Paul Mills Speaks about Government Debt

The former IMF analyst in interview with Peter Warburton

1 Paul, does your Christian faith lead you to view our present national and international economic situation differently from most economists?

My Christian faith and biblical wisdom informs an economic worldview that does differ from others in many respects. In particular, I would emphasise the importance of right relationships as the basis of human flourishing (the supposed purpose of economics) and the dangers of debt as a form of finance.

2 The UK is reckoned to be one of the richest countries in the world, ranking between fifth and eighth, depending on the basis of measurement. Surely, we have the resources to deal with the global pandemic without serious disruption to our standard of living?

That would have been true if we had not shut the economy down through a lockdown to suppress infections because we were under-prepared for the virus through tracking and testing infrastructure and a grossly inadequate stockpile of protective equipment. Being a predominantly service- and trade-based economy, the UK could be one of the hardest hit by the current recession and the resulting reconfiguration of economic activity and trade.

3 Thinking specifically about government debt, how much debt was the UK carrying ahead of the coronavirus outbreak? How significant was this debt in comparison to our history and to other wealthy countries?

At the end of 2019, the government's total (gross) debt was £1,890 bn. This was 85.4% of GDP. A more telling comparison, however, is with tax revenue (£862 bn for 2019) meaning that the government's debt:income ratio was 219%. Relative to GDP, an 85% debt ratio is high for peacetime and is more than double the level at the end of 2007 (40%).

The UK's debt:GDP ratio peaked somewhat after the Napoleonic Wars (182% in 1822); the First World War (186% in 1922); and the Second World War (243% in 1947). Hence, on-balance sheet debts have been substantially higher relative to GDP after crises in the past. However, if current off-balance sheet debts are included [for details

