. The ‘new’ fiscal framework announced by the government in March has already been rendered meaningless. Given the emphasis shift from quantity to price of debt, a fiscal framework must make specific reference to the cost of refinancing debt and its average debt maturity. To ensure sustainability of public finances a maximum threshold of debt interest payments in relation of tax revenue has to be adopted for every financial year for the next decade. If the threshold were reached this would automatically trigger new policies to return public finances to a sustainable path. It would add credibility to such a framework for the UK authorities to announce beforehand a menu of policies that could be pursued in such eventuality. We propose a threshold of a ratio of 11-12 percent of debt interest payments to tax receipts to be adopted as the trigger. Ideally, the trigger should be linked to direct taxation measures, as indirect taxation is regressive. In extreme cases, indirect taxation (e.g. increases in the price of tobacco, fuel and alcohol) could be employed to support the NHS.

Second, given the sensitivity of debt interest payments on the average debt maturity, attention has to be drawn on the demand for 30-year gilts and the interest rate paid on them. This is the case, as in order to preserve the 14-15 years average debt maturity, future gilt sales have to rely on selling a certain proportion of 30-year gilts. Put it differently, if the bulk of future gilt sales were to be based on 5-year and 10-year gilts, by definition the average debt maturity would be reduced. Demand for long dated UK debt from 2020 to 2025 will thus prove vital. Lack of demand for 30-year UK debt in gilt auctions should also be adopted as a trigger for fiscal policies aiming to restore credibility in long-dated UK debt.

Including the above two rules in a new fiscal framework together with the BoE’s commitment to engage in gilt auctions of long-dated debt will be conducive to maintain the price of debt stock relatively low. It will therefore provide a price-anchor that will allow the DMO and the UK authorities to plan when formulating and adjusting their fiscal policies. The authors do not recommend permanently ignoring the stock of debt, but there is recognition that in the current juncture this may not be a priority for good reason. Eventually though and when a return to normality is realised it would be prudent to enact policies aiming to reduce the stock of debt and the debt-to-GDP ratios. This could be the case post-2025. Not addressing the stock of debt would inevitably place the UK economy when the next crisis hits on a debt trajectory that would increasingly resemble many features of the Italian debt stock.