

3. Fiscal vulnerability: a stocktake

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Summary

- In opting for an aggressive pace and size of fiscal consolidation, the government hopes to have insulated the UK from the types of funding crises that have beset other European nations.
- The UK government bond market has not shown any material signs of stress over the past year, implying that investors believed the UK deficit problem would be dealt with effectively. Investor demand for UK government debt remained healthy even after the Bank of England halted its bond purchases under its policy of quantitative easing.
- In financial markets, past calm is no guarantee of future stability, however, and so we attempt to gauge how secure the UK's fiscal position is. Using 16 indicators of fiscal vulnerability, we find that the UK ranks close to the middle of our sample of 57 countries.
- The UK benefits from the long average maturity of its debt and the fact that the vast majority of government borrowing is in sterling. The strength of regulation and the rule of law also lower the likelihood of a funding crisis. However, the large government deficit and high reliance on external debt are sources of vulnerability.
- Achieving a sustainable reduction in the structural budget deficit stands out as a policy priority. Effective oversight of banks' external exposures is also important if risks are to be contained.
- The front-loading of tax increases and capital spending cuts should ensure that the deficit reduction plan stays on track in the near term, although the risk of political turbulence remains high. Fiscal adjustment may also be hampered by further adverse macroeconomic shocks, which monetary policy is, arguably, not well placed to counter.

3.1 Introduction

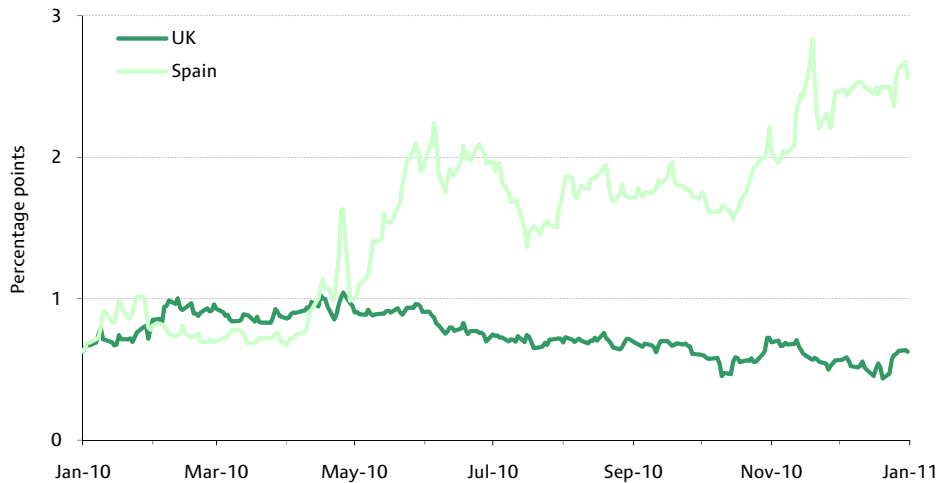
The issue of how best to cut the fiscal deficit has become highly contentious. The Chancellor, George Osborne, has argued that the government's deficit reduction plan has removed 'the biggest downside risk to the recovery – a loss of confidence and a sharp rise in market interest rates'.¹ Financial markets seem to have reacted positively to the plan: the interest rate differential between UK and German government bonds has declined since the general election, in contrast to that between Spanish and German government bonds, for example (Figure 3.1). The UK's triple-A credit rating appears assured for the time being.

However, critics have contended that the government is cutting the deficit too quickly, causing unnecessary hardship and risking a renewed recession. Household and business

¹ G. Osborne, 'Building the economy of the future', speech to Bloomberg, 17 August 2010 (http://www.conservatives.com/News/Speeches/2010/08/George_Osborne_Building_the_economy_of_the_future.aspx).

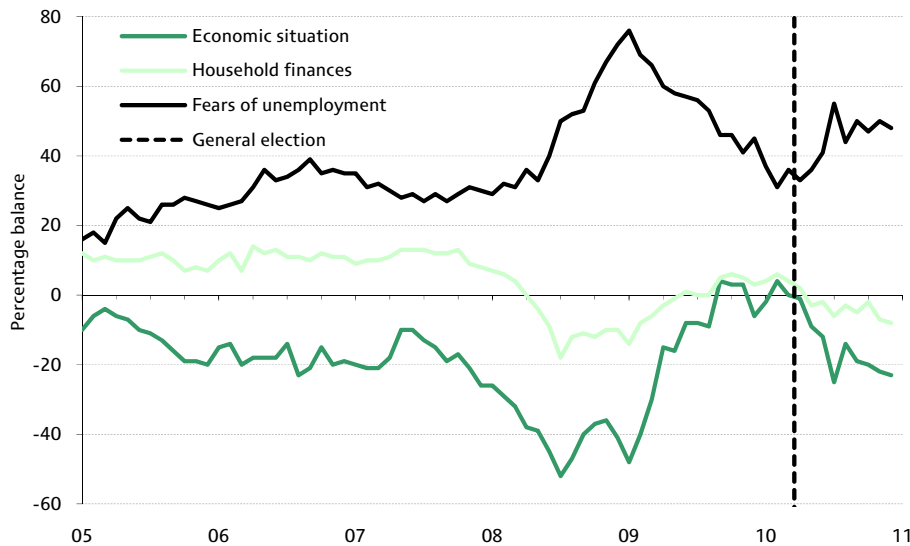
confidence have sagged as the size of government cuts has become clear (Figure 3.2). The opposition Labour Party has maintained that its plan when in government – to halve the deficit over a four-year period – would have been more likely to generate a sustainable improvement in the public finances.

Figure 3.1. Interest rate spreads over German government bonds



Source: Barclays Capital.

Figure 3.2. Consumer confidence



Note: The percentage balance is the difference between the percentage of respondents saying the situation has improved and the percentage saying the situation has worsened.

Sources: Haver Analytics; Barclays Capital.

