

How Much Debt Is Too Much?

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LONDON – Is there a “safe” debt/income ratio for households or debt/GDP ratio for governments? In both cases, the answer is yes. And in both cases, it is impossible to say exactly what that ratio is. Nonetheless, this has become the most urgent macroeconomic question of the moment, owing not just to spiraling household and government debt since 2000, but also – and more important – to the excess concern that government debt is now eliciting.

According to [a 2015 report](#) by the McKinsey Global Institute, household debt in many advanced countries doubled, to more than 200% of income, between 2000 and 2007. Since then, households in the countries hardest hit in the 2008-2009 economic crisis have deleveraged somewhat, but the household debt ratio in most advanced countries has continued to grow.

The big upsurge in government debt followed the 2008-2009 collapse. For example, British government debt rose from just over 40% of GDP in 2007 to 92% today. Persistent efforts by heavily indebted governments to eliminate their deficits have caused debt ratios to rise, by shrinking GDP, as in Greece, or by delaying recovery, as in the UK.

Before modern finance made it easy to live on borrowed money, getting into debt was considered immoral. “Neither a borrower nor a lender be,” Shakespeare’s Polonius admonishes his son Laertes. The expectation of uninterrupted economic growth brought a new perspective. Mortgage debt, unknown a century ago, now accounts for 74% of household debt in developed countries (43% in developing ones). Banks have been lending, and households borrowing, as if tomorrow was sure to be better than today.

Likewise, governments used to be expected to balance their budgets, except during wartime. But they, too, came to expect continually rising revenues at unchanged, or even falling, tax rates. So it seemed prudent to borrow against the future.

Today, with many households and governments facing severe financing problems, that no longer appears to be true. But the only certainty is that the “safe” debt ratio depends on the context.

Consider Denmark and the United States. In 2007, Denmark’s household debt/income ratio reached 269%, while the US peak was 125%. But household default rates have been negligible in Denmark, unlike in the US, where, in the depths of the recession, almost a quarter of mortgages were “under water” and some homeowners chose strategic default – fueling further downward pressure on housing prices and harming other indebted households.

This can be attributed to the distribution of borrowers. In Denmark, high-income households borrowed the most, relative to their income, and standards for mortgage lending remained high (mortgages were capped at 80% of the value of the property). In the US, households with the lowest income (the bottom quintile) had a higher debt/income ratio than the top 10%, and mortgages were

dispensed like gumballs. In the US, as well as in Spain and Ireland, banks and households became what the *Financial Times* columnist Martin Wolf [called](#) “highly leveraged speculators in a fixed asset.”

As for government debt, Japan’s debt/GDP ratio is 230%, compared to Greece’s 177%. But the consequences have been much more dire in Greece than in Japan. The distribution of the creditors is crucial. Most of Japan’s bondholders are nationals (if not the central bank) and have an interest in political stability. Most Greek bondholders are foreign banks. Yet, while crises of confidence come much sooner if debt is mainly owned by foreigners, no steps have been taken to restrict government borrowing to domestic sources.

We now know that the expectation of uninterrupted growth was a delusion. But governments have been slow to rearm against the next crisis. Macro-prudential tools like counter-cyclical capital and reserve requirements on banks have been emasculated by vested interests in the financial industry. And, while governments have been trying (albeit ineffectually) to reduce their net liabilities, they have been encouraging households to increase their debt, in order to support the restoration of “healthy” growth.

The McKinsey report uses consensus data from the International Monetary Fund and the OECD to forecast that, with the notable exceptions of Germany, Greece, and Ireland, the debt/GDP ratio in advanced economies is set to rise. This seems alarming. But a great deal of the alarm is based on the oft-repeated canard that government spending is unproductive and a burden on future generations. In fact, future generations will benefit more than the current one from government infrastructure investment, so it is reasonable that they should pay for most for it.

The purpose for which the debt is incurred is important. Debt crises are likelier if debt is being used to cover current spending. But now, when real interest rates are almost zero or negative, is the ideal time for governments to borrow for capital spending. Bondholders shouldn’t worry about debt if it gives rise to a productive asset.

All governments nowadays aim for a fiscal surplus to pay down debt. This is sensible, but how it is done matters. In conditions of incomplete recovery and stagnating growth, raising taxes or cutting welfare spending is the wrong approach; fiscal consolidation requires taking active steps to increase GDP growth.

In the long run, this can be achieved only by raising productivity. But governments can help make the long run shorter. They have been relying on printing money to offset their fiscal policies’ deflationary effects. But as McKinsey puts it, “Liquidity...cannot translate into inflation when demand is depressed, the propensity to save is high, and banks are still de-leveraging.”

Expansionary fiscal policy is taboo, because it threatens to increase national debt further. But much depends on how governments present their accounts. In 2014, the Bank of England held 24% of UK government debt. If we discount this, the UK’s debt/GDP ratio was 63%, not 92%.

So it makes more sense to focus on debt net of government borrowing from the central bank. Governments should be ready to say that they have no intention of repaying the debt they owe their own bank. Monetary financing of government

spending is one of those taboo ideas that is sure to gain support, if, as is likely, economic recovery grinds to a halt.