

Fax (01524) 381454 E-Mail G.Steele@lancaster.ac.uk Telephone (01524) 594210

## WHEN DOES NATIONAL DEBT POSE A PROBLEM?

## 8/10

## G.R. Steele

- **Q:** When does national debt pose a problem?
- A: When it becomes too large. As debt rises, the fear of default is also likely to rise. As some creditors then decide to sell (or not to buy) debt instruments (that is, 'bonds') this depresses their market price.
- **Q:** That's a problem?
- **A:** It becomes a problem if the debtor wishes to raise more debt. A lower valuation of 'bonds' effectively raises the interest that must be paid in order to borrow.
- Q: That is happening with Greece, Ireland, Portugal ...
- **A:** ... yes, and a few others. Suppose, for example, the governments of Greece and Germany wish to sell bonds which, on maturity three years from now, have a redemption value of 1000 euros. The price of the Greek bond would be much lower than that of the German bond.
- **Q:** Each bonds is redeemed for 1000 euros but, in selling for less, the Greek bond gives a higher return?
- **A:** Yes, to compensate for the higher default risk. With ever-rising debt, the price of high-risk bonds might fall to the point of becoming worthless, which would make further borrowing impossible.
- **Q:** How could that be avoided?
- **A:** By reducing the need to borrow, by cutting government expenditure or by raising taxes. Even with zero borrowing, debt continues to rise by the cost of 'servicing' existing debt. However, concern is rarely about the absolute level of debt.
- **Q:** Why is that?
- **A:** With their concern that debt might not be repaid, creditors are interested in the value of outstanding debt in relation to the earnings capacity of the debtor. This is why government borrowing and national debt are usually quoted in relation to GDP.
- **Q:** What levels are considered safe?
- **A:** There's no straightforward answer to that but, prior to the introduction of the euro, nations were required to bring borrowing and debt respectively to levels no higher than 3 per cent and 60 per cent of GDP.
- **Q:** And did that happen?

**A:** Where it did, it was often achieved by creative accountancy and wilful chicanery.

**Q:** How was that possible?

**A:** One explanation is that the euro was among the agenda of those driving towards a European political union. To keep that show on the road, it was convenient to conduct lax audits.

**Q:** Can we stick to the economics?

**A:** If only they had!

**Q:** What do you mean?

**A:** Had consideration been given to the economic implications of deficit spending and ever-rising borrowing after sovereign nations had surrendered control over their respective currencies, Greece, Ireland, Portugal ...

**Q:** ... would not now be presenting problems for the European Central Bank and the International Monetary Fund to deal with.

**A:** Exactly.

**Q:** Well, we are where we are, so what can be done?

**A:** What can be done, or what should be done?

**O:** Whichever.

A: Let's start with a less complicated case: that of a nation like the UK which has retained its sovereign currency.

**Q:** And UK debt is currently seen to be on the high side.

**A:** UK borrowing for 2010/11 is forecast at 12.6% of GDP and debt at 63.7% GDP, with some estimates suggesting the latter might rise to 100% by 2012.

**Q:** And creditors are becoming anxious.

**A:** Creditors would be more anxious if expenditure cuts and tax increases were not being implemented.

**Q:** And if those measures were deferred or simply not expected to take place at all?

**A:** In that event, UK bond prices would fall, the cost of borrowing would rise and price inflation would be likely.

**Q:** Price inflation, why price inflation?

**A:** UK bond prices are denominated in sterling. On redemption the par value of a bond is in sterling. So, effectively, there is a one-for-one parity between, say, a £50 bond and a £50 currency note.

Q: Hold there .... you previously said that if creditors sell bonds this could depress their price.

**A:** It's good that you are paying attention. Although bonds regularly trade below their par values, their redemption price remains fixed. The only proviso is that, when debtors find themselves in financial difficulty, they may seek to 'restructure' their debt.

**O:** Restructure?

**A:** To be blunt, debt restructuring implies a partial default. More recent jargon is to say that creditors 'take a haircut'. Which means they agree to accept only part-repayment of what is due to them.

**Q:** Let's get back to inflation. How does rising national debt lead to inflation?

**A:** As an alternative to raising taxation, a nation state with its own sovereign currency can create new currency to redeem its maturing bonds. The implication is that bond holders are not exposed to default risk. Instead, as the value of the currency in which bonds are denominated falls, the value

of bonds also falls. This is called 'exchange risk'. In place of 'default risk' (faced by creditors of Greece, Ireland, Portugal ... and, indeed, all the eurozone nations), UK bond holders risk a fall in the exchange value of their bonds.

**Q:** Inflation erodes the exchange value of bonds and currency?

**A:** Exactly. In fact, UK government bonds and sterling currency notes are components of UK national debt. The difference between the two is that a sterling currency note pays no interest.

**Q:** So price inflation reduces the real value of UK national debt?

A: It certainly does..

**Q:** Then why should the UK engage with public expenditure cuts and tax increases, when a little bit of inflation does the trick?

**A:** I'll answer your question with a question: "How 'little' is 'little'?"

**Q:** Inflation doesn't do that much damage, so long as it doesn't run out of control.

**A:** That's true; but the problem is that, if the UK were seen to be taking that option, creditors might seek alternatives to UK bond-holding. The UK was in that position in the early 1970s, when fiscal deficit spending and rising debt were the means by which an attempt was made to boost economic growth.

**Q:** This was the Heath-Barber boom?

**A:** If you are young enough to remember that, you might also recall that inflation quickly ran out of control.

Q: Wage demands, strikes, power cuts and a three-day week ...

**A:** ... and in the face of a chronic trade deficit, a plummeting international value of sterling and escalating prices, there was a policy U-turn. Painful readjustments by families and businesses were required over many years before monetary stability was restored.

**Q:** And that could happen again?

**A:** Were the authorities to attempt to use inflation to reduce the national debt, a similar outcome would be highly plausible.

**Q:** Not a healthy prospect

A: Indeed not.

**Q:** Can we stop there?

**A:** Perhaps we should!