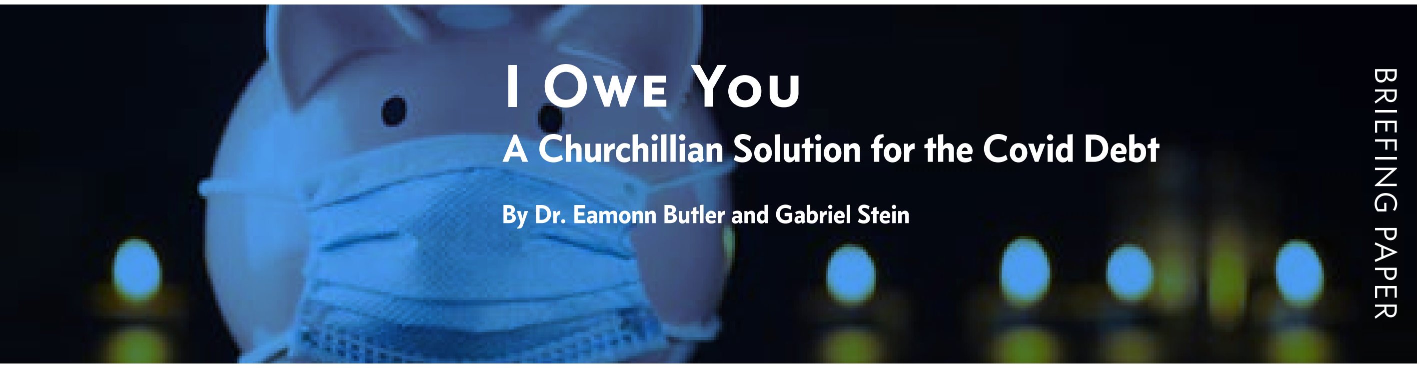

I Owe You

A Churchillian Solution for the Covid Debt

By Dr. Eamonn Butler and Gabriel Stein

BRIEFING PAPER

EXECUTIVE SUMMARY

- The Government has borrowed hundreds of billions in response to the Covid pandemic. This has led to a record peacetime debt totaling £2.2 trillion, representing 97% of GDP.
- The use of regular bonds, with repayments in 10 or 30 years' time, create a substantial future financial burden that could be rolled over even further into the future.
- The Covid debt could be separated from day-to-day lending using 'consols' or 'consolidated annuities'.
- Consols are like normal bonds, with a fixed interest rate paid to the bearer, however, they have no fixed repayment date. They continue to exist until the Government decides to buy them back.
- Consols were first used in Britain in 1751 to pay for the War of Austrian Succession, and were used again to finance the Napoleonic Wars, and by Winston Churchill, when Chancellor, in 1927 to refinance World War I debt.
- Consols would lock in ultra-low interest rates and not have to be paid back at any specific date — Napoleonic War consols were only fully repaid in 2014. They provide greater flexibility, with the government able to repay them when ready rather than on an arbitrary date in the future, with limited annual cost.
- The Government could specifically legislate to convert existing Covid debt into 'Covid Emergency Bonds' based on consols, with a commitment to repay when the economy recovers.
- Consols should not be used for routine big-spending projects, but rather, rare and unexpected emergencies like wars and pandemics that create an immediate large need for borrowing.

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TRYING TO PUT OFF REALITY

At dawn on Thursday, 4th November 2021, markets were braced for the message that the Bank of England would raise interest rates. The ground had been well prepared, with hawkish statements from Governor Andrew Bailey and the new Chief Economist Huw Pill. Moreover, high and rising inflation (3.1% in the year to September, the fifth month at or above the Bank's 2% target), coupled with robust output growth, meant that a shift towards a more neutral monetary policy was seen as both justified and prudent.

However, when the Bank announced its decision at noon, markets were surprised to hear that there was no change — and this in spite of the Governor saying that he now expected inflation to last longer than previously thought and to eventually reach an 11-year high of 5% before (hopefully!) falling back towards the 2% target.

There are valid reasons for not raising interest rates at this stage. One is concern that the post-pandemic recovery is still fragile and that a too rapid rise in interest rates would derail the economy. But if interest rates are not raised when inflation is above target and headed further up, and the economy is growing at a healthy pace, when can they ever be raised? In six months, will Mr Bailey tell us that: "Our current forecast is for inflation to increase from its current 6% and peak just under 10% before retreating. We have, however, left interest rates unchanged at 0.1%. It was a close call and we expect to raise rates in the coming months, but we deemed the time not right to do so just yet."?

