



# **Slash and grow? Spending cuts and economic recovery**

Giles Wilkes

**CENTRE:FORUM**

## Table of Contents

<b>Executive Summary</b> .....	3
<b>Introduction</b> – the Conservative route to sustainable growth.....	4
Basic GDP maths.....	6
<b>What recent history tells us about government fiscal consolidations and growth</b> .....	7
Chart 1: 40 years of growth and government consumption.....	7
Chart 2: Percentage points contribution to growth: household consumption, capital expenditure and net exports.....	8
Chart 3: Percentage points contribution of government consumption and net exports to GDP growth.....	8
Chart 4: Effective sterling exchange rate, 1990-2009 (2005 = 100).....	9
<b>Looking forward – can we repeat the trick?</b> .....	10
Household consumption.....	10
Chart 5: Income growth, consumption growth and household savings ratio.....	10
Chart 6: The growth of household indebtedness.....	11
Government consumption – how fast will it fall?.....	12
Chart 7: Historic annual rates of growth of household and government consumption.....	13
The overall consumption ratio.....	14
Chart 8: Total consumption as a ratio of GDP, changes in the borrowing requirement.....	14
Capital Expenditure.....	14
Chart 9: Capital expenditure growth, with moving average.....	15
Chart 10: Government consumption against capital investment 1971 to 2009.....	16
Exports and imports.....	17
Chart 11: Export and import growth since 1980.....	17
Chart 12: Changes in exports and imports 2000-07, selected developed countries.....	18
Chart 13: The relationship between growth in home consumption and imports minus exports.....	19
<b>Putting it all together – what needs to be achieved</b> .....	21
Scenario 1: Making the Conservative scenario materialise.....	22
Scenario 2: Capital growth responds, net exports don't.....	23
Scenario 3: Emulating Germany 2000-07 – export-led growth, weak capital growth.....	24
Scenario 4: An increase in household spending, a lesser contribution from exports and capital.....	25
<b>Conclusions</b> .....	27
Appendix 1: Various sources for data.....	29
Appendix 2: Past components of growth from France, Germany and the USA.....	29

## Executive Summary

George Osborne has earned plaudits for taking a sombre and realistic view of Britain's fiscal situation, and promising 'honesty' about spending cuts. Unlike the Prime Minister, who as recently as June was still trying to deny that his Budget plans implied lower spending, it seems that the Conservatives are willing to adopt a hyper-austere approach to the deficit, even implying that the pain will be all out of the way within one electoral term.

Many words have been written about the implications of the Conservative approach for public services and living standards. Rather less attention has been given to the economic effects. There is now a strong consensus that the government was right to allow the deficit to expand in support of the economy, notwithstanding its culpability for previously allowing the structural deficit to grow. By opposing the fiscal stimulus, the Conservatives were left vulnerable to the charge that they would have deepened and lengthened the recession. But their views on how best to manage the economic recovery have found greater support. George Osborne claims that less government spending can help produce a boom in exports and investment that will deliver sufficient growth to achieve his objectives for deficit reduction. This approach has been endorsed by a number of credible economic actors and analysts – Goldman Sachs investment bank, the Confederation of British Industry, and NIESR amongst others

This short paper takes a look at this important claim. If Osborne is right, then a future Conservative government might fix many of Britain's problems in the space of four or five years, returning the private sector to increased savings and higher growth while dealing with the government's structural deficit. However, there are reasons to doubt whether this can be done. Past Conservative expansions relied very heavily on household consumption, which will surely be much weaker if their plans for closing the deficit are taken literally. The weakness of the world economy may undermine attempts to grow through exports. And unlike in previous recoveries, Britain is not emerging from a period of high inflation and interest rates: in fact, both are so low that there remain serious doubts over the efficacy of monetary policy.

After considering the likely constraints upon the different components of growth, we examine four different scenarios for the future path of the economy. The scenario that Osborne lays out is by far the most attractive - and the least likely. A failure of either of his central planks – net exports or investment – would leave the economy extremely weak, and the deficit large. A safer course would be to pursue a slightly less ambitious fiscal consolidation, allowing households to increase spending, and letting growth bear more of the burden of deficit reduction. Too narrow a focus on cutting the deficit, while hoping that growth will come from forces beyond the government's control, may result in neither objective being realised.

## Introduction – the Conservative route to sustainable growth

Conference season has brought an end to the ‘phoney war’ over public spending cuts and tax rises. There is now real distance between the parties’ views on the pace of spending cuts, with the Conservative party signalling that it would reduce the deficit faster than Labour<sup>1</sup>. Finally, we have an economic debate between the parties about the economic effects of fiscal policy.

Over the long term, it is clear that the UK needs a more sustainable economic structure. In the words of Mervyn King, the UK needs “to rebalance the economy, with more resources allocated to business investment and net exports and fewer to consumption”.<sup>2</sup> The National Institute for Economic and Social Research (NIESR) also regards a shift out of consumption and into exports as both necessary and inevitable. They forecast three consecutive years of lower household consumption and weak overall growth out to 2011.<sup>3</sup>

But a crucial question remains about the timing of government cuts, and whether the broader economy can withstand the impact of sharp fiscal retrenchment. This is where political divisions have emerged. In simple terms, Labour and the Liberal Democrats line up with the Keynesians. They hold the view that cutting the government deficit too fast will cause growth to plummet, unemployment to soar – and might in the end not even result in lower debt, since the country’s productive base would be damaged. So the government needs a plan for fiscal restraint, but should not enact it until the economy is recovering sustainably: a position Vince Cable refers to as ‘Augustinian’ after the early Christian saint who prayed to be virtuous, but not yet.

The Conservatives, on the other hand, hope that easy monetary policy will help boost growth through exports and higher business investment. Shadow Chancellor George Osborne has argued that his policy of prioritising debt-reduction would help in this regard. In a recent speech, he asks:

“What about the argument that cutting spending risks undermining the recovery by reducing demand in the economy? Not only does this argument ignore the risks of a loss of confidence and higher interest rates, it is also too simplistic. It ignores the impact of fiscal policy on the exchange rate in an open economy like the UK”.<sup>4</sup>

Osborne quotes Ben Broadbent of Goldman Sachs who says fiscal tightening in an open economy “has little appreciable impact on aggregate output”. This is an orthodox view for the behaviour of economies in ordinary conditions. In the leading textbook, *Macroeconomics*, Olivier Blanchard writes “a reduction in the budget deficit does not affect output forever. Eventually, output returns to its natural level . . . but the price level and the interest rate are lower than before the shift.” In essence, with lower interest rates and a weaker currency, investment and net exports rise to replace lost government spending.

Philip Hammond, the shadow Chief Secretary, recently suggested that fiscal austerity might be out of the way within a couple of years, and “that within five years Britain could be enjoying growth similar to the mid-1990s, when the economy raced ahead at

---

<sup>1</sup> Guardian, ‘Conservatives to raise state pension age in bid to cut budget deficit’, 5 October 2009

<sup>2</sup> <http://www.bankofengland.co.uk/publications/speeches/2009/speech406.pdf>

<sup>3</sup> Financial Times, ‘Economists call for pensions at 70’, 21 October 2009

<sup>4</sup> George Osborne, “The Conservative Strategy for the recovery”, 15 September 2009

an average 3.4 per cent a year".<sup>5</sup> The Conservative approach has been echoed by the Confederation of British Industry, which has called for a balanced budget by 2015.<sup>6</sup>

But the fragile conditions that follow a deep recession call for sensitive timing. It is one thing to have an aspiration of higher national savings, and quite another to claim that achieving this within one electoral term is possible or desirable. If government policies leave Britain growing too slowly, the economy might become mired in a self-fulfilling deflationary slump. The risks of leaving the UK dependent on unreliable sources of growth are higher than they have ever been.

Predicting the future is a quick way to make a fool out of any economist. Plenty of professional forecasters were wrong-footed both by the speed of the economy's recent collapse and the length of its prior expansion. For 15 years growth persisted, despite economists' fears about fiscal consolidation, Asian economic turmoil, the dotcom collapse, terrorism and deflation before it finally succumbed to financial collapse. For most of the last decade, forecasters underestimated the ability of households to continue spending in the face of growing debts.

Given this record, no one should declare definite limits to how much the United Kingdom can grow in any particular area, be that through business investment, exports or ordinary consumption. But it makes sense to examine the assumptions of politicians against the evidence of history. The Conservatives are not the first party to propose an export-drive to rescue the economy: this was the normal approach during the Bretton Woods system of fixed exchange rates.<sup>7</sup> Indeed, it is an obvious policy for any country seeking both growth and debt-reduction. How well Britain has achieved this in the past surely holds important clues about our future.

---

<sup>5</sup> Financial Times, 'Senior Tory sees 'two years of pain'', 7 October 2009,

<sup>6</sup> CBI, 'A credible plan for balancing the budget and supporting economic growth', 15 October 2009

<sup>7</sup> S Brittan, 'Weapons exports: The bogus moral dilemma', World Economics, April – June 2003

### Basic GDP maths

In the discussion that follows, it is useful to recall that one way of analysing national economic output is to break it into expenditure categories: household consumption, government consumption, capital investments, and net exports (exports minus imports). The national product is either consumed by households or the government, invested or exported.

$$Y = C + G + K + (X - I)$$

For simplicity we assume that inventory accumulation is part of capital investments and tends to average zero over the medium term; and that 'Non Profit Institutions Serving Households' are included in household consumption.

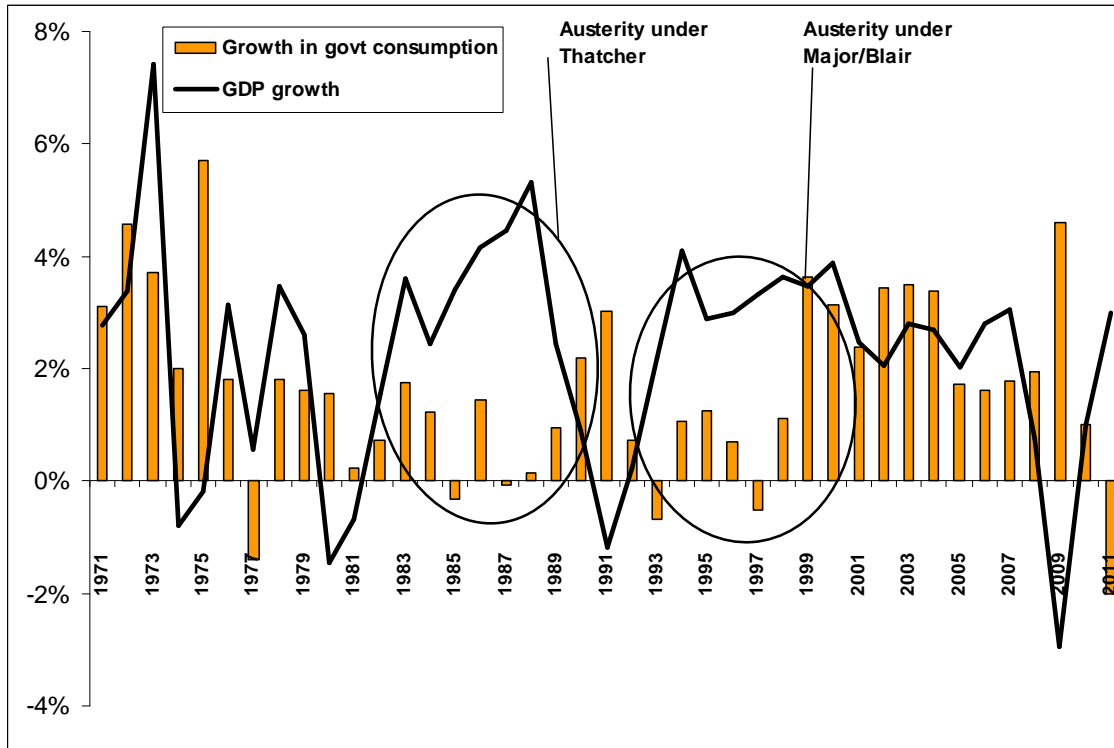
It is important not to confuse government consumption with government spending. Currently, the government *spends* about £700bn annually, but government itself *consumes* less than half this amount goods and services. The rest comprises items like transfer payments - pensions and benefits – as well as capital investments and debt interest. Transfer payments will largely end up being consumed by households, and capital investments will form part of the overall figure for capital expenditure.

