Moving from the financial crisis to sustainable growth

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CENTREFORUM

About the author

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Contents

	Executive summary	4
1.	Introduction	8
2.	Where we came from	15
3.	The six pillars of growth and rebalancing	26
4.	Managing the risks	39
5.	Conclusion	51

: Executive summary

The financial turbulence of recent months has vindicated the government's financial discipline. Had we not made the decision to get in place a firm plan for dealing with the deficit, few of the observations made in this paper would be possible. Instead we would in all likelihood be dealing with an emergency: rising borrowing costs, falling financial confidence, the banking sector under even greater strain, and quite possibly even more fiscal austerity but concocted in a rush, as we have seen in some continental economies.

But thanks to our early action we have a sound platform from which to plan a return to sustainable recovery. However, in recent months there has been growing anxiety about a slowdown in growth both domestically and in overseas markets. As a small part of a large global economy, we are inevitably affected by this. At the time of writing, economic forecasts suggest weak growth as opposed to outright recession, and it is perfectly possible for confidence to return and the economy to resume its upward path. But given the difficult starting conditions, the risk of prolonged slow growth across the developed world cannot be discounted. President Obama's proposed stimulus package is a recognition of this danger, and a response to it, made possible despite the large US budget deficit by the unique role of the dollar as the global reserve currency.

We cannot and will not allow the economy to fall into a trap of stagnation. This paper is written in large part in order to explain how the government's plan contains the tools to deal with any such challenge.

Britain has strong factors supporting recovery: some world class companies, universities, scientists and creative talents; flexible labour markets; favourable demographics; a liberal, open economy; a competitive exchange rate and low interest rates. The government has set out a growth strategy based around infrastructure investment, a new industrial strategy to support manufacturing, promoting exports and inward investment, and deregulation. I have little time for those who think that Britain is somehow doomed to years of low growth. Our potential is as great as it ever has been, so long as we pursue sensible policies.

But we also have the inheritance of a seriously unbalanced economy: as well as the budget deficit, excessive (household) debt, a property bubble and an overweight and badly damaged banking sector. Historical experience suggests that the process of deleveraging after a banking crisis is long and difficult.

And the process of deleveraging – by individuals, governments (not just in the UK), banks and companies – has the effect of reducing spending and investment: aggregate demand. Across the developed world these negative factors are now contributing to a slowdown.

The immediate issue for UK policy is how to counter a serious threat to growth caused essentially by weak demand rather than lack of capacity. The government's growth strategy makes serious and credible steps that will improve the medium and longer term performance of the economy. And if there were a shock to demand, the plan allows for the economic stimulus that might be required. Some of the key mechanisms for stimulating the economy which were available in 2008 no longer are: interest rates are already close to zero and there is limited flexibility in fiscal policy, since we must maintain fiscal discipline.

There are, nonetheless, five broad initiatives which can be taken to restore business and consumer confidence that demand – and, therefore, business profits and jobs – will be sustained.

- Unconventional monetary policy – QE in some form, partially in support of private credit - can be activated by the Bank of England;
- Bank lending has to be regulated countercyclically to prevent a fresh credit crunch, whether through 'macroprudential' policies, lending agreements or both
- Tax cuts have a role if they stimulate demand and are fully funded: in particular, tax cuts for low earners (such as the coalition – and Liberal Democrat – policy of raising the tax threshold) or measures specifically designed to stimulate business investment such as the government's reductions in corporation tax rates.
- Allowing maximum fiscal flexibility within the current coalition plan by allowing the automatic stabilizers to help offset any slowdown.
- Creating greater market certainty to support business investment. There is great potential for infrastructure investment financed by the large sums currently sitting with institutional investors, if the right market signals are sent.

All of these policies need to be considered in the light of international cooperation. With financial markets in a febrile state, coordination to sustain demand is extremely important. That is why the government has been actively engaging with our international partners to ensure that the global response is properly coordinated.

This paper develops the reasoning behind these suggestions. It is part of a process initiated by Nick Clegg to develop with colleagues a considered response to the challenge for UK economic policy by a deteriorating growth outlook. The document is in the nature of a 'green paper' inviting comments from all those concerned to promote sustainable growth. And it is necessarily speculative. At the time of writing, economic conditions are fast changing, as would be the appropriate policy response. As a small part of a large

and turbulent world economy, Britain can't dictate its own path regardless of external events, and similarly the ideas here may become more or less pertinent depending on decisions elsewhere.

1. Introduction

Underneath the froth of personality and party politics around the coalition, the coalition's core purpose and justification has been to manage the aftermath of the financial crisis of 2008/9: to progress from gradual stabilisation of the fiscal position to growth, and growth which can be sustained because it has secure foundations. That means not just a recovery, but an entirely new economy. That is why we joined the coalition.

The economic policy trajectory so far has been largely predictable. In the autumn of 2009, both George Osborne and I in our separate ways warned of the difficult times that were to come. In September 2009 I wrote "over the next decade, the dominant issues in economic and social policy mostly arise from the massive budget deficit, bequeathed by the 'credit crunch' and this (Labour) government's economic policies. The consequences will be painful and difficult and will involve a period of austerity in public spending including real cuts in many areas".[1]

Any responsible government of any party or parties would have been driven down a similar path by the scale of the deficit, its structural character and risks around financial market confidence. Our government is often described by its critics as "ideological". But financial discipline is not ideological: it is a necessary precondition for effective government of right or left. This government is following a pathway trodden years before by Cripps and Attlee and by Jenkins and Wilson, as well as Howe and Thatcher.

After its first year in office the coalition has established

1 V Cable, 'Tackling the fiscal crisis: a recovery plan for the UK', Reform, 2009.

financial credibility, reflected in bond market judgments which set long term interest rates (see figure 1). While some of the recent decline in UK borrowing rates reflects falling global growth expectations, the important fact is that our rates have fallen while those of similar countries on the continent have risen to dangerous levels. When critics accuse us of gambling in our fiscal policy, I ask them to look at the government borrowing rates of Italy and Spain, which both soared through 6 per cent in August, and consider what havoc that might have wreaked upon the indebted UK economy.

This remains a very dangerous world. European countries with perceived financial weakness are beset by lack of confidence in sovereign debt leading to an existential crisis for the eurozone. Even the United States drifted into an unnecessary, ideologically driven, crisis of confidence in debt management. There are serious problems of access to

Figure 1 – Yield of 2020 bond

business finance posed by a badly damaged, dysfunctional UK banking system. Quite apart from the record government deficit that Labour bequeathed to us, it left behind an over-indebted household sector, focussed on paying back loans accumulated over a decade long borrowing binge. This is a difficult backdrop against which to plot a return to vigorous sustainable growth.

Supply or demand problem?

The economic crisis hanging over the Western economies is an unusual one, not experienced before in modern times. It stems from an accumulation of debt in the boom period leading up to the crisis, especially in the UK – by millions of consumers, hundreds of banks, some businesses and governments and the process of deleveraging from that.

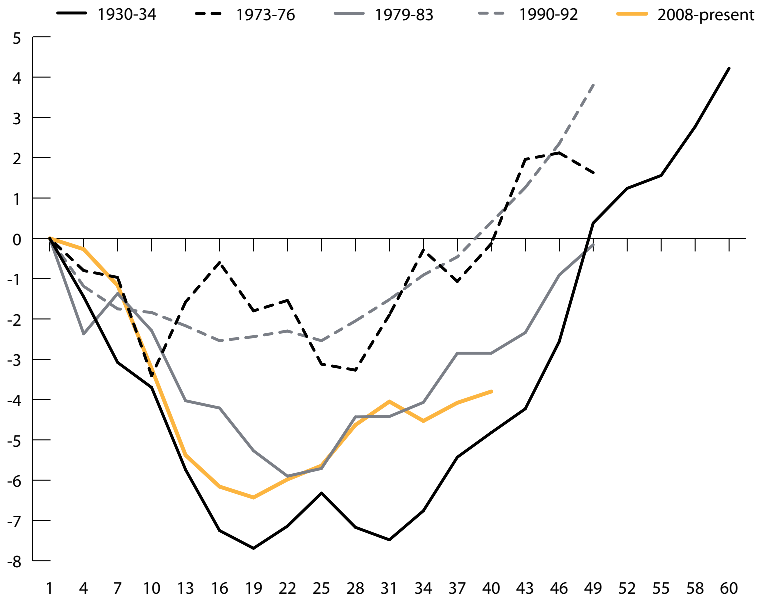
It is essential however to establish whether the current problem with the UK economy is predominantly one of its supply potential or demand.

Clearly both factors are important in terms of long term growth but the immediate issue is how to realise recovery in a weak economy. If this is essentially a problem of demand, spare capacity can be mobilised given supportive demand management, a competitive currency and easier credit availability through the banking system. Alternatively, if the problem is one of a loss of capacity, this will require not just a greater emphasis on supply side measures but an opposite set of policies in respect of demand management including monetary as well as fiscal tightening. The 'supply side' argument would be that there is little genuine spare capacity and that demand stimulus will either generate inflation and/or "crowd out" production and investment elsewhere in the economy.

