OCM Asset Management

Discretionary Asset Managers | Stockbrokers

Market Update: 19th November 2020

UK Borrowing Levels: Are We Concerned?

Concerns over the economic impact of a new four-week lockdown in England were quickly met earlier this month with fresh stimulus from the Treasury and the Bank of England, as policymakers announced coordinated action designed to show that they are prepared to do whatever it takes to support the UK economy throughout the pandemic. This time around, the restrictions are much less stringent than those implemented in March, however they are expected to drag on GDP in the fourth quarter of the year, with many businesses unable to operate, prompting a £150bn QE injection from the central bank and an extension to the government's furlough scheme until the end of March. At the same time, the government removed the requirement that firms must be temporarily closed due to lockdown restrictions and announced increases in grants for the self-employed, allowing more jobs to be saved.

But while recent support will provide a welcome temporary boost for UK businesses and consumers in the short term, the outlook remains fragile and further policy support could yet be required, particularly if the lockdown is extended. Given major question marks around the effectiveness of monetary loosening from here, fiscal policy may need to do more of the heavy lifting if more support is needed. This has prompted questions on what impact the recent surge in borrowing may have on the UK economy in the years to come.

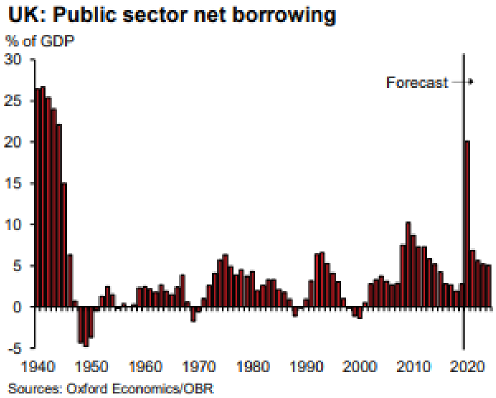
Rising Debt Levels

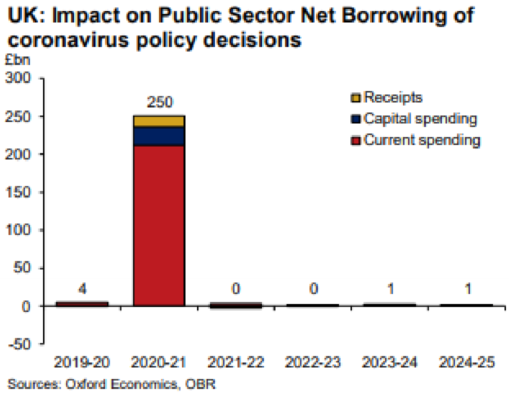
This fiscal year is likely to see the highest level of public sector net borrowing as a percentage of GDP since the end of World War II. The UK's net debt has reached its highest level as a share of GDP since the late 1950s, highlighting the unprecedented level of public spending so far this year on efforts to reduce the damaging economic impact of the pandemic, with more likely to come over the coming months. But looking past the near term, as the health outlook improves, once a durable economic recovery is underway, the fiscal stance will be shaped by two key factors:

- The political choices the government makes about the levels of deficits and debt it targets
- The degree of medium term scarring the economy suffers as a result of the recession

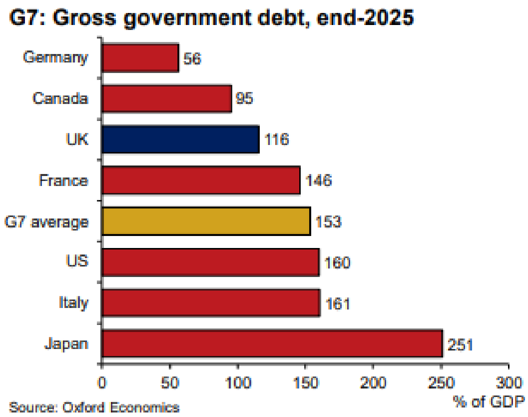
The Scale of Deficits

When analysing the current deficit and how this will be managed in future years, it is key to point out that virtually all of the present stimulus is temporary, meaning that although it is expected to add £250bn to the deficit this year, it will have virtually no impact on future years. Additionally, given the collapse in output, the automatic economic stabilisers have kicked in, leading to lower tax receipts and higher spending in areas such as welfare. As a recovery gets underway and activity picks up, the impact of the automatic stabilisers will reduce, and borrowing should come down.





Additionally, while fiscal tightening is likely to occur over the medium term to help stabilise the debt to GDP ratio, it is clear that there is little need for urgency. Debt servicing costs are expected to remain low, and the size of UK debt is set to remain well below most other G7 nations, with expectations that the debt to interest revenue ratio will remain well below the government's 6% limit. Political considerations favour stabilising the debt ratio over a more stretching period and target, with more aggressive fiscal tightening likely to threaten the government's election aim of 'levelling-up' the regions across the UK. At the same time, the damaging effects of the premature austerity of the 2010-2015 parliament are still fresh in the minds of many, and the government must fight a general election in 2024, therefore will be keen to avoid any politically damaging policy shifts.



The Degree of Scarring

When the fiscal impact of the economic stabilisers reverses, borrowing should come down. But progress in reducing the deficit and borrowing levels will depend largely on the degree of scarring the pandemic leaves behind and any drag it may have on long term growth. At this stage, the degree of scarring is difficult to judge. In the best-case scenario, scientific advances permit a rapid return to normality and a strong rebound in activity. In the worst-case scenario, the drag on demand from the slow removal of public health restrictions is compounded by a prolonged recession. Given recent vaccine developments and the activity bounce back observed in Q3, we are optimistic that vaccine rollouts will facilitate a faster return to normality in 2021. In all scenarios, we will need a level of stimulus on the recovery to support growth and prevent longer lasting economic scarring, with markets expecting further stimulus in the first half of 2021.

Where Next?

By postponing the budget until next spring, the Chancellor has bought some time to consider his options. By then, we should also have a better idea of the timetable for scaling back social distancing measures. It is our view that political motives and concerns about the fragility of the recovery will lead the Chancellor to opt for a more cautious course, aiming to stabilise the debt ratio over the medium term rather than taking the more aggressive course to balance the current budget. The expectation that debt servicing costs will remain low means that the government can let the recovery become well established before acting, and then move more gradually. For this reason, we are not concerned about the current level of borrowing, and expect to see further fiscal stimulus over the coming months as the country emerges from the pandemic, aided by vaccine developments and evolving business practices.