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FEATURE ARTICLE

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Debt or Deficit?

I was somewhat surprised to learn recently that apparently only a tiny proportion (around ten per cent according to the Centre for Policy Studies) of Britons understand the difference between the government's debt and the government's deficit – or indeed know which one the Conservative Government is currently trying to reduce. I believe that this confusion stems from "debt" and "deficit" being used interchangeably by the press and indeed by politicians of all colours. So in this article I am going to discuss government debt and deficit.

Basically, "Government or National Debt" is the total amount the country owes historically (think of it as the outstanding balance on the UK credit card), while the "Government Deficit" is what is added to that outstanding balance each year as expenditure is greater than revenue. So in essence although this Conservative, and indeed previous Coalition Government, has indicated that it wants to "pay the nation's credit card off", in actual fact, to use the analogy correctly, it should be saying that it wants to reduce the amount that is added to the credit card debt each year, not pay it off.

What is the recent history of the National Debt?

After a period of financial restraint, from the mid 1990s, National Debt as a percentage of Gross Domestic Product (GDP) fell to twenty nine per cent in 2002. (GDP is basically the total market value of all final goods and services produced in a country in a given year.) Then from 2002 to 2007 National Debt increased to 37.5% of GDP. This increase in debt levels occurred despite economic expansion and was primarily due to the Labour government's decision to increase spending on health and education plus there was also a marked rise in social security spending over this period.

Since 2008, National Debt has increased sharply from the 2007 levels because of, for example, the financial bailout of Northern Rock, RBS, Lloyds and other banks plus the effects of the double dip recession (e.g. lower tax receipts, higher spending on unemployment benefits).

So what is the "structural deficit" that I sometimes see being discussed in the press?

Whereas the deficit is the difference between what the government receives as taxes and other revenue and what it spends, the "structural deficit"" is the part of government over-spending which it is calculated would still remain even when the economy is booming and government receipts are at their maximum. The structural deficit is basically the current budget deficit, adjusted to strip out the cyclical nature of the economy. You would expect, for example, the budget deficit to narrow when the economy grows after a sluggish period. The structural deficit attempts to exclude the effect of this recovery. In other words, the structural deficit is the underlying deficit that is not directly affected by economic performance.

Where to from here?

Now the question has to be why are government budget deficits seen as potentially "undesirable"? Well one scenario is that to finance the deficit the government has to borrow from the private sector; it does this by asking the Treasury to sell gilts to the private sector. Selling gilts will increase the national debt, which is currently approximately £1.5trillion. The annual interest payments on this potentially have a high opportunity cost because it may require future generations to pay higher taxes. There is also the possibility that depending on how the UK is viewed by the markets (basically the institutions that purchase gilts) in terms of the risk of paying back the gilts at the end of their term (known as a credit rating); if the government sells significant amounts of bonds this might cause interest rates to increase because the government might in the future need to increase interest rates in order to attract investors to buy gilts that the government wants to issue. If government interest rates increase this will push up general market interest rates as well. (Quantitative easing actually is basically creating demand for gilts by printing (creating) money and having the Bank of England purchase gilts issued by the Treasury).

There is also an argument that says that increased government borrowing may cause a decrease in the size of the private sector through a process known as "crowding out".

Now at the time of writing this article Britain retains its triple A credit rating status, meaning the major rating agencies believe we're still one of the safest bets and can therefore borrow money at historically low rates. But if the UK loses its triple A credit rating status and the demand for gilts weakens that would have potentially severe implications, especially if for whatever reason the rating were cut by several notches (as for example happened with Greece). Of course unlike Greece in that situation the Bank of England could always print more money to buy gilts, so-called "Quantitative Easing," but that increased supply/degrading of sterling raises the possibility of high inflation once the economy begins to recover. In addition, if investors see their gilt holdings devalued they are, in all probability, likely to be reluctant to buy further gilts and may even start to sell, sending UK interest rates higher.

Is debt in fact "bad"?

UK net public debt (which excludes Treasury owned gilts – money you owe yourself effectively cancels itself out) nearly tripled from £526.7bn in 2007 to about £1.5tn as of the last financial year. Relative to GDP, it more than doubled, from 37.5% in 2007 to 87.1% at the end of May 2015. To be precise at the end of May 2015, General Government Gross Debt was £1,617.9 billion (87.1% of GDP) and General Government Net Borrowing in the financial year ending 2015 (April 2014 to March 2015) was £93.4 billion (5.2% of GDP)

An important fact to remember and consider however is that total debt does not necessarily matter. Yes, let me write that again, total debt does not necessarily matter! It is debt affordability that is crucial, and currently with the lowest interest rates that we have ever seen Britain's debt is cheap.

Now individuals, including myself, are hard wired to dislike debt. But let's imagine for a moment a world without debt? Consumers couldn't borrow to buy homes. Businesses couldn't borrow to finance new plant/machinery and research and development. Not much economic growth in that economy then.

It is also worth noting that governments may not spend money wisely but that money is not spent just the once. There is what economists term a "multiplier" effect in the economy as some of the money that was spent by the government is spent by the recipient and some saved or used to pay down debt and so on.

In the current economic environment if you want cheaper government debt, you want the government to keep doing what it has done since the start of the financial crisis and the reduction of interest rates to the lowest level ever – extend the average maturity of all outstanding gilts. Higher interest rates affect only newly issued debt. The longer our debt's average maturity, the longer it would take rising interest rates to increase the total debt servicing costs. As long as the UK has access to credit markets and retains its triple A rating, the debt can be rolled over perpetually, it is the cost of doing that that is important.

It is also worth remembering that when considering where interest rates might go in the future markets move on probabilities not possibilities and therefore rarely look more than a couple of years ahead. A significant interest rise is simply not forecast within this time-frame based on current assumptions and probabilities.

Conclusion

In any event having read this article hopefully you can now see that the National Deficit is important but it is not the same as National Debt and that debt is not as important as the cost of that debt.

The fact is that in terms of reducing the deficit this can really only be done in a limited number of ways:

- Economic expansion, which tends to mean that tax revenues grow and also leads to lower spending on welfare benefits.
- Cuts to public spending.
- Tax increases.
- Inflation, which reduces the "real" value of the existing debt.

My concern is that one solution that the government and the Bank of England Monetary Policy Committee might not be too worried about in the short to medium term (perhaps because they will be unable to control it over the short term) could be a significant increase in inflation? In that scenario it is important to obtain professional financial advice as to how you can protect the real value of your wealth.

After all, as I always say, investment is simple, but not easy!

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