

DBrief

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How the UK mortgaged its future: the deficit is the solution and the problem

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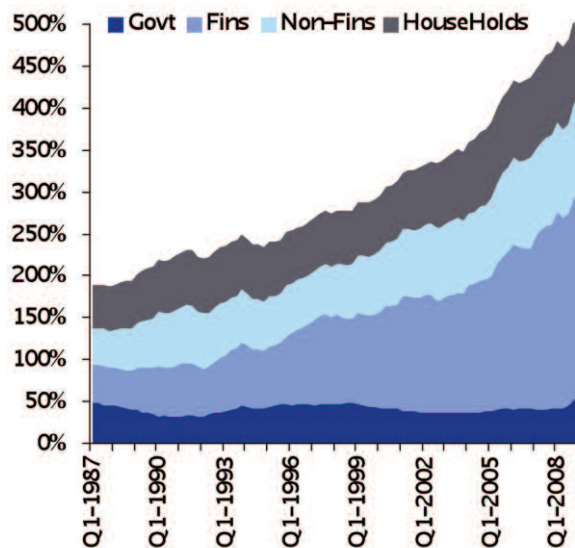
The oldest slogan in Western political economy is “seisachtheia”. Roughly translated, it means “the cancellation of debts”. Some 2,500 years since it was first used by indigent farmers, it remains a topical and emotive message. Ironically, the term owes its existence to a previous Greek financial crisis.

In the context of the forthcoming election, the fiscal deficit dominates the political discourse – and with good reason. Since 1987 the UK has taken on debt at unprecedented levels. As the recent financial crisis unfolded, the private sector proved unable to sustain the absolute volume of debt incurred. The public sector stepped in. What we need to ask now is whether the public purse can sustain this volume of debt – and, if so, for how long.

Central Banks have many functions in a modern economy, but their fundamental role is to balance demand with supply. They do this mainly via the price – the “interest rate” – of money.

Very rarely, they are forced to act regarding the “quantity” of money in circulation, as occasionally there is not enough to buy the goods produced by the economy. This is

UK debt to GDP ratios: UK debt to GDP back to 1987



Source: Deutsche Bank, Federal Reserve, *The Statistical History of the US, from Colonial Times to the Present*, by Ben Wattenberg, ONS

principally observed in the aftermath of a banking crisis.

The financial crisis of 2008 held out the possibility of a debt deflation across the developed world, including the UK. Leverage on any measure was at an all-time high (see above). The economy was moving into a recessionary phase, and loans were defaulting, looking like they might default or being called in.

Banks in our system have to maintain their reserve ratios at or above minimum levels. In the good times they can lend many times their capital base; in the bad times this leverage works in reverse to inflict rapid and severe damage to bank capital.

This meant that to preserve their capital ratios as the crisis developed banks had to raise reserves by



calling in other loans. This led to a contraction in funds available to the real economy.

Crucially, the Bank of England already had interest rates close to zero and so could do no more to stimulate the economy. The government had to step in to replace private spending with public spending or face a severe recession – perhaps even a depression.

There are two ways to implement this policy:

1. *The Central Bank sells gilts to the non-banking sector on behalf of the Treasury.* The government would borrow from the public, competing for funds in the market. This approach would have raised interest rates, making mortgages and investment expensive and so exacerbating the downturn.
2. *The Central Bank buys gilts with newly minted money – “Quantitative Easing”.* The Bank itself simply provided the banks with money through fiat. Since the normal transmission for lending had failed, the Bank of England resorted to “printing money”.

The key objective of QE was to prevent a contraction in bank lending from leading to a spiral of asset liquidations, further reserve accumulation and additional contraction in economic activity.

So far, so successful, but – and this should not be forgotten – this “policy success” has been achieved at the price of a peacetime record budget deficit. The National Debt is equivalent to just about one year’s GDP – i.e. the sum of all economic activity in Britain.

Furthermore, the endgame of this type of financial crisis can be hyperinflation, where governments lose control of the money stock or alternatively, default – sovereign

debts are simply not paid. Sovereign debt ratios in excess of 90% – where we are now – give rise to the conditions where sovereign defaults happen.

In a European context, as can be seen only too clearly, the UK is second only to Italy in terms of outstanding debt.

There are three possible scenarios arising out of this quagmire, all of significant relevance to investors:

1. *Deflationary bust.* The economy fails to respond to stimulus or stimulus is withdrawn too quickly to maintain confidence in sound money.
2. *Inflationary bust.* Stimulus is maintained and repeated Japan-style but without high domestic savings. Debt issuance is monetised by the Bank of England, leading to further devaluation and loss of confidence.
3. *Muddle through.* The recent policy gives the economy time to adjust to a lower level of output. The national debt is stabilised at a ratio below 90%. Stimulus is withdrawn gradually. The UK economy feels poorer but not depressed, trend

growth is shown to be far lower than previously thought, and debt acts as a drag on investment and consumption. The ineluctable laws regarding wealth creation through efficient production reassert themselves.