BUDGETING FOR DEBT

However, there is another, possibly more important reason why the Bank is reluctant to raise interest rates. This is that the Government most likely wants higher inflation. Why is that? In one word, debt. This Government has massively increased the UK government debt. It has done so for two reasons. Most recently, by a Budget that seems finally to have changed the Conservative Party from a party of low taxes and small government (at least in name, if not in fact), to a party of very high spending and not so low taxes. But there is a problem with that: if taxes do not suffice to cover your spending, you must borrow to pay for the rest.

Unfortunately, that is exactly what our Government is doing. Chancellor Rishi Sunak, at the end of his Budget speech on 27 October 2021, indicated that it would be 'wrong' to cut public expenditure at this critical point for the British economy. Indeed, he unveiled what the Office for Budget Responsibility called "a large and sustained increase in public spending" over the next five years, rising from 29.8% of GDP before the pandemic to 41.6% of GDP in 2026-27, the largest sustained share of GDP since the late 1970s. To help fund that, taxes will rise from 33.5% of GDP before the pandemic to 36.2% of GDP by 2026-27, their highest level since the 1950s. That still leaves a gap to be filled by additional borrowing of £183 billion in this year alone, with another £83 billion expected next year, and further annual additions after that.

The Chancellor reiterated his hope of getting taxes on a downward trajectory, in terms of a percentage of GDP, before the next general election. But there seems to be a scant prospect of that in the Budget figures. And without any reduction in public spending, such hope depends on future economic growth forecasts that may well prove to be optimistic. There seems little chance of the government's debt burden falling any time soon.

INFLATION AND INTEREST RATES

Debt certainly is a burden. Another of the problems caused by debt is the interest that has to be paid on it. And that, of course, is dependent on what happens to interest rates. In an almost throwaway remark in his Budget speech, the Chancellor noted that: "just a one percentage point rise in inflation and interest rates would cost us around £23 billion".

His comment was not entirely complete and correct. Certainly, a rise in inflation will cost the government money in the sense that inflation-linked payments (for instance, the state pension) will rise — though on the other side of the equation, inflation will erode the real value of the debt that the government has to pay back at some point. It also increases revenue from various taxes.

However, the real killer for the government is a rise in interest rates. And on that point, the Government has compounded its own problems with a massive own goal—and a badly missed opportunity. To explain why, we have to get a little technical about the mechanics of public borrowing. Please bear with us; it is worth the effort to understand these details.

THE MECHANICS OF BORROWING

When a government borrows, it issues bonds. Bonds are IOUs. Each bond carries a promise to pay a certain sum, expressed in pounds, every year. This sum is calculated to reflect the interest rate that is appropriate to the particular type of bond at the moment of its issue. As an example, let us assume for simplicity that the interest rate appropriate to UK government 10-year bonds is 1% (in fact, at the time of writing, it is 0.8%). Then for each bond worth £100 issued today, the government will pay the owner the promised £1 every year. And after 10 years, the government is pledged to repay the whole original £100.

So far, this is fairly straightforward. But it gets more complicated. Once the government has issued a bond, what it has agreed to pay is the same fixed sum (in this case £1) every year. That figure stays the same, regardless of what happens to interest rates. Changes in interest rates, therefore, will not affect how much the government has to pay — but only until the time comes to repay the bond. Then, a problem arises, for the simple reason that most governments never actually repay their debt. What they do instead is issue new bonds to the same value as the ones they are repaying at the end of those bonds' term (in this case, 10 years). The government then uses the money raised from the new batch of bonds to repay the amount due on the old batch (in this case, again, £100). And at that stage, as in the first round, the annual payment on the new bond needs to reflect the interest rate that then prevails.

This is a problem, because, at the moment, interest rates (not just in Britain, but in most of the world) are extremely low. Indeed, they are at levels lower than we have ever seen before. By the time that any bonds issued in 2021 need to be rolled over, interest rates will almost certainly be higher, and probably much higher, than they are today. So, the annual payments on those bonds will have to reflect that. These higher annual payments will then add to the government's (and thus the taxpayers') borrowing costs.

Interest rates rise for two reasons: One is when the Bank of England raises Bank Rate in order to rein in inflation. (By making borrowing more expensive and saving more attractive, higher interest rates slow people's spending, dampening businesses' ability to raise prices.) The other reason that interest rates rise is when markets worry about higher inflation and either expect or want the Bank to raise Bank Rate. They then push up long-term interest rates. And nobody expects today's historically low interest rates to stay low in perpetuity. The Bank cannot hold back the tide forever.