The expenditure-method is clearly not the only way to disaggregate GDP. The reason it is useful to the analysis that follows is that the recent recession resulted from a collapse in *demand*. Some parts of the economy that had been capable of spending suddenly stopped doing so. Their capacity to resume spending may be limited in future, by their balance sheets or external factors. It is these limits that the following sections examine.

## What recent history tells us about government fiscal consolidations and growth

The Conservative faith in the ability of the economy to grow without government support is understandable given the nature of the last two long economic expansions, both of which started when the Tory party was in power. In both periods they presided over fiscal tightening without damaging economic growth:

**Chart 1: 40 years of growth and government consumption**

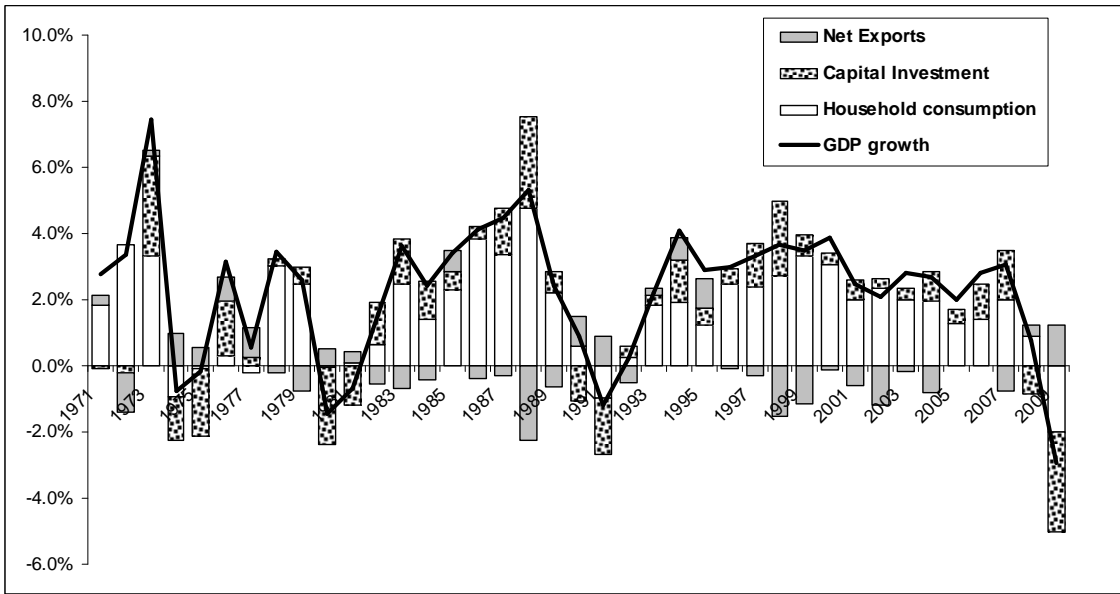


Between 1983 and 1989 government consumption grew by 0.7 per cent per year, while the economy grew at 3.7 percent. Between 1992 and 1998 government consumption grew by 0.5 per cent while the economy grew at 2.3 per cent.

Capital investment certainly boomed during the 1980s, averaging annual growth of almost 9 percent in the seven years to 1988 (see later Chart 9). However, at around a sixth of the economy, its contribution is normally dwarfed by that of household consumption which comprises roughly three fifths of the economy. Furthermore, net exports and capital investment have seldom pulled in the same direction (see Chart 2). This is perhaps a result of the high ‘import-intensity’ of capital goods<sup>8</sup>. The UK imports about a quarter more capital goods by value than it exports. Booms in investment probably tended to worsen this deficit, unlike in Germany or France, which have been able to grow through both channels in the recent past (see Appendix 2).

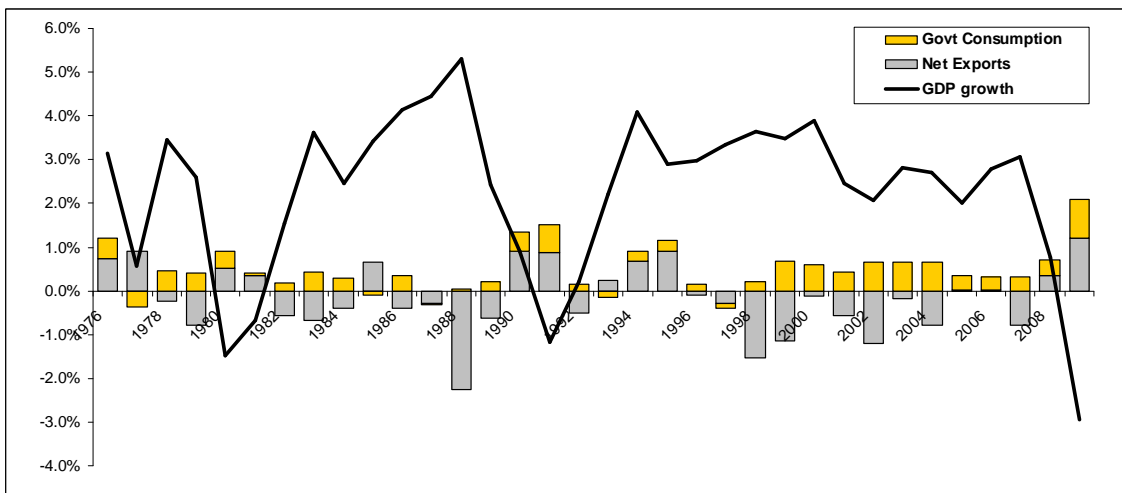
<sup>8</sup> I am indebted to Chris Dillow of the Investor’s Chronicle and the blog ‘Stumbling and Mumbling’ for this useful insight

**Chart 2: Percentage points contribution to growth: household consumption, capital expenditure and net exports**



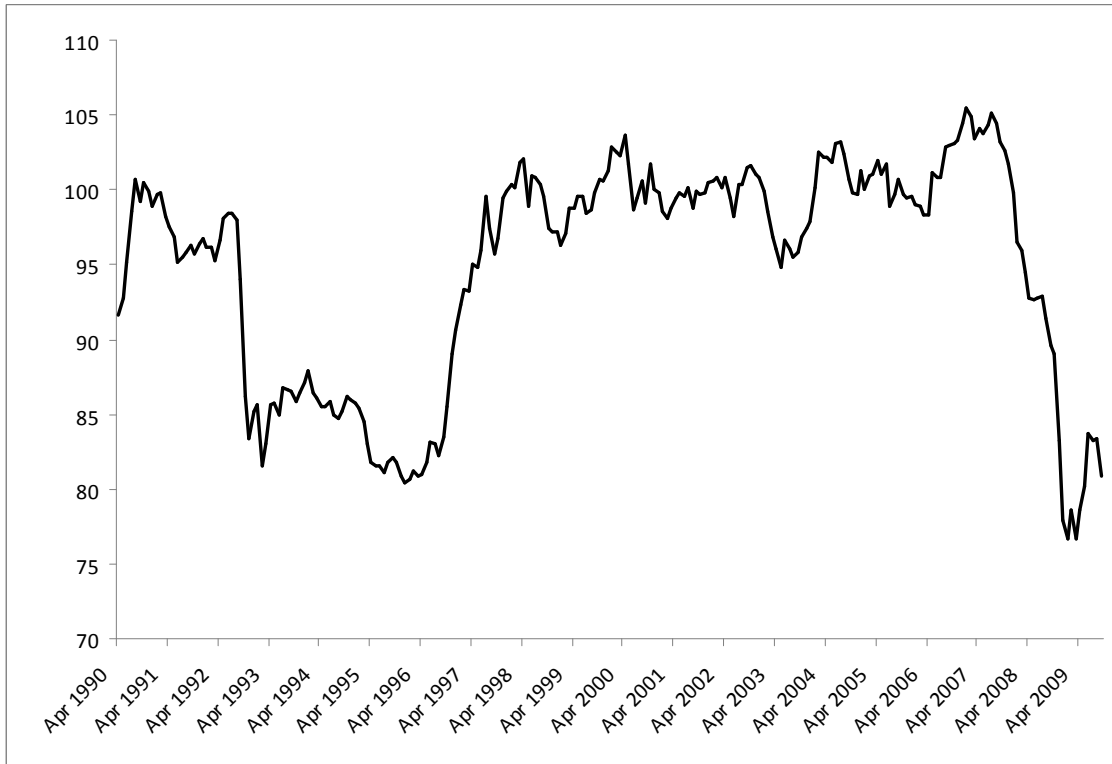
No five-year period since 1970 has seen net exports contribute more than an average of 0.4 percentage points to annual growth. The peak was in the early 1990s, when the fall in sterling after 'Black Wednesday' spurred an increase in exports and some import substitution. The last eight years of economic growth (1999-2007) saw net exports take an average 0.4 percentage points off annual growth – a figure that was neutralised by the steady increase in government consumption. This period matches the Conservative/textbook story quite well: the pound was strong, UK interest rates were above those in the Eurozone, domestic consumption was high and imports grew 2 per cent faster than exports. The Conservatives hope to achieve the opposite when in power: higher export growth and lower interest rates making up for the lower growth of government consumption.

**Chart 3: Percentage points contribution of government consumption and net exports to GDP growth.**



In 2009 exports are projected to fall by £30bn and imports by £36bn, contributing perhaps 0.5 per cent to GDP growth.<sup>9</sup> Budget projections foresee a continued contribution for 2010 and 2011. Overall, this will match the performance that followed the post ERM devaluation, when exports outgrew imports by over £10bn (or 1.3 per cent of GDP). Both periods can be explained to some degree by movements in sterling:

**Chart 4: Effective sterling exchange rate, 1990-2009 (2005 = 100)**



<sup>9</sup> All historic figures derive from the OECD database, which uses figures rebased to year 2000 currency values. Projected figures for 2009 are taken from the last Budget's projections

## Looking forward – can we repeat the trick?

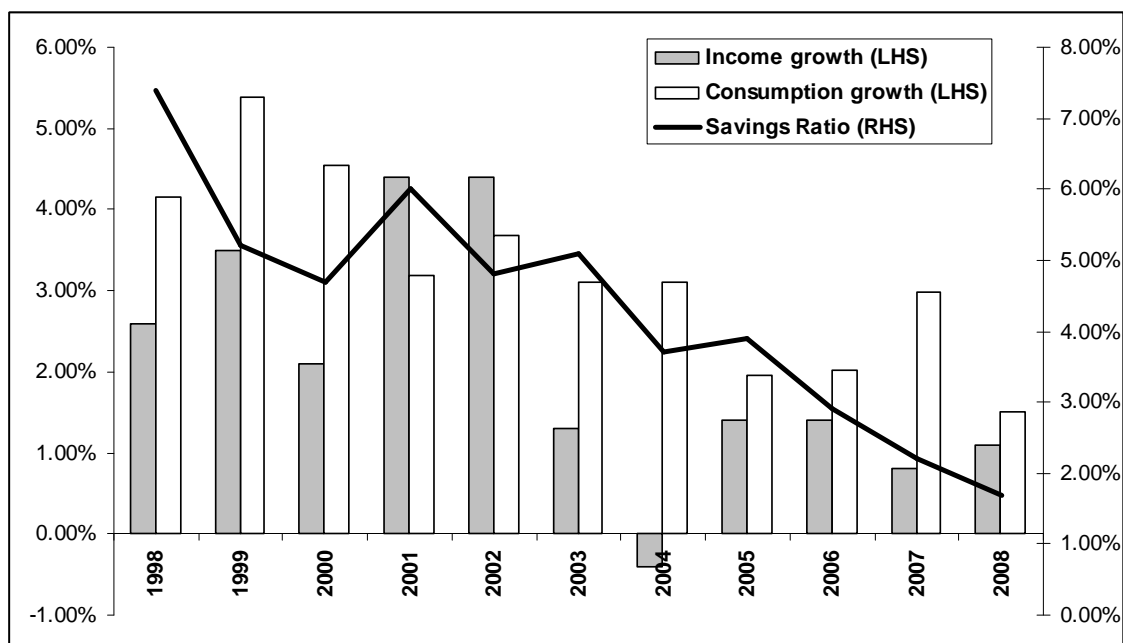
Superficially, history provides some encouragement to the Conservative view; the economy can grow strongly at a time of public sector retrenchment, and may in fact benefit from the fact that spending restraint can suppress interest rates.<sup>10</sup> However, previous periods of austerity differ sharply from the impending one in several crucial respects: inflation is low, the UK’s trading partners are weak and the ability of monetary policy to induce extra demand is reduced by the fact that rates are already low, the banking sector is fragile and households are so indebted.

