

Thought for the weekend

“I’m afraid to tell you...”

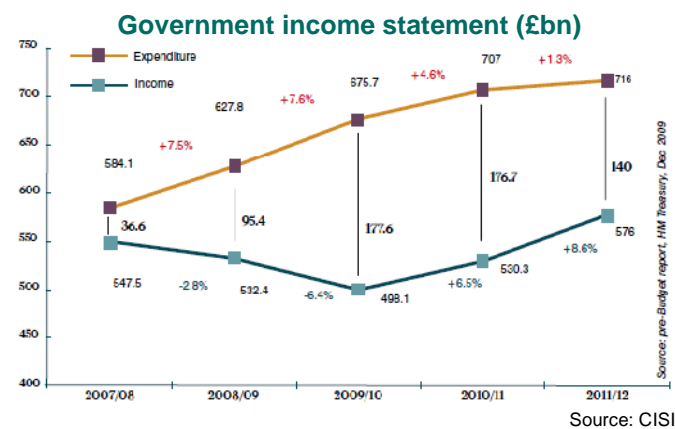
Outgoing chief secretary to the Treasury Liam Byrne was not kidding when he left his helpful comment for his successor, Liberal Democrat MP David Laws. There really was no money left! In fact the national debt is escalating at an alarming rate, adding to debt that was already large to start with. While it has been convenient to blame the banks the simple truth is that fixing the banks was relatively cheap. The expensive bit is going to be fixing the government’s finances.

As the chart below shows, at circa £170bn the gap between government income and government expenditure is vast. In fact so vast that the recently announced cut of £6.25bn barely scratches it. It is just 4% of this year’s increase!

With government expenditure now accounting for as much as 50% of the economy on some measures, any spending cuts will have a major impact. Tightening your belt may be a sensible strategy for an individual or company but for a government it is not so simple. Lower government spending means less money for both the public and private sectors. And lower tax receipts.

“I’m afraid to tell you there’s no money left” *Liam Byrne MP, former chief secretary to the Treasury*

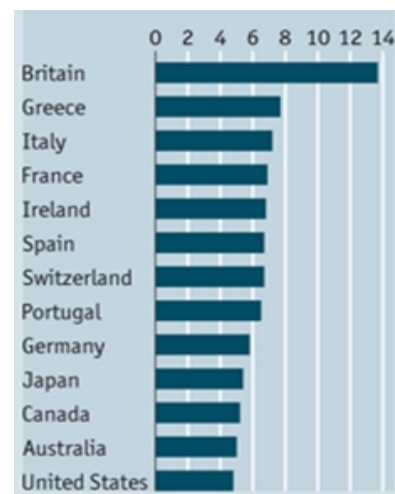
And while a company can cut jobs to save money all that happens when the government makes workers redundant is that they pay them benefits rather than salary. They then pay less tax and are unable to borrow, which further damages the economy. This is why many economists argue that the only solution is to maintain government spending and let economic recovery close the gap. Worryingly, nobody is talking about actually reducing the debt, just about slowing its growth!



For the moment investors’ attention is focussed on Europe where the peripheral economies of Portugal, Ireland, Greece

and Spain face similar problems though with important differences. First, euro membership means that devaluing their currencies to regain international competitiveness and stimulate their economies is not an option: austerity and deflation is the only way. Second, not only do they have to borrow to cover their budget deficit but they also have large tranches of existing government debt due for repayment. Financing all of this at the higher interest rates now demanded by investors means that more and more of their economic output is devoted simply to servicing interest payments.

Sovereign debt, years to maturity



Source: The Economist

Make no mistake: Our position is also bad. But as the chart shows we are not under the same pressure to refinance our national debt. In fact at 14 years we have almost twice as long as the average. Furthermore, we can use the pound to help by repaying our debts in a devalued currency.

The traditional escape route for indebted governments is inflation. But today’s generation of central bankers and politicians have founded their reputations on economic prudence and keeping the inflationary genie in the bottle. Initially they will argue that there is no gain without pain and favour spending cuts.

But longer term it is not difficult to understand why inflation will eventually be the solution. To see why you need look no further than Greece, the cradle of democracy. This is about people not economics. Forced to take a substantial cut in their standard of living and to accept strict financial disciplines imposed by the EU and the International Monetary Fund the Greeks have taken to the streets.

In the short term it may look like a protest against the austerity plans. In fact it is a vote for inflation.

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Thought for the weekend

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