**Lingfield College: 13 December 2024**

**Slide 1 – Opening Remarks**

Good morning, everyone. It’s a pleasure to be here. My name is Damian Pudner, an economist and visiting lecturer, and today, I’ll be guiding you through one of the most critical and, at times, controversial aspects of economic policy — deficits and national debt.

We’ll discuss how these concepts have evolved over time, their significance today, and the challenges they pose for the UK as we look to the future. By the end of this session, I hope you’ll have a clearer understanding of what’s at stake and the trade-offs that policymakers face as they navigate these fiscal waters.

**Slide 2 - Historical Context**

Let’s begin by taking a step back and examining the historical role of deficits and debt.

Historically, deficits were seen as extraordinary measures—used sparingly, in response to events like wars or major economic crises. They were, in essence, a temporary solution to exceptional problems.

However, over the past 30 years, this perspective has shifted. Deficit spending has become more normalised and a regular feature of government policy. Since the 2008-09 Global Financial Crisis, public spending has risen consistently, and with it, deficits and debt. Low interest rates have made this transition easier to accept, as governments could borrow cheaply without raising alarm bells.

More recently, however, the narrative has shifted again. Rising inflation, alongside the ongoing cost-of-living crisis, has placed deficits and debt firmly back in the spotlight.

During the Covid-19 pandemic, government borrowing surged to fund public health measures and economic support. As a result, UK debt levels today are comparable to those last seen in the early 1960s.

However, the cost of servicing this debt has now become a pressing challenge. Debt interest alone accounts for 10% of all government spending, a burden exacerbated by central banks raising interest rates to combat inflation. This raises fundamental questions about sustainability. People are asking, how long can we maintain this level of borrowing in a high-interest environment? And what does this mean for fiscal policy moving forward?

**Slide 3 – Understanding Government Deficit and Debt**

To ground our discussion, we need to clarify two key terms at the outset: deficit and debt.

The deficit is an annual figure. It measures the shortfall when government spending exceeds revenues in a given year. Think of it as the yearly gap between what’s coming in and what’s going out.

Debt, on the other hand, is the cumulative total of all those annual deficits over time. It’s the sum of what the government owes, often referred to as the national debt or public sector debt. So, while the deficit reflects the current year’s fiscal stance, the debt shows the accumulation of borrowing over many decades.

As of 2023/24, the UK’s Public Sector Net Debt (PSND) stands at £2.7 trillion, or roughly 98% of GDP. To put that into perspective, the figure is equivalent to about £38,000 per person or around £90,000 per taxpayer. As you can see, these numbers underscore the scale of the challenge we face.

To further complicate matters, the government has recently shifted to a new debt metric called Public Sector Net Financial Liabilities (PSNFL). Unlike PSND, PSNFL includes government assets, such as equity holdings and expected student loan repayments, offering a more comprehensive view of the public sector’s financial position. While this change provides additional context, it also highlights the growing complexity of assessing debt sustainability. But more on that later.

**Slides 4 - Current Fiscal Landscape**

This slide brings us to the present fiscal reality in the UK. Budget deficits remain at historically high levels, largely due to pandemic-related spending, but the root causes extend far deeper.

The three largest spending areas—welfare (which includes pensions), healthcare, and education, consume 64% of all public expenditure. Add to this the 10% spent on debt interest, and you’ll find that nearly three-quarters of government spending is locked into these areas.

This raises fundamental questions: Can we sustain this level of deficit spending over the long term? And if economic growth remains sluggish or interest rates rise further, what trade-offs will we need to make?

**Slide 5 – Graph (Govt Spending in Financial Year 2023/24)**

**Slide 6 - How Big is the Current Budget Deficit?**

So how big is the current budget deficit? Well, for 2023/24, government revenue is projected at £1.1 trillion, largely generated through taxation, while spending stands at £1.22 trillion, resulting in a budget deficit of £120 billion, equivalent to roughly 4.4% of GDP. For comparison, the United States has a much larger deficit of $1.8 trillion, or around 6.2% of its GDP.

While significant, this figure is not unprecedented in historical terms, ranking as the 18th largest deficit since 1948.

To make this more relatable, the £120 billion shortfall translates to roughly £1,800 per person in the UK. Framing the deficit in this way helps us understand its tangible implications for individuals and households.

The critical takeaway here is that deficits don’t always lead to an immediate rise in the debt-to-GDP ratio. If economic growth outpaces borrowing, the ratio can actually decline. This highlights the importance of policies that promote sustained economic growth. Something the new Labour government is very keen to pursue.

The key question then for the chancellor is what strategies or policies could help narrow this gap or ensure that economic growth outpaces borrowing?

**Slide 7 - UK National Debt Historical Perspective**

To fully appreciate the UK’s current debt situation, it’s essential to look back at the historical trends that shaped it. These trends reveal not only the scale of today’s challenges but also the forces—both domestic and global—that have influenced fiscal policy over time.

At the start of the 20th century, the UK’s national debt was relatively modest, standing at just under 40% of GDP. This reflects the limited role of government spending in the economy at that time. However, the First World War triggered a dramatic shift. Financing the war effort caused debt to surge to over 140% of GDP, underscoring the immense financial strain that major conflicts impose.

This pattern was repeated, but on an even larger scale, during the Second World War, where debt soared to a historic peak of just over 250% of GDP—the highest level ever recorded in the UK. This extraordinary figure highlights the sheer cost of wartime spending, as well as the enormous fiscal challenges the government faced in rebuilding the post-war economy.

What followed, however, was a period of sustained debt reduction. From the 1950s through the 1970s, the UK benefitted from strong economic growth and disciplined fiscal management. By the early 1970s, debt levels had fallen to around 60% of GDP, and by the 1990s, debt reached a 20th-century low of just over 20% of GDP. This was a time of relative economic stability, supported by prudent financial policies and a growing economy.

