How will we pay for it?

By David Hearne, Researcher, Centre for Brexit Studies

This is apparently the question on the lips of Treasury mandarins, according to a leaked document[1]. Naturally, this has raised hackles across the political spectrum, with commenters aghast at proposals for renewed cutbacks to the public sector alongside mooted tax rises.

We should always be wary of commenting on leaks reported in the press. However, if the reports are accurate (and I stress that this is a significant *if*) they represent quite a profound misunderstanding.

According to media reports, there is a belief that an announcement will need to be made in the coming weeks to "enhance credibility and boost investor confidence" (*ibid*). There is concern about the potential for a "sovereign debt crisis".

How could such a "crisis" conceivably emerge? The UK government borrows by selling gilts to investors. There are a variety of such investors, including banks, pension funds and others.

There can only be such a crisis if people are unwilling to purchase these. Basic supply-and-demand suggests that if you can't sell something then you cut the price: make it cheaper.

So the government sells you a "promise" to pay £100 in a year. If you don't want to buy it for £100 then the government will sell it to you for £90. You make £10 profit and the government makes a £10 loss. This is (in a very fundamental sense) what interest is. It's exactly the same reason that I repay my bank more than it lends me for my mortgage.

So the first sign of distress in the market for gilts should be a significant rise in the interest rate. At the moment, this has not happened – quite the opposite, in fact[2]. Investors are desperate to buy gilts and are prepared to lend money to the government for a pittance.

So what might cause demand for gilts to dramatically shrink? Typically a sovereign debt crisis occurs when there is concern that the country borrowing might not be able (or willing) to pay the money back. This

happened to Greece (and, to a lesser extent, Italy) during the Eurozone crisis last decade. Concerns around Italian government debt are well-founded.

At present, there is no sign that such a crisis is likely in the UK and there is good reason for this. The UK, unlike Italy or Greece, is able to borrow in its own currency. Why does this matter?

Ultimately, if the UK government suddenly found itself unable to repay a creditor it could order the Bank of England (which is operationally independent, but ultimately is a branch of the state) to print enough money to repay it.

Now, this is a pretty extreme action and would have consequences, but it does mean that for countries like the UK, sovereign default is a choice. This is a bit like a nuclear weapon – the knowledge that it exists is often enough to prevent it needing to be used.

So talk about the risk of a "sovereign debt crisis" in the UK is disingenuous at best. So why don't we just let borrowing rip and print money?

The constraint is inflation. As you can imagine, if you just print money then the "value" of money (in terms of what it will buy) falls. In extreme cases, this leads to hyperinflation – as famously happened to Germany between the World Wars and more recently in Zimbabwe – which is why it is anathema to central bankers.

In spite of the scaremongering, there is absolutely zero evidence (and no theoretical reason) why this should be binary. There is no switch labelled "hyperinflation". To take an extreme example, printing £2.50 extra is not going to have a meaningful impact on inflation.

Indeed, when people talk about Quantitative Easing (QE) being akin to "printing money", something not too dissimilar has occurred. In reaction to the financial crisis the Bank of England decided (independent of the government) to purchase government debt and has printed money to pay for it. It did this not to finance the government deficit but rather to drive down long-run market interest rates.

Yet this latter point is important. After all, if interest rates are deliberately kept low then a debt crisis – which by definition would involve a dramatic increase in the interest rates on government debt – is effectively impossible if you have borrowed in your own currency.

To make things yet more complicated in "normal" times, the Bank of England would use interest rates to regulate inflation (and, as a secondary concern, to ensure stable economic growth over time). If inflation goes too high then the Bank increases interest rates, too low and it will reduce them.

However, things are not "normal" and haven't been so for over a decade. Interest rates have been close to zero throughout that period (and it is not realistically possible to go much lower), rendering the Bank's key weapon ineffective.

The upshot is that fiscal policy (government borrowing) needs to take up the slack. This is not particularly controversial – such material is routinely taught to undergraduates – although there is a lively academic discussion over its efficacy in different economies and circumstances[3].

In practice, this means that until interest rates start to increase from their current very low levels (opinions differ, but I would see 2% as a reasonable guide) the UK government not merely *can* continue to borrow more but it *should* borrow more. Yes, that does mean that debt will need to be serviced into the future but right now that looks like a nice problem to have.

After all, a growing economy makes servicing (and even reducing) debt easy. The key point is that now is not the time to be talking about reducing government borrowing, and that the idea of a sovereign debt crisis in the UK at the present time is a chimera.

[1] Rayner, G., & Mikhailova, A. (2020). Exclusive: Treasury blueprint to raise taxes and freeze wages to pay for £300bn coronavirus bill. The Telegraph. Retrieved from https://www.telegraph.co.uk/politics/2020/05/12/exclusive-treasury-blueprint-raise-taxes-freeze-wages-pay-300bn/

[2] https://markets.ft.com/data/bonds/tearsheet/summary?s=UK10YG

[3] Generally, the smaller an economy and the more it trades, the less effective fiscal policy is likely to be. The UK is broadly speaking in the middle of the pack here.