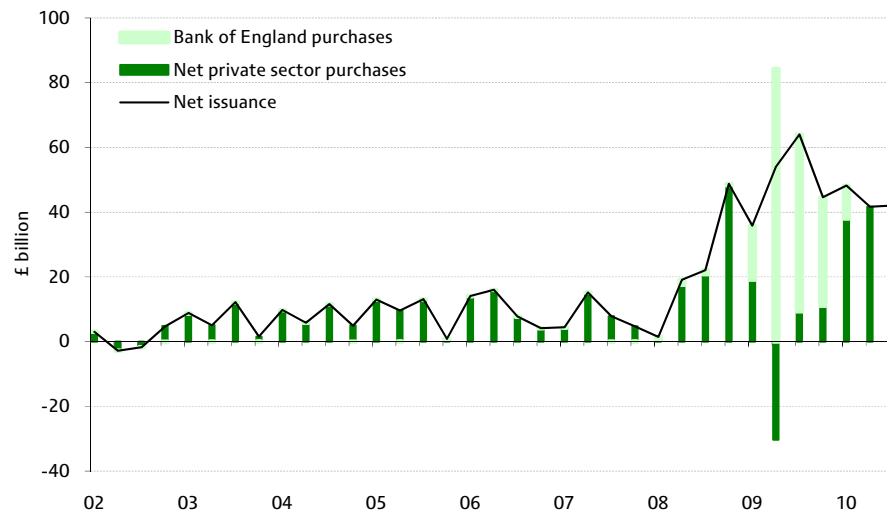
Implementation of the plan remains in the early stages, and uncertainty about the macroeconomic outlook is even higher than usual. If financial markets become concerned about the government’s ability to reduce the deficit, they may demand a large risk premium on government bonds. Higher borrowing costs add to the pressure on the public finances, and, if large enough, can tip a country from solvency into insolvency. It is therefore worth asking how secure the UK’s situation is.

In this chapter, we assess the UK's vulnerability to a fiscal crisis. Our analysis has three parts. First, we study how the market for UK government bonds (gilts) has behaved recently, against the backdrop of volatile economic and political developments both in the UK and overseas (Section 3.2). We look for evidence that investors have become unusually concerned about the risks associated with purchasing UK government debt. Second, we examine international evidence to identify the main factors that determine a country's susceptibility to a fiscal crisis (Section 3.3). This analysis draws on Barclays Capital's Fiscal Vulnerability Index, which provides a summary measure of a country's fiscal strength. Third, we identify specific risks facing the UK and ask what policymakers need to do to minimise the threat from these latent vulnerabilities (Section 3.4). Section 3.5 concludes.

3.2 Financial markets and the public finances

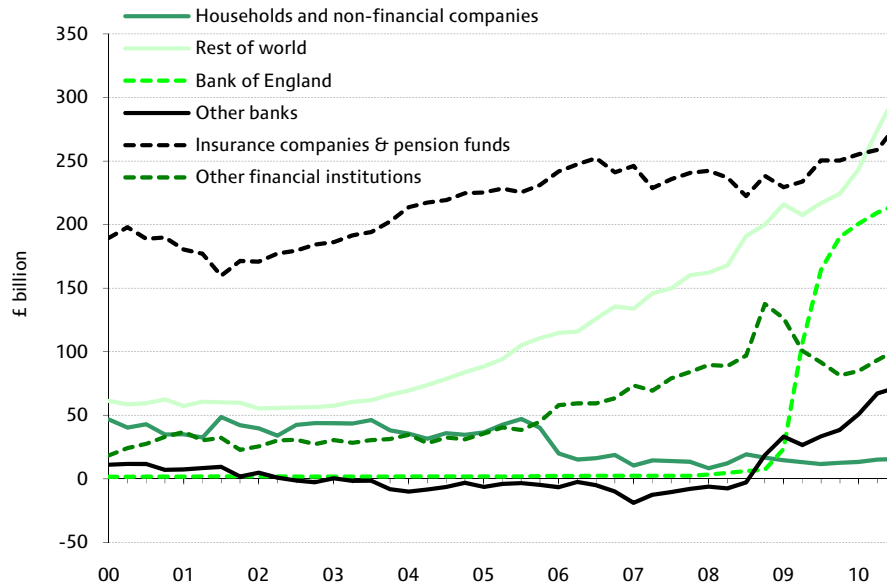
A year ago, there was widespread concern that the UK government might be unable to obtain funding from financial markets at reasonable rates of interest. The Debt Management Office (DMO), which sells bonds on behalf of the government, had embarked upon a programme of gilt sales that was several times the size of previous plans, and the Treasury's projections for the deficit implied that large quantities of gilts would be issued for some years to come. Moreover, whereas in 2009 the Bank of England had been a major purchaser of gilts under its quantitative easing (QE) policy, these purchases had been halted, meaning that private sector investors were to be asked to buy government debt to an unprecedented degree. Some commentators worried that the requisite private demand might not be forthcoming. Furthermore, the rating agencies had intimated that the UK's triple-A government credit rating was under threat, and sterling appeared vulnerable to a further decline, having already fallen by a quarter from its pre-crisis level.

Figure 3.3. Gilt sales



Sources: Haver Analytics; Barclays Capital.

Figure 3.4. Gilt holdings



Sources: Haver Analytics; Barclays Capital.