To address the likelihood and strength of an investment- and export-led recovery, it is useful to discuss the outlook for the separate components of GDP growth, starting with the largest, household consumption.

### Household consumption

During the earlier periods of ‘growth-despite-austerity’, household consumption remained strong, growing at 2.9 per cent during 1983-89 and 1.8 per cent through 1992-98 (see Chart 2). Household consumption will be determined by (a) household incomes and (b) the proportion of these incomes that is saved or consumed. In the last decade in particular, a continuing fall in the savings ratio has allowed private consumption to carry on rising despite relatively stagnant incomes.<sup>11</sup> Over the period from 1998 to 2007, eight years out of ten saw consumption grow faster than incomes:

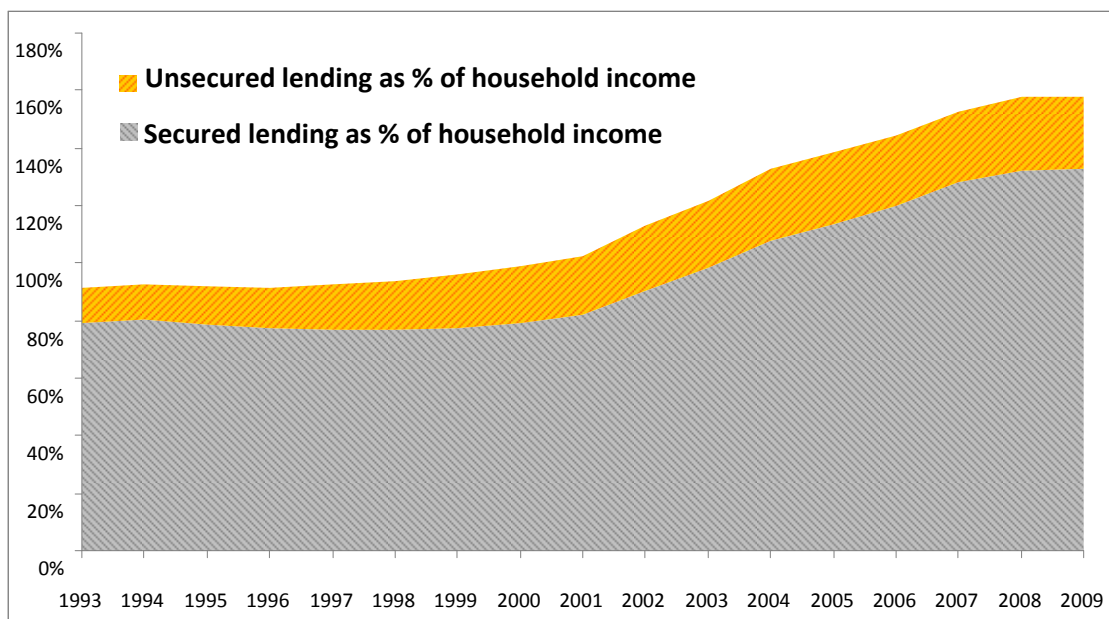
**Chart 5: Income growth, consumption growth and household savings ratio**



This resilience was driven by an increase in debt, a process that gained strength from 1998 as a new housing boom took hold.

<sup>10</sup> However, the Conservative ex-Chancellor Nigel Lawson now expresses some scepticism about whether large government deficits had an immediate effect on interest rates, when global capital markets are so large and deep. See N Lawson, ‘The View from Number 11’, p89-90

<sup>11</sup> Incomes data from IFS, ‘Poverty and inequality in the UK, 2009’

**Chart 6: The growth of household indebtedness**

Predicting household saving behaviour is extremely difficult. Crucially, it depends on what 'rule of thumb' the forecaster applies. If we assume that households are keen to restore their debt levels to a lower ratio of incomes, then Chart 6 would suggest several years of retrenchment; people are much more indebted than before. A similar conclusion would apply if we assume that households intend to target a particular savings ratio (see Chart 5), or a ratio of debt to housing wealth.

On the other hand, Spencer Dale of the Bank of England provides an account of the surge in debt that allows for a more optimistic outlook. He observes that most of the increase in household debt went into house purchases.<sup>12</sup> House prices rose enormously, and (older) owner-occupiers sold to younger families, using the profits to purchase financial assets. When house prices fell, it clearly lowered the net worth of some individuals – including the wealthy with financial assets – but it also reduced the cost of the 'future liability' that is the price of buying a house in the future. This last factor has improved the position of people who had been made *worse off* by the housing boom. Furthermore, the most important asset is often what people expect to earn in future. This asset is unlikely to have fallen as far in value as the financial markets.

Nevertheless, given the state of the banks, and a need for people to recalibrate their own estimate of their future earnings, it is difficult to see another large reduction in the savings rate driving consumption. Unlike in previous recoveries there cannot be another large fall in interest rates to encourage borrowing and spending. Even at current low rates, recent statistics from the Bank of England suggest a continuing tendency to use any income boost to pay off debt.<sup>13</sup> The NIESR, a leading forecasting group, predict that the household savings ratio will carry on rising to 8 per cent by 2011, reflecting both precautionary behaviour and greater restrictions on credit. This will cause consumer spending to fall by 0.7 percent in 2010 and a little less in 2011.<sup>14</sup>

<sup>12</sup> S Dale, 'Separating Fact from Fiction: Household Balance Sheets and the Economic Outlook', 24 September 2009

<sup>13</sup> Monetary & Financial Statistics (Bankstats) September 2009  
[http://www.bankofengland.co.uk/statistics/ms/2009/sep/bankstats\\_full.pdf](http://www.bankofengland.co.uk/statistics/ms/2009/sep/bankstats_full.pdf)

<sup>14</sup> Financial Times, 'Economists call for pensions at 70', 21 October 2009

Household income growth is meanwhile likely to remain sluggish. Insofar as the state provides incomes to a significant proportion of households through pensions, benefits and salaries, austerity in Westminster will produce lower consumption elsewhere. For example, the Conservatives have announced a one year pay freeze for public-sector workers, which would reportedly save £3.6bn per year in the form of incomes.<sup>15</sup> Even 'efficiency savings' can reduce household incomes – cutting administration necessarily involves paying less money to the supposedly unnecessary administrators. For this reason, the government's fiscal squeeze will not fall *entirely* upon government consumption.

While unemployment has not risen as far as many people have feared, it is likely to remain high for a while. Eventually, public sector job losses – which haven't yet begun in earnest – could add up to three quarters of a million to current figures.<sup>16</sup> Thus far, employers have used pay-freezes, pay cuts and time-off in order to avoid letting people go – but this foreshadows less re-hiring when an economic recovery is under way.

**Conclusion:** with household incomes under pressure from both unemployment and a government fiscal squeeze, and the savings ratio still below its long-term average, it would be surprising if household consumption played as large a part in future growth as it had in previous recoveries. The NIESR in fact predicts that it will fall in 2010 and 2011. Even if confidence were to return, the weakness of the financial sector combined with changes in future lending behaviour will reduce the likelihood of debt-fuelled consumption growth.

### Government consumption – how fast will it fall?

It is clear that the upcoming fiscal consolidation will lower government consumption, whoever is in charge. The Labour government's most recent Budget sees it decreasing by 1 per cent over 2010-11. A leaked Treasury document about future expenditure levels describes how the squeeze will continue. Current Departmental Expenditure Limits (DEL) will fall by roughly 2 per cent per year out to 2014: Annual Managed Expenditure (AME) – which includes 'demand-driven' items like benefits and pensions - will rise by 3-4 percent annually, but without debt interest by closer to 1 per cent.<sup>17</sup> Government consumption is more closely related to DEL than AME, so Labour's plans suggest that government consumption will be flat at best, and probably down over 1 percent annually.

Another way of estimating the future path of government consumption is to look at the total fiscal tightening and apportion a fraction of this to consumption. The IFS has calculated that plans since Budget 2008 amount to a fiscal squeeze of 0.8-1.2 per cent of GDP (£15bn) every year to 2017-18. About two fifths of government spending is actually consumption. If we assume that 40 percent of the fiscal squeeze (£6bn) is similarly apportioned, this implies an annual drop of almost 2 per cent in government consumption.

But the Conservative strategy asks for them to be 'tougher than Labour'. How tough will this be? Philip Hammond, the shadow Chief Secretary to the Treasury, has indicated that the pain might only last for two years, or at least be over within one electoral term. This echoes the CBI's call to deal with the deficit by 2015. Since current government plans leave the fiscal deficit at over 5 per cent in 2014-15, the Conservatives would need to cut by a *further* 0.8 per cent of GDP, or £12bn, each year

<sup>15</sup> <http://blogs.ft.com/westminster/2009/10/the-osborne-axe-full-gorey-details/>

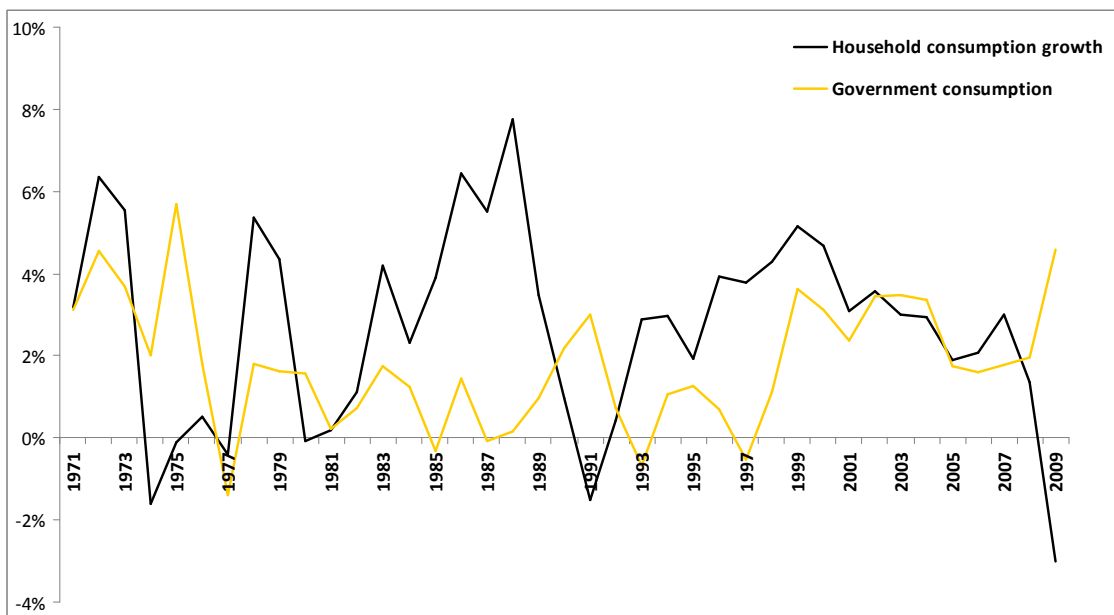
<sup>16</sup> Financial Times, 'Slowdown in job losses lifts hopes of return to stability', 15 October 2009

<sup>17</sup> The document can be seen online here:  
<http://www.guardian.co.uk/politics/blog/2009/sep/16/leaked-treasury-document-tories-cuts>

to reach a sustainable deficit of 2 per cent. This may require government consumption to fall at an average annual rate of 4 per cent.

