HOUSE OF LORDS

Economic Affairs Committee

Corrected oral evidence: Sustainability of the UK's national debt

Tuesday 28 January 2025

3.15 pm

Watch the meeting

Members present: Lord Bridges of Headley (The Chair); Lord Blackwell; Lord Burns; Lord Davies of Brixton; Lord Lamont of Lerwick; Baroness Liddell of Coatdyke; Lord Londesborough; Lord Razzall; Lord Rooker; Lord Turnbull; Baroness Wolf of Dulwich.

Evidence Session No. 7 Heard in Public Questions 125 – 136

Witnesses

I: Dr Peder Beck-Friis, Senior Vice President and Economist, PIMCO; Roger Bootle, Senior Independent Advisor and Non-Executive Director, Capital Economics; Allan Monks, Executive Director and Chief UK Economist, JP Morgan.

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Examination of witnesses

Dr Peder Beck-Friis, Roger Bootle and Allan Monks.

Q125 **The Chair:** Good afternoon and welcome to this meeting of the Economic Affairs Committee, where we are following up on our report into the sustainability of UK debt. We have three excellent witnesses: can I ask you to introduce yourselves for the record? I am going to go from left to right, so Peder, would you like to go first?

Dr Peder Beck-Friis: I work as an economist at PIMCO, where I am mainly focused on the UK but also other developed markets.

Roger Bootle: I have worked all over the place, but most recently and most famously I founded Capital Economics, which I am still partly associated with and where I am still working.

Allan Monks: I am chief UK economist at JP Morgan.

The Chair: Thank you all very much for coming in. I will start with a scene-setter question, which is on the back of what Ray Dalio at Bridgewater said about a week ago, where he warned that the UK is possibly heading for a, "Debt death spiral". My simple question is, do you agree with his analysis? Are we heading for a, "Debt death spiral"? Peder, maybe you can go first and then allow the others to pick up.

Dr Peder Beck-Friis: My short answer is, no. I agree that fiscal dynamics in the UK look fragile. I agree that the combination of low growth, high interest rate and high debt means that fiscal policy will probably be tight in the coming years. But, conditional on the fiscal tightening plans that have been laid out by the Government, debt looks broadly sustainable in the UK.

Financial markets, bond markets, and to some extent the financial press, are more sensitive to fiscal policy news, given the recent history of Liz Truss and the October Budget by the new Labour Government. But, fundamentally, I do not think the UK fiscal position significantly differs from some peers such as France, where debt is higher and the deficit is also higher. Tight fiscal policy will have consequences: one will be probably low growth going forward. That may lead to lower tax revenue, but there is a lot of monetary policy space and room for the Bank of England to ease policy to counteract that. So, conditional on the monetary policy space and on the tightening plans laid out by the Government, debt in the UK looks broadly sustainable.

Roger Bootle: I am tempted to answer yes and no, in the sense that the statement was a little over the top, a bit excitable. I very much agree with Peder: it is not a crisis situation, it seems to me. But what strikes me about the finances is they are terribly fragile. We are in a position that is the very opposite of robust. We are here with this enormous debt ratio, and the dynamics of debt and interest and growth do not look at all good. If something were to go seriously wrong, we would be in a really serious position.

Of course, the essence of wanting a low debt ratio, which umpteen people have laid out many times, including Gordon Brown when he was Chancellor, is in order to be able to allow the debt ratio to expand in the event of some nasty occurrence. We have had a few. We are not in that position and, Lord help us, but if we were to find ourselves in a war or something like that, we are in a very difficult starting point.

Allan Monks: You can always have negative growth shocks that bump debt higher through time, but if you look at the current OBR projections, debt is rising for most of the next four or five years or so, then it starts to stabilise and then come down. I agree with most of the comments made here, but one issue I would flag is that, whether that debt trajectory is on track will depend on whether the growth assumptions that underpin it are correct or not. If you look at the OBR's growth forecast, it is on the more optimistic side. It has 2% for this year and an average growth of 1.7% for the next five years. That could be right, and we can hope that is correct, but for me the risks are on the downside, and that is something that could lead to a different debt trajectory through time. Ultimately, the Government can make alternative choices on taxation and spending to address that, but my pessimism is a little more on the growth side, and that would be relevant for borrowing.

The Chair: There is a lot of food for thought in those answers, thank you. In terms of the fiscal rules and the OBR coming back at the end of March, do you think the Government are going to be meeting their fiscal rules as things currently stand?

Allan Monks: We have had the rise in yields over the past six months or so. On some estimates, there was not much fiscal room left around the rules, roughly £10 billion or so, and the rise in interest rates since the Budget will probably use up most of that headroom. Will that require some changes? Again, a lot will depend on the assumptions the OBR makes on growth. If it sticks to its current growth forecast, then maybe there is no action necessary. But some data we have seen from business surveys over the recent months suggests there is some downside risks to the outlook.

The Chair: Are you more optimistic than pessimistic? Sorry to press you on it.

Allan Monks: I am more pessimistic on growth. I am quite below the consensus on growth for this year.

The Chair: Thanks. Roger, what do you think?

Roger Bootle: It is very much in the balance. It is touch and go, really: the Chancellor might just about squeeze through, and she might not. I do not think that matters a very great deal. Of course, if she misses the target then something will have to be done to preserve credibility but, dare I say it, I do not really think it is a big issue. The big issues are the ones that you outlined in your report about fiscal sustainability going forward. The markets will be sensitive to the rules in the sense they all

know the rules can be remade and have been umpteen times—they are not that daft—but nevertheless, they would rather have rules than not, and there is a degree of intolerance with regard to massive elasticity on the rules. So, they will want some action if they are broken.

Dr Peder Beck-Friis: It is fragile. We will see where interest rates are in the spring: it is possible they fall, and that opens up more fiscal space. From a bond market and a financial market point of view, the important thing is there is credibility to stick to the fiscal rules. We would be very surprised if the Government did not adjust the spending or taxation if needed to meet the fiscal rules. If they need to adjust, based on the Government's rhetoric, it looks more likely they will cut spending than raise taxes but, from a bond market point of view, the most important point is that they stick to the fiscal rules and adjust taxation or spending if needed.

The Chair: I might come in on a few other points, but I am going to hand over to Lord Blackwell.

Q126 **Lord Blackwell:** Can I fix a bit on the interest rate side of this question? The gilt yields have risen a lot, taking the Government a bit by surprise. We know that has been true worldwide, but the spread with the German bonds has risen. I am interested in your thoughts on what has driven that rise in rates in the UK, specifically: are there special factors? How much of that is a risk factor, and what impact does that have on the economy? Roger, do you want to go first?

Roger Bootle: Part of the answer lies in what you said, actually: this is largely a global phenomenon. The other day I was tracking the rise in US yields since September and it is very similar to what happened in the UK. You are right about the spread of Britain against Germany. Interestingly, in both the US and the UK, it has been predominantly a rise in real yields rather than an increase in implicit inflation expectations, which you can infer from the nominal versus the real yield.

In the case of America, that is partly optimism about growth. It is also worry about public borrowing, and I suspect something similar is going on here. That mixture of real yields and inflation tells you that the markets are saying they do not think all this borrowing and spending is going to lead to some sort of inflation disaster, but they are of the view that the level of real interest rates that is going to be needed to prevent that from happening is higher than they thought previously. There is a little anxiety about the UK, but if you look at the US versus UK over that period, there is not that much difference.

Lord Blackwell: Does anyone have a different view?

Dr Peder Beck-Friis: I very much agree with Roger in terms of global factors. In fact, since yields have increased since mid-September, they have increased more in the US than in the UK. Where I perhaps disagree a little is I think the reason they have increased is more around the near-term macro story in the US: so signs of higher growth and more sticky

inflation. That has led markets to reprice their expectation of the Fed policy rate, and that has led to global yields being higher.