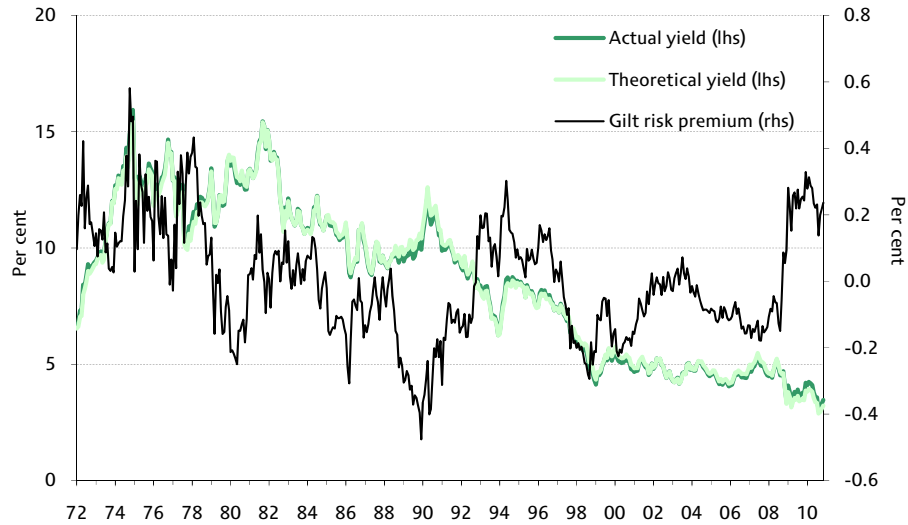
A funding crisis has not transpired, however. Private investors have stepped up their purchases of gilts to fill the void left by the Bank of England (Figure 3.3). Perhaps surprisingly, given the concerns that the UK was set to fare particularly badly in the wake of the global banking crisis, foreign investors continued to increase their purchases of gilts (Figure 3.4). UK banks also raised their gilt holdings, in part to strengthen their liquidity positions in line with guidance from the Financial Services Authority. Domestic insurance companies and pension funds also stepped in, albeit to a limited degree.

Remarkably, all of this has been achieved without any major pressure on gilt prices. The price of a government bond is inversely related to the interest rate (yield) the market charges for the government to borrow, and we might have expected gilt prices to fall and gilt yields to rise. In fact, the yield on a ten-year gilt has fallen by around 0.7 percentage points over the past year, and stands close to historical lows at around 3.5%.

To some extent, the fall in gilt yields reflects the stance of monetary policy. The Bank of England’s policy rate has been set at an all-time low of 0.5% since March 2009 and the Bank has purchased £200 billion of gilts under QE, a policy specifically aimed at lowering longer-term interest rates. We cannot, therefore, conclude that concerns about government default risk have had no effect on gilt yields, as they may have been even lower had the public finances been in better shape. We have therefore attempted to estimate the extent to which gilt yields are different from what would have been expected on the basis of monetary policy changes alone.

To this end, Figure 3.5 compares the actual interest rate charged in financial markets for the government to borrow for ten years with a measure of what this interest rate would be ‘in theory’. The posited theoretical value is based on the idea that long-term interest rates should be closely related to current and expected future shorter-term interest rates – the so-called ‘expectations hypothesis’ of the term structure of interest rates. For example, the interest rate on borrowing for ten years should, in theory, be close to the interest rate for borrowing for five years plus the five-year borrowing rate that is expected to prevail in five years’ time. If the ten-year rate were lower than the current

Figure 3.5. Ten-year gilt yield and the gilt risk premium



Source: Barclays Capital.

and expected five-year rates, for example, borrowers would shift towards borrowing for ten years rather than for two sequential five-year periods and this would push the ten-year rate up and the five-year rates down until equilibrium was restored.

The calculation shown in Figure 3.5 involves estimating, for each month, the theoretical ten-year interest rate from forecasts of the one-year interest rate over the subsequent ten years.² The one-year interest rate moves closely with the Bank of England's policy rate. We also allow for a constant risk premium in our calculation of the theoretical rate, and so the resultant risk premium series measures deviations from the average premium.

A change in monetary policy would affect the forecasts of one-year interest rates and so change our estimate of the theoretical ten-year interest rate. Any remaining deviation of the actual gilt rate from the theoretical rate therefore reflects time-variation in factors not related to short-term interest rate expectations. These include investors' perceptions of the risks attached to purchasing government debt relative to other assets. We label this deviation the 'gilt risk premium'. If investors were unusually concerned about UK government default risks, we would expect the observed gilt yield to be higher than its theoretical counterpart, generating a positive risk premium.

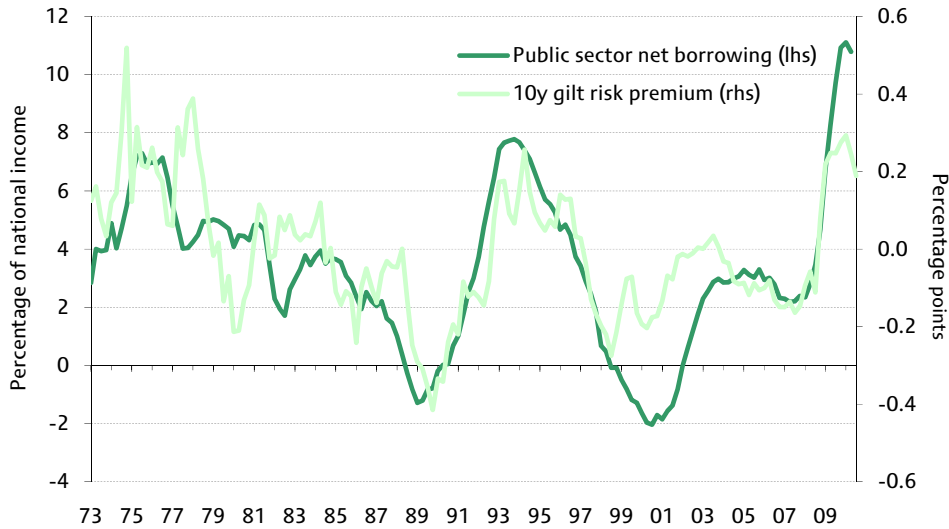
Figure 3.5 illustrates a crucial point, which is that government bond yields are primarily driven by changing expectations of monetary policy. Other factors, such as government default risk, have played a relatively minor role. The residual risk premium is small – tens of basis points, rather than percentage points, in size. Even so, our estimates indicate that although the gilt yield has fallen recently, it has not fallen by as much as would be predicted solely on the basis of interest rate expectations, and so the implied risk premium has risen.

