Brittle Britannia: what just happened?

Peter Warburton *writes that in late September 2022, the UK plunged into financial crisis as the cost of borrowing soared and the purchasing power of Sterling slumped. While an ill-conceived mini-Budget provided a convenient scapegoat, the real story is the underlying fragility of our debt-ridden economic and financial system. The UK government's extravagant support for the economy during the pandemic has unleashed some powerful forces that will bring profound consequences.*

This article seeks to share a perspective on the UK's recent economic troubles using a long lens. Dramatic events in history are usually a culmination of many forces, triggered by something that would otherwise be considered trivial or inconsequential. My favourite analogy is the formation of a sandpile: grains of sand falling in a steady stream in the same place. The sand pile grows organically, gaining a conical shape, until it collapses due to hidden fault lines in its structure. Each additional grain of sand is indistinguishable from the last, but one of them will trigger the collapse.

In Ernest Hemingway's 1926 novel, *The Sun Also Rises*, the character Mike Campbell was asked about his money troubles: "How did you go bankrupt?" Bill asked. "Two ways," Mike said. "Gradually and then suddenly."

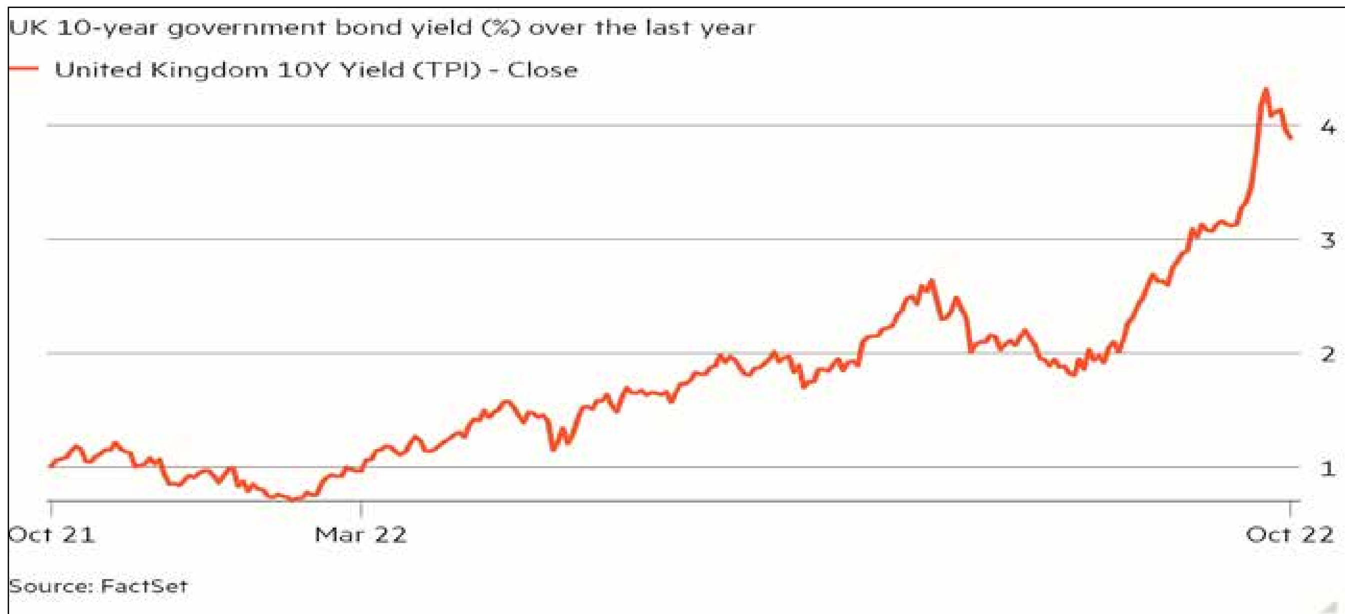
The UK has the reputation and standing of a rich nation - the fifth-largest economy in the world until recently. When the pandemic struck, the UK exercised the privilege of a rich nation – to spend whatever was believed necessary to resolve the intertwined human health and economic crises. It was inevitable that government borrowing would rise to foot the bill for the crisis response, but few imagined for how long the support measures would remain in place and how significantly total debt would grow. Fewer still contemplated the possibility that this increment of public debt might compromise the UK's membership of an elite (cheap) borrowing club.