But then came the 2008 Global Financial Crisis, a turning point that reshaped fiscal policy in the UK and beyond. The crisis necessitated substantial government intervention to stabilize the financial system, bail out banks, and stimulate economic activity. As a result, debt levels rose sharply, reaching 85% of GDP by 2019.

The Covid-19 pandemic added another layer of unprecedented fiscal pressure. To fund public health measures, business support schemes, and stimulus programmes, the government borrowed heavily, pushing debt to nearly 100% of GDP, roughly where it stands today.

One critical factor that has facilitated this rise in debt over the past 15 years has been the prolonged period of historically low interest rates. These low rates made borrowing relatively inexpensive, allowing the government to manage higher debt levels without immediately unsustainable costs. However, with rising interest rates, this dynamic is beginning to shift, adding urgency to discussions about debt sustainability.

This historical perspective offers two key insights. First, external shocks—whether wars, financial crises, or pandemics—have consistently been the primary drivers of significant increases in national debt. Second, while borrowing can provide vital support during times of crisis, it underscores the need for a delicate balance: meeting immediate fiscal needs while safeguarding long-term sustainability. Understanding this balance is essential as we navigate today’s fiscal challenges and consider what lessons history can offer for the road ahead.

**Slide 8 – Graph (Public Sector Net Debt)**

**Slide 9 – Graph (UK % Debt-to GDP vs. EU Member States)**

**Slide 10 - The Current Debate on Govt Debt**

Today, you cannot read the financial press or social media without hearing someone mentioning escalating government debt and voicing concern and warnings about its potential consequences. You just need to look at Elon Musk’s twitter feed to see how vocal he is on the topic as he prepares to run the Department of Government Efficiency (DOGE).

For its part, the Bank for International Settlements, the central bankers bank, has taken a particularly stark stance, cautioning that if governments fail to address their rising deficits, they risk triggering widespread financial instability. This isn’t just a domestic issue for individual nations—it poses a threat to the stability of the entire global financial system.

So, what exactly is the risk? At its core, financial markets rely on trust—trust in a government’s ability to manage its debt sustainably. If this trust is undermined, we could face what the BIS describes as a “wake-up” moment: a sharp and sudden rise in bond yields, which are the interest rates investors demand to lend money to governments. This kind of shift would have profound ripple effects, extending far beyond the bond market.

To understand why bond yields matter so much, we need to consider their role in the financial system. Government bonds act as benchmarks for the pricing of a wide range of other assets. For example, a sharp rise in US bond yields wouldn’t just affect the United States—it would reverberate across global financial markets. Corporate borrowing costs would increase, mortgage rates could rise, and the broader economy would feel the strain.

Already, there are warning signs of growing stress. Investors are becoming increasingly uneasy about the rising supply of public debt, driven by concerns over whether governments have credible strategies to manage it sustainably. Without clear and decisive fiscal policies, this discomfort could translate into reduced demand for bonds or higher borrowing costs, compounding the problem.

The BIS’s message is clear: highly indebted countries must act now to rein in their deficits. Failure to do so risks reaching a tipping point where restoring fiscal balance becomes not just difficult but potentially impossible. This isn’t just about economics—it’s about preserving the trust and confidence that underpin global financial markets.

The broader lesson here is that proactive debt management is essential. Governments must strike a delicate balance: stabilizing their economies today while ensuring that their fiscal policies do not erode the trust and stability of the financial system tomorrow. For policymakers, this debate is a stark reminder of the urgency of addressing rising debt—not just to safeguard their own economies, but to protect the global system as a whole.

**Slide 11 – Graph (Global Debt has hit Record Highs) comment on 44% increase over 8yrs.**

**Slide 12 - Trends in UK Govt Borrowing**

Taking a long-term perspective on UK government borrowing reveals intriguing patterns that shed light on the evolution of fiscal policy. Borrowing, it’s worth emphasizing, is not inherently unusual. Governments routinely use it to manage economic cycles, fund essential public investments, and respond to crises. However, what stands out in the UK’s case is how infrequent budget surpluses have been. Remember, a surplus is when government revenues exceed expenditures.

Since 1970/71, the UK government has recorded a budget surplus in only five financial years, with the most recent one occurring over two decades ago in 2000/01. This means that running deficits—where spending exceeds revenue—has become the norm for UK fiscal policy. To provide some context, the average annual deficit over this period has been about 3.7% of GDP, while the current deficit of 4.4% of GDP sits just above this historical average.

Now let’s consider some of the key periods when deficits have spiked. These episodes provide valuable insights into how fiscal pressures often coincide with major crises:

**The Mid-1970s**

This was a period of acute economic turmoil. High inflation, the oil crisis, and widespread industrial unrest severely impacted the economy, pushing up government borrowing as revenues dwindled and costs rose.

**The Early 1990s Recession**

A deep economic downturn during this period led to falling tax revenues and increased government spending on welfare and other support measures, further exacerbating deficits.

**The 2008-09 Global Financial Crisis**

This was a defining moment for modern fiscal policy. In response to the collapse of the financial system, the government borrowed heavily to stabilize the economy, bail out banks, and stimulate growth. The crisis fundamentally reshaped public borrowing trends.

**The Covid-19 Pandemic (2020/21)**

The pandemic necessitated unprecedented levels of government borrowing, resulting in a record-breaking deficit. The government introduced large-scale interventions to protect jobs, businesses, and public services, with borrowing reaching historic levels.

These episodes illustrate a recurring pattern: government deficits tend to surge during crises—whether economic, financial, or global in nature. Borrowing during such periods is often necessary to stabilize the economy, but it also raises important questions about fiscal sustainability.

