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## Introduction and Summary

1. The House of Lords has opened an Inquiry into Debt Sustainability. That is has chosen to do so is revealing: the House has many noted economists who, if the answers to the questions on debt sustainability were clear and agreed, could simply inform the rest of the House of those answers. This poses the question: *why are they **not** clear and agreed?*
2. The principal reason is an inconsistency between the financial system the UK now operates and the models still used to describe it – an inconsistency which both confuses analysts and commentators and leads policy-makers to formulate sub-optimal fiscal policy for the UK:
   - Most commentators implicitly use a model based on gold-standard restrictions;
   - Developments since the Global Financial Crisis (GFC) mean that gold-standard restrictions no longer apply to the UK's *fiat* currency system;
   - Using models which no longer reflect reality has led policy-makers to pursue sub-optimal fiscal policy.
3. Conversely, using models which reflect the current reality of the UK's financial system will result in better policy-making (and make it possible to answer the questions raised in the Inquiry). Figure 1 below briefly summarises this issue, which is explained in detail in the following sections of this paper.

*Figure 1: Summary of System changes since the Global Financial Crisis*

| System | Gold Standard | System 1 | System 2 | System 3 | *Fiat* currency |
|---|---|---|---|---|---|
| *Time frame* | *Intermittently until 1971* | *Pre-GFC 1971-2009* | *Pre-COVID 2010-2020* | *Post-COVID 2020-??* | *?* |
| Can we create money not backed by gold? | N | N? GFC → | Y | Y | Y |
| Can we use created money for current spending? | N | N? | N? COVID → | Y | Y |
| Can we cancel debt to the BoE? | N | N? | N? | N? ??? → | Y |

Legend
Crisis
Opportunity

Most commentary and analysis implies we are here

Actions since the GFC and COVID imply we are here

## Most commentators use a model based on gold-standard restrictions

4. When Cameron and Osborne took office they asserted that debt sustainability was the biggest issue facing the UK[1]:

*"I have been in office for a month and I have spent much of that time discussing with the Chancellor and with government officials the most urgent issue facing Britain today, and that is our massive deficit and our growing debt….There are three simple reasons why we have to deal with the country's debts. One: the more the government borrows, the more it has to*

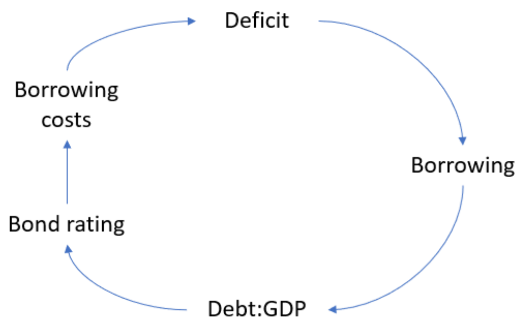
[1] (Cameron, 2010)

*repay; the more it has to repay, the more lenders worry about getting their money back; and the more lenders start to worry, the less confidence there is in our economy."*

Justified by this (unsound, as we shall see) analysis, they imposed their policy of austerity.

5. The answers to the three questions in Figure 1 were – according to them – unchanged by the fact that the UK was no longer on the gold standard. If this were the case, then we should be in System 1 and debt dynamics (and sustainability) would operate as in the diagram below.