It goes without saying that a consolidation on this scale has never been done before. It took John Major a full electoral term to reach sustainability from a starting deficit of 7.7 per cent. This was achieved with government consumption remaining flat. Instead, his government benefited from an economy that grew by over 3 per cent annually on the back of booming household consumption. Osborne expects to inherit a deficit 5 percentage points higher than this, and a household sector that is surely less well placed to embark on a consumption boom.

**Chart 7: Historic annual rates of growth of household and government consumption**

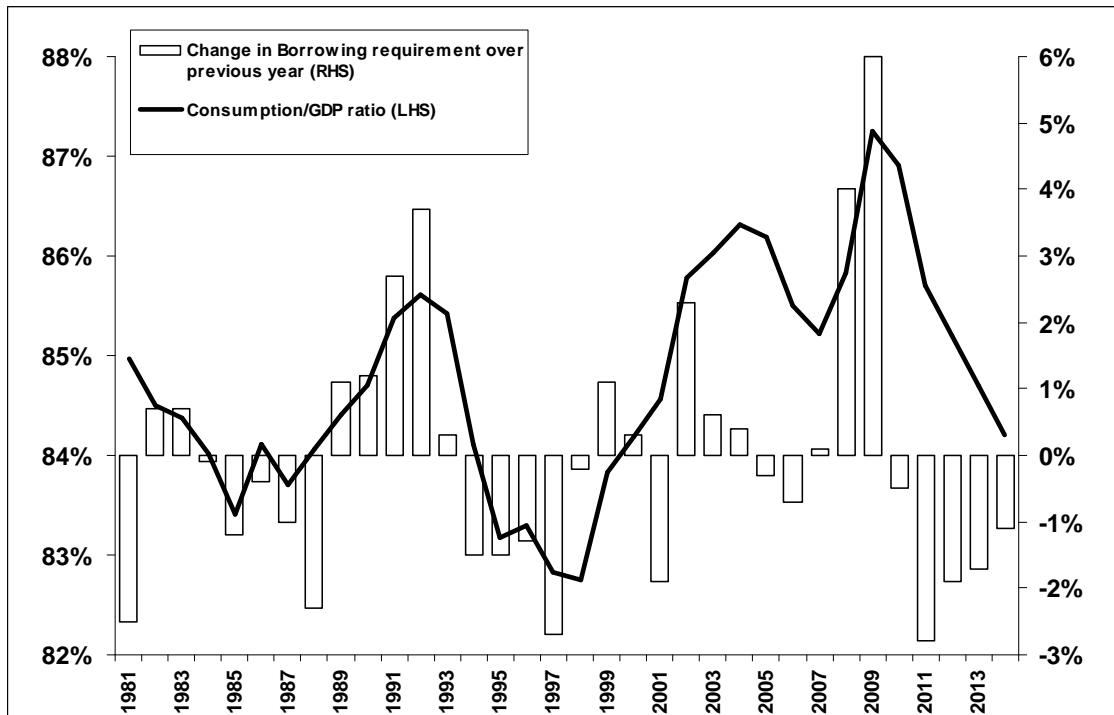


**Conclusion:** This is the only variable over which the next Chancellor has direct control. Labour’s existing plans already imply a fall in government consumption for several years. If the Conservatives really intend to have the fiscal consolidation out of the way by 2015, they will need to reduce government consumption much faster than ever before.

### The overall consumption ratio

There is considerable interplay between what governments and households consume; government austerity will often bring lower overall consumption, particularly when tax rises play a significant part, as they have in previous fiscal consolidations. The pattern of the last thirty years confirms that such periods tend to coincide with total consumption in the economy falling (as happened between 1994 and 1997).

**Chart 8: Total consumption as a ratio of GDP, changes in the borrowing requirement**

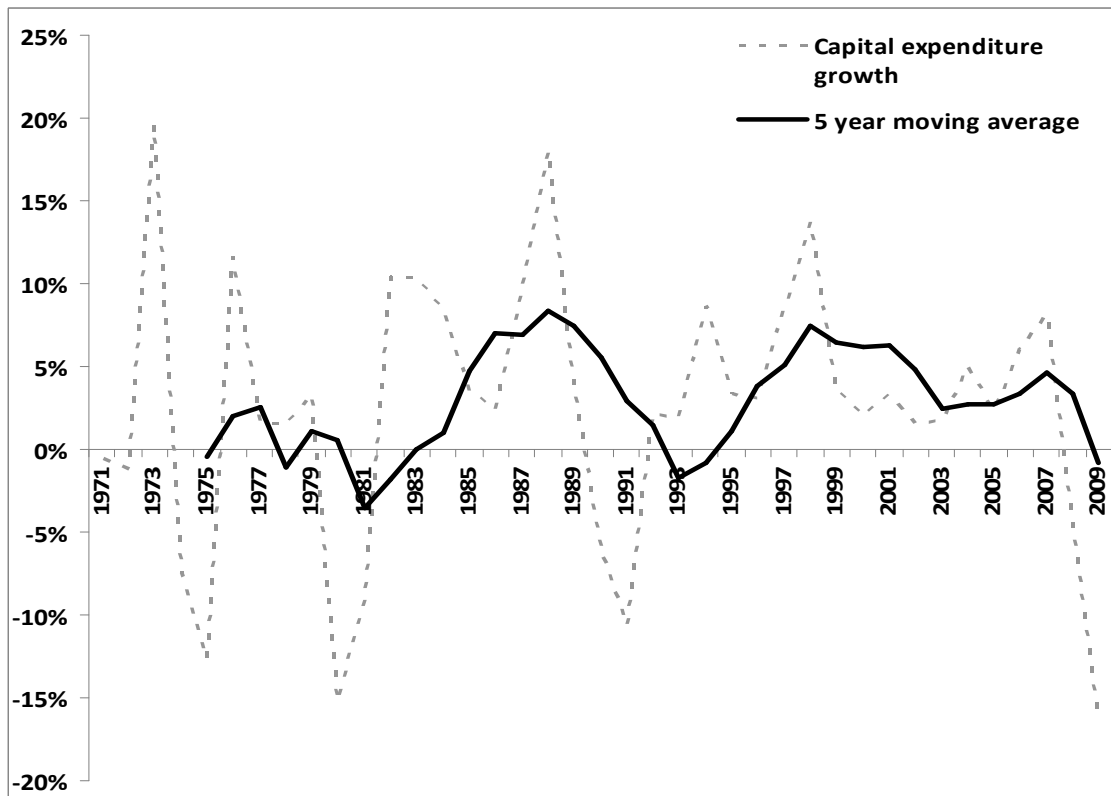


Conversely, in periods when the government has let the deficit increase (e.g. 1989-92, 2007-10) the consumption/GDP ratio has tended to rise. The relationship is not exact: households can increase their spending without government help, as in the 1997-2005 boom. But given the scale of the fiscal retrenchment required it would be very surprising if overall consumption did not fall by 3-4 per cent by 2015.

### Capital Expenditure

As Keynes observed long ago, business investment is the most volatile component of GDP: alongside household consumption it is collapsing capital expenditure that drove the UK into recession this year:

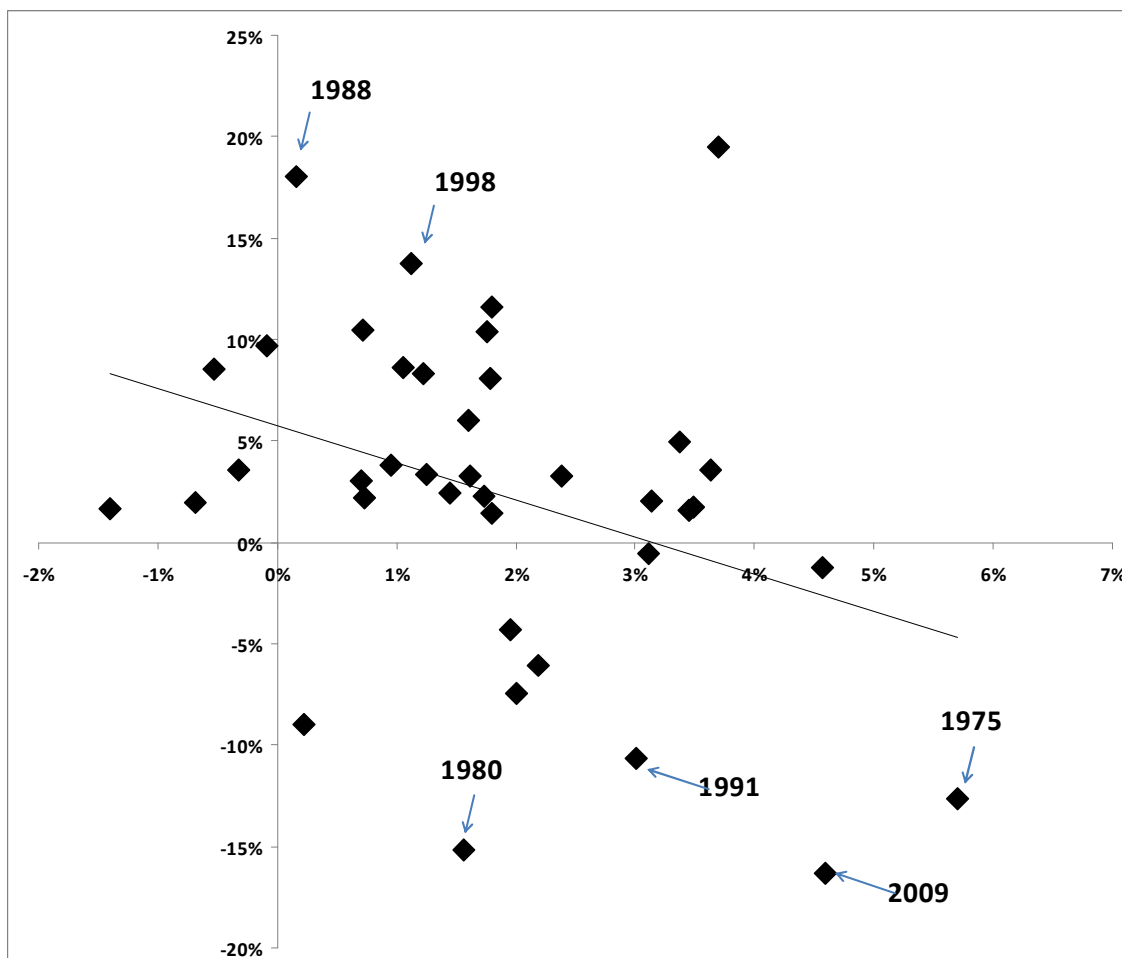
**Chart 9: Capital expenditure growth, with moving average**



The Conservatives are right to point out that business investment can prosper during a fiscal consolidation: the two previous peaks in the late 1980s and 1990s both occurred during a period of government austerity. The notoriously tight 1981 Budget took place shortly before a prolonged surge in capital investment.

