

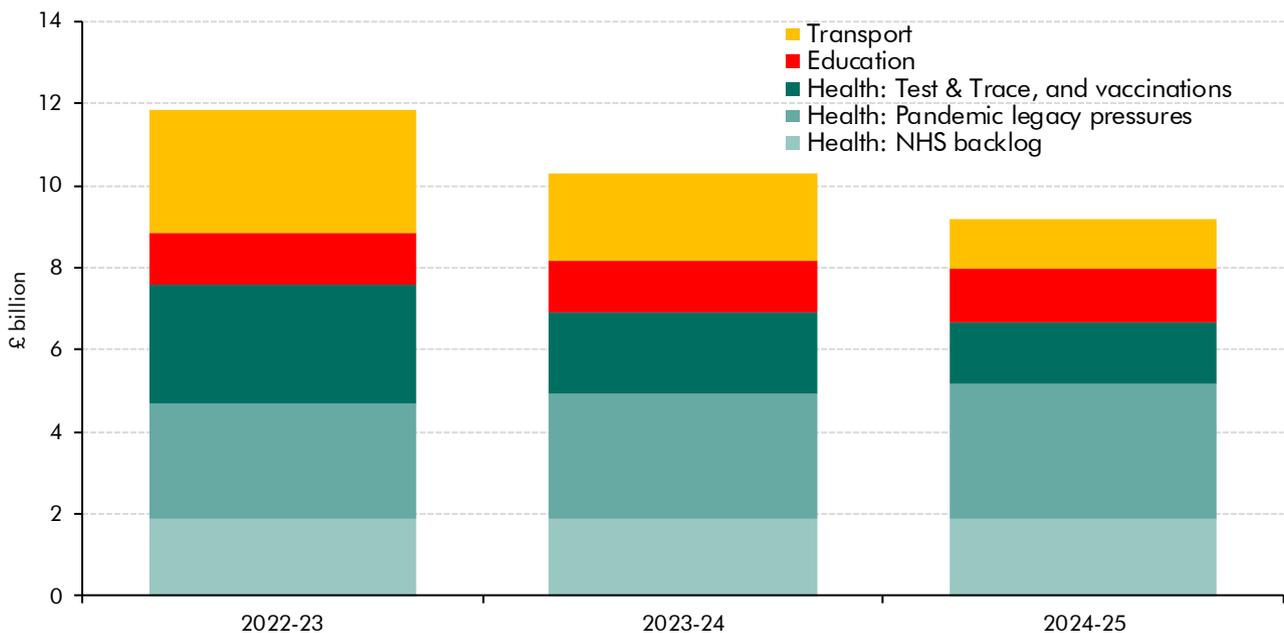
Fiscal risks report – July 2021

In the wake of the largest peacetime economic shock in three centuries, our third *Fiscal risks report* focuses on three large, and potentially catastrophic, sources of fiscal risks.

Coronavirus pandemic

Chapter 2 looks back at the fiscal impact of the coronavirus pandemic over the past year and ahead to its potential legacy for the public finances over the medium and long term. The UK suffered one of the deepest recessions of advanced economies in 2020 and borrowing reached a peacetime high of 15.6 per cent last year. The UK's fiscal policy response to the pandemic was large by historical standards and the second largest in the G7. Looking ahead to this year's Spending Review, the pandemic could leave the Government facing around £10 billion of unfunded pressures on departmental spending on average over the next three years, from legacy effects across health, education and transport. The pandemic could do longer-term damage to the economy. Our last two forecasts assumed a 3 per cent permanent loss of output which we will review ahead of our Autumn forecast.

Illustrative estimates for selected pandemic-related pressures on departmental resource spending

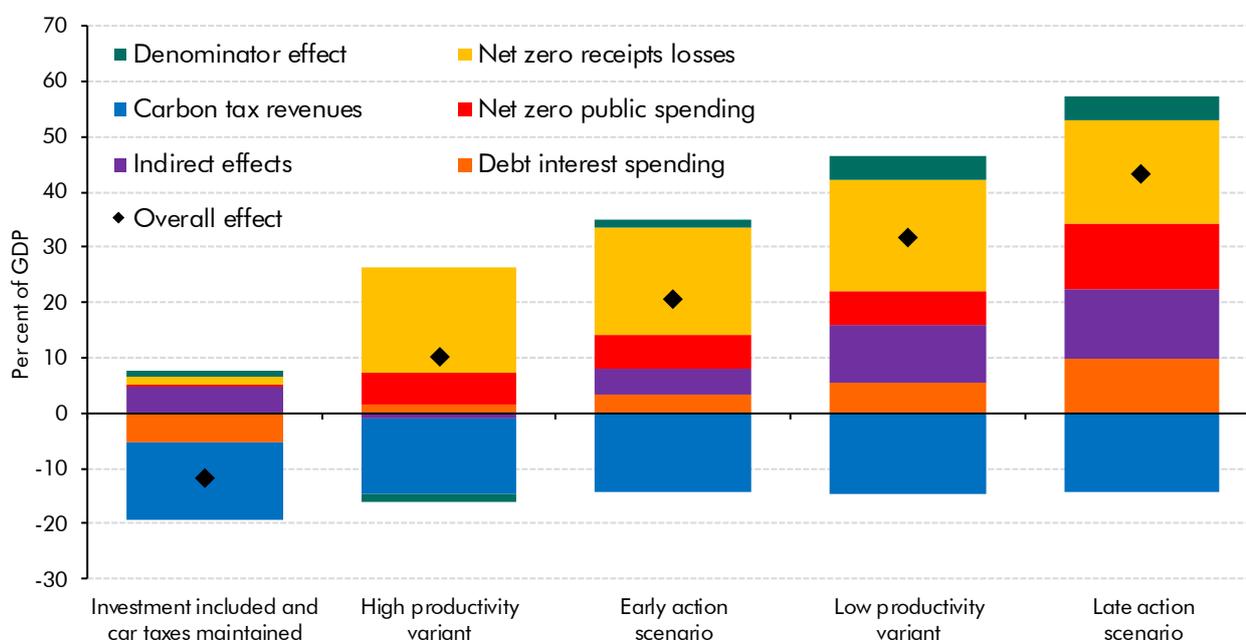


Note: Assumptions and sources underpinning estimates of individual pressures can be found in Chapter 2.
Source: OBR

