Debt is the new Black Death. Something not just to be avoided, bur feared and shunned by all sensible people. And Gordon Brown's government appears to have the plague spots written all over it. In the financial year 2007/08, British government debt totalled just over £500 billion. The Treasury now project this rising to nearly £1,400 billion by 2013/14.

£1,400,000,000,000! A stupendous figure, yet one which many outside commentators regard as a potential underestimate. Surely Britain either already is or will soon become bankrupt?

It is not just hedge funders and traders in financial markets who are looking askance at these numbers. For many on the Left, the word 'debt' has become virtually synonymous with gross moral turpitude, with all the alleged evils of capitalism, whether real or imagined.

We need to step back and put the situation in a wider perspective. Most of the time, debt is a Good Thing for an economy to have. For example, companies with new plans, new ideas, need loans in order to translate them into reality. These often fail, but when they succeed, the rewards can be spectacular. Think Microsoft, think Google.

Governments, too, need to borrow to finance large infrastructure projects. Crossrail, for example, has a price tag of some £20 billion, and it is simply good sense to borrow this money, at least in part.

Occasionally, of course, debt gets out of hand and causes economic explosions. The Great Depression of the 1930s is the classic example, and the current recession looks set to be one for the economic history textbooks of the future.

But these are very rare events. The Great Depression has such a strong grip on economic folklore precisely because it was a unique event. There was a debt-fuelled banking crisis in the early 1990s, but this was confined merely to Scandinavia. Their banks had long agitated to remove exchange controls, and the governments eventually complied. The banks used the opportunity imaginatively to invest in European commercial property at the very height of the late 1980s boom, and the subsequent collapse bankrupted them.

In the 20th century as a whole, the 1930s aside, there were hardly any serious financial collapses in the West. True, there are lots of examples of economic recessions. But most of these lasted just a single year, and hardly any for more than two. Capitalism has the dynamism, almost all of the time, to recover of its own accord. A serious financial crisis is something else altogether.

So the current circumstances really are most unusual. And the actions of the American authorities have reflected this fact. In September 2008, the American government created a stupendous amount of debt. But in doing so, they really did save the world. Without their actions, the world would already be in a recession on the scale of the 1930s.

They nationalised the two main mortgage companies, Freddie Mac and Fanny Mae, they bailed out the insurance giant AIG, they eliminated investment banks, they forced huge retail banks to merge, they guaranteed money market funds. Oh, and yes, they did bring in the Troubled Asset Relief Programme (TARP) amidst a welter of controversy and grandstanding. But TARP was merely one of the actions the Americans took to avoid a repeat of the 1930s. It got most of the publicity because it involved the political process of getting through Congress and the Senate, the other acts, in many ways even more decisive in terms of impact, were purely administrative decisions.

Even despite all this action, output in Germany and Japan is falling faster than at any time since the Second World War, and in Britain and America the falls in GDP are matching those of the early 1980s, the biggest recession since the 1930s.

Set in this context, in circumstances which are truly unusual, it isn't strange to see governments doing unusual things - like increasing public sector debt massively to bail out the financial system. It would be far stranger indeed if this were not happening at all.

We can all have our various quibbles about the details of how the bail out has been done. We are also allowed to jump up and down in rage at the rewards which pompous and arrogant bankers have trousered.

But the abiding lesson from the 1930s is that, in a financial crisis, banks are more important than individuals. No matter how much money individual people might lose or gain, the monetary authorities have ultimately to defend banks and not people. Indeed, we saw a glimpse of what might have happened when the American let Lehmans go bankrupt. It rapidly became clear, within a matter of days, that this was simply one experiment too far

What, then, is the problem? Why has the media become seemingly fixated on the projected increase in debt by the British government? The figures are big, almost unimaginably so. But the circumstances seem to warrant something along these lines.

Certainly, when we set the British experience into an international context, the hysteria does not appear to be justified. To make comparisons, we need to look at not just the absolute amount of debt in the domestic currency, whether pounds, Euros, dollars or whatever, but this relative to the size of the economy. Britain's debt, for example, would dwarf the Irish economy, but look small in the context of the much larger American one. We can usefully think of the ratio of debt to the size of the economy (GDP) as being the same concept as the size of an individual's mortgage relative to his or her income

So, as I write these words, I read in the newspaper that the Italian government has revised upwards its forecasts for public sector debt relative to GDP. In 2009, Italian debt will be 114 per cent of GDP, rising to 118 per cent in 2011. On a comparable basis, Britain's figures are 72 and 87 per cent respectively.

If we were not well-behaved readers of the *New Statesman*, we might react to this news about Italy with a stereotypical shrug of the shoulders, ah, these Italians, they do things differently. But what about the prudent Germans? In the 1997-2006 decade, for example, before the current problems started to materialise, German public sector debt relative to their economy averaged 64 per cent. In the United States, the average was 61 per cent, and in Japan a massive 164 per cent. The bursting of the late 1980s boom in Japan was spectacular, with shares falling in value by 75 per cent and Tokyo land values by some 90 per cent. The Japanese government reacted to the resulting banking crisis in fits and starts over the course of a decade or so. But the cost of these initiatives mounted up, and now stands at a cumulative figure of some £1,000 billion.

