May 2012

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THE Adviser

Government Debt Solutions

This is another of my articles where I am banging on about Gilt yields, I make no apology for it either. I clearly find it absolutely fascinating and I am really enjoying living through these times where Quantitative Easing (QE) experiments have been used to solve the world's debt problems.

In this article I am putting forward a very simple and excellent idea by Jim Leavis who is head of Fixed Interest at M&G.

UK Public sector net debt to GDP ratio (debt to annual output ratio) is currently 63%. The current debt level is around £1 trillion pounds (excluding debt of part nationalised banks) and costs £50 billion a year to service.

These numbers are truly eye watering and this is where it gets interesting (to me and my old Economics teacher anyway). The Bank of England of course holds a large portion of them, which it has purchased via Quantitative Easing. It actually holds over £350 million of UK Gilts that it purchased on behalf of the Treasury. This means that the Treasury are paying the Bank of England interest on assets it bought with free printed money. Could it be decided that the Gilts could just be cancelled???

This would take the debt to GDP ratio down to 41% and would be the envy of the Western world. It would take the cost of servicing this debt down from £50billion to £32 billion. It would also secure our prized AAA rating. No default has occurred and it sets UK finances on a much more sustainable footing. The markets would also be reassured that the monetary injection from QE is permanent possibly boosting growth and reducing unemployment.

Of course the permanent nature of the monetary injection would likely to be inflationary at some point in the future. This could be solved by increasing interest rates or selling gilts in the future to drain the excess liquidity.

Another twist to this argument is that as long-term Government borrowing is as cheap as it ever has been i.e. Gilt yields are at all time lows. This could allow the Government a massive opportunity to borrow again, and then invest the proceeds. This could be spent on schools, hospital, roads and other infrastructure in chronic need of investment with a positive influence on employment. Again this is a Keynesian idea of spending that I have discussed previously.

Back in late 2008 and early 2009 the talk was of “V, W, L” shaped recessions and recoveries. We have not seen any of these. Obviously the recession started in 2008 and a quick and severe downturn in Gross Domestic Product (GDP), a measure of an economies output, began. The economy then produced a sharp about turn in early 2009, inspired by the first round of Quantitative Easing. From then on we have seen a plateau since mid 2010 and it appears that UK GDP remains stuck at 4% below the pre-crisis peak. The idea above would help stimulate growth and increase GDP as well as reduce unemployment. A further likely consequence would be inflation which as we have discussed before would reduce the real value of debt.

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