Recession Watch: was the UK fiscal wobble a sign of things to come?

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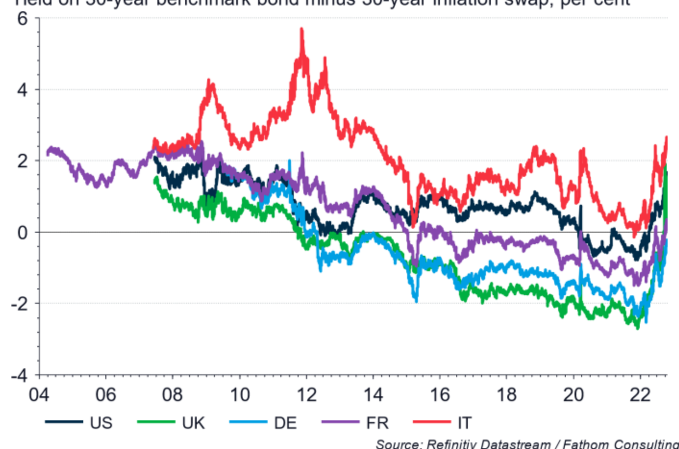
Headlines

- Two and a half years after the pandemic hit, crisis risks are elevated globally
- The UK suffered a fiscal wobble in late September, but even now that the unfunded tax cuts have been rescinded, the prime minister has resigned, and the dust has settled, the fiscal arithmetic remains less attractive for the UK and for other major economies than it has for decades
- Market pricing of government debt over the past month, combined with plausible estimates of long-run economic growth, suggest that both the US and the UK will need to move to a sustainable primary surplus — something neither has achieved for the past two decades — and Italy will need to run a larger primary surplus
- Germany and, to a degree, France, appear in marginally better shape for now
- The dramatic turnaround in index-linked government yields, which has gone beyond what can be explained by expectations of conventional monetary tightening, is hard to square with textbook models of the fall in global real risk-free rates of interest
- Those models may be wrong, or it may be that even major-economy sovereign yields were never quite as risk-free as the textbooks had imagined
- But another explanation relates to QE and the idea of fiscal dominance — central banks announcing a partial reversal of QE signals that the era when monetary policy was set to suit the government's fiscal needs is over, thanks to rising inflation, so markets are now taking a renewed interest in the fiscal position

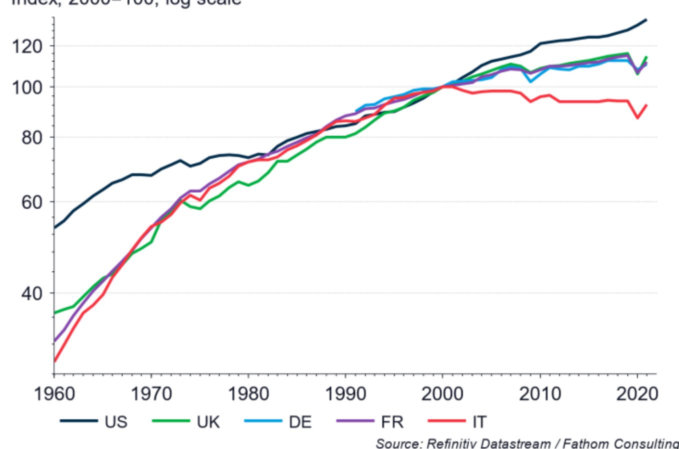
Economies are most likely to suffer a crisis not in the teeth of a major economic downturn but a year or two down the line. Ever since the pandemic hit, Fathom's proprietary Financial Vulnerability Indicator has warned of a growing global threat of a series of financial crises, with the risk peaking about now. Until recently we would not have placed the UK particularly high on the list of countries to which we should pay close attention. Nevertheless, former Chancellor Kwasi Kwarteng, having been in post for a matter of days, took the UK perilously close with his 'fiscal event' of 23 September. His request effectively to borrow a further £72.4 billion, worth some 3% of GDP, driven by a combination of increased spending on the government's energy support package and substantial tax cuts, while simultaneously refusing to allow the Office for Budgetary Responsibility to provide its own independent assessment, was seen by investors as a step too far. Long-dated gilt yields rose some 140 basis points in the space of a week — effectively a twelve-sigma event. Both Mr Kwarteng and Prime Minister Liz Truss subsequently resigned, and their plans have been largely rescinded. The immediate threat of a UK sovereign crisis has receded, as yields have fallen back more or less to levels last seen before 23 September, but the fiscal arithmetic continues to look much less pleasant, for the UK and for other major economies, than it did at the start of the year. The recent experience of the UK warns us that the global recession we are now entering is likely to be compounded by fiscal contractions to placate nervous bond holders, adding an additional headwind to the relatively gloomy economic prospects.