Climate change

Chapter 3 looks at the economic and fiscal implications (both positive and negative) of alternative paths to meeting the Government’s legislated goal to reduce net greenhouse gas emissions to zero by 2050. Based on an ‘early action’ scenario in which action is taken globally and in the UK from now, the transition to net zero adds 21 per cent of GDP to public debt over 30 years (relative to a hypothetical baseline in which no climate-related headwinds exist) – slightly less than the pandemic has added in just two years. This rise is more than explained by the loss of fuel duty and other emissions-related revenues. The gains from taxing carbon more heavily are sufficient to cover the costs of public spending on net zero investments. Alternative scenarios outline the implications of unmitigated climate change, a delayed and abrupt policy response, and different productivity outcomes and fiscal policy choices, with the impact on debt ranging from a *reduction* of 12 per cent of GDP to an increase of 43 per cent.

Climate scenarios: impact on public sector net debt in 2050-51



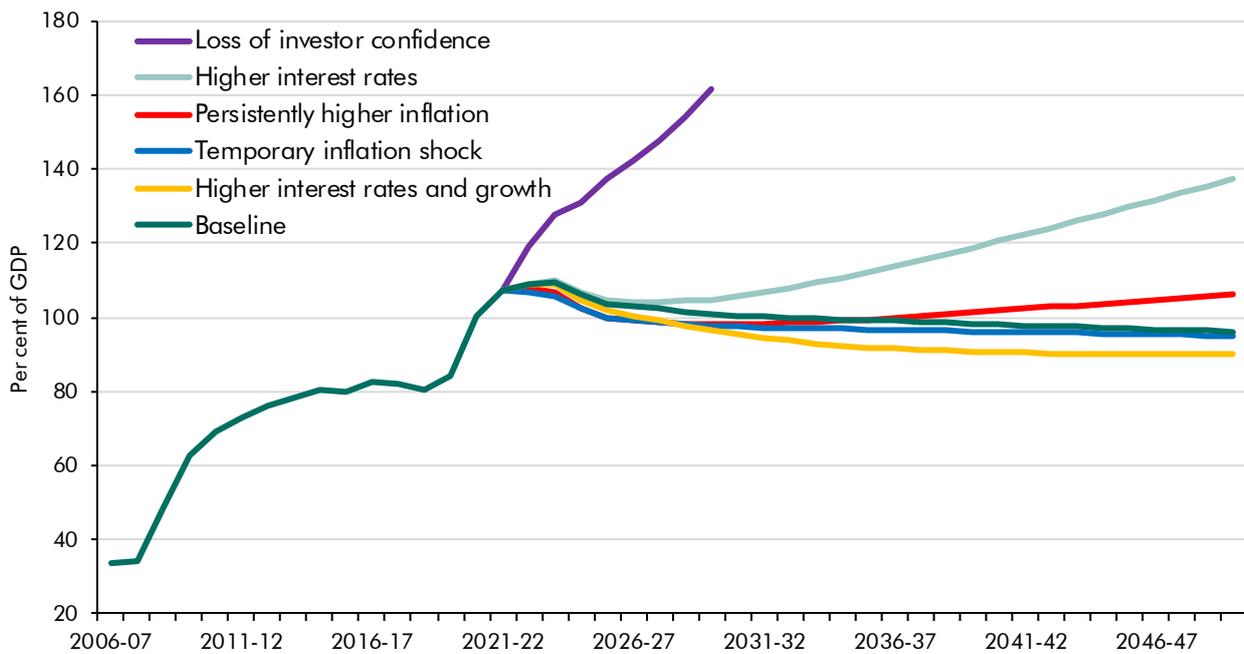
Source: OBR

Cost of public debt

Chapter 4 considers the fiscal risks associated with the cost of government debt. These risks depend on the future path of interest rates, but three developments make the UK public finances more sensitive to any changes in these. First and foremost, debt is around three times higher than it was in 2008, largely due to the fiscal consequences of the financial crisis and the pandemic. Second, public sector liabilities have a shorter effective maturity as a by-product of quantitative easing, meaning changes in interest rates feed through more quickly to debt costs – twice as much of the cost of any interest rate increase is felt in the first year than was the case in 2008. Combined with higher debt, that means interest payments are six times more sensitive over a one-year horizon than they were just prior to the financial crisis. Third, increased foreign holdings of UK gilts, from 18 per cent in 2000 to around one-quarter today, potentially make the UK

government finances somewhat more susceptible to changes in investor sentiment or developments abroad. Our scenarios explore the consequences for public debt of alternative paths for key interest rates, inflation and growth. They suggest that the Government will find it more difficult to either grow out of or inflate away its debt stock and face a more immediate fiscal cost from any future rises in interest rates owing to the shorter effective maturity of its consolidated liabilities.

Cost of public debt scenarios: public sector net debt



Notes

1. The OBR is the UK's independent fiscal watchdog. We produce forecasts for the economy and the public finances, assess progress against the Government's fiscal targets, and report on long-term fiscal sustainability and fiscal risks.
2. All the documents and supporting material, including data behind all charts and tables, published today is available on our website: <https://obr.uk/>
3. Questions about the *Fiscal risks report* should be sent to obr.press@obr.uk