

# COVID-19: deficits, debt and fiscal strategy

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# The UK economic outlook

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The outlook is **precarious** and **uncertainty** massive.

Will discuss:

- A plausible main-case scenario
- Risks to the short-term outlook
- Risks to the long-term outlook



# Uncertainty mainly about:

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- Path of the **virus** and possible recurrences in UK and other countries
- Effectiveness of **social distancing** in workplace and possible future lockdowns
- The extent and duration of **government support**
- Survival of physical, network and (firm-specific) human **capital** through Covid-19 period



# NIESR May 2020 main-case forecast scenario

## Summary of the forecast

Per cent

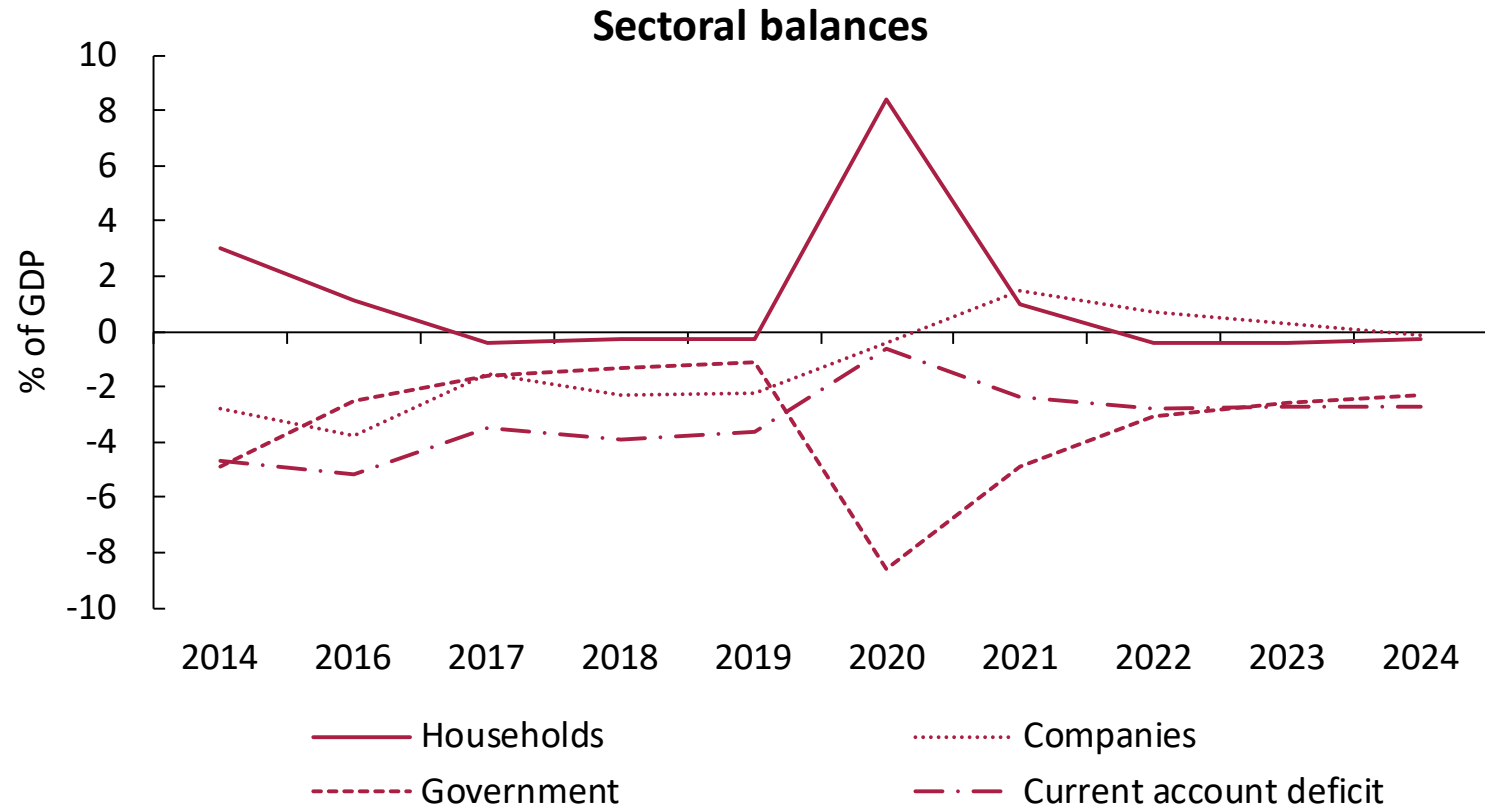
	Real GDP	CPI <sup>(a)</sup>	ILO unemployment	Bank Rate	External current balance	PSNB <sup>(b)</sup>
	annual growth	Q4/Q4	Q4	end-year	% of GDP	
2019	1.4	1.5	3.8	0.75	-3.8	2.6
2020	-7.2	1.7	10.5	0.10	-0.6	10.1
2021	6.8	0.5	5.8	0.10	-2.5	4.6

Notes: Calendar years unless otherwise stated. (a) Consumer price index. (b) Public sector net borrowing, financial years.

- This is a plausible scenario rather than a confident prediction,
- conditioned on gradual easing of lockdown from mid-May, with no significant recurrence of virus.
- Very large, **mainly downside** risks.



# Government deficit matched by household surplus



- Higher government borrowing is matched by higher private saving, so it is financed by borrowing from those unable to spend. National balance sheet largely unscathed.



# What has changed in last two months?

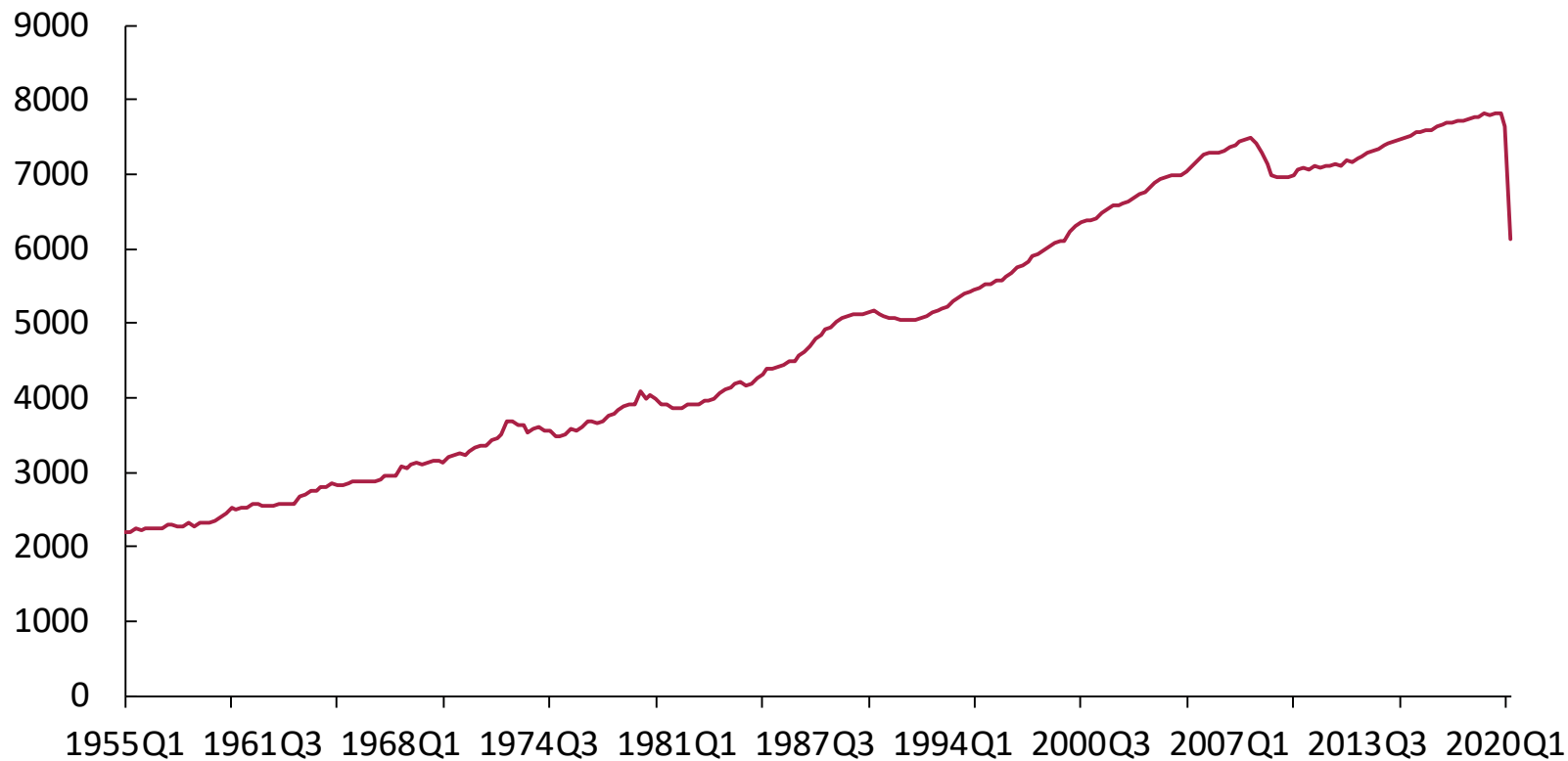
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- **Infection rate** fallen, but still present in community
- **Lockdown measures** have been progressively eased
- **GDP 25 per cent lower** in April than February
- **CJRS** extended to end-October. **9.2 million** jobs furloughed by 21 June, plus **2.6 million** self-employed
- **600k fewer paid employees** in May than March
- Around a **third** of workforce are working only from home
- Financial markets **no longer stressed**

