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MONEY BOX

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LEWIS: Hello. In today's programme - debt, debt and more debt. Not ours - well not personally - but our country's: the UK's, or if you prefer, the government's. Forget a couple of hundred quid overdrawn or a few thousand on a credit card or to buy a car. Today we're talking international debt - a trillion pounds, a million million pounds, and growing by more than a hundred billion a year. It's about £13,000 for each person in the UK, and over the next 5 years that will almost double to just under £24,000 each. Today I'm going on a journey to find out when this debt began, how it's grown, and see if I can reduce it. What must politicians do to get us to agree to real cuts? And what if they don't? Finally, how does this growing debt affect our own personal finances?

But, first, that word deficit. What does it mean? John Lanchester is a novelist turned economics writer, whose latest book on the banking crisis is called simply 'Whoops!'

LANCHESTER: Etymologically deficit is related to the Latin facere meaning to make or to do. It's coupled with the prefix di to mean unmake or undo. There's going to be a lot of unmaking and undoing, a lot of projects abandoned, buildings going un-built, jobs being lost, all because of that one word 'deficit'. Deficit, like debt, is obviously bad, but what exactly are they and what's the difference? The best description of a deficit is the one given by Dickens's character Mr Micawber.

CLIP: Mr Micawber - DAVID COPPERFIELD

Let the fate of this miserable wretch you see before you be a warning, Copperfield. Annual income twenty pounds, annual expenditure nineteen nineteen and six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds nothing and six, result misery.

LANCHESTER: When your income is less than your expenditure, you have a deficit. In Micawber's example, the deficit is sixpence. In the case of the UK, it is £167 billion. As for the debt, it's nothing more than the sum total of all the deficits accumulated over time and still being paid off. Here again, the numbers are pretty spectacular. UK debt stands at £776.6 billion and is projected to rise to £1406 billion by 2014. That means that in the 6 years after the credit crunch, the government will have borrowed more money than every government since the Norman Conquest added together. As Mr Micawber would say: result misery.

LEWIS: John Lanchester. Or was it Mr Micawber? The roots of the government debt though go back a lot further than the Charles Dickens of the 19th century. Adrian Bell is Senior Lecturer in the History of Finance at the University of Reading. His specialist subject: medieval finance.

BELL: This goes back to the reign of Edward I, obviously King of England, who started using deficit financing to run government because his income was very much seasonal but he wanted to spend throughout the year. So he established relationships firstly with a group of Italians called the Ricciardi who basically provided him money for the periods when he wasn't having his income, and then he would repay them when his income came in.

LEWIS: And for those of us who aren't as familiar with history as you, what date was Edward I?

BELL: So Edward I started in 1272. His reign ended in 1307.

LEWIS: Right, so it really goes back more than 700 years?

BELL: That's correct, yes. And he used this very successfully to run two wars against the Welsh, where his outgoings peak well above his incoming, but then he settled down the years after and repaid this deficit. So he was trying always to get back to his standing start, so he'd go into deficit and then try and get it back again.

LEWIS: So we had financial prudence even in the 13^{th} century?

BELL: Yes, I mean the English kings are very prudent in the sense they would never devalue the pound as a way of creating extra money. They always wanted to have a sound money policy.

LEWIS: Dr Adrian Bell of Reading University. But surely the debt we see now, heading for a trillion pounds, doesn't really date back to Edward I? He only borrowed about £20,000 a year and he paid it back. So where does the blame lie for our current debt? Andrew Dilnot is Principal of St. Hugh's College, Oxford, but he's probably better known as a broadcaster, economist, and general explainer of numbers and money.

DILNOT: The simple answer to how did we get to a large national debt is that just about every year for most of the last 300 or 400 years, the government has spent more than it's earned. It's spent more in public spending than it's raised in taxation. It's just that in the last 7 or 8 years, we've seen a consistent increase in public spending without a corresponding increase in tax, and then we saw the deficit balloon during the recession.

LEWIS: Yes. And you mention the recession of the last couple of years. I think, looking at the budget report, something like £120 billion was spent broadly bailing out the banks, as we like to say. How significant has that been in this current problem?

