Chief Economist's Note

UK public finances need fixing, but so do the rules that bind the Treasury

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This will be a big week for the UK economy. On Thursday, the Bank of England’s Monetary Policy Committee (MPC) will meet to set interest rates. Only a few months ago it had seemed that this would be the meeting at which policymakers might start to cut interest rates. However, a combination of stronger activity data and stubbornly persistent services inflation means that the first cut is now more likely to come at September‘s meeting. Even so, if the MPC is to move in September then it is likely to start laying the groundwork at this week's meeting. With this in mind, the split votes on the MPC will be critical.

Rachel Reeves to show her cards

The second major event of this week happens today when the new Chancellor, Rachel Reeves, makes her first statement to the House of Commons since taking office. This will provide some idea of the government's priorities when it comes to economic policy.

The new team at the Treasury have been laying on the gloom pretty thick since the election. Reeves has even stated that she has been bequeathed the worst economic inheritance of any incoming government since the Second World War. This gloom has been motivated more by political positioning than economic reality, reflecting efforts to manage the expectations of both an electorate that voted for change and backbench MPs who are clamouring to loosen the purse strings.

With that said, it is clear that the government will have to run a tight fiscal ship. Public debt is currently running at 99.5% of GDP – the highest since 1962 . Accordingly, Reeves' speech will be important in setting the government's overall approach to fiscal policy. A key part of this will be the rules that she chooses to anchor tax and spending.

The UK's fiscal rules are a mess

The Blair government introduced fiscal rules in 1997 to impose discipline on its tax and spend. They were left alone for their first 10 years but governments since the Global Financial Crisis couldn't manage to resist tinkering with them. Given the UK is on its ninth set of fiscal rules in 16 years, it would be wrong to say that addressing the whole framework is overdue. It would nonetheless be welcome. Since November 2022, the primary fiscal rule has stipulated that public debt should be falling as a share of national output between the fourth and fifth year of the forecast horizon of the Office for Budget Responsibility, the UK's fiscal watchdog. This is madness. Not only is the choice of a four-to-five year horizon arbitrary but forecasts this far out are notoriously uncertain. Anchoring fiscal policy like this not only makes little sense but can also force the government into changing its fiscal plans in response to small changes to the forecasts for variables such as economic growth, inflation and interest rates.

We set out ways in which the fiscal rules could be reformed in a recent note. An improved set of fiscal rules should seek to do three things: it should bring down public debt as a share of GDP over the medium term; it should allow governments room to borrow in order to invest; and the rules should allow some flexibility within them. In particular, the amount of headroom that the government has against meeting its fiscal rules should not be tied to a particular point forecast several years ahead.

Were it drawn up from scratch, an improved fiscal framework would require the government to balance the current budget (i.e. excluding capital expenditure) over the economic cycle and have a supplementary rule stipulating that debt as a share of GDP must fall over the term of the parliament. Crucially it would also embed thresholds around targets in order to provide flexibility and ensure that the government isn't held hostage to small changes in forecasts.

Treading carefully

In the event, all of this may be too big a change for a Chancellor keen to burnish her fiscal credentials. If so, an easier win would be to alter the definition of public debt within the fiscal rules to exclude profits and losses arising from the Bank of England's Asset Purchase Facility (APF). This is the vehicle that was set up by the Bank to make purchases of bonds as part of its quantitative easing program. It used to bring in significant profits because the bonds that the Bank bought paid a coupon but the commercial bank reserves that it created to purchase them were remunerated at Bank Rate, which for a long time was 0% or close to 0%.

However, the APF is now a source of significant losses. This is because. as interest rates have increased, so the amount the Bank has to pay on the reserves created to purchase bonds has also increased. These rates now exceed the coupons that the Bank receives on the bonds it holds in the APF. Also, because many of the bonds bought by the Bank were purchased above par, the Bank has been hit with capital losses as they mature.

Crucially, the government compensates the Bank for losses incurred via the APF, which in turn reduces the fiscal headroom that it has against its rules. Just over £60bn has been transferred from the Treasury to the Bank to cover these losses since October 2022.

Admittedly, excluding the APF from the measure of public debt used in the fiscal rules would leave the government open to accusations of cherry picking, since it happily received remittances from the APF in years that it made a profit. But there are few good economic reasons for the operations of the APF to be a binding constraint on fiscal policy, not least because central banks are not like commercial banks and so can run significant losses for long periods of time. At the same time, adjusting the measure of public debt to exclude the APF would be unlikely to create a backlash in markets and would increase the government's headroom against its main fiscal rule, perhaps by about £17bn.

As it happens, this would be sufficient to cover almost all of the shortfall in the government's budget plans that Reeves is rumoured to disclose today. It appears that she intends to plug this gap with tax increases but, with the tax burden already at its highest level since the Second World War, a better alternative would be to make this modest adjustment to the fiscal rules.

Not everything is fiscal

Yet while this week's focus will be on the stance of monetary and fiscal policy, it's important to keep in mind neither are major impediments to improving the long-term performance of the UK economy. As I argued in a recent note, the key to raising GDP growth lies in a set of supply-side reforms aimed at lifting the UK's perilously low rate of trend productivity growth. Many of these, most notably those related to planning, incur little or no fiscal cost.

So while the bond markets will naturally focus on what the Chancellor has to say about the direction of fiscal policy and the rules that anchor it, and what the Bank of England has to say about the future path of monetary policy, the real challenges lie elsewhere.

In case you missed it:

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