Who has got it right, Cameron or Obama?

The two governments have pursued different paths to economic recovery. The US looks the better bet today

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What has been the worst news since the new year for the British economy and the Government? The easy answer is the unexpected plunge announced last week in the fourth quarter's gross domestic product, a statistic conveying the message that Britain may already have entered a double-dip recession. This possibility was further underlined by the near-record fall in January consumer confidence, the further decline in house prices and a new low for mortgage lending. That dismal message was by no means negated by yesterday's news of growing optimism among the country's manufacturers and exporters, of which more below.

There was, however, another reason for anxiety in the Government and the Bank of England. This was the very strong run of statistics from America, released last week. While the British economy contracted by 0.5 per cent in the fourth quarter, the US expanded in the same period by almost twice that amount.

The details showed a tremendous surge in US exports, alongside a recovery in consumption to decent levels, suggesting that the US economy was starting to fire on all cylinders. In fact net exports grew so strongly that the US would have hit a Chinese-style 7 per cent growth rate had it not been for a temporary drawdown of industrial inventories, as manufacturers found themselves unable to keep up with the pace of global demand. The implication of this powerful export performance was that US industrial activity and job creation would accelerate even more in the months ahead.

Why should good news from America upset economic policymakers in Britain? Isn't a stronger world economy exactly what the doctor ordered to assist the export-led recovery that everyone in Britain wants to see? The answer, as so often in economics, is yes and no.

To the extent that stronger American

Strong US growth will raise pressure on oil and commodity prices

growth boosts global trade and creates a bigger market for British exports, it should certainly be helpful for job creation and growth on this side of the Atlantic. But there are several consequences of a possible economic boom in America that ought to give David Cameron sleepless nights.

The first problem is obvious: strong US growth will increase the pressure on oil and commodity prices caused by booming demand in China and geopolitical turmoil in the Middle East. At a time when Britain's inflation is already well above the official target, this will make it difficult, if not impossible, for the Bank of England to stimulate the economy with additional doses of easy money if a double-dip recession does occur. A less obvious problem is that the strength of exports from America makes it harder for other countries also to achieve export-led growth.

While global growth is by no means a zero-sum game, in which one country's success is another's misfortune, it is an arithmetical fact that the world as a whole cannot increase exports faster than imports. Yet this is exactly what the US, Britain, Spain, Greece, Ireland and the other nations with large trade deficits are now trying to do at the same time.

In the next few years, the US needs to reduce its trade deficit — and increase its net exports — by several hundred billion dollars annually in order to rebalance its trade with China and Japan. Given the advantages that US exporters enjoy in terms of scale, technology and potential government backing, it is likely to achieve this objective.

If the US proves successful in reconquering world markets while the countries of Southern Europe focus on cutting back their imports, Britain will find it extremely difficult to increase its market share. British exporters were given an enormous boost in early 2009 by the sharp decline of the pound, and this advantage is now flattering the manufacturing figures. But unless the pound weakens further, the Government's hopes of an export-led recovery will be very difficult to achieve, since much of this growth will be driven by exports from advanced economies that compete directly with Britain. This is what last week's figures from the US suggested. The upshot is that an economic recovery in Britain cannot just rely on exports — it must also be driven by consumption and investment at home.

Which raises the third and most

The UK's hopes of an export-led recovery will be hard to achieve

disquieting contrast between the British and US economies in 2011. From the end of the financial crisis in early 2009 until the middle of last year, retail sales, consumer confidence and employment all moved roughly in parallel in the US and Britain. This was not surprising because the two economies had fairly similar industrial structures and faced broadly comparable problems. They also implemented very similar policies of fiscal and monetary stimulus in response to the crisis.

After the election in Britain last May, however, their macroeconomic policies diverged. The British Government embarked on a policy of almost unprecedented fiscal austerity well before the economy had fully recovered from recession. The US, by contrast has stuck to the policy recommended by Keynesian economists, that the Government should continue running large deficits until the economy has returned to clearly sustainable growth. Only when the US has restored something approaching full employment will Washington seriously consider the spending reductions and tax increases needed to narrow the budget deficit.

The upshot is that the world is now witnessing a controlled experiment of a kind that is rarely possible in economics. If the British Government's essentially monetarist views about fiscal and economic policy are right, then the US should be punished for its budgetary laxity by a long period of economic underperformance and perhaps a series of financial crises. If, on the other hand, the Obama Administration's approach turns out to be valid, then the US economic recovery will accelerate while Britain will descend into a long period of stagnation, or outright recession.

This fascinating experiment is only just starting. But the omens so far look better for President Obama and the Keynesians than for Mr Cameron and the monetarists.

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