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exponential debt

the british challenge in a global context

- **For governments and individuals for whom 'consume now, pay later' has become an established mind-set, 'later' has now arrived.**
- **Governments and regulators have been at best negligent, slackening and then removing credit limits, maintaining unrealistically-low interest rates, applying tax policies which discourage saving while incentivising borrowing.**
- **Bank rescues have played a pretty modest role in the take-off of sovereign debt.**

Britain's newly-created independent fiscal watchdog has underlined the scale of the debt challenge faced by Mr Cameron's new government, and has highlighted the sharply rising cost of unfunded public sector pension obligations.

But the British debt challenge needs to be seen within a global context of escalating public debt. This report looks at the issue of exponential debt, and explains that, for governments and individuals for whom 'consume now, pay later' has become an established mind-set, 'later' has now arrived.

It is axiomatic that any newly-elected government should act briskly in order to maximise the benefits of the 'honeymoon' (typically regarded as spanning a hundred days) which it can expect to enjoy. David Cameron's coalition administration is certainly following this axiom, and the newly-created (but long-needed) Office for Budget Responsibility (OBR) has reflected this alacrity with the rapid delivery of its independent assessment of Britain's fiscal outlook.

Since the crisp downgrading of the previous chancellor's heroic growth assumptions was always a given, perhaps the most interesting aspect of the Pre-Budget Forecast (PBF) is its focus on the future costs of public sector pensions. These, as we have argued before, constitute a huge off-balance-sheet obligation[1]. Moreover, annual deficits on these unfunded, pay-as-you go (PAYGO) schemes are poised to rise sharply, the OBR says, from £3.1bn last year to £9.4bn by 2014-15. A clear subtext of the PBF is that action has to be taken on this front.

But the broader point – which is that even declared (let alone off-balance-sheet) government debt is on a briskly rising trend – needs to be seen within a broader context, which is that **public debt has taken on an exponential trajectory across the developed world**.

[1] See Tullett Prebon Strategy Insights, issue four, *Britain at the Crossroads*, April 2010

Confronting reality

Rising public debt is, in turn, part of a broader escalation of indebtedness. If anyone had doubted that the banking crisis of 2008-09 was the outrider for the sovereign debt crisis of 2010, recent events have surely put the issue beyond question. Greek public debt has been reduced to junk-bond status both by the markets and by the rating agencies, and fears over the viability of a string of other borrowers – including Ireland, Portugal and Spain – have prompted a sharp fall in the value of the euro, even when measured against other hardly-robust currencies such as the dollar and sterling

In a ground-breaking report[2] published in March, the Bank for International Settlements (BIS), customarily a bastion of calm conservatism, pointed to the development of ominous exponential trends which now characterise the outlook for a string of developed-world sovereign borrowers. Even if reasonably resolute action is taken, the report shows, debt-to-GDP ratios are heading inexorably upwards, and are likely to be nudging 200% within a decade, and anywhere from 300-500% not all that many years after that. Sovereign debt now seems to be, to all intents and purposes, out of control.

Be under no illusion that such ratios are remotely sustainable. Even based on recent real interest rates, debt service will absorb ever-rising proportions of national budgets, locking governments into an ever-worsening vice in which the sheer scale of debt service obligations permanently embeds escalating deficits into fiscal balances. On top of this, of course, perceptions of an out-of-control debt progression are likely to be self-reinforcing if – as is to be expected – interest rates are driven upwards by investors increasingly unwilling to meet ever-rising appetites for debt.

Why has debt become exponential?

Is the increase in public debt, as some believe, simply the fall-out from the banking crisis? After all, the response to the 2008 crisis transitioned huge quantities of toxic debt from bank to state balance sheets. In fact, our research indicates that bank rescues, though they have not helped, have played a pretty modest role in the take-off of sovereign debt. Structural deficits are the real cause of the problem. And, though there are some individual cases – such as Greece, Ireland and the UK – in which the process can be blamed on recent profligacy, the sheer breadth and scale of the sovereign debt problem suggests that something more systemic is going on.

As populations age, demographics are worsening fiscal balances by pushing age-related expenditures upwards. Again, and though it doesn't help, the impact of ageing is a gradual and a predictable fiscal process, which cannot be identified as a principal cause of the problem.

Our view is that **an excessively relaxed attitude to debt is the real problem**, applying pretty equally to governments, businesses and individuals. Debt, properly considered, is 'anticipated consumption' – in other words, the borrower consumes at above-income levels now, on the understanding that, at some unspecified point in the future, consumption will have to be foregone in order for the debt (plus interest, of course) to be repaid.

But western societies seem to have been succumbing to a psychology which decrees that 'tomorrow doesn't matter, at least until it arrives'. In our research, we have identified one particularly pernicious aspect of this mindset, which we term 'generational theft'[3]. Today's generation is piling huge debts onto coming generations, with an attitude that amounts to 'want

[2] *The future of public debt: prospects and implications*, BIS Working Papers No. 300, March 2010. For a discussion of this issue, see Tullett Prebon Strategy Notes, issue six, *Out of Control*, May 2010

[3] For more on this issue, see Tullett Prebon Strategy Notes, issue one, *The Dick Turpin Generation* , March 2010

it now, let the kids pay for it tomorrow'. Unfortunately, it is beginning to look as though 'tomorrow' has now arrived.

Over the past quarter-century, while debt ratios have broadened successively, governments and regulators have been at best negligent, slackening and then removing credit limits, maintaining unrealistically-low interest rates, applying tax policies which discourage saving while incentivising borrowing, and removing the barriers which previously separated commercial and investment banking activities.

Governments, corporates and individuals alike have forgotten the time-honoured adage which says that, **while asset values are variable, debt is immutable**. Throughout history, debt crises have always followed the bursting of asset bubbles, and bubbles have been a recurrent feature of financial markets. But what has been new over the last decade or so is that, while the bubbles of the past tended to be well separated in time, the economy is now displaying a *sequential* bubble-creating tendency, in a process which began with the Asian financial crisis and has since engulfed dotcoms, property and derivatives.

Welcome to tomorrow

Across the OECD – though most notably in Europe – fiscal tightening has now become the order of the day. Keynesian-minded economists point out that fiscal retrenchment at a time of weak economic performance is a recipe for slower growth, impaired output, increased business failures and higher unemployment. Within its limits, their analysis is right, but, as a prescription, it presupposes that debt can continue to rise.

It can't. For governments as well as for individuals, 'tomorrow' has now arrived. Borrowing, as remarked earlier, means over-consuming now at the expense of under-consuming later. Welcome to 'later'.

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