For more than a decade, there has been an elite group of governments in the world, whose sovereign debt – consisting of the bonds issued to cover budget shortfalls – has been held in high regard. Such high regard that their cost of borrowing was close to zero – and in some cases less than zero. Politicians and their advisors have long argued that this interval of very low interest rates was a golden opportunity for governments to pursue bold spending agendas, such as infrastructure projects, a national basic income and climate initiatives, using borrowed money. Before the pandemic struck in early 2020, the advocates of such policies were routinely branded financially irresponsible and economically illiterate by the mainstream media.

Yet, within weeks of the Covid outbreak, western governments announced stringent limitations on economic activity and human mobility accompanied by vast support and compensation packages, in addition to a large increase in health-related spending. Suddenly, the public purse was unzipped and opened wide. The most extravagant public policy responses to the crisis came from the US and Canada, but the UK was not far behind. Effectively, political leaders declared *force majeure* and justified their actions on the grounds of national emergency.

As recently as July 2021, it appeared that the international capital markets were satisfied that the UK government's pandemic response had not damaged its long-term creditworthiness. The benchmark bond (shown in the chart on the next page) carried a yield (annual interest rate) of just 0.5%. However, since the summer of 2021, there has been a resurgence of inflationary pressures around the world that has prompted central bank policymakers to tighten monetary policy. Much of the increase in UK yields in the first 8 months of 2022 was led by rising US bond yields.

The spike in UK yields that occurred since the beginning of September, reaching 4.5% at the end of September, is another story. Over the summer, it became clear that the effects of the war in Ukraine would probably persist through the winter, persuading both the candidates who replaced Boris Johnson as Prime Minister that an energy price cap was unavoidable. The implication of the cap would be to add another £75bn to £100bn on to government borrowing. Meanwhile, policymakers at the Bank of England settled on a plan to shrink its holdings of government bonds, even though many more new bonds would need to be issued to fund the price cap. The foolish addition of tax-cutting measures in the infamous Truss-Kwarteng mini-Budget on 23 September



– requiring government borrowing to rise even further - was the final straw. Soaring UK yields had already begun to trigger problems for pension funds, requiring them to liquidate assets urgently, but the mini-Budget poured fuel on the fire.

The crisis was mercifully brief, as the Bank of England changed course and stepped in to buy more government bonds and reassure the financial markets, and a new government was installed, which has reversed the proposed tax cuts and imposed additional taxes, but the reputational damage was done. Inadvertently, the UK had explored the outer limits of its sovereign debt capacity.

The importance of leverage

My perspective on the UK economic and financial system stretches back to 1975, when I started work as a researcher in the London Business School's Econometric Forecasting Unit. As a close observer of the scene for almost 50 years, for me the most striking economic development has been the assimilation of credit and debt, not only by governments and large companies, but by businesses of all shapes and sizes and by individuals in all kinds of circumstances. I will argue that the events of September and October this year can only be properly understood in the context of our national debt addiction.

Debt was a dirty word to my father. The miseries of the Great Depression were etched into his psyche during his formative years working for the Co-operative Insurance Society in Manchester. He saved to buy his first home for cash and, to the best of my knowledge, never used debt to buy anything. I have adopted a more flexible approach to credit and debt but have been heavily influenced by him. I wrote a book, *Debt and Delusion*, in 1999, warning about the consequences of the misuse of credit and the associated dangers of financial sophistication.