*Figure 2: The Conventional Model of Debt Sustainability (M1)*



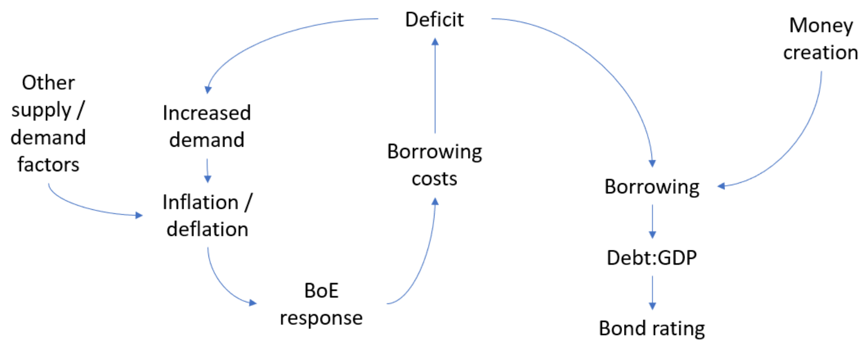

6. In this model, any deficit would naturally have to be funded by borrowing. Borrowing would, if large, increase the debt:GDP ratio. That ratio would be taken into account by the bond-rating agencies. And when the agencies reduced their ratings, the bond market would react accordingly and borrowing costs would rise, further fuelling the deficit and creating problems of sustainability.
7. It is not only politicians who analyse the situation this way. The OBR was set up with a remit to assess debt sustainability according to a model along these lines. Most commentary in the press implicitly uses this model. And in a recent interview with the Financial Times[2], the outgoing head of the Debt Management Office implied that his mental model is similar, claiming that *"British politicians should be wary of provoking a backlash in financial markets* ***by increasing borrowing too quickly."***
8. This model, M1, is still so widely used that it can be regarded as the Conventional model of UK debt dynamics.

## The post-GFC period demonstrated that gold-standard restrictions do not apply

9. In fact, the period since the Global Financial Crisis has shown that the answers to the first two questions at least are *not* the same as they would have been under the gold standard. The Bank of England *has* now created £895 billion of money not backed by gold. And when the government needed to spend to prevent the UK population from unacceptable hardship during lock-down, it became clear that money thus created *could* be used for spending rather than to stabilise asset prices[3]. UK public finances are therefore described by System 3, not System 1. The System 3 equivalent of the model above is shown below:

*Figure 3: Updated model of Debt Sustainability (M3)*

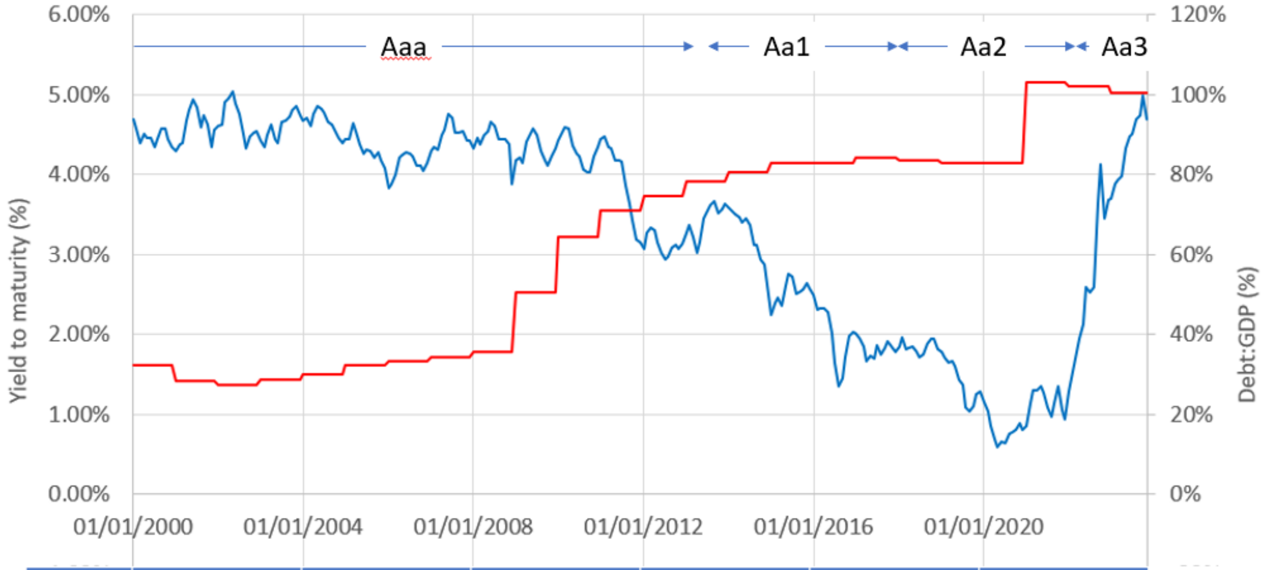
[2] (McDougall, 2024)
[3] (Giles & Georgiadis, 2020)




