

CUTTING GOVERNMENT BORROWING: DAMNED IF YOU DO AND DAMNED IF YOU DON'T?

A real difference or not?

At first glance, the dispute among economists about how and when to cut the level of government borrowing, waged through letters to newspapers, seems to have had no decisive impact.

The comfort that the Conservatives could take from the first letter to the Sunday Times, calling for faster cuts,¹ was neutralised by the comfort that Labour could take from the responses to it, broadly supporting the government's current plan.²

As the dispute subsided, the general view among commentators seems to have been that the difference between the two sides was fairly slight anyway.³

It is certainly true that a reading of the letters which gives weight to the qualifications each side attaches to its main argument can support this view.

The highlight of the first letter was its call for a 'credible medium-term fiscal consolidation plan'. In plain terms, this meant a clear commitment to deeper cuts in government spending than are currently planned, with the new measures starting to take effect in the financial year beginning this April. However, this last point was qualified by the statement that the exact timing should 'be sensitive to developments in the economy, particularly the fragility of the recovery'.

In response, the second letter agreed that fiscal consolidation would indeed be necessary – and that the 'timing of the measures should depend upon the strength of the recovery'. But 'the priority', in its view, 'must be to restore robust economic growth'.

Looked at like this, both parties to the dispute are making the same, connected points, the only difference between them being one of emphasis and perhaps timing.

Yet the inference which has been drawn from this, that there is no real difference here, is not only wrong but dangerous. These economists are not just engaged in some arcane internal wrangle. Rather, they are trying to alert outsiders – politicians and policy makers of course but also the general public who are shortly to give their verdict on those politicians – to the perils that they see in the present situation. Instead of being lulled by the similarity of their conclusions, we should be alarmed by the fact that the perils highlighted by each side are different – and not in the least mutually exclusive.

¹ Sunday Times, 14 February 2010, 'UK economy cries out for credible rescue plan': <http://www.timesonline.co.uk/tol/comment/letters/article7026234.ece>

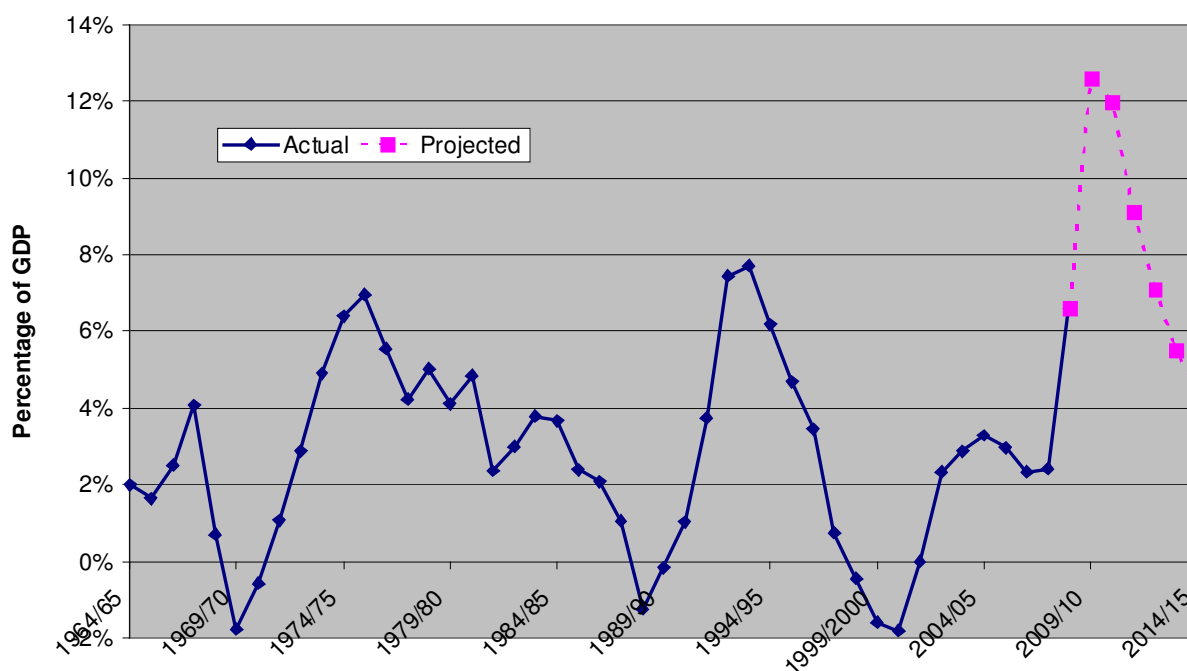
² Financial Times, 18 February 2010, 'First priority must be to restore robust growth': <http://www.ft.com/cms/s/0/84b12d80-1cdd-11df-8d8e-00144feab49a.html>

³ See, for example: BBC, 19 February 2010, 'Fiscal reductio': http://www.bbc.co.uk/blogs/thereporters/stephanieflanders/2010/02/fiscal_reductio_ad_absurdum.html or The Telegraph, 19 February 2010: 'War of the economists is not what it seems': <http://www.telegraph.co.uk/finance/comment/jeremy-warner/7272244/War-of-the-economists-is-not-what-it-seems.html>

The fears of the fiscal consolidators

What so concerns the first group, or 'fiscal consolidators', is the unprecedented amount of money that the government is now having to borrow. The first graph below, which combines historical data back to the mid 1960s with projections from the 2009 Pre-Budget Report up to 2014/15, shows the annual amount as a percentage of the overall size of the economy (GDP). It is easy to see why they are worried: quite simply, the UK is now in uncharted territory with the projected deficits in the current year and the two following completely outside the range of previous experience. Even the two years either side of this are still in the other worst half dozen.