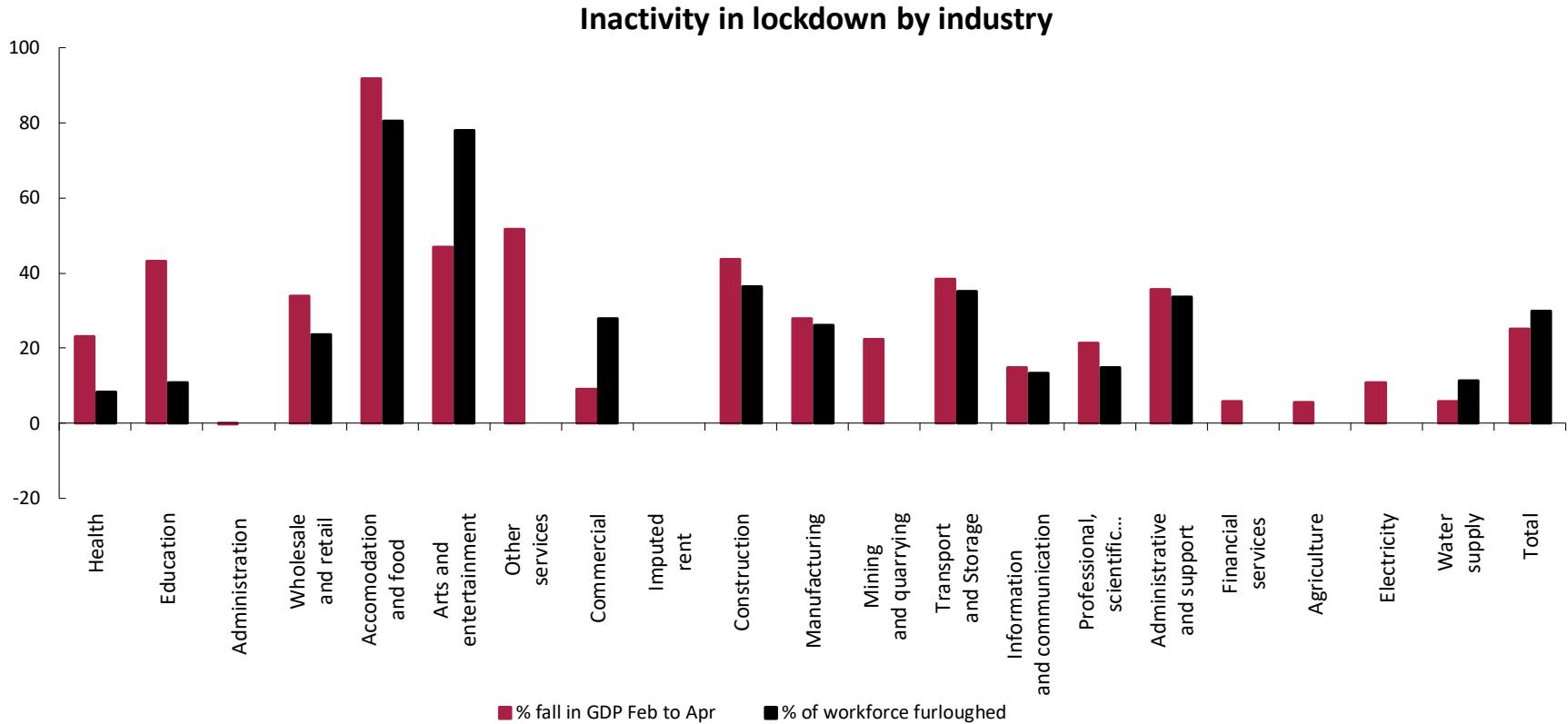


# GDP Per head in 2020q2 is at 1999 level

GDP per head (£ per quarter at constant prices)



# All industries affected, but to different extents





# Risks to short-term outlook

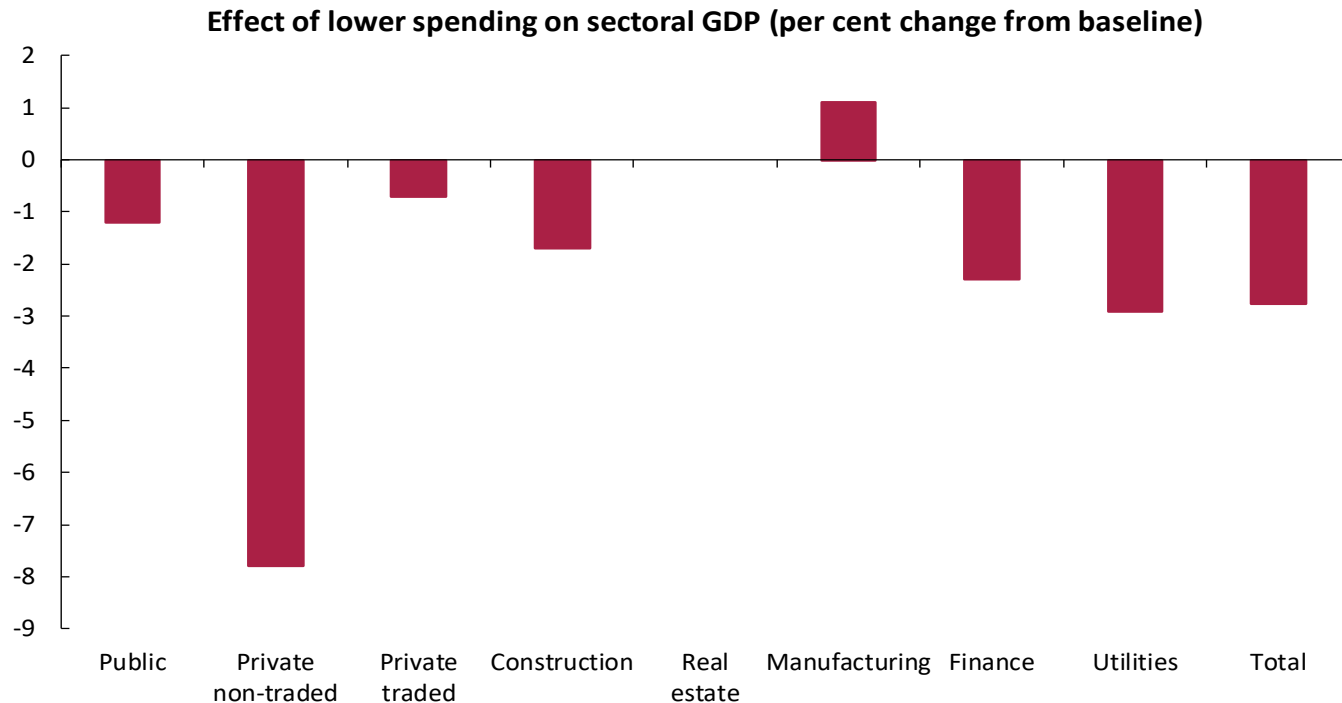
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- Is 25% hit to GDP as bad as it gets?
  - Maybe: but ONS estimate is uncertain and impact could be bigger in longer lasting lockdown.
- In scenario, GDP 7 per cent lower in 2020H2 v 2019H2
  - Spending affected by:
    - reduced business investment due to uncertainty
    - reduced exports due to measures in other countries
    - reduced activity in job-rich hospitality, arts and travel industries.