10. In this model, a deficit need not increase borrowing (as the money could, in a *fiat* currency system be created by government) though it may do so[4]. As in M1, large enough borrowing would increase the ratio of debt:GDP and this in turn may affect bond ratings. And there the similarity ends. The important dynamic in M3 relates to inflation rather than debt:GDP.
11. The Bank of England has a remit to maintain inflation at around 2%[5] and it has one tool at its disposal to do this: interest rates. When inflation is low, it will lower interest rates and conversely if inflation is high, it will raise them. If interest rates are high and it wishes to lower them, it can do this by lowering the rate at which the BoE lends to commercial banks. When they are close to zero, as they were after the GFC[6], it must resort to asset purchases.
12. Deficit spending puts more money into the economy than is taken out in the form of taxes and therefore adds to inflationary pressure. For much of the last decade, UK demand has been insufficient to fuel growth, and deficit spending has been an appropriate fiscal response. But at the time of the Truss Budget, the environment was inflationary. The BoE had no choice under its remit but to raise interest rates sharply, and this caused serious problems for businesses, for households and in particular for pension funds, whose business models rely on gilts.
13. *Which of these models – M1 or M3 – is a better description of realit*y? The period since the Global Financial Crisis has provided a severe test of both models. The results of that test are summarised below.

[4] And in fact has done so, except for very short periods, as the Debt Management Office has kept the Ways and Means Account approximately in balance by issuing debt in accordance with the "Full funding rule." (HM Treasury, 2021).
[5] (Bank of England, 2024)
[6] (Bank of England, 2024)

*Figure 4: Consistency (Y/N) of M1 & M3 with UK data over time*




| | | | | | | |
|---|---|---|---|---|---|---|
| **M1** | **Y** | **Y** | **N** | **N** | **N** | **N** |
| M3 | Y | Y | Y | Y | Y | Y |

*Source ONS, DMO, Moody's; 99% analysis*

Cost of debt (LH axis) Debt:GDP (RH axis)

14. According to M1, as debt:GDP rose between 2008 and 2020, and the bond ratings declined[7], we should have seen a steady *increase* in borrowing costs; in fact we saw a steady *reduction*. When debt spiked as part of the COVID furlough scheme, bond yields should have shot up; they remained around 1%. When Truss's budget proposed a modest (in comparison with the COVID deficit) increase in the deficit, bond yields should *not* have risen as they did. M1 has failed to explain post-GFC reality.
15. M3, in contrast, very well fits the data *throughout* the period shown – and explains why the Truss Budget caused such problems when previous borrowing had not.

## Using models divorced from reality has led to sub-optimal fiscal policy

16. Austerity, one of the most consequential policy choices in recent history, was, as Martin Wolf wrote, *"a mistaken choice, not a necessity"*[8] caused by following M1. The continued underfunding of public services since austerity formally ended is another – we are now in the situation where the spectre of possible (under M1 but not M3) debt issues in 50 years' time means we think we 'cannot afford' to tackle climate change, repair crumbling schools or even fund healthcare so that, as the former Deputy Governor of the Bank of England commented, *"For perhaps the first time since the industrial revolution, health factors are acting as a serious headwind to UK economic growth. They are contributing significantly to a shrinking labour force and stalling productivity."*[9]
17. In short, being driven by a no longer applicable notion of debt sustainability has led us to a situation in which our wider economic policy has become **unsustainable on multiple dimensions.**

## Answering the Inquiry Questions

18. The arguments above make it clear that answers to the Inquiry questions based on M1 are unlikely to be reliable, and answers which do not specify the underlying model on which

[7] (World Government Bonds, 2024)
[8] (Wolf, 2023)
[9] (Haldane, 2023)

they are based are likely to be using M1. Using M3 as the model suggests the following answers to the questions raised in the Inquiry.