City of London in Lockdown
Photo: Financial Times

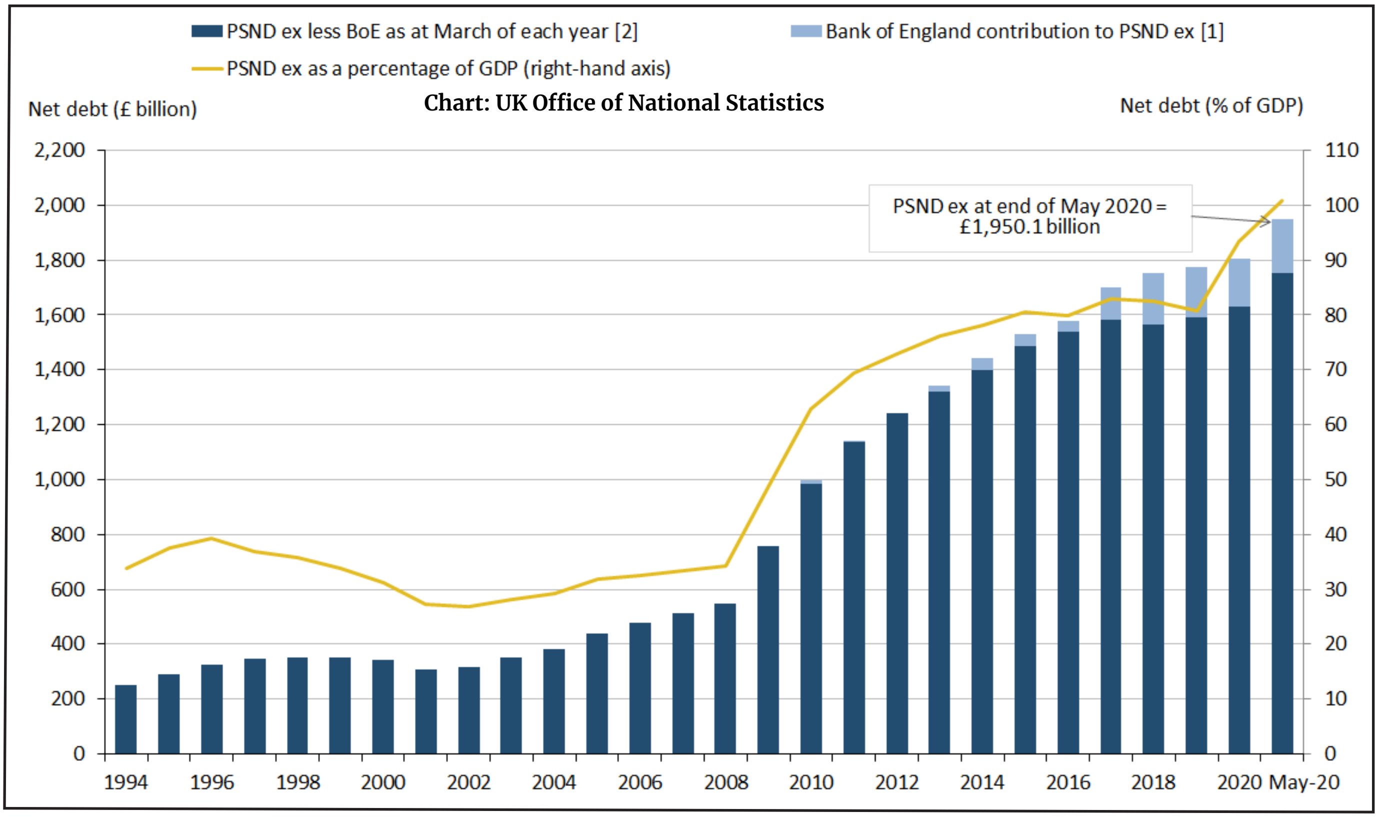


Chart: UK Office of National Statistics

of these see question 4 below], total debt:GDP is now comparable to these periods and rising rapidly.

The government's on-balance sheet debt puts the UK roughly in the middle of comparable G7 and EU economies. The highest gross debt:GDP ratio is that of Japan (238%), followed by Greece (174%), Italy (133%), Portugal (119%), the US (107%), Belgium (100%) and France (99%). Austria (71%), Ireland (62%), Finland (60%), Germany (59%) and the Netherlands (52%) are lower than the UK's ratio.

4 You mention that the government has some significant debts that are not visible on its balance sheet. What are these 'off-balance sheet' items and how large and important are they?

The main off-balance sheet debts that the government has are legally binding contractual commitments to make future payments. These are primarily for Private Finance Initiative and leasing contracts (£44 bn), NHS negligence claims (£78 bn) and nuclear decommissioning costs (£260 bn), but easily the biggest is for the underfunded public sector pensions liabilities liability (£1,900 bn at end March 2018). The pensions underfund itself is as large as the debt that is counted on-balance sheet. If the government were a company operating with a deficit so significant (220% of annual revenue), the Pensions Regulator would require immediate remedial action to be taken by the directors, if not their prosecution.

In addition, the government has no financial assets to set against its state pension liabilities. The state pension costs approximately £100 bn a year and enjoys a legally binding 'triple lock' on its indexation. The total present value of state pension commitments was last officially calculated at £4,100 bn in 2015 (then 212% of GDP) using a grossly optimistic discount rate. A more realistic updated valuation would now likely exceed £5,000 bn.

5 If the UK government was already heavily indebted, what will be the likely impact of all the additional spending related to the coronavirus? Can the public finances cope with this extra burden?

The government's debt is now forecast by the Office for Budget Responsibility to rise dramatically as a result of direct virus-related expenditure (£123 bn), losses from loan guarantees, rising welfare expenditure and a collapse in tax revenue from the decline in economic activity. The deficit in 2020/21 is forecast to be £298 bn (15.2% GDP) compared to £55 bn (2.4% GDP) prior to the virus lockdown as borrowing explodes and GDP shrinks. Debt is now forecast to rise to at least 95% of GDP by March 2021 and will almost certainly exceed 100% in the following year.

This is not unprecedented in UK history after wartime (see above) or in other countries currently (such as Japan, Greece, Italy, the US). However, the UK economy was already struggling with low productivity growth and the costs of an ageing population, and so this crisis has simply amplified and brought forward the tough fiscal decisions to turn long-term debt prospects around that have thus far been postponed.

6 The government is preparing to issue a massive amount of bonds to finance the extra spending relating to the coronavirus emergency. Who will buy them? Could there be a lack of willing buyers of the debt?

Initially, the Bank of England (BoE) will be the primary buyer of extra gilt supply, purchasing £200bn of gilts (with a further £100bn mooted). At times of great economic uncertainty, private (household and corporate) savings tend to rise sharply. These will also be recycled into banks' demand for short maturity gilts and pension fund demand for long and index-linked gilts. The danger of rising long-term gilt yields may occur should the BoE cease its gilts purchases while the government still has a sizeable deficit to cover.