# Illustration of spillovers to other sectors

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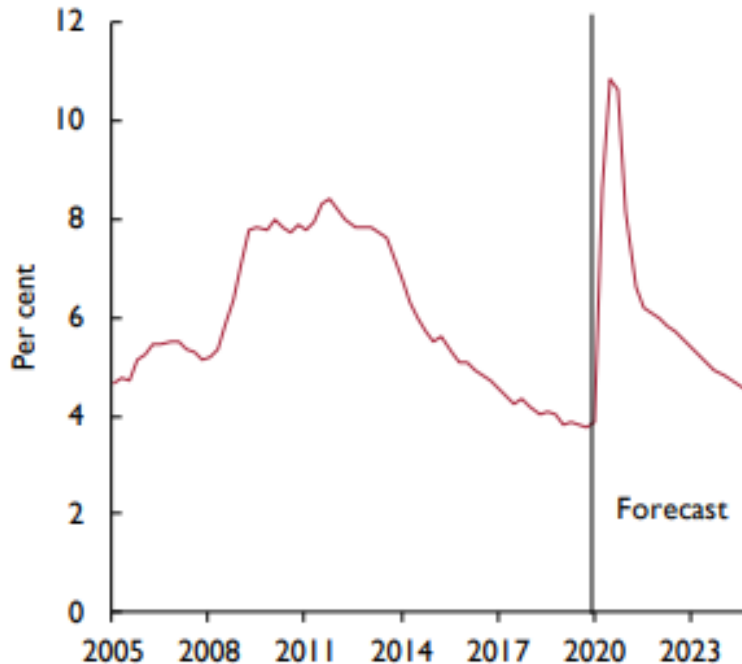


- Industry specific shock (in hospitality, arts and travel) could spill over to other sectors. Unlikely to be much reallocation of jobs across sectors in short term.



# Employment in second half of 2020

Figure 12. UK ILO unemployment rate and forecast



Source: NiGEM database and NIESR forecast.

If CJRS is not extended or replaced then unemployment could be over 10 per cent by end of year, largely due to job losses in hospitality, arts, travel and spillovers to other sectors. This would be highest since 1992-93.

Sectors most likely to be impacted by social distancing rules are relatively job intensive, especially accommodation and food (3% of GDP, 7% of jobs).



# Risks to long-term outlook

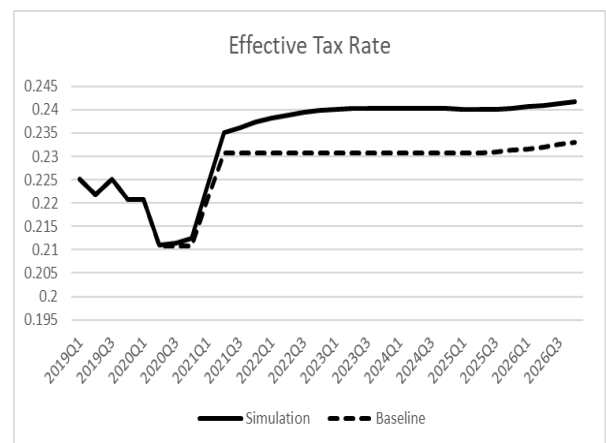
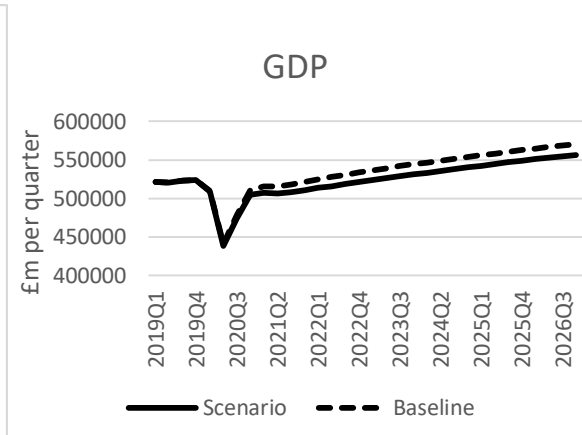
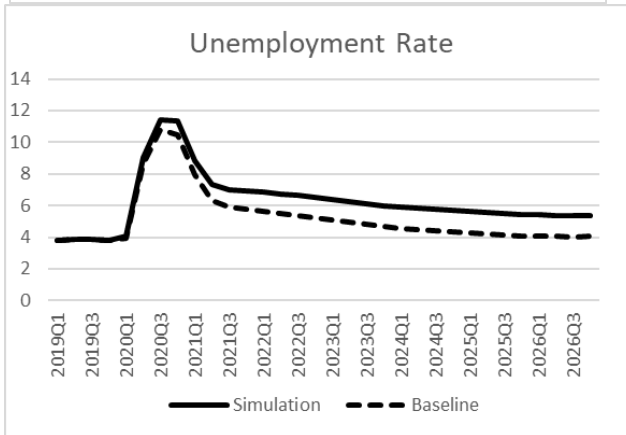
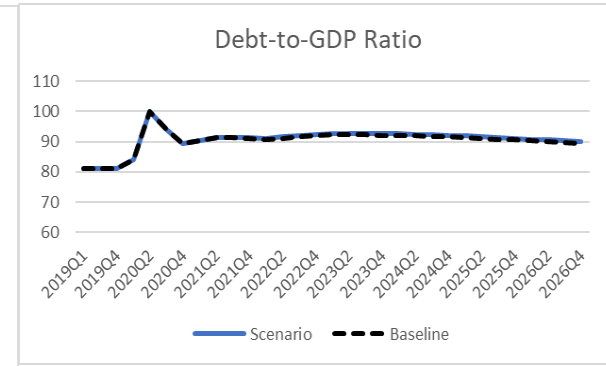
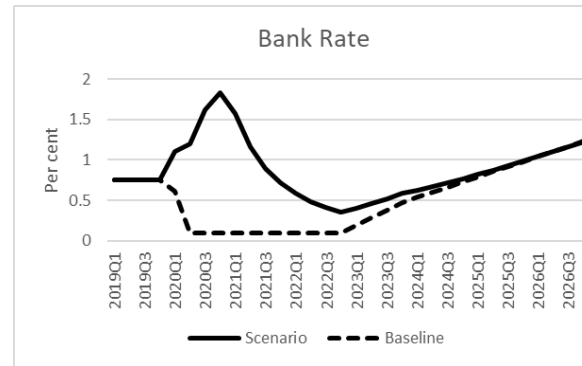
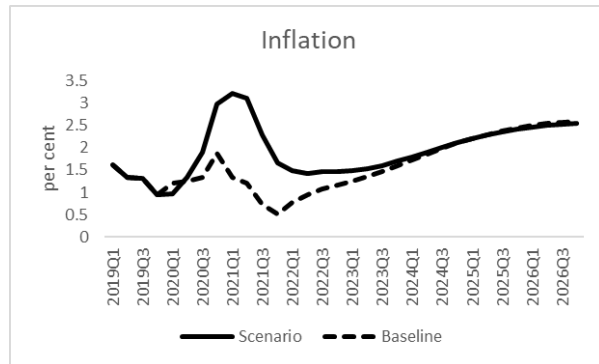
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- **Potential output** due to:
  - Changes to **labour supply** (+ to make up for lost time, - due to hysteresis)
  - Changes to **productivity** (- due to lost time, + due to creative destruction)
- **Demand** due to effects of:
  - changes in **private sector balance sheets** through crisis (+/-)
  - **fiscal response** to extra government borrowing through crisis (-)
  - **spillovers** from other countries (+/-)
- **Real interest rates** could revert to historical levels (note these are ultimately determined in global markets)
- **Inflation** upside risks should be largely contained by monetary policy remit. More concerning would be falling prices.



# Illustrative long-term scenario

What if productivity lower (by 1%) and NAIRU (1pp) higher as a consequence of withdrawal of fiscal support?



GDP lower than otherwise in long term (by 2.5%) and higher tax rates needed anyway.



# Summary

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- Economic outlook is **extremely uncertain** and depends critically on path of **Covid-19**.
- Even without recurrence, **recovery could be slow**.
- Important for policy to **limit transmission of economic shock** by continued support for businesses and households.
- Otherwise **risk of significantly worse long-term outlook that could be as costly as short-term support**.