The debate is profoundly important and subject to a growing polarisation of opinion. So far the government has avoided that polarisation and is rightly using a combination of demand and supply side stimuli. Its policies assume the need for demand stimulus via loose monetary policies

offsetting fiscal tightening alongside 'supply side' tax and deregulatory measures to encourage 'rebalancing'. There is a rather exaggerated debate emerging between, on the one hand those who believe that the answer to slow growth is simply monetary expansion or 'Keynesian' fiscal policy and, on the other, those who oppose both and want to see radical deregulatory initiatives (like stripping away labour protection to reduce the cost of labour) or tax cuts for high earners. This divide is not ideological in the familiar sense since the former – 'demand siders' – brings together not just much of the left but those on the right who would be characterised as 'monetarist' (Keynes and Milton Friedman are here invoked on the same side of the argument).

Figure 2 – Percentage of GDP change from peak in recessions



What is the evidence? There is little evidence to justify 'supply side' pessimism[2] and there is some evidence that recovery has been slower than in the past (see figure 2). The worrying scenario that our approach is designed to avoid is that the recovery is weaker than expected with slow growth inflicting lasting damage as government and households each seek to boost savings at the expense of the other. If the problem is deficient demand, the escape is a set of policies which encourage a revival of demand – loose monetary policy and low exchange rate; the use of 'cycle sensitive' budget deficit management; and continued structural reform to rebalance the economy. As this essay will make clear, this is the approach the government is pursuing and which I strongly favour.

The Bank of England too seems to take the view that the problems with the economy are on the demand side; if they felt that recent inflation came from a surge in demand bumping against permanently constrained supply, we might have expected further tightening. Instead the biggest factors contributing to inflation are global increases in commodity prices and one-off tax increases, both of which will drop out of the inflation data over the next year.

But what about the longer-term shape of the economy – isn't it hopelessly out of condition?

The recession itself was definitely a result of a crisis of demand. The banks' sudden withdrawal of funds, asset price falls and collapse in confidence hit the willingness and ability of consumers and companies to invest and spend. This can be seen in many different prices falling – for example, the collapse of the oil price from over $130 to below $50 at one time – but is perhaps best illustrated by the behaviour of average wages. If we were in a position of straining against our supply capacity, you would see far more evidence of increasing wages. Barring extremely high paid executives, this is not happening. Even before the onset of recession, average wage growth lagged inflation,

2 'Is the British economy supply constrained?' University of Cambridge, Centre for Business Research July 2011.

suggesting that workers have little bargaining power over employers. Once recession was fully upon us, the response of many firms was to impose wage freezes. Since wages are usually over 50% of a firm's cost base, the risk of the supply capacity of individual firms being hit by labour costs is very slight. A greater possible risk to supply might instead have come from the atrophy of skills through persistent unemployment.

Another possible sign of a supply shock, which we saw in the 1970s, would be the difficulty of making profits or a return on capital in the economy. This is also not the case. The corporate surplus as a share of gross national product has not been under great pressure.

Neither, in aggregate, is there a problem of firms not being able to make profits because of burdensome taxes or regulation. The problems are small compared to the 1970s, where return on capital almost disappeared.

Finally, another cause of us being in a supply-constrained position might be if we were hopelessly imbalanced in terms of sectors. However, while we do have an overdependence on finance, this is generally overstated. Finance is 8% of the economy in terms of GDP, and much of that is quite respectable – a part of the professional business services economy at which we excel. It is true that we could have more manufacturing. It is right to call for a different balance in our economy, both on the supply-side and the demand-side, and geographically. But there is no overwhelming proof either that this can't be stopped or reversed to some extent, or that policies to achieve this would necessarily doom us to much lower growth than previously. This does not make the problems any easier to solve – as I have already argued, Labour left us with a profoundly unbalanced economy in terms of the source of demand, with far too much coming from indebted households, and far too little from cash rich business.

But underling this imbalance is an economy with strong potential. As I said to the CBI almost a year ago:

> "Britain has a lot going for it and good prospects for recovery. We are an outward looking country. We have world class companies, universities, scientists and creative talents. We have flexible labour markets and favourable demographics, unlike most of Europe. There is a competitive exchange rate favouring exporters and inward investors. There are negative real interest rates creating strong incentives for new investment and a large pool of savings looking for investment opportunities. And you have a strong, stable coalition government committed to fiscal discipline and radical reform."

The challenge is to pursue the policies that unlock this potential.

2. Where we came from

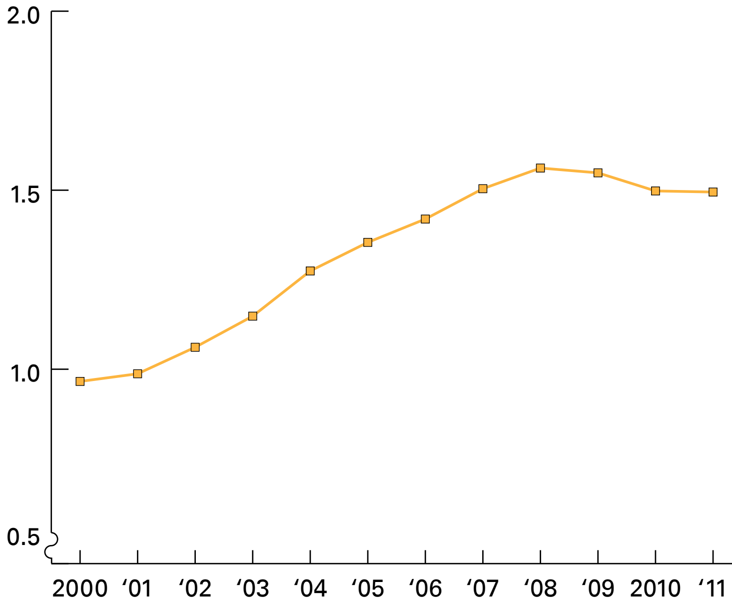
The financial crisis of 2007/8 will dominate economic policy for a long time. Managing the consequences and building a new model of balanced growth will preoccupy the whole of this government and probably the next.

Unless the origins of our current problems are remembered and understood, the painful measures required to deal with them will lack public support. The government has been successful in developing a narrative built around the inherited deficit and public debt, and Labour's deficit denial. But this is only part of a much bigger story.

These deeper problems I described at length in the book, The Storm (2009). On one level the UK was caught up in a wider, global financial disaster. But the UK built a construction with major structural defects, which proved exceptionally vulnerable to global financial shocks. After a broadly successful and economically well managed first term in office, the Labour government presided over what Gordon Brown claimed to be an economic miracle: the longest period of strong growth on record.

But it was incubating a disaster. Growth was driven primarily by household consumption boosted by growing indebtedness (see figure 3); the UK's ratio of gross household debt to disposable income became the biggest of any significant economy and remains so. This borrowing, and the confidence to maintain high levels of consumer spending, was boosted by an asset bubble, mainly housing. The belief was propagated that house prices could be expected to rise for ever, blissfully ignoring the history of regular boom and bust cycles. The

Figure 3 – Household debt/disposable income ratio

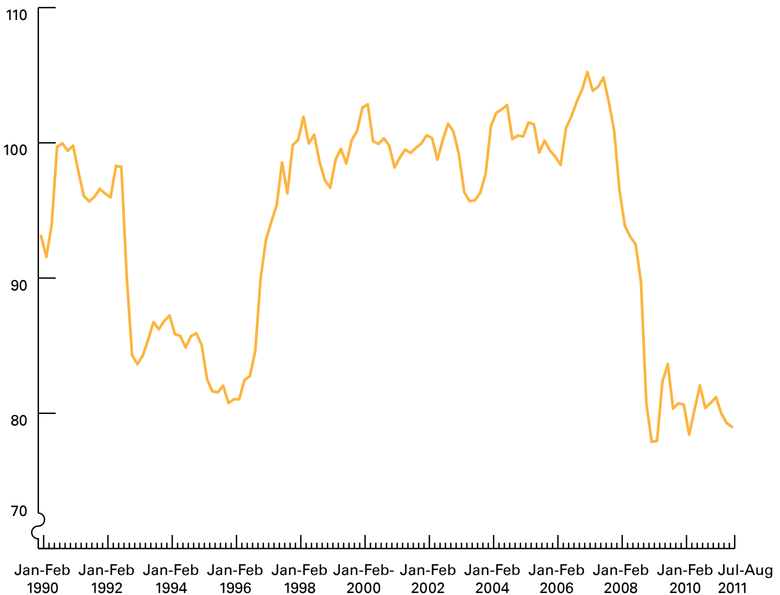


mortgage lenders who financed the borrowing, and fuelled the property boom, shared this historical amnesia. This British obsession with property and property prices, rather than productive investment, lies at the heart of our problems and has yet to be properly confronted, economically or politically.