DILNOT: My own view is that's not a very significant part of the position that we're in at the moment. Indeed I don't think the recession's very important as far as the deficit is concerned. The money that was spent on bailing out the banks, I'm not sure spend is the right way of putting it. What was done is that we acquired assets by and large. And in some cases, as in the case of Lloyds at the moment, if we were to sell those assets now, we'd make a profit for the government. So I don't think that was a very important part of the increase in the underlying deficit. Nor do I think the ballooning of borrowing during the recession's terribly important because that borrowing will tend to go away. The *real* problem that we face now is that at the end of the longest consistent period of economic growth that we had ever seen - the longest in all known history, 16 years of consistent economic growth before this recession - the government was spending 4.5% of national income more than it was raising in tax. 4.5% sounds like a small number. Well actually 4.5% of national income is about £70 billion a year. That's over £1,000 for every single person in the United Kingdom. That's what we have to sort out.

LEWIS: And sorting it out means something structural rather than efficiency savings and nibbling round the edges, the easy cuts. We've got to do something difficult and structural in order to prepare ourselves for the next 10 years or so.

DILNOT: I think there's no escaping making some serious choices. The idea that we'll do this by efficiency savings is charming but, in my view, very, very naïve. I've said to generations of politicians in the last 25 years that it's probably worth them remembering that their predecessors were quite keen on gaining efficiency savings. We've been playing this game since 1975/76 and the IMF crisis. The then Labour government tried very hard. Nigel Lawson tried very hard when he became Chancellor of the Exchequer in 1983 and writes in his biography that it turned out to be quite difficult. Michael Portillo tried in 1992/93 when he was Chief Secretary to the Treasury. The Labour government had a go when they began in 1997. Of course every new government and every senior civil servant are always on the lookout for efficiency savings, but the idea there's a pot of money here that will make a big difference is, I think, in the end just an illusion.

LEWIS: You said serious choices. Politicians have said frequently over the last few weeks difficult choices. What are those choices? What is a choice we have to make to begin to solve this problem?

DILNOT: Let's take each of the big three areas: social security, health and education. In social security, the really big choice is do we go on paying retirement pensions that are generous to everybody at roughly the same age that we do at the moment? The easiest way of saving money would be either to raise the retirement age or to move even further towards means testing. The state pension is the single largest item of public spending in the United Kingdom and I'm sure that that will continue to be looked at. In education, a major issue is the funding of universities. I might be thought to have a special interest here because I now work in a university. We've already seen a shift towards people having to pay more for their own university education. I think a further reduction in public funding of education and further increases in fees for students is a perfectly plausible possibility - although not one that everybody, including me, would welcome. And then on health, many of our European neighbours have co-payment systems, and I think in the next 10 or 20 years that's certainly going to be on the agenda in the UK.

LEWIS: So although it would be free, if you like, we'd also have to make a contribution?

DILNOT: If you were perhaps in the top third of the income distribution, yes.

LEWIS: Andrew Dilnot with a slightly alarming view that nothing can be sacred - not even state pensions, not even the NHS - if we really want to stop the haemorrhage in government finances. But is it really that difficult to make meaningful cuts to just stop spending so much? Households have to do it. Why can't the government? My next stop was the Institute for Fiscal Studies, a research organisation respected by all sides as an impartial analyst, and it has a computer programme that lets you play at being chancellor. How could I resist?

TETLOW: My name's Gemma Tetlow and I'm a Senior Research Economist at the IFS, and I work on public finance analysis.

LEWIS: Okay, so this is the do it yourself 2010 spending review. So in here, you've got all the data right up to date from the Budget the other day, so that we know exactly what the government's plans are at this stage?

TETLOW: Yes, so what we've got in here is the government's plans from the Budget for total spending over the next 4 years. So they've set up plans to halve the deficit by 2013/14 through a package of measures which is about £19 billion tax increases and £38 billion spending cut.

LEWIS: Right, so here we have total public spending £704 billion. And then it starts to get complicated, doesn't it? You've got annual managed expenditure. What's that?

TETLOW: The bits of government spending that they argue they have slightly less control over, particularly in the short-term. So things like benefit payments.

