HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

Richard Hughes
Chair, Office for Budget Responsibility
102 Petty France
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23 March 2022

Dear Richard,

Response to the 2021 Fiscal Risks Report

I am writing in response to the Fiscal Risks Report (FRR), published on 6 July 2021. The FRR has made a major contribution to the monitoring of risks to the sustainability of the UK's public finances since its introduction in 2017, with the International Monetary Fund recognising that the FRR "raises the bar on the assessment and quantification of fiscal risks to a new level that other countries should look to meet".[1]

The move to an annual sustainability report, as outlined in the autumn 2021 update of the Charter for Budget Responsibility, will further strengthen the independent risk monitoring provided by the Office for Budget Responsibility (OBR). This will ensure that short- to medium-term risks to the public finances are considered alongside long-term sustainability factors, providing a more regular and comprehensive overview of the public finances. The government's commitment to respond at a subsequent fiscal event further increases fiscal transparency.

The FRR focused on three sources of potential fiscal risk: the cost of public debt, the COVID-19 pandemic and climate change. In line with this approach, I will address each of these areas in turn and outline the actions that the government is taking to mitigate these risks.

<u>Cost of public debt</u>

As a result of the pandemic and the government's necessary package of support, borrowing and debt reached historically high levels. Increases in the stock of debt and the shortening of its effective maturity resulting from quantitative easing have increased the sensitivity of the public finances to changes in interest rates. You described these changes in the FRR and, at the time of publication, your analysis showed that the first-year fiscal

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[1] 'Stressing the Public Finances – the UK Raises the Bar', IMF, July 2017.

impact of a one percentage point rise in interest rates was six times greater than it was just before the financial crisis, and almost twice what it was before the pandemic.

The UK's relatively large stock of inflation-linked debt means that the public finances are also sensitive to changes in inflation. Spending on debt interest has risen sharply in recent months, with new monthly debt interest records in each of the last three months.[2] Debt interest spending is forecast to reach £83.0 billion next year – the highest nominal spending ever and the highest relative to GDP in over two decades.[3, 4] This is nearly four times the amount spent on debt interest last year (£23.6 billion in 2020-21) and exceeds the budgets for day-to-day departmental spending on schools, the Home Office and the Ministry of Justice combined (totalling £78.3 billion in 2022-23).[5] Taxpayer money spent servicing debt is money which could have been spent on public services.

The new fiscal rules I introduced at Autumn Budget and Spending Review 2021 will manage these risks by ensuring that debt falls over the medium term, keeping the public finances on a sustainable footing. Through the new fiscal framework, the government will seek to reduce exposure to debt interest risks. The fairest and most sustainable way to achieve this continues to be balancing current spending with tax through a current budget rule.

The UK was one of the first countries to set out fiscal rules for after the pandemic, with the IMF recognising that the "new fiscal rules have anchored fiscal policy well".[6] As a result of the government's responsible decisions, and despite higher inflation, the fiscal rules are met in the latest forecast.

HM Treasury (HMT) will also consider wider data and analysis on the affordability of public debt to support the achievement of the government's fiscal objectives. The analysis provided by the OBR on a range of indicators through its Economic and Fiscal Outlook and annual sustainability reports will support our assessment.

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[2] 'Public Sector Finances, UK: February 2022', ONS.
[3] This is central government debt interest, net of APF.
[4] 'Economic and Fiscal Outlook', OBR, March 2022; 'Public Sector Finances, UK: February 2022', ONS.
[5] 'Autumn Budget and Spending Review 2021', HMT, October 2021.
[6] 'United Kingdom: 2021 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for the United Kingdom', IMF, February 2022.

COVID-19 pandemic

As the Prime Minister announced last month, the UK is moving into a new phase of managing COVID-19.[7] The success of the vaccination programme has allowed society and the economy to open up more quickly than many comparable countries and for the government to remove the remaining domestic restrictions in England.

The cost of government support throughout the pandemic has been unprecedented, but the cost of inaction would have been far greater. The government provided unprecedented support for the economy during the pandemic.[8] This included the Coronavirus Job Retention Scheme which supported 11.7 million jobs across the whole of the UK and played an important role in limiting labour market scarring by preserving the relationships between employers and employees.[9] This action helped to keep unemployment significantly below the peak of 12% that was expected in July 2020.[10] Unemployment peaked at 5.2% in Q4 2020 and has fallen steadily for twelve consecutive months to 3.9% in the three months to January, below pre-pandemic rates.[11] Vacancies are now at record levels and redundancies are at an all-time low, reflecting the tightness in the labour market. By taking action to protect jobs, the government helped to limit the short- and long-run economic effects of the pandemic.