The critical challenge we face now is determining whether today’s deficits are still a reflection of extraordinary circumstances—such as the pandemic’s lingering effects—or whether they point to a deeper, structural reliance on borrowing. If deficits have become ingrained in the fabric of fiscal policy, addressing them will require more than just recovery-driven strategies; it will demand structural reforms and forward-looking fiscal planning.

This question—whether deficits are cyclical or structural—will be central to shaping the UK’s fiscal policy going forward.

**Slide 13 – Graph (PSNB % GDP) – highlight surplus years**

**Slide 14 - The Budget Deficit during the Pandemic**

Let’s now turn our attention in more detail to the unprecedented budget deficit of 2020/21, which reached an extraordinary 15% of GDP. This was the largest deficit ever recorded in peacetime UK history. It was not business as usual—this was the government responding to an extraordinary crisis with equally extraordinary measures.

The pandemic forced the UK government to introduce large-scale interventions aimed at shielding the economy from collapse. One of the cornerstone measures was the furlough scheme, which provided direct support to businesses, enabling millions of people to retain their jobs during a period of severe economic disruption. Alongside this, there were grants and loans to help struggling businesses remain operational and significant additional funding for the NHS to manage the enormous public health pressures brought on by Covid-19. Together, these measures came with an enormous price tag—£229 billion in 2020/21, followed by £78 billion the following year as the economy began to recover.

But spending wasn’t the only factor behind the ballooning deficit. The economic contraction caused by lockdowns and restrictions played an equally critical role. With businesses shuttered or operating far below capacity, and millions of workers earning less, tax revenues plummeted. This created a sharp shortfall in government income at the very moment spending was surging.

Adding to the fiscal strain, welfare spending increased significantly. Rising unemployment during the pandemic meant that more people relied on government support, further adding to public expenditure.

The result was a perfect fiscal storm: soaring public spending, plummeting revenues, and a record-breaking deficit.

This period offers important lessons about crisis management and fiscal policy. Borrowing at this scale was essential—it protected jobs, supported businesses, and ensured public services could function during one of the most challenging periods in recent history. However, it also raises critical questions about long-term sustainability.

Can we afford to borrow at this level again if another crisis strikes?

The pandemic highlighted the importance of fiscal flexibility, but it also underscored the risks of accumulating such high levels of debt in a short period.

Regardless, whether through building fiscal reserves, improving economic resilience, or enhancing public health infrastructure, governments must consider how to be better equipped for the next major disruption

**Slide 15 – Graph (UK Annual Budget Deficit as % of GDP)**

**Slide 16 - Understanding Deficit & Debt in Assessing Government Creditworthiness**

When evaluating a government’s financial health, it’s essential to distinguish between deficit and debt—two interrelated but distinct concepts that play critical roles in shaping a country’s fiscal outlook and its creditworthiness in the eyes of investors and markets.

Let’s begin with the deficit. Deficits are particularly relevant to short-term fiscal policy. As we have seen, during economic downturns or recessions, governments often run higher deficits to fund stimulus measures aimed at supporting businesses, individuals, and the broader economy. While this approach is often necessary to stabilize the economy in the short term, persistent deficits raise questions about sustainability, as they add to the national debt over time.

Turning to debt, which you remember is the cumulative total of all past deficits, it reflects the overall amount of money the government owes. Debt is therefore typically seen as a longer-term indicator of a country’s fiscal responsibility. High levels of debt can signal risks if they suggest the government may struggle to meet its obligations, undermining confidence among investors and markets.

To understand the sustainability of both deficit and debt, we must consider three critical factors that shape a government’s ability to manage its financial position effectively:

1. Average Maturity of Bonds

Bonds are the primary mechanism through which governments borrow money. The maturity of these bonds refers to how soon the government must repay or refinance this debt. In the UK, the average bond maturity is approximately 14 years, which is relatively long compared to other countries. This longer timeframe provides a buffer against sudden changes in interest rates, offering greater financial stability. In contrast, countries with shorter bond maturities face more frequent refinancing needs, leaving them vulnerable to market volatility and rising borrowing costs.

1. Who holds the debt?

A significant share of UK government debt is held by foreign investors, including those who purchase UK gilts. While foreign ownership reflects confidence in the UK economy, it also introduces risks. For example, currency fluctuations and global market conditions can create vulnerabilities. If overseas investors lose confidence in the government’s fiscal management, it could lead to financial instability, driving up borrowing costs and creating broader economic challenges.

1. Economic growth and tax revenues.

The strength of the economy plays a crucial role in determining a government’s ability to manage its debt. A growing economy generates higher tax revenues, which provides the government with more resources to service its debt or reduce the need for additional borrowing. Conversely, weak economic growth or pessimistic economic forecasts increase fiscal risks, making it harder to sustain both deficits and debt levels.

The key takeaway here is that governments face a delicate balancing act. They must address short-term economic challenges, such as managing recessions or responding to crises, without compromising long-term fiscal sustainability. Striking this balance is vital—not just to maintain economic stability but also to retain the trust of markets and investors, which underpins the government’s ability to raise funds and manage its obligations effectively.

By understanding the nuances of deficit and debt—and the factors that influence their sustainability—we can gain a clearer picture of what makes fiscal policy sound and why it is so central to a country’s economic future. For policymakers, this means making informed decisions that not only address current needs but also build resilience for the years ahead.

**Slide 17 - Government’s Definition of Debt**

The government’s recent decision to replace Public Sector Net Debt excluding the Bank of England (PSND ex BoE) with Public Sector Net Financial Liabilities (PSNFL) as the primary measure of national debt represents an important shift in fiscal management. While technical in nature, this change reflects deeper strategic priorities and has significant implications for how the UK’s financial health is assessed.

