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Healthy debt management can help raise living standards, but has the West finally learned to pay its bills?
*Charles Purdy*

SO WHAT POSSESSED us to take on so much debt? Did we really think that the good times would last forever and that we could have it all at somebody else's expense? It seems like it.

Warren Buffet has a saying, "when the tide goes out you find out who isn't wearing a swimming costume". I think this sums up the current economic situation here in the western world nicely. The tide is well and truly out and the number of people without a swimming costume is reminiscent of a busy nudist beach in Spain, where the sun and sea are warm, rather than a nudist beach in Brighton, which is only for a very few brave bathers. And most of the swimmers are suffering acute sunburn, especially in parts the sun doesn't often reach!

It also surprises me that more time isn't spent in school teaching the effect that compound interest has on debt. It doesn't take long for a debt to double if interest rates are ten percent and the interest isn't being paid off. And how many people work out how much interest they would pay over the life time of a 25-year property mortgage? If they do it becomes quite chastening.

So why is, or was, debt so popular? Two main reasons: the ability to buy or pay for something earlier than you could have done without using debt and/or the ability to increase the value of your purchase by using the cash flow from your purchase to pay back the debt over time. When economic conditions are good it all seems to work. However, when the economy hits the buffers, debt can destroy what was considered to be a healthy business as falling profits make interest payments and debt repayments unsustainable out of cash flow.

Governments also like to borrow as it allows them to pay for services in excess of those that would be possible just out of tax revenue. The last Labour government under the auspices of Gordon Brown were the masters of finding ways to borrow ever more money. Gordon Brown was convinced he had developed a new economic Shangri-La where boom and bust were a thing of the past. Perhaps he thought it was for the greater good but it seems to have been alchemy at best. Or perhaps he just wanted to ensure that the voters loved Labour. It is always difficult for politicians when trying to make a dispassionate decision if it could lose you votes in the process.

WHEN THE ECONOMY HITS THE BUFFERS, DEBT CAN DESTROY WHAT IS CONSIDERED TO BE HEALTHY BUSINESS

With the government change here in the UK we saw a complete change in government policy. There was a realisation that things could not go on as they had been. Austerity measures came to the fore and interest rates were slashed. Action had been taken which the markets appreciated and the credit status for UK government debt maintained its AAA rating. The benefit of this credit rating is very significant as it means that the interest that the UK government pays on its debt is low and much lower than some of our European neighbours. In fact, it has meant that we are paying much less in interest than the government originally budgeted.

But what of the eurozone? The southern states of the eurozone – Spain, Greece, Italy and Portugal – have very significant debt problems as their credit status has been downgraded. This means that they are having to pay record levels of interest which they can't afford to do as their economies are in or very close to recession, which means that their tax receipts are down and their other expenditure, such as unemployment payments, are up. The view is that if the interest rate they have to pay on their debt exceeds seven percent then their debt becomes unsustainable.

And what of the banks? In every debt transaction there has to be lender as well as a borrower, and when the debt goes pear shaped the lender, normally a bank, loses out. And with so much concern about government and business debt, the value of the banks' loans are viewed as being very suspect.

The net result of this is that the banks' balance sheets are weak, which has the knock-on effect of reducing the ability of the bank to lend more money. And this seems to be a significant factor in allowing the western world economies to grow at a reasonable rate.

So given this, the conclusion seems to be that debt is an important factor in helping the western world to grow and allow ever improving living standards. The danger arises when the borrowers [and the lenders] don't adhere to prudent levels of debt and/or make realistic assumptions as to future cash flows. Human nature being what it is combined with the lack of common sense possessed by our politicians, this seems very unlikely. □

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