The Bank of England ignored asset inflation since it did not come within its remit. Moreover, it shared a complacent belief with other central bankers that asset bubbles could not be spotted in advance, but should instead be allowed to burst, with the central bank mopping up afterwards.

There was another, even more destructive, development. The banking sector expanded rapidly, freed from regulatory restraints after the financial sector liberalisation of the 1980s. London attracted global banks and the City revelled in its role as the world's leading banking centre. Led by three UK-domiciled universal banks the UK economy acquired

Figure 4 – Effective exchange rate (2005 =100)



an extraordinarily high level of dependence on the banking sector, with UK-domiciled bank assets to GDP ratios of well over 400%. This dependency provided substantial tax revenues in the boom period but left the economy badly exposed to the risks of a banking collapse. It did collapse. The first dramatic sign that something was deeply wrong was the run on the former building society, Northern Rock, followed by the bigger, transatlantic, financial heart attack. But in that period of crisis one of Britain's global banks failed and had to be nationalised (RBS), Lloyds-HBOS followed, and another (Barclays) almost failed.

We are now living with the consequences of that financial heart attack: an economy still dependent on the drip-feed of state support for banking and the steroids of cheap money.

One further malign consequence of this model of economic growth was that Britain acquired a version of the 'Dutch disease': the success of tradable financial services acting

like gas or oil in resource-rich economies to create a strong real exchange rate (see figure 4), undermining the competitiveness of other tradeable activities, notably manufacturing. The relative decline in manufacturing was on a scale unmatched by any other developed country, even when we take into account the intensification of Chinese competition and the remorseless increase in productivity that characterizes manufacturing compared to services (with the corollary that the same volume of manufacturing goods will represent a dwindling share of GDP). Between 1997 and 2010, the share of manufacturing in GDP fell from 21 per cent to 12 per cent; and manufacturing employment declined by over a third (from 4.7 million in 1994 to 2.7 million in 2009): a pace of decline exceeding that of the 1979-90 period when a high real exchange rate twice squeezed the sector's profit margins and price competitiveness.

When the financial crisis was at its peak in the autumn of 2008 the government of Gordon Brown and Alistair Darling acted to prevent a complete meltdown of the banking system and pursued expansionary policies, in concert with other countries, to stave off a 1930s style depression. Expansionary policies centred primarily on monetary easing and low short term interest rates but included a small (1 per cent of GDP) fiscal stimulus on top of fiscal stabilisers allowed to offset recession.[3] While they may deserve praise for a well executed rescue that was supported across the political spectrum, future historians will hold the captain responsible for the fact that the shipwreck owed much to his falling asleep on the bridge while his boat headed at full speed onto the rocks.

The badly damaged vessel was passed on to the present government to repair. The outgoing administration acknowledged at the time (but not since) that a substantial part of the inherited budget deficit which it was passing on was 'structural'; that is, spending was based on windfall revenues from the financial sector and housing which would

3 Opponents of Keynes believe that the size of the fiscal stimulus is necessarily the same size as the increase in the deficit. That is a mistake (because of the cyclical effects); a government that suddenly loses revenues through a weakening of the economy is not thereby stimulating the economy.

not continue. A rough working assumption was that there was a structural deficit of around 6.5 per cent of GDP and Alistair Darling prepared a plan for removing it over an eight year period, with a fiscal contraction commencing in 2010-11.

In my pamphlet *Tackling the Fiscal Crisis* I argued that an even bigger fiscal tightening might be required over a shorter (five year) period "to persuade the UK's creditors that the government is serious". When discussing possible macro economic policy options, I described the most plausible scenario as "weak recovery, low inflation risk". Despite the one-off effect of higher oil prices (largely caused by the Arab spring and at time of writing dissipating), this appears to be the most likely outcome for the medium term, and the corresponding policy mix – easy money and tight fiscal policy –the right one.

That is what has happened. In the event the coalition has adopted a comparable scale and timing of deficit reduction. And it has recognised that, while the immediate task is deficit reduction, the broader economic strategy must be to achieve recovery based on investment rather than consumption; exports rather than credit-based household spending; manufacturing rather than bank-dominated financial services.

The economic debate cannot, however, be conducted in isolation from politics. The fact that Liberal Democrat politicians can work with traditional political opponents in the face of, often vituperative, attacks from Labour is not just due to the parliamentary arithmetic but also the inability of the Opposition to confront and acknowledge the economic history of the last decade.

Too much, too soon?

In practice the political debate has narrowed from the big strategic picture to the narrower issue of short term fiscal policy. Criticism of the coalition's economic policies range from a generalised opposition to any curbs on public spending anytime, anywhere, to a more narrow critique based on the

phasing and timing of deficit reduction. The latter is the main concern here.

There is clearly an issue of balance. I argued in the pamphlet 'Tackling the fiscal crisis':

> "if action is taken too soon and too abruptly there is a risk of deepening and prolonging the recession. If it is taken too late the problem of managing government borrowing and debt becomes progressively more serious (because of risks of declining market confidence)."

A meaningful comparison can however be made between the government's plan to deal with the deficit in one parliament and the Labour government's plan, phasing deficit reduction over 8 years.

In simple arithmetical terms the government's plans involve a deficit reduction of 9.6 percentage points over six years, or 1.6 per cent of GDP per annum, while Labour's plan involved cutting by 7.3 percentage points over five years, or 1.4 per cent of GDP per annum (these figures can be deduced by looking at the OBR's early reports). Of course, they did not explain where the cuts would fall. Labour's plan involved – slightly – less reliance on public spending cuts relative to tax increases as a way of cutting the deficit, but in the short term the government's VAT increase to 20 per cent has meant a relatively greater reliance on tax (a Labour government was planning a VAT increase in any event). The Labour cuts involved somewhat deeper reductions in capital, relative to current, spending. Labour's cuts were also 'front end loaded' so they were not greatly different from this government's in 2011/12. The government's cuts involve a fairly flat profile with no reductions in health (which has real growth), schools and foreign aid, and no cash reductions in science. The Labour plan also assumed 3 per cent economic growth after 2011/12 though the origins of this growth were never explained, and we now know that those growth forecasts were politically manipulated, whereas the government's more modest growth assumptions were based on the analysis of the independent Office of Budget Responsibility.

Critics argue that the government's ambitious deficit reduction plan may have contributed significantly to the slowdown in economic growth in the latter half of 2010/11 and early 2011/12. Household spending has indeed fallen quite sharply as reflected in retail sales and it is argued that the combination of VAT increases and worries over the impact of future public sector job cuts have encouraged this mood of household retrenchment (see figure 5).

It is likely however that the causes of depressed retail spending are based on factors largely outside government control: the sharp cut in disposable income caused by rising world commodity prices, the (growth-stimulating) currency devaluation of 20 per cent or so since 2009; and, also, the negative 'wealth effects' of falling house prices in many parts of the country. Many of these factors are mirrored throughout the developed world.

Figure 5 – Household final consumption expenditure (seasonally adjusted) £million

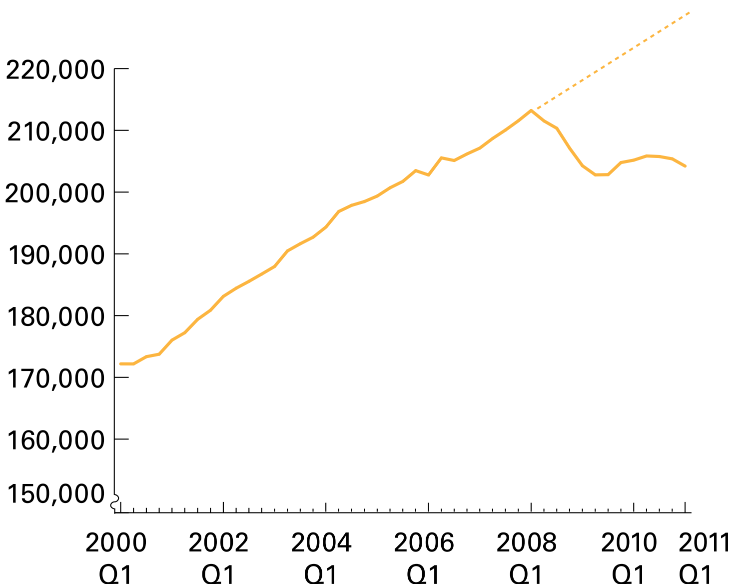
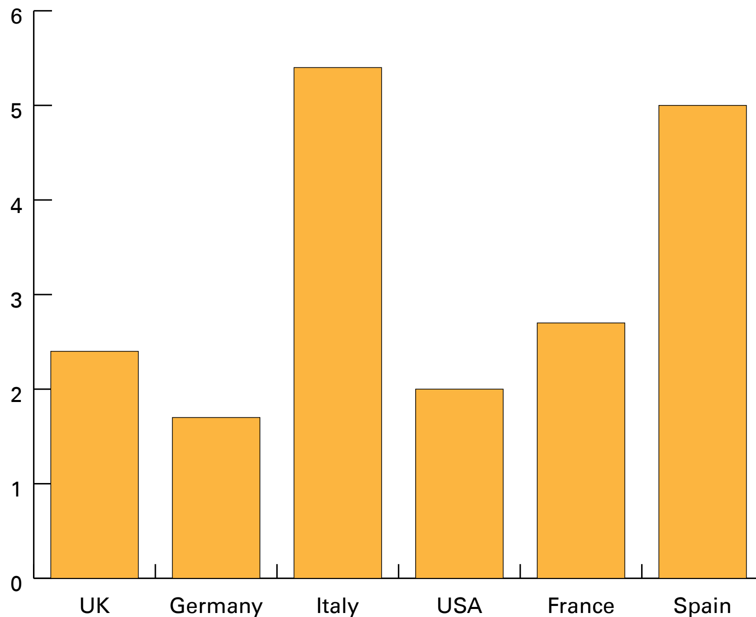


