



PROMOTING
**GROWTH AND
SHARED PROSPERITY**
IN THE UK

DISCUSSION PAPER

LEARNING TO LIVE WITH THE DEMON DEBT

John Cullinane

January 2012
© IPPR 2012



ABOUT THE AUTHOR

John Cullinane leads a risk management function within a professional services firm.

ABOUT IPPR

IPPR, the Institute for Public Policy Research, is the UK's leading progressive thinktank. We produce rigorous research and innovative policy ideas for a fair, democratic and sustainable world.

We are open and independent in how we work, and with offices in London and the North of England, IPPR spans a full range of local and national policy debates. Our international partnerships extend IPPR's influence and reputation across the world.

IPPR
4th Floor
14 Buckingham Street
London WC2N 6DF
T: +44 (0)20 7470 6100
E: info@ippr.org
www.ippr.org
Registered charity no. 800065

This paper was first published in January 2012. © 2012
The contents and opinions expressed in this paper are those of the author(s) only.

ABOUT PROMOTING GROWTH AND SHARED PROSPERITY

This major programme of work aims to identify public policies that will promote the economic growth needed to return the UK to full employment and ensure that the benefits of future prosperity are more equally shared.

For more information, see:
<http://www.ippr.org/research-projects/44/7144/promoting-growth-and-shared-prosperity-in-the-uk>

IDEAS to
CHANGE OPINIONS

Contents

In praise of debt	2
Business leaders and logicians.....	4
Mathematicians and economists	5
Politicians and voters.....	6
They are all in it together	7

Learning to live with the demon debt

In the autumn statement, the chancellor repeated a familiar message: ‘The current environment requires that we take further action on debt to ensure Britain continues to live within its means.’

He is in good company. Ed Miliband told the last Labour party conference: ‘Think of how you pay off your credit card bill. You need to make savings in the household budget.’

Most people in most countries would agree.

And yet this is strange. Although economists famously differ, the majority probably incline to Keynesian analyses and remedies for current conditions. In the battle of economists’ letters before the 2010 general election, most favoured deferring and pacing deficit reduction to avoid damaging the economic recovery. If policies which reduce debt also reduce the national income out of which the debt must be paid, the politicians’ ‘credit card’ analogy, with notions of a fixed limit to what can be afforded, does not make sense. (True, Miliband did say you could not pay it off if you lost your job, but trying to pay off your credit card does not normally put your job or income at risk. This is exactly where the government’s finances are different.)

Rapid debt reduction was pursued here and elsewhere, and recovery has duly faltered, just as the economists warned. Yet even though the consequences are unpopular, protest is almost invariably at particular ‘cuts’ or tax rises – sometimes proposing alternative targets (bankers, immigrants, foreign aid or ‘the rich’) – rather than challenging the underlying notion of attempted rapid deficit reduction.

Even if headlong austerity was undesirable, perhaps it was necessary? Indeed, the currently fashionable argument is that it was necessary to prevent the cost of borrowing rising to the 7 per cent or more seen in Italy. However, this never seemed close to happening in the UK, in part because the last government’s ‘fiscal stimulus’ was, in reality, not largely funded by borrowing in the markets at all. Some £200 billion was printed – obligingly in practice if truculently in tone – by the Bank of England. Printing money is not of course available at will to eurozone countries. Even here in the UK it was initially discussed in hushed tones, as if the breach of taboo might cause the sky to fall in. But now we are printing money again, a further £75 billion in an attempt to stave off the ‘double dip’ recession. We do it because we can, just as Italy doesn’t because it can’t.

The authorities do not need to print money constantly to show bond dealers who is boss. The prime minister has rightly been urging it on a bemused Mrs Merkel as the 'big bazooka', the ultimate trump card in the card game with the markets. Being able to do it, and to show that you will if need be, is enough to keep borrowing costs down. For this very reason, UK, Japanese and US government bonds are all 'safe haven' assets paying bargain basement yields, despite the supposedly staggering amounts of those governments' debts.