As Figure 3.6 illustrates, the idea that this premium is related to concerns about government default is given credence by its correspondence with movements in public

² A vector autoregression is used to produce the one-year rate forecasts, similar to the method employed in K. Cuthbertson, S. Hayes and D. Nitzsche, 'Are German money market rates well behaved?', *Journal of Economic Dynamics and Control*, 2000, 24, 347–60, which itself draws on the methodology set out in J. Campbell and R. Shiller, 'Cointegration and tests of present value models', *Journal of Political Economy*, 1987, 95, 1062–88.

sector net borrowing, with higher borrowing being associated with a larger gilt risk premium.³ On this measure, the gilt risk premium is close to its highest levels since the mid-1970s, around the time of the UK's IMF bailout. Moreover, to the extent that QE has depressed ten-year gilt yields, the true gilt risk premium will be even higher, and possibly at its highest level since at least 1973.

Figure 3.6. The gilt premium and the public deficit



Source: Barclays Capital.

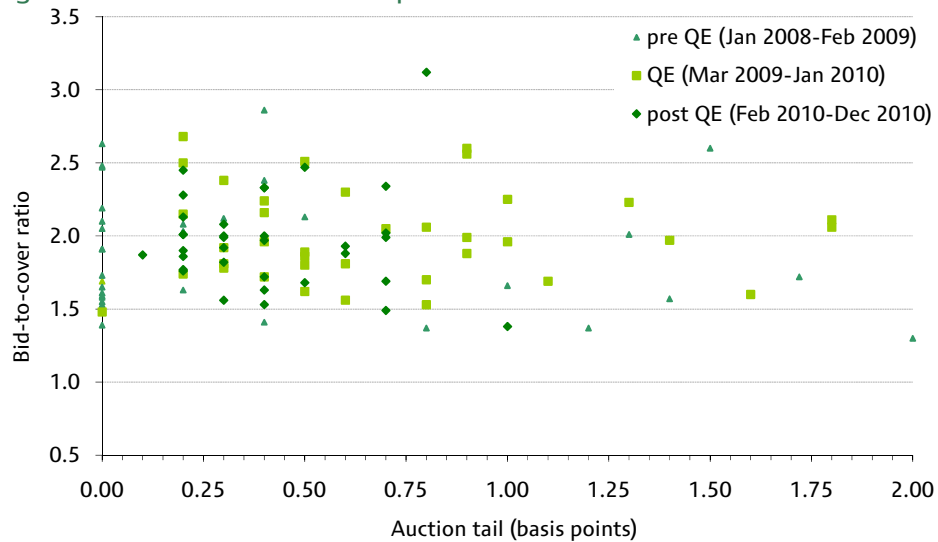
Another way of looking at the pressure on the gilt market over the last year is to examine the DMO's bond auctions, at which government debt is first issued in the market.⁴ In a bond auction, investors typically place bids for certain quantities at specified prices/yields, and the DMO accepts the most favourable bids (i.e. the ones with the highest prices/lowest yields) until the requisite amount of money has been raised. One way of judging how smoothly an auction has proceeded is to look at the 'auction tail', which is defined as the difference between the yield paid at the average accepted price and that paid at the lowest accepted price. A small tail indicates that the government was not forced to accept bids at much lower prices (higher interest rates) than the average. A second measure of the 'success' of a bond auction is the bid-to-cover ratio, which is the ratio of the total amount of bonds that investors offer to buy to the amount the DMO wishes to raise. A large bid-to-cover ratio tends to be associated with a healthy amount of demand.

Taking these two measures together, an ideal auction from the DMO's perspective would have a small auction tail and a high bid-to-offer ratio. Conversely, if the increase in government borrowing had put extra strain on the gilt market, we would expect to have seen larger tails and lower bid-to-cover ratios. This would have been especially likely in the period after the Bank of England stopped its gilt purchases under QE. Figure 3.7 shows the bid-to-cover ratio and auction tail for each of the DMO auctions over the past three years. Dots in the north-west of the figure denote 'healthy' demand while those in

³ The same pattern is apparent if the difference between the gilt yield and the market interest rate on overnight swaps is used instead of our model-based estimate of the theoretical yield.

⁴ I am grateful to Moyeen Islam, Barclays Capital's gilt strategist, for this analysis.

Figure 3.7. DMO bond auction performance



Source: Barclays Capital.

the south-east are indicative of difficult auctions. There is no discernible evidence of a worsening in demand since QE was halted.

This analysis indicates that the gilt market has taken the step-up in government borrowing in its stride. It would be inaccurate to characterise the gilt market as having become distressed as the hole in the public finances became apparent, and then becalmed by the coalition government's deficit reduction plan. However, the cost of borrowing, and therefore the solvency of the government, is not immune to worries about the deficit. Moreover, although we may take some encouragement from the fact that movements in the gilt risk premium have so far been undramatic, financial markets can suddenly lurch from tranquillity to crisis: past calm is no guarantee of future stability. In the next section, we examine the factors that appear to drive financial markets' views about the soundness of a country's fiscal position.