Figure 6 – Latest 10 year bond rates



But putting aside these short-term conjunctural factors, are the government's more ambitious deficit reduction plans likely to reduce growth (and employment) or increase it, on balance? Other things being equal, fiscal tightening will reduce short term growth. But in macroeconomics other things are seldom equal. One of the consequences of the government's approach is that it has had the benefit of the doubt in bond market assessments of the country's creditworthiness.

This advantage in borrowing rates (see figure 6) affects the long term cost of capital for both public and – indirectly via corporate bond markets - the private sector. As such, it contributes materially to growth.

A related factor is that short term interest rates are, also, indirectly, influenced by the degree to which the public sector is expected to be boosting the economy. If the Monetary Policy Committee judges that the coalition's actions are less likely

to be inflationary in the longer term (i.e. two years ahead), interest rates (and the exchange rate) are more likely to be kept low, with important implications for growth. A large proportion of existing mortgages are automatically linked to the base rate, so an increase by the MPC would immediately feed into higher repayments and lower disposable incomes.

It is difficult to quantify these effects more precisely and even more difficult to assess the significance of what critics call the 'Greek scare'; the argument that the alternative to the coalition's austerity is being overwhelmed by a sovereign debt crisis as Greece, and later, Ireland and Portugal have been, and Spain and Italy could be. Critics argue that these are economies with some fundamental differences from the UK, not least membership of the eurozone and the associated difficulty of making a major economic adjustment when the exchange rate is fixed. However, the 'Greek scare' is relevant since confidence crises originate in market assessments of default risk and, while the UK has more scope for making real economic adjustments, it has a bigger budget deficit, a bigger banking sector and bigger problems of private debt than any of the so-called PIGS.

Whilst there is no exact read across from the 'Greek scare' to the UK (or a wider PIGS 'scare') it is entirely plausible to argue that by taking strong pre-emptive action on the deficit, the UK has headed off more drastic, imposed, measures. Over the summer we have seen sudden financial panics hit the bond markets of Spain and Italy, and even France. The consequences go far beyond a few extra points on the interest rate. Money leaves the country. Funding dries up. Banks are unable to lend and companies drastically curtail their investment plans. Avoiding this sort of crisis of confidence is a key duty for any responsible government.

So far, the coalition government has been vindicated in its judgments by the avoidance of financial crisis and by achieving roughly the same bond yields - long term interest rates - of a country with high standing in financial markets, like Germany. Our critics do however pose a legitimate question about the future: are the government's plans sufficiently

flexible to be able to respond to a serious deterioration in the growth outlook? Is there, they ask, a Plan B?

The government has a robust response in answer to the Plan B question: why do we need a Plan B when Plan A is working and will work?

What is often missing from the current debate is recognition of how much built-in flexibility exists in the current policy. Part of Plan A is loose monetary policy. Indeed the response of the major Western economies to the post 2008 crisis has been, through their Central Banks, overwhelmingly 'monetarist': virtually zero interest rates; quantitative easing to boost money supply directly; and (in the case of the UK), devaluation.

Critics of Keynesian thinking lazily assume that its only policy prescription is for endless government deficits. This is untrue. Keynes' suggested response to the inter-war crisis included easy money, as is clear from his open letter to President Roosevelt in 1933. He recognised however the limitations of monetary policy: interest rates had a floor (in practice, zero) such that they could not be reduced to remove an excess of savings over investment, leaving an economy in a condition of slump.

But our situation is very far removed from those circumstances. Current short term real interest rates are below zero: around minus 4% (allowing for inflation). Even at longer durations, real interest rates have dipped below zero for borrowing money over ten years. The failure (so far) to trigger a wave of new investment on the back of low real interest rates has multiple causes. Part of the explanation must lie in the source of recent inflation, which has come from higher commodity prices which do not provide the same inducement to invest as increased nominal demand. Weak investment also has a lot to do with institutional failure in the banking system: an issue Keynes did not deal with (indeed his work scarcely touched on the economic consequences of banking failure). Above all, it must reflect uncertainty about future demand.

Furthermore, the leading Western Central Banks have broadened out monetary policy to include direct measures to boost money supply (and, thereby, nominal demand). The exact mechanisms by which quantitative easing operates are as yet imperfectly understood, and there is some concern that it has fed asset inflation rather than demand for goods and services, but there has been no lack of policy inventiveness. And the results so far have been to keep nominal spending in the UK broadly within the range needed for reasonable growth. I will discuss more radical applications in monetary policy later.

And while fiscal policy is tight, it is also more flexible in the event of economic weakness than the caricature criticisms allow. Despite the hysterical accusations of some of the government's critics, unlike Keynes we are not dealing with a 1930s style Treasury, hell bent on making the budget balance regardless of economic conditions. The deficit reduction plan allows fiscal stabilisers to operate. The coalition's plan concerns the cyclically adjusted deficit not the deficit per se.

3. The six pillars of growth and rebalancing

The government's strategy for dealing with the inherited crisis has been essentially twofold:

- As discussed above, to maintain fiscal discipline and deficit reduction objectives with offsetting, loose monetary policy, operated by the Bank of England
- To stimulate but also to 'rebalance' growth in the longer term by means of interventions which support recovery in private investment and exports and which diversify from overdependence on international banking relative to manufacturing, creative industries and other sectors.

The coalition was built around the first objective which was a short term imperative. But the government also understands that the second is no less important - in fact, without growth, fiscal discipline becomes much harder. A growth strategy reflecting both approaches is built around the following themes.

1 – 'Hard' infrastructure and long term investment

A strong revival of infrastructure investment is a key component of sustainable growth. There is substantial evidence that the quality of UK infrastructure – especially transport, broadband, energy production and distribution – lags behind that of other major developed countries, impeding private sector efficiency and growth. And to delay risks reinforcing a boom-bust cycle in infrastructure with bottlenecks and pressure on costs in the next upswing. Moreover, if large scale infrastructure

investment could be encouraged quickly, it could alleviate unemployment since UK income and employment multipliers are particularly large in construction.

The government's growth review is seeking to break through some of the most serious obstacles particularly where big complex projects – like the Atlantic Gateway on Merseyside; or the new deep water development on the Thames Estuary – are being held up by planning bottlenecks or by lack of coordination between agencies. There are roughly 30 to 40 major projects of this kind. But a more fundamental problem is finance. It has been estimated that roughly £200bn of investment has to be mobilised over the next five years to meet plausible estimates of capacity requirements, particularly in the energy sector. There is a large pool of capital in financial institutions like pension funds looking for long term investment opportunities with a reliable, utility return. The issue is how to channel this money into large scale infrastructure investments, and quickly.

Dieter Helm has described how a 'regulated asset base' – a regulatory regime – can be created to provide certainty and predictability – for institutional investors. The long term cost of capital is currently very low (negative in real terms) but much inflated in practice by political risk. The RAB model provides investors with, in effect, a long term contract to provide a secure revenue stream based on an assumed rate of return (typically around 5 per cent in real terms). An independent regulator sets the terms. This model is already applied in the water and sewerage sector, airports, railways and energy distribution. There is scope for extending it to the road network by allowing tolls on new roads (the Coalition Agreement precludes tolling for existing roads), extensions of London Underground and elsewhere. The electricity sector is being developed under a different model under the Electricity Markets Review – contracts for difference – which, it is believed, will create a similar degree of clarity and certainty. The growth strategy is based on this combination of funding models triggering large scale infrastructure investment, with other obstacles reduced to a minimum.

The debate around infrastructure is also part of a wider debate about how to engender long term investment in the interests of sustainable growth. There are activities outside of infrastructure which also require a long term perspective – investment in research and capital intensive manufacturing; oil and gas production and refining; and, arguably, housing. There is some evidence that British equity markets are not conducive to 'long termism' and this is reflected in the problems faced by companies in raising capital and in the pattern of company takeovers. I have asked Professor John Kay to look at the causes and remedies.