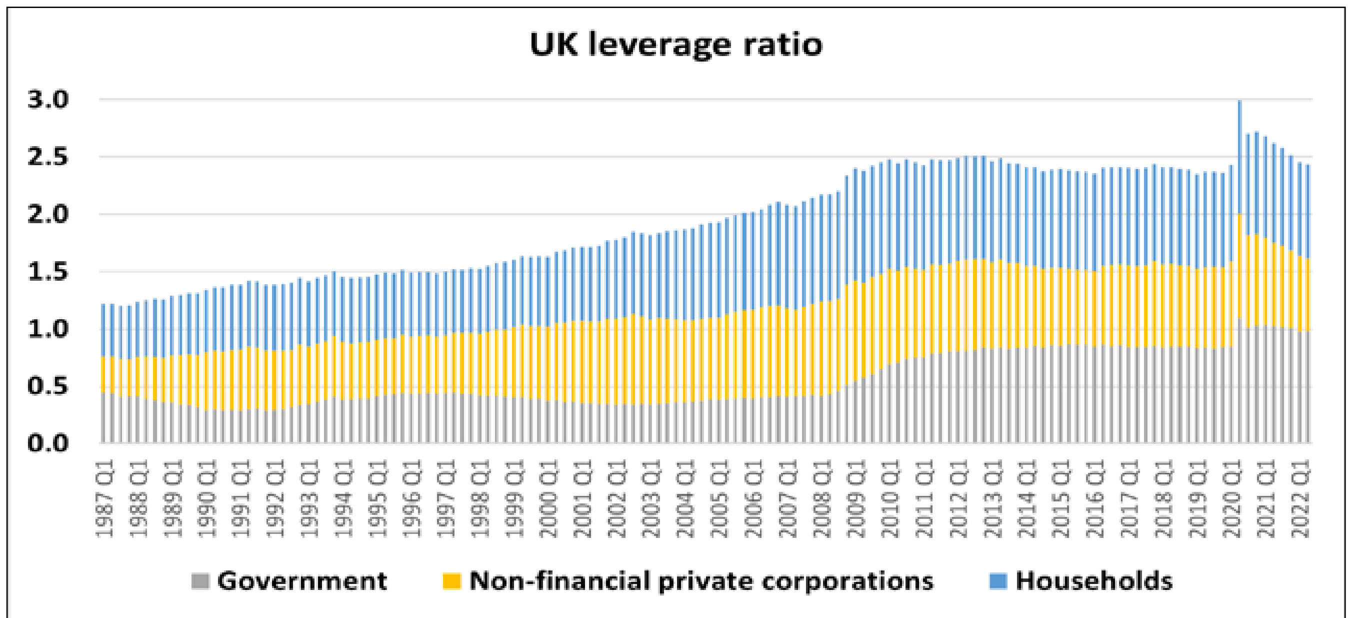
At its best, debt can be used as a short-cut to a desirable destination, such as building a road bridge over a river, inoculating a village against diphtheria, or providing broadband access for schools to enable distance learning. At its worst, debt can facilitate reckless and wasteful spending, bringing financial ruin to a household, a community or even a country. Debt is like battery acid in an old car. Whilst contained in the battery, it does a great job: sprayed around the carburettor and the cables, it is destructive.

Debt has a moral dimension and the acts of lending and borrowing are as old as human society itself. From primitive times, societies have grappled with the questions of how much should be lent to whom and on what terms. These questions are soon followed by another: what should happen to the borrower who cannot repay or who chooses not to repay? What is a safe amount of debt to hold, one that can be readily managed by the borrower across a range of predictable outcomes – come sunshine or rain, bounty or blight, clear or stormy skies? From the borrowed axe head that fell into the river (2 Kings 6:5) to the parable of the unmerciful servant (Matthew 18: 21-36), issues relating to debts, particularly unrepayable ones, have exercised the minds of theologians, philosophers, scholars and practical men and women involved in commerce, trade and finance.

How much debt is too much?