3.3 Measuring fiscal vulnerability

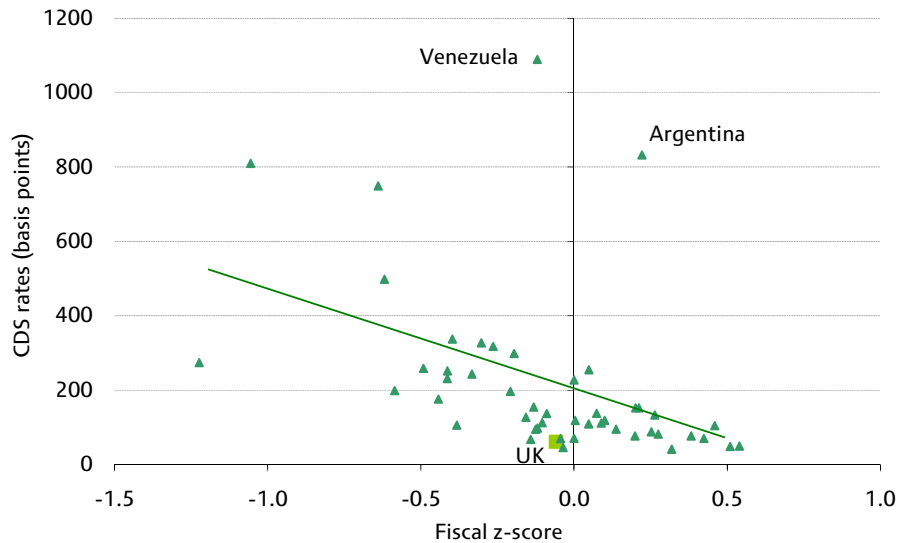
The likelihood that a country will find itself facing prohibitively high borrowing costs, or unable to raise finance at all, depends on many factors. However, although no two crises are exactly the same, they tend to have common elements, both across countries and through time. Researchers have therefore attempted to identify the main features of an economy that make it vulnerable to a fiscal crisis.⁵ Barclays Capital has drawn on this literature and developed a Fiscal Vulnerability Index (FVI) based on 16 indicators of fiscal vulnerability across 57 countries.

To measure fiscal vulnerability, the Barclays Capital FVI uses a measure of financial market concerns about a country's debt sustainability, namely the cost of insuring against a government defaulting on its bonds, as measured by credit default swap (CDS) rates. A higher CDS rate indicates that investors attach a higher likelihood to a government default, and we take this to indicate a heightened probability of a financing crisis. The

⁵ See, for example, P. Manasse, N. Roubini and A. Schimmelpfennig, 'Predicting government debt crises', International Monetary Fund (IMF), Working Paper 03/221, 2003.

choice of vulnerability indicators and the weights given to them in the overall FVI are determined by their ability to account for cross-country variation in CDS rates. Although there are some notable outliers (the CDS rates of Argentina and Venezuela are difficult to account for on the basis of our set of indicators, for example), the resultant FVI shows a strong negative correlation with the CDS rates of most countries (Figure 3.8).

Figure 3.8. Five-year CDS rates and the Fiscal Vulnerability Index



Source: Barclays Capital.

We group the indicators under five broad headings: solvency, government financing needs, external financing dependence, financial sector health and institutional strength.

Solvency

The notion of solvency is less straightforward in the context of a government than for a household or business. A firm or household might borrow more money than it can ever hope to pay back. This is likely to be less true of a government, which has recourse to taxation to repay debt, and can even resort to printing money to pay back debt denominated in its own currency. However, beyond some point, the government might think that servicing the debt would impose an excessive cost on its citizens (including the costs of currency debasement in the case of printing money) for it to be practicable. Government default is therefore often said to reflect a lack of willingness to repay, rather than a lack of ability to repay.

Our indicators of government solvency provide measures of the degree of effort a government would need to expend to ensure that its debt profile is stable and at a sustainable level. Specifically, we take the prevailing ratio of gross general government debt to GDP and compare it to 'benchmark' levels of 40% of GDP for emerging markets, 60% of GDP for most developed economies and 90% of GDP for the US and Japan. The higher is the prevailing debt level relative to the benchmark, the more difficult the government is likely to find it to adjust to a sustainable debt level.

The benchmarks are arbitrary: economic theory provides little practical guidance on the optimum level of public debt. The 40% and 60% levels have been employed by the IMF on the basis that they are 'often considered' to be levels beyond which fiscal risks become

a concern.⁶ We have chosen a higher level for the US because the dollar's position as a world reserve currency means the US is able to sustain a higher level of public debt than other countries. Japan is afforded a higher level because the vast majority of its public debt is held domestically. This is likely to reduce the incentive to default and so means that it can support a higher debt ratio.

Our second measure of solvency is the degree of adjustment in the government deficit needed to stabilise the public debt ratio at its prevailing level.⁷ The size of adjustment in relation to the level of government revenues is used to gauge how likely it is that the adjustment would be achieved.

Government financing needs

A government is more vulnerable to a funding crisis if it needs to raise large amounts of money at frequent intervals; or, to put it another way, a period of high financial market interest rates matters only if the government needs to raise large amounts of finance during that time. The vulnerability is likely to be heightened if the financing need is in foreign currency, as foreign investors are often seen as a less reliable source of financing than domestic investors. Our FVI incorporates three measures of financing needs: the fiscal balance over the next year; the average duration of government bonds (a measure of how frequently borrowing needs to be refinanced); and the share of debt that is denominated in foreign currency.

External financing dependence

Problems with the government finances are not the only catalyst of funding crises. An economy that is heavily reliant on external finance may be vulnerable to a crisis whichever sector has a substantial dependence. For example, economies in which banks, large non-financial corporations or households have borrowed heavily in foreign currency may encounter difficulties if there are sharp movements in exchange rates or shifts in foreign investors' appetite for international lending. Governments may be called upon to support other sectors, placing a strain on the public finances. Our FVI therefore includes two measures of dependence on external finance, the current account balance and the ratio of external debt to the value of the country's exports.

Financial sector health

Banking crises and government debt crises often go hand-in-hand. As has been evident recently, banks' balance sheets have the capacity to expand to multiples of a country's annual national output and the provision of support by the government in the event of a crisis can have major implications for the public finances. We therefore include three indicators of financial sector health in our vulnerability index: the banking sector's capital ratio, which indicates the sector's capacity to absorb losses without recourse to government support; the ratio of loans that are non-performing, which measures the quality of banks' past lending; and the ratio of loans to deposits. This last measure captures the banks' dependence on wholesale funding, which may be more prone to volatility in availability and cost than are deposits.

⁶ International Monetary Fund, 'Navigating the fiscal challenges ahead', *Fiscal Monitor*, May 2010.

⁷ Specifically, the primary deficit, which is the deficit before debt interest payments are made.