Traditionally, PSND ex BoE has been the go-to measure for national debt. It focuses on liquid financial assets, such as cash and deposits, alongside immediate liabilities like loans and government-issued debt securities. Importantly, it excludes the balance sheet of the Bank of England—meaning assets and liabilities related to quantitative easing (QE) or other central bank operations are not accounted for. This makes it a relatively narrow metric, capturing only a slice of the government’s fiscal position.

In contrast, PSNFL provides a broader and more inclusive picture by factoring in both assets and liabilities. Specifically, it includes: Illiquid financial assets, such as student loans, valued based on expected future repayments. Equity holdings, that reflect government stakes in private companies or public investments. And Liabilities from funded public sector pension schemes, representing long-term commitments to employees.

This approach offers a more comprehensive view of the government’s overall financial standing.

Therefore, the move to PSNFL is significant for several reasons:

1. By including assets with potential long-term value, PSNFL aims to balance the picture of what the government owes with what it owns. For instance, while student loans may not deliver immediate returns, they represent future revenue streams that offset liabilities.
2. PSNFL’s broader scope often results in a lower net liability figure, giving the government more room to borrow for capital investments, such as infrastructure projects, which generate long-term economic returns.
3. The inclusion of equity holdings and long-term assets aligns with the government’s emphasis on investment-led growth, particularly in infrastructure and innovation.

While the measure has clear advantages, it also presents notable challenges:

1. Estimating the value of assets like student loans depends on assumptions about future repayment rates, economic growth, and even potential policy changes. These assumptions can introduce uncertainty and subjectivity
2. PSNFL’s inclusion of long-term assets and liabilities makes it a less straightforward metric. This complexity could make it harder for financial markets and the public to fully trust or understand fiscal reporting.
3. As a result, the broader, more inclusive measure like PSNFL might paint an overly optimistic picture of fiscal health, potentially downplaying immediate liabilities or risks

**Slide 18 - Transition to PSNFL**

Building on this change, I’d like to briefly highlight the implications of PSNFL for fiscal policy and economic management. As mentioned, PSNFL takes a more holistic view, that include equity holdings and Illiquid financial assets.

The government’s decision to prioritize PSNFL is a strategic move.

This broader scope often shows a lower net liability, reflecting a more optimistic picture of fiscal health. By including assets, PSNFL creates an additional fiscal headroom. According to the Institute for Fiscal Studies, the change is expected to provide the government with £53 billion in additional borrowing, enabling greater investment in infrastructure and capital projects.

However, it is not without challenges. Assets like student loans depend on economic conditions and repayment behavior, which are inherently uncertain. Similarly, equity holdings can fluctuate with market dynamics.

This complexity could reduce transparency and lead to skepticism among markets and the public. So, while PSNFL reflects future opportunities, it requires careful communication to avoid underestimating immediate fiscal risks.

**Slide 19 – Graph (Different Measures of Public Sector Balance Sheet)**

**Slide 20 - How is the Budget Deficit Funded?**

So, let’s now talk in more detail about how budget deficits are funded. To answer that question, we need to focus on the role of government bonds, which are central to public sector financing.

Government bonds are essentially interest-bearing IOUs. When government spending exceeds revenue, it issues these bonds to raise the necessary funds. In doing so, the government makes a promise to repay the borrowed amount, plus interest, over a specified period.

But who buys government bonds? Well, pension funds and Insurance companies are traditionally big buyers. Their need for stability and predictable returns makes bonds an ideal investment to meet long-term obligations, such as paying pensions or insurance claims.

Then there’s, banks and other financial institutions, as bonds offer a low-risk investment option. Additionally, they can be used as collateral for other financial operations, playing a critical role in the broader financial system. Overseas investors and foreign entities often view UK government bonds as safe and reliable assets, allowing them to diversify their portfolios and mitigating exposure to more volatile markets.

Finally, there’s the Bank of England, particularly through its use of Quantitative Easing. During QE, the Bank purchases government bonds in the secondary market, injecting liquidity into the economy. By supporting bond prices, QE helps to keep borrowing costs (or yields) low, enabling the government to fund its deficit at manageable rates.

Of course, once issued, government bonds don’t simply sit in investors’ portfolios—they become actively traded in secondary markets. Here, investors buy and sell bonds based on changing economic conditions, interest rate expectations, and inflation forecasts. This active trading ensures liquidity, making it easier for the government to issue new bonds and for investors to adjust their portfolios. Liquidity in the bond market is crucial—it helps maintain confidence in the government’s ability to manage its financing needs efficiently.

In essence, government bonds are far more than a tool to plug the budget gap. They act as a bridge between public policy and financial markets, directly linking fiscal decisions to economic stability. A well-functioning bond market ensures that governments can fund deficits while maintaining market trust.

**Slide 21 – Graph (Who owns UK Debt?) Discuss the composition.**

**Slide 22 – Graph (BoE QE: Losses & National Debt)**

**Slide 23 - Interest Cost on Government Borrowing**

So now we get to a critical issue: the cost of servicing government debt. In the financial year 2023/24, the UK government spent £116 billion on debt interest—an astonishing figure by any measure. To provide some perspective, this accounts for 3.8% of GDP, a significant increase from 1.7% in 2018/19. Moreover, as mentioned earlier, debt interest payments now represent 10% of total government spending, consuming a substantial portion of the national budget.

How does this compare internationally? In the United States, debt interest payments make up a smaller proportion of GDP at 3.1%, but they represent a larger share—around 20%—of federal government spending. This comparison highlights how rising borrowing costs are a shared concern across advanced economies, as both the scale of debt and the conditions for servicing it grow more challenging.

So, what’s driving the increase in debt interest costs?

Well, over the past two years, we’ve seen a dramatic surge in UK debt interest payments, and this rise is primarily driven by two factors:

1. Inflation-Linked Debt

About one-quarter of UK government debt is tied directly to inflation, meaning that when inflation rises, so does the cost of servicing this debt. During the inflation spike of 2021/23, these payments increased significantly, illustrating how macroeconomic factors like inflation can exert pressure on public finances.

