

We can survive a dip but we risk a fatal plunge

If growth falters and the coalition doesn't moderate its macho cuts, a vicious downward spiral beckons

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Who's afraid of a double dip? With world recovery slowing and the phoney war over deficits about to

escalate into serious tax increases and spending cuts, the newest member of the Monetary Policy Committee told *The Times* yesterday that Britain faces a significant risk of a new recession.

Martin Weale said that it would be foolish to rule out the possibility of a second downturn next year, well before the nation has had a chance to recover from the last crisis. This warning from the former head of the National Institute for Economic and Social Research, Britain's longest-established forecasting institution, triggered a plunge in the pound and a fall in the interest rate on ten-year British government bonds to 2.9 per cent, the lowest on record.

These rock-bottom rates are good news for homeowners wise enough to avoid apparent bargain fixed-rate mortgage deals of as much as 5 or 6 per cent a couple of months ago. But the collapse in long-term interest rates implies a drastic downgrading of Britain's growth prospects by investors over the summer.

The Government and the business community, however, seem unperturbed. Indeed, talk of savage spending cuts remains macho, especially among ministers and consumer company executives who seem to have most to lose from a new recession. Perhaps they have a point. If economic activity merely dips next year and unemployment briefly shoots up, it may not matter much except to

those who lose their jobs, businesses and homes. So long as any dip is followed by a quick rebound, the long-term prospects for sustained growth will not be damaged.

This is the calculation apparently being made by the Tory-Liberal coalition and by the vast majority of business leaders, who enthusiastically support its aggressive policy on public borrowing. There is, however, a frightening possibility that they seem unwilling to acknowledge: that a dip in economic activity next year could turn into a protracted plunge.

How serious is this risk? This must be answered in two parts. The first stage is to identify the forces that could cause Britain's economy to suffer a significant slowdown next year. The second issue is how policymakers, businesses and consumers respond.

The main reason to worry about a slowdown is the unprecedented magnitude of spending cuts and tax increases to be implemented next year. Many politicians and business leaders seem to believe that the public has been prepared for hard times by George Osborne's tough rhetoric in the Budget. They conclude from the

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fairly robust performance of the economy that consumer and business confidence have survived the announcements in the Budget and that the worst is over in terms of the public response to fiscal retrenchment. This is almost certainly wishful thinking.

Tax rises and spending cuts have hardly begun to be felt. Experience suggests that the effects of a fiscal tightening are only manifested with a six to twelve-month lag and certainly not before the measures have even been put into effect. It will only be in



They're cutting by how much? Martin Weale's gloomy forecast hit the pound

the middle of next year, after VAT has been raised to 20 per cent and millions of government employees and welfare recipients have seen their incomes cut or eliminated altogether, that the economic impact of the Government's fiscal policies can be judged.

On top of the pressures from fiscal policy, risks to the British economy from abroad have intensified in the past few months. The pace of recovery appears to have slowed abruptly, especially in the US, which appears to be heading for policy paralysis after November's congressional elections. Governments all over Europe are planning to cut almost as aggressively as Britain. Japan may be sliding back into recession as its inexperienced new Government clashes with a stubbornly incompetent Bank of Japan.

Which brings us to policy responses. If next year brings a slowdown instead

of the acceleration still expected by the Government, the Bank of England and most independent economists, the policy response could well make the difference between a transient double-dip and a prolonged, potentially catastrophic, recession.

Unfortunately, the key policy decision needed in the event of a slowdown would be one for which the Cameron Government seems totally unprepared. If growth comes to a standstill, instead of accelerating from 1.8 per cent this year to 2.4 per cent next year as Mr Osborne predicted in his Budget, then the Budget's revenue and spending targets will prove hopelessly out of kilter.

The precise impact of GDP growth on public borrowing is notoriously unpredictable, but there is no doubt that public debt levels are generally more sensitive to growth than to

changes in tax rates or public spending programmes. If a government responds to unexpected budget deficits caused by weak growth with tougher cuts in public spending or tax rises, growth is likely to slow further. The result will usually be an even wider deficit. If such a budgetary blow-out triggers further rounds of tax increases or cuts, the nation will find itself in what economists call a debt trap.

Such self-defeating deflationary spirals can be avoided if an economy is given a stimulus through interest-rate or currency policy that is even more powerful than the fiscal tightening.

This is what happened after Geoffrey Howe's notoriously tough 1981 Budget, when the pound was devalued by 40 per cent against the dollar, and after Norman Lamont's 1993 Budget, when interest rates were slashed by 6 percentage points, more than offsetting the defects of spending cuts and higher taxes.

But with interest rates already near zero and the pound very cheap against both the dollar and euro, there is little scope for more monetary stimulus. In that sense, Britain today is much more like Japan throughout the past two decades than the UK in 1981 or 1993.

A dip in the economy next year would make the Government's fiscal targets completely unattainable. At that point the coalition will have a clear choice. Either it will have to drop the promises of debt reduction that it has made its hallmark. Or it will condemn Britain to a prolonged recession and miss its fiscal targets anyway. Either way, a double-dip would definitely make the Government feel terrified.

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