As I highlighted in a recent *Viewpoint* (see the 'Interesting reading' list at the end of this note), the policy prescription for stabilising the public finances turns crucially on the balance between '*r*' (the long-run real rate of interest on government debt) and '*g*' (long-run real economic growth). For the past 20 to 30 years, most major economies have been in a position where $r < g$.

That is a good place to be because it means governments can run a primary deficit indefinitely, and government debt as a share of GDP will not explode. If the primary deficit is too high for government debt as a share of GDP to stabilise, then it will simply move to a new, higher, equilibrium and stay there. The intuition is that, when $r < g$, economic growth generates sufficient additional resources both to cover the primary deficit and to service the debt. If, however, we are in a world where $r > g$ things rapidly become much more difficult. In this world, a primary surplus is necessary to stabilise government debt as a share of GDP. The surplus will need to be larger, the larger is government debt as a share of GDP, and the larger is the gap between r and g. When $r > g$, government debt as a share of GDP will grow exponentially until a sufficient primary surplus is achieved.



In the days following Kwasi Kwarteng's fiscal event, the yield on long-dated, index-linked gilts moved close to 2%, well above the UK's trend rate of growth, suggesting an urgent need for fiscal consolidation. How do things look now, not just in the UK but in other major economies? The chart above shows an estimate of the long-run real rate of interest on government debt in different countries measured by the difference between the yield on a 30-year conventional government bond, and the 30-year inflation swap. On this basis, long-term real rates of interest have risen across the board since the beginning of the year, by somewhere between 200 and 300 basis points.



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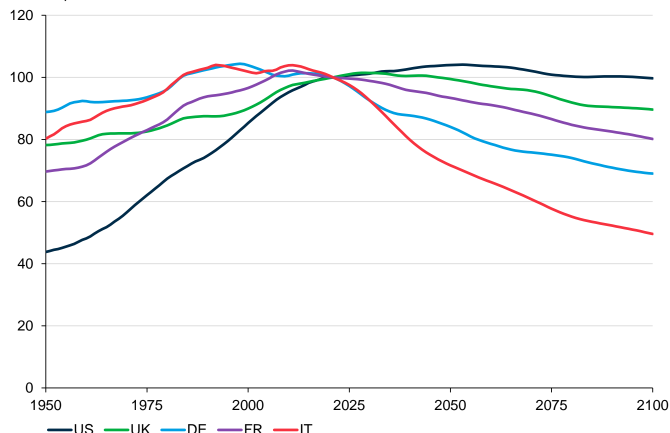

How do these estimates of *r* compare with prospective growth rates across countries? Conceptually a country is able to grow either because each worker is able to produce more, or because it has more workers, or through a combination of the two. From that perspective, the trend rate of growth is the sum of two parts: labour productivity growth and growth in the working-age population. As we show in the two charts above and in the table below, not only has labour productivity growth slowed across the board since the Global Financial Crisis, in most major economies the size of the working age population is projected to be either broadly flat, or to fall over the next 30 years.

Determinants of trend growth

	Productivity growth		Projected growth in working-age population	Trend growth
	1992-2006 (1)	2010-2019 (2)	2022-2052 (3)	(2)+(3)
US	1.8%	0.7%	0.1%	0.8%
UK	1.9%	0.7%	0.0%	0.7%
Germany	1.1%	0.7%	-0.6%	0.1%
France	1.2%	0.7%	-0.2%	0.5%
Italy	0.9%	-0.2%	-1.1%	-1.3%

Source: Fathom Consulting

Our analysis suggests that, on average over the past month, 30-year real rates of interest on government debt have exceeded plausible estimates of sustainable economic growth over that same 30-year period not just in the UK, but also in the US and in Italy.[1] In France and Germany *r* remains below *g* for now, but the gap has narrowed substantially since the beginning of the year.

1. It is likely that *r* remains above *g* even following the fall back in UK yields under the new Rishi Sunak administration once one adds in an adjustment for the fact that the RPI measure, on which swaps are based, overstates inflation by 100 basis points or more.