2 – Banking for the real economy

What I have described as an economic heart attack cannot be dealt with, without addressing the weakness of the heart itself – the banking system – and the clogged arteries which are preventing credit flows to productive firms. There are two sets of actions to achieve economic recovery.

The first is to prevent the rapid deleveraging of banks damaging the real economy as they seek to strengthen their balance sheets. Data from the Bank of England and others has shown that credit availability for large companies, either through banks or the capital markets, has stabilised. But many smaller companies do not have the luxury of choice and still have to rely upon their banks. There have been worrying signs that SMEs are facing a severe squeeze from reduced availability, or increased cost, of working capital and other finance or are discouraged from applying for credit.

The government has sought to address this problem through voluntary agreements – Project Merlin - with targets for additional gross lending. They are deliberately stretching targets, asking for an increase in lending of 15% when the underlying nominal growth of the economy might be just a third of this. Their purpose is to elevate the performance of smaller company lending to the board room and make it a strategic priority for banks that might otherwise ignore this vital part of their business, and instead focus either on their investment banking priorities or on repairing their balance

sheets. The agreement includes a commitment to recognise performance to these lending targets in the remuneration of top executives.

At the time of writing, it is not clear that banks would meet the targets. However, after a disappointing first quarter, political pressure has seemed to produce a response: the numbers are now broadly on track, and there is some sign of a cultural shift back towards business relationship banking in some of the leading banks.

The further response to the problems around access to finance has been to stimulate new forms of funding. The Business Growth Fund, another outcome of Project Merlin, will provide equity capital to mid-cap companies meeting a longstanding gap in capital markets, most recently identified by the Rowlands Review in 2009. The £2.5bn of funds are being provided entirely by the banks, and should be contrasted with the £500m that Alistair Darling announced in his last budget. The government via the ECGD is also supporting four different kinds of trade finance to boost exports (the ECGD, being self funding, does not count against public deficit or debt targets). A variety of smaller scale initiatives are being launched via the government's Regional Growth Fund to support micro-businesses.

The other major policy issue relates to structural reform. The Independent Banking Commission, reporting to the Chancellor and myself, has argued for the separation of retail (including business) lending from wholesale and investment banking. The Banking Commission has recommended structural reform through a form of separation: ringfencing.

While structural reform will not have immediate effects on economic growth it will play a crucial role in rebalancing: ensuring that the vast balance sheets of global banks based in the UK do not continue to have a perceived taxpayer guarantee. The government has welcomed its report.

There are signs that, for the first time for many years, there is real competition emerging in business lending with the prospective sale of a chunk of Lloyds branches and the

emergence of new entrants like Handelsbank. There are also useful and interesting developments to fill the 'equity gap' for mid cap companies (the Business Growth Fund) and the re-emergence of asset backed finance. But the core issue remains one of maintaining bank lending to the business sector, especially SMEs.

3 – A new industrial strategy

If Britain is to achieve a more balanced form of growth – export based, less dependent on the banking sector, less concentrated in the southeast of England – it will have to build on some existing but underdeveloped or underperforming competitive strengths. Analysis suggests that Britain has a strong 'revealed competitive advantage' in advanced, innovative, manufacturing (including pharmaceuticals, chemicals, vehicles and many specialist, high value added activities) and also in many service activities: creative industries and professional and business services especially.

The traditional distinction between manufacturing and services is perhaps unhelpful here since successful manufacturing often rests on good design or marketing or IT services and successful service industries like music making or computer games depend on using and designing sophisticated equipment. A large part of industrial value-added, these days, involves intellectual property and other intangibles, rather that metal bashing. But, however we define it, manufacturing contributes disproportionately to productivity, growth and exports. And that judgment has led us to the conclusion that government should facilitate the process through some form of industrial strategy.

Industrial policy has become unfashionable, particularly in Anglo-Saxon countries. The idea that government can anticipate or make better choices than markets is anathema to liberal economics. And past, expensive, experience of active industrial policy, as in the 1970s, persuaded a generation of policy makers, including me, not to go there again. Government was not good at 'picking winners' and even worse at making the difficult choices of withdrawing support from 'losers'.

That said, there is a strong case for a more sophisticated form of industrial strategy that involves two key elements: one is a strong evidence base for decisions which identifies the market failures and wider economic benefits - the externalities - of any intervention; a second is the creation of a 'firewall' between Ministers and specific decisions so that the industrial policy doesn't become a gravy train for well-organised vested interests. Such an approach has been evolving under this government but has the scope for substantial development and enlargement:

- **Technology innovation centres** where core future technologies are identified by a (politically independent) Technology Strategy Board and supported through networks of existing (or new) institutions with public support, established through a competitive process. The core idea is partially inspired by the German Fraunhofer model, and the work of the inventor-entrepreneur Herman Hauser. It is aimed at a particular early stage technological development that will not be adequately financed through private markets alone, combined with a strategic decision as to which core technologies should receive state support. So far, advanced manufacturing, including materials science, cell therapy and new renewable energy ideas have been identified as core technologies and there is going to be funding for others over the next few years.
- **The Regional Growth Fund** provides a mechanism by which the government can directly support projects which contribute to growth in parts of the country disproportionately affected by public sector cuts. There are tests of value for money, employment generation and a leverage multiple for private capital. A panel led by Lord Heseltine makes recommendations though – in this case – there is ministerial discretion over the final decisions for utilising the £1.4bn fund.

- **The Green Investment Bank**, currently being established with £3bn start-up capital, will be (initially) a state bank co-financing: renewable energy, industrial energy efficiency projects; and industrial waste disposal. The projects being considered will not materialise without government support; the novelty of the projects and potentially high degree of political or regulatory risk constitute a form of market failure. The Bank will be at arms' length from government and state aid clearance is being sought, while the first investments should be made next year. The Green Investment Bank in many ways is the government's response to the Liberal Democrat call for a National Infrastructure Bank, made before the election.
- **The low carbon economy** The GIB is one of several interventions designed to overcome the perceived high level risks and maximise the externalities in making long term investments which will be important in an economy with a much smaller carbon footprint: subsidies for an infrastructure of charging points for electric vehicles; research and development on electric vehicles as on the Nissan Leaf; and the "Green Deal" creating regulatory incentives for households to invest in energy saving, utilising advance financial commitments by utility companies.
- **Supply chain development** In some industries, notably aerospace and vehicles, much of the value of production lies not in the final assembler (the OEM) but in the supply chain. Supply chains have largely evolved through market driven subcontracting on a global basis. But there are advantages in proximity (demonstrated in the UK by the disruption caused by the tsunami in Japan) and there is a strong externality in clustering caused by the interconnectedness of producers. In the UK supply chains have been allowed to fall apart following a long period of uncompetitive exchange rates and the damage caused by the drying up of credit in 2008/9.

> There is currently a move to bring back automotive and other supply chains and the government is helping indirectly through pan-industry bodies like the Automotive Council which can pool information and intelligence on supply chains without infringing cartel rules; or directly by supporting OEMs which sit at the head of the supply chain (Airbus, Augusta Westland, JLR, Vauxhall). The Industrial Development Board helps to depoliticise decisions involving direct assistance.

Taken together these activities do not amount to a full blown, interventionist, industrial policy, which we know failed when last tried in the 1970s. Instead, they recognise that government should not be passive and has a role, not only in addressing market failure, but also in the case of new industries of playing an active role in creating new markets.

One area of industry policy is more controversial: public procurement. At present UK public procurement is dominated by consideration of cost – 'value for money' – and competition, based on compliance with EU rules. These are good principles and previous attempts to use public procurement for wider industry policy objectives have resulted in defence contracts with massive cost overruns, delays and equipment without a sound military rationale. But the controversy surrounding the Thameslink contract has suggested that the more purist approach can neglect wider economic impacts and the positive long term value for money advantages that stem from sustaining a more competitive supplier base. At the very least, the government should be aiming to improve on its past record of 'famine and feast' in procurement. Without lurching back to protectionist procurement and while remaining within international rules there is undoubtedly more scope for supporting UK industry and supply chains than we are currently doing.

Most of these activities are constrained by public finance but they also involve co-financing with the private sector so there is a strong incentive to maximise the leverage involved. Most of them also have a short term impact; so they contribute to

recovery as well as long term rebalancing. What I call a New Industrial Strategy should be extended and enlarged.