What that means for the UK is clearly more pressure on the Government to potentially tighten policy, and higher long-term interest rates is something that would probably weigh on economic activity here in the UK. The way we tend to think about that is it will probably add more pressure on the Bank of England, on monetary policy, to ease to counteract this.

Lord Blackwell: If real interest rates are now higher for those reasons and we are pessimistic about growth, the equation of real interest rates with less growth, which has an impact on sustainability, is now looking very negative for sustainability. Are we stuck with this now, or do you see interest rates coming down? Or are we in for a period where we have r - g in positive territory?

Allan Monks: Yields were already high when the OBR compiled its last set of forecasts, so to a certain extent that would have been embedded into its forecast already. I happen to think that rates will come down a little more quickly than what markets have been assuming just recently. I have 100 basis points of easing for this year, and we think that would filter through and impact longer-term rates as well, maybe bringing them closer to 4% by the end of this year, for the 10-year. So, that would ease some of these pressures. Maybe that is not entirely obvious by the time we get to March, but if my forecast is correct, it is something that could perhaps alleviate some pressures during the remainder of this year.

I go back to the point I made earlier: the r - g calculation depends on where you are on the growth picture, because the OBR has made the judgment that growth rebounds after the disappointments that we have seen, and it has maintained a fairly optimistic longer-term view. If that is correct, that will help that side of the equation as well.

Lord Blackwell: Are gilts now a buying opportunity?

Dr Peder Beck-Friis: There is a lot of near-term uncertainty, but it is easier for us at least to think of scenarios, fast-forward a few quarters, where gilt yields are lower than higher from here. The important point here is that the reason interest rates are high in the UK to some extent may reflect some fiscal credibility risk premium, especially in the long end of the curve. But the reason the entire curve is so high is because the Bank of England's policy rate is high: it is 4.75%. It is now the highest among all the large developed economies. Our assessment is that it is weighing on activity. Growth appears to be slowing, especially in the labour market. We agree with Allan. We see more room for the Bank of England to ease policy by more than markets expect, and in that environment the r - g factor in the debt sustainability equation may even improve.

Roger Bootle: Can I make two comments on that? First, on r - g: it is a very helpful way of looking at the problem, but we have to be careful

because there may be one G—actually there are not; there are lots of Gs—but there are several Rs. That is to say, it depends on which interest rate, what sort of length and maturity of instrument you are looking at. Often it does not much matter, because the yield curve is flat, but it is certainly not flat now. So, you have some very alarming long real yields on index-linked, and the shorter ones are much lower. Although the position is worse than it was a few months ago, it is not absolutely dire if you look at the short real yields, but it is pretty serious if you look at the long ones.

In terms of what is going to happen to interest rates, we all know what the market is saying, and it may be right. I take a slightly different view. I am more worried about inflation stickiness in this country because of the series of measures, most or all enacted by the Government, which are going to push up the price level. I am referring to the minimum wage, various wage awards, national insurance and so on. The Bank of England could find itself in a difficult position. That is to say, the economy could be quite weak, but price pressure is still obstinately strong, and there will be a battle about what it should do about interest rates. It may well cut the next time round, but I suspect the pace of cuts subsequently will be very slow.

Lord Blackwell: What about quantitative tightening? What impact is that having on interest rates?

Dr Peder Beck-Friis: In the context of the rise in yields that we have seen, it is pretty small. The main reason why interest rates are high is because the front-end, or the policy rate, is high. It is true, though, that the very long-end of the UK gilt curve, if you think of the 30-year point, has increased a little more than the 10-year point. Historically, that tends to be the area where some form of fiscal credibility concerns would show up. Since the budget, the steepness of that curve has increased a little. That may also reflect some quantitative tightening, but it is pretty small in the context of the starting level of yield that we have.

Lord Blackwell: You are all hopeful interest rates may come down, although Roger is less hopeful. If they go up, what is the point at which interest rates would start to cause a problem in the markets in terms of people’s worries about sustainability?

Dr Peder Beck-Friis: It is a difficult question because in principle, and in theory, debt can be sustainable under any level of interest rate. What higher interest rates mean is that it requires more fiscal tightening. So, for the bond market, the most important portion is that the link between interest rates and the fiscal policy reaction function is intact, and I very much think it is intact in the UK. If you think of the Liz Truss episode, for instance, there was a very sharp increase in interest rates and within a month there was a new Government that announced fiscal tightening. Even at the start of the year, when yields increased 30 basis points, there was so much pressure on the Government to stick to the fiscal rules.

There is an interesting question: is there a level of interest rate above which it becomes too constraining on the Government to tighten fiscal policy? Of course, it is always difficult to tighten fiscal policy, raise taxes or cut spending, but I do not see any constraints on the Government to not being able to do so. For instance, the tax burden in the UK is high versus its history, but it is still fairly low versus the rest of Europe. So, it is a difficult question to answer. But the most important point for the bond market is the fiscal credibility, the fiscal policy reaction function.

Allan Monks: I would say it depends on the reason rates are rising, if we are in that situation. If it was because of stronger growth, then it would not just be higher interest rates that are relevant: you would have a more optimistic growth forecast, and maybe the two balance out. But if you had higher rates because of a pure inflation problem, and you had a stagflation environment, then it would be a lot tougher in terms of the fiscal options available.

Lord Burns: You mentioned UK and US rates have been moving in step, but both have moved slightly differently to German rates, for example. What is this telling us that is different about the UK-US pattern from what is happening in Europe?

Allan Monks: It is quite common for UK rates to have quite a close correlation with US rates; it is not out of the ordinary in that sense. I suppose you would look at both economies and say they have had issues with high inflation, and there has been fiscal expansion as well. There is quite a lot of commonality between UK and US that justifies that correlation that you have continued to see, even though you have weak growth in one economy and stronger growth in the other.

Lord Burns: It is not so much the explanation of why we are moving in line with the US, because this has been the position for the last several years. The issue was the difference that has emerged with regard to the German rates.

Roger Bootle: It must be connected with the extreme weakness of the central European economy, I presume, with the implications of all that for interest rates going forward. I say central because, of course, some southern European economies are doing relatively well, but both Germany and France are looking extremely weak.

The Chair: Can I pick up on this and join some dots? I remember in our inquiry on debt there was this concept that we do not want to become an outlier in terms of debt sustainability in the eyes of the markets. I hear you say that Ray Dalio has been too extreme—Peder, you said you do not agree with him—but to what extent is the risk growing we are at danger of becoming an outlier in terms of debt sustainability, or lack of it?

Dr Peder Beck-Friis: If you compare the UK with the other main developed market countries, I do not think it stands out that much in terms of the debt level, which is broadly similar to many countries. The deficit level is very high in the UK, but it does not really stand out. The

one variable where the UK stands out—we have been speaking about this—is the r - g. It is only Italy that borrows at high interest rates compared to growth rates like in the UK. If you look at the fiscal trajectory, and take the Government's fiscal plans credibly and seriously, I do not think the debt path or the debt sustainability really stands out versus other countries. The one outlier is the US, and I am happy to speak about that.

The Chair: We will come on to that in just a second. Do you have anything to add on that, Roger or Allan?

Roger Bootle: There is one thing we have not so far mentioned which may be relevant. You are right about the debt ratios in these various countries, Germany being obviously an awful lot lower, but one difference here is the political scene. Across much of Europe, but particularly France and to a lesser extent Germany, the political scene is, I would argue, extremely weak and worrying. Putting Dalio's remarks to one side, if someone asked, "Which country do you think is most in danger of becoming a real outlier?" I would say France. I cannot see the political will in France to undertake a fiscal tightening; the debt ratio is higher than in the UK. Whereas, as you were saying, there is reasonable confidence that here the fiscal reaction function will ensure that, even though the r - g does not look good, we do not reach an outlier. France is the most worrying of the lot.