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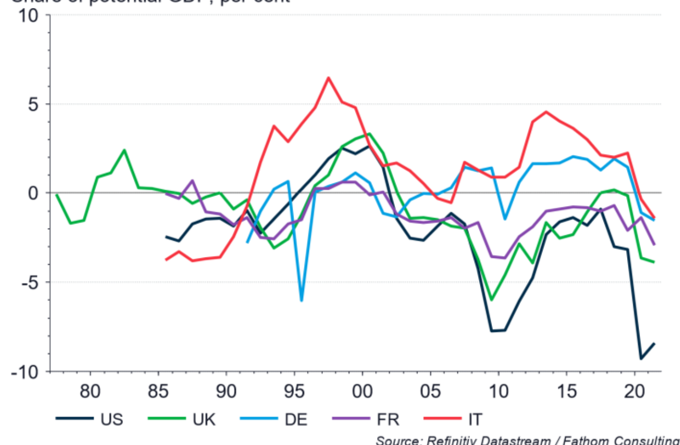
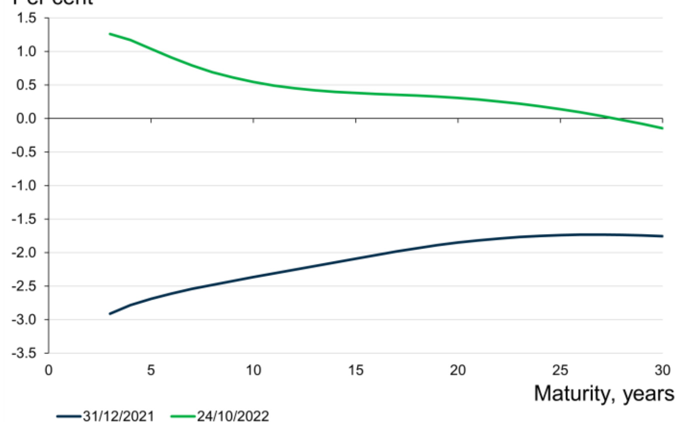


On current market pricing, most major economies have either left, or are close to leaving the rather attractive world where *r* < *g*, and governments do not need to worry too much about running a primary deficit. When and if they do leave that world, each will need to develop a plan for running not just a primary surplus, but a primary surplus that is sufficient to stabilise government debt as a share of GDP. As we show in the chart above, after stripping out the effects of the economic cycle, incentivised by a world in which *r* has been less than *g*, the US, the UK and France have all run persistent deficits for the best part of 20 years. Italy has tended to run a primary surplus, but given very high levels of government debt as a share of GDP in that country, and the sizeable gap between *r* and *g*, it has not been of sufficient size to ensure stability. Only Germany looks relatively safe for now.

Why have long-term real rates of interest on government debt risen so sharply? Double-digit inflation in many major economies has led to expectations of tighter monetary policy, but that is unlikely to have such a marked effect on 30-year real rates of interest. Each day, the Bank of England publishes a real forward interest rate curve — estimates of the real rate of interest on government debt implied by market pricing out to 30 years. As we show in the chart below, real forward rates have indeed risen by more at the short end, reflecting expectations of tighter monetary policy, but they have risen across the curve, by between 250 and 450 basis points. There is more at work than expectations of tighter monetary policy.



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The UK was the first major economy to issue index-linked government bonds. As we show in our final chart, UK index-linked yields have been on a downward trend since the mid-1990s, dropping from around 4%, passing through zero in the early 2010s, and continuing on down, bottoming out close to -3.5% late last year before rebounding sharply this year. Index-linked government yields have fallen in all major economies. The conventional wisdom, among economists at least, is that what we were seeing was a fall in the global real risk-free rate of interest as an ageing population demanded more assets in preparation for a long retirement. UN projections suggest that the global population is expected to continue to age, as birth rates drift lower, and life expectancy continues to improve. The conventional wisdom, then, was that the real risk-free rate would continue to fall. Such a dramatic reversal was not on the cards.

How do we square what we are seeing in index-linked markets with the conventional wisdom? There are a number of options. First, the conventional wisdom, that one could account for the decline in index-linked yields using fundamentals, may simply have been wrong: part of the decline in what we had considered to be a measure of the global real risk-free rate might simply have been a bubble. Second, there might have been a reassessment of the prospects for global asset demand and global asset supply. It may be that investors believe that improvements in life expectancy are coming to an end, or perhaps they anticipate an increase in asset supply through greater investment in fixed capital. Third, with government debt as a share of GDP moving above 100% in a number of major economies, it could be that index-linked yields are no longer an adequate measure of the risk-free rate. A big part of the reversal in index-linked government yields has coincided with a growing expectation that a policy of quantitative tightening (QT), implying outright asset sales, would be put in place by major central banks. The Federal Reserve has been conducting outright asset sales since 1 June 2022, with the Bank of England expected to join them next month, and the ECB early next year. Whatever the explanation for the sharp reversal of the downward trend in long-term real rates of interest, if sustained it will create a challenging environment for the public finances, of a kind we have not seen in decades.

Interesting reading

- Former Bank of England Deputy Governor, Sir Paul Tucker, explains how the maturity transformation of government liabilities effected by more than a decade of QE has made UK debt interest payments far more sensitive to changes in the policy rate of interest: Quantitative easing, monetary policy implementation, and the public finances – Institute for Fiscal Studies (ifs.org)
- The UK loses its magic money tree – Fathom Consulting (fathom-consulting.com)
- Global Outlook Autumn 2022: Spiralling…out of control? – Fathom Consulting (fathom-consulting.com)

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