# The public finances under the long shadow of Covid-19

Carl Emmerson

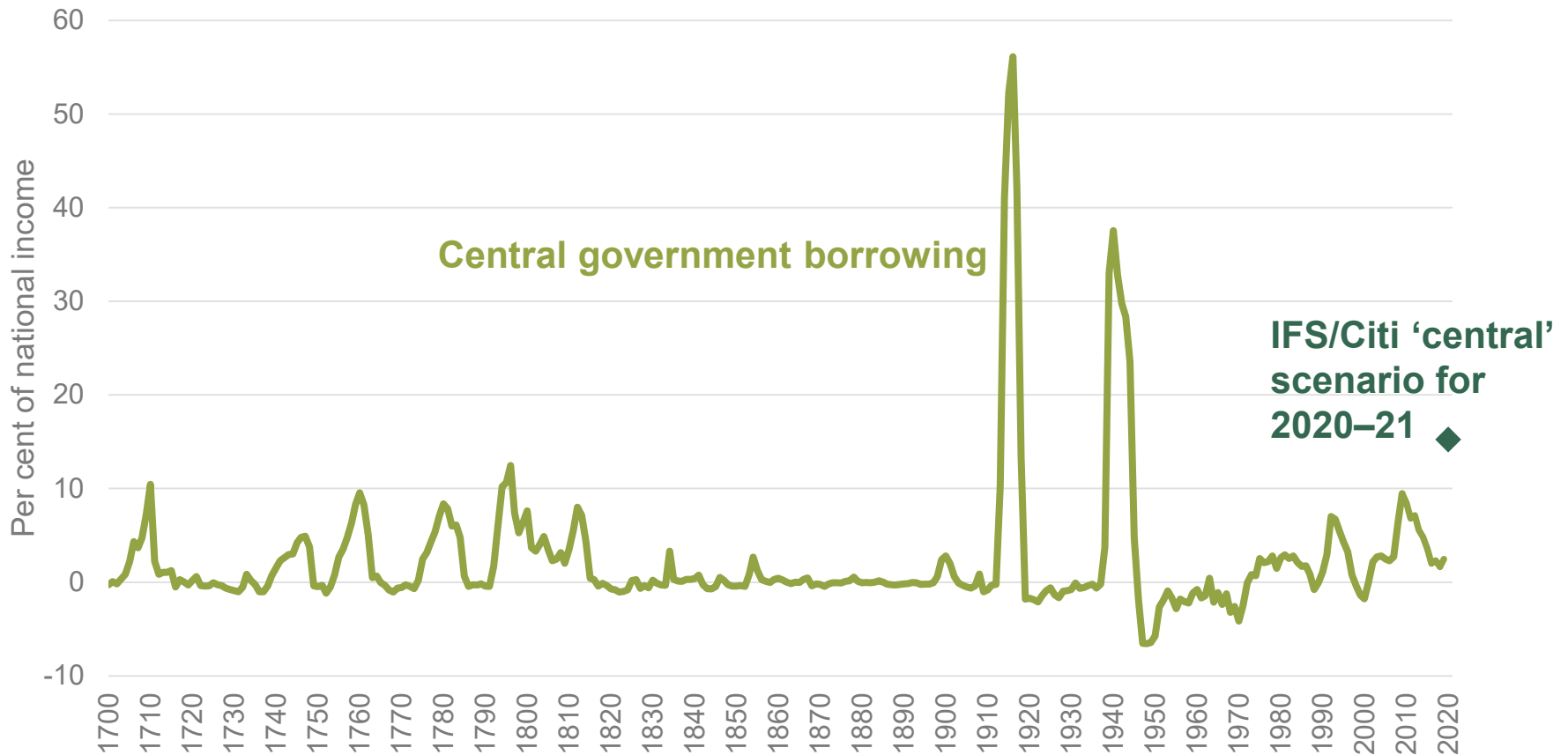
Based on joint work with Ben Nabarro and Isabel Stockton

Presentation at joint IFS-NIESR webinar “Covid-19: deficits, debt and fiscal strategy”

<https://www.ifs.org.uk/events/1832>

1 July 2020

# Borrowing to reach highest level seen outside of World Wars in 320 years



Notes: Calendar year until 1948. IFS/Citi 'central' scenario for 2020–21.

Sources: Bank of England, Office for Budget Responsibility.



# Deficit to remain elevated after this year's spike



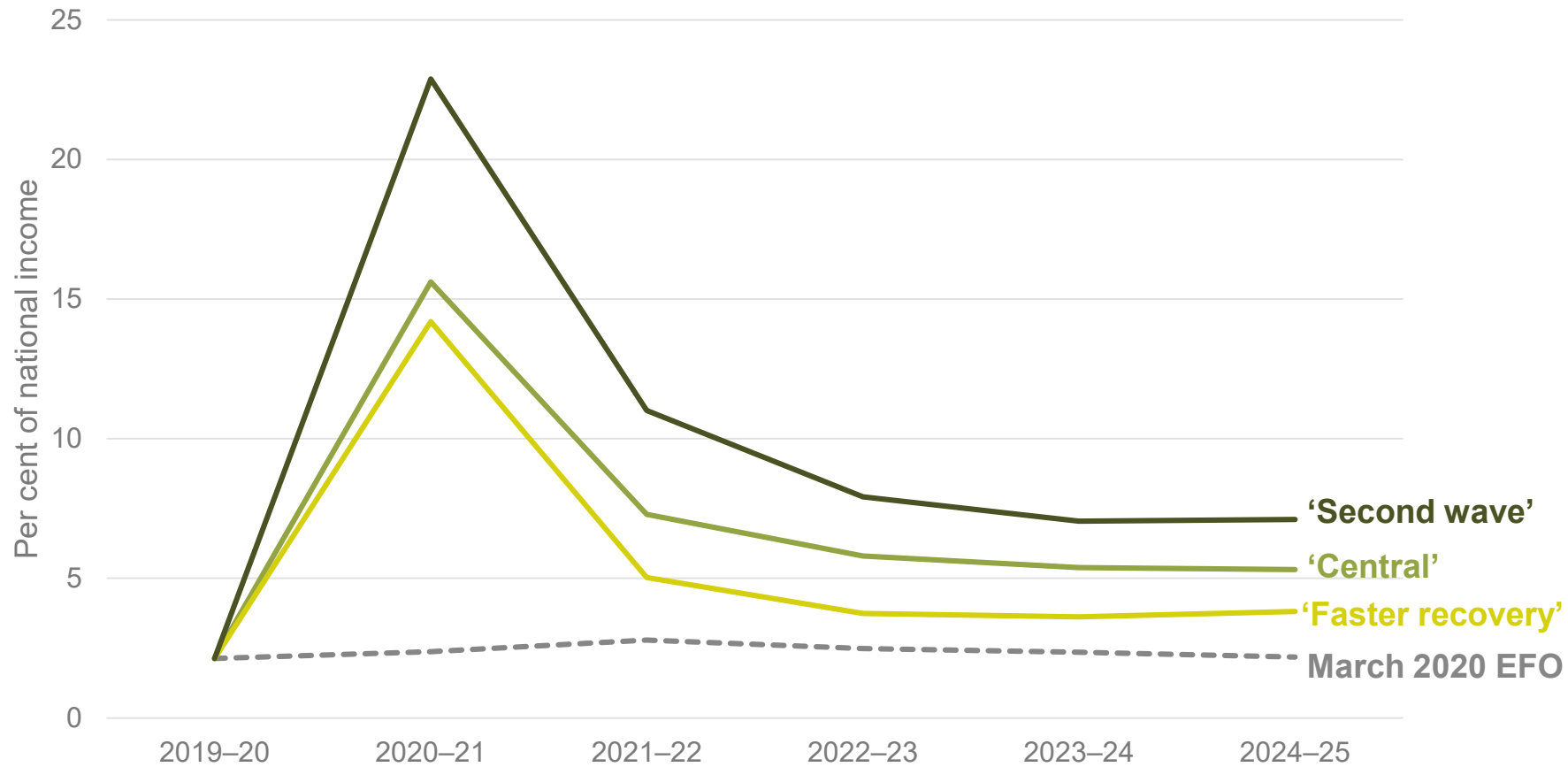
Notes and sources: See Figure 3 of Emmerson, Nabarro and Stockton (2020).