There are two fundamental ratios that help to decide whether a debt is likely to be affordable. First, the size of the debt in relation to the income of the borrower ('leverage'). If I were to borrow £1m at an interest rate of 5% per year to make an investment, but only had an income of £40,000 a year, the debt would go bad immediately, since I lacked the means to pay even the interest, let alone repay the principal sum. A debt-income ratio of 25 is an absurdity. Second, the size of the debt in relation to all the borrower's unencumbered assets ('gearing'). A borrower with wealth three times as large as the debt, could clear the debt at any time – although she may not always be able to sell assets on favourable terms to do so.

While the UK has many examples of very highly geared companies – those whose assets cover their debts by slender margins – and some that are technically insolvent – having debts greater than



the market value of their assets, this is not true of the country as a whole nor of many households. Such is the personal wealth of UK residents in aggregate that it would require property and financial asset prices to crash by more than 70 % before excess gearing became a national crisis. However, this is not to diminish the problems faced by a small, but growing, minority whose debts are overwhelming and whose physical and mental wellbeing is compromised by their debt burdens.

There is another context in which excess gearing has a capacity to bring distress: in instances where so-called private equity funds and other investment companies have acquired businesses engaged in health and social care using borrowed money. The cost of servicing the debt can be such a significant expense as to compromise the viability of the underlying business, putting the provision of care to the frail and elderly at risk.

It could be argued that the UK government is highly geared, in that its financial obligations – including unfunded public pensions – outweigh its tangible and financial assets. However, unlike the crisis-ridden emerging nations, virtually all the UK government's debts are in domestic currency. Furthermore, the sovereign has an invisible and very valuable asset: the unique right to collect taxes from its subjects in perpetuity.

This article focuses on leverage since our national predicament is a cost-of-living crisis, and the rising costs of debt service – interest payments and contractual promises to make debt repayments – threaten to deepen and prolong this crisis. Over the past dozen years, borrowers' interest rates have been historically low in the UK as part of the response to the Global Financial Crisis of September 2008. Low interest rates have protected mortgage borrowers but have fostered unhealthy attitudes towards debt. The surge in interest rates this year implies that millions of mortgage borrowers will face huge payment increases once their fixed-rate deals expire in 2023 and 2024.

Glancing at the chart of the UK leverage (debt-to-income) ratio – comprising the borrowings of UK households, non-financial corporations and government – we observe a steady increase between 1987 and 2008.

This marked increase – from 122% of income to 220% – has occurred in stages. From the table overleaf we observe that there was a modest increase in private sector leverage between 1987 and the end of 1996 but no change in the government's ratio. From 1996 until the eruption of the Global Financial Crisis (GFC) in September 2008, there was a substantial increase in household and corporate leverage, but again hardly any change in government debt to national income.

In the aftermath of the GFC, the government intervened heavily to stabilise the financial system, virtually doubling its leverage ratio. In the 13 years that followed the GFC, there was a modest reduction in the amount of leverage, but this was overtaken by the events of March 2020. The whole economy leverage ratio peaked at just below 300% – or three years' worth of national income – before tumbling back as government-backed emergency loans were repaid and price inflation worked its magic in scaling back the debt burden.

The substantial ethical issue raised by the UK private sector's increasing use of leverage, thinking particularly of the 20 years to 2008, is whether the improvement in living standards achieved in that period was authentic. To the extent that increased leverage supercharged economic performance, was it inevitable that the modest de-leveraging that followed (2008-2019), would bring economic disappointment (which it did)? And does the rapid unwinding of the Covid-related leverage carry even harsher implications for living standards?

One of the obvious consequences of the upsurge in inflation and borrowing costs, is that household incomes are threatened, both as after-tax income growth fails to match the pace of price increases and as a larger share of their disposable income must be allocated to servicing their debts.