So the clear warning given of the consequences of the current austerity has been vindicated, and the key argument that it was necessary regardless is demonstrably flawed. Rarely have real world events so swiftly borne out one way of thinking over another.

But this academic victory does not resonate with the public. The very word 'Keynesian' is pronounced hesitantly and suspiciously, as if it were a kind of mystic religion, rather than a profound breakthrough in human understanding, one which inspired decades of unparalleled economic growth and stability after the second world war – and, indeed, the policies which prevented meltdown in 2008/09. It is as if modern medicine and electricity were suspect, and leeching by candlelight were common sense.

At the heart of this is the demonisation of debt. Businesses of all sizes need to raise debt to finance expansion, as the autumn statement acknowledged, not just with words, but in proposing new ways to enable them to do it. People borrow money to become home owners, and the three main parties now promote it to finance university education. But when it comes to escaping from recession, the talk is of 'burdening our children', as if they have no interest in economic recovery.

And in the present, one person's spending is another person's income – so cutting public spending in a recession pretty much means cutting private income. In just the same way, one person's (or government's) debt liability is another person's (or pension fund's) financial asset (and may well be the safest asset in the fund). It is time to look at the other face of debt.

In praise of debt

Margaret Thatcher once said that the Good Samaritan was only able to help the man mugged on the Jericho Road because he had money. But St Luke's gospel records that he had only two silver coins to offer the innkeeper, and had to ask for tick.

Almost all good causes or commercial ventures need to raise funds. If people who see the need or opportunity happen to have the money lying around, they will not likely have been making good use of it before – like the man in another of Christ's parables, who buried his talent in the ground.

Why is modern capitalism more productive than a medieval economy, where merchants had to wait for their ship to come home from the last venture, and sell its cargo, before they had capital to risk in a new one? Because funds can be raised from anyone with money that is temporarily spare and so many more opportunities can be pursued.

What does talk of rebalancing the economy away from 'debt' toward 'savings' and 'investment', actually mean? That people shouldn't get mortgages, but should rent their homes, and open a bank savings account? Perhaps they should. (After all, the desire for home ownership drives Anglo-Saxons to borrow, just as fear of sickness and old age drives Asians to save and lend. There seems little hope of correcting global imbalances

while these things go unchallenged.) But even if the British public became great savers, debt would not go away. Their money in the bank would be the bank's debt liability.

Perhaps they should invest in insurance policies? But they are, to all practical purposes, the liabilities of the insurance companies.

And what about equities – stocks and shares? Well, equity is really an extreme form of junk debt, which promises and sometimes delivers high returns – but only as the reward for taking more risk. The company of which the shares are a liability is not under any obligation to pay you back, unless it goes into liquidation, and then only to the extent that there is anything left, after all the people with more honest, boring debt have been paid. That may be more secure for the business, but only because you take the risks instead – as shareholders in many banks, or in BP after its Deepwater Horizon spill, have been reminded in recent years, sometimes to their great surprise.

On balance, the economy gains. Because the risks of a commercially desirable venture – like drilling for oil in the Gulf of Mexico – can be spread around many investors, that venture can be more easily undertaken. The invention of the stock market to achieve this remains as important as ever – but it hadn't been here long before we had the South Sea bubble. The people who lost money then, like Sir Isaac Newton – no fool exactly – probably thought they were building their futures on 'savings' and 'investments'.

Of course, not all debt is equally risky. Perhaps the most prudent variety is debt incurred at low cost to finance an asset that will reliably yield returns. Currently, hardly anyone can borrow as cheaply as the UK, US or Japanese governments and all are rejecting, for alleged lack of funds, many investment projects offering high rates of return. Even if borrowing costs rose a little as a result of pursuing more of these 'riskier' projects, many would still be viable. A modest increase in rates would also bring much relief to the pension funds, and the businesses that sponsor them, who are currently struggling to meet their pension commitments because the returns on offer under any remotely safe investment strategy are so low. This combination of circumstances is the markets' way of trying to tell the government to borrow more money. As the Good Samaritan discovered, debt, as much as money, makes the world go round. Trying to live without it risks causing it to stop.