The Chair: That is very interesting.

Allan Monks: On the growth side, I do not think the UK is an outlier. There is a weak growth problem across Europe. But perhaps you would say, thinking about the r side of the equation, interest rates are higher in the UK, and there has been a bit more evidence of the UK being an inflation outlier. That is one of the issues that could separate the UK from some of its European counterparts. That probably relates back to some supply issues that the UK has had through numerous channels in recent years.

Q127 **Lord Lamont of Lerwick:** I would like to ask about the subject of the moment, President Trump and tariffs, and what effect you think Trump's potential measures might have on the public finances of the UK. Also, if we get in a tit-for-tat situation between the United States and Europe, what do you think the British position ought to be? Ought it be to keep out of it completely? Perhaps we will not be able to. Could we start with Allan?

Allan Monks: In terms of tariffs, we do not know exactly what will happen, so that makes the question a little harder to answer. If you were to have something like 10% tariffs on UK exports into the US, maybe the direct impact of that is not as large as you may think. If you look at goods exports to the US, 2% to 3% of UK GDP, it is not insignificant, but it is perhaps not as large as some people may have in mind. If you were to have tariffs implemented, what is the direct impact? If you assume full

pass-through, we are probably talking about one or two tenths on GDP for the UK.

Maybe the broader issue is the impact all this has on business sentiment. That is not just an issue for the UK; it is for other countries as well. If you look back at 2018, when we had some tariff increases that came in, they were pretty small and narrow, really, but there was some evidence of declining business confidence in the manufacturing sector during that episode. That is the kind of thing that could affect the UK, but also there is probably an indirect effect via the EU if there is an effect there. Obviously, the UK is dependent on that region as its largest trading partner.

Roger Bootle: The UK is relatively well placed compared to many other countries, largely because of the split in our trade between services and goods. We always think of tariffs as being levied on goods. I do not think there are any instances of them being levied on services. In principle, I guess it could be done; perhaps we would not call it a tariff. We are assuming there would not be any sort of levy on services. Together, goods and service exports to the US account for about 20% of all British exports. That is big, but the overwhelming bulk of that is services, which is good. Whereas, of course, in most of Europe, it is the other way around.

The other thing, from the point of view of, as it were, keeping on side for President Trump and his advisers, apart from services, British goods trade with the US is balanced. In one measure last year it was a tiny surplus compared to other countries. I do not think we are going to be in his sights, as it were, but we might get carried along in the backwash. As to what we should do, we should do as little as possible. You rightly said last time round we did very little, did we not, in retaliation to the US tariffs. This of course plays into the whole geopolitical question of Britain's position vis-à-vis the EU on the one hand and the United States on the other. We would be well advised—this betrays my views on this overall European question—to do as little as possible and to try to keep as close as possible to the US.

Dr Peder Beck-Friis: I have nothing really to add; I fully agree with what Roger said. The UK looks more immune certainly to this relative to the rest of Europe. Europe has a much larger manufacturing sector and a much larger goods surplus than the UK. But of course if President Trump introduces 10% tariffs on everyone, 60% on China, then this will certainly impact the UK indirectly through global trade.

Lord Lamont of Lerwick: But it is not just tariffs; Trump has weaponised trade, energy and taxation as well. Does this not mean, if carried out, that we are likely to move worldwide into much more nationalistic economic policies, which will lower growth, protect the inefficient and hold back the efficient?

Allan Monks: A full implementation of the proposed tariffs would have a material impact on global trade. But we don't know if that will happen.

And there are multiple channels to consider. If you look at business sentiment since the US election, there has been evidence of some move up there because of expectations of deregulation and fiscal easing. Global sentiment has also held up so far. To play the other side of the argument, that is something that could potentially lift growth in the US, and there might be some spill overs of that generally for trading partners with the US as well. Obviously, you have the tariff issue to take into account. There are a number of different channels. There is higher interest rates potentially as well and the impact that would have.

Lord Lamont of Lerwick: Roger, what I was getting at was really, are we going to see a cost to the world economy from having much more autarky and self-sufficiency?

Roger Bootle: The answer is, yes, if that does indeed happen, but as we know, his bark tends to be rather worse than his bite. There is some form on this, because we had a bout of tariffs before, and we saw how the world responded. The general assessment is the effect was not that big. Of course, people might react differently this time. It is a very dangerous situation, not least because there are so many other geopolitical things which feed into it. If he is at the same time being very aggressive towards Greenland, for instance, the EU might get very nasty in its response to the imposition of US tariffs. These things are related. But I share your general sentiment that a move towards autarky cannot be good for general growth. It cannot be. It produces specialisation.

Dr Peder Beck-Friis: I agree with that. It seems we are moving into a more protectionist, bipolar world with higher tariffs. Everything else equal, that should be negative for global growth. The other implication from President Trump, if you think of the fiscal balances in the UK, is there may be more pressure on more defence spending in the UK and elsewhere. That is another sign of focusing more on resilience rather than productive growth. It is easier to think of downside scenarios in terms of growth than upside from this.

Lord Lamont of Lerwick: Trump said he wants to get rid of the debt ceiling. Could you comment on the merits of that and what its implications are?

Allan Monks: I do not really have a view on whether that should happen or not, but if you did have a higher debt ceiling, first of all, it does not automatically imply that fiscal policy will be easier. It is possible, but that does not follow as an automatic development of that policy change. If you were to have easier fiscal policy though, you would expect higher interest rates in the US. We have had a discussion previously here about the correlation of UK and US rates. That may put some pressure on UK rates as well, and that could affect some of the debt sustainability calculations.

Roger Bootle: I do not think it is a very big issue, one way or the other. It might prove to be a good thing at the margin, in the sense they have been through been a number of occasions when there has been real

worry in the markets that the debt ceiling would be breached, and all sorts of nasty things might happen, with worries about US default and all sorts of shenanigans about what sort of rinky-dinks would be adopted to avoid that. I do not think that is very constructive. The debt ceiling does not determine US fiscal policy. Congress debates both sides of the account, spending and tax; it does not need the debt ceiling in order to do that. So, I do not think this is a major issue.

Dr Peder Beck-Friis: I agree with Roger. At first approximation, it should not matter too much for bond markets. Bond markets and financial markets have not viewed this as a credible constraint on US fiscal policy. I am not sure if it has raised the ceiling more than 100 times since the Second World War. There are other constraints on fiscal policy—the bond market will be a constraint on fiscal policy—but I do not think the debt ceiling has acted as a constraint on fiscal policy in the past.

The Chair: There is the debt ceiling issue, but in terms of the market assuming and predicting that President Trump might increase the spending and debt buy, what are your respective assumptions and forecasts here? What is the market looking for debt to increase by over the course of this presidency in the US? Then consequently, what is the potential knock-on impact in terms of rates, both in the US and knocking on to here?

Dr Peder Beck-Friis: The deficit now in the US is about 6% to 7% of GDP. Our baseline is that will remain at 6% to 7% of GDP going forward. He will cut taxes—the Trump tax cuts—but that is not new policy; that is not going to add to the baseline view of 6% to 7%. There is risk around spending cuts and even more tax cuts, so there is a wide uncertainty band, but our baseline is that fiscal deficit will remain unchanged at 6% to 7%.

Conditional on that, we have all seen the debt-to-GDP projections by the CBO, which are widely explosive. Let me say a few points here. A fiscal crisis in the US, something that we saw two and a half years ago in the UK, is very unlikely. It is not only the supply of debt that matters but also the demand for debt, and there is a tremendous amount of demand for US dollars and US treasuries, given the fact it is a global reserve currency. So, we do not see any threat to fiscal credibility in the near term.