# Deficit to remain elevated after this year's spike



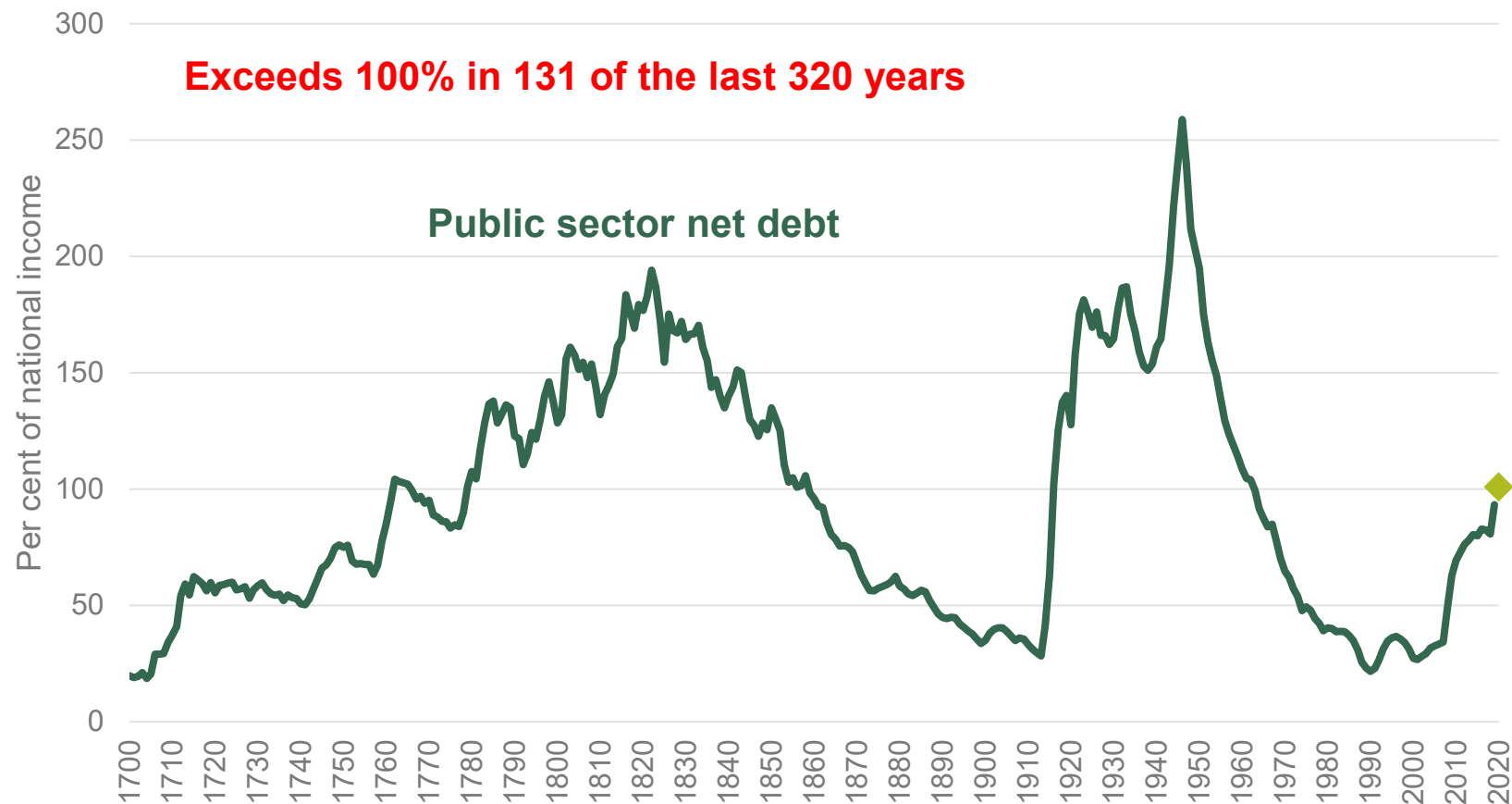
Notes and sources: See Figure 3 of Emmerson, Nabarro and Stockton (2020).

# Uncertainty around this – or indeed any other – forecast particularly high in present climate



Notes and sources: See Figure 4 of Emmerson, Nabarro and Stockton (2020).

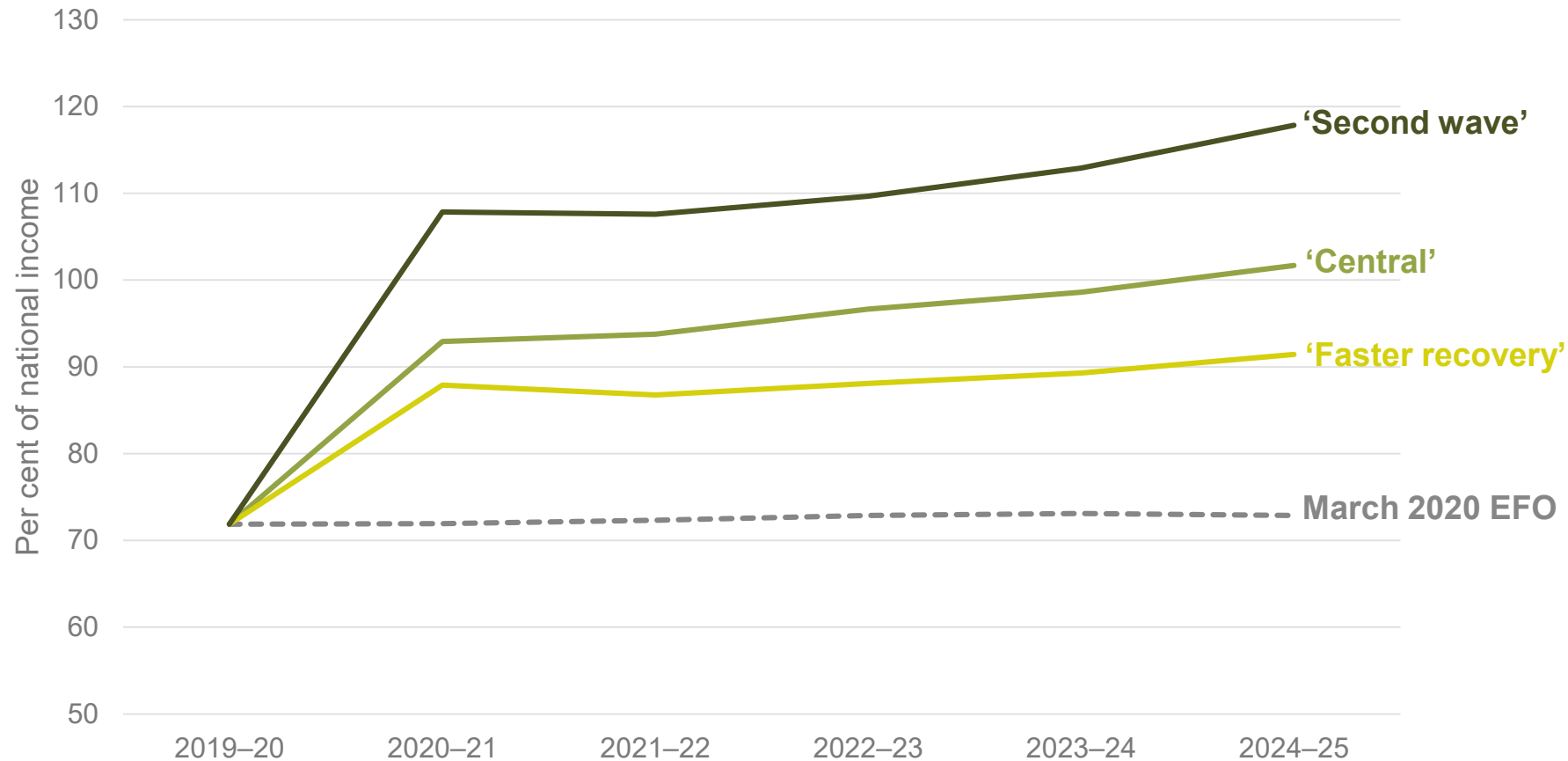
# Debt reaches its highest level since 1963, but not uncharted territory



Notes: Calendar year pre 1920, financial year post 1920. Includes Ireland pre 1920.