Taken together, the success of the vaccine programme and the government's Plan for Jobs have contributed to a stronger than expected economic recovery with GDP growth of 7.5% in 2021, the fastest in the G7.[12] The IMF highlighted this in February, stating that "strong policy measures and rapid vaccination campaign that helped contain the health, economic, and financial impact of the pandemic, which supported a faster than expected recovery".[13]

The economic recovery and the tough but responsible decisions that the government has taken over the past year have strengthened the public finances. This action ensures that public services receive the long-term funding they need to allow them to tackle backlogs as we emerge from the pandemic. This includes the introduction of the Health and Social Care Levy which will allow for one of the biggest catch-up programmes in the history of the NHS and provide permanent funding for the government's plan to fix social care.

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[7] 'COVID-19 Response: Living with COVID-19', GOV.UK, February 2022.
[8] 'Autumn Budget and Spending Review 2021', HMT, October 2021.
[9] 'HMRC coronavirus (COVID-19) statistics', HMRC, December 2021.
[10] 'Fiscal sustainability report', OBR, July 2020.
[11] 'Labour market overview, UK: March 2022', ONS, March 2022.
[12] 'Gross Domestic Product: Year on Year growth: CVM SA %', ONS, February 2022.
[13] 'United Kingdom: 2021 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for the United Kingdom', IMF, February 2022.

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Climate change

The FRR makes clear that unmitigated climate change is a significant fiscal risk. Action to reach net zero is less costly but there are fiscal implications associated with the transition which require careful management, in large part due to its impact on receipts from changing the tax base and the demands on government spending to support the investment required to meet the government's target for net zero emissions by 2050.

In October, HMT published the Net Zero Review, an analytical report that explores the key issues as the UK decarbonises. The Net Zero Strategy, published at the same time as the Review, sets out a comprehensive range of policies to support and capitalise on the UK's transition to net zero by 2050 across the whole economy. Autumn Budget 2021 confirmed the announcements in the Net Zero Strategy: since March 2021 the government will have committed £30 billion of public investment in climate change, as well as introducing new non-fiscal measures to crowd in private investment for the transition.

In response to Putin's invasion of Ukraine, the government has announced that it will phase out the import of Russian oil by the end of 2022.[14] This phased approach allows the UK more than enough time to adjust supply chains ensuring a smooth transition. The government will soon be setting out an energy security plan. This will include measures across hydrocarbons, nuclear and renewables to support energy resilience and security while delivering affordable energy to consumers. Building on the Prime Minister's Ten Point Plan for a Green Industrial Revolution, the government is raising its delivery ambitions across energy technologies to end the UK's dependency on hydrocarbons from Russia.

The importance of fiscal space

The FRR highlights that the UK has faced two "once in a century" economic shocks in just over ten years and in the past month the whole world has been rightly appalled at Putin's unprovoked invasion of Ukraine. Acting in unison with our allies, the government announced a large package of economic sanctions designed to apply severe economic cost to these actions. The invasion has had global economic consequences and is an important reminder of the FRR's final conclusion that "fiscal space may be the single most valuable risk management tool".

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[14] 'UK to phase out Russian oil imports', GOV.UK, March 2022.

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Action taken by my predecessors over the past decade to rebuild the public finances allowed the government to support businesses and individuals through the pandemic, when it was needed most. That is why the government has taken the action I have outlined above to support a strong economic recovery and repair the public finances, guided by the new fiscal rules, to ensure that governments have buffers to respond as future risks materialise.

The fiscal framework includes an aim to strengthen the public sector balance sheet, supported by and encouraging the effective management of assets, liabilities and risks. Balance sheet metrics provide a wider set of information to inform analysis of fiscal space, helping to ensure that fiscal rules are met in a sustainable way and the IMF recognised their introduction as an "important innovation".[15] As one of the early adopters of this type of approach, it puts the UK at the forefront of best practice in public financial management.

HMT will continue to survey the most important fiscal risks and actions being taken to manage them through its robust internal risk management. The independent analysis produced by the OBR is an important contribution to these risk management processes.

I am placing this letter in the Libraries of the House and copies will be available in the Vote Office and the Printed Paper Office to ensure that Parliament is kept updated on the action that this government is taking to protect the public finances.

Best wishes,

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[15] 'United Kingdom: 2021 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for the United Kingdom', IMF, February 2022.