Furthermore, a pattern of lower government consumption alongside higher investment seems to be quite well established. This chart below shows growth on government consumption on the X-axis and growth in investment on the Y-axis, since 1971:

**Chart 10: Government consumption against capital investment 1971 to 2009**



However, there are powerful reasons not to assume that low government consumption will *cause* high capital growth, not least the problem of identifying the direction of causality. For example in 1991 and 2009, we can be fairly certain that high government spending *responded* to a collapse in business investment. Equally, we know that strong capital growth produce the sort of boom conditions that *allow* a government to cut back, as occurred in 1988 and 1998.

Previous periods of high investment growth also coincided with strong economic growth globally. Between 1983 and 1988, for example, the USA grew by 4 per cent per annum. Furthermore, they came after central banks had fended off a bout of high inflation, and subsequently eased monetary conditions. Current conditions are very different. Rates cannot fall much further; instead, credit *availability* is the major issue for smaller firms- although a recovery in asset prices has supported greater issuance of corporate bonds for larger companies.

Does this mean that investment will boom again once the problems of the banking sector are fixed? There is some inevitable cyclicity in investment, and the most recent Budget foresees a bounce back next year of 6 per cent. But with a threat of tighter capital requirements hanging over the banking sector, it is unlikely that credit growth will drive capital investments like it did before the crunch. Moreover, business investment is also a function of future economic demand. There is a strong case for saying that this business recession was led by increased debt-aversion and drastically

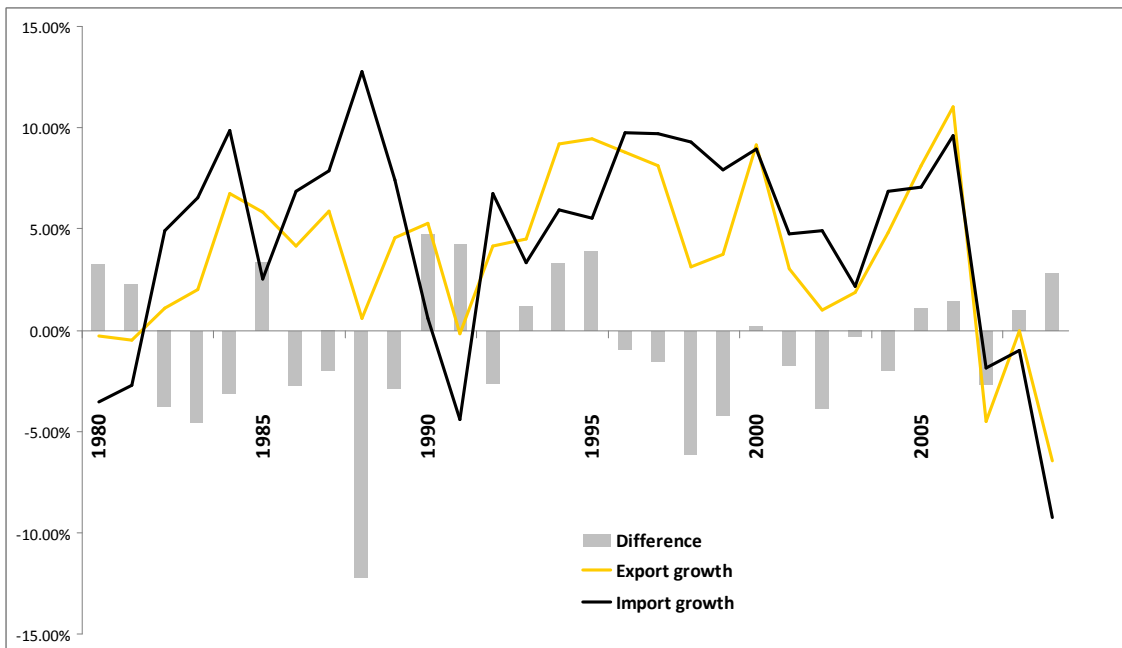
lower estimates of future growth, not just the non-availability of finance.<sup>18</sup> Foreknowledge of government plans for a sustained period of fiscal consolidation might damage confidence rather more than it did in previous episodes.

**Conclusions** The two previous recessions ended with a surge in business investment as interest rates fell. Predicting this notoriously volatile component is almost impossible. Optimists look forward to a sustained period of cheap capital powering another investment boom. But a pessimist might respond that businesses also need to expect booming economic demand if they are to take risks. As Lord Skidelsky recently observed, “the volume of investment depends not just on the cost of borrowing but on the expectation of profit. Recessions are the result of a collapse in profit expectations. And it may be that no feasible reduction in interest rates can revive profit expectations sufficiently to produce a robust recovery”.<sup>19</sup> Credit may already be available, but have no ready takers.

**Exports and imports**

It has been remarked that 26 September 1992, when sterling was ejected from the Exchange Rate Mechanism, should be rechristened “White Wednesday” owing to the economic resurgence that the UK economy enjoyed from that date.<sup>20</sup> But while the lower exchange rate led to some export-led growth, it did not last long, partly because of a recovery in the pound from 1996 onwards (see chart 4). The period of export-led growth lasted barely half a decade.

**Chart 11: Export and import growth since 1980**



The pound has suffered a large fall since 2007. As Chart 3 showed, this is expected to lead to a strong contribution from net exports towards growth in 2009. But it is questionable how much this can be sustained. Previous periods of strong growth have been helped by a favourable international environment. From 1992 to 1996, when a weak pound helped the UK export sector to recover, weighted average growth for

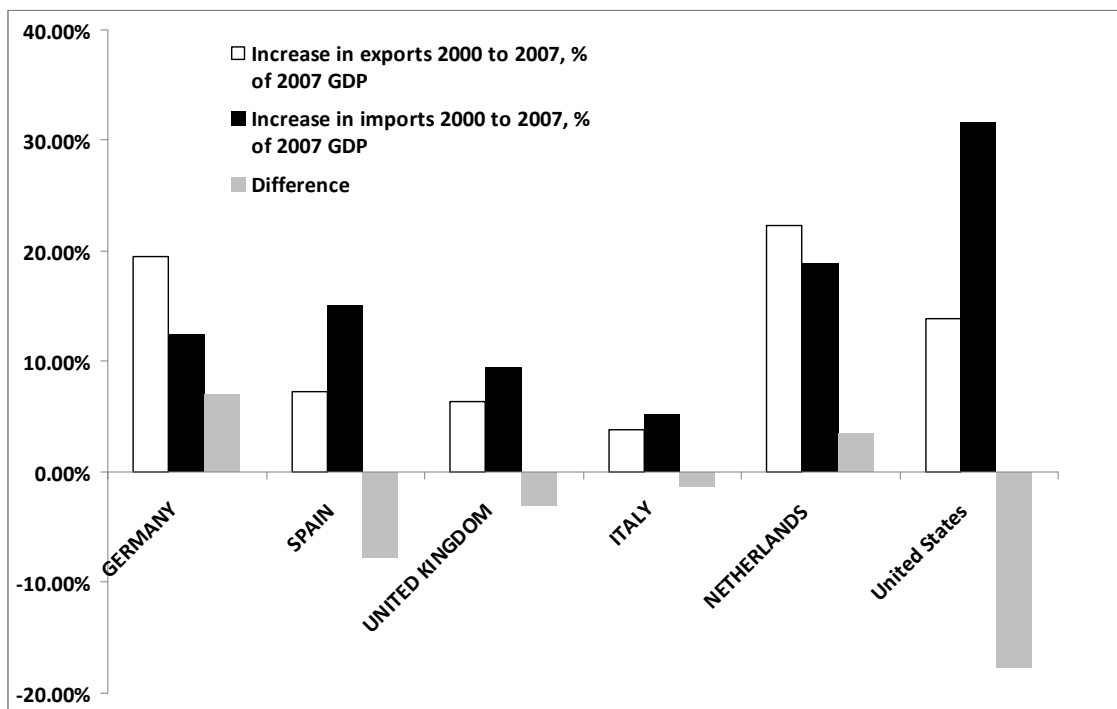
<sup>18</sup> Richard Koo, “The Holy Grail of Macroeconomics: Lessons from Japan’s Great Recession’, argues persuasively that debt-aversion drove lower Japanese investment during their long recession  
<sup>19</sup> R Skidelsky, ‘George Osborne fails to mind the output gap’, Sunday Telegraph, 20 September 2009  
<sup>20</sup> See S Brittan, ‘Black or White Wednesday?’, Financial Times 8 October 2004

Germany, France, Spain and the United States— who together comprise two fifths of our export partners – was 2.7 per cent. The international recession of the last year has left in its wake much lower growth projections for the future. In the last Budget the Treasury forecast real GDP growth for the G7 countries to be 0.75 per cent in 2010 and 3 per cent for 2011, while Euro area GDP is projected to grow by 0.25 per cent and 2 per cent.

Another big problem is that *many* countries would like to use increased exports or reduced imports to grow. The period from 2000 to 2007 saw a considerable increase in trade imbalances even within Europe. This issue is now taken sufficiently seriously for it to be a matter for the G20. Imbalances are widely seen as having created the conditions for the financial meltdown of 2007-09.<sup>21</sup> Negotiations to reduce these imbalances will take place at an international level. It is difficult to imagine the United Kingdom being given a free rein to pursue policies that drive growth through net exports when other large countries – the USA included - are in full pursuit of the same goal.

Meanwhile key surplus nations like Germany are unwilling to abandon their model of export-based growth and, like China, are far better positioned, structurally, to benefit from booming world economic demand.<sup>22</sup> As Jeremy Warner notes, Britain’s manufacturing sector has been “shrunk by years of public policy neglect and an overvalued exchange rate” and our less-traded service sector would not respond to a change in price to the same extent as manufacturing.<sup>23</sup>

**Chart 12: Changes in exports and imports 2000-07, selected developed countries**



The great unknown is how far the pound would need to depreciate in order to achieve significant export-led growth. Past performance has not been encouraging: the IMF has observed how UK exporters use devaluations to boost margins rather than

<sup>21</sup> Martin Wolf, ‘Fixing Global Finance’, 2008; also M Wolf, ‘US deficits aren’t just China’s problem’, Financial Times, 19 April 2005

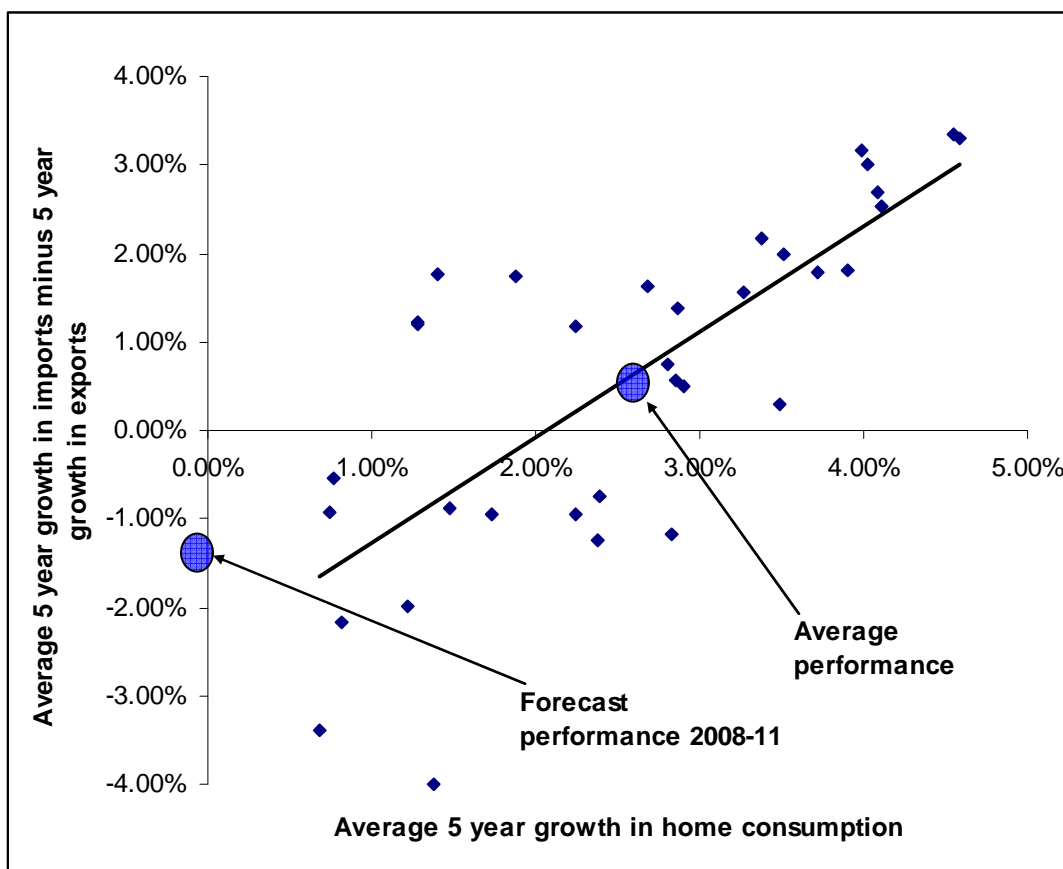
<sup>22</sup> The Economist, ‘The export model sputters’, 7 May 2009

