ECO POL
cc P.M.s meetings with Ch. Ex. 10/83

PRIME MINISTER

The Chancellor has asked if he can come and have another talk with you in preparation for the economic discussion at Cabinet next Thursday.

As the Treasury have looked closer at the public expenditure prospects, he is becoming more and more worried about it. It is beginning to look impossible to maintain the planning total for next year. He would like to share the problem with you, and discuss with you how you feel that it should be approached.

Since you have the YC speech on Saturday, and then have a dinner on Sunday evening after you return from Chequers, the best time for a talk with him looks likely to be tomorrow evening after you have finished preparing the YC speech. So we have put the Chancellor in the diary provisionally at 1700. But he has no engagements during the evening, and if you need more time on the YC speech he will be perfectly happy to come in later in the evening.

F.E.R.B.

Didn't happen

7 February, 1985.

Publiz Exp

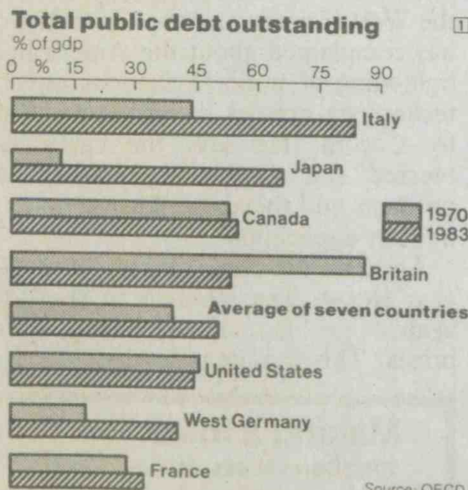
The burden of public debt grows heavier

Governments trying to cut spending are running into a new bind. Interest on their earlier debts is uncuttable—and rising fast. That is leaving governments with awkward choices that some are choosing to duck. Their successors—and taxpayers—will not be amused.

Politicians have been running up debt for centuries. Economists have been debating its significance for almost as long. Most had concluded that public debt was benign. Now the mood is changing. The managing director of the International Monetary Fund, Mr Jacques de Larosière, said last year that public debt is "the origin of many past, present and—in the absence of corrective measures—future problems". A few months later, the Organisation for Economic Cooperation and Development (OECD) called debt interest "a major policy concern".

Why the change of mind? Part of the answer lies in the rapid growth of public debt. For the seven largest industrial countries, outstanding public debt rose from 40% of gnp in 1970 to 51% in 1983. The average includes a rise from 44% to 84% in Italy, and from 12% to 67% in Japan (see chart 1). The ratio also rose rapidly in most smaller OECD economies: eg, from 14% to 31% in Spain, 31% to 67% in Sweden, 11% to 63% in Denmark and 73% to 116% in Belgium.

Debt has an obvious cause: budget deficits. If they were cyclical—ie, if they grew in recession and swung into surplus



during recoveries—public debt would not accumulate. But many governments have been running "structural" deficits—those that would still be there even if their economies were at full employment. Funding them has meant that debt piles up, in good times and bad.

Don't worry about it, said many economists in the 1950s and 1960s. They claimed that debt need never be a burden if an economy grew fast enough. The extra revenues the government obtained from successful reflation would be more than enough to service its extra borrowing. An early proponent of this view was Mr Evsey Domar, an academic and also a governor of the Federal Reserve.

For years, this comforting analysis seemed correct. Indeed, inflation proved as much a boon to debtor governments as to any small businessman or house-buyer who had borrowed on fixed interest rates. Britain's rapid inflation in the 1970s was the main reason why its ratio of public debt to gdp fell from 86% in 1970 to 54% in 1983.

Government debt interest payments as % gdp

	1970	1975	1980	1985*	1989*
United States	2.2	2.5	3.3	5.5	5.7
Japan	0.6	1.2	3.2	4.7	3.8
W. Germany	1.0	1.4	1.9	3.0	2.7
France	1.1	1.3	1.6	3.2	3.7
Britain	3.9	4.0	5.6	4.3	4.3
Italy	1.7	4.0	6.3	10.1	13.6
Canada	3.8	4.0	5.6	7.9	8.4
Average	**1.9**	**2.3**	**3.4**	**5.2**	**5.4**

*Source: OECD *forecast*

In the past few years, however, Mr Domar's reassurances have gone sour. His claim that deficits were not a burden rested on a single equation that, paraphrased, required real economic growth to be higher than real interest rates. So it was, for years on end. But by the late 1970s real interest rates began to rise, just as growth slowed down.

The higher interest rates were the result of tighter monetary policies imposed by central banks to curb inflation. Much of that inflation had been caused by central banks monetising budget deficits rather than funding them. And the slower gdp growth was partly due to the distortions wrought by that same inflation. The factors that had once combined to make deficits seem painless turned round to make them doubly painful.

By 1980 the real rate of interest exceeded the gdp growth rate in all seven of the big OECD countries. Their ratios of public debt to gdp began to soar. So did the cost of servicing their debt—from 1.9% of gdp in 1970 to an estimated 4.9% last year. The bills have been biggest for countries with high interest rates and a lot of debt. The Canadian government, for instance, had an interest bill equal to 7.6% of gdp; Italy's was even higher, at 9.6%.

In the United States, the annual debt bill has doubled in cash terms over the past four years, to $111 billion. It now accounts for about 13% of federal spending. There, as in many other countries, debt interest is the fastest growing item of government expenditure.

Where will it stop? That depends partly on whether the Domar world—fast economic growth, low real interest rates—returns. Growth has picked up in every industrial country since the 1981-82 recession, but real interest rates have yet to fall far. In some countries they have risen. America's gdp grew last year by more than 6½%; but real interest rates on government bonds averaged about 7¼% (see chart 2).

The Domar equation has one scary implication. If (a) budget deficits excluding debt interest do not fall as a proportion of gdp; and (b) real interest rates are higher than gdp growth; then (c) debt interest will keep rising indefinitely as a percentage of gdp. It is not enough for governments to say that debt interest is "beyond their control": it really will be unless they make room for it by cutting the spending they can control, or else raise taxes. Either way, they need to cut their structural deficits.

There is a third option, of course. If policy makers dislike high interest rates, more taxes and less spending, they may be tempted to start monetising, rather than funding, their deficits. The inflation that reduced the real value of debts before would do so again.

Or would it? Once people anticipate faster inflation, long-term interest rates would go higher still. If the exchange rate also fell, the result would be faster inflation and higher interest rates.

So far, governments in the big industrial countries seem to have realised these risks and are shunning the inflation "solution". Some are even having success in cutting their structural deficits. The OECD estimates that West Germany ran a small structural surplus last year, while Japan, France, Britain and Italy reduced their structural deficits.

North America has been less virtuous. The OECD reckons that the United States' structural deficit rose from 2% of gnp in 1983 to 2.2% last year, while Canada's went from 3% to 3.2%. Many of their politicians understand the danger of rising structural deficits. They are less good at heading it off.