| Question | Suggested Answer |
|---|---|
| *What is debt sustainability?* | As well as defining **Public Debt Sustainability**, the House of Lords should consider a wider definition of **Economic Sustainability** which the OBR could use as the basis of its Budget assessments.<br><br>**Public Debt sustainability** could be defined as **'maintenance of public debt in a form, with a maturity and quantum which does not pose risks to the economic performance or resilience of the UK.'** Public Debt sustainability could be put at risk if the UK lost control of its own currency or borrowed in a currency it does not control – for example, joining the euro could cause problems as it did for the peripheral countries in the eurozone; borrowing in dollars could cause problems as it has for many South American countries. Similarly, if all maturities were 1 year, then 100% of our debt would need to be refinanced each year. The impact of a policy mistake would be disastrous. If all maturities were 100 years, a policy mistake would affect <1% of the debt and would be far less consequential.<br><br>**Economic Sustainability** should also include such factors as having adequate growth in productivity to prevent mass impoverishment; ensuring private debt sustainability; maintaining a healthy workforce; preventing climate catastrophe, etc.<br><br>The OBR does take many of these factors into consideration already, but is forced to treat them as contributory factors to Public Debt Sustainability rather than as fundamental issues in their own right. |
| *Is debt: GDP an adequate target?* | No – it is inadequate even as a target for debt sustainability as it takes no account of form or maturity.<br><br>It has also been used politically to create needless fears around sustainability: as the Bank of England data show, even today, our debt to GDP is not significantly higher than the average level over the last 300 years[10]. In fact, given that the BoE currently owns roughly £750 billion in gilts[11] – debt which would be automatically defeased (cancelled) in a corporate setting – true debt:GDP is around 75% – far below our long-run average. |
| *How robust are OBR assumptions?* | No economic forecast assumptions are truly robust – as SJ Wren-Lewis wrote[12], *"Macroeconomic forecasts produced with macroeconomic models tend to be little better than intelligent guesswork. That is not an opinion – it is a fact. It is a fact because for decades many reputable and long-standing model based forecasters have looked at their past errors, and that is what they find."*<br>The OBR assumptions do represent intelligent and professional attempts to guess what may happen.<br>Their work would be more helpful if explicitly based on M3 rather than M1 and if their assessments were based on a wider definition of economic sustainability. |
| *What are the* | The UK government has two sources of demand for its debt: 1) the market |

[10] (Bank of England, 2024)
[11] (Bank of England, 2023)
[12] (Wren-Lewis, 2014)

| | |
|---|---|
| *market risks created by high levels of public debt; and what factors will influence the market's appetite for this debt?* | and 2) the Bank of England. As long as the BoE stands ready to purchase, temporary lack of market appetite is not an issue, as the Debt Management Office[13] pointed out, despite the huge increase in debt since 2009: *"We've had over 500 auctions since the last uncovered auction in 2009, and it's not obvious to me that we should expect another one any time soon."*<br><br>It should also be noted that market demand means that debt should *not fall too low* – sectors like pension funds rely on access to risk-free investments. And since, because of the law of sectoral balances, a public surplus would imply a private deficit, aggressive attempts to tackle public debt sustainability could cause private debt unsustainability. |
| *What levels of productivity and growth are required to ensure our national debt is sustainable?* | Low levels of growth produce **economic unsustainability** rather than debt unsustainability.<br><br>We should aim to return to levels of productivity and economic growth we sustained during the Golden Age of Capitalism[14] (roughly 1945-1980). |
| *If we are to ensure our national debt is sustainable, what might this mean for fiscal policy?* | We would suggest tackling a slightly wider question: *If we are to ensure our **national economy** is sustainable, what might this mean for fiscal policy?*<br><br>A complete answer would take many volumes, but in brief:<br><br>1. Confirm the currency system we are operating in (*fiat* currency)<br>2. Define debt and economic sustainability as above<br>3. Strengthen inflation control mechanisms and redefine the Bank of England's remit<br>4. Formulate economic policy to return to levels of growth experienced during the Golden Age of Capitalism[15] |

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[13] (Miliken & Bruce, 2020)
[14] (Thomas, 2019)
[15] (Thomas, 2019)

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