The most likely long-term solution in the US is there will be some fiscal tightening, perhaps not in the next five years but fast-forward the next 10 years. At the moment, the US spends more in interest than it does on its entire military budget: about 14% of its total expenditure is in interest. We know from history that whenever the interest burden or the interest expense rises sharply, fiscal tightening quickly follows. We saw that after World War II, we saw that with the Reagan in the 1980s, and we certainly saw that with Clinton in the 1990s. So, even though we do not expect fiscal tightening in the next five years, long term the most likely scenario is that we at some stage will see some fiscal tightening in the US.

Roger Bootle: One element to consider here is the revenue from the tariffs. I do not think he is made an explicit statement about what is going to happen to that, but I was doing some back of the envelope calculations. It is a couple of per cent of GDP, I would guess, if he imposes 10% tariffs. It may be a bit less; I do not know. It is not insignificant.

The Chair: Do you have anything to add on why you are assuming?

Roger Bootle: No.

Allan Monks: Our expectation would be that tax cuts are extended, so it is not new stimulus as such but a continuation of the existing stimulus. There may be other measures that could be added on to that, but they may take a little longer to come through given that they need the approval in Congress. Some impact of this has already been factored into market pricing. It is not just about fiscal policy; there is also the generally solid, growth backdrop in the US as well as high inflation. All these things are feeding together into reduced expectations of Fed rate cuts. You have already seen that in market pricing, and it is probably one of the factors that has contributed to the rise in yields that we see in the UK over the past few months.

The Chair: But you think that is priced in, and there is not much more of a shock.

Allan Monks: There could be new announcements, but I am saying that a portion of them has already been priced in.

Q128 **Baroness Liddell of Coatdyke:** I am interested in the geopolitical situation as it affects, for example, the Middle East, where there is considerable uncertainty. What would a lasting peace following the Palestinian conflict do for something like UK financing?

Dr Peder Beck-Friis: Again, speaking from the bond market and financial markets, what is happening in Palestine at the moment has pretty marginal impact on UK growth and UK borrowing costs. I cannot think of any meaningful channels where that would impact interest rates in the UK. But you are right: we live in a world with much higher geopolitical risks after Russia's invasion of Ukraine. China/Taiwan is a low probability but potentially very high impact event. For us, the main implication is that again we seem to be moving into this bipolar world that adds downside risks to growth and potentially more pressure on governments to spend more on defence. There are lots of geopolitical uncertainty and geopolitical risks, absolutely.

Roger Bootle: I agree with that. I do not think the direct impact on the UK is very significant at all. When people think about the geopolitical risk in that region, they of course tend to focus very heavily on the oil price and the markets have periodically had bursts of panic about what might happen. In practice, not an awful lot has tended to happen to the oil price. It goes up and down a bit, but there are some more fundamental points here that principally Saudi Arabia, but also other producers in the

Middle East, are sitting on enormous amounts of spare capacity. So, there has been a sense in which that has underpinned reasonably low oil prices.

Taking away the danger of terrorism would be a plus, economically, but I agree that there are other geopolitical risks that are more important. If you think about the implications for defence spending, surely the Russia-Ukraine thing is much more relevant in the UK case, and more so even than China-Taiwan.

Allan Monks: I do not have much more to add. You can look at this through the lens of oil prices: if you think peace is going to have an impact on oil prices, if they were elevated in the first place, I guess a peace deal would have a larger impact. But I do not think we saw oil reach as high as some people had feared after conflict broke out in the region.

Baroness Liddell of Coatdyke: If you look at geopolitical events throughout the world, what gives you the biggest worry? What are you monitoring as we go forward?

Dr Peder Beck-Friis: The highest impact event, again low probability, is China-Taiwan, as Taiwan produces most of the semiconductors in the world. We have been used to supply chain disruptions during the pandemic, but this would be on a different level. If that led to the western world sanctioning China, that would be a big shock to global growth. Remember, Russia is a fairly small economy, economically. It is about the size of the Nordics. China is one of the largest economies in the world. It is the largest export sector in the entire world. If the western world were to move to sanction China, then I could see pretty significant downside risk to growth going forward.

Roger Bootle: I would agree with that. I have only one possible hint of disagreement, and that is when you say it is a high-impact/low-probability event. I am not sure about the low probability. I do not know how you would even assess the probability. It seems to me to be one of those things that is genuinely uncertain. But I agree, it could be extremely damaging.

Allan Monks: I do not have anything much more to add there. We have spoken about the impact on energy prices and oil, but there are other disruptions to trade on a broader range of goods and commodities that could have a big inflation and growth impact if the conflict were to escalate.

The Chair: We have been talking for about half an hour, but what you said right at the start, Roger, in terms of your concern about the fragility of the situation we are in, what we have not seen since we published our report is the Government acting to get greater resilience into our public finances. Would that be a fair critique, given what Baroness Liddell is saying?

Roger Bootle: Yes.

The Chair: We can talk about how there may be diminishing geopolitical risks in certain parts of the world—I am putting words into your mouth so feel free to disagree—but do you all share that view, that we are in a very fragile situation in terms of public finances in still a very volatile political world, and that is where we should be concerning ourselves? Is that right?

Roger Bootle: Yes, that is exactly my sentiment. The Government of course wanted to address this problem through simulating growth. But what they have is actually done, I would argue—I am not the only person to argue this—is to achieve exactly the opposite. Now the Prime Minister is talking about finding the growth lever, which is deeply concerning. It is the right thing to do to try to grow your way out of this problem because you cannot do anything directly about interest rates. You could conceivably to do something about growth, and of course you could do something about government spending.

Allan Monks: There is obviously a need to try to improve longer-term growth. It is easier said than done; these things can take time. It is a process. There are some elements that are falling into place, but you have to be patient. Until you get there, in the short term, there probably needs to be a greater buffer built in around the fiscal rules in terms of additional headroom. We have seen quite a small margin of close to £10 billion, which is small in any sense but around a third of the average degree of headroom that we have seen in various budgets in recent years. If there was a bit more headroom built in, then whatever plans the Government had would be more resilient to unforeseen shocks, whether it is a move up in rates or a slight downgrade in the growth assumptions.

The Chair: Peder, do you want to add anything? No, in that case we will move on. Lord Burns, over to you. I do not know if you want to continue on this theme or follow a new one.

Q129 **Lord Burns:** Let me go back to the issue of China for a moment and take this slightly wider. We talked about the issue of China and Taiwan, but for the last 20 years, China has played a big role in keeping the world economy going. There are some concerns, for demographic and lots of other reasons, as to why Chinese growth may not continue at the rate it has been going. Is this an issue we need to worry about, or is it just business as usual as far as China is concerned?

Roger Bootle: I am not sure it is something to be directly worried about. In many ways, I regard what is happening as helpful. About a year ago, my firm said we are effectively at peak China, by which we meant relative to the rest of the world and to the United States. We think the chance of China overtaking the United States has gone now, partly for demographic reasons. The demographic outlook is very striking, but over and above that is what has been happening to productivity. If you start off as backward as China was, and as massively distorted, you do not need to do many things right to get spectacular growth. Of course, the

longer you go down that path, the more difficult it becomes. We would also argue that the increased politicisation of China overall is not helping. President Xi clearly now puts various political objectives right at the forefront of what he wants to achieve rather than boosting the Chinese economy. He wants that too of course, but the political thing is absolutely paramount.

I suspect we are going to see a slowing in the Chinese growth rate, and indeed other countries—India before long—will overtake China. I do not see that as a danger. There is potentially an opportunity in all this, which is if China alters its policy stance to favour more consumption. You say China has been supporting the world economy. Partly that is true, but it has also been taking an awful lot from the world economy in terms of demand. It would be a favourable development for everyone if China's economy became more of a generator of consumption demand and imports.