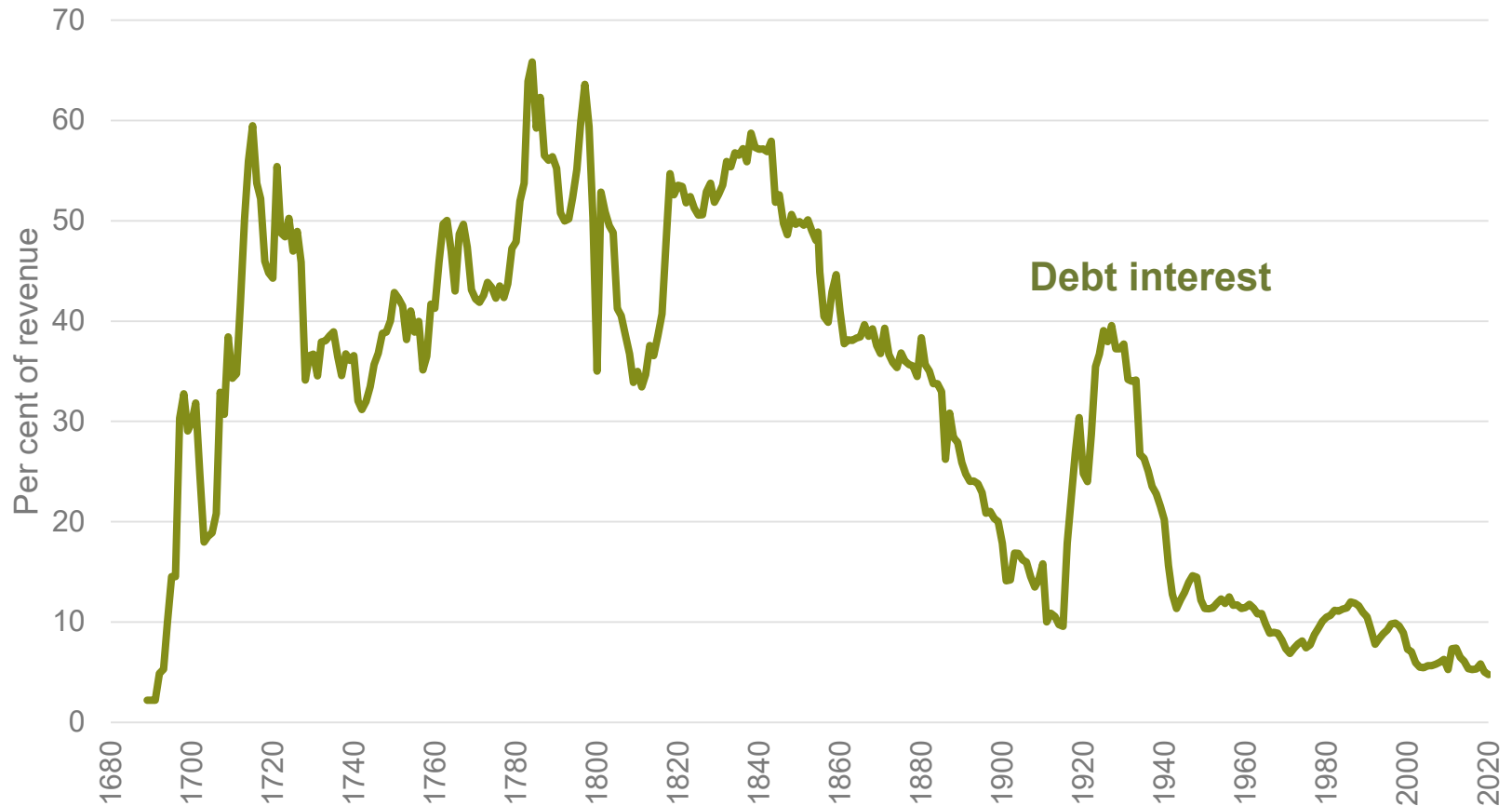
Sources: Bank of England, Office for Budget Responsibility, Office for National Statistics.

# Debt forecast to continue rising in all scenarios



Notes and sources: See Figure 4 of Emmerson, Nabarro and Stockton (2020).

# Debt interest as a share of revenues at a 320 year low



Notes: Financial year basis (breaks in length of financial year in 1751, 1800 and 1854). Excludes Asset Purchase Facility.  
Sources: Bank of England, Office for Budget Responsibility, Office for National Statistics.

# Conclusions

**Lockdown, and emergency support, to push borrowing to highest level ever seen in the UK outside of the two World Wars**

as these expire borrowing will return towards its pre-crisis path

**Debt pushed up levels not seen in almost 60 years, and will remain elevated for many years**

at least for now debt interest costs set to remain below that forecast pre-Covid

## **Key issues for fiscal policy:**

1) is there more we can and should do to strengthen the recovery, even if it means more borrowing now?

2) once crisis is over should taxes rise to help return borrowing towards its pre-crisis path and/or to finance any new desired increase in spending?

# Fiscal Strategies in Uncertain Times

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Jagjit S. Chadha

Joint NIESR-IFS Seminar

1<sup>st</sup> July 2020



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National Institute of Economic and Social Research



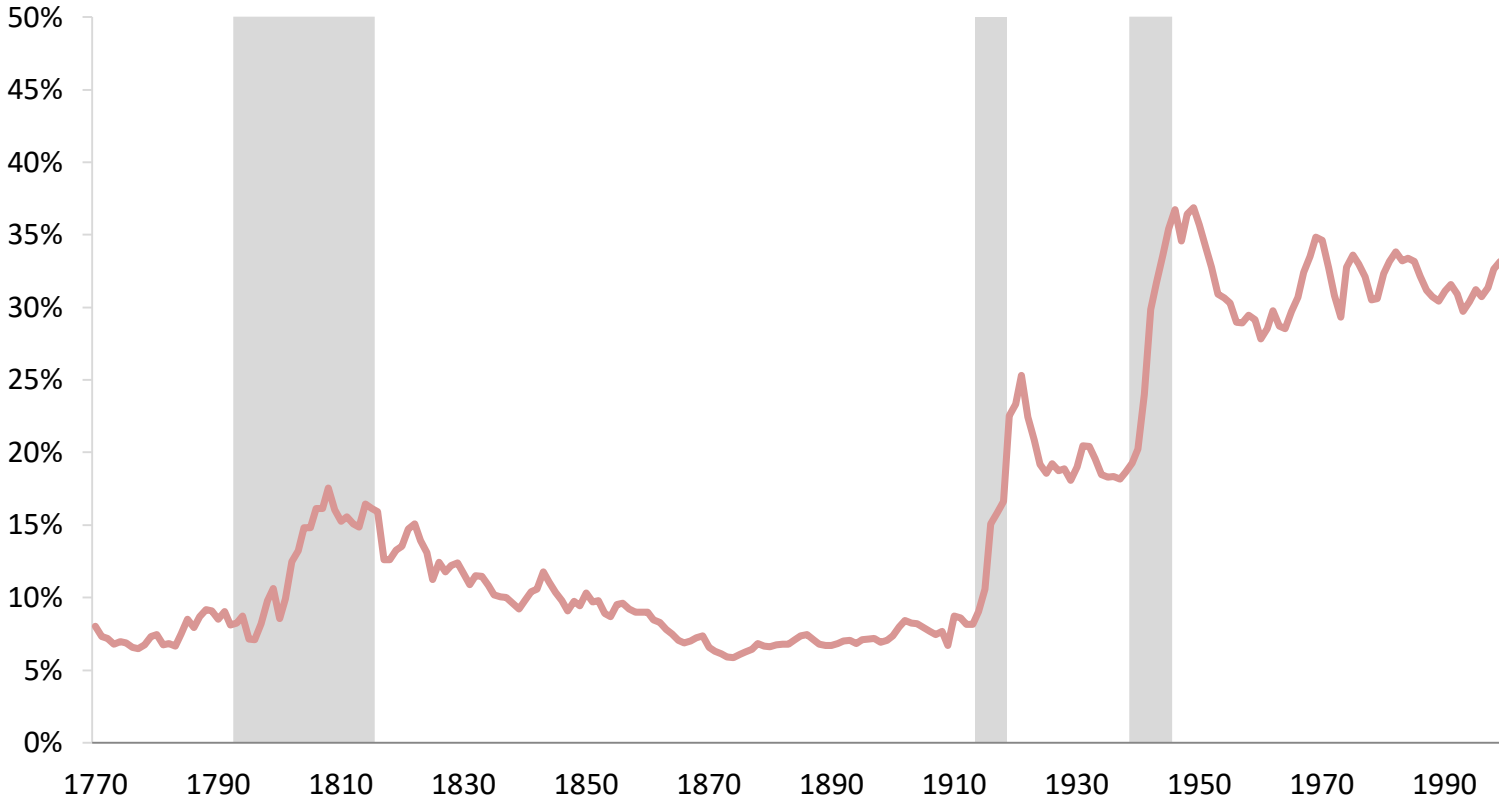
# A Framework for Debt

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- Public debt shares risk with future generations
- Control of debt fosters efficiency in the provision of debt but also maintains capacity to respond to future shocks
- Large expenditure shocks need to be met by tax smoothing
- Tools to reduce debt have been sequences of fiscal surpluses and nominal GDP growth
- Call for general social objective for fiscal policy
- Reform of instrument setting and timetables of revenue and expenditure plans, recognising inherent uncertainties



