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Is writing off the UK's National Debt such a dramatic departure from current policy? From a budgetary perspective, it has already happened!

The authorities cannot state explicitly that Quantitative Easing (QE) has wiped out around 30% of the UK's overall debt, yet this is the impact of current policy from a budgetary perspective, as Toby Nangle explains.

Lord Turner, one of the leading candidates to replace Sir Mervyn King as Governor of the Bank of England, is open to writing off the £375bn of government debt accumulated thus far by the Bank of England, according to recent reports.[1] The news has generated a mixture of derision, alarm and disbelief among market participants. Yet, I believe that the report and the ensuing response highlights a widely-held but erroneous view. To explain, we can see from Eurostat data that the UK's debt to GDP was 85.7% at the end of 2011. But the QE programme totals 24.9% of GDP (measured using the same data). Rather than incurring an interest burden on the full 85.7%, the Treasury actually pays full interest on only 60.8% debt to GDP. Put simply, the debt has already been cancelled from a fiscal perspective.

I write not as a gold bug, or with the belief that the Bank cannot be trusted, or that hyperinflation is around the corner. My point, rather, is that differences between debt issued by a monetary sovereign and other forms of debt are as important as they are misunderstood.

In the popular imagination, governments and households finance themselves in the same way, albeit on different scales. In other words, if both spend more than they earn, each must first secure a source of borrowing. This is indeed essentially the case for eurozone governments, and for any public borrowing in a foreign currency. Debt in this conception is something temporary that must be repaid at some point in the future when times are better. We know this in economics as the 'transversality condition', and it is the underlying principle behind debt-sustainability modelling.

However, this description simply does not hold true for monetary sovereigns such as the UK government, which can always create money via fiscal expenditure. A civil servant or government contractor will thus have his/her bank accounts credited with 'cash', and bank reserves will increase correspondingly. At the same time, the Debt Management Office will seek to sterilise this act of monetary expansion by issuing debt – thus taking the base money out of circulation by swapping the zero-maturity bank reserves that earn base rate out of the system, and replacing it with coupon-bearing, term-debt. After all, the latter cannot be spent in the shops, whereas base money can. As long as a policy of sterilisation continues (as it must for the UK under the Maastricht Treaty), fiscal deficits will thus result in corresponding issuance of government debt. However, this commitment to swap money for long-dated monetary promises in the UK differs from the financing constraint that operates at the household (and the eurozone sovereign) level. Ultimately, the issues of creditworthiness that dog Spain, Greece and Portugal are irrelevant as regards the UK. However, they are replaced with issues concerning the credibility of the currency as a store of value.

[1] http://www.bbc.co.uk/news/business-19918332

QE places sterilisation process into reverse

So how does QE fit into this conception of debt as an instrument, not of finance, but of monetary sterilisation? The answer is that QE effectively puts this sterilisation process into reverse, 'un-sterilising' cumulative historic fiscal deficits. It swaps coupon-bearing, term-debt for zero-term bank reserves. This has the fiscal effect of cancelling the debt for as long as QE is in operation (as the government pays itself the coupons that would otherwise be distributed to the market on the debt it has bought). As I explained in July, the scale of unremitted coupons (minus financing costs) associated with QE has reached a level in excess of £20bn (and is growing by around £10bn per annum), and this practice of non-remittance is in sharp contrast to the practice in place in the United States and the Eurosystem.[2] It is nevertheless within the power of HM Treasury to remit these unspent dividends, and some commentators have recently followed me in pointing to this course of action as being increasingly likely.

It may sound radical to say that the budgetary implications of QE correspond exactly to a debt write-off, but let's compare them. In the case of QE, the coupons are paid by HM Treasury to the Bank of England Asset Purchase Facility Fund. These coupons are the property of HM Treasury and will be remitted back to the Treasury. In the case of a debt write-off, the coupons never leave HM Treasury in the first place. Hence, the fiscal benefits of cancelling the debt would be precisely zero. ***In other words, the debt, equivalent to around 30% of the UK's overall debt, has from a budgetary perspective already been effectively cancelled.***

By contrast, the impact of a *de jure* (rather than a *de facto*) debt cancellation would be principally to signal to the currency market that sterling could no longer be regarded as a store of value. This is because a *de jure* cancellation would impede the Bank of England's ability to re-sterilise the monetary base at some point in the future. After all, this policy would introduce the possibility of some future government being unwilling to provide monetary instruments – in the form of term debt – that the Bank could have used to effect monetary policy, thus impeding its ability to pursue its mandate. It is always hard to accurately forecast the market implications of a new policy signal, but it appears reasonable to expect that it could be disruptive.

Moreover, a *de jure* cancellation of the debt would bring no fiscal benefit. This will become clearer when the Treasury follows international practice and remits around £20bn of cumulative coupons, perhaps to finance infrastructure investment – as I highlighted some months ago.

[2] http://www.threadneedle.co.uk/media/2082896/en_viewpoint_unspent_dividends.pdf

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