LEWIS: Right. So we've got £170 billion on social security. Now that also includes the retirement pension, presumably, which must be a big chunk of that. But then we've got this terrifying amount of nearly £42 billion on *interest*. So that's not *doing* anything. That's just paying the people who've lent us all this money to cover our debt in the past.

TETLOW: And that figure's expected to grow quite rapidly over the next few years because we're borrowing so much this year and over the next few years.

LEWIS: I mean that's more than we spend on defence, which is £41 billion. Is that right?

TETLOW: Yes, that's right.

LEWIS: So that's in descending order. So the NHS, the most expensive thing. Schools. Defence is next. And development assistance. That's overseas aid. So these are all things that the government is saying it doesn't really want to cut?

TETLOW: Yes, those first four categories are separated out because they're the areas that have been sort of priorities for the government.

LEWIS: Right. And then we've got all the rest, which is actually less than half the money that we've got left to play with - local government; transport; the Home Office; justice; DEFRA, energy and climate change. They've got to cut by 9% a year, which is 31/32% over the next 4 or 5 years, to meet the government's hoped for target set out in the Budget. So that works that all out for us automatically?

TETLOW: Yes and this reflects really if you do ring fence large chunks of public spending, the squeeze elsewhere will be much more severe. One way to make these numbers add up slightly more favourably for public services would be to announce a further tax increase.

LEWIS: Okay. So supposing I was being really radical. Supposing I looked at the NHS and I said any organisation that big must be able to save 1% a year, for example, so we could put that in. So it says here that under the Labour government NHS spending has grown 6% a year, so even freezing it is a big cut. So my idea of cutting another 1% would not be popular, would it? And then of course defence. Right, so if we put in the maximum cut - so that's going to bring defence spending down by 10%, which would be 30 billion by the end of the period, which is a 25% cut. Now I'm sure that anyone involved in the armed forces would say that is absolutely impossible. But this is an example of the kind of impossible choices that politicians are having to make. They want to protect some things. Even if you put in a big cut in something sensitive, you're still not really solving the problems that we face.

TETLOW: Politicians have talked about tough choices, but I think perhaps it's not necessarily been clear to the public exactly how tough these choices are.

LEWIS: Well that was the number crunching, and I must say I feel crunched as much as anything. A really difficult problem for politicians clearly to try and get any of those numbers to add up to something that internationally would be seen as reasonable. So now we're going to talk to the Institute for Government to see how politicians can deal with those difficult problems that the arithmetic is throwing up.

(presses buzzer)

WOMAN: Hello.

LEWIS: Oh hello, it's Paul Lewis here from Money Box, BBC Radio Four, to see Julian MacCrae.

MacCRAE: The first thing you've got to think about is that nobody in the UK has really faced a situation like this before. The last time we really had to do expenditure control on this scale was back in the 1970s. But there are people internationally across the world who have done this. So Sweden, another country which faced a very large consolidation similar to ourselves, went from a budget deficit of around where we are now - 12/13% of GDP - to within a couple of years having very stable public finances running forward.

LEWIS: Is it really possible to cut in 2 years? How did Sweden do that?

MacCRAE: Well Sweden's a very interesting example. They had an economy, an economic situation that actually looks quite like the UK. They had a financial crisis; and in part in consequence of that, they ended up with a very large budget deficit. They were facing real problems borrowing money. So they were running into a General Election where literally the Finance Minister was travelling round the world having to negotiate with bond dealers for the Swedish government to receive funds to keep itself going. That forced very real action on the incoming government and it forced them to act very quickly. What they did in Sweden, they have a very consensual style of politics. The Prime Minister's view at the time was that he wanted to start with a flat rate cut across the board as the starting point for discussion, so every department was expected to cut 11% from its expenditure. And then there was a political negotiation that followed that, which allowed the politicians to protect things that they felt there was a political consensus to protect.

LEWIS: That means bigger cuts somewhere else.

MacCRAE: So the trades were being made very explicitly. But from that baseline, something that could be seen to be fair.

LEWIS: You can just see the headlines though, can't you? 'Chancellor goes cap in hand to bond dealers in Europe.' That would be a very unfortunate thing for any politician to have to do.