Allan Monks: We expect China to resume its growth target of close to 5% for this year. That would be a slowing compared to the years before the pandemic, where you had closer to a 6% or 8% range. There is a secular slowdown that we have built into our forecast, but at the same time, the UK's trade exposure to China is not huge. It is around 4% of export. It does matter, it is still a fast-growing economy, but you compare that to the US or the Europe area, and the dynamics of those regions is going to matter much more. China could have an indirect effect on growth in those regions, and that is the backdoor way of how this filters through to the UK. Then you have tariffs to consider on top of that: if you have much larger tariffs on China, the growth slowdown could be more significant there and affect the UK indirectly.

Dr Peder Beck-Friis: The only thing I would add is, cyclically speaking, it is also going through severe frictions in the property market. Real interest rates are very high. Nominal interest has been falling. We speak about fiscal fragility in the UK, but there is fiscal fragility in China as well. Government debt level is very high, as is private debt level. I agree with my colleagues here that it is easier to think of downside risk to China going forward.

Lord Burns: On the other hand, it is being quite competitive in some markets, is it not, by and large? Not the ones that are worrying us, but we see the impact it is having on the German auto industry. And, of course, yesterday we saw the whole issue about AI beginning to emerge. It may not be growing as fast, but possibly it is becoming a stronger competitor in some sectors of the economy. I will leave it there.

Q130 **Lord Davies of Brixton:** Roger, you mentioned the problems we face with low growth and high inflation in an earlier reply—back in the 1970s, it is what we called stagflation. Is it the same thing? Going back to the 1970s again, are we still really confronted with what we call the British disease? Do these things compound each other and make any action by the Bank of England or the Government difficult?

Roger Bootle: It is on a completely different scale. Analytically, I suppose it is the same thing in the sense that we have, in some cases, price and wage cost pressures developing. Looking at the overall state of the economy, we would think that those pressures should be much weaker. That is what stagflation is. I remember those days very well, and we are nothing like in those conditions. It is not just the extent of both the "stag" and the "flation"; the institutional character is also very different. We now have a much higher proportion of the economy in private hands as opposed to the public sector, and that was an important part of what went wrong in the stagflationary 1970s.

Lord Davies of Brixton: Do you think the British disease has gone away?

Roger Bootle: It is not just Britain. Our inflation rate is comparatively high; other countries have some signs of something similar. I would not go that far; I would not call it the British disease. As I said earlier, I am concerned that actions by the Government in the first flush of victory, as it were, have made this problem an awful lot worse by awarding such high pay awards in the public sector and to the rail workers, and various other things they have done. This British disease does not necessarily come from the British people; some of it comes from the Government.

Allan Monks: I agree with a lot of what Roger says. You have Bank of England independence, you have an inflation target, and that matters a lot. When you have had the kind of inflation shock that we have had in recent years, you look at longer-term measures of inflation expectations—there was some movement there—but generally, as inflation has hit its peak and come down, so too have many of those longer-term inflation expectations measures to levels that are consistent with the target. That gives more of an anchor and an underpinning for the inflation shocks that we see. In an environment of weak growth, that helps the Bank of England. It has been cautious in terms of easing and has not been able to go very quickly, but it is lowering rates now, and I expect that process to continue.

Dr Peder Beck-Friis: I agree. The main difference now versus the 1970s, not only in the UK but in the rest of the world—it is one of the most remarkable features of financial markets since the start of the pandemic—is how remarkably anchored inflation expectations have been. If we fast-forward three or five years, we see that financial markets, globally speaking, have been expecting inflation to fall down towards target levels. That speaks to central bank credibility, that we just did not have in the same amount in the 1970s and 1980s.

My central view on inflation is perhaps a little more benign than that of my colleagues here. Let us remember that inflation has fallen over the last few years pretty impressively; it has almost halved over the last year. Growth, granted, has been weak. There are signs of near-term price pressures picking up, but the main driver of that is most likely the national insurance hike. In my book, that would not constitute an inflation shock; it is a price level shock that is very similar to a VAT hike

or to a tariff hike. Typically and historically, that is something that central banks have tended to look through. The complication today is this path dependency. We come from a long period of high inflation, so the more of these price level shocks you get, then perhaps that may lead to second-round effects on wage growth and inflation expectations. My central view is that we may see inflation picking up in the spring, but, fast-forward a year, I think underlying inflationary pressures will continue to ease.

Lord Davies of Brixton: I get people's views about the Government's policies. I have heard it argued that there is a beneficial effect in that it will force employers to become more productive: that they will give up on cheap labour and because labour is more expensive, they are going to use it more efficiently and we will all benefit from that.

Roger Bootle: It did not work in the 1970s.

Lord Davies of Brixton: But you just said it was not like the 1970s.

Roger Bootle: It is a funny view of the world that employers have to be hit over the head to do something that is in their self-interest. I do not really see that. The way so many employers have reacted—you have seen many cases of it—is by cutting down on employment levels.

Allan Monks: If there were big productivity gains to be had, you would assume firms would have done this already rather than wait for the tax to come in first. I am not sure I expect there to be significant improvements in productivity as a result of this in the long run. If we look at business surveys, we see that there are a range of ways in which firms are indicating they intend to respond to this. Higher prices is one; weaker hiring is another. There is some absorption in profit margins as well. But maybe the surprise has been that some of this stuff is coming through a little more quickly than you would have thought. When you raise taxes, you would expect that firms would absorb it in their profit margins first, and then stage 2 is passing it on. But again, some business surveys that we have seen recently suggest that pass-through phase is happening a little more quickly than in many people's forecasts.

Lord Davies of Brixton: I understand that. The fear is that British entrepreneurs just are not very good and will always take the easy option, and so they need a bit of a push, a boot, in order to do things. They like the easy life rather than the theoretical model of profit maximisation. I do not think any of you share that view.

Allan Monks: I have mentioned the business surveys before: they tend to indicate slower hiring. If you were getting productivity gains, you would have increased expectations of output, but I do not think that has happened, because some of the forward-looking components, output expectations of these surveys—the PMI, for example—have also come down by quite a bit. Maybe that is not measuring things very accurately, but I do not see evidence in the surveys of what you have just described.

Q131 **Lord Turnbull:** Let us say that, a few days before the next financial

statement, the OBR comes in and says, "Given what you've said about the way you've defined your own fiscal objectives in terms of debt, tax trajectory and so on, the promises you made on tax, the deals you've done with colleagues on future spending, we just cannot make the numbers add up. You had a little fiscal headroom, but it's now negative. Something has to give".

What do you think would have to give, and what would be the market reactions to different responses that might turn up?

Dr Peder Beck-Friis: From a bond market point of view, I do not think it matters too much if the adjustment takes place through spending or taxation. What matters for the bond market is that the deficit comes down.

Now, let us suppose we end up in a scenario where the fiscal headroom is negative and the Government do not adjust fiscal variables to meet the fiscal rules, then what would be adjusted is interest rates. You would then certainly expect to see a much bigger risk premium in gilt curves, especially at the long end of the curve to sell off. But again, from a bond market point of view, I do not think it has meaningful implications in terms of individual tax and spending policies.

Roger Bootle: That is broadly right from a first-order point of view, but I wonder whether there is not a difference between tax and spending, as far as the markets are concerned. I would argue that the markets would be less impressed if the Chancellor tried to square the circle by increasing taxes, because they are not bound to bring in the amount of revenue that she might expect because of adverse effects on the economy.

That is always true, but given the past few months, there is surely a danger that it is particularly true now: the mood is very negative among businesses, and it might adversely affect the long-term trend of the economy if you establish the idea that, at every drop of a hat, up go British taxes on individual firms and Uncle Tom Cobbleigh and all.

Taking what you said, that the most important thing is the deficit, I think the markets would be more impressed by spending cuts, but spending cuts that were credible. Indeed, one of the great temptations would be to ratchet down the presumed growth of spending in the future, hoping that we never quite get to that point. The markets tend to see that and not to like it.

These are all painful and difficult decisions. I guess the markets would want to see the Chancellor taking a particularly painful decision that they were pretty confident would improve the deficit. They would be marginally more impressed by spending than they would by tax rises.