There is a very basic reason for this. Money is simply a form of debt. It is what you get when you deliver goods, or do a service (like working as an employee), and do not mean it as a gift, and do not immediately get something back in return. Later on you will spend the money, and enjoy something you want. Only then are you really paid back. In the meantime, the rest of the economy is in your debt and your money is simply your claim against it. Ultimately, China will only get value for its surpluses if it learns to buy American.

Whatever our problems, at least the English have truly honest money. Our banknotes merely 'promise to pay the bearer on demand'.

If only the Germans realised that taking more Greek holidays was the key to being paid back. But they are not the only ones confused by debt. Instead of spending to get repaid, most of the world is cutting back to try to pay down debt, failing, and seeing its income fall as a result.

Why do we drink this bitter cup? Many misguided and mostly unwitting witches have contributed to the brew.

Business leaders and logicians

Business leaders were early protagonists of rapid debt reduction, albeit this enthusiasm may be waning now. Of course, they have to control costs in their day jobs, and if in their spare time they think about public policy, they (being busy people) apply the familiar reasoning of the business world. Many will have successfully turned around companies by cost-cutting – some indeed have made their career in this way. They also tend to promote a cult of ‘tough decisions’ which they (sometimes rightly) believe themselves well accustomed to make. Usually this ‘tough love’ involves cutting payrolls.

The remedy of firing people, applied to an individual struggling company, can save it and the jobs of the survivors (not to mention the reputation of the business leaders). And, if there is a sufficiently buoyant wider economy, the workers displaced will find more productive jobs elsewhere. But the same solution, applied to tackle public debt in a recession, will transfer the displaced workers to the dole, reducing but not eliminating the cost to the state. And they will have to cut their own spending, meaning reduced profits for business, lower tax revenues, and so on, and so on.

There is an error of logical approach here – the ‘fallacy of composition’. This is the belief that what is true at the level of one individual unit – a company, or an individual – also holds true at the composite level, at the level of society as a whole. On this logic, because a well-run company can benefit by laying off workers, the government should apply this approach to the overall economy.

There are many examples of this fallacy – where an individual can benefit from a strategy which would be self-defeating or even counterproductive if everyone did it. In the days of ‘standing room only’ football terraces, the classic example was of one man standing on a wooden box to get a better view of the match. It works for the individual, but if everyone did it then no-one is any better off. Except everyone is now tottering around precariously (and maybe not totally soberly) on top of wooden boxes, a situation affording all sorts of opportunities for accidental or deliberate injury.

The business-inspired recipe of taking the knife to the public payroll in a recession is a logically erroneous approach of the same type: ‘every individual, family, and business has to do it, so the government should too’. A company can forget its former workers, but for society as a whole, the unemployed are always with us. Rather than recognise the fallacy at source, policymakers tend to turn their thoughts instead to how to get rid of the unemployed. The recessions of the late 1970s and early 1980s in the UK produced the cult of early retirement which is now proving so hard to finance.

Bad logic isn’t just an academic matter. When people think there are ‘too many people’ – a much more powerful image than ‘lack of effective demand’ – they begin to rail against each other, stigmatising immigrants, bankers, or some other arbitrary target group. Although Germany’s hyperinflation of the early 1920s weakened the Weimar Republic, it was actually the mass unemployment of the Great Depression that propelled Hitler to power and opened the door to the logical conclusion of this line of thinking: the politics of *Lebensraum* and of extermination.

The fallacy of composition can also produce less extreme public policy choices. For example, most countries strive to be more competitive – but of necessity all cannot succeed at once. Another modern classic is helping first-time house buyers through stamp duty exemptions or the like. If this help was targeted at one family, it would be very effective. When such policies are discussed, we can all picture that one family and

empathise. But by applying the relief to the housing market as a whole, the risk is that the price of houses simply increases. Subprime mortgages ‘helped’ first-time buyers, and look where that ended up. But politically, the argument for giving such help, even if illusory, is very hard to resist.

