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Public sector net debt jumps above 40% of national income as ONS reclassifies Northern Rock plc as a public corporation

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Today the Office for National Statistics announced that Northern Rock plc and the Bank of England are both to be classified as part of the public sector. This will temporarily push public sector net debt significantly above the ceiling of 40% of national income set down as one of Gordon Brown's fiscal rules in 1998. But the long term impact on net debt – and the need for any fiscal policy response – remains uncertain for the time being.

"It is doubtless embarrassing to the Government that the Northern Rock saga is now likely to add around £100 billion to public sector net debt, shattering Gordon Brown's pledge to keep it below 40% of national income. But most, or conceivably all, of the effect is likely to be temporary. For the time being the Government should publish net debt figures with and without the impact of Northern Rock. Whether or not tax and spending plans will need to change in response to this reclassification should depend only on the long-term impact of Northern Rock on public sector net debt, which remains uncertain. But today's decision underlines the need for the Treasury to clarify its goals for public sector indebtedness over the next few years", said Robert Chote, Director of the IFS.

Why has the decision been taken?

The ONS argues that the conditions attached on 9 October 2007 to the Bank of England's loan to Northern Rock gave the Government effective control of the company from that date. For example, Northern Rock needs the Bank's permission to restructure, change its business, pay dividends, or acquire or dispose of certain types of assets.

The ONS and the Government agreed as long ago as 2003 that the Bank of England should be classified as part of the public sector, but this had not yet been done. The ONS has decided to do so now to avoid "an unnecessarily complicated and potentially misleading" presentation of the transactions between Northern Rock and the Bank.

What is the short-term impact on measures of the public finances?

The reclassification decisions mean that the debts of Northern Rock and the Bank of England (minus their short-term financial assets) will be added to public sector net debt. The latest available data suggest that reclassifying Northern Rock will *increase* public sector net debt by roughly £100 billion (around 7% of national income), while reclassifying the Bank of England will *reduce* public sector net debt by around £2 billion (0.1% of national income). Public sector net debt stood at £536.5 billion (37.7% of national income) in December, so the reclassification will probably increase public sector net debt to around 45% of national income.

What is the long-term impact on measures of the public finances?

Public sector net debt rises sharply in the short term because the measure of debt used for the fiscal rules is net of short-term financial assets, but not long-term financial assets. Crucially this means that the increase in debt is not offset by the value of Northern Rock's mortgage book. When Northern Rock or its mortgage book is sold, this should offset a large part of the increase in public sector debt. It is even conceivable that the net debt will end up lower than it started.

Does the rise in public sector net debt mean that taxpayers are now exposed to bigger losses?

No. How the ONS classifies Northern Rock makes no difference to the underlying exposure of taxpayers. Taxpayers have provided a direct loan of around £25 billion (via the Bank of England) and guaranteed some other creditors of Northern Rock, estimated at around £30 billion, to ensure that savings deposited at Northern Rock remain risk-free from the point of view of savers. Therefore in principle the total potential exposure of the taxpayer is around £55 billion (or 4% of national income). But in practice all or most of this exposure should be recoverable from the sale of Northern Rock's assets, in particular its mortgage book.

Does this mean that the Sustainable Investment Rule has been broken?

Gordon Brown said in 1998 that in order to stick to his "Sustainable Investment Rule" public sector net debt should be kept below 40% of national income in each year of the current economic cycle. But Mr Brown said earlier this year that he believed that the economy was now beginning a new cycle. Strictly speaking, the sustainable investment rule is not currently defined – an omission that we have been urging the Treasury to rectify for some time.

But, on the reasonable assumption that the rule is to be interpreted as defined to date, it will now have been broken by a significant margin. Indeed, the addition to net debt is so large that this would have been true had the Northern Rock saga taken place at any time in the last four years.

Sensibly the Code for Fiscal Stability allows the Government to depart from its stated fiscal rules temporarily so long as it specifies:

- the reasons for departing from the previous fiscal policy objectives and operating rules;
- the approach and period of time that the Government intends to take to return to the previous fiscal policy objectives and operating rules; and
- the fiscal policy objectives and operating rules that shall apply over this period.

This means that the Treasury can, and should, modify the sustainable investment rule for the period over which Northern Rock has a material but temporary impact on measures of the public finances. It should state clearly what arrangements will be in place during this period. One way to retain the spirit of the sustainable investment rule would be to continue to aim to keep public sector net debt below 40% of national income, excluding the impact of Northern Rock. To measure outturns and plans against this objective the Treasury should publish measures of debt that exclude the impact of commitments made to Northern Rock, while it remains classified as a public corporation.

Last week, in the 2008 IFS Green Budget, we argued than on current policies it is more likely than not that the Government would breach the 40% ceiling anyway in the next few years, even in the absence of any Northern Rock effect.

What is the right policy response?

There is nothing sacrosanct about the 40% of national income debt ceiling, although it is clearly embarrassing for the Government to breach it. The Government should decide how to deal with Northern Rock by determining what is best for taxpayers and the long-term strength and stability of the banking system, not the impact on the fiscal rules.

Whether or not tax and spending decisions need to respond will depend on the long-term impact on public sector net debt, and whether there is any significant addition or subtraction once Northern Rock's future is resolved. For the time being the impact remains unclear, notably because the value of the Northern Rock's mortgage book is uncertain.

Does this affect the Government's chances of sticking to the golden rule?

No – the ONS has stated that the impact of the reclassification of Northern Rock on the current budget should be minimal.

Further information and contacts

For further information on today's public finance release please contact: Robert Chote, Carl Emmerson or Gemma Tetlow on 020 7291 4800, or email rchote@ifs.org.uk , cemmerson@ifs.org.uk or gtetlow@ifs.org.uk

For a discussion of the Government's fiscal rules see Chapter 3 of the January 2008 IFS Green Budget which was published last week (http://www.ifs.org.uk/budgets/gb2008/index.php)

The ONS press release announcing today's announcement is available at http://www.statistics.gov.uk/pdfdir/cnr0208.pdf. Background notes on the decision to classify Northern Rock and the Bank of England as part of the public sector are available at http://www.statistics.gov.uk/cci/article.asp?id=1938 and http://www.statistics.gov.uk/cci/article.asp?id=1939 respectively.

Statements by HM Treasury, the Bank of England and the Financial Services Authority relating to Northern Rock are available at http://www.bankofengland.co.uk/publications/northernrock/index.htm

The Code for Fiscal Stability is available at http://www.hm-treasury.gov.uk/documents/uk_economy/fiscal_policy/ukecon_fisc_code98.cfm

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