27TH NOVEMBER 2008

PROFESSOR ANDREW CLARE

fathom

ISSUES WITH ISSUANCE

This week the UK's Chancellor of the Exchequer laid out his plans to provide the beleaguered UK economy with a fiscal boost to help it through these difficult times. A raft of fiscal initiatives will gradually ripple through the UK economy over the next few months, including a headline grabbing cut in VAT from 17.5% to 15%. The Chancellor's fiscal largesse (with our money) will not be enough to stave off the coming recession but together with looser monetary policy it will help to protect some UK households and corporations from the worst ravages of the global recession.

This fiscal boost will make an even bigger hole in the UK government's already rapidly deteriorating finances. Because of this, government borrowing has to rise. So along with the announcement about tax cuts the Chancellor also laid out the Treasury's borrowing plans over the next few years. For the fiscal year of 2008/09 there is now a planned increase in gilt sales of £66.4bn. That's additional borrowing represents over £1,100 for every man woman and child in the UK. This debt will have to be paid back at some time but before it is paid back we have to find investors willing to lend us the money in the first place.

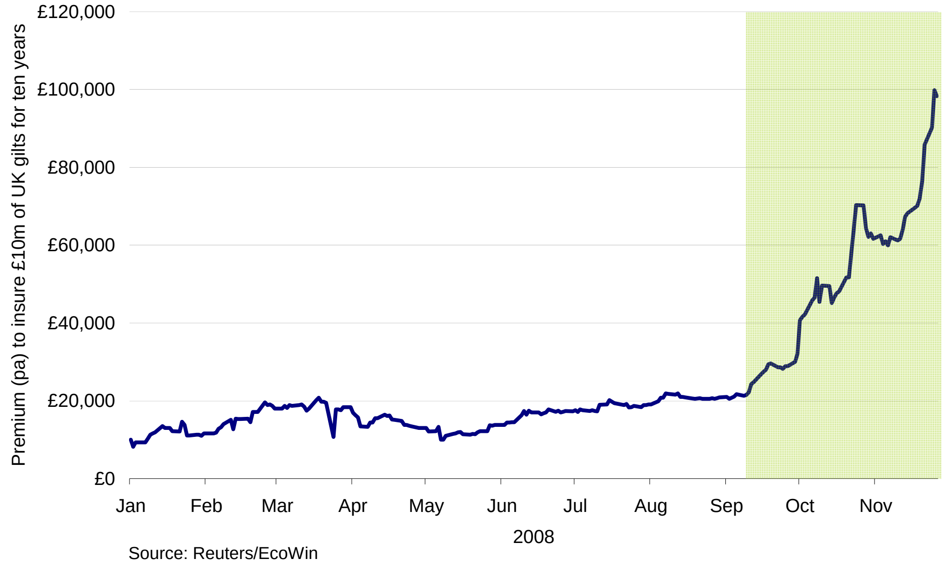
Overseas investors have been significant buyers of gilts over the last few years. In other words, they have been willing to lend the British government money. And why not? Until recently the UK had expanded every quarter since the middle of 1992. The steady and respectable growth and low stable inflation over this period meant that we were a good debtor. But the events of the last twelve months or so have dented overseas confidence in the UK economy. This is most evident in the price of sterling, which has fallen by 22% against the dollar and by 15% on a trade-weighted basis.

But it is also evident in the market for credit default swaps, which offers investors a way of insuring themselves against the prospect of a debtor defaulting. This week's chart shows the cost of insuring £10m worth of UK government debt for ten years. At the start of this year the insurance premium was £10,000 per annum. After bailing out the banks and ahead of a sharp recession this insurance premium has now risen to just under £100,000 per annum. Quite a hike. Imagine your home contents or car insurance increasing by a factor of ten in less than one year. This increase in the premium represents a marked deterioration in the UK government's credit standing with the world.

Given the amount of borrowing in the pipeline, the real prospect that the borrowing may need to be higher still and the fact that confidence in the UK economy is sinking fast, there is a genuine prospect of a wholesale run on an already weakened pound if overseas investors decide to sell sterling denominated assets – including UK government debt.

One way of mitigating this risk might have been to issue bonds that are attractive to UK investors – thereby reducing our reliance on overseas investors. We know that the UK's pension industry has been crying out for long-dated government bonds for a while now, and in particular for long-dated index-linked gilts. And yet the government has skewed its additional issuance towards short-dated, conventional gilts. Of the £66.4bn increase in planned gilts sales for the current fiscal year, only £6.3bn will be in long-maturity conventional gilts and only a measly £2bn will be in the form of index-linked gilts.

The annual cost of insuring UK government debt



Source: Reuters/EcoWin

The National Association of Pension Funds (NAPF), which represents 1,200 pension schemes with around 15 million members with assets of around £800bn, recently had this to say on the matter:

> "*Before the Pre-Budget Report, we urged the Government to ensure that any increase in debt issuance was skewed towards greater issuance of long-dated low-risk assets, which would help pension funds and their members, UK companies and the government itself. The fact that so little extra has been made available is a missed opportunity*."

Issuing long-dated index-linked gilts in particular would provide pension funds with the assets they need to match their liabilities. This issuance policy would also reduce our reliance on overseas borrowing and thereby reduce the risk of a run on the pound (though not eliminate it entirely). Finally, a significant increase in index-linked issuance would send a signal to all investors that the UK government remains committed to keeping inflation under control. This last point may seem less important since we are almost certainly headed for deflation in 2009 but higher inflation might be the eventual consequence of all this government borrowing and spending.

# of words: 786