Mathematicians and economists

Another problem lies in the power of big numbers. A trillion-euro bailout fund is even bigger than a banker’s lifetime earnings and still more frightening by the benchmarks of our own lives. But that is not the right comparison. If the hole in the economy is big – as the hole left by subprime debt and its derivatives certainly is – then governments’ response needs to be big too. The size of a thing only really matters by reference to the size of others to which it somehow relates. In this frame, governments and central banks together have unlimited firepower, and a trillion euros is too little for the task.

Not all economists are blameless. Over the last 30 years their profession has generated an array of mathematical models, somewhat obscuring the practical purpose of predicting human behaviour and its likely responses to different courses of action. Certainly, rearranging terms mathematically can allow you to see things in a new light, or even to allow theories to be tested against statistical information. But the whole exercise can be vitiated by plainly ridiculous assumptions, made partly for the understandable purpose of making mathematical manipulation easier – but sometimes also to ‘fix’ the result, to prove that the market is perfect, or at least as good as it gets. Like the efforts of medieval astronomers to account for the simple paths of the planets in terms of complex movement around the earth, this seems to satisfy a sort of religious craving – as well as special interests – but often is simply a manifestation of garbage in, garbage out.

Such over-engineering contrasts with a sloppiness about specifying any plausible theory of behaviour which the statistics can test. You establish some sort of correlation without exploring whether there is a real causal connection – or if there is, how it flows. Usually, that is where the real questions lie. Did the debt cause the crisis, or the crisis the debt? And, in either case, exactly how?

One theory beloved by economists is that people accurately and indeed omnisciently foresee the income they will earn over their whole lives and adjust their consumption to maximise their lifetime satisfaction – without paying regard to fluctuations, which are known to be temporary and can be smoothed away by saving or borrowing in perfect capital markets. In this scenario, there would be no recessions, and logically debt could never be a problem, but somehow it is used to promote premature debt reduction. As Keynes himself commented, economists set themselves too easy and too useless a task if the only advice they can give to the captain of a ship in rough seas is that when the tempest subsides, all will be calm again.

In the boom, complex mathematical models predicted that bonds would pay out from the proceeds of mortgages lent to people too poor to repay them. These were short on any causal explanation of where these people would find the money, and long on statistical records of historical experience of low levels of default, ignoring the fact that the scale of the bonds being issued were taking us into uncharted territory. Now there are models saying that there is little or no spare capacity in the economy. Again, there is little or no explanation of what – by this account – has happened to the skills or infrastructure that existed in the economy a few years ago, but much fascination with the devastating

consequences of financial crises in the past, rather ignoring that these were generally tackled with even more destructively pre-Keynesian policies than those adopted now.

In the boom, bankers would hear that their cleaners had five or six buy-to-let mortgages. Now most business people are running around trying to drum up work, when they would much rather be actually working. But these things are not in the models. Such everyday experience pointing to different conclusions is dismissed as 'anecdotal evidence', lacking in the required sophistication. No doubt the brain is a more sophisticated organ than the eye, but it can be affected by fevered imagination, and sometimes simple observation helps more.

Politicians and voters

At least business people understand that both sides can win from a good deal, or indeed lose from a bad one. Politicians tend to see only zero-sum games. The political right loves the private sector but generally dislikes public spending (with some exceptions, such as military expenditure – this indeed was what finally got us out of the 1930s slump, although world war seems rather a high price to pay).

In principle, of course, you can have Keynesian policies in a recession, combined with a low ongoing level of public spending – you just need an even lower level of taxes. But starting from where we are, the political right sees an opportunity to exploit the public mood of penny-pinching, jealousy and resentment – always present when times are hard – to advocate for reducing debt by making the public spending cuts they couldn't have persuaded people to support in the genial ambiance of the boom.