There may be a lack of willing gilt buyers at any realistic yield if the authorities signalled that: high inflation and/or a rapidly depreciating exchange rate were to be objectives of policy; high deficits were going to be accommodated indefinitely; the BoE were directly financing government expenditure over a sustained period; or a restructuring of gilts (i.e. a default) was being contemplated.

7 What are the risks and consequences of high government debts? If we have been storing up trouble for the future, what are the possible resolutions of the problem?

High government debt tends to have a depressing effect on future economic growth. It is disputed whether the threshold of 90% GDP would in practice be a valid threshold (as some claim) but it is clear that high levels of government debt tend to depress future economic prospects. This comes through various channels including the expected higher taxation needed to service the debt and the undermining of monetary policy independence – interest rates may not be raised sufficiently for fear that the government's interest bill becomes unsustainable. In addition, if the credit rating of the government is impaired, this raises the cost of borrowing for companies and, in particular, banks who ultimately rely on bailout insurance from the government. At the extreme, if the government can only finance its deficit by money-printing, this risks the transition into high- or hyper-inflation.

The possible resolutions of the problem are limited and usually politically unpalatable unless the population has a cultural aversion to government borrowing (as in Germany). These are fiscal tightening (cutting spending or raising taxes to reduce deficits or create surpluses), inflating the real burden of the debt away (as the UK did in the 1970s, at the cost of higher future interest rates) or defaulting. The last can be a legal non-payment of an outstanding financial commitment (which the UK has never done on its sterling debt in 327 years) or the changing of the terms of a future spending commitment (such as state pensions).

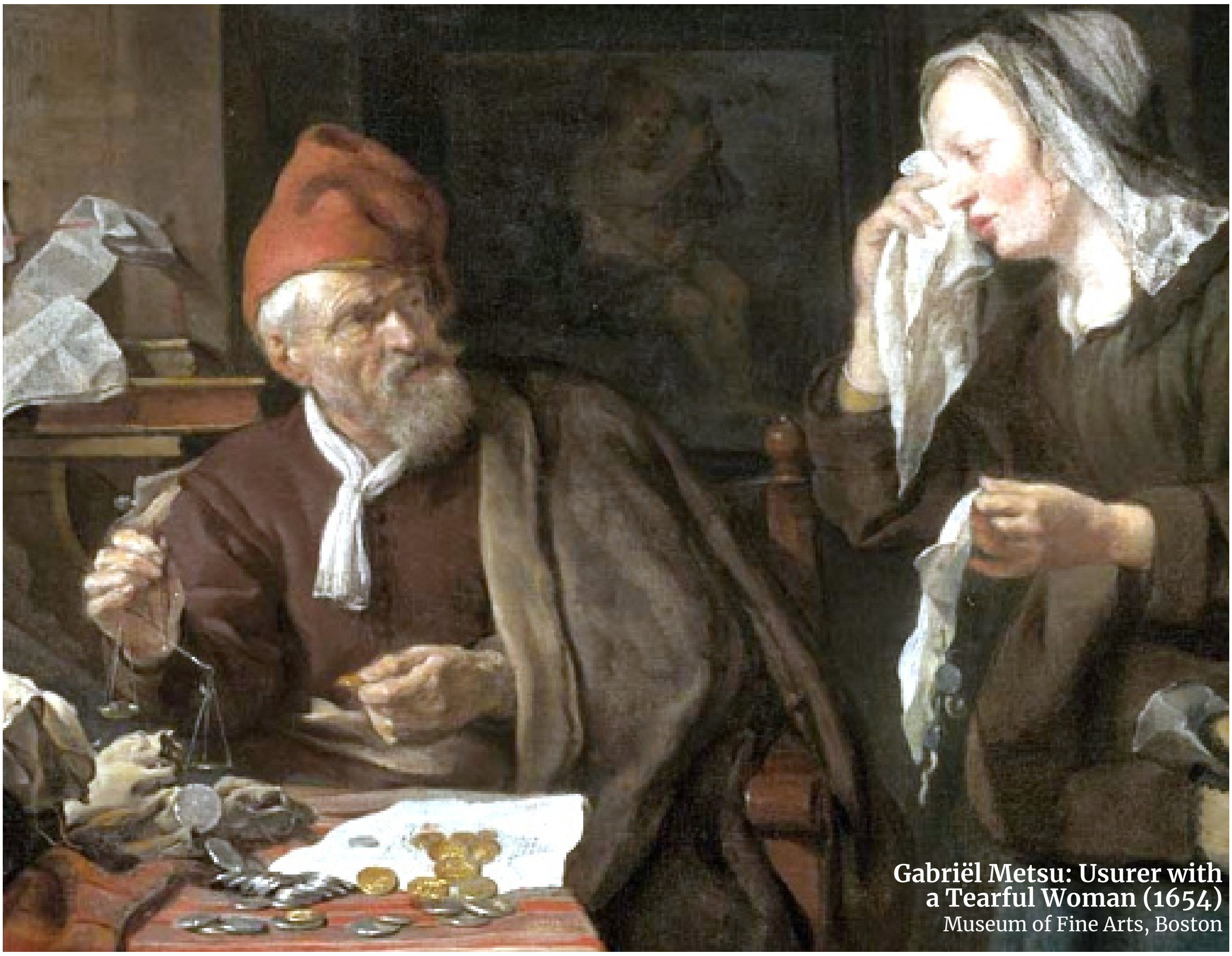
8 Given that the Bible does not address the issue of government debt head-on, what are the biblical principles that should guide our understanding of the problem of excessive public debt?