# Government revenue to GDP



# Debt Consolidations

Table I. Debt consolidations after WWI and WW2 (per cent)

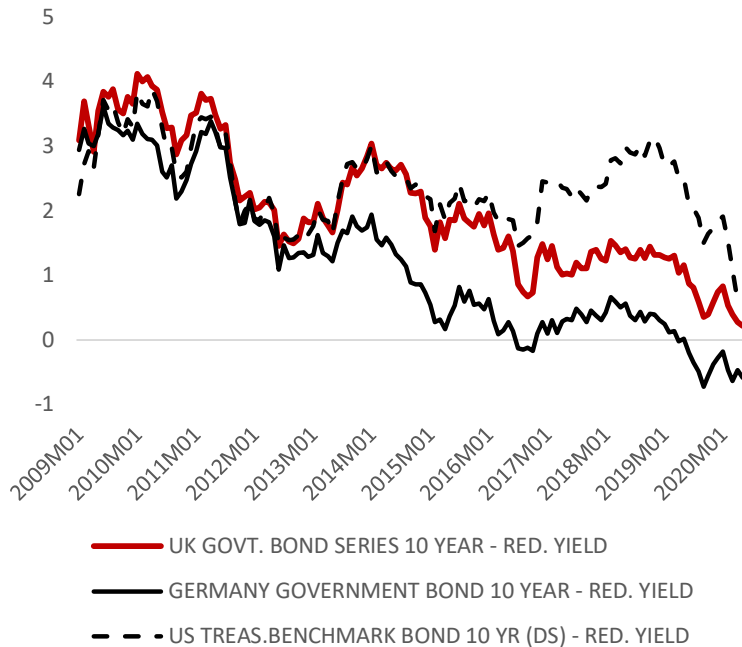
	$\Delta \frac{Debt}{GDP}$	$\bar{y}$	$\bar{\pi}$	$\bar{i}$	$\bar{s}$	$\bar{\varepsilon}$
	overall change	average contributions p.a				
1923–30	-18	-2.3	+1.0	+7.2	-7.6	-1.0
1950–60	-94	-3.4	-3.9	+4.6	-4.2	+1.0

Note: We show the overall magnitude of the fiscal consolidation in the 1920s and the 1950s and show the average contribution from the components of the debt dynamics equation.