4 – The knowledge economy: 'soft' infrastructure

A necessary precondition for the success of any industrial strategy and long term growth is investment in education and skills: the knowledge economy. International research suggests that investment in education and R&D correlates strongly with economic performance in developed countries. The Work Foundation has sketched out a vision of what a UK knowledge economy will look like in 2020[4] and the government is putting in place some of the key building blocks. I acknowledge that, in the last decade, there has already been a substantial expansion of higher education and a well supported and intelligently crafted science policy under Lords Sainsbury and Drayson The issue now is how to build on that inheritance, and correct its deficiencies – the shortage of quality STEM students especially in engineering; the deficiency of intermediate level skills; the poor numeracy and literacy of many school leavers – within a framework of highly constrained public spending. The key elements of policy are:

- Investment in intermediate level and higher vocational skills, focusing on *apprenticeships*. Despite a greatly reduced departmental budget, I have prioritised support for apprenticeships in the Spending Review (in effect, the government covers 50 per cent of the cost, the rest being paid by the employer). This priority reflects the analysis which shows that skill shortage is one of the most serious constraints on expansion by existing and prospective investors. There has been an upsurge of apprenticeships – a 50 per cent increase in the last year - and we plan to increase the numbers by around a quarter of a million over the parliament over what was planned hitherto. I also attach great importance to the work of the 'sector skills councils' to evolve 'license to

4 'A plan for growth in the knowledge economy', Work Foundation, June 2011.

practise' and levy arrangements which overcome the reluctance of individual employers to invest in training (and become 'free riders' on other companies' investment in training). This is an area where market failure justifies state intervention but public spending can be wasted unless it is structured to create good incentives by employers and employees to invest.

- The most politically difficult challenge has been to maintain the supply of *graduate* level 'knowledge workers' through the university system. Faced with a roughly 25 per cent cut in the budget, whichever government was in power, the most tempting route for government would have been to cut student numbers and/or cut the quality of university experience. A different approach was taken: to replace government direct grant funding of university teaching by increased funding via the student loans scheme – with graduates making a substantially bigger contribution, albeit in a 'progressive' manner related to future income. This is not the place to rehearse again all the arguments around student finance beyond noting that the new arrangements will maintain university funding, will encourage better teaching and will permit the partial dismantling of the quantity control system on student places. STEM subjects, particularly engineering, are crucial for the knowledge economy – though not exclusively so – and protections are being put in place to ensure that they are not disadvantaged, but encouraged, in the university reforms
- With a difficult budgetary settlement, the *science* budget was protected from cuts, and ring fenced. A wider *innovation* strategy, dealing with the commercial application of research, is being evolved and has the Technology Innovation Centres at its heart.
- Radical reform in relation to intellectual property: freeing up copyright (as with the Hargreaves Review) and introducing the 'Patent Box' in the tax system

5 – Being open for business

A critically important part of the growth strategy is an emphasis on trade and openness to inward investment. Exports provide a source of effective demand in the short run and a longer term refocusing of production towards rapidly growing emerging markets. There has been a devaluation – in real, effective, terms – of around 25 per cent since 2007. This represents a substantial market incentive to export (and substitute imports) after a decade of apparent over-valuation of the currency.

The government policy is to reinforce the effect of devaluation. It starts with a recognition that the UK has a general problem in the relatively low participation of SMEs in international trade by comparison with, say, Germany. There is a specific market failure in short term export finance. The collapse of trade finance in the aftermath of the global financial crisis has been followed by continued difficulties in access to finance which are compounded for SMEs in particular by the additional risks and complexities of cross border trade. Four new – self financing – products are now being made available through the ECGD.

The second initiative is to refocus the efforts of the trade promotion body, UKTI, on the big, rapidly emerging markets and SMEs' efforts to build up marketing networks within them. It is a striking, if worrying, fact that UK exports to Ireland are greater than those to China, India, Brazil and Russia combined. The UK share of imports in these countries is very small and in several cases well below 1 per cent. Active trade diplomacy is being deployed to help counter years of neglect, particularly in those areas where emerging market state entities are themselves involved in trade.

In parallel, the UK is pursuing trade liberalising policies by the EU in external multilateral and bilateral negotiations and within the EU Single Market. That is clearly right and consistent with the UK's longstanding commitment to an open trading system. But, with the near collapse of the WTO Doha Round, trade policy may in future be less congenial.

The philosophy of being 'open for business' also involves an active policy of seeking to attract inward investors. Some multinational companies are adept at gaining behaviour to maximise fiscal incentives and minimise tax and it is important that we are not sucked into expensive bidding wars but make an offer to overseas investors based on the overall attractiveness of the UK tax system and the business environment. The UK starts from a strong position, though there is growing competition from France and Germany.

The most controversial aspect of openness is immigration. Immigration has contributed substantially to growth in the last decade. Policies designed to support growth must involve liberal and flexible immigration rules for highly skilled workers and inter-company transfers and also for overseas students who represent a major, successful, and growing 'export' industry for the UK. Action is being taken to prevent abuse of the immigration rules by overseas students and employees on work permits but it will remain crucial to have a proportionate response which reflects the economic benefits to the UK from legal non-EU, migration in these categories (we have no control over EU immigration or UK emigration in any event).

These policy points have however to be seen in a much bigger context. The UK has 2 per cent of global GDP and 1 per cent of the world's population. Both ratios are declining owing to growth elsewhere. The UK has an exceptional level of influence, 'soft power', as a result of its history and the engagement of the policy elite with international institutions. But this influence is also declining along with the West in general. A new world order is being created with a remarkably rapid shift in the global centre of economic gravity towards the big emerging nations and they, rather than we, will shape the future structure of the world economy; future patterns of demand; and, increasingly, the rules governing trade, investment flows, climate change emissions targets and much else. In some cases the impacts on the UK will be painful – as with rising Asian demand hitting up against raw material and food supply constraints affecting the commodity

terms of trade. But the only sensible long term position is not to retreat into inward looking and protectionist policies towards trade and foreign investment either at national or EU level, but to understand and adapt to this new global environment.

6 – Supply side reform:

What Keynes called the ‘animal spirits of entrepreneurs’ is partly about business having confidence in market demand but also includes so-called ‘supply side’ measures which affect costs or regulatory impediments to expansion.

However, recovery can be accelerated if investment can be made more profitable through deregulatory and tax reform, and the long term restructuring of the economy hinges on private investment.

The coalition has embarked on a series of supply side reforms. Steps include some far-reaching deregulation (at least by previous, timid, experience), as in the ‘red tape challenge’ and our commitment to end the gold plating of European regulation; simplification of planning rules; and reductions in tax on corporate profits and employers’ costs (NICs). More can be done. And business attaches importance to deregulation.

There are however limits as to how far and how fast supply side reform can go and how effective it is. In some areas, like employment law, the United Kingdom is generally reckoned to have one of the lowest burdens in Europe. Many regulations have legitimate social, environmental, safety, consumer or worker protection purposes. Nonetheless, within these constraints, it is right that the government should be radical in this area to reduce the large and costly burden of regulatory compliance faced by SMEs in particular.

4. Managing the risks

The government's overall approach to the economy – the emergency budget; the Spending Review; the ongoing Growth review – has been undertaken in rapidly changing conditions, external and internal. Within this framework we have the flexibility to confront future risks.

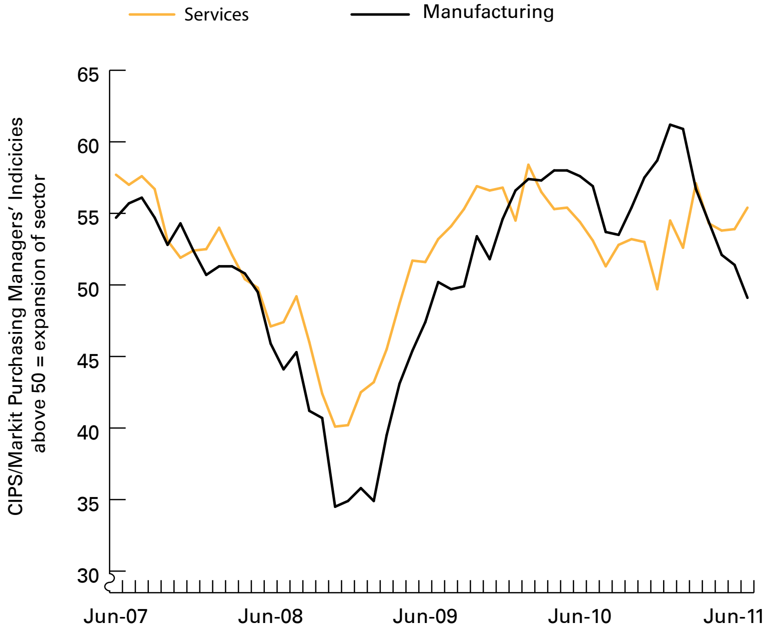
One risk is that financial markets seize up as they did in 2008. For example, if the eurozone sovereign debt crisis spreads beyond Greece and intensifies in severity to a point where major countries like Italy and Spain face questions about the sustainability of their public debt. There is risk to our trade from contracting economies in the eurozone which accounts for 50 per cent of our viable trade and then from a hit on UK based banks from their eurozone lending.

British banks are better capitalised than in 2008, and have far more robust funding arrangements in place – the result of a strong regulatory response by government – and the Bank of England is better prepared to deal with a serious liquidity crisis. Lessons have been learnt as to how to protect trade credit and supply chains, and in particular SMEs.