<sup>23</sup> J Warner, ‘Thanks to a devalued pound, Britain may soon be in surplus on trade’, 23 September 2009

volumes, for example.<sup>24</sup> Recent research has uncovered how high performance firms are able to use pricing power, increasing margins when the exchange rate falls.<sup>25</sup> Other recent research finds that “exchange rate movements have little effect on firm’s export participation and exit decisions”. So there is very little reason to expect with any confidence a large structural change of the UK economy towards exports, even with a large drop in sterling.

Nevertheless, it is true in theory that countries that lower their consumption will see a reduction in imports, and the UK’s recent past confirms this pattern. A key reason our exports have not grown faster than our imports has been our high consumption growth. To show the historical relationship, consider Chart 13, which plots the five year average growth in domestic consumption (households, government and capital) against the five year average growth in imports minus exports:

**Chart 13: The relationship between growth in home consumption and imports minus exports**



Any policy that plans to produce swingeing cuts in domestic consumption ought automatically to feed through to an improvement in the growth rate of exports relative to imports. A quick look at recent history suggests that if the rate of consumption growth is cut from its historic average of 2.6 percent down to 1 percent, exports will grow faster than imports by about 1.8 percent. However, the expected performance of the next few years should make us cautious: while total domestic consumption is forecast to be flat, exports are only expected to outperform imports by 1.4 percent. It looks like the pound will have to weaken even more if the UK is to enjoy a sustained boost to its economy from net exports.

<sup>24</sup> IMF, ‘Exchange Rate Fluctuations and U.K. Manufacturing Exports’, November 1994

<sup>25</sup> CEPR, ‘How do different exporters react to exchange rate changes?’, October 2009

It is also far from clear how any future government is to maintain the pound at a sufficiently low level to make this policy effective. It is not a cast iron rule that fiscal tightening will necessarily cause the exchange rate to weaken: this was not the case for 1996-8 for example. Some, including George Osborne, have argued that it is unsustainable fiscal behaviour that weakens currencies, not the opposite.<sup>26</sup> Osborne's past warnings about a sterling crisis sit uneasily with his recent conversion to the merits of a weak currency. It also raises the question as to whether the Conservatives intend deliberately to weaken the pound and if so, by how much. Given how little the 20 per cent devaluation has achieved so far, it is possible that the pound will need to fall by a similar amount again, pushing it down to \$1.30 against the dollar and making it worth only 90 cents against the euro. If this is the future government's policy, international confidence in our currency may be lost, and British companies may not be able to borrow on competitive terms.

**Conclusion:** The government is already forecasting three years of export-led growth. With a sufficiently weak pound, this may be possible. However, to maintain such a posture for several years relies on many uncertainties: the notoriously unpredictable behaviour of the foreign exchange market; the risk of similar devaluations from competing countries; a potential loss of confidence in sterling assets that forces higher interest rates. Above all, a strong reaction from net exports requires a prospering world economy.

---

<sup>26</sup> BBC News, 'Osborne fears sterling collapse', 15 November 2008.

## Putting it all together – what *needs* to be achieved

Several organisations, from the CBI to the Bank of England, predict that the UK can only grow sustainably through net exports and business investment. Consumption, both by households and the government, needs to fall. But if these two elements (which tend to comprise 80-85% of the economy) are to remain stagnant, the other two will be left with a huge burden to carry. The highest 5 year contribution that capital investment and net exports have *ever* made was in the mid 1990s, when they added an average of 1.1 percentage points to annual growth.

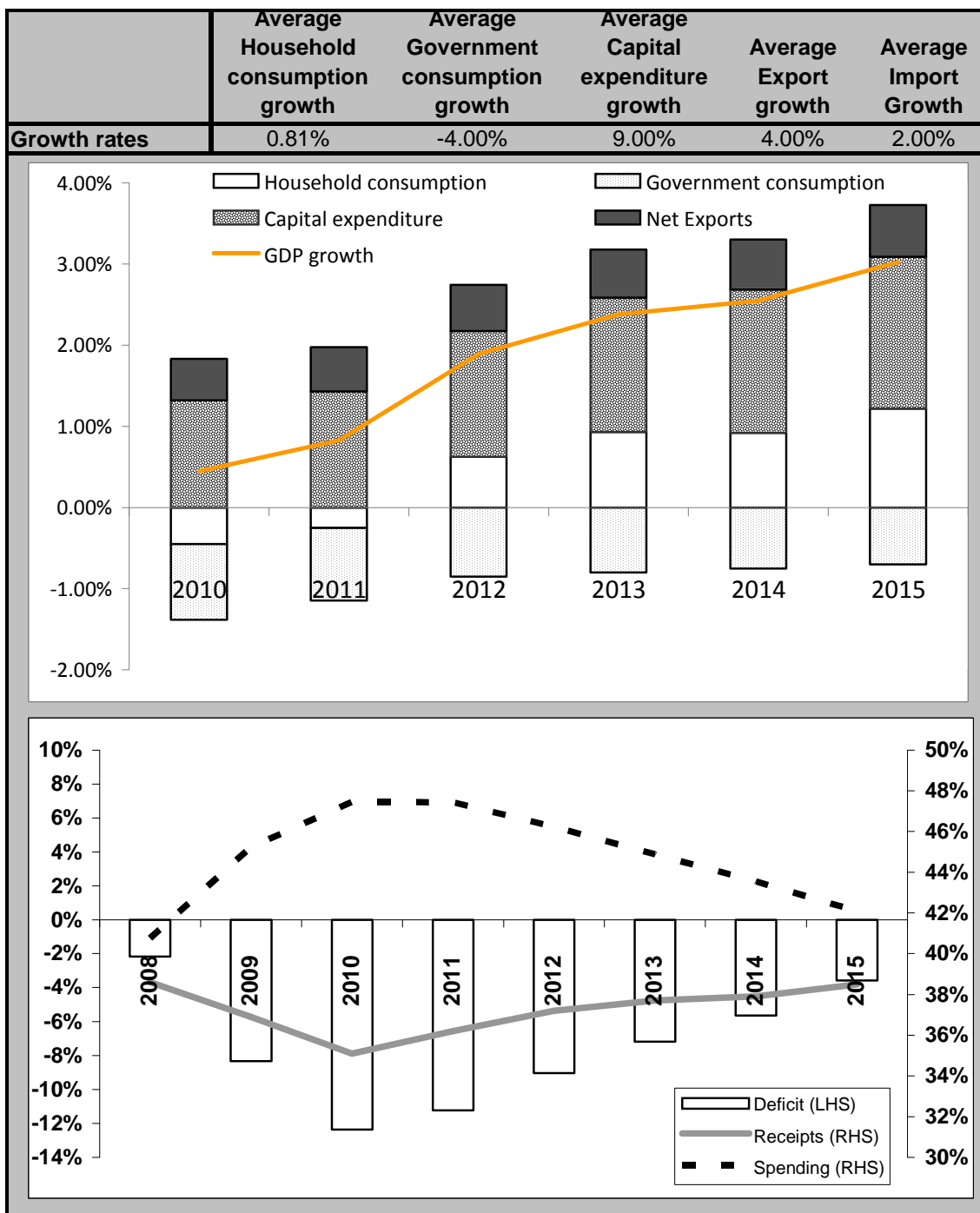
An even more extraordinary performance will be needed if a future Conservative administration is to achieve budget sustainability by 2015. This is because, even with spending flat in real terms for five years, the gap will need to be closed by higher revenues, which require economic growth.

Taking these steep requirements as our starting conditions, we have constructed some rough scenarios for future growth, bearing in mind the constraints we have argued for above. The first scenario tries to calculate what the Conservative scenario would require of net exports and investment. It starts with the following assumptions:

- Household consumption growth remains weak for 2010 and 2011 (as predicted by NIESR), and then grows at 1.5 percent per annum, slower than the overall economy
- Government spending that *excludes* government consumption follows the expected path of AME to 2011, as laid out by Treasury's leaked document. It then grows at 2 percent annually.
- Government consumption itself falls by 4 per cent every year from 2010 to 2015
- Exports outperform imports by 2 percent annually, matching the record in the 1990s and substantially ahead of recent performance
- Total government receipts as a proportion of GDP rise every year from roughly 36 percent to 38 percent, as anticipated in the last Budget (table C7).
- The deficit is reduced to 4 per cent of GDP by 2015.

These assumptions are optimistic, if not heroic. It is unlikely that AME can stay that low through such a long period of high unemployment, particularly if pensions are re-linked to earnings and debt continues to climb. Such an export performance is also at the outer limit of expectations, more than matching what Germany has achieved since the 1990s.