1. Rising Interest Rates

To tackle inflation and stabilize the economy, the Bank of England has significantly raised interest rates over the past two years. While higher rates are necessary to curb inflation, they also make borrowing more expensive, adding to the government’s debt interest burden.

This sharp increase in debt servicing costs underscores a broader fiscal challenge. While borrowing can support short-term priorities, rising interest costs can quickly consume a larger share of public resources. This reduces the funds available for other critical areas like healthcare, education, and infrastructure. This creates a pressing trade-off between servicing past borrowing and funding current and future investments.

**Slide 24 – Graph (UK National Debt Interest as % of GDP)**

**Slide 25 - What is the Structural Deficit?**

When we talk about a government’s budget deficit, it’s important to understand that it has two main components: the cyclical deficit and the structural deficit. These two elements help explain the nature of borrowing and its drivers.

The cyclical deficit fluctuates with the ups and downs of the economy. During economic booms, when businesses thrive and individuals earn more, tax revenues increase naturally, while spending on welfare programs decreases because fewer people need support. This reduces the need for government borrowing.

In contrast, during recessions, the economy contracts, tax revenues fall as incomes and profits decline, and government spending rises to provide support to those affected by unemployment or economic hardship. This leads to higher borrowing.

The structural deficit, however, is different. It reflects the underlying gap between government revenues and spending that exists regardless of where the economy is in the business cycle. Even if the economy is performing at full capacity, a structural deficit points to persistent fiscal imbalances that need addressing.

Understanding the structural deficit is crucial because it provides a clearer picture of the government’s long-term fiscal health. While cyclical deficits may shrink as the economy recovers, the structural deficit persists unless deliberate policy changes are made. This makes it a critical measure for evaluating fiscal sustainability and planning for the future.

However, estimating the structural deficit isn’t straightforward. It’s not directly observable and relies on assumptions about factors such as the economy’s potential output, tax revenue trends, and government spending patterns. These assumptions can vary significantly, leading to debates about the true size of the structural deficit.

In essence, while cyclical deficits reflect short-term economic conditions, the structural deficit highlights long-term challenges that governments must address to ensure fiscal stability. Understanding this distinction is key to developing policies that balance short-term needs with long-term sustainability.

**Slide 26 – Graph (Public sector surplus/deficit)**

**Slide 27 - National Debt Sustainability**

This brings us on to debt sustainability. For that, we have to consider how the UK’s unique position as a monetarily sovereign nation influences its ability to manage national debt, as well as the risks associated with rising debt levels.

The UK operates with monetary sovereignty, which gives it a key advantage. It issues its own currency—the British pound—and its debt is denominated in pounds, not foreign currencies. This means the UK is not reliant on external borrowing and cannot experience a conventional sovereign debt default. If necessary, the UK government could create additional currency to service its debt obligations, something countries borrowing in foreign currencies cannot do.

This sovereignty significantly reduces the risk of default. However, it doesn’t mean that debt is without limits. Unlike a household, the UK’s ability to sustain debt is influenced by broader economic factors like growth, inflation, and interest rates.

At this point it’s worth noting that there’s no fixed debt-to-GDP ratio at which debt automatically becomes unsustainable. But I’ll have more to say on that later. Instead, sustainability depends on whether the economy is growing fast enough to offset borrowing costs.

While monetary sovereignty provides flexibility, it doesn’t eliminate risks. One such risk is the debt trap. This occurs when the debt-to-GDP ratio exceeds 100%, and the economy’s growth rate falls below the interest rate on debt. In this scenario, the debt burden grows faster than the government’s ability to generate revenue, making it harder to manage.

Another concern is fiscal dominance, which arises when the Bank of England is pressured to print money or keep interest rates artificially low to finance government deficits. While this can help in the short term, it risks fueling inflation, undermining the value of the currency, and eroding public confidence in the financial system.

Furthermore, the costs of rising debt don’t stop at the government level. More broadly, excessive debt may lead to inflation, reducing the value of money and purchasing power. A perceived loss of financial stability could lead to declining public and investor trust. This could lead to downgrades by credit agencies that would also make borrowing more expensive, compounding the fiscal challenges.

High debt would also limit the government’s ability to respond to future shocks, such as recessions or public health crises. And finally, rising interest payments on debt could crowd out funding for essential services and investment in future growth opportunities.

The key takeaway here, is that while the UK’s monetary sovereignty provides significant tools to manage debt, it doesn’t exempt the government from maintaining fiscal discipline. Balancing debt management with economic growth, public trust, and long-term financial stability is essential. In essence, sovereignty is not a free pass to borrow without caution; it’s a responsibility to use that flexibility wisely.

**Slide 28 - Ways to Reduce National Debt 1**

There are a number of options governments can use to address the challenge of reducing national debt. And each approach comes with its own advantages and trade-offs. So, policymakers must carefully consider the broader economic and social impacts when choosing which strategy to use.

One of the most sustainable ways to reduce national debt is to foster stronger economic growth. A growing economy naturally generates higher tax revenues without the need to raise tax rates or cut spending, allowing the debt-to-GDP ratio to decline over time.

Advancements in technology, particularly in areas like artificial intelligence, hold enormous potential here. By driving productivity, efficiency, and innovation, these technologies can unlock faster economic expansion. A more dynamic economy reduces the pressure on fiscal policy and creates a virtuous cycle: growth begets revenue, which in turn facilitates investment in further growth.

Similarly, expanding the workforce is another way to bolster long-term economic performance. Immigration, for example, can provide a straightforward solution, especially for ageing economies facing low birth rates. Increasing the number of workers means more taxpayers contributing to public revenues and a healthier balance between workers and dependents. It also helps sustain essential services like pensions and healthcare while supporting overall economic output.