Institutional strength

Investors are likely to retain confidence more readily in a country that is perceived to have strong legal and political institutions. The World Bank has compiled a set of indicators for six dimensions of governance:⁸

- voice and accountability, which refers to the degree of democratic participation, freedom of expression, freedom of association and the freedom of the media;
- political stability and absence of violence/terrorism, which measures perceptions of the likelihood that the government will be destabilised or overthrown by unconstitutional or violent means;
- government effectiveness, which measures the quality of public services, the quality and independence of the civil service and the credibility of the government's commitment to policy implementation;
- regulatory quality, covering dimensions such as competition law, financial regulation and the degree to which regulations and taxes are burdensome and distortionary;
- rule of law, in particular the quality of contract enforcement, property rights, the police and the courts;
- control of corruption, which captures perceptions of the extent to which public power is exercised for private gain.

The aggregate indicators are derived from a large number of surveys of individuals, businesses and experts.

The UK's fiscal vulnerability

Our FVI is reported as a z-score for each country.⁹ A z-score is a measure of how far a country's vulnerability is from the cross-country average, and so it is a measure of relative, rather than absolute, vulnerability. A positive score indicates that the country's fiscal resilience is above average, while a negative score indicates below-average resilience.

Table 3.1 shows the overall z-scores for our sample of 57 countries. The UK's score of -0.06 places it close to the middle of the pack: the UK is ranked 32nd, close to Japan (31st) and the US (30th). Among the larger European economies, the UK scores reasonably well. Although it ranks well below Germany (11th), it is above France (39th), Spain (42nd), Portugal (49th), Italy (51st), Ireland (52nd) and Greece (56th).

⁸ See <http://info.worldbank.org/governance/wgi/resources.htm> for more information.

⁹ The z-score is the difference between the value of an indicator for a given country and the average value of the indicator across all countries in the sample, divided by the cross-country standard deviation of the indicator.

Table 3.1. Barclays Capital Fiscal Vulnerability Index

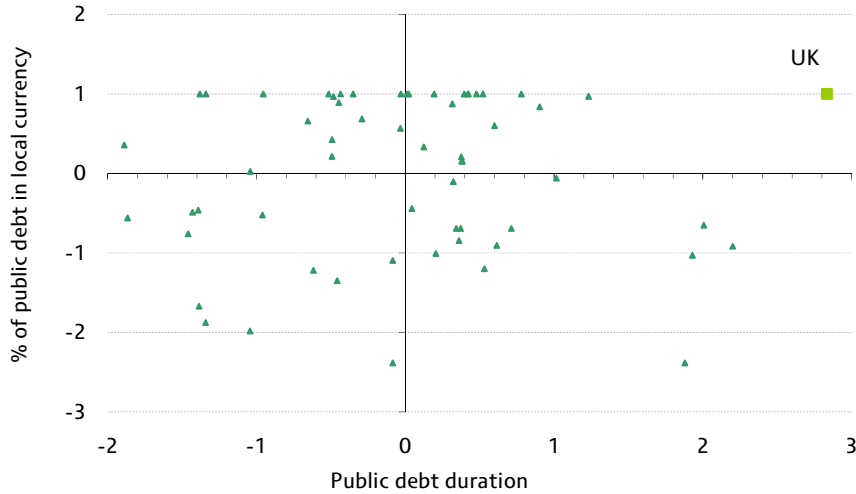
Rank	Country	FVI	Rank	Country	FVI
Top	Switzerland	0.86	30	United States	-0.04
2	Norway	0.62	31	Japan	-0.04
3	Hong Kong	0.54	32	United Kingdom	-0.06
4	Australia	0.52	33	Philippines	-0.09
5	Canada	0.52	34	Colombia	-0.10
6	Singapore	0.51	35	India	-0.12
7	Korea	0.46	36	Venezuela	-0.12
8	Chile	0.42	37	Panama	-0.13
9	Finland	0.41	38	Turkey	-0.13
10	Taiwan	0.38	39	France	-0.14
11	Germany	0.32	40	Poland	-0.16
12	Denmark	0.32	41	Dominican Republic	-0.20
13	Sweden	0.28	42	Spain	-0.21
14	Czech Republic	0.27	43	Hungary	-0.26
15	South Africa	0.26	44	Serbia & Montenegro	-0.30
16	Malaysia	0.25	45	El Salvador	-0.33
17	Netherlands	0.24	46	Iceland	-0.38
18	Argentina	0.22	47	Tunisia	-0.38
19	Uruguay	0.21	48	Romania	-0.40
20	Russia	0.20	49	Portugal	-0.41
21	China	0.20	50	Lithuania	-0.41
22	Peru	0.14	51	Italy	-0.44
23	Mexico	0.10	52	Ireland	-0.49
24	Brazil	0.09	53	Egypt	-0.59
25	Indonesia	0.07	54	Ukraine	-0.62
26	Belgium	0.07	55	Pakistan	-0.64
27	Bulgaria	0.05	56	Greece	-1.06
28	Thailand	0.05	Last	Lebanon	-1.22
29	Israel	0.00			

Source: Barclays Capital.

Unpacking the aggregate score into its component parts shows that the UK's middling score is the average of some strong positive and large negative scores. The UK scores particularly strongly on some of the government financing needs indicators: it ranks 4th overall, 1st on public debt duration (i.e. the UK has the longest average maturity of its borrowing of any country) and joint 1st on the percentage of borrowing that is in domestic currency. This is illustrated in Figure 3.9, in which a dot in the top right quadrant is a sign of strength (above-average scores on both indicators) while a dot in the bottom left quadrant denotes weakness (below-average scores on both). However, the UK's aggregate financing needs score is reduced by the large government deficit, on which it is ranked 52nd with only Iceland, Japan, Spain, Lebanon and Ireland having worse scores.

Another positive area for the UK is institutional strength, in which it is above average (with positive z-scores) on all six of the World Bank indicators.

