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Lessons from history on public debt: Hows did the UK's Fiscal Famine and Monetary Necrophilia Work in the Inter-War Period?

By Martin Wolf

What happens if a large, high-income economy, burdened with high levels of debt and an overvalued, fixed exchange rate, attempts to lower the debt and regain competitiveness? This question is of current relevance, since this is the challenge confronting Italy and Spain. Yet, as a chapter in the International Monetary Fund's latest World Economic Outlook demonstrates, a relevant historical experience exists: that of the UK between the two world wars. This proves that the interaction between attempts at "internal devaluations" and the dynamics of debt are potentially lethal. Moreover, the plight of Italy and Spain is, in many ways, worse than the UK's was. The latter, after all, could go off the gold standard; exit from the eurozone is far harder. Again, the UK had a central bank able and willing to reduce interest rates. The European Central Bank may not be able and willing to do the same for Italy and Spain.

The UK emerged from the first world war with public debt of 140 per cent of gross domestic product and prices more than double the prewar level. The government resolved both to return to the gold standard at the prewar parity, which it did in 1925, and to pay off the public debt, to preserve creditworthiness. Here was a country fit for the Tea Party.

To achieve its objectives, the UK implemented tight fiscal and monetary policies. The primary fiscal surplus (before interest payments) was kept near 7 per cent of GDP throughout the 1920s. This was, in turn, accomplished by the "Geddes Axe", after a commission chaired by Sir Eric Geddes. This recommended slashing government spending in precisely the way today's believers in "expansionary austerity" recommend. Meanwhile, the Bank of England raised interest rates to 7 per cent in 1920. The aim of this was to support the return to the prewar parity. Coupled with the consequent deflation, the result was extraordinarily high real interest rates. This, then, was how the self-righteous fools in the British establishment greeted the hapless survivors of the hellish war.

So how did this commitment to fiscal famine and monetary necrophilia work? Badly. In 1938, real output was hardly above the level of 1918, with growth averaging 0.5 per cent a year. This was not just because of the Depression. Real output in 1928 was also lower than in 1918. Exports were persistently weak and unemployment persistently elevated. High unemployment was the mechanism for driving nominal and real wages down. But wages are never just another price. The aim was to break organised labour. These policies resulted in the general strike of 1926. They spread a bitterness that lasted decades after the second world war.

Quite apart from their huge economic and social costs, these policies failed in their own terms. The country went off gold, for good, in 1931. Worse, public debt did not fall. By 1930, debt had reached 170 per cent of GDP. By 1933, it had reached 190 per cent of GDP. (These numbers put the panic over today's far lower ratios in perspective.) In fact, the UK did not return to its pre-first world war debt ratios until 1990. Why was the UK unsuccessful in lowering the ratio of debt to GDP? Briefly, growth was too low and interest rates too high. As a result, even a huge primary fiscal surplus could not constrain the debt ratio.

The story is relevant to the eurozone today. To regain competitiveness quickly, rather than eke out adjustment over a decade or more, wages need to fall. To achieve that unemployment must be very high. In the case of Spain, it is. But, even with unemployment at 25 per cent of the labour force, nominal wages have risen little less than in Germany since the crisis (see chart). Meanwhile, Spain's real GDP is shrinking. Efforts to tighten fiscal policy are sure to reduce it further. So are the high interest rates, as foreign and domestic capital flees.

All this risks putting Spain into a debt trap, in its case one that threatens both private and public sectors. Italy, a country with a smaller fiscal deficit but higher public debt, risks falling into a similar trap if interest rates remain high and GDP weak. This is why the European Central Bank's plan to lower interest rates on public debt in these countries is a necessary condition for escaping the disaster of simultaneous fiscal defaults and banking collapses. But it is not a sufficient condition for an escape. Prospects for growth must improve.

The IMF looks at a number of other interesting cases. The post-second world war reduction of US public debt is one. Another is the experience of Japan over the past two decades, which has parallels with the UK in the 1920s and 1930s, particularly as regards deflation. Other cases are Belgium in the 1980s, and Canada and Italy in the 1990s.

The most important conclusion is that fiscal consolidation is impossible without a supportive monetary environment, with ultra-low real interest rates and a buoyant economy. Japan failed on this in the 1990s and 2000s, as did the UK in the 1920s and 1930s. The ineffectiveness of monetary policy in countries with leveraged private sectors, such as the UK and US today, creates similar constraints, as the UK government is learning. Inflation has also accelerated the lowering of public debt burdens in the past. It would be surprising if it did not do so again.

My criticism of the chapter is that it does not put efforts to lower fiscal debt into the context of what is happening to private indebtedness. It is far harder to control fiscal deficits if the private sector wants to lower its own excessive indebtedness too: less spending by one side means less income for the other. In the absence of strong external demand, the result is then likely to be deleveraging via default and depression. That is the worst imaginable outcome.

Nevertheless, this is an extremely useful study, not least for bringing out the lessons of the UK's interwar experience for the eurozone today. There is a high risk that the combination of tight fiscal policies with stringent monetary conditions will push Italy and Spain into debt traps via the interaction of high interest rates with low growth. At least the UK retained control over monetary conditions: in the end, it went off gold and lowered interest rates. Members of the eurozone do not have those painless options. But fiscal austerity and efforts to lower wages in countries suffering from monetary strangulation could break societies, governments and even states. Without greater solidarity, the story is unlikely to end well.

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