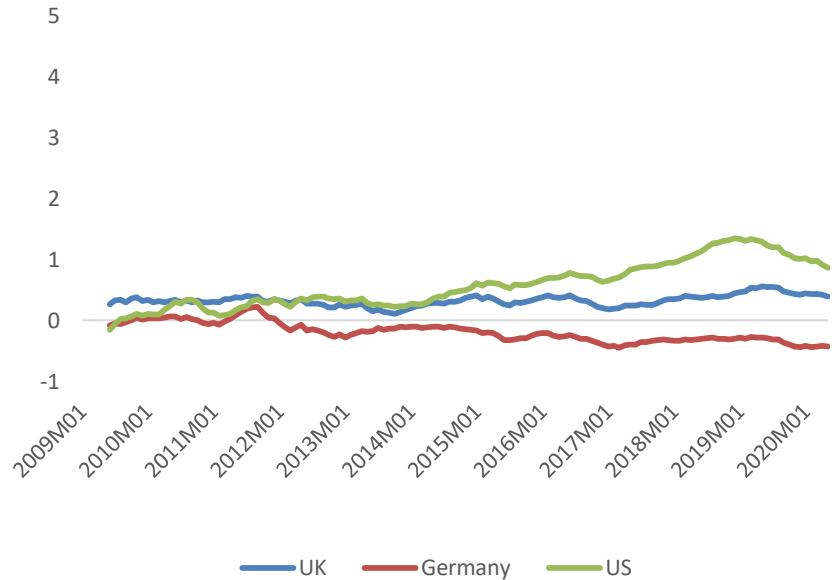


# Long Run Costs of Funding

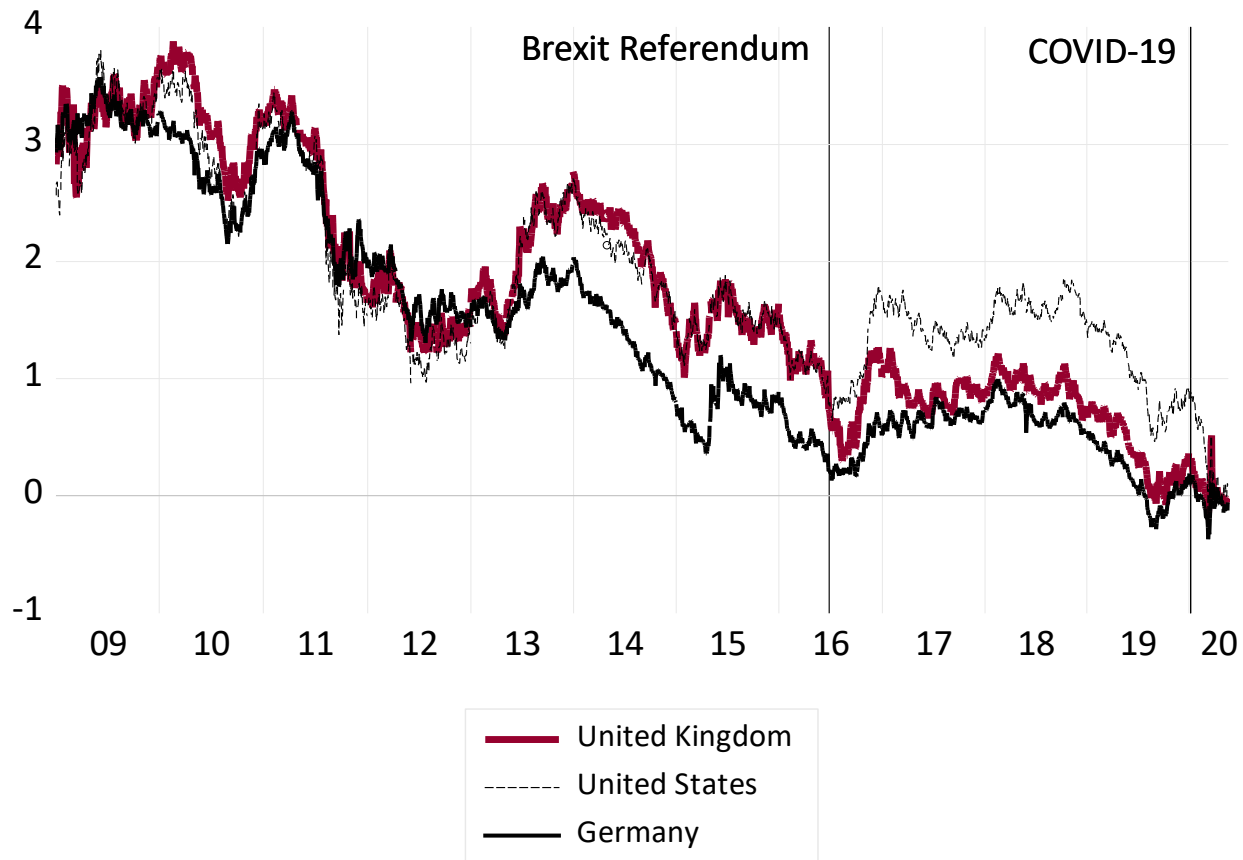
## 10 Year Government Yields



## Implied Risk Neutral Yields



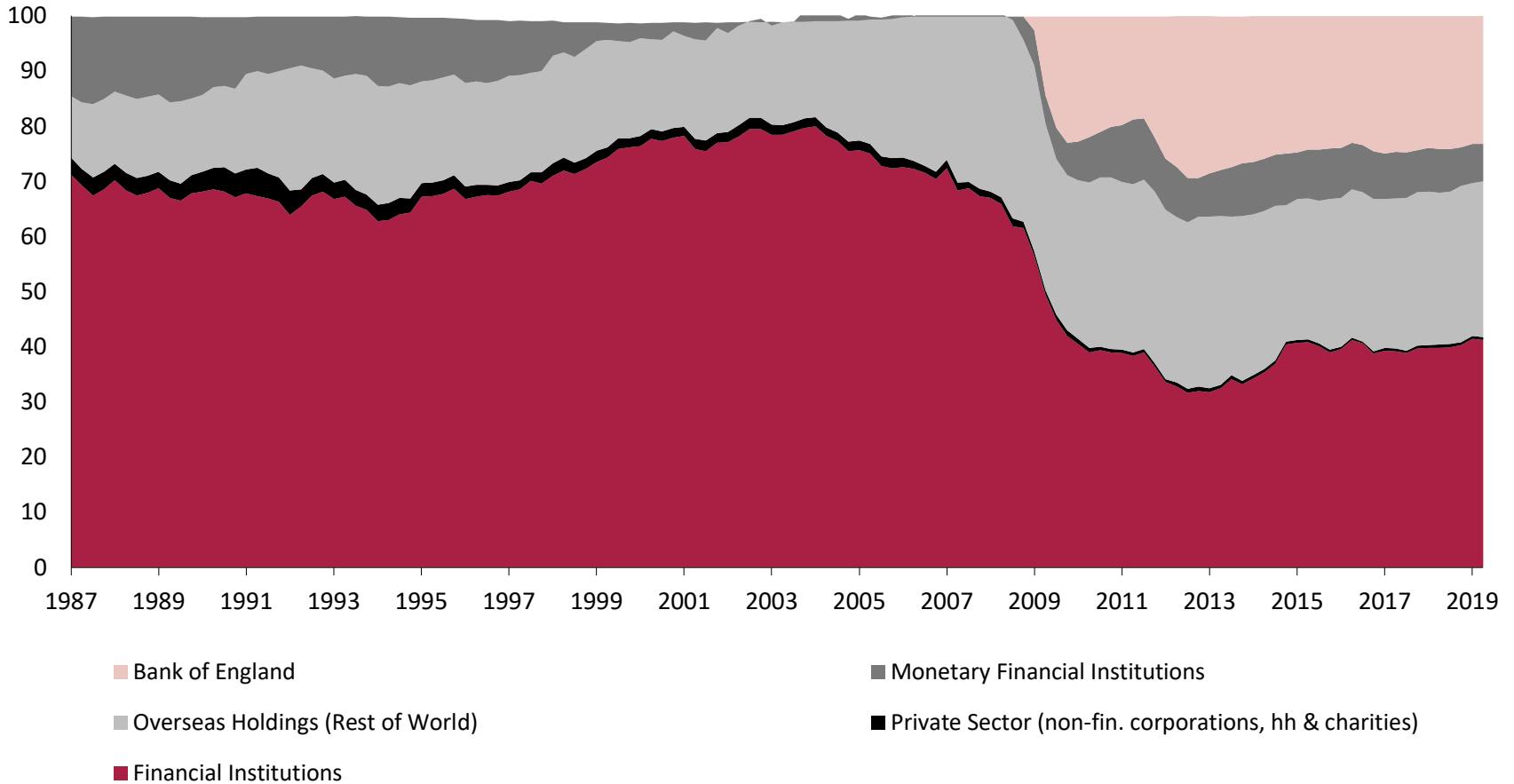
# Term Premia



Source: NIESR



# Holders of UK Public Debt



# Bonds Outstanding

## Bonds outstanding: total and currency composition<sup>1</sup>

Table 2

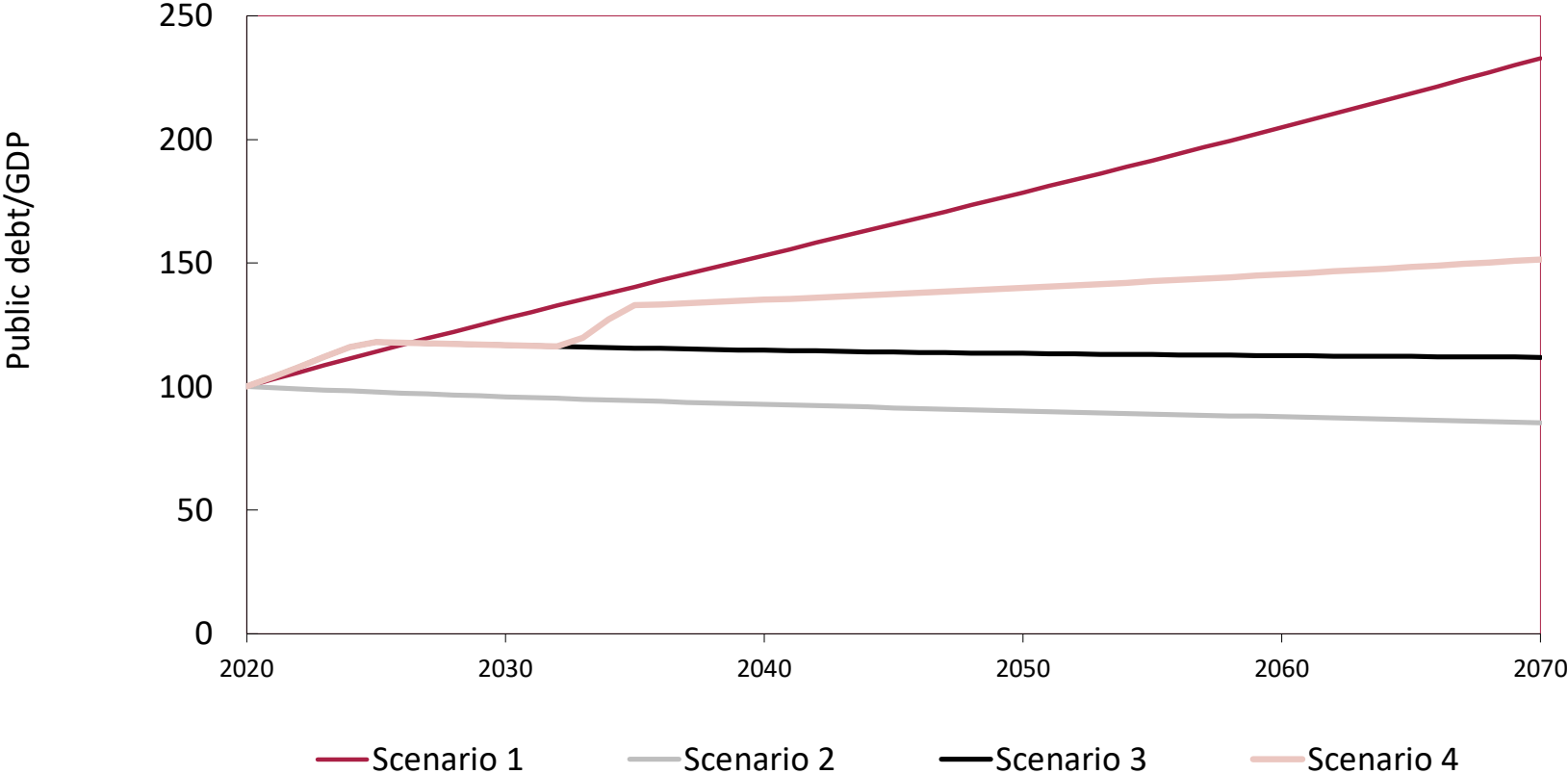
Period ending	Total amount <sup>2</sup>	Share in % of total		
		US dollar	euro	Pound sterling
2000	26.0	61.5	29.8	5.6
2005	44.1	55.0	36.7	5.5
2010	69.1	49.8	41.4	5.4
2015	72.2	58.6	32.3	6.7
2019	84.0	60.3	31.5	6.1

<sup>1</sup> Comprise international debt securities in all currencies (dollar, euro and sterling together comprise about 85% to 93% of total outstanding), domestic dollar debt securities in the US, domestic euro debt securities in the euro area and domestic sterling debt securities in the UK. Instruments such as bonds, medium-term notes and money market instruments are included. <sup>2</sup> Amounts outstanding in trillions of US dollars.

Sources: BIS Debt Securities Statistics; ECB statistics on euro area debt securities statistics; authors' calculations.



# Debt Dynamics





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