Dr Peder Beck-Friis: I agree with that, but let us suppose that the Government need to adjust tax or spending to meet the fiscal rules. The risk for the bond market is that they do not deliver on that but continue to do it rhetorically and push it forward into future years. The last few Governments have been pushing fiscal tightening into future years. It is

important for the Government now to really follow through on the fiscal tightening they have announced, with that translating into lower deficit numbers, as opposed to pushing it into the future.

The Chair: Over what timeframe do you want that action to yield results?

Dr Peder Beck-Friis: Under the fiscal plans the Government have announced, the main tightening kicks in with the national insurance hikes in April. It is important that they stick to that plan. If there need to be more spending cuts or tax rises, then obviously the bond market would perceive a near-term action as much more credible than pushing it to, say, three or five years' time.

Allan Monks: I agree with a lot of that. If the Government are ultimately committed to the fiscal rules, they should take action to show that those will be met. That is probably the most important thing for the market.

We have one Budget this year, which is later on in the year, so that may mean that tax changes are less likely in the spring. That may put a little more emphasis on the spending side. You probably would not want to make big changes to spending in the very near term, because if the macro picture suddenly changed in a more positive direction later on in the year, you would not want to commit to additional public spending in the near term and then find out it was not necessary.

So, there probably is a logic to saying, "You can push that a little further into the future if there needs to be more spending restraint", but I agree with the point Peder made, which is that if it is too far into the future then it may lack credibility. If it falls outside a spending review, for example, or if it has not undergone a spending review, then that may raise some questions about how likely it is to be delivered.

Lord Lamont of Lerwick: Can I just ask Peder, and I hope this makes sense: supposing the overall deficit comes down but it none the less looks as though the ambition of financing current expenditure totally out of revenue is not going to be met, would that matter?

Dr Peder Beck-Friis: That is secondary as well; the headline fiscal deficit matters most. Investment spending may, of course, matter in terms of long-term growth potential, and if the Government do more investment spending then we may raise our long-term growth forecast, but for bond markets, the most important factor is the overall deficit, partly because that relates to fiscal credibility, but partly because the fiscal deficit overall also dictates how many gilts the Government need to issue. The Government have announced plans to lower the deficit from 4.5% to 2%. We can speak about the fiscal rules, but even abstracting from the fiscal rules, if they achieve that it looks very sustainable and comparable to other countries.

Lord Turnbull: One of the problems is that we are still stuck with this rule which says, "You can do what you like, as long as year 5 is better

than year 4, you are in the clear, but you can have more borrowing in between". Should the Government address that? It would be a change in the fiscal rules, but it would be a beneficial one.

Roger Bootle: It would be beneficial. The markets would like that a great deal, but of course it is framed as it is for a very good political reason. It would be quite courageous government to undertake a change like that, but surely the markets would like it.

Dr Peder Beck-Friis: Yes, I think so. The fiscal rules will add some pressure on the Government to adjust fiscal variables. No matter what the fiscal rules are, the bond market, the financial markets, will make their own assessment of debt sustainability. Even though the Government are now targeting net financial liabilities, as a global fixed income investor we compare all countries on a like-for-like basis, so we tend to look at gross debt in Italy, France, Japan and the UK, then we look at the deficit path.

Again, based on the fiscal tightening, that looks broadly sustainable, but it is irrespective of the fiscal rules the Government have announced—although of course it adds pressure on them to follow through.

Lord Lamont of Lerwick: Given, as you said, that markets can work out perfectly easily on their own what combination of inflation, growth and an annual deficit adds up to in terms of the growth of the stock of debt, does that not show that the only value of fiscal rules is internal, in enabling the Chancellor to restrain Ministers, and that actually they have no effect on the markets?

Dr Peder Beck-Friis: To the extent that fiscal rules put pressure on Governments to follow through, they add fiscal credibility that the market will like. But yes, you can imagine a world in which a Government do not have fiscal rules, yet the market will still give them a tremendous amount of credibility given the actions and the deficit path they have announced.

Allan Monks: One feature of the fiscal rules is that we used to have a five-year rolling target, but that will eventually be shortened to a three-year rolling target. Okay, it is still a rolling target, but one of the significant elements is that more of the years in question in your forecast horizon will be covered by spending reviews, assuming that those reviews are covering the next two to three years. That would probably add a little more credibility to whatever spending plans are embedded within the rules over that horizon.

The Chair: That is very good, thanks, Allan. Lord Razzall wants to come in on the fiscal rules.

Q132 **Lord Razzall:** There was a lot of discussion, obviously before the Chancellor's Statement, about whether the Government were going to change the definition of debt. As you indicated, they have now changed it from public sector net debt to public sector net financial liabilities. What do the three of you think of the merits of that change, and what do the

markets think of it?

Dr Peder Beck-Friis: Let me say a few things on that. First, it is always a challenge for any new Government to change fiscal rules before they have established credibility. It is much easier for markets to digest it when a Government who have been in place for a few years and established fiscal credibility then change fiscal rules.

The important thing, however, is that the Government actually stick to these fiscal rules, and as I said, that they follow through on the fiscal tightening in action and not only in rhetoric. Having said that, I do not think the change in the debt rule to net financial liabilities is that drastic. Again, we make our own assessment of debt sustainability.

Lord Razzall: It is £10 billion, or something, is it not?

Dr Peder Beck-Friis: Allan would know the numbers better than me, but if you look at net debt, that was also stable under the plans laid out by the Government in October. So I do not think the rule was that drastic, although of course it freed up a little fiscal space.

In terms of the market reaction, yes, there has been a lot of volatility in gilt yields, as we discussed, which has been driven primarily by global factors. Markets have been functioning and orderly; all the gilt auctions have been fine, and liquidity has been okay.

Going back to my earlier point, there may be signs of a small increase in the fiscal risk premium in the very long end of the gilt curve, but in the context of where the policy rate is, the main driver of why interest rates are high in the UK is the Bank of England policy rate as opposed to fiscal credibility.

Lord Razzall: That is not to do with this issue. Roger, what do you think?

Roger Bootle: I agree with that; it is really second or third order stuff. What the markets have to be wary of, and what they are wary of always, is the sense in which they are being played with a definitional change which, in effect, loosens fiscal policy and gives the Chancellor an awful lot more headroom. I do not think this did really; it is at the margin. I am trying to remember—Allan may recall— the reaction of the gilt market at the time, because of course we were expecting something like this change. What happened to gilt yields around then? Were there fiscal difficulties?

Allan Monks: There was some discussion about the change in the rule in advance of the Budget, so it was not a surprise.

Lord Razzall: There were various other alternatives, were there not?

Allan Monks: Yes, and there were some merits seen around that: a broader measure of debt was included in that rule and if you are netting off financial assets, that frees up some scope for investment purposes in

financial assets. So, there were mixed opinions on it, but I think it was generally well received.

However, it is not the measure of debt that matters; it is the headroom that you leave around it and whether that is appropriate or sufficient to deal with the shocks, which is the point I made earlier.

Lord Razzall: Am I right that the effect was about £10 billion?

Allan Monks: For the debt rule, it was £15.9 billion, and on the deficit rule, it was £9.9 billion, which is quite modest.

Lord Razzall: That has mostly been exhausted already.

Allan Monks: Based on current market pricing, you would expect the deficit rule to have that space used up, and that is the real issue.

Lord Razzall: So, you think the change is marginal, in effect.

Allan Monks: Yes, I think so. Maybe there is a broader issue with the fiscal rules. There was a stat that since 1997, on average, the rules have been changed once every three years or so. Eventually that would start to add up and people would ask whether they should assume that the current rule will be left in place. There may be a challenge there.

It is much more important, however, to present a credible picture for the public finances, and exactly which rule you use to do that is secondary.