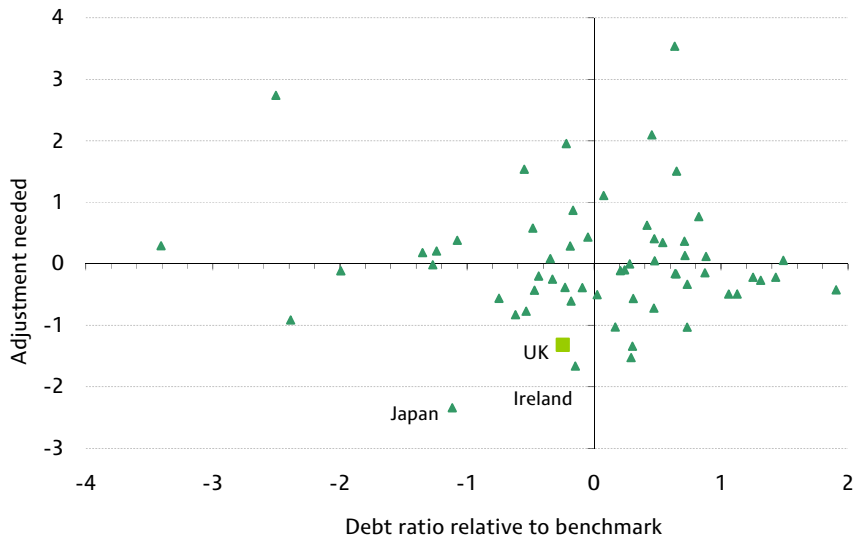
Figure 3.9. Financing needs z-scores



Source: Barclays Capital.

The main areas of vulnerability for the UK relate to solvency and external financing dependence. Figure 3.10 shows that the UK scores below average on both the level of debt relative to its sustainable benchmark and, in particular, the degree of adjustment needed to stabilise debt. Ireland is close by, and only Japan scores materially worse on both indicators. If the avoidance of a fiscal crisis is a government priority, therefore, cutting the deficit stands out as a policy priority.

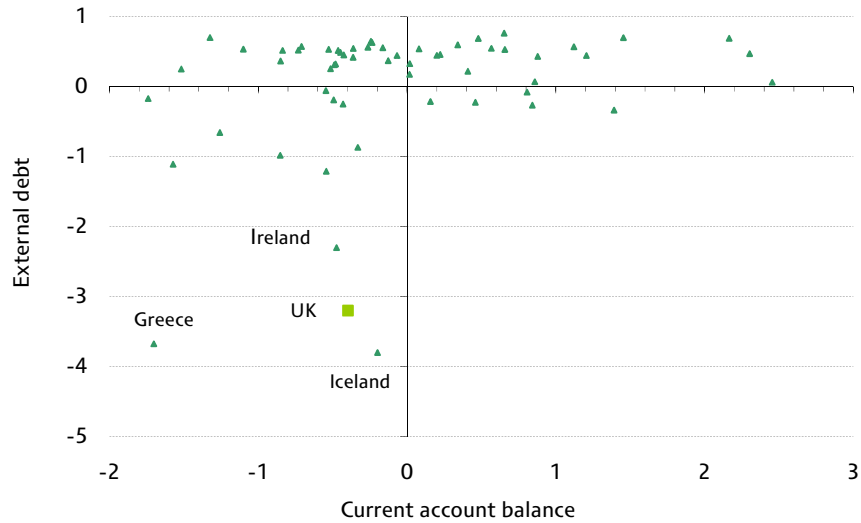
Figure 3.10. Solvency z-scores



Source: Barclays Capital.

Figure 3.11, which shows our two measures of external financing dependence, also raises an alarm. The UK is one of four large outliers, the others being Ireland, Iceland and Greece, all three of which are currently operating under IMF programmes.

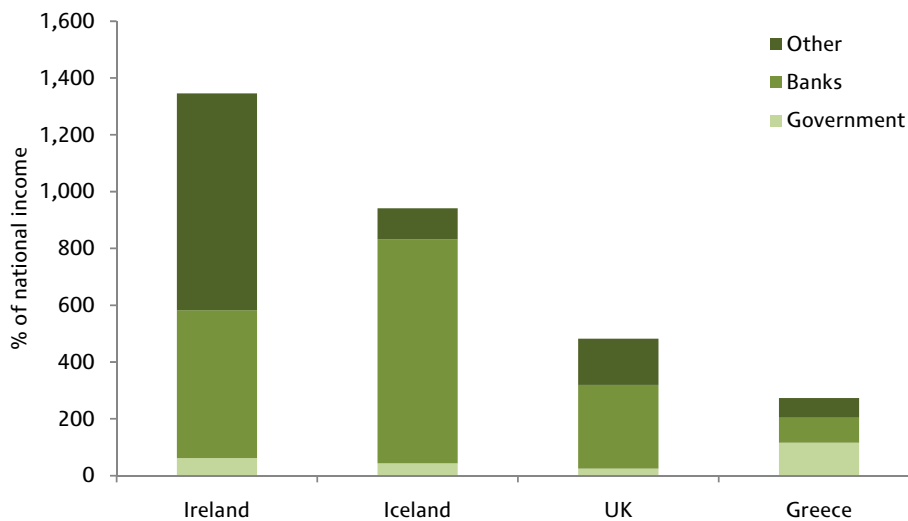
Figure 3.11. External financing dependence z-scores



Source: Barclays Capital.

The amount of external debt is the main common vulnerability flagged by this analysis. This is worthy of further investigation. Our FVI analysis, in common with all similar studies, is designed to identify broad-brush vulnerability indicators. The transmission mechanism for the vulnerability, and therefore the degree of vulnerability itself, may differ across countries with similar overall scores.

Figure 3.12. External debt (% of national income)



Sources: Haver Analytics; Central Bank of Iceland; Barclays Capital.

Figure 3.12 breaks external debt for each of the four countries identified in Figure 3.11 into government debt, bank debt and other (i.e. private sector non-bank) debt, as a percentage of each country's national income. Greece has relatively little private external debt, but its public external debt, at 116% of national income, is the highest. The fiscal vulnerability applying through Greek external debt is therefore directly related to government borrowing. Iceland's external debt vulnerability is largely a banking sector issue: the external debt of Iceland's banking sector amounts to nearly 800% of national

income. Ireland has both a large banking sector exposure (520% of national income) and a huge non-bank private sector exposure (764% of national income).