In addition to disaster risks from the eurozone there are concerns around faltering recovery in the USA and also about severe imbalances in the global economy, with 'deficit' countries, including the UK, pursuing more austere fiscal policies in order to maintain their credit standing but 'surplus' countries like Germany and China not offering compensating stimulus. These external factors could further weaken UK growth.

The most recent growth rate forecast by the OBR (in March) is 1.7 per cent for 2011, a significant cut from their estimates

Figure 7 – Manufacturing and service sector PMIs



of November. Robert Chote, the director of the OBR, has recently warned that even 1.7 per cent will now be difficult to achieve. In common with almost all other developed economies, estimates of UK growth from the OECD and IMF have similarly weakened, with the IMF cutting its estimate for 2011 from 1.7 to 1.5 per cent, and the OECD's index of leading indicators weakening for six months in a row.[5] Even allowing for exceptional seasonal factors there has clearly been a slowdown across the developed world. In the UK the slowdown appears to have been concentrated in the retail sector where consumer confidence is weak. But there is some evidence that other sectors, hitherto growing quite strongly like manufacturing, are also affected (see figure 7).

The policy response depends in part on whether this slowdown is treated as a temporary 'blip' as the economy gradually moves to more solid, sustainable, growth. If that is

5 www.telegraph.co.uk/finance/economics/8689295/UK-growth-deteriorates-for-sixth-month-running-says-OECD.html

the case, the policy response is patience. There is a plausible argument that consumer confidence and behaviour has been badly but temporarily hit by the squeeze on real incomes from higher commodity, especially energy, prices which may abate or at least stabilise. This pattern has been repeated across the developed world and is not specific to the UK.

But many consumers (and business investors) are entirely rational in reassessing the expectations they had before the crisis; and those families with worrying levels of indebtedness will be preoccupied with increasing saving at the expense of spending – especially if house price deflation reduces their net wealth. Resurgent consumer confidence is unlikely to come to the rescue, unlike in previous recoveries where "expansionary austerity" relied upon the household sector.

What action, then, can be taken to support growth? Although different in many respects (in particular the size of their asset price collapse, and their position as a large net exporter), Japan's two decades of stagnation provides a cautionary tale of what can happen after a major banking crisis. The inter-war period also offers an experience not as remote as we might wish.

There is no longer the same scope for actively expansionary fiscal policy that there was a few years ago, especially in high deficit countries: nevertheless, it is important to examine all possible policies within this constraint. At the same time we have to allow fiscal stabilisers to operate as the economy slows which means accepting bigger deficits and borrowing in the short term. What else can be done?

1 – Monetary easing

The successful management of the aftermath of the 2008 financial crisis has depended in very large measure on aggressive monetary policy by the leading western central banks – the Fed, the ECB and the Bank of England – working with the Banks of Japan and Canada and monetary authorities in China and other major emerging markets. Low interest rates and quantitative easing has been the

dominant response. Central banks have varying degrees of operational independence but orchestrated strong measures to counter deflation (and the risk of deep 1930s style depression). The contribution of discretionary fiscal policy was more modest though deficits were allowed to rise to exceptional levels as a counter cyclical measure.

How far should monetary policy now be expanded further in the UK to boost demand and head off a period of poor growth? Thankfully, this is now a question for independent central bankers acting under a clear mandate from the government. There is no possibility for further meaningful interest rate cuts – real short term rates are now minus 4 per cent. That means further recourse to quantitative easing: the mechanism by which central banks have directly increased the supply of money by purchasing government securities from financial institutions (but could involve the purchase of other, private, assets as has happened in the USA, particularly to support private credit).

There is however some concern about QE on several grounds. First, it is said that it would add to worries about inflation when consumer inflation is already running at twice the target level set for the Bank of England (4.5 per cent as against 2 per cent). Increasing the supply of money will (assuming money continues to circulate at the same speed) produce a combination of increased output and increased price levels. When there was a real and present danger of price deflation this was not a great concern but there is now a worry that inflation is back and could be aggravated. Those who worry seriously about inflationary pressures also favour monetary tightening – high interest (and exchange) rates. But the evidence suggests that inflationary worries in the UK are overdone. The excess inflation over target is explained by import prices and one-off tax increases and there is little sign of indigenous wage inflation which is below pre crisis levels.

A second criticism is that QE is something of an economic 'black box'. How it works is unclear and there may be

unintended and malign consequences.[6] In essence, the policy involves pumping liquidity into financial institutions (banks and others). What happens then (if anything) is difficult to trace and there are varying complaints that QE finishes up inflating asset prices (property; shares as well as bonds) or has limited effect at all since the liquidity is not circulated (in other words the velocity of circulation of money slows to offset the increase in money supply). There may well be leakages of this kind but the policy does appear in the light of recent experience to work and be quick acting.

A more technical (indeed, rather arcane) worry is what this does to the accounts of the Central Bank. The idea of a nationalised Central Bank going bust or 'losing' money may seem detached from reality but worries central bankers. So far purchases of government securities have 'made a profit' since the government bonds which the Bank holds have increased in price (as yields have fallen). But a more targeted asset purchase directly linked to the real economy like corporate bonds or a securitised bundle of SME loans involves the central bank acquiring assets of poorer quality. The Bank has made it clear that when credit risk is involved, the question invariably becomes fiscal and not therefore a matter that they can act upon without the government being involved.

It could be asked whether even discussing such interventions compromises the independence of the Bank. LibDems have been strong supporters of such independence from the outset (and I made my maiden speech in Parliament on the issue). The financial crisis of 2008 did however fundamentally change the assumptions on which the Monetary Policy Committee was established. The Bank has been required to make extraordinary interventions which go way beyond a narrow remit of price stability, and necessarily involve a degree of credit risk, rendering their operations fiscal to some degree. Any further innovations in how it operates will require sign off from the government if they further encroach into fiscal territory. The Bank is itself very mindful of the

6 G Wilkes, 'Credit where it's due', CentreForum, 2010.

importance of this line, as is the government. If we reached a situation where even more unconventional policy were required, the question would require a careful discussion between Bank and government, so that its monetary independence remained unimpeachable. In the meantime, it is surely right and sensible to have an open debate on the relationship between the Bank's action and wider policy in this unprecedented, and difficult, economic environment. I have not raised here even more radical options like the use of QE to finance the budget deficit or to finance consumptions – these are options only for an extreme emergency.

There is in any event a natural complementarity between government fiscal policy and the Bank of England, in that the Central Bank's mandate leads it to help offset disciplined government fiscal tightening through QE provided it does not compromise the inflation target in the medium term or undermine the integrity and operational independence of the Bank. The IMF, no less, acknowledges that the current slowing of growth may now give rise to such conditions, again.

2 – Boosting bank lending

The case for QE would be less strong if the banks could be relied upon to increase the supply of credit to the business sector to help it maintain production and invest. Unlike large quoted companies, the SME sector has few other sources of liquidity if firms cannot fund their operations from cash flow. SME's cannot easily access equity or debt markets and other sources – like supply chain finance or leasing – are available only occasionally and expensively. Many SMEs have come to grief in the last three years because, as banks have scrambled to replace funding and also to boost their capital ratios, bank lending has dried up or terms have become, as they see it, prohibitively expensive. Although the economy overall has stabilised, lack of access to finance remains a significant issue as surveys conducted by the Bank of England's agents and others confirm. The banks claim that the problem is lack of demand and it is true that many companies are seeking to

reduce their exposure rather than increase it. Weak property markets and a generally uncertain economic outlook make it unlikely that demand for credit will return to the levels of 2005-6 any time soon. They also make it more difficult for the banks to fund their loan exposures – the almost total disappearance of securitization markets will take a long time to absorb.

The basic policy point is that since banks have, in several cases, been directly rescued by the UK taxpayer and are, as a sector, indirectly dependent on taxpayer guarantees, they have a responsibility to the wider, real, economy and not just to their own shareholders to meet a target (short term) equity return. The banks can argue not unreasonably that they are under conflicting pressures from markets, the government, and both domestic and international regulators: to increase their capital and liquidity to ensure financial stability; to lend more to the business sector; and – in the case of publicly owned banks – to increase their value to ensure profitable sales for the taxpayer.

Regulators as well as the banks themselves have a responsibility to bear in mind the consequence of their actions for the wider health of the economy. This responsibility is becoming explicit with the new Financial Policy Committee of the Bank of England operating 'macroprudential' policies. These include using capital requirements of banks to operate countercyclically – dampening lending in a boom and stimulating lending in a downturn.

If the economy were to continue to grow weakly it will be even more important to use the policy instruments available – including lending agreements with banks as well as macroprudential policy - to maintain the flow of credit to business and to resist pressures to create a vicious spiral of further retrenchment (since a weakening property market could lead to an even more restrictive approach to collateral).