The Chair: Before I come to Lord Londesborough, I just want to go back to Lord Turnbull's point about what happens if the OBR comes in and says, "You've got no headroom, you've got to make some changes".

Let us flip that on its head, just for a moment. Let us say the OBR comes in and says, "Great news, you've met your fiscal rules; you're fine". If the Chancellor then said, "Actually, you know what, I hear what you're saying, but there could surely be a great benefit"—this is really me building a question to you, Peder and you all—"if I actually surprise the market on the upside, and I'll come out and I am going to say, 'We're going to cut benefit spending and we're going to bring in a whole range of measures to build the resilience that we know we need to have in our fiscal position'".

Would that not be a good thing to do? You would get positive feedback, because all of you would say, "We're going to reward the UK from our position". Debt interest payments will start to come right down, and we will have more money to pay for the NHS, education, and everything else the Government want. Is not that what the Chancellor should also be looking at?

Dr Peder Beck-Friis: In that scenario, interest rates would no doubt fall, perhaps to some extent because of fewer fiscal credibility concerns. If the Government were to announce significantly more fiscal tightening, then you have the standard macro effects that growth is going to go down and

inflation is going to go down, and that will add pressure on the Bank of England to ease. So yes, in terms of fiscal credibility, that would be a positive move.

The Chair: The only reason I am asking this is that your initial response to my very first question about debt spiralling was, in essence, "We're not in this, but we do have a fragility issue". I am trying to address the fact that the fragility issue is going to be there whether or not we hit the fiscal rules in March. That is why I am asking the question.

Roger Bootle: Your logic holds, whatever the OBR comes in and says. Whether it says, "You're spot on", or "You're much better", or "You're much worse off", what you say is exactly right.

There is a strong argument for being extremely tough on fiscal policy at the moment because the risks going forward are so great, even though we are not yet at a crisis point. The constraints against that, I would argue, are almost wholly political. Obviously, it would have an adverse effect on aggregate demand, which the Bank of England would respond to by cutting interest rates further and faster. You would end up with a better set of macroeconomic policies and the economy overall would be better structured.

Allan Monks: There are two angles to this. If you built in more headroom, then presumably there would be a more favourable market reaction to that, but how do you get the headroom in the first place? That is the big question. It will be through either higher taxes or lower spending. As we have seen from discussions in the past, both are quite challenging and would potentially have significant consequences for near-term growth.

The Chair: That brings us on to Lord Londesborough.

Q133 **Lord Londesborough:** Yes, my question is in relation to spending. As you may have seen, following a short inquiry, this committee has just written to the Government to urge them to take immediate action to address the flaws in the benefits system, specifically health-related benefits, which have almost doubled in the last five years to £65 billion, and the OBR forecasts they will breach £100 billion by 2029.

We are not going to ask how you would address the flaws in the benefits system, but how serious a variable do you think our benefits spend is, and perhaps more broadly, our rate of economic inactivity in relation to our debt sustainability equation? Perhaps we could start with you, Allan.

Allan Monks: If we look at the UK's labour force participation rates, we see that the proportion of the population that is available for work declined significantly during the pandemic, as it did in most other countries. But unlike the UK, most other countries around Europe saw a complete rebound and normalisation. The UK's participation rate, notwithstanding the data measurement problems that we have, still looks very low. The UK does seem quite unique in that sense, and the

respondents to the survey suggest that the inactivity is associated with long-term sickness.

I suppose you could look at the UK and ask, "Are health-related issues in the UK that much more severe than in other countries post pandemic?" I am not sure I have a good reason as to why that would be the case. One area that could be looked at is trying to reintegrate some of those who are inactive back into the workforce. That would have benefits for a lot of people: you can reduce expenditure through the welfare bill but also bring in more tax revenues as well if people are working. So, that would be a potential upside if it can be managed in the right way.

Roger Bootle: I absolutely agree, and I think we are going to come on to talk about productivity in due course. Many aspects of the British economic situation look intractable, and Governments have very few levers to pull or buttons to press. But here is an instance of something that is pretty much directly under their control which could bring big benefits—sorry to use that word—for the economy in the sense that not only is there the prospect of reducing public spending but—as you were alluding to—you can at the same time hope to increase the workforce, which would loosen up the labour market, bring disinflationary pressure, encourage the Bank of England to cut interest rates and potentially lead to higher output, which then brings in more tax revenue. So yes, the Government ought to be making serious efforts to do something along the lines of what you suggested in your letter.

Dr Peder Beck-Friis: I agree and I do not have much to add except that there are quality issues with the labour force surveys, so I am not sure how much we can trust those numbers. I know financial markets tend to discount them.

As for what Allan laid out, that the UK is the only developed country where labour force participation is below where it was before the pandemic, that also raises questions as to whether that is perhaps a function of the quality of the labour force survey.

Lord Londesborough: We saw a new projection from the ONS this morning that the population will grow by 5 million by the year 2032, almost entirely through immigration since birth rates are falling, and yet the working population is forecast to grow by considerably less than that, which raises more concerns about dependency ratios. I am just wondering what demographic factors in relation to debt sustainability keep you awake at night.

Dr Peder Beck-Friis: I am not sure it keeps me awake at night.

Lord Londesborough: What keeps you alert during daytime, then?

Dr Peder Beck-Friis: I get your point about the split between the working-age population and dependency, but in terms of debt sustainability, a larger labour force and a bigger economy would be beneficial for the debt-to-GDP ratio. Against that, I take your point that

there may be more pressure on other forms of spending that will add pressure to the deficit as well, but I am not an expert in that area, so I will leave it at that.

Roger Bootle: The two of us are sleeping quite well. One advantage of this issue, serious though it is, is that it develops slowly. It is a big one, but you have time to react to it. I am afraid it is the rather shorter-term things that keep me awake. I agree with you that a bigger workforce in the short term should actually be a boost. The problems come along later.

Allan Monks: The immigration number that the ONS came out with—I think 340,000—was the annual pace in a few years' time. That is around 1% of the labour force. Not all those people are coming here to work—there are study visas and family immigration—so I guess that takes it lower.

You mentioned ageing and demographic changes. Although you have more people coming into the country, ageing factors put a downward impact on the participation rate as well. Off the top of my head, I think it is 0.2% or 0.3% a year, so it is quite significant. Once you take that into account, the contribution to growth coming from labour supplies is probably nowhere near what you would think if you were just looking at the immigration figures alone.

There is one other point as well that is probably even more significant for longer-term growth: productivity. The trend we have seen since the GFC is, I think, close to 0.6%. The OBR has an assumption that we will be running closer to 1.2% at the end of its forecast horizon. Let us not say it cannot happen, but it would be quite a big step up from the average pace that we have seen for quite a few years now.

We should not put too much weight on recent trends in productivity, because there is a cyclical component to them. For what it is worth, and maybe the data will be revised—I do not know—productivity has been falling over the past couple of years by 0.5%, so a lot needs to be done to try to turn that trend around. There are some positive things that could change it around, but as I said at the start, these things take time.

Q134 **Lord Rooker:** Going back to Lord Londesborough's question, one of the things that takes time is pension provision. One of the issues is access to pension provision outside of the state pension. It is 55 now; it is going to move to 57 in about two years' time. Notice was given about four or five years ago.

When we looked at this in our inquiry, we found huge numbers of people who have been able to take their pension earlier and can survive on it, so in that sense, they are not in the labour force.

The demographics indicate quite clearly that the age limit is going to have to go up so that people cannot access their pension until, let us say, they are 60 or 60-plus. It is already legislated to go up to 57, but, quite clearly, it has to go higher, because we are taking the pension too early.

You have not proposed or suggested that it would be a good idea to make increases in taxation or even changes in taxation, but if you consider the total tax take, which has gone up quite a lot in the last few years and is probably going to go higher, is there a point where the tax take becomes apparent to people who are making investment decisions for growth? So they simply say, "Well, the tax take is too high; I'm not going to invest for growth".