Public sector net borrowing as a percentage of GDP: annual 1964/65 to 2014/15



Sources: Economic and Labour Market Review, January 2010, tables 5.05 (ANNX) and 1.03 (YBHA); Pre-Budget Report 2009, table B2

The government and its economist supporters would point to the way in which the graph shows how current plans will bring this deficit down sharply, to just over 4% in 2014/15.

Yet fiscal consolidators remain unconvinced. One problem is that this target, in effect beyond the lifetime of the next parliament and therefore too distant to be binding on government, is unconvincing. Another is that it assumes that the economy will grow at 3¼% a year from 2011/12 onwards. Although within the range of historical experience (being comparable for example with performance in the late 1990s), it is certainly optimistic. Even the growth for the year beginning in April, of 2%, though lower than the long term average, would still mean a sharp recovery from recession in the next few months. In short, unless conditions are really very favourable, the deficit reduction in future years will fall short of the projection.

If this is why the fiscal consolidators are fearful, what they are fearful of is the financial institutions' reaction to these deficits. One possibility is that while the government is still able to borrow the money it needs, it has to pay a higher rate of interest. Besides increasing the amount of money that tax payers will have to pay back in future years, the resulting higher interest rates will reduce firms' willingness to borrow and invest, thereby depressing future economic growth.

The other possibility is that the institutions with the money to lend so lose confidence that they eventually decline to lend the government the money it needs. Were that to happen for any length of time, the result would be an acute economic and financial crisis, with severe consequences.

It is to reduce the likelihood of each of these outcomes that the fiscal consolidators want measures to be taken in the next few months to reassure those, both in the UK and abroad, from whom it expects to borrow the unprecedented sums of money it will need over the next few years.

How should we react to this? My first reaction [link to ES] was that the letter offered too slight an explanation of how their proposal for earlier and deeper cuts would help. Up to a point, I think that reaction still stands. In particular, while the fears expressed are all too easy to envisage, we were – and are – offered no evidence that can help ascertain either the likelihood of the problems actually materialising, or of how big a change in policy would be needed to head them off.

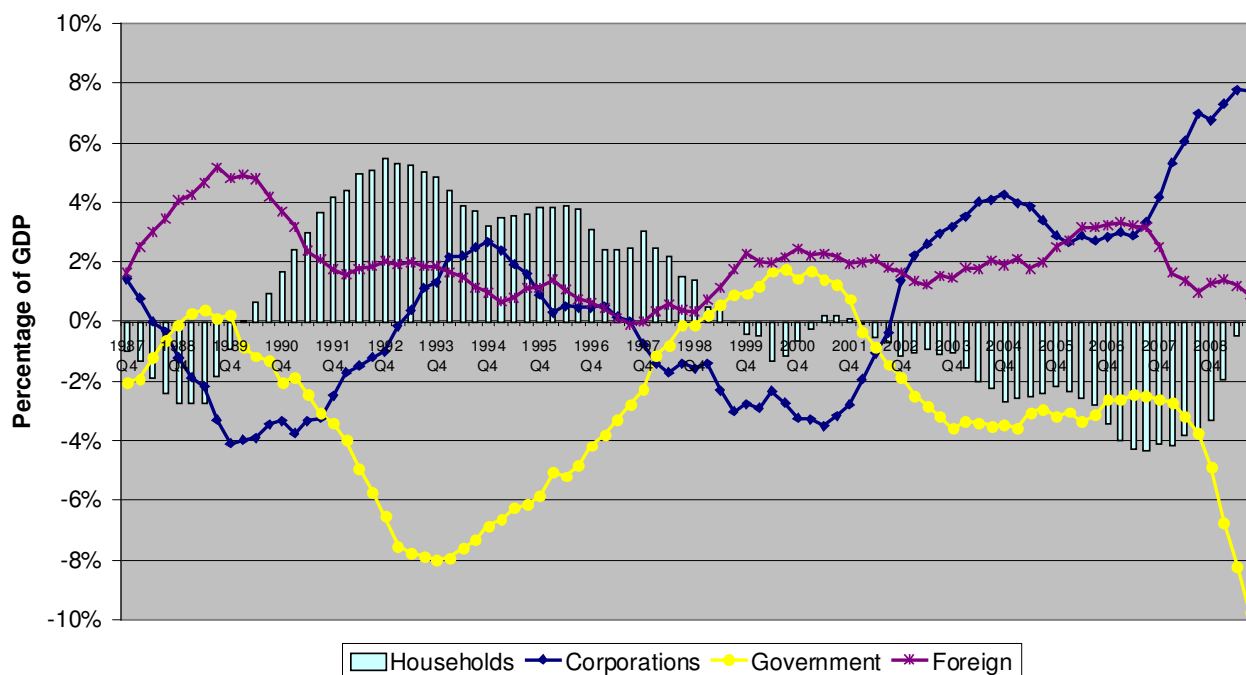
Yet at the same time, neither can the concerns simply be dismissed. Self evidently, the size of the deficit is unprecedented. It is far from clear that the projected downward path is assured. And confidence is a vital element in the workings of the economy even in the best of times, never mind the much more challenging circumstances which now prevail.