There is no biblical material that directly refers to the issue of government debt itself. The very concept was largely unknown until the seventeenth century when first the Netherlands and then the British state borrowed for the first time as a corporate entity. In Britain's case this was in 1693, via the newly established Bank of England. At the time, it was even questioned whether it was morally right and even legally possible for the Treasury of a nation's citizens to borrow on their corporate behalf without their direct agreement or authority.

Indeed, this is the root of the problem of government debt from a biblical perspective. Lending and borrowing are relational activities entailing strong moral obligations of love, care, and promise-keeping. Yet government borrowing is as non-relational a financial transaction as it is possible to get. There is no relationship between the lender and an identifiable borrower; usually little to no information as to what the funding is to be used for; no direct means for the lender to communicate and influence borrower behaviour; and no formal means for negotiation and compromise if the borrowing government finds itself unable to repay on time. A heavy debt burden tempts politicians to break their country's promises to repay through using default or an inflation shock. Hence, we shall need carefully to apply biblical wisdom on lending and

Hyperinflation: A kilogramme of tomatoes sits next to the 5 million "strong" bolivars needed just to buy the bunch in Caracas, Venezuela, 2018.

Photo: Reuters



Gabriël Metsu: Usurer with a Tearful Woman (1654)
Museum of Fine Arts, Boston

borrowing in an area that is singularly alien to its very concepts. I have set these teachings out more fully and applied them elsewhere. In summary, here are eight key principles. However, all of them are undergirded by relational considerations:

(i) Debts are promises to be honoured (Psalm 37:21; Romans 13:8). Borrowing entails a solemn promise to repay – hence default is morally worse than theft because the lender is both deprived of their property and a promise is also broken (cf. Psalm 15:4).

(ii) Borrowing entails financial bondage for the debtor (Proverbs 22:7). Those in debt are under an obligation to keep their promise to repay or face the loss of their collateral (e.g. Deuteronomy 24:7,13) or freedom (cf. 2 Kings 4:1). Hence, the wisdom in not giving a pledge for the debts of another, thereby losing one's liberty (Proverbs 6:1–5 etc.). Prudence and saving are 'wise' for the financial independence they bring.

(iii) Debts are periodically to be cancelled, and debt-slaves released (Deuteronomy 15:1–6; 12–18) to ensure periodic intervals of debt freedom within the community and prevent the concentration of wealth and land into the hands of rich creditors. If practised, this would mean that long-term debt would not have existed and that debt could not be inherited. Also, unlike today, government debts could not readily circulate as 'money' as they would periodically lose all their value.

(iv) Interest could not be charged on debts within the OT Israelite community (e.g. Deuteronomy 23:19; Psalm 15:5) for this would be to profit hard-heartedly from the bondage of a 'neighbour' (cf. Leviticus 19:18; Luke 19:22,23). Jesus then extends the OT injunction against lending at interest for his disciples to include seeking any reward (Luke 6:34,35). Equity, leasing and rental contracts are the preferred alternatives to interest-bearing debt as ownership responsibility and financial return are not separated.