The tax take in Scandinavian countries is a lot higher in some respects even than what we are forecasting here. Bearing that in mind, is there a particular figure? Is that an issue?

Roger Bootle: It is certainly an issue. I am going to leave the pension question to Peder—I am not an expert on that—but on the point about tax take, I do not think there is a single point at which it becomes critical. There is a mass of literature on this, and unfortunately, it is very highly politically charged—that is to say, people on the right produce all sorts of evidence that tax rates are extremely damaging for growth, and on the left they produce studies that say, "Ah, but look at these countries".

It depends very much on the country, and it depends also on what you do with the money. It is not just the one side. Having a higher tax take to fund expenditure which is then, in effect, squandered on consumption is very different from one where an awful lot of valuable and profitable investment is done by the Government.

Dr Peder Beck-Friis: I will pass on the pension question on to Allan. I agree with Roger: it depends on your political leaning, and there are lots of academic studies on this. We tend to think that UK trend growth has been roughly in between the rest of Europe and the US, and if you compare that versus the tax burden, it maps pretty well. So perhaps there is some correlation there.

It is not only the level of tax that matters but the composition of taxes. You mentioned Scandinavia; I am from Sweden myself. In Sweden, we have high taxes on labour and we have high taxes on consumption, a much higher VAT than here, but we have much lower taxes on capital. The composition of taxes matters as well as the level of taxes.

The Chair: Allan, do you have any more to add?

Allan Monks: Do you want me to answer the pensions question?

The Chair: We do, yes.

Allan Monks: It is obviously a difficult political choice, but we have seen people choosing to work longer than they would ordinarily have to. If we look at age groups around pension age, we see that the contribution that they have been making to employment and average hours worked has tended to go up. I guess there is an endogenous response here: if you have strong incentives to work, if wage growth is high, that could naturally pull more people into the workforce instead of them otherwise retiring.

On the issue of taxation, I do not think there is a specific level, but if there is, I certainly do not know what it is. It probably depends quite a bit on which tax we are talking about. There might be different thresholds depending on the area of tax. A general point that comes up is tax reform. I think a lot of people would agree there are some decisions that could be made there. That is not necessarily to say that we raise more or less tax, but if we were to look at some tax rates—stamp duty, council tax, et cetera—others have come up with lots of ways in which they could be reconfigured so as to incentivise more growth and more activity, which could be positive for the public finances and growth.

Lord Rooker: People are very frightened of talking about council tax, because it has almost become like dealing with the rates, which frightened everybody. We had the poll tax and the solution to that was the council tax. Lord Heseltine said at the time that it was designed just to last for a few years. He made the change very quickly after he became Deputy Prime Minister, but that was 1991.

Now we have an incredibly regressive tax in terms of council tax: all the gainers seem to be in the south-east of the country. To make a political point, the losers are definitely in the red wall seats, in terms of the balance of property price changes since 1991. So why is everybody frightened of dealing with it?

The Chair: Maybe you do not want to answer that. I think it might be a hypothetical question.

Lord Rooker: It was, yes.

The Chair: We will leave that hanging and move on to productivity with Lord Turnbull.

Q135 **Lord Turnbull:** I am struck by Peder's view of Scandinavia as having more taxes on labour and lower taxes on capital. I would say the proposition that gains most traction among economists is the under-taxation of property, particularly residential property. It is not a very avoidable tax either. In which direction would you want to move the balance of the structure of UK tax? Are you making a distinction between residential property and business capital?

Dr Peder Beck-Friis: I am sorry, but I have to pass. I would rather not comment on individual tax and spending policies in the UK.

Roger Bootle: If we could devise a practically effective land tax, which is a slightly different idea from property tax, all sorts of people have shown that it would be enormously beneficial. The devil is in the details; the practicalities are actually quite tricky. But there is a strong case that an effective land tax would produce far fewer distortions and much less ill effect on incentives than the combination of taxes we have now. Of course, whether it is a pure land tax or a property tax, it will be immensely unpopular, so the political barriers against introducing something like this are enormous.

The Chair: Allan, do you have anything to add?

Allan Monks: I do not have a strong view on that.

The Chair: Can I ask final a question about productivity and AI? A lot of hype about AI emanated from the Alpine delights of Davos last week. You could call it hype, and that is my question, I suppose: is it hype, or is it not hype that AI is going to be the cavalry coming over the horizon to improve our productivity? What impact will it have in the short term? Some astounding forecasts were made last week about the impact of the new paradigm shift in AI that may come to bear on economies in the next two to three years. Is this factoring into any of your deliberations?

Dr Peder Beck-Friis: I think we all need to be pretty humble in forecasting AI. The range is that it will increase productivity growth by zero to 3% in the US. What we can say from a macro point of view is that it has not really changed the overall macro numbers globally. Investment demand in the US has been a little stronger perhaps, but it has not really affected the global macro picture.

Where it does show up, of course, is in equity prices. Historically, whenever we have seen equity prices front-running macro data on new transformation and new innovation, that has created risks further down the line in terms of corrective actions. We obviously saw a little correction yesterday.

We are convinced it is a big thing, but it is very difficult to estimate and there will be delayed effects. Whenever there is a new innovation, it takes years for that to transform into macro data so, it will take a few more years for us to see that.

Roger Bootle: I agree. There is a lot of economic historical evidence from the 19th century and the early 20th century about exactly that: a transformatory technology emerges, but to get it fully operational takes a very long time. We can think of so many examples. One I particularly like is the automatic passport machines at Heathrow, which are manned just about as heavily as the original human model. That is partly because they go wrong, people get in the way and some people do not know how to operate them. There are all sorts of barriers to reaching the final result.

My own instinct, based on reading the history of such things, is that the eventual impact will be very big. But I expect the great enthusiasts to be proved wrong about the extent of the immediate impact, which I think will be much lower.

Allan Monks: I do not have a strong view on this; it is very difficult to predict. I suppose you would expect the US to benefit, and then maybe a spillover to the rest of the world. But I really do not have a view on exactly when and what numbers to put on this.

Lord Lamont of Lerwick: One question you could all answer is why productivity in the financial sector has had one of the biggest drops since the financial crisis?

Roger Bootle: I defer to my colleagues.

Dr Peder Beck-Friis: Increased regulation may be part of that, but productivity growth has slowed not only in the financial sector; it has slowed across many other sectors. Perhaps it has been more pronounced in the financial sector, but I do not have the expertise in terms of the precise regulation that would impact that.

Q136 **The Chair:** Finally, our report was *National Debt: It's Time for Tough Decisions*. If the Government were sitting here, if the Minister was sitting here, I am sure that he or she would say they have taken tough decisions. When you look ahead to the rest of this Parliament, given what you were saying to us right at the start about the fragility of the situation we are in, do you think that further tough decisions will be needed, irrespective of where we are in March with the OBR?

Roger Bootle: Yes. It would be possible, of course, to duck those decisions and then, as was said earlier on, according to the OBR's projections and depending on what happens to growth, everything may be fine. But that is taking a huge risk. As I said, sometimes you have to take decisions to promote one objective which actually compromise your position with regard to another, and the one I am thinking of in this instance is the overall structure of the UK economy. In this case, it is not true that you are compromising at all; you are favouring it. If we were tougher fiscally, we would have a much better balance of outturns. We would probably boost investment; we would end up with lower interest rates, and that would then impact the fiscal position. There is a very strong argument for being tough on fiscal policy.

The Chair: Allan, do you have anything to add to that?

Allan Monks: I would just go back to the point I made at the start, which is that if growth undershoots the expectations that are built into those projections, that probably means that some choices need to be made.

The Chair: Thank you, all, very much for a very interesting hour and a half, and we are very grateful to you for coming in. With that, we will end the session.