Buy the crisps and make a packet
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Opinion

We're growing now but don't be sure it will last

The jobs we need for recovery won't be forthcoming unless the Bank starts up its money-printing press again

Anatole Kaletsky

The good news is that the British economy is growing quite strongly and has emerged convincingly from recession. While Britain's economic activity is still some 4 per cent below its pre-recession peak of early 2008 and unemployment is almost one million higher, the 2.8 per cent annual growth rate reported yesterday suggests that a fairly normal recovery began in summer 2009.

Despite the doom-laden prophecies last year about astronomical banking losses, collapsing house prices and years of depression as over-borrowed families and businesses cut back on spending and investments, the economy has responded to the stimulus of falling interest rates, temporary tax cuts and rising government spending pretty much as it has in the past.

The Budget forecasts published by Alistair Darling in March 2009 were met with widespread scepticism and derision, but they now look like being met or slightly exceeded. That, in itself, might be reason to expect expansion to continue at its present pace. One of the dirty little secrets of the branch of necromancy known as economic forecasting is that the most reliable way of predicting the economy's growth in normal conditions is to extrapolate forward its performance of the previous year.

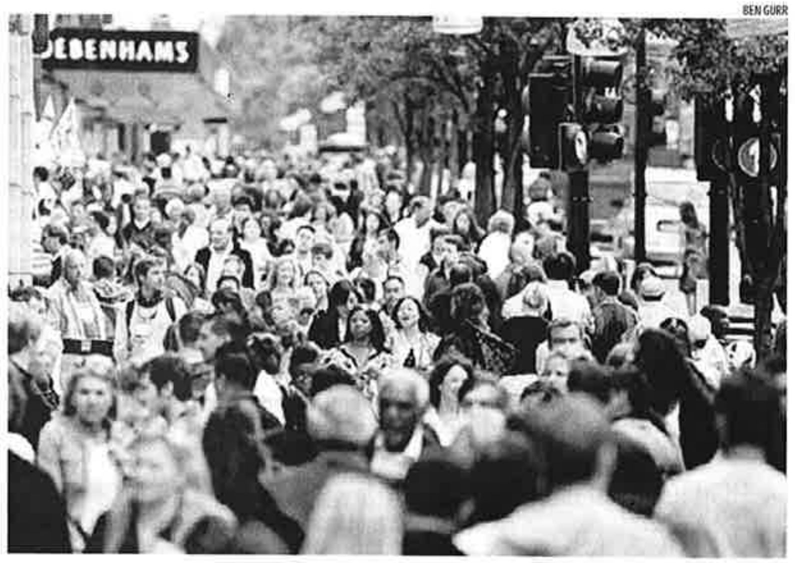
Which brings me to the bad news. Economic conditions today are far from normal and are set to become even more abnormal. The main abnormalities are, on the one hand, unprecedented government deficits and public spending cuts designed to curb them and, on the other hand, the low interest rates engineered by the Bank of England to help this process.

Under these circumstances the fairly robust performance of the economy this year could augur badly for the future. The pain from retrenchment is only just beginning, while the stimulus provided by expansionary monetary policies may already be running out. And yesterday's relatively strong figures have dangerously reduced the chances that the Bank of England will take timely further measures to offset the effects of government belt-tightening.

The trouble is that monetary and fiscal policies take a long time to work their way through the economy — typically, one to two years. Yesterday's robust growth figures reflect last year's decisions by the Bank and the previous Government. They tell us nothing, and indeed may mislead us, about how the new Government's fiscal measures will interact with the Bank's monetary policies in the years ahead.

George Osborne and Mervyn King will doubtless continue to express confidence in the Bank's ability to offset public spending cuts with "quantitative easing" or QE. But yesterday's figures may well encourage the Bank to hesitate from doing it until it is too late. With high street sales in the next few months certain to be distorted by a burst of consumer spending anticipating the January VAT increase, the Bank may well decide to delay any decisions on QE until it can get a clearer view of the economy in February or later. By that time, it will be too late for its actions to have any significant effects until 2012.

> Britain has never experienced cuts and tax rises on this scale



BEN GURR

There can be no sustained growth unless squeezed households spend more

The Bank, of course, is well aware of the long lags involved in monetary policy and therefore presumably understands the dangers of delay. That is why I still hold out hopes that the Monetary Policy Committee will announce QE next week. But what if it decides to delay for a few months?

If growth continues to power ahead in 2011, as it has done since the middle of 2009, then the MPC's caution will be vindicated, Britain can look forward to a bright economic future and Mr Osborne should hit his deficit targets. This optimism is likely to be built into next month's official forecasts by the Office for Budget Responsibility, simply because extrapolating recent performance is usually the best that forecasters can do.

In the next few years, however, past performance may turn out to be a very unreliable guide to the future, since Britain has never before experienced spending cuts and tax increases on the scale the Government has planned. So what might happen if the Bank fails to offset fiscal tightening with further monetary stimulus? The best way to answer this is to consider where new jobs and economic activity might come from as the public sector shrinks.

Over the next four years, cuts in public spending and higher taxes will withdraw 2 per cent of spending power from the economy annually, roughly equivalent to total growth in the past year. To compensate for this and generate the 2.5 per cent growth required to meet Treasury forecasts, the private sector will have to grow by 4 to 5 per cent. So where will this growth come from?

Unfortunately, history offers no reassuring answers, since all of the growth in the British economy in the past 30 years has come from three sectors — government, construction and finance, and business services — none of which looks promising. Since 1979, 2.6 million jobs have been added in public administration, health and education; 2.5 million jobs have been added in finance and business services, and 400,000 jobs were added in construction up to its collapse in 2008.

Employment in the rest of the economy declined from 13.8 million to 9.4 million. Since public sector employment is scheduled to decline by half a million and finance is currently treated as a pariah, where could Britain find new engines of growth?

The usual answer is manufacturing. But in manufacturing today, total employment is just 2.5 million, so this part of the economy would have to expand by 20 per cent in the next four years just to make up for the loss of jobs in the public sector. Given that manufacturing employment has never increased by more than 3 per cent annually in Britain, this is a tall order.

The reality is that whatever growth takes place will continue to depend on a broad-based revival of consumer spending and investment across the whole economy, including finance, business services and housing, as well as manufacturing. To accelerate such spending, with incomes squeezed by taxes and welfare cuts, savers will have to be forced to consume their capital and businesses to invest in projects they previously shunned because of low returns. The only way to achieve these twin objectives is by pushing the cost of money even lower. With short-term interest rates already near zero, long-term interest rates on bonds and fixed mortgages will have to be reduced. That is exactly what quantitative easing is supposed to achieve — and it is time for the Bank of England to get on with the job.

Anatole Kaletsky was named Financial Commentator of the Year 2010 by the Editorial Intelligence Comment Awards

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