BE CAREFUL OF WHAT YOU WISH FOR

As explained above, a deeply indebted government like that of the UK certainly does not want higher interest rates. But with inflation, the situation is not quite as clear. In fact, there is quite a strong reason to suppose that the government does want higher inflation.

That is because government debt is a fixed sum: a £100 IOU remains a £100 IOU for its duration. But if the government borrows £100 today and repays it in ten years, any inflation over that time will erode the value of that £100. As hinted above, this means that the government will be repaying it in devalued money. Quite simply, £100 will be worth less in ten years' time than it is today.

It is remarkable how even quite modest annual inflation can make a big difference on this score. For example, if inflation is just 2% every year for ten years, the £100 that is due to be repaid a decade from now becomes worth just £83 in today's money. At higher inflation rates, the effect of inflation is even more profound. If annual inflation rose to 5%, for example, the original £100 would only be worth £63 in today's money. So, the government would be paying off its debts very cheaply. The inflation would have relieved the government of more than a third of its obligations to bondholders.

What the government would ideally want, therefore, is higher inflation (to erode the value of its repayment obligations) without higher interest rates (which would raise the cost of borrowing in the future). This may not be easy to achieve. Long-term market interest rates are likely to rise even faster if markets fear future inflation and the Bank of England does not raise Bank Rate to clamp down on rising prices.

Moreover, the inflation that the government may wish for in order to ease its debt repayment burden has very harmful effects on the rest of us. Rapid inflation (say 4-5% or higher) dislocates everybody's lives and businesses. It makes financial planning very difficult. Relative price movements (some things going up fast, others less fast) become harder to spot and therefore to react to — leading to investment mistakes and a fall in the economy's efficiency. That is one reason why inflation is usually associated with slower economic growth. Meanwhile, different groups are impacted differently. Borrowers benefit from inflation, while savers and lenders suffer from the eroding value of their assets; and the people who suffer the most are those on fixed incomes, like pensioners.

THE COST OF THE PANDEMIC

This brings us back to the issue of the Government's entirely avoidable mistake: namely, how it handles the very large sums it borrowed in order to deal with the effects of the pandemic.

It should be said at once that, though one might quibble about some aspects of government spending on pandemic policy (remember the 'world-beating' track and trace system?), the pandemic, like a war, was one of those few occasions when massive extra government spending is both necessary and generally justified.

Even so, just like wartime spending, this money must come from somewhere, and must be repaid somehow. And given the sums that the UK Government has borrowed as a result of the pandemic, it has been left with a very large amount of money to find. Indeed, the additional borrowing that the Government has undertaken because of the Covid emergency is in the region of £550 billion — equivalent to around £20,000 for every household in the country.

In 2020/21 for example, an extra £244 billion went on furlough payments, grants, loans and other support for workers and businesses, while £83 billion more was needed to make up for the Government's lower lockdown tax revenues and higher welfare spending. This year, 2021/22, the additional borrowing is expected to hit £183 billion — though it could be more if the economy is slow to recover. In addition, yet further borrowing may be needed to clear the National Health Service treatment waiting lists that have resulted from the NHS being focused on Covid.

PROBLEMS OF THE 'WAR DEBT'

Many problems have arisen from this. First, total government debt has hit a peace-time record, reaching a total of £2.2 trillion in August, equivalent to 97% of the nation's annual earnings. That of course is much less than the 249% it hit at the end of WWII, but we still have seen nothing like it since the 1950s. Second, every £1 billion that is paid out in interest on debts, as the Chancellor hinted in his Budget remark, is another £1 billion that isn't available to spend on schools, hospitals, social care, defence, policing, roads and other public services — seriously restricting the Government's freedom of movement.

Third, a large debt overhang like this gets in the way of sensible policymaking. That is because it confuses the exceptional, 1-in-100-year emergency borrowing for the pandemic with the normal ups and downs of the public finances. This in turn poisons the public debate: it becomes too easy to ridicule Mr Sunak for his famous promise to 'balance the books'. And it also becomes easy for critics to crow that debt has doubled since Labour left office in 2010 (while conveniently forgetting the exceptional circumstances behind the rise). Such a large debt overhang mitigates against good financial policy too: even prudent governments might give up in despair of ever repaying a debt of over £2 trillion; and equally, less prudent governments might imagine that adding another £50 billion or £100 billion more borrowing onto that does not matter very much. But it does.