3 – Funded tax cuts

As the economy has slowed there has been a clamour for tax cuts from critics of the government on the left (Ed Balls: a cut in VAT) and right (Boris Johnson: a cut in the top 50 per cent rate for high earners) with miscellaneous proposals from business lobbies and others reflecting particular interests. These proposals range from the sensible to the absurd depending on how they are couched. At the absurd end of the spectrum are proposals for unfunded tax cuts by people claiming that they will somehow 'pay for themselves' by generating additional activity, and revenue, (the Labour VAT cut) or because of the often quoted 'Laffer curve' whereby reduced tax rates lead to less tax avoidance and higher revenue. There undoubtedly is a revenue bonus from mobilising unemployed people (especially if they are on benefit) but there is no evidence base for suggesting that it will generate anything like the revenue lost. And while the Laffer curve has been demonstrated in one or two cases (as when Mrs Thatcher's government cut the top rate, then 80 per cent) this has become an all purpose, but weak, rationale for cutting the taxes of rich people. These proposals have been correctly dubbed 'voodoo economics'.

It is important therefore to be clear as to whether the proposed tax cut is revenue neutral or not. If it is not, then the proposal will have the effect of weakening the government's deficit reduction objective which business groups, who argue for tax cuts, also claim to support.

There is certainly a case for cutting direct taxes on the low paid by continuing to increase the personal allowance in a funded way (as coalition policy dictates). Low earners have a high propensity to spend so if funded in the right way this is demand stimulating. There is a separate issue of the 50p rate which is being reviewed in government, and Liberal Democrats have long argued that a tax on high value property would be more efficient.

In the longer term we should be looking at how to switch the tax base from individual and corporate income. In a parallel paper Lord Newby discusses in more detail some of the tax options.

4 – Mobilising investment

Where Keynesian thinking has greater relevance is in relation to public investment. Keynes argued strongly that to combat a slump and high unemployment there must be low interest rates to stimulate private investment – as we currently have – but also a willingness to finance public works. The major objections from the Treasury at the time (and his critics like Professor Robbins) was that public investment would 'crowd out' private investment. That argument is no stronger now than it was then; indeed there are many areas where public and private investment is complementary (where internationally mobile investors want the government to provide associated infrastructure or share risk).

Government capital budgets were cut aggressively – by half - by the Labour government in 2010/11 – because it found it easier to cut investment than confront issues like public sector pensions and staff levels, benefits and other entitlements. Great damage and distress was caused in the construction sector compounding the effect of the collapse of commercial and residential property development in the post-crisis recession. The coalition government eased the restraints on capital spending in the Spending Review, so as to create essential, efficient infrastructure as with science, broadband and transport, and to leverage in new private investment as with the Regional Growth Fund.

One of the government's considerable strengths in a world where business confidence is fragile and financial markets are febrile in the extreme is a belief that it is serious and united in eliminating, in this parliament, the large 'structural' element in the budget deficit which in turn is the largest in the G20. The benefits of this credibility are tangible and experienced in low interest rates on government debt.

In a slower growth environment the government faces pressures from the opposite direction. One is to relax deficit reduction to support demand through – unfunded – tax cuts or rephasing spending cuts. But as I have already argued, this undermines credibility with uncertain but probably

costly consequences in public debt markets.[7] From the other direction, there is more likely to be delayed improvements in deficit reduction because of falling revenue. There is a knife edge problem: further fiscal tightening is not appropriate if growth is weak; fiscal relaxation risks undermining credibility.

Fortunately there is enough flexibility in the current policy to avoid the risk of falling off the knife edge. The latest forecasts from the independent OBR showed the fiscal mandate being met one year early, and as I have argued earlier, both the fiscal (through the automatic stabilisers) and monetary tools (through the Bank of England) are more flexible than the critics would allow.

How in practice can capital investment be freed up while respecting the fiscal mandate? The last government also had a target for debt of 40 per cent of GDP, but tried to get around it by making extensive use of 'off balance sheet' accounting, particularly via PFI. That mechanism proved expensive; relies on bank finance; and, in any event, is now being brought 'on balance sheet'. In the current public financing environment any government engaged in accounting tricks should receive short shrift.

An alternative approach is to try to finance capital investment by one off asset sales. Asset sales cannot sensibly be used for reducing the budget deficit reduction since they are non recurring, but they can finance capital. The government is already seeking to maximise asset sales and some potentially large sales are in prospect: spectrum sales, for example, and land.

The biggest potential asset sale is bank shares but these will take some years to prepare for sale without loss, particularly in the light of recent share price movements. Furthermore, this would compete with other promising ideas such as those discussed in Stephen Williams' recent CentreForum pamphlet 'Getting your share of the banks: giving the banks back to the people'.

7 There is an argument that markets are more likely to be 'spooked' by lower growth than fiscal weakness but we have seen no evidence of that.

One further way for freeing up capital investment would be to allow local government to pursue their own innovative ways of financing projects against their own balance sheets. Local authorities have prudential borrowing rules and are being allowed to develop new revenue streams, such as from the New Homes Bonus, and business rate retention. While local innovation is desirable in itself the capital investment will however still count against the public sector net debt.

A paralysis of both public and private investment would see the UK caught in a low growth trap. Given the significant need to boost investment in areas that need it, this would be a pointless waste, and it is quite natural that government is putting efforts into avoiding that outcome. Aside from macro-economic - monetary – policies to sustain demand there are several initiatives which could be taken to boost investment, private and public:

Public sector investment does require an innovative approach but one which recognises the overall constraints of public finance:

- providing more certainty and predictability in how we procure as a government
- accelerating asset sales to fund new capital projects, as above.
- making maximum use of EU funding. It may be galling that the EU budget is less constrained than the UK budget but we should take advantage of it for research and infrastructure financing.

Private business investment is inhibited by a mixture of weak financial demand at home and abroad, lack of confidence, especially on high risk projects and lack of access to finance (in the SME sector).

Steps that can be taken are:

- greater urgency to put in place the regulatory reforms necessary to excite domestic institutional investors and foreign sovereign wealth funds to commit to the National Infrastructure Plan, as with the RAB

model and equivalents. We should be prepared to consider ideas like toll roads for new capacity in order to produce revenue certainty for private sector investors.

- rapid implementation of the Green Deal – a large scale programme of home insulation - which is conceptually agreed but requires legal certainty for future investors so that they can retrieve the outlay through reduced energy bills.
- prioritisation within grant government spending and support for programmes which cofinance private investment, as with the Regional Growth Fund.
- an intensification of efforts, building on the Merlin Agreement, to ensure that banks lend counter-cyclically, rather than cyclically, to the SME sector.
- a much bigger commitment to supporting export finance via the ECGD, building on new short term financing schemes (which do not count against spending limits).
- sweeping away obstacles to investment in home building. Action is being taken to reform sclerotic planning systems. A big step forward would be to bring forward the steps announced in the Growth Review to legalise community land auctions (a long standing Liberal Democrat policy).[8] Land could be freed up, the planning gain could finance social housing or local infrastructure, giving the community something in return for allowing development.
- a recognition that private investor confidence will be built in if the various disparate strands of industrial policy are unified in an explicit commitment to strengthen manufacturing and support for supply chains as part of rebalancing the economy.

8 CentreForum proposed the idea of community land auctions in 'In my back yard: unblocking the planning system', Tim Leunig, 2007.

5. Conclusion

The summer of 2011 has been filled with commentators' gloom, both about Britain's slow recovery from the 2008 financial crisis and the spillover from the severe problems of the eurozone. This gloom is obscuring both the positive achievements of the last year in establishing fiscal stability and a long term strategy for growth. The impatience for a return to strong growth also fails to take into account the enormous damage done by the uncontrolled credit and housing boom and Britain's extreme overdependence on a handful of global banks. Research, notably by Reinhart and Rogoff, reminds us that recovery from banking crises involving slow deleveraging, is bound to be slow and difficult even in good external conditions and with appropriate policies.[9] The way forward has several elements:

First, the government cannot and should not abandon its deficit reduction objectives. Should action be needed to sustain demand, the best instrument available is expansion of the money supply through QE – though conditions may call for the use of more creative mechanisms designed to stimulate private credit.

Second, there is scope for boosting private investment while continuing to support public investment, the two being complementary rather than competitive in the current environment. The section above suggests possible initiatives to stimulate investment.

Third, the mess we are in was caused in a large part by a banking collapse (with Britain at its centre). Reform of the

9 C Reinhart and K Rogoff, 'The aftermath of the financial crisis', American Economic Review, May 2009.

banks remains a central policy objective, as does the need to ensure that the real economy does not suffer from a pro-cyclical retrenchment of lending to SMEs.

Fourth, Britain is trying to rebalance the economy towards tradable activities – manufacturing, creative industries and other international services. Britain has 2 per cent of the world economy. We cannot control external forces be they weak growth or inflated commodity prices. Such influence as we have has to be used to ensure that the world does not revert to 1930s style protectionism and nationalism but remains open and strengthens multilateral rules and institutions at a global as well as an EU level.