MacCRAE: I don't think we'll face that situation in the UK. That's the extreme of what might happen. The strength the UK has in controlling public expenditure and in raising taxes, we have demonstrated we have in the Treasury one of the most powerful finance ministries in the world. We have the ability to raise taxes, as we demonstrated on several occasions in the last 30, 40 years, unlike countries, say, like Greece where there are more questions about their ability to control their spending. The real question for the UK is not *could* we control our deficit. It's when will we have the political *will* to control our deficit.

LEWIS: All the time we've been doing this, I've been puzzled about this huge amount of money we have to borrow each year as a country - £170 billion nearly this year, £163 next, and hundreds of billions over the next few years. Who's got this money? Where does it come from? So now we're on the underground going to Canary Wharf, the heart of the new financial district of London, to talk to someone at Barclays Capital about who lends us all this money.

HAYES: My name's Simon Hayes. I'm Chief UK Economist.

LEWIS: Simon Hayes, we're sitting here on this, I must say, vast trading floor. At least it looks very big to me. Over the next 5 years, the government's got to borrow around about half a trillion pounds on its current plans. Who is there to lend the government half a trillion pounds?

HAYES: When tax revenues aren't sufficient to cover government expenditure and the government goes into the debt markets in order to borrow, to a large extent that's done by issuing government bonds; or in sterling government bonds are called gilts.

And these are essentially IOUs that the government sells to private investors. They can be UK domestic private investors such as pension funds and insurance companies, or they may be overseas investors. And these essentially say that if you give me £100 today, I'll pay you the £100 back in 10, 20 or 30 years time, and in the meantime I'll pay you an interest rate.

LEWIS: So although half a trillion pounds sounds a lot of money to me - and I'm sure to most of the listeners - looking at this trading floor here, are you saying that even though this is a big deficit we're running up, there isn't actually a problem in getting people to lend half a trillion pounds to the government?

HAYES: The answer in the end is people will buy gilts if they're priced appropriately. The more gilts there are, the lower the price. The lower the price, the higher the interest rate. So really it comes down to a question not of whether it's possible but what interest rate you end up having to pay in order to borrow those sums.

LEWIS: So given that we have to borrow that sort of amount, are we going to have to pay more for the money? We're already paying a lot. We're already paying more than £40 billion a year, just paying interest on it.

HAYES: Yes, I think we are. At the moment we're paying about 4% on a 10 year maturity gilt. We expect that to go up to around 5% over the course of the next year or two. There's also an issue to do with the UK's credit rating. If you're lending money to a government, then you have to take into account the small chance that actually that money won't be repaid. Now the UK government hasn't defaulted on its debt for several hundred years, so we are really talking about very small probabilities here.

LEWIS: So we have this so-called AAA rating because we haven't defaulted as a country. Is it conceivable that could be reduced?

HAYES: Well certainly recently the credit rating agencies have put a question mark over the AAA rating. They've raised some concerns about the government's plan for reducing the deficit, and have said essentially that they want to see the deficit reduced more quickly.

LEWIS: And if they did reduce it, what would that be to and what effect would that have?

HAYES: The next step from AAA would be a AA+ rating, which in today's terms would be another £5 billion a year annually that you'd be devoting to debt interest costs.

LEWIS: Simon Hayes at the end of my journey this week, warning we are going to be paying even more for our debt in the future and even more more if our credit rating is affected. And that's if we don't have a clear plan to pay it back. You can let us know how you would cut the deficit. You can email us directly: moneybox@bbc.co.uk. So what effect will the government's financial problems have on all of us? With me to discuss that is Adrian Lowcock of independent financial advisers Bestinvest. Adrian, what effect will this government debt have on our personal finances?

LOWCOCK: Well it affects different sort of asset classes differently, so …

LEWIS: You mean different things you invest in?

LOWCOCK: Different things you invest in. So, for example, corporate bonds would fall in price because the cost of borrowing from the government goes up. Other asset classes like equities are more dependent on quantitative easing and inflation.

LEWIS: Yeah, equities, shares of course.

LOWCOCK: Yes.

LEWIS: Also listening to us is Morven Whyte. She's Portfolio Manager of

Redmayne Bentley. She's in Leeds. Morven, what do you think the effect of this growing public deficit, sorry - this big public deficit and the debt will have on our personal finances?