Relative to this set of bedfellows, the UK does not appear overly stretched in any dimension. The direct fiscal vulnerability is small: external holdings of UK government debt amount to only about 25% of national income. Non-bank private liabilities are 163% of national income, reflecting the fact that the UK hosts a number of multinational non-financial companies.

The UK banking sector exposure, although substantially less than those of Iceland and Ireland, is sizeable at 295% of national income. This potential source of vulnerability is well known, however. For example, in its December 2010 *Financial Stability Report*, the Bank of England noted that UK banks' lending to French and German banks provided one channel through which the UK could be affected by a European government debt crisis. As the IMF has highlighted¹⁰ when contrasting the performance of Ireland and Iceland with that of Hong Kong and Singapore – two other economies with large banking systems relative to national income – such exposures need not be of major concern so long as they are subject to appropriate oversight by bank management and regulators.

In summary, our overall assessment is that the UK is neither particularly susceptible to a fiscal crisis but nor is it home and dry. The UK benefits from the long average maturity of its debt and the fact that the vast majority of government borrowing is in sterling. The strength of regulation and the rule of law also lower the likelihood of a funding crisis. However, the UK's large government budget deficit puts a question mark over the government's solvency. Cutting the deficit, other things equal, would further insulate the UK from potential financial market volatility.

3.4 Risks

The analysis in the previous section suggests that achieving a lasting reduction in the public deficit stands out as a policy priority if the risk of a funding crisis is to be minimised. The absence of bond market stress documented in Section 3.2 suggests that the government's plan to cut the deficit is viewed as credible by financial markets. But there are still risks. In particular, there must be some uncertainty over whether the government will be able to implement the proposed tax increases and spending cuts, and whether the level of aggregate demand in the economy will be sufficient to support the requisite adjustment.

The largest single year of tightening is 2011–12, during which the government is seeking to cut the structural deficit by £32 billion (2.1% of national income). Around half of this is due to come through net tax increases, with higher VAT, National Insurance contributions and increases in other taxes more than outweighing the cost of an above-inflation rise in the income tax personal allowance. The other half comes from spending cuts, primarily capital spending. To the extent that tax increases and capital spending cuts are more easily achievable, both practically and politically, than cuts in current departmental spending and welfare, this configuration may mean that the deficit reduction plan stays on track in the near term.

Clear signs that the deficit reduction plan is on course may help bolster support for the programme from the general public. Nevertheless, some of the proposed cuts to

¹⁰ International Monetary Fund, 'Cross-cutting themes in economies with large banking systems', IMF Policy Paper, April 2010 (<http://www.imf.org/external/np/pp/eng/2010/041610.pdf>).

government spending are likely to be politically contentious, and the cohesiveness of the coalition government is likely to be tested. But any substantial watering-down of the fiscal consolidation plan might reignite market concerns about the UK's public debt trajectory, and the triple-A credit rating might come under renewed pressure.

Other vulnerabilities stem from the outlook for aggregate demand. Household and business demand are fragile, as real labour incomes have fallen and uncertainty about the strength of the recovery remains unusually high. The recent turbulence in some euro-area countries has raised concerns about an outright government debt crisis, which could adversely affect UK export sales and possibly lead to losses for the UK's banks, further impeding their ability to lend.

The much-touted Plan A is that in the event of an adverse shock to demand, the automatic stabilisers would be allowed to operate and the Bank of England would loosen monetary policy. However, it is questionable how effective a further monetary expansion would be in the current circumstances. There is little scope to cut the policy rate from its current level of 0.5%, and so the most likely response by the Bank of England would be to embark on further QE via purchases of gilts. According to the Bank of England, QE works primarily by lowering the yields on government bonds and thus encouraging investors to buy other assets, such as corporate bonds and equities.¹¹ The resultant rise in financial asset prices can then boost aggregate demand through 'wealth effects'.

This is a rather circuitous channel, however, and may be impotent in the short term. For example, if consumer and business confidence were damaged by renewed economic turmoil, households' and firms' willingness to spend in response to increased wealth might be similarly reduced. If Plan A were to prove ineffective, a Plan B might be needed, potentially involving some reduction in the size and pace of cuts in the structural deficit. The coalition government has been reluctant even to hint that a Plan B exists, however, possibly fearing that such an indication would call into question its commitment to the announced consolidation path. From this perspective, good luck in the form of a continued, steady recovery is likely to be an important ingredient in the successful achievement of the deficit reduction plan, and the ongoing solvency of the UK government.

3.5 Conclusion

In opting for an aggressive pace and size of fiscal consolidation, the government hopes to have insulated the UK from the types of funding crises that have beset other European countries. The market for UK government bonds has not shown any material signs of stress over the past year, implying that investors believed the government would deal with the deficit problem effectively. Investor demand for UK government debt has remained healthy even after the Bank of England halted its bond purchases under its policy of quantitative easing. The gilt risk premium has risen, however, and, in financial markets, past calm is no guarantee of future stability, and so fiscal vulnerability remains an important issue.

Our fiscal vulnerability analysis indicates that the UK ranks close to the middle of our sample of 57 countries, suggesting no immediate cause for concern. However, the large structural government deficit remains a source of vulnerability, and achieving a

¹¹ See, for example, Bank of England, 'Quantitative easing explained: putting more money into our economy to boost spending' (<http://www.bankofengland.co.uk/monetarypolicy/pdf/qe-pamphlet.pdf>).

sustainable deficit reduction stands out as a policy priority. The front-loading of tax increases and capital spending cuts should ensure that the deficit reduction plan stays on track in the near term, but the risk of political turbulence remains high. Fiscal adjustment may also be hampered by further adverse macroeconomic shocks, which monetary policy is arguably not well placed to counter.