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Britain should not take its credit status for granted

By Kenneth Rogoff

I am puzzled by commentators who are certain that governments had it all wrong, at every step, in balancing stimulus and stability in the aftermath of the crisis. One often sees claims, for example, that the UK borrowed heavily in the distant past with little ill effect. So today's leaders were foolish not to engage in even heavier borrowing and stimulus. These people seem to believe everything will be fine when it comes to public debt: like Voltaire's character Dr Pangloss, they assume "all's for the best in the best of all possible worlds".

According to the debt panglossians, UK leaders watched as the economy stagnated, rationing stimulus out of a baseless concern over credit risks. Even though the UK ran one of the largest deficits of any advanced country, the panglossians say it should have borrowed more. Perhaps, but their logic is based on a shallow reading of the evidence – and on amnesia about recent risks to eurozone stability.

They do have some very solid points on their side, particularly when it comes to high-return infrastructure projects. Such projects, if done at a reasonable cost, pay for themselves. Governments should have done more, and not just to stimulate demand. There are good neoclassical arguments for higher government spending in a slack economy when resources are cheaper. But debt panglossians are far too confident that the UK's credit status is bulletproof, and too dismissive of the risks.

Yes, from the 1800s until the first world war, the UK was a global superpower that commanded vast colonial resources and investments. Over long periods, these foreign assets yielded returns well in excess of interest on debt. But comparing government debt ratios back then, when the UK was a massive net creditor, to debt ratios today, when British foreign liabilities exceed foreign assets, is utterly misleading. Moreover, back in the 1820s, the UK was pioneering the industrial revolution; things are not quite the same today. Back then, the UK did not have to worry about pension liabilities or existential threats to the banking system that could require massive injections of cash to fix.

From the Depression to the mid-1970s, as empire faded, the UK's credit performance was less than stellar. During the 1930s, Britain defaulted on debt to the US accumulated during the first world war and its aftermath. Though all but forgotten today, the UK's Depression default was arguably of comparable magnitude to some of the more spectacular emerging market defaults of the past three decades once eventual recovery rates are taken into account. This was arguably an "excusable default" but it is not a forgettable one.

It is often stated that after the second world war the UK debt reached almost 250 per cent of gross domestic product and was brought down merely through growth and inflation. This is a myth. As Carmen Reinhart has argued in her work on financial repression, had the UK not used a labyrinth of rules and regulations to hold nominal interest rates on debt below inflation, its debt-to-GDP ratio might have risen over the period 1945-55 instead of falling dramatically.

Then there is the high-inflation era of the 1970s – another de facto default. Last but not least, what about the UK's serial dependence on International Monetary Fund bailouts from the mid-1950s until the mid-1970s? This is hardly a country with an indestructible credit status.

From early 2010 until quite recently, there was every reason to worry about a disorderly exit from the eurozone potentially blowing up the whole thing. This was the big call – the one that everyone was focusing on. To state that credit risk was gone by 2010 is ludicrous. None other than The New York Times columnist Paul Krugman prognosticated the euro's early demise regularly from April 2010 to July 2012. His big call has turned out – so far – to be dead wrong. But his estimate underscores the uncertainty policy makers faced – and inconsistency in the debt panglossians' advice.

On the one hand, they were berating the UK government for worrying about large deficits and soaring debt. On the other hand, they were saying that its greatest fear was likely to materialise. I suppose one could argue that a collapse of the eurozone would have caused a stampede into gilts. Maybe. But this was a country that was still running twin current account and fiscal deficits. More likely, a euro collapse would have triggered a stampede out once investors realised that the UK banks and trade would be savaged, a flexible currency notwithstanding. In that scenario, UK leaders would have been forced to close massive budget deficits almost overnight. That would have been truly catastrophic austerity.

We now know the euro did not collapse. With 20-20 hindsight, yes, the UK could have borrowed more. But we do not have hindsight at the moment decisions have to be taken. To pretend we always knew everything would be fine, and to assess performance accordingly, is just plain bunk.

I am certainly not arguing that the UK or other advanced countries handled the post-crisis period perfectly. There should have been more infrastructure spending, even more aggressive monetary policy and probably more ruthless bank restructuring. But there has to be a balance between stimulus and stability. To assume we always knew things would calm down, and to retrospectively calibrate policy advice accordingly, is absurd.

The writer is a professor of economics at Harvard and co-author of 'This Time is Different'