Contributions to the leverage ratio, measured in percentage points

	Government	Companies	Households	Whole economy
1987Q1-1996Q4	0	17	9	26
1996Q4-2008Q3	2	30	40	72
2008Q3-2019Q4	38	-10	-11	17
2019Q4-2020Q2	26	20	16	62
2020Q2-2022Q2	-12	-26	-18	-56
1987Q1-2022Q2	54	31	36	121

A subsidiary issue concerns the widening wealth differentials in the latter period, as emergency policy responses concentrated capital gains in the upper reaches of the wealth distribution. These consequences may have been unintended, but they have fuelled resentment between regions of the country, between the generations and within communities. If leverage had been held in check, there may not have been a financial crisis, the radical policies that followed would not have been employed and prosperity would have been shared more generally.

Two Old Testament texts have spoken to me concerning our economic, financial and moral predicament.

The first passage is from Isaiah 30, which can be summarised: “Woe to the obstinate nation.” The Israelites are the rebellious people who say to the seers, “See no more visions!”, and to the prophets, “Give us no more visions of what is right! Tell us pleasant things, prophecy illusions. Leave this way, get off this path, and stop confronting us with the Holy One of Israel!" Is there a sense in which the UK has been lured away from a path of sustainable growth by tempting offers of credit, culminating in the crisis of September 2008? The GFC was evocative of a “high wall, cracked and bulging, that collapses suddenly, in an instant” and there was plenty of broken pottery soon after.

Perhaps there was a measure of “repentance and rest” in the decade or so that followed, but when the pandemic struck, we would “have none of it”, reaching for debt again as our salvation, riding off on “swift horses”. Our politicians and officials seemed genuinely to believe that they could outrun the pandemic and quickly restore economic prosperity. It is perhaps an occupational hazard for politicians to “tell us pleasant things”.

There has been little high-level debate about the progressive leveraging of the household and business sectors over the past three decades. But when the scope for increasing private sector leverage results in losses, there is a presumption that government will pick up the pieces - that the losses will be pooled or socialised.

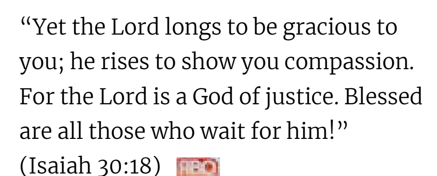
The second passage is Nehemiah 5, in which Nehemiah takes his fellow Jews to task for pressing home economic advantage at the expense of their own people during a famine. “We are mortgaging our fields, our vineyards and our homes to get grain during the famine”. “We have had to borrow money to the pay the king’s tax on our fields and vineyards”. On Nehemiah’s reprimand, a debt moratorium was called, when mortgaged assets were returned to their owners and interest payments cancelled. While financial capital was destroyed by the moratorium, social capital was rebuilt. Nehemiah’s de-leveraging brought an end to injustice and hardship, restoring self-respect and a sense of common purpose.

The unwelcome challenge of a global pandemic has exposed the fragility of the UK's social, political, economic and financial systems. We have been confronted once again with our underlying folly: the over-use and misuse of leverage.

A seemingly innocuous policy decision - for the Bank of England to absorb the additional government debt on its own balance sheet - has exposed our underlying fragilities. Instead of allowing financial markets to re-price UK government debt during the pandemic, the Bank shielded borrowers from that outcome initially, but only by creating a tidal wave of money. Over the past 18 months, this tidal wave has crashed on to our shores in the form of inflation, the worst inflation for 40 years.

The whole nation is facing a period of contraction and loss, of (relative) economic, social and financial hardship. As a nation we need to repent of our reliance on debt and worthless promises and build again on solid foundations.

On the threshold of 2023, neither households nor businesses are well prepared for the likely escalation of interest payments. We can stand by and watch the drama unfold, or we can appeal for a fairer outcome, as Nehemiah did.



“Yet the Lord longs to be gracious to you; he rises to show you compassion. For the Lord is a God of justice. Blessed are all those who wait for him!” (Isaiah 30:18)

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