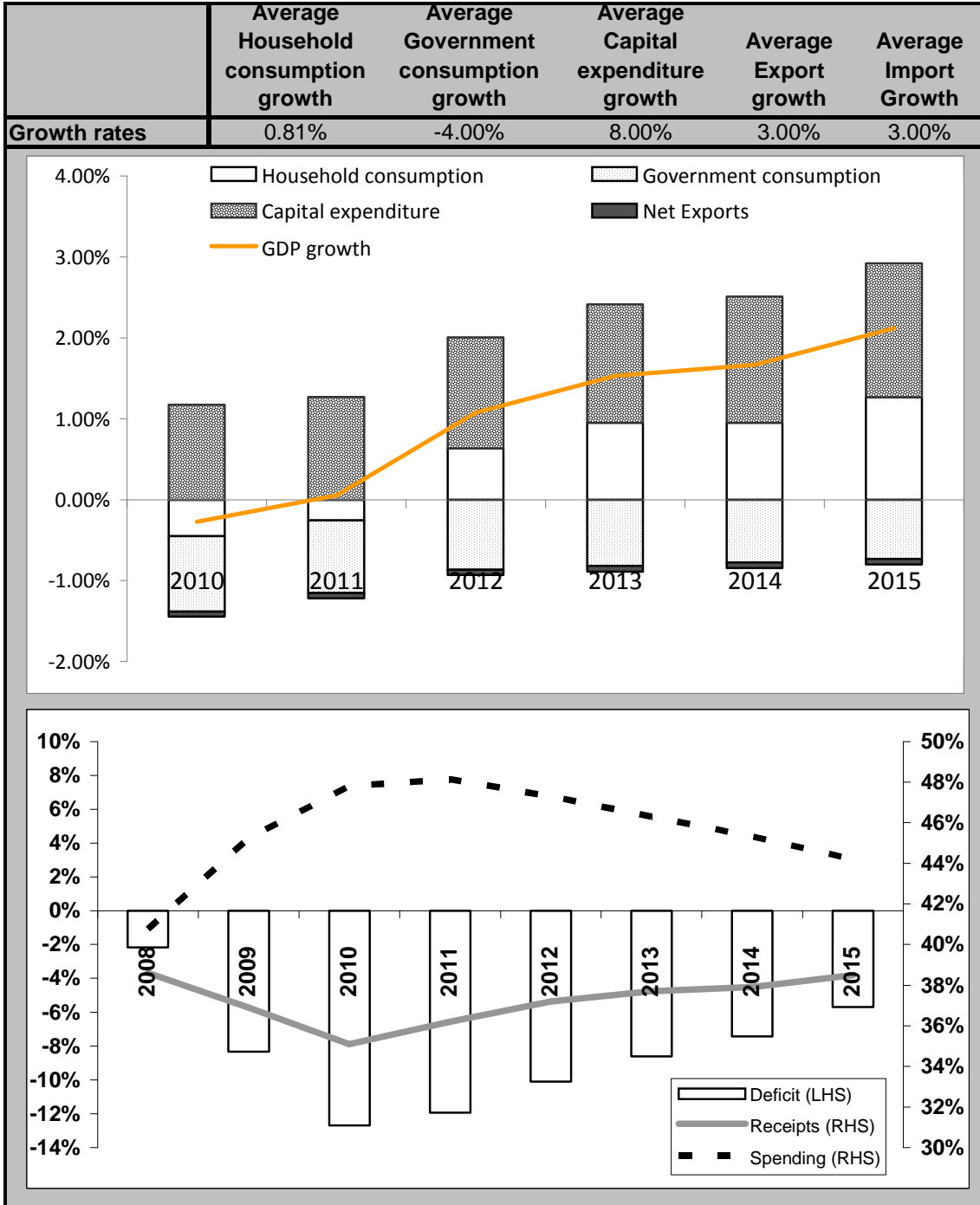
Scenario 1: Making the Conservative scenario materialise



In order to make the deficit fall so fast under these assumptions, capital expenditure has to grow at 9 percent, and exports outpace imports by 2 percent for five years. This would enable GDP to grow at 2 percent in 2012 and climb steadily from there. Under this scenario, the household savings rate would have recovered to 10 percent by 2015, creating the conditions for a renewed consumption boom. Events would indeed pan out as Philip Hammond anticipates: a few (very) hard years, followed by some very good years.

**Scenario 2: Capital growth responds, net exports don't**

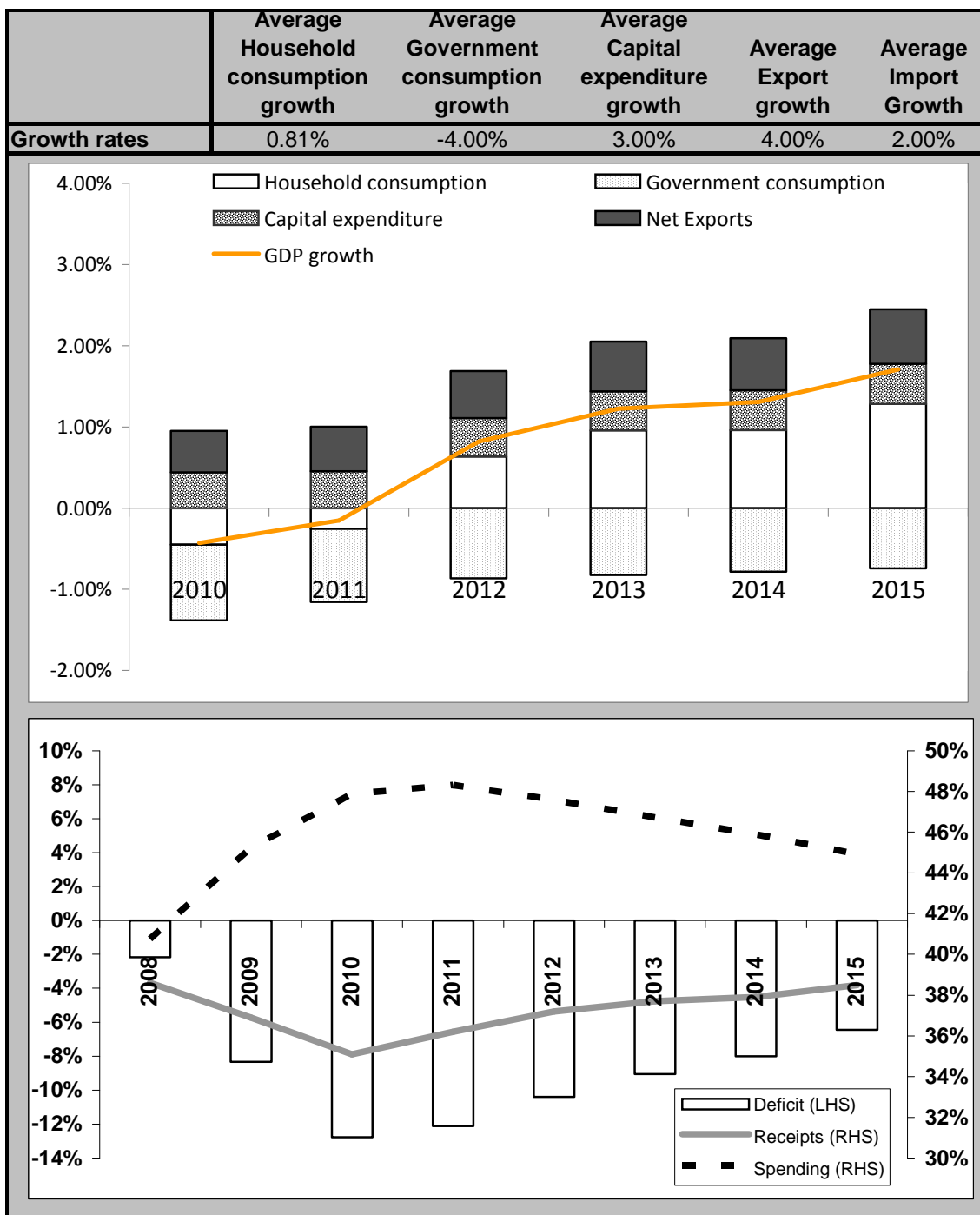
One way in which the Conservative scenario might fail is through the net export channel. If a weak world economy prevents the UK enjoying the expected rebound in net exports, then even five years of strong capital growth could leave GDP growth too low to cut the deficit.



In this scenario, GDP growth stays below 2 per cent out to 2015, and the deficit falls to about 6 percent of GDP, despite unprecedented government austerity. Net exports make a small reduction from growth.

### Scenario 3: Emulating Germany 2000-07 – export-led growth, weak capital growth

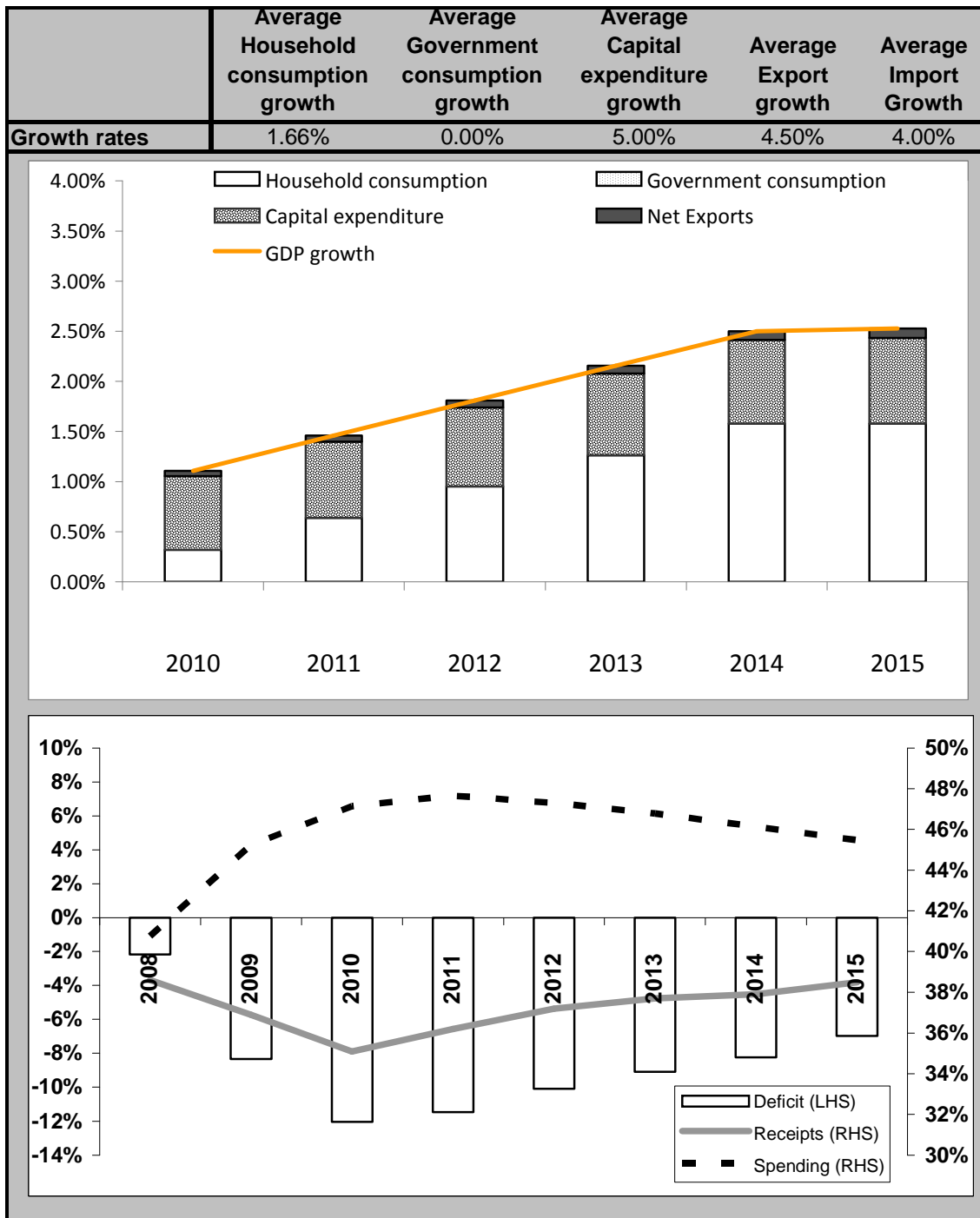
Germany over 1997-2007 managed to produce weak overall growth based on exports and weak consumption growth alongside government fiscal consolidation.



Once again, achieving one of their aims (growth through exports) without the other (a capital boom) leaves the UK's economy weak, so long as household consumption lags GDP growth. This mirrors the case of Germany and Japan, where capital expenditure growth overall was virtually flat, with strong years punctuated by rapid retrenchments. Under this scenario the deficit falls but only to 6.5 per cent in 2015, with fiscal sustainability three or four years away.

### Scenario 4: An increase in household spending, a lesser contribution from exports and capital

If as Spencer Dale suggests, households are not as scarred by the recession as expected, they might contribute more growth than anticipated. This may only happen if the government does not embark on too brutal a fiscal squeeze.



In this scenario, household spending grows from 2010 onwards at an escalating pace, though still below the pace of GDP growth. This is partially a result of the government cutting its consumption more slowly. The savings ratio returns gradually to 6 percent. The deficit also falls, though only to 7 percent in 2015: there are still three years to go before the debt is stable.