Another common approach is austerity. This can involve cuts to government services, benefits, or public sector wages. While austerity can deliver immediate reductions in deficits, it remains highly controversial.

Critics argue that spending cuts can harm public services, disproportionately impact vulnerable groups, and risk stifling long-term economic growth. Proponents, however, view austerity as a necessary tool to restore fiscal discipline and reduce the burden of debt on future generations. In the UK, austerity has been a flashpoint in political debates, with the Labour Party frequently criticizing Conservative-led spending cuts over the past decade. Regardless of one’s stance, it’s clear that austerity comes with significant economic and social trade-offs.

Governments can also turn to financial repression to keep borrowing costs under control. This strategy involves creating conditions that ensure a steady demand for government debt. For instance, requiring banks to hold government bonds as part of their liquidity requirements creates a captive market. Other tactics might include imposing limits on interest rates to make borrowing more affordable or restricting capital movements to direct resources into government funding.

While these measures can stabilize borrowing costs and reduce fiscal pressure, they are not without drawbacks. Financial repression can distort market signals, discourage private investment, and reduce overall economic efficiency. It’s a trade-off between maintaining fiscal stability and preserving the dynamism of financial markets.

Finally, there’s the option of debt restructuring, though it is typically seen as a measure of last resort for advanced economies like the UK and is more common in emerging economies. Restructuring involves renegotiating the terms of debt repayment—extending payment deadlines, reducing interest rates, or even writing off part of the debt. While this can ease immediate fiscal pressures, it often signals financial distress, damaging investor confidence and potentially leading to downgrades in a country’s credit rating.

For countries like the UK, where maintaining a reputation for fiscal reliability is paramount, debt restructuring is rarely pursued. However, for economies under severe fiscal strain, it can be a necessary step to restore stability.

**Slide 29 Ways to Reduce National Debt 2**

Building on the primary strategies I’ve just discussed, there are some additional, albeit more contentious, approaches to addressing national debt. These options often involve navigating difficult trade-offs between immediate fiscal pressures and longer-term priorities, which makes them the subject of heated debate.

One controversial option is to temporarily reduce spending on environmental initiatives, including projects aimed at achieving net-zero carbon emissions. Advocates of this approach argue that it could free up much-needed resources to address more immediate financial challenges. However, the risks of delaying climate action are profound. The long-term costs of inaction—rising sea levels, extreme weather events, and economic disruptions—could dwarf any short-term savings.

Moreover, scaling back these investments risks leaving the UK behind in the green economy, a sector where many nations are making significant advancements. Delays could mean missing out on opportunities for innovation, job creation, and economic growth tied to renewable energy and sustainable technologies. In essence, the trade-off here is between short-term fiscal relief and the long-term costs of climate inaction.

Another potential area for savings is the defence budget. Yet, this is particularly challenging in today’s volatile geopolitical climate. Ongoing conflicts and rising global tensions demand robust national security measures, and any significant cuts could undermine the UK’s ability to safeguard its interests and uphold its commitments to allies.

Such reductions could also strain international partnerships, including NATO, and diminish the UK’s influence on the global stage. While defence spending is a significant line item in the national budget, the potential risks to national security and international relations make this a politically and strategically sensitive area for policymakers.

A more direct and immediate way to raise revenue is through higher taxes on individuals and businesses. One proposal that has gained attention is the introduction of wealth taxes, targeting the most affluent individuals or large corporations. This approach is often seen as a fairer way to address deficits, particularly during periods of economic inequality.

However, the potential downsides are substantial. Higher taxes can erode business confidence, deter investment, and, in some cases, lead to capital flight, where individuals and businesses move their wealth to countries with lower tax burdens.

**Slide 30 - Currency Debasement**

Before we move on, I’d like to take a moment to talk about currency debasement, a concept that highlights how governments can erode the value of money over time and the implications this has for an economy.

Currency debasement occurs when governments create additional money to meet their financial obligations instead of raising taxes or cutting spending. This approach effectively reduces the purchasing power of the currency, eroding its intrinsic value.

In simple terms: while the nominal value or “face value” of money remains unchanged, its real value—the goods and services it can buy—declines. This process disproportionately affects savers and those relying on fixed incomes, as the value of their money diminishes. Conversely, it benefits debt issuers (like governments) by lowering the real value of their debt, making it easier to repay.

During the Covid-19 pandemic, accusations of currency debasement were directed at the UK government and the Bank of England. This stemmed from the quantitative easing programmes that the Bank implemented. QE typically aims to stabilize financial markets by purchasing government bonds, injecting liquidity into the economy.

However, during this period, the timing and scale of QE closely aligned with government stimulus announcements, raising concerns that it was indirectly funding government spending—also referred to as monetization of debt. While the Bank of England maintains that QE is not designed for this purpose, its use during Covid-19 highlighted how monetary and fiscal policy can blur under extraordinary circumstances.

A critical driver of currency debasement is inflation. When inflation rises, the purchasing power of money falls. This means that savers and households relying on fixed incomes face significant losses, as the value of their savings diminishes in real terms. Borrowers, however, benefit because the real value of their debt is reduced—effectively allowing them to "inflate away" their liabilities. For governments, inflation can serve as a tool to ease the debt burden, but this approach comes at the expense of households, businesses, and overall economic stability.

It’s important to differentiate between debasement and devaluation. Debasement is a reduction in the intrinsic value of money within a domestic context, without changing its face value. Devaluation is a drop in a currency’s value relative to other currencies, typically reflected in exchange rates and impacting international trade and investment.

While both diminish the value of money, debasement primarily affects domestic purchasing power, whereas devaluation has broader implications for global trade and exchange rates.

