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Large PSBR means high interest rates

From Mr Gerard Lyons

Sir: I disagree with Gavyn Davies (Economic Commentary, 16 March), who suggests that the Public Sector Borrowing Requirement (PSBR) will be easily financeable. In fact, it will probably require very high interest rates for the deficit to be financed.

By definition, the public sector's borrowing must be matched by higher savings from the private sector and/or the overseas sector. Mr Davies's argument is that the main source of funding of the PSBR will be domestic, with any increase in the PSBR being auto-[illegible]tically financed by the private [illegible]or surplus. However, it is crucial to see who is accounting for the private sector's surplus before one can judge whether the Budget deficit is easily financeable.

Latest Bank of England figures show that last year the market's holding of gilts was £107bn. Of this, insurance companies and pension funds held £68bn (62.8 per cent), the overseas sector held £14.4bn (13.4 per cent) and industrial and commercial companies held only £1.3bn (only 1.2 per cent of the total). Thus, one can see that gilts are mainly bought by the insurance and pension funds, not the corporate sector. This was also the case in the Seventies when the Government's deficit last soared.

If the private sector behaves as Mr Davies, the Treasury and most others assume, then the financing of the Budget deficit will be offset mainly by the movement of the corporate sector towards surplus. But this is the problem. These industrial and commercial companies (ICCs), as they are referred to, are not large buyers of gilts.

It is difficult to imagine the corporate sector funding the Government's deficit when their overall holding of gilts last year was only one-third the size of expected gilt issuance in any one month this year. More realistically, interest rates will have to remain competitively high to attract insurance and pension funds into the gilt market.

Of course, if the recovery proves to be stronger than expected, then the combination of a Budget deficit, combined with a reduction in the private sector surplus, will inevitably lead to a larger current account deficit. In this case it is the overseas sector that will be the key lender to the UK government. Either way, the funding of the Budget deficit will not be easy and could require high longer-term interest rates.

Yours faithfully,
GERARD LYONS
Chief Economist
DKB International London, EC4