The right also dislikes admitting that markets fail and that government can be part of the solution. By following the theory that markets are perfect, they make them incurable in practice.

Those on the left are still burdened by the tradition of struggling against capitalism. They are not really sure if they want it to be nursed back to health. And even when they decide they do, they prefer to think that reforming it will be a big deal, requiring struggle and sacrifice, with capitalists punished by higher taxes rather than tapped for loans. Maybe the old delusion lingers still, that capitalism's crisis is socialism's opportunity, as in Russia in 1917. In truth, 1930s Germany is a more likely model for stricken advanced economies – right-wing populism just appeals to more vested interests.

And the centre ground of politics? Keynes himself was a Liberal. Sadly, without either his intellectual rigour or the anchor of ideological prejudice, too many such people find themselves adrift on the tides of conventional thinking.

And the public are as affected by the fallacy of composition as their business leaders. We all know, in our own lives, that once you have spent money, it cannot be spent again. But as we've seen here, it is only spending by one person that creates another person's income, and enables them to spend in turn. To appreciate this, and to begin to explore its policy implications for the economy as a whole, requires a Copernican revolution. Especially amid the factional, scapegoat-seeking, pessimistic psychology of the slump, which works to poison our view of the cure, this is something which people seem to find it hard to get their minds round.

There is also some guilt and much recrimination about the frothy excesses retrospectively ascribed to the boom – as if it makes sense to starve struggling businesses of loans now because lending criteria were too lax before.

We are almost comfortable with a political cycle which lurches from sacrifice and expiation in the early part of a parliament to later relaxation and hoped-for redemption at the polls. Like the object of early heart surgery, Keynesianism encounters an almost physical ‘rejection’ by the body politic.

There are ancient forces at work here, from the dark side of our intelligence and nobility as a species. Most animals fall into a pecking order with relatively little actual fighting, finding their place by reference to body weight, size of antlers, or depth of voice. Humanity, with the gifts of reason and imagination, finds a new weapon, or tactic, or springs a surprise – David can beat Goliath with a sling. Except one innovation can be countered by another; the bad guy can fight back. The result is that we fight each other a lot, and get very used to the idea of sacrificing everything for victory. Self-delusion is integral to this, as only one side’s hope of winning can be satisfied, usually at a higher cost than can ever be imagined. You do not count the costs, you stay the course.

In the song, dreaming the impossible dream soon leads to fighting the unbeatable foe and bearing the unbearable sorrow. Workers fight to overthrow capitalism; entrepreneurs to free themselves from the state. Hercules fights the Hydra; chancellors battle with deficits. Stirring stuff all, but not a good basis for economic policy.

They are all in it together

As so often, the combined effect of all this is greater than the sum of its parts. The public hear the warnings of business leaders and (while increasingly hating them for their money and success) assume they know what they’re talking about. Politicians fear to fall out of tune with the despondent voters, or the hard-nosed business world. Market-worshipping economists provide a sort of priestly blessing. And business leaders, when they stray into political comment, as with entering any market, have one eye to the way the wind is blowing. They all mistake common delusion for ‘credibility’.

Of course, it was just the same in the boom. How did bankers, regulators, central banks, rating agencies, governments, oppositions and financial pundits all believe that you could safely bet the financial system on the ability of poor people to repay loans once an initial interest holiday had run out? It’s simple really: everyone thought everyone else knew what they were talking about.

But today’s self-delusion has deeper roots. The people who tell you to fight recession with austerity are the spiritual heirs of those who told you to fight Germans by ‘going over the top’, to fight sickness with leeching, witchcraft with drowning, heresy with burning, and the nightly disappearance of the sun with human sacrifice. All these things were the conventional, and authoritative, wisdom of their day. We were called to evolve beyond them.

Debt is necessary, and partially good. The fallacy of composition and the cult of pointless sacrifice are the real demons that we must exorcise if humanity is to move beyond its current predicament.