Currency debasement carries significant risks. It can erode public trust in the monetary system, destabilize savings, and raise fundamental questions about the sustainability of a government’s fiscal and monetary policies. In this context, understanding the dynamics of debasement is crucial—not just for policymakers but for anyone seeking to grasp how governments navigate crises and the potential risks involved.

**Slide 31 - National Debt: Looking Ahead**

Looking ahead, it’s important to recognize that rising public debt is not a challenge unique to the UK—it’s a global phenomenon. The Office for Budget Responsibility (OBR) has highlighted just how dramatically debt levels have surged worldwide over the past two decades. Among 33 advanced economies, the average debt-to-GDP ratio climbed steeply, from 52% in 2000 to 81% in 2021. For G7 countries, which include major economies like the US, Japan, and Germany, the increase was even more pronounced—from 76% to 131%.

So, what’s behind this surge? The primary drivers as we have mentioned are governments responding to major crises. The 2008 global financial crisis and the Covid-19 pandemic both necessitated unprecedented levels of borrowing. These interventions—whether to stabilize economies, support struggling citizens, or address public health emergencies—were essential at the time. However, the legacy of these actions has been historically high levels of public debt that many nations, including the UK, now struggle to manage.

The International Monetary Fund (IMF) has described the fiscal challenges facing governments as a ‘policy trilemma.’ This refers to the difficult balancing act of navigating three competing priorities:

1. Strong Spending Pressures: There is rising demand for public funding in critical areas such as healthcare, social welfare, and infrastructure—demands that are only increasing due to demographic changes and societal expectations.
2. Political Resistance to Taxation: Tax hikes remain deeply unpopular with both voters and businesses, leaving governments hesitant to pursue this route even when necessary.
3. Debt and Deficit Containment: Failure to address unsustainable fiscal policies could undermine market confidence, destabilize financial systems, and increase borrowing costs.

Longer term the OBR has issued stark warnings about the UK’s fiscal trajectory. Without significant policy reforms, the UK’s national debt could rise to a staggering 350% of GDP over the next 50 years under certain assumptions. What drives such alarming forecasts? Primarily:

* Demographic pressures, such as an aging population, which will significantly increase demand for pensions and healthcare spending.
* Structural deficits, as government spending consistently outpaces revenue collection.

**Slide 32 – Graph (OBR Forecast for National Debt)**

**Slide 33 - National Debt: Why such a Pessimistic Outlook?**

When examining the UK’s long-term debt outlook, it’s vital to look beyond the headline figures and consider the deeper forces shaping this debt trajectory. A combination of demographic, structural, and global challenges is creating formidable headwinds for the sustainability of public finances.

The aging population is arguably one of the most pressing fiscal issues facing the UK. As life expectancy rises, the demand for health and social care services—both costly and resource-intensive—is set to increase significantly. On top of this, the rising cost of state pensions will place additional strain on public finances in the decades ahead.

Exacerbating these pressures is a shrinking working-age population, which poses several economic challenges:

* Fewer workers mean reduced national savings, which could push up wage inflation as businesses compete for a smaller labor pool.
* Rising wages may, in turn, lead to upward pressure on interest rates, increasing the government’s cost of servicing its debt.
* A smaller labor force limits the economy’s capacity to grow, dampening tax revenues and constraining public finances further.

The UK’s pledge to achieve net-zero carbon emissions represents another major fiscal challenge. Transforming the economy to a greener, more sustainable model will require significant upfront investments in areas like renewable energy, green infrastructure, and emissions-reduction technologies. Beyond these proactive measures, the costs of adapting to the physical impacts of climate change—such as flooding, extreme weather, and infrastructure damage—will also rise in the coming years.

On the international stage, geopolitical instability is adding further complexity to the UK’s fiscal outlook. These challenges underscore the need for bold, forward-thinking strategies.

**Slide 34 – graph (Projected Government Revenue and Spending)**

**Slide 35 - Does National Debt Matter?**

So, we have to ask an important question, does national debt matter, and if so, why? This is at the heart of broader debates about fiscal policy, economic stability, and societal wellbeing.

Debt, as we’ve discussed, is an essential tool for governments. It enables them to finance transformative, long-term investments in infrastructure, healthcare, education, and other vital areas when immediate revenues are insufficient. Borrowing also acts as a critical buffer during economic downturns, helping governments stabilize the economy, support businesses, and protect citizens.

However, borrowing is not limitless—it carries inherent risks. Poorly managed debt can undermine economic stability, social equity, and future resilience.

This slide highlights four key risks that arise when debt is not managed effectively:

1. Economic Instability

Excessive debt levels can erode investor confidence. If investors lose faith in a government’s ability to manage its finances, financial markets can become volatile, driving up borrowing costs. Higher borrowing costs not only slow economic growth but also make it harder to attract both foreign and domestic investment.

2. Impact on Social Welfare

When debt becomes too burdensome, governments may struggle to fund essential public services such as education, healthcare, and infrastructure. This can lead to reduced access to critical services, exacerbate social inequalities, and erode public trust in the government’s ability to serve its citizens effectively.

3. Vulnerability to Future Shocks

High debt levels limit fiscal flexibility, leaving governments ill-equipped to respond to unforeseen crises such as pandemics, natural disasters, or recessions. In such cases, governments may be forced to make tough trade-offs, such as cutting spending on critical programs, which can further weaken the economy.

4. Funding Challenges

A history of poor debt management can tarnish a government’s reputation, making it harder to secure funding in the future. Higher borrowing costs—or worse, the inability to borrow—can disrupt government operations and, in extreme cases, lead to defaulting on obligations, causing severe economic and social consequences.

Balancing debt is about borrowing to invest in the future while preserving the flexibility to act in the present.