The first scenario – the one that resembles what the Conservatives would like to achieve – is by far the most attractive. But it is based on wildly optimistic assumptions.

Capital investment has only ever grown by over 8 percent in the years up to the Lawson boom in 1988. But that period saw (a) strong domestic consumption, which must have helped encourage businesses to invest (b) a ballooning trade deficit, with imports outgrowing exports by 3 percent every year and (c) generally strong global growth. No one should be surprised that the Conservatives aspire to such a scenario: the trouble is, the UK has never achieved it before. While one or other of the elements they need may be present, it is difficult to imagine them *all* being there in such force that they achieve their aims for deficit reduction.

Depending on the course of policy, either of the next two scenarios might follow from the Conservative attempt to pursue non-consumption growth. If prolonged monetary easing eventually produced a capital-investment boom, the structure of the UK economy and the weakness of our trading partners suggest that strong growth through net exports is unlikely. On the other hand, both Germany and Japan have shown how it is possible to have a strong export performance, without sustained capital growth. In both these scenarios, the government would cut back hard to achieve the target of balance by 2015 – but end up failing, bringing with it weak domestic spending.

The final scenario is a rough attempt to show what may happen if household consumption is stronger than envisaged by forecasters like the NIESR. This is a possibility if the government does *not* attempt to cut its deficit too fast. Interestingly, this scenario doesn't involve either a collapse in the savings ratio, or an explosion of the government deficit: higher growth makes the transition easier.

Of the four scenarios, the first is by far the least likely. Of the remaining three scenarios, it is worth observing that they all achieve a similar amount of deficit reduction – although the last achieves this more through economic growth. This growth, of course, could be threatened should fiscal tightening lead to a sharp retrenchment in domestic spending. If the first of these four scenarios is the least likely, history suggests the fourth is the most likely. UK households have shown considerable resilience in the past. But capital investments again play an important part, and their failure to materialise would jeopardise the recovery in this scenario. This gives another reason to investigate the possibility of creating a British version of the National Investment Bank proposed by Barack Obama for the US, as was recently proposed by Vince Cable of the Liberal Democrats.

## Conclusions

Writing when we are still awaiting a recovery after 15 months of recession, it would be foolhardy to produce definite macroeconomic forecasts. Instead, this paper presents some scenarios for future growth, in order that their implications might be better understood.

In some ways, George Osborne's prescription of export- and investment-led growth bears *superficial* similarities to past Conservative expansions. But as he recognises, household consumption, which has been absolutely critical to economic growth for the last forty years, will almost certainly play a smaller role than it did during those episodes, particularly if the government engages in a fiscal consolidation on the scale envisaged by the Conservatives. If his scenario *could* be achieved, it would produce marvellous economic results. However, it is extremely risky to assume it *will* happen:

- There have been precious few periods when net exports and capital investment have both pulled in the same direction. The UK may not be able structurally to enjoy massive business investment without a growing trade deficit. Even Germany's recent export surge has been accompanied by quiescent business investment – and relatively disappointing growth. This is also true of Japan during its recent recovery.
- At times lower government consumption has seemed to have spurred on business investment. But these were periods when fast falling interest rates allowed pent up demand for investments to be realised. They possess crucial differences with the current deflationary environment. It is much more likely now that the government deficit is providing some *support* to business investment
- It is difficult to envisage net exports continuing their recent contribution to growth when so many other countries have the same ambition, and when the UK lacks the deep structural advantage in manufacturing that helped Germany and Japan achieve this for an extended period. In fact, given the scale of the fall in sterling and consumption, the expected performance of net exports in the next two years is weak.

The relationship between government spending and the other elements of GDP is a crucial matter for the next administration. On the negative side, governments can compete with firms for scarce resources and finance, and by their very size introduce instability into the economy. This may well have happened in the 1970s. But in today's very different environment, government fiscal support is playing a critical role in supplying the demand that businesses and households need if they are to invest or spend. At some point, the private sector will again be able to stand on its own two feet. Until then, it is hard to overstate the damage that could be done by assuming that government spending is 'crowding out' private sector activity when, in fact, it is 'propping it up'.

It may seem odd to urge a future government to care about economic growth. But the Conservative's extreme aversion to public debt risks producing policies that prioritize deficit reduction over all other objectives. Public debts have risen largely to allow private indebtedness to fall without producing catastrophic consequences for the economy. The prior rise in private indebtedness passed unnoticed by the same Conservative opposition that is now almost hysterically worried about a similar rise in public debt. This makes no sense; if the past few years tell us anything, it is that Britain's macro-economy can be at far greater risk to private debts than public. What matters above all is that the public debt is *sustainable* – that we can reach a position where the outstanding debt is no longer rising, and the interest payments are affordable. This is as much about producing sufficient growth as debt reduction.

If the next government is to take economic growth as seriously as the deficit, it should consider taking an economic path that allows for slightly more consumption. Japan's experience during its long struggle against deflation is highly pertinent; twice (in 1997 and 2001) it introduced fiscal reforms to tackle the deficit, and twice achieved the precise opposite.<sup>27</sup> Despite being an export-champion, its last fifteen years have been dire. If the next British government proceeds upon the basis of deficit reduction before growth, it risks achieving neither.

---

<sup>27</sup> See Richard Koo's discussion here, slide 18:  
[http://csis.org/files/media/csis/events/090326\\_koo\\_presentation.pdf](http://csis.org/files/media/csis/events/090326_koo_presentation.pdf)

## Appendix 1: Various sources for data

Note on data. I have used OECD data for the various components of growth in the UK and other countries. This information is expressed in year 2000 currency terms. To acquire estimates of the future, I used Table 1.12 from the Supplementary tables of the 2009 Budget: these figures are expressed in Chained Volume terms. Other elements have been expressed, variously, in real terms (the leaked Treasury document) or nominal money (future estimates for DEL and AME). In order to minimize potential confusion about the units being used, I have tended to refer to annual increases; these refer to the increase *in real terms* except when stated otherwise.

## Appendix 2: Past components of growth from France, Germany and the USA

<b>Germany</b>	<b>Household consumption</b>	<b>Government consumption</b>	<b>Capital Investment</b>	<b>Exports</b>	<b>Imports</b>	<b>GDP Growth</b>
1996	1.56%	2.08%	-3.57%	6.05%	3.53%	0.99%
1997	0.81%	0.50%	1.28%	11.71%	8.22%	1.80%
1998	1.37%	1.80%	5.32%	7.96%	9.45%	2.03%
1999	2.91%	1.15%	3.26%	5.94%	8.55%	2.01%
2000	2.33%	1.37%	2.26%	13.53%	10.17%	3.21%
2001	1.96%	0.53%	-7.84%	6.44%	1.23%	1.24%
2002	-0.84%	1.47%	-9.14%	4.29%	-1.44%	0.00%
2003	0.10%	0.38%	2.44%	2.46%	5.36%	-0.22%
2004	0.08%	-0.71%	-0.31%	10.25%	7.28%	1.21%
2005	0.24%	0.41%	-0.99%	7.67%	6.53%	0.77%
2006	1.10%	0.62%	7.50%	12.69%	11.85%	2.96%
2007	-0.40%	2.19%	5.01%	7.47%	5.03%	2.46%
<b>Averages</b>	<b>0.93%</b>	<b>0.98%</b>	<b>0.43%</b>	<b>8.04%</b>	<b>6.31%</b>	<b>1.54%</b>

<b>USA</b>	<b>Household consumption</b>	<b>Government consumption</b>	<b>Capital Investment</b>	<b>Exports</b>	<b>Imports</b>	<b>GDP Growth</b>
1996	3.42%	0.47%	8.30%	8.38%	8.70%	3.75%
1997	3.78%	1.27%	11.59%	11.89%	13.58%	4.55%
1998	5.04%	1.69%	9.08%	2.42%	11.64%	4.22%
1999	5.11%	3.34%	7.82%	4.31%	11.46%	4.49%
2000	4.67%	1.89%	5.40%	8.74%	13.14%	3.69%
2001	2.54%	3.20%	-6.13%	-5.44%	-2.71%	0.76%
2002	2.74%	4.62%	-1.55%	-2.26%	3.40%	1.61%
2003	2.76%	2.82%	3.19%	1.26%	4.07%	2.52%
2004	3.65%	1.85%	8.07%	9.75%	11.32%	3.65%
2005	3.05%	0.48%	4.91%	7.03%	5.93%	2.94%
2006	3.05%	1.78%	1.90%	9.08%	5.96%	2.78%
2007	2.79%	1.93%	-4.23%	8.45%	2.17%	2.02%
<b>Averages</b>	<b>3.55%</b>	<b>2.11%</b>	<b>4.03%</b>	<b>5.30%</b>	<b>7.39%</b>	<b>3.08%</b>

<b>France</b>	<b>Household consumption</b>	<b>Government consumption</b>	<b>Capital Investment</b>	<b>Exports</b>	<b>Imports</b>	<b>GDP Growth</b>
<b>1996</b>	1.57%	2.09%	-3.71%	3.67%	2.13%	1.11%
<b>1997</b>	0.45%	1.25%	2.36%	12.91%	7.94%	2.24%
<b>1998</b>	3.83%	-0.61%	11.68%	8.24%	11.64%	3.50%
<b>1999</b>	3.47%	1.44%	7.53%	4.62%	6.69%	3.30%
<b>2000</b>	3.61%	1.90%	9.36%	12.44%	14.93%	3.91%
<b>2001</b>	2.53%	1.16%	0.24%	2.52%	2.18%	1.85%
<b>2002</b>	2.21%	1.87%	-3.34%	1.47%	1.70%	1.03%
<b>2003</b>	2.16%	2.00%	0.54%	-1.19%	1.15%	1.09%
<b>2004</b>	2.60%	2.31%	6.60%	3.96%	7.10%	2.47%
<b>2005</b>	2.64%	1.23%	4.38%	3.15%	5.95%	1.90%
<b>2006</b>	2.32%	1.29%	3.96%	5.41%	6.12%	2.17%
<b>2007</b>	2.47%	1.39%	5.58%	3.12%	5.51%	2.17%
<b>Averages</b>	<b>2.49%</b>	<b>1.44%</b>	<b>3.76%</b>	<b>5.03%</b>	<b>6.09%</b>	<b>2.23%</b>

<b>Japan</b>	<b>Household consumption</b>	<b>Government consumption</b>	<b>Capital Investment</b>	<b>Exports</b>	<b>Imports</b>	<b>GDP Growth</b>
<b>1996</b>	2.89%	2.52%	3.49%	5.88%	13.37%	2.75%
<b>1997</b>	0.79%	0.79%	0.00%	11.11%	0.51%	1.57%
<b>1998</b>	1.79%	-1.09%	-8.64%	-2.71%	-6.84%	-2.05%
<b>1999</b>	4.16%	0.86%	-2.88%	1.89%	3.61%	-0.14%
<b>2000</b>	4.35%	0.91%	-0.12%	12.70%	9.19%	2.86%
<b>2001</b>	3.00%	1.63%	-3.02%	-6.93%	0.63%	0.18%
<b>2002</b>	2.39%	1.01%	-6.90%	7.51%	0.92%	0.26%
<b>2003</b>	2.34%	0.29%	-2.23%	9.21%	3.89%	1.41%
<b>2004</b>	1.86%	1.54%	1.23%	13.93%	8.12%	2.74%
<b>2005</b>	1.56%	1.26%	3.29%	6.96%	5.81%	1.93%
<b>2006</b>	-0.39%	2.00%	2.16%	9.54%	4.15%	2.40%
<b>2007</b>	0.74%	1.47%	0.27%	8.64%	1.74%	2.08%
<b>Averages</b>	<b>2.12%</b>	<b>1.10%</b>	<b>-1.11%</b>	<b>6.48%</b>	<b>3.76%</b>	<b>1.33%</b>