

Is the UK in Debt Danger?

Page 1/3

News Story

The UK public are evidently now among the biggest borrowers in the world.

They borrow far more than the UK government; an amount that exceeds the whole external debt of Africa and South America combined.

Yes. In terms of borrowing, we are in the company of giants - the heavily indebted governments of the US, Japan, Germany and Italy, and credit card wielding American public.

And as we have a trillion pounds of debt, be ready for a trillion newspaper features on Britain's borrowing binge, and different ways of seeing what a trillion pounds will buy. (My best effort is that a trillion pounds buys one hundred trillion penny chews.)

But before we go overboard on our booming debt, and before we get carried away with moralistic sermons about feckless families losing control of their finances, here are three important points about debt.

Each of the three offers us some reassurance that we do not need to panic about debt. But each of the three also gives rise to some concern.

Point number one: it does not much matter if we have big debts, if we simultaneously have big assets.

And as it happens, over 80% of our trillion pounds of debt is borrowed to finance the purchase of homes, which in total, are worth just under three trillion pounds at current prices.

Add to the value of our homes, the value of our financial assets - stocks, shares, pension assets and the like - and you find the net worth of households is about five trillion pounds.

This means that households - if we treat them as one single entity - are comfortably in the black overall.

The worrying counterpart to this is that over-inflated house prices are flattering the balance sheet. When or if house prices fall, the household sector will look more vulnerable.

Cheap debt

Secondly, what matters most in terms of the financial position of households is not the stock of debt that we may be carrying; but the burden of servicing that debt each month.

If households can easily afford the payments on their low interest loans, we don't have to worry much.

At the moment, the monthly payments are comfortably affordable.

At about 10% of post-tax income, they are not far off the average for the past decade.

In other words, we have taken out more debt, as debt has become cheaper.

The worrying counterpart to this is that as interest rates rise, the burden of servicing variable rate mortgages will become significantly more onerous - although the debt burden will probably not return to the crisis levels of the late 80s.

Is the UK in Debt Danger?

Page 2/3

News Story

Deteriorating

Thirdly, although we look at household debt, or household assets, there is more to the finances of the United Kingdom than UK households.

We are all shareholders in a large entity called the Her Majesty's Government, for example.

We should take that into account. And the accumulated stock of UK government debt is relatively small. It is about 35% of national income, compared to 48% in the US, and 53% in the euro area.

The worrying counterpart here is that the UK government's balance sheet is deteriorating. Just at the time that we the public started borrowing, the government started borrowing on our behalf.

So, taking all these arguments together, how worried should we be about debt? Will it end in tears - as it usually does?

What catalogue of plagues might be dropped upon us if the Gods view our credit-fuelled spending boom with displeasure?

Consequences

Well, if it turns out that a significant number of people have borrowed more than they can sustain, and get into financial distress, there are three potentially disastrous consequences.

Firstly, there are the difficulties endured by individual families when they are unable to meet payments which are due. The most notable consequence is home repossession, which was experienced on a wide scale in Britain in the early 90s.

Secondly, there is the danger of general financial instability caused by the ripple effects of loan defaults. If one group of borrowers fails to meet its financial obligations, it can drag the banks into problems, so they are themselves unable to meet their own obligations.

Britain escaped this consequence in the 90s - quite remarkably given the depth of the debt crisis.

But Japan endured a banking crisis on the back of its 80s bubble.

Thirdly, there is the risk to the economy that excessive household borrowing will rapidly turn into a high level of household saving, as people attempt to improve their finances.

While saving is not generally a problem for an economy, it is if everybody does it simultaneously, and without warning.

Massive saving can lead to recession as firms find they can't sell anything.

Again, Japan in the 90s experienced unhelpfully high levels of personal saving - to the point that the authorities distributed free shopping vouchers to encourage people to go out and spend.

Don't panic

When it comes to the UK right now, these dangers provide cause for concern, but no grounds for national panic.

Is the UK in Debt Danger?

Page 3/3

News Story

It is obvious that some individual households are facing, and will face, financial distress.

The rising personal bankruptcy numbers testify to that. It will only get worse as interest rates rise. And when house prices fall after this boom, it will be harder to escape financial crisis by selling the house to repay the excessive mortgage.

But while individuals will be hurt, it is less obvious that Britain faces a systemic financial or economic crisis.

The British banks have been making large profits, and (I might come to regret saying this), their finances are in relatively good shape to withstand a shock.

And as for the economy, if the debt boom leads to bust, the Bank of England has plenty of room to cut interest rates to get savings down again.

Long term

The danger to the economy comes if the public do not respond to low interest rates; or if inflation picks up too much to give the Bank of England room to manoeuvre on rates.

Both are possible, but neither seems likely.

To conclude, the economics of debt are more ambiguous than some of the headlines imply. There may be problems, we need to watch for them, but they are not inevitable.

So rather than devoting all our attention to the possibility of an impending debt crisis like that we had in the late 80s, we should perhaps think more about the long term - and the balance between spending and consumption in Britain, of which high borrowing is a mere symptom.

In the long term, it is savings that matter: the gap between total income and total spending.

Saving now represents 6.1% of our income. That is not catastrophically low. But it is below its historic norm since the 1960s of about 8%. And that norm is a little low to provide us with adequate retirement pensions.

At some stage, we will have to save more or decide to work longer.

And at that stage, we might come to regret having borrowed as much as we have.