**Slide 36 - Reinhart & Rogoff Debt-to-GDP Debate**

As we approach the end, at this point I want to introduce you to one of the most influential contributions to the debt and growth debate, that of the 2010 study, *Growth in a Time of Debt,* by Harvard economists Carmen Reinhart and Kenneth Rogoff. This research became a cornerstone of fiscal policy discussions in the aftermath of the 2008 financial crisis, as governments grappled with rising public debt and its potential economic consequences.

Reinhart and Rogoff’s study investigated how high levels of public debt influence economic growth, analyzing data from 20 advanced economies over a period spanning 1946 to 2009. Their key finding was striking: when public debt remains below 90% of GDP, economies typically enjoy robust growth rates of around 3% to 4% per year. However, the study claimed that once debt exceeds the critical threshold of 90%, economic growth slows dramatically, with an average contraction of -0.1%.

This 90% figure was presented as a potential “tipping point,” beyond which debt becomes a significant drag on growth. The implication was clear: excessive debt levels could undermine an economy’s ability to expand, and policymakers should aim to keep public debt below this threshold to safeguard long-term prosperity.

The study’s conclusions resonated strongly in political and economic circles. Many governments used Reinhart and Rogoff’s findings as a rationale for fiscal austerity—cutting public spending and reducing budget deficits to avoid crossing the 90% threshold. In Europe, particularly, the study became a powerful argument for tightening fiscal policies, despite ongoing economic recovery challenges.

However, while the research was influential, it was not without controversy. Subsequent analysis would raise significant questions about the robustness of Reinhart and Rogoff’s findings, as well as their implications for fiscal policy.

**Slide 37 - The Reinhart-Rogoff ‘Error’**

While Reinhart and Rogoff’s work significantly shaped global discussions on the risks of high public debt, it wasn’t immune to criticism. A subsequent reassessment by Ash, Pollin, and Herndon uncovered key methodological flaws in their analysis that ultimately altered the interpretation of their findings.

For example, Reinhart and Rogoff had initially claimed that when debt exceeds 90% of GDP, economic growth turns negative, averaging -0.1%. However, using the same dataset, Ash and colleagues recalculated this figure and found that average growth for countries with debt above 90% was actually 2.2%. This is a substantial difference, reframing the supposed ‘tipping point’ as less dramatic than originally suggested.

Moreover, the reassessment highlighted an important nuance: the relationship between debt and growth is neither uniform nor universal. It varies considerably based on factors such as the time period studied, the economic structure of individual countries, and the specific circumstances driving debt accumulation. The 90% debt-to-GDP threshold, presented as a definitive tipping point, was revealed to oversimplify the complex dynamics of debt and economic performance.

These findings had important policy implications. Critics argued that Reinhart and Rogoff’s original results had been used to justify austerity policies, with the assumption that high debt levels alone necessitated drastic spending cuts. The reassessment challenged this logic, suggesting that decisions about austerity should take into account broader structural and economic conditions, rather than relying on a one-size-fits-all threshold.

In short, while the study’s central message about the risks of excessive debt remains relevant, its errors serve as a reminder to approach fiscal policy with careful analysis and consideration of context. High debt doesn’t automatically mean an economy is in crisis—it’s how that debt is managed and the surrounding economic conditions that truly matter.

**Slide 38 - Thoughts on the Recent Budget**

Lastly, I wanted to comment on the major takeaways from the UK’s recent budget and the challenges it raises for policymakers. This budget introduced significant changes that aim to address fiscal pressures but come with notable trade-offs.

The budget outlines an increase in government spending by £70 billion annually—a substantial injection that the Bank of England estimates will raise inflation, measured by the Consumer Price Index (CPI), by around 0.5%. To partially offset this spending, an additional £36 billion in taxes has been targeted primarily at the private sector, lifting the overall tax burden to 38.2% of GDP, a level not seen in decades. Despite these measures, the budget deficit is projected to widen by £34 billion per year, adding further pressure to already strained public finances.

The question then is how will this growing fiscal gap be managed?

Increasing taxes even further may seem like a straightforward solution, but it risks discouraging private-sector activity. Higher taxes can dampen consumer confidence, deter business investment, and potentially slow economic growth—precisely the opposite of what is needed to alleviate fiscal pressures. And with public debt approaching 100% of GDP, further borrowing risks undermining fiscal stability.

They could reintroduce austerity and rein in spending; however, it remains a politically sensitive and deeply controversial option. Especially as Labour have spent the last 14 years attacking the Conservatives for its austerity policies.

Improving productivity is arguably the most desirable long-term solution. Higher productivity would lead to increased economic output, stronger tax revenues, and reduced fiscal pressures. However, progress in this area remains slow—public sector productivity, for example, is still 6.4% below pre-Covid levels. This highlights the need for sustained investment in skills, innovation, and infrastructure to unlock productivity gains.

Personally, I believe the path forward will likely require higher taxes, which must be carefully balanced against the potential risks to economic growth. Ultimately, the success of this approach—or any other measures introduced by the new government—will hinge on their ability to address immediate fiscal pressures while simultaneously laying a strong foundation for long-term economic stability. Equally critical will be how these measures are received by financial markets, as investor confidence will play a pivotal role in ensuring fiscal sustainability.

**Slide 39 – Conclusion**

In conclusion, the UK government is facing a mounting challenge as debt interest payments are set to rise significantly in the coming years. This increase stems from a combination of growing debt levels, higher interest rates, and persistent inflationary pressures. These factors will undoubtedly place a considerable strain on public finances, complicating the government's ability to manage competing fiscal priorities.

Policymakers will need to navigate this delicate balancing act with great care. Addressing the escalating debt burden is imperative, but it must be done in a way that supports sustainable economic growth and does not stifle opportunities for investment or recovery. Striking this balance will be one of the defining tests for the government in the years ahead, as it seeks to ensure both fiscal stability and the long-term prosperity of the UK economy.

Thank you.