WHYTE: I think it's a real worry. I think it's going to obviously hit the public sector jobs; and if you consider the number of people that work for the public sector, then, you know, they're going to have to consider saving for the rainy day, better housekeeping, being more frugal. And they may, you know, have to consider what their pension is going to be in the future and a possible raise in retirement age. So they've enjoyed life I think just now because their jobs have been reasonably secure, but as we tackle the deficit, that security's going to be pulled away.

LEWIS: So government cuts mean job losses. They mean cuts in public sector pensions and maybe even cuts in the state pension and longer waiting. So we're all going to have to do more with our own money. How are we going to do that, Morven?

WHYTE: Well I think in the old days, or at least for the last 10 years, I suppose, people have been able to put cash in the bank or the building society and enjoy a fairly good rate of interest. And what we've seen obviously is interest rates have fallen and banks have been under pressure. Those high interest rates are no longer there. So if you consider interest rates that you're being paid on your cash compared with inflation, the real value of that cash in the bank, the capital value is going to fall. So investors are going to have to look elsewhere and that's one of the reasons, I suppose, why shares have been rising and people are looking at the likes of index linked gilts and national savings.

LEWIS: Yes, certainly share prices rose strongly last week, didn't they? And Adrian Lowcock, we heard, when I was talking to Simon Hayes, that professional investors expect 4, maybe 5% when they lend money to the government. Is that the sort of rate we should be looking for?

LOWCOCK: I think if you look at what cash pays out, it can pay up to 4% over 5 years.

LEWIS: As long as you fix it, so you don't want it back for 5 years.

LOWCOCK: Absolutely. But if you look at what happens if the rates of return increases, so it goes from 4 to 5%, the capital value of your investment will actually fall. So it's better to look elsewhere and actually find an investment that gives you a bit more growth opportunity; and then when the rate is 5%, 5.5%, then perhaps move back into that investment.

LEWIS: Of course growth opportunities are certainly opportunities. But they are risky, aren't they, and risk doesn't mean reward; it means you might lose your money.

LOWCOCK: Absolutely. I mean the greater the potential return, the greater the risk that it could go wrong. What we've seen is with cash rates so low, we've seen people being forced into taking higher levels of risk to get that income, so it's a very …

LEWIS: Well to *hope* to get the income.

LOWCOCK: To hope to get the income, absolutely. And you've got to balance that up and sort of see what your objectives are and how comfortable you are with that risk. It's not suitable for everybody.

LEWIS: And Morven Whyte, risk is the issue, isn't it? If you don't want to take a risk, you are stuck with cash or government investments and that is producing, you know, 3 or 4%, 5% maybe before tax.

WHYTE: I mean I would argue that there is now no such thing as no risk. Cash is a risk because inflation takes off and there's a big …

LEWIS: *(over)* Yes, but inflation takes the value down of investments as well, doesn't it? It's the same thing.

WHYTE: Well if you have a share, then you would expect the value to rise and the dividends to rise in real terms. If you’ve got cash in the bank or the building society and inflation takes off, that is not a low risk investment. And I think that’s what people really need to understand.

LEWIS: So you’re suggesting they do take a risk by putting their money into shares because cash will fall in value?

WHYTE: I’m suggesting that cash is not a low risk investment anymore, particularly if we have an inflationary environment.

LEWIS: And do you think we’re going to have that, briefly?

WHYTE: I think that that’s the only way that we’re going to be able to tackle some of our deficit problems.

LEWIS: So actually boost inflation to cut the deficit …

WHYTE: That’s right, that’s right.

LEWIS: … which I think is what Henry VIII said, as I’m told.

WHYTE: Yes.

LEWIS: Morven Whyte and Adrian Lowcock, thanks. And of course with or without money, the government of any colour will be doing less, so we are going to have to be spending more of our own money on services and pensions.

That’s it for today. More from the BBC Action Line - 0800 044 044; our website, bbc.co.uk/moneybox. And you can help us cut the deficit: moneybox@bbc.co.uk. Money Box Live is on Wednesday. Back with a more usual Money Box next weekend. Today producer Richard Knight, editor Richard Vadon. I’m Paul Lewis.