Funding the Future

The most important piece of economics that you should k…

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I am cross-posting this from Prof Charles Adams, writing on Progressive Pulse yesterday, with his permission:

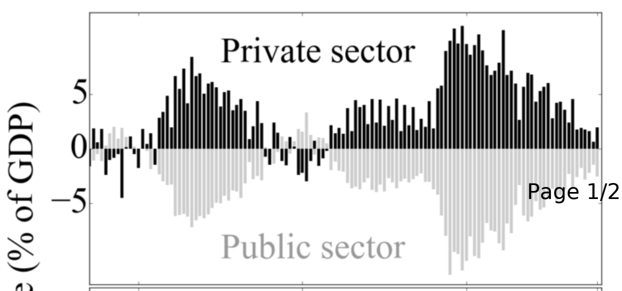
[Sectoral balances](#) may not sound like something you need to know, but if you will give me a moment I will try to convince you. It might change what you do.

We are all familiar with whether our bank account is in the black or the red. Sectoral balances are the same, except that now we are talking about the accounts of groups (or sectors) rather than individuals. You and I are part of the household sector. There is the government sector, a business sector (which is often sub-divided into financials and non-financial), and a rest of the world sector (which is related to our trade surplus or deficit).

There are few things in economics that are true so when we find one we should cling on to that. Something that is true is that the sum of all sectors is zero. This is a simple accounting identity. Basically, someone (or sector) can only be in surplus because someone else (or another sector) has lent them the money.

If we aggregate all the sectors into only just two, public and private, then it follows summing to zero means that when we plot their respective surpluses or deficits they will be a mirror image of one another. In words, the public sectors deficit is the private sectors surplus or as vice versa, or as Stephanie Kelton puts it succinctly in [this video](#), the governments red ink is our black ink.

To see this mirror effect, below I plot the public/private sectoral balances as percentage of GDP going back to 1987 (all data is available from the ONS website, e.g. [central goverment time series](#)). Surplus is above the line, deficit below. Most of the time, the government is in deficit and the private sector is in surplus — the governments red ink (or grey in this plot) is our black ink!



Now a related interesting question is, why is a government not like a household? Why can government maintain a deficit forever whereas households cannot? The answer is very simple. The income of a household is time-limited, whereas the state goes on forever (barring occupation by a foreign power). A government can simply roll over a debt ad infinitum. The [UK has debts that date back to the South Sea bubble of 1720](), and it is only worth repaying them if interest rates fall below historical levels which for very old debt has become the case recently. In 2015, George Osborne proudly announced how he would be paying back some one hundred year WWI debt, but this only made sense because the economy was doing so badly that interest rates were lower than when the debt was issued.

Now let's come to the household sector (you and me) which as we know operates on different time scales. You and me are time limited. We cannot roll over a debt for decades or centuries. In the lower plot, I show the household sector on its own. This is really interesting. As you see households are mainly in surplus — they are saving rather than spending. Only very occasionally do they slip into deficit (red) — spend more than they save. This happened around 1988. If individuals spend more than they earn then eventually they have to stop, spending falls and the economy stalls. The result of the 1988 household deficit was the recession of the early 1990s. During a recession, households are, on average, repairing their balances sheets, i.e. saving rather than spending. Consequently, during and after a recession, we see a large private sector surplus and therefore necessarily a large public sector deficit — the mirror effect. This happened in both the mid-90s and after the recession of 2008.

Given what I have described, the most shocking part of the household data is what happens after 2016 — follow the big red arrow. We have entered a period of household deficit of a magnitude and duration that is unprecedented in our history.

Good luck, if you think this is going to turn out well.

For further discussion, see here and here.