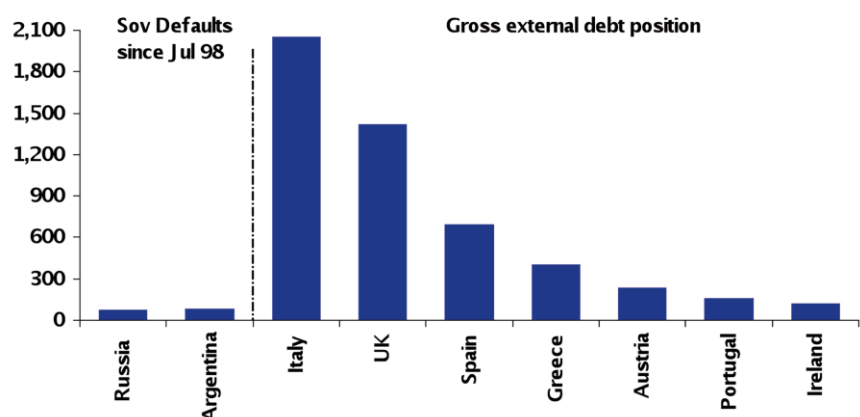
Scenarios 1 and 2 are tail-risks. There is a possibility that a strong Conservative win would be biased to rapid deficit reduction, which could derail recovery. A strong Labour win would probably bias policy to 2. The overwhelming probability, however, is 3 – a long, depressing work-through of accumulated debt in a slow-growth environment lasting many years.

The single act of hubris in this period was to mistake a debt-funded consumer boom for a step-change in UK productivity. Debt accelerates growth and is fundamental to capital formation; but that capital must be productive, otherwise increased investment leads directly to diminishing returns.

We have just had our very own Asian crisis, and therein lies a clue as to where investors should be looking.

What is striking is the divergence between the debt burden of

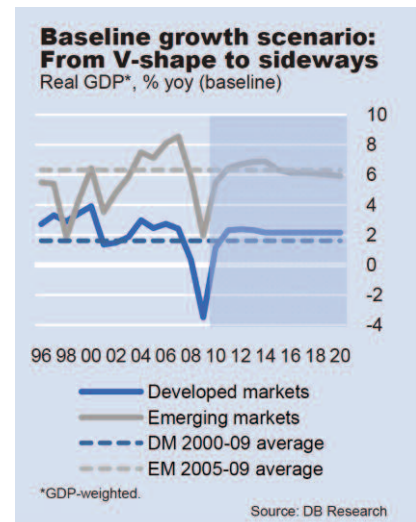
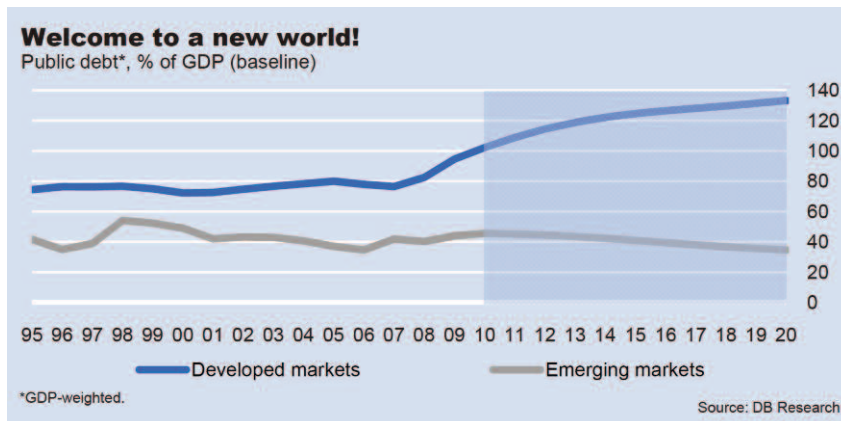
European government debt in context of largest ever sovereign defaults. The two largest sovereign defaults since 1998 and outstanding government debt from recent European sovereign CDS underperformers



Source: Deutsche Bank, Bloomberg, Moody's



The likely path of Debt/GDP in advanced and developed countries



Source: Deutsche Bank, Mark-it

Developed Markets versus Emerging Markets. In the 12 years since the 1998 Asian crisis sovereign risk has been transformed. It is with the West, not the East.

Deutsche Bank research paints a disturbing trend in developed economies, with aggregate public debt rising inexorably as a percentage of GDP. This is a long-term tax on growth. By contrast, debt levels in Emerging Markets are already much lower than in the West and are forecast to go lower still.

This divergence shows up in the competing growth rates, with EMs

growing at 6% and we in the West struggling to maintain 2%.

The key lesson for investors is that this debt constraint will limit growth in the UK for many years to come. What is equally clear is that the emerging economies learned their lessons the hard way in 1998 – and it is to these economies that we should look for growth, for they possess the balance-sheet strength to fund it.

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A version of this piece first appeared in Investment Week.

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