WRONG ANSWERS

Somehow, therefore, we need to 'isolate' the Covid 'war debt' so that it does not get mixed up with the normal public finances and the everyday policy planning. And, at the same time, so that the repayment of this exceptional debt can be postponed until the economy is in much better shape to bear it.

There are various ways of dealing with this problem, including some options that, on inspection, are best avoided.

For example, the government could offer special 'Covid Bonds' which pay interest only after (say) 30 years. But since the interest foregone would be rolled up in the value of the bonds, by then, the capital cost of the bonds would have soared, and repaying them would have become an even bigger and more expensive headache. Alternatively, the government might repay (say) 1 in 30 of the bonds each year, which would help to spread the burden. But that still leaves a big debt shadow over the public finances. A third option sometimes mooted is that the government should simply get the Bank of England to tear up all the Treasury IOUs it is holding — but that amounts to a sovereign debt default many times bigger than we have seen from Mexico, Russia, Argentina, Ecuador, and Greece in the past. As well as the reputational damage, such a default would make it harder, or costlier, for the government to borrow in the future.

WHAT SHOULD BE DONE?

The first thing we need to do is to accept that the extra borrowing taken on to fight Covid was akin to a 'war debt' — borrowing caused by a 1-in-100-year emergency — and that repaying it is going to take a very long time.

Then, we should deal with it just like past wars and other national emergencies have been dealt with — by issuing a special kind of government IOU called consols.

Consols are a tried and tested way of dealing with exceptional debt. In fact, Britain first used them back in 1751 to pay for the War of Austrian Succession, and they were used again to finance the Napoleonic Wars. Winston Churchill, when Chancellor, used them in 1927 to refinance debt taken on in WWI. Other countries have occasionally used them as well.

The name consols comes from 'consolidated annuities'. They are government securities, like the normal 10-year or 30-year bonds that the government issues, except that they have no fixed repayment (or 'redemption') date. They continue to exist, year after year, until the government decides to buy them back. The advantage is that this repayment need not happen any time soon: in fact, the Napoleonic War consols were only fully repaid in 2014! In the meantime, just like normal bonds, consols pay their holders a fixed cash sum every year — maybe a little more than today's 30-year bonds, say around £1.50 a year on a £100 bond.

THE BENEFITS

There are powerful advantages in adopting this strategy.

First, the government does not have to worry about repaying its exceptional debts — in this case the Covid £550 billion — in 10 or 30 years' time. Nor would it be obliged to issue a second round of IOUs to roll over that debt should the public finances happen to still be tight at that particular moment. Instead, it can repay some or all of the debt at any time, as and when it feels that the economy is strong enough.

Second, consols lock in today's ultra-low interest rates. Maybe £1.50 a year forever seems a pretty good deal on a £100 investment right now, when interest rates are so low — particularly for pension funds and other long-term investors who seek to have a secure and steady income stream. Certainly, it will look less good if long-term interest rates rise beyond 1.5% — but then, if interest rates rise, the market value of people's bonds will fall — since the £1.50 a year will then seem a poor return — meaning that the government can repay its debt rather quicker.

Meanwhile, the annual payments on the debt remain manageable — just over £8 billion a year on £550 billion — especially if the economy does grow strongly.

Ideally, the Government should have issued consols when the Covid costs started to hit. That is the opportunity they missed. But it is not too late to recover. The Government could legislate to convert its Covid expenditure into consols. That is what Churchill did with WWI debt in 1927.

A word of warning. It is important to keep consols as something special for major emergencies, like war debts are. At the very minimum, one might give them a distinctive name. In this case, it might be something like 'Covid Emergency Bonds', which would distinguish them from other general borrowing. Also, to ensure that future Governments do not abuse the perpetual-bond idea, perhaps they should come with a pledge to pay them off as soon as economic circumstances permit — say, when the economy has grown large enough that it has shrunk the total value of the debt to (say) 3% of GDP.

Whatever the details, the important thing is that consols must be kept in reserve for exceptional 1-in-100-year emergencies like wars and pandemics. That is, for where events have unfolded quickly, and it has been necessary to spend fast, without thinking too much about the details, resulting in a big financial hole that must — afterwards, somehow — be filled.

In those circumstances, consols have a significant and useful role. However, consols are definitely not designed for funding routine future spending on politicians' pet projects, be they HS2, green energy or bridges across the Irish Sea. Allow that, and we would soon be drowning in debt with no hope of repaying it.