9 December 2014

Central government debt interest

There have been a number of changes to our central government debt interest forecast since March, reflecting methodological changes implemented by the ONS, movements in the key underlying determinants, and modelling updates.

The various changes have been set out in our latest *Economic and fiscal outlook (EFO)*, but given the number of moving parts and the scale of these changes, we have received requests to bring these together in one place.

This supplementary forecast note and table draw on material from different tables in our latest *EFO*.[1] It employs the same format used to describe the changes in public sector net borrowing in Table 1.2 of the *EFO*, starting with changes stemming from the move to the 2010 European System of Accounts (ESA10) and implementation of the ONS review of the public finances, then setting out forecasting changes on a broadly like-for-like basis.

Classification changes (shown in Table 4.23 in the EFO)

The ONS has implemented two changes that affect estimates of debt interest payments:

- broadening the 'ex-measures' in the public finances to exclude only public sector banks has brought the Asset Purchase Facility (APF) inside the public sector boundary. This means that coupon payments made by the Exchequer on gilts held by the APF now cancel out because they are received within the public sector. The same applies to the cash transfers from the APF to the Exchequer, which were previously recorded as dividend receipts. Instead of the gilt coupon payments, the cost to the APF of financing its loan at Bank Rate is recorded as debt interest. Were we to have anticipated this change in March, debt interest payments would have been £12.5 billion lower in 2014-15, with the amount declining to £2.0 billion by 2018-19 as the APF was expected to unwind; and

- Network Rail has been reclassified from the private sector to the central government sector, so its income and spending are now included in public sector totals. If it had continued to finance its own debt, these payments may have risen from £1.3 billion in 2014-15 to £2.2 billion in 2018-19.

[1] The figures in our *EFO* and this note refer to debt interest payments made by central government only, but after taking into account the consequence of, in effect, financing some of the debt at Bank Rate through the APF.

In total, restating our March forecast on the new ESA10, post-PSF review basis leads to an £11.2 billion reduction in debt interest in 2014-15, with the amount declining over time, to a small increase by 2018-19.

Forecasting changes (shown in Table 4.24 in the EFO)

Underlying forecast changes since March reduce debt interest payments by £5.0 billion in 2014-15, mainly reflecting lower RPI inflation, which reduces the amount the Exchequer is committed to pay on index-linked gilts (these affect the accrued measure of debt interest, although most of the actual cash payments will not occur until the gilts are redeemed). Lower RPI inflation reduces debt interest payments throughout the forecast period. Lower interest rates also reduce the forecast, with the effect building up over time as debt is refinanced. This reduces payments by £0.6 billion in 2014-15, increasing to £7.0 billion by 2018-19.

We had previously over-predicted the stock of debt due to an error in the way the model used to estimate debt interest captured the refinancing of gilts at redemption. When a gilt reached its redemption date, the model removed an amount based on an out-of-date snapshot, but refinanced an amount based on the latest (higher) numbers. So less was removed than was added, and the stock therefore increased more than it should have. The error became apparent when the forecast was extended to 2019-20 and generated an unexpected change in the effective interest rate on the debt stock that prompted further investigation. Correcting this has reduced the forecast by amounts rising from £1.1 billion in 2015-16 to £3.9 billion in 2018-19.

Other changes reduce central government debt interest payments by around £1 billion in the medium term. This includes taking into account the latest outturns, and, implicitly, the savings associated with now financing Network Rail's new and maturing debt through the Debt Management Office (DMO), rather than by Network Rail directly.

It is not possible to decompose this net effect into its component parts, but we estimate that Network Rail will pay £0.9 billion directly to the private sector in 2018-19 (shown in Table 4.38 of the *EFO*) and that the DMO will also now pay more than it otherwise would have done (included in the 'financing CGNCR' line in Table 4.38), but that the total will be less than the £2.2 billion Network Rail would otherwise have paid without this agreement (shown in Table 4.23 and described above).

Reductions in market expectations of Bank Rate since March have reduced debt interest payments further, by reducing the cost to the APF of financing its loan from the Bank. Lower gilt yields – and therefore higher gilt prices – also reduce the losses that the APF would make if it sold gilts, as we assumed in March. But we now assume that

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gilts held by the APF will not be actively sold during the forecast period, and will only be run down through redemptions once Bank Rate has started to rise. In combination, these changes reduce debt interest payments by around £3.8 billion by 2018-19.

Total spending impact

The Government has set an assumption for total spending beyond 2015-16. But the changes up to 2015-16 affect the jumping off point for the spending assumption and the size of the real cut that is then rolled forward.

Forecasting changes have reduced debt interest payments by £9.7 billion in 2015-16. Pushing this into later years through the spending assumption leads to a £10.0 billion reduction in total spending by 2018-19. The further changes in debt interest payments beyond 2015-16 – in particular the modelling and interest rate changes that cumulate over time – have been implicitly offset by additional departmental spending.

Central government debt interest, net of APF

	£ billion					
	Outturn	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
March 2014 (ESA95, pre-review)	**48.4**	**52.1**	**59.1**	**65.1**	**71.6**	**75.2**
Changes due to implementation of ESA10 and the ONS PSF review						
Total	**-11.1**	**-11.2**	**-9.0**	**-4.7**	**-1.9**	**0.2**
of which:						
Reductions in debt interest due to APF	*-12.4*	*-12.5*	*-10.4*	*-6.4*	*-3.9*	*-2.0*
Include Network Rail debt interest payments	*1.2*	*1.3*	*1.4*	*1.8*	*2.0*	*2.2*
March 2014 (ESA10, post-review)	**37.3**	**40.9**	**50.1**	**60.4**	**69.7**	**75.4**
Forecast changes						
Forecast changes since March 2014	**-1.1**	**-5.0**	**-9.7**	**-13.1**	**-15.7**	**-17.8**
of which:						
Central government debt interest	-1.0	-5.2	-8.6	-10.6	-12.3	-14.0
of which:						
Gilt rates	*0.0*	*-0.2*	*-1.4*	*-2.8*	*-4.2*	*-5.3*
Short rates	*0.0*	*-0.4*	*-0.8*	*-1.4*	*-1.7*	*-1.7*
RPI inflation	*0.0*	*-3.2*	*-4.3*	*-3.2*	*-2.3*	*-2.2*
Revisions to stocks	*0.0*	*-0.8*	*-1.1*	*-2.3*	*-3.1*	*-3.9*
Other	*-1.0*	*-0.6*	*-0.9*	*-0.9*	*-1.0*	*-1.0*
APF	-0.2	0.3	-1.1	-2.5	-3.4	-3.8
of which:						
Interest rate and other underlying movements	-0.2	0.3	-1.2	-2.4	-2.5	-2.4
Profile of APF drawdown	0.0	0.0	0.1	0.0	-0.9	-1.5
December 2014	**36.1**	**35.9**	**40.4**	**47.3**	**54.0**	**57.5**
Memo: Resulting change in spending since March [1]	*-1.1*	*-5.0*	*-9.7*	*-9.7*	*-9.8*	*-10.0*

[1] After taking into account interactions with the spending assumption.