Government borrowing: How much is too much? | Ian King

Liz Truss is planning a massive intervention aimed at insulating households and businesses from the impact of surging energy prices.

No costings have yet been given – but the implication is that it will involve spending at least £100bn, which, in all probability, would be raised in higher government borrowing given the new prime minister’s aversion to raising taxes.

Financial markets have responded by selling gilts – UK government bonds – an anticipation of more borrowing.

The yield (bond yields rise as prices fall) on a number of gilts moved dramatically on Tuesday. On 10-year gilts, the yield – an implied borrowing cost – hit 3.1% for the first time since July 2011, while on five-year gilts, the yield hit 3.015%, a level not seen since February 2010. The yield on 30-year gilts, meanwhile, saw its biggest one-day move since the start of the pandemic in March 2020.

All of this suggests that investors are starting to demand a higher premium for the risk of owning UK government debt, although it is worth pointing out that the yield on US Treasuries (US government bonds) also surged on Tuesday as markets continued to price in further aggressive interest rate rises from the US Federal Reserve.

But there is no doubt that, for some investors, lending to the UK government is looking a riskier proposition. That can also be seen by the fact that, today, the cost of insuring against a default by the UK – as measured by instruments known as credit default swaps – rose to its highest level since June 2020.

The prospect of all this extra government borrowing has raised questions about whether there is a limit to what the government is able to borrow. That is certainly a question that is being asked in the gilt market; the yield on 10-year gilts has risen from 1.7% at the beginning of August to 3.1% now – making August the worst month for this particular asset since 1986.

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It is a point that was made by Rishi Sunak, the former chancellor and defeated Conservative leadership candidate, in an interview with the Financial Times on 30 August in which he said, essentially, that it could not be assumed that markets would maintain confidence in the UK.

‘Complacent and irresponsible’

He told the paper: “We have more inflation-linked debt by a margin than any other G7 economy – basically more than double. Because of the structure of QE [quantitative easing], we’re also particularly much more sensitive to an upward rate cycle than we have been.

“My general view in life: you can’t take anything for granted.”

Telling the FT that a prime minister and chancellor would be “complacent and irresponsible not to be thinking about the risks to the public finances”, Mr Sunak added: “Ultimately, you have to decide whether you think sustainable rates of borrowing are important or not. I think they are.”

The point at which the debt markets refuse to lend to a government has long been debated.

For a while, the received wisdom on this subject came from research by the Harvard economists Ken Rogoff and Carmen Reinhart, who published a research paper in January 2010 called Growth In A Time Of Debt.

Their central thesis was that economic growth slows markedly once the size of a country’s debt rises above 90% of its GDP.

The paper was highly influential on both sides of the Atlantic and was seized on by, among others, the former chancellor George Osborne – who oversaw what has since been called “austerity” in an attempt to reduce the UK’s borrowing in the wake of the global financial crisis. It was also an influence on a number of members of the European Commission around that time. Rogoff and Reinhart subsequently rowed back on the 90% claim when errors were highlighted in some of their work.

So it is by no means clear that there will be a tipping point for the UK where markets say enough is enough.

And, even assuming there will be, it is by no means clear where that point might be. Japan, for example, has a debt to GDP ratio of 234% – making it the world's biggest creditor nation.

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'The kindness of strangers'

Yet Japan remains the world's third-biggest economy and enjoys a standard of living and prosperity that remains the envy of most other countries. Japan's debt is unproblematic because the vast majority of it is owned by Japanese financial institutions and by the Japanese public. Just 6% of it is owned by foreigners. By contrast, just under 30% of gilts are owned by foreign investors, who the UK needs to keep onside. This is what Mark Carney, the former Bank of England governor, was referring to when he memorably described the UK as being reliant on "the kindness of strangers".

Ms Truss and her advisers will argue that the UK is not yet at the point where borrowing will become prohibitively expensive. The UK's debt to GDP ratio stands at just under 100% – more or less in line with other wealthy economies such as the United States and France, and lower than in other G7 economies such as Canada, Italy and Japan.

They can also point out that, although the cost of UK borrowing is rising and rising sharply, the UK is still able to borrow money on the debt markets relatively easily. For example, on Tuesday, the UK sold £2.75bn in 10-year gilts with a coupon (interest rate) of 3.088%. There were bids from would-be buyers for 2.4 times as many gilts as were being sold – scarcely evidence of a buyer's strike.

A big increase in government borrowing to fund a package offering relief from energy prices will also be tolerated by markets if the new prime minister and chancellor can convincingly argue that it will help the UK to return to growth more rapidly than would otherwise be the case.

'An unsustainable debt spiral does not necessarily follow'

As Simon French, chief economist at the investment bank Panmure Gordon, wrote in The Times this week: "There is little evidence, contrary to our natural instincts, that there is a maximum amount of public debt that an economy can bear.

"Should the new prime minister instruct the Treasury to transfer tens of billions of pounds to support households and businesses, and fund it by additional borrowing, the UK is not going to pass some magic threshold where financial markets lose faith in the UK's ability to repay its debts.

"Yes, the total interest bill will be larger, and the average interest rate paid will be higher. But no, an unsustainable debt spiral does not necessarily follow."

That is not to say that gilt yields will not carry on rising. Interest rates are rising around the world and, as has been seen in the US, that is resulting in higher borrowing costs for all governments – even those whose borrowings are denominated in what is effectively the global reserve currency.

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And, for the UK, there is an additional wrinkle in that the Bank of England is due to begin unwinding its extraordinary asset purchases – QE in the jargon – which means it will be offloading gilts onto the market just at a time when the government will be seeking to raise money by selling more gilts. That means would-be buyers will be in a stronger position to demand more attractive terms.

So spare a thought, as we learn in coming days of the extent to which government borrowing is to rise, for the Debt Management Office – the Treasury agency tasked with raising all this money via gilt sales.