The fears of the 'growth first' group

The fear of the 'growth first' group is that a reduction in the government deficit – cuts in public spending and/or rises in taxes – in the present situation will return the economy to recession. The unprecedented rise in the government deficit is a response to the severe recession of the last two years providing the 'extraordinary public sector fiscal and financial support needed to prevent the UK economy falling off a cliff'.

The sense that the rise in the government deficit is largely a reaction to changes in other parts of the economy is portrayed in the second graph. Here, the economy is divided into four sectors – government (or public sector), households, corporations and foreign – with the financial surplus or deficit (as a proportion of GDP) at each point in time shown for each sector. In effect, the line shown here for the government is the mirror image of the line shown in the previous graph.

Financial surplus (+) or deficit (-) by sector: four quarter moving average 1987Q4 to 2009Q3



Source: Financial Statistics, January 2010, tables 11.1B (EABO), 11.1E (NHCQ), 11.1K (NNBK), 11.1N (NSSZ) and 11.1O (NHRB) and GDP (YBHA), via ONS time-series statistics

As a result of the way in which the national accounts statistics are compiled, the four sectors' surpluses or deficits at any one time add to zero. This means that a change in any one of the lines must be matched by a combination of changes in the others. So it is that the steep deterioration in the government deficit since 2007 has been matched by a steep increase in the surplus of corporations and a steep reduction (to such an extent that it has become a small surplus) in the deficit of households.

Particularly notable is the change that has taken place in the household sector, moving from net borrower to net saver for the first time in some ten years. Indeed, as recently as 2007, this sector's deficit was actually bigger than the government's.

Although its supporters don't do so themselves, one way of putting the 'growth first' argument is this: if the government is to succeed in cutting its financial deficit, which of the other sectors of the economy is expected to reduce its surplus/increase its deficit in order to allow this to happen?

The easy answer from a UK point of view is 'the foreign sector'. If exports rise or imports fall then foreign sector savings are indeed reduced accordingly. But there is no reason to believe that a cut in government spending would boost exports. A cut in imports is likely, but only via reduced levels of spending by households and businesses, that is, by a return to recession.

The best answer would be that corporations greatly reduce their level of saving, using the money instead to undertake investment. As the graph shows, there are periods in which corporate savings have fallen (the late 1980s, the mid 1990s to the end of the decade) and these have accompanied spells of strong economic growth. That is not the same thing, however, as growth led by investment – which is what would be needed here.

The most likely answer is that the household sector will have to start reducing its surplus first. Certainly, in the last recession in the early 1990s, the household surplus was the first to fall, accompanying the start of the improvement in the government deficit in 1992. But it is a moot point whether it is either desirable or even possible for the household sector to start reducing its surplus any time soon given how deeply it has been in deficit since 2002.

But while this is an argument against the fiscal consolidators it also points to weaknesses in the growth-first position.

First, if the government deficit is all that has stopped the ‘economy falling off a cliff’, why not actually increase the deficit further in order to drive the economy further away still from the edge of the cliff? Although I doubt many would support it, that would seem to be the logic of the growth-first position.

Second, in making ‘robust economic growth’ the priority and deferring moves towards greater fiscal consolidation until it has been restored, the growth-first group is assuming away the problem of how that is supposed to happen. That is because the argument against making deeper cuts now is also an argument against there being any realistic prospect of a return to robust growth in the near future. This will remain the case until either households or businesses show signs of being ready to reduce their financial surpluses or until the economies into which the UK exports, above all the Euro-zone, return to growth.

Conclusion: the public spending challenge

The lesson we draw from this dispute is not that the two groups of economists are almost saying the same thing but rather that they are pointing to different dangers which exist simultaneously – and will continue to do so for so long as growth remains weak.

What is perhaps surprising (and surely frustrating for those who have to act) is that there is no precision on either side as to when to act or how far to go. To overcome this, a view needs to be formed as to when, and under what circumstances, the private sector will once more have both the appetite and the capacity to be the engine of economic growth.

Assuming that the private sector will not be in a position to do this in the near future, borrowing and spending by government will have to continue. In these circumstances, the crucial question is how this money is spent and the value that we get for it. It is no more than common sense that there must be all the difference in the world between public spending that creates high quality, long-lasting assets and public spending that does not. Such assets don’t have to be restricted to physical things like houses or machines; a better standard of education or a higher level of training can also be seen in this way.

From that perspective, ensuring that the money is well spent, rather than straining to make the greatest possible cuts, is the formidable challenge facing the next government.

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24 February 2010