In addition, other relevant teaching and laws apply to the role of government and intergenerational covenants:

(v) The powers and prerogatives of the OT king are to be tightly controlled and placed under God's law with firm restrictions on central spending (Deuteronomy 17:14–20) as a constraint on the abuse of power by sinful rulers. If these are not respected, a powerful central government will likely abuse its tax-raising powers to enslave the populace (1 Samuel 8:11–18).

(vi) God's covenants with His people span the generations, with both blessings and curses having intergenerational consequences (Genesis 12:3; 15:18; Exodus 20:5,6; Deuteronomy 28:58–63). Hence the need for the wise to bless succeeding generations (Psalm 71:18; 145:4) and for parents to educate their children

(Deuteronomy 6:4–7). A good government that emulates God's intergenerational perspective will therefore be one that does not abuse its current temporal position at the expense of the future but seeks to balance the needs of the present and future generations. Through God's spanning of the generations, the obligation of neighbour love of neighbour still applies, even if a direct relationship does not.

(vii) Government ultimately is appointed by (and responsible to) God to punish wrongdoing and promote the common good (Romans 13:1–7b; 1 Peter 2:13–14). God's purpose for those made in his image is to work in, and tend, his Creation for the fulfilment of God's purposes and the benefit of future generations (Genesis 2:15). Hence, good government manifests stewardship by passing onto future generations an improved means of existence, rather than obligating the unborn with far larger debts than their parents inherited.

(viii) When planning for the future, we should take a humble approach, for only God knows the future (Proverbs 27:1; James 4:13–16). It is folly to base current plans on the optimistic extrapolation of current trends (Isaiah 56:12; Luke 12:16–20; 2 Peter 3:3–10).

9 If the burden of debt that is bequeathed to the next generation is deemed unreasonable, even intolerable, does this make the case for debt cancellation? Is the biblical concept of jubilee relevant?

Technically, the Jubilee in Leviticus 25 entailed the return of familial agricultural land that had been leased and the release of non-Israelite slaves. Debts were meant to be cancelled every seven years (Deuteronomy 15). The key point for this discussion is that Mosaic debt cancellation was on a pre-announced timetable; that is, lenders knew when the next cancellation was due and prepared accordingly. The problem with sovereign debt is that there is no pre-defined bankruptcy process and so any debt reduction arises out of a process of negotiation between creditors and the debtor.

The large majority of UK government debt is owned by domestic holders. Hence, any default would be felt primarily by UK-based household through losses to pension funds, insurers and banks as well as their direct holdings of government debt (e.g. National Savings and Investments). These losses could trigger bankruptcies of companies with pension shortfalls or provoke the collapse of banks, which the government may then have to bail out, or risk the failure of the payments system. The Bank of England would need to be recapitalised. The breaking of the government's contractual promise would also undermine confidence in wider financial contracts going forward. Hence, the costs of defaulting on domestic debt are often higher in the medium- and long-term than the short-term savings from doing so. This is why traditionally governments around the world have tended to reduce their debt burdens through inflation or defaulting on foreign currency debt (which is traditionally held by foreign investors).

If the burden on future generations is deemed excessive, rather than contractually default on its on-balance sheet debt (the tip of the iceberg), the government could seek to restructure its off-balance sheet debts in the form of pension commitments (the iceberg itself). Removing the 'triple lock' of super-indexation of the state pension would be the first step along that road. Cutting past public employees' pension commitments would save significant sums but would face significant legal challenges as these are deemed to be as legally binding commitments as gilts.

We are most grateful for these comprehensive answers, Paul. You've given us a lot to think about!

Dr. Paul Mills joined the UK Treasury in 1992 after completing his PhD at Cambridge University on non-debt financial thinking and systems. There he specialised in government debt management, financial stability analysis and regulation. He joined the IMF in early 2006 to work on global financial stability issues and the U.S. financial system and headed the Fund's London office (2009-14) focusing on financial market surveillance and stability analysis. He is an elder of a Baptist church, writer and speaker.

Peter Warburton has worked as an applied economist in the UK since 1975, starting out as a researcher at the London Business School. He gained his PhD from City University in 1987 and has worked as a City economist for Lehman Brothers and Flemings. He spent 15 years as an economist at asset manager Ruffer LLP and has run his own macro-financial consultancy, Economic Perspectives, since 1996. He is a founder member of the Shadow Monetary Policy Committee and lectures occasionally in Cardiff and Edinburgh.