So where is the profligate UK in this international pantheon? Well, in the 1997-2006 period, our public sector debt averaged just 46 per cent of GDP. And literally every government is projecting large increases in debt over the next few years.

An obvious worry is what the debt is costing us, regardless of which country is our focus. Just like a domestic mortgage, there are two separate components, the interest payments and the eventual repayment of the capital sum.

So in the UK, for example, the government offers for sale what have been known since time immemorial as gilts – from the phrase 'gilt-edged', meaning that if the British government and not Johnny Foreigner backs them, you are certain to get your money back. The gilt states the interest which will be paid, and the date the government will repay the holder at the relevant time. Of course, the holder then may very well not be the original purchaser, gilts like shares can be traded on a everyday basis. The repayment date can vary between just a year or as long as 20 or even 30 years into the future

Unlike a personal mortgage, repaying the capital sum isn't something governments, at least those in stable Western democracies, have to worry about too much. When one tranche of gilts comes up to its repayment date, it is usually not a problem just to issue a new set if the government wants to. Obviously, if all the £1400 billion debt came up for renewal at the same time, there might well be problems in persuading investors to refinance the whole lot. But provided the Bank of England is reasonably professional and astute, the repayment dates can be spread out over the next two or three decades. The debt still has to be paid back, but not all at once

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Since the Second World War, all governments have had an important ally in their programme of rolling over and re-financing their debts. Inflation. When a pension fund, say, buys part of a new issue of gilts, the amount which the government agrees the repay on the due date is fixed in money terms. But inflation means that when payback time comes round, this fixed amount is worth much less. A simple example illustrates the point. I borrow £100 today and promise to pay it back in 10 years' time. If inflation averages 3 per cent a year, that £100 is only worth £74 when I make the repayment. If I borrow over 20 years, its value drops to £55.

Inflation erodes the value of debt denominated in cash terms. Here is a real example. At the height of the crisis of the mid-1970s, public sector debt in the UK reached 52 per cent of GDP. In the prices of 1975, the value of that debt was £65 billion. By 1991, debt had fallen to just 26 per cent of GDP. A crucial reason was that over the intervening period, high inflation had eroded the real value of £65 billion in 1975 to just £15 billion in 1991.

So one of the current worries about government debt is that we might be about to live in a zero inflation world. Indeed, the price level is actually falling in America, where we currently have negative inflation. And just as positive inflation erodes the real value of debt, negative inflation increases it. Objectively, any government of a large Western economy should have little difficulty in refinancing its debt over a period of time. But markets are far from rational. And the idea that governments might have to refinance the current levels of debt with real rather than with inflated money is causing knitted brows.

A matter of genuine concern is the stream of interest payments which has to be paid over time to holders of the gilts. If debt is 100 per cent of GDP, say, and the average interest rate on the debt is 5 per cent, then 5 per cent of GDP has to be paid out in interest by the government each year. In the current UK context, this would be around £75 billion a year in cash terms. That's £75 billion which can't be spent on state benefits, which can't be spent on the NHS, which can't be spent on education. It has to be paid to whoever is holding the gilts at the time. And it is this stream of interest payments which ultimately sets a limit to the sustainable size of a government's debt.

But this does not mean that at the moment the country is in any sense bankrupt. Britain remains a large, vibrant capitalist economy with the ability to generate this sort of cash. Further, a substantial part of these interest payments will remain entirely within the UK's borders. Pension funds are major purchasers of gilts, for example, so the interest they receive will simply be paid out the British pensioners.

The interest payments on gilts do not just end up in pension funds. Some gilts will be bought by foreign asset managers, though the impact of this on the UK will be partly offset by our funds buying foreign government debt and receiving interest payments from them.

However, wealthy individuals are also holders of gilts. So the stream of interest payments diverts money from public spending to this particular group. . Keynes thoroughly disapproved of this process, labelling such people as 'rentiers'. In other words, people who lived off rent and interest payments. He looked forward to a time which would usher in, using his phrase', the 'euthanasia of the rentier'. But even Homer nods. On this at least, Keynes was completely wrong.

So there are definite downsides of building up so much public sector debt. But, whether it is in terms of international comparisons, or of our ability to refinance the capital sums involved, or even to pay the interest, the government appears to be getting a bit of raw deal on this matter. Or is it?

At heart, the problem for the government is that this massive expansion of debt has served to focus attention on Gordon Brown's economic incompetence. When the economy was doing well, instead of repaying debt, he and his acolytes invented a bogus rule to justify continued public sector deficits. He proclaimed, ludicrously, the end of boom and bust.

But, above all, the debt figures crystallise the feeling that Brown has encouraged a public sector culture of wasting money on a truly Soviet scale. Billions upon billions are spent on useless computer schemes, health and education in Scotland have gone backwards despite the stupendous sums lavished on them, executives at public agencies dedicated to relieving world poverty receive £1 million a year. The list could go on and on.

Ironically, much of the increase in debt does have a sound economic basis as the inevitable consequence of a massive financial bail out. But the perception is that it is going not in investment to rebuild the economy, but in hand outs to the public sector middle class to sustain their private consumption levels, at exactly the time when everyone else is feeling the pinch.

END Paul Ormerod 3 May 2009

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