If the cuts don't work, we bank on Mr King

Official forecasts look good, but what if growth doesn't happen? Don't look to the coalition for a plan B

Anatole Kaletsky

Everyone likes to sound original. So because it seems very obvious that the economy and the coalition Government are about to suffer a series of potentially crippling body blows from the toughest programme of tax increases and spending cuts since the 1930s, the original thing to say these days is that the cuts are going to be successful, both as an economic policy and as a political strategy.

At the cost of sounding boringly unimaginative, let me explain why the more conventional view about the fiscal cutbacks is probably right. We must begin with a genuine paradox. It is generally assumed that the harsh public spending cuts that will be announced next month by George Osborne will be highly unpopular, but that voters will accept them as the price to be paid for restoring the Government's credit and improving the nation's economic performance. The political reality, however, is the other way round.

Many voters are quite enthusiastic about cutting spending, reducing welfare benefits for the work-shy and extravagant pay and pensions in the public sector. The trouble is that these cuts, desirable as they may be for the economy and the social fabric in the long term, are more likely to damage than to improve growth or employment prospects in the next year or two, and an economic slowdown, if it happens, will thwart the Government's deficit reduction plans.

Thus the greatest challenge to the Government next year will not be the harshness of the spending cuts. It will be the risk that these tough budgetary policies fail to achieve their advertised objective of strengthening the economy and improving public finances.

Mervyn King has linked his reputation to two risky propositions

For David Cameron, this situation will not be disastrous, since many of his Tory supporters will relish the decimation of the public sector, as well as looking forward to a probable election victory if the economy eventually recovers by 2015. But this long journey to 2015 is much riskier for the Prime Minister's two co-pilots.

Why two co-pilots? Because Nick Clegg is not the only British leader pinning his reputation to the Government's economic strategy. The other is Mervyn King, Governor of the Bank of England. I am not suggesting, as some Labour spin doctors have unjustly hinted, that Mr King has "sold out" to the Tories. Mr King has always been a scrupulously non-political public servant who works just as hard for the success of the British economy, whether Labour or the Tories are in power. But the Governor has now linked his reputation to two risky propositions that are unconnected with politics in his mind, but are in truth political to the core.

The first is that the Government's planned budget cuts are indispensable for Britain's financial stability. The second is that Britain's economy will not be pushed by these cuts back into recession or prolonged stagnation because the Bank of England can use monetary policy to offset any losses of spending power suffered by welfare recipients and public employees.

The first proposition can be debated forever, since everyone agrees that some cuts in borrowing are necessary but nobody can be sure how far and how fast the consolidation needs to proceed. The important issue is the second. Can monetary policy really avert a serious setback to the economy, no matter how big the cuts?

Mr King believes the answer is "yes" and, speaking purely as an economist, he is probably right. Even though short-term interest rates are already near zero, the Bank has many more ways to stimulate demand. By resuming its policy of quantitative easing, the Bank could push interest rates on long-term government bonds, which are still at more than 3 per cent, much nearer to zero. This would reduce fixed mortgage rates and bond rates, encouraging homeowners to borrow and forcing savers to spend their capital instead of trying to live off interest income. It would also create conditions for the pound to fall even farther, stimulating exports, and for savings institutions to invest more in productive assets, such as commercial property and shares. Such additional monetary stimulus might cause some worries about inflation, but that would be no deterrent in a situation where the Bank's top priority was to offset the deflationary effects of a fiscal squeeze.

Can monetary policy really avert a serious economic setback?

The problem, however, lies not in economics, but in politics, particularly the fractious politics of coalition. If all goes well, with spending cuts accepted quietly by the public sector, unemployment declining and the economy accelerating towards 3 per cent growth, as predicted by the Treasury, the coalition will be hailed as national saviours by this time next year.

But what if the official forecasts turn out to be over-optimistic? It has happened in the past, after all — and almost no private sector economists believe that growth of 3 per cent will be achieved next year. What if, instead, growth stutters and unemployment rises, as public employees and welfare beneficiaries cut back their spending — not to mention the possibility that some new economic storm might blow in from America, Europe or elsewhere?

Suppose the Chancellor has to admit in next year's Autumn Statement that the Government's budget targets have not been met, despite all the cutbacks. The Tories would instinctively respond by wanting to cut even deeper. They genuinely believe that public borrowing is an evil and want their leaders to show Margaret Thatcher's political courage. Most crucially, they see reduction of welfare and public spending as an end in itself.

For the Liberal Democrats, by contrast, the spending cuts are purely a means to an end. For them, a failure to hit deficit targets, if it were combined with rising unemployment, would remove the last remaining justification for staying in the coalition — especially if they have meanwhile lost the referendum on voting reform.

And what would the impact of the coalition's collapse be on consumer and business confidence? The answers hardly bear thinking about.

The Bank may believe it has the instruments to prevent recession, but it has no tools to prevent political disintegration. By the time the Government's policies have started to go off track, it will be too late to revive economic growth with monetary policy. The Bank must therefore do everything in its power right now to prevent even the possibility of recession or slowdown next year. The Government has no Plan B and coalition politics makes it impossible to devise one. Over to you, Mr King.