US recovery is more creditworthy than ours

Despite the threat of a downgrade to its AAA rating, America is striking the right balance on tax and spending

Anatole Kaletsky

When Standard & Poor's, the credit rating agency, said that it was considering a downgrade to America's AAA-status for the first time since Pearl Harbor, George Osborne, who had just returned from the annual meeting of the International Monetary Fund in Washington, took it as good news. He declared that S&P's announcement proved once and for all that Labour politicians and many British economists (including me), were "way out of step with world opinion" in opposing his emergency programme of drastic cuts.

The Government even used it to justify its mean-spirited veto of the growing international support for Gordon Brown as the best-qualified European candidate to be managing director of the IMF. This might be the last opportunity in history to put Britain at the head of any leading international organisation, and would have been grasped enthusiastically by any other European government.

I have just spent two weeks in the US speaking to officials, economists and Wall Street investors, and my sense is that the US approach to fiscal policy actually commands rather more international support than Britain's — and with US economic conditions steadily improving, while Britain's get worse, nobody in Washington or at the IMF would dream of emulating Britain's scorched-earth approach.

As Larry Summers, the former US Treasury Secretary and chief architect of America's successful economic policies in the Clinton Administration and under President Obama, told the Institute for New Economic Thinking last week: "I find the idea of an expansionary fiscal contraction every bit as oxymoronic as it sounds.

"If Britain enjoys a boom in the next two years while the US experiences a slowdown, I will be happy to change my opinion — but as anyone who

No one in Washington would emulate the UK 'scorched-earth' policy

knows me can tell you, that is not something I like to do."

So what are the right conclusions to draw from the US debate on budget cuts? S&P's threat of a downgrade, if it matters at all, should be seen as what investors call a "contrary indicator", an apparently negative sign that actually suggests conditions are improving.

The so-called credit rating agencies, since they turned themselves in the 1990s into profit-motivated businesses dedicated to maximising revenues and, therefore, publicity, have had an almost unbroken record of sending false signals, especially in their analysis of AAA credits. On the one hand, they bestowed the coveted rating on thousands of toxic mortgage securities that became worthless during the sub-prime debacle in exchange for generous fees from the now defunct investment bank that issued them. They also honoured the Irish and Spanish governments with AAA ratings until 18 months ago.

On the other hand, they downgraded Japan to below Botswana and Estonia in 2002, since when the Japanese Government has consistently enjoyed the world's lowest interest rates on its borrowings.

Closer to home, S&P warned Britain of a possible downgrade in May 2009. This was exactly when Britain's recovery started and international investors did the opposite of what S&P predicted, becoming big buyers of sterling and British gilts. S&P lifted its downgrade warning in October 2010, when economic activity slid back into negative territory.

The US went through a similarly perverse experience in 1996, when Moody's, the main competitor to S&P, issued its only warning to Washington that fiscal policy was unsustainable and could lead to a credit downgrade. Within two years President Clinton had eliminated the budget deficit entirely and by 1999 financial analysts predicted that the entire national debt would soon be paid off.

The rating agencies, in short, can safely be ignored. The IMF is another matter. It does a serious, albeit politicised, job of assessing national economic policies. Washington would do well to heed its call last week for "sizeable reductions in medium-term deficits" and "broader reforms, including to social security and taxation".

The good news is that both President Obama and the Republicans have decided to focus on precisely this debate in the 18 months leading up to the 2012 election. For the moment the two sides may be completely at

The rating agencies can be ignored. The IMF is another matter

loggerheads but the key questions have finally been put on the agenda. During the next presidential cycle, the US Government will have to raise taxes, limit retirement spending, reduce defence capabilities and control the growth of healthcare costs.

Until a few weeks ago, all four of these options were deemed untouchable "third-rail issues". But by November 2012 it should be clear that by implementing reforms in all these areas in a gradual and balanced manner over ten years, the US could minimise social hardship and completely avoid any damage to economic growth. American voters will effectively be presented with a choice in the 2012 election on the balance they want to strike between fewer public services and higher taxes. And provided these options are debated openly and backed up with honest numbers (admittedly a big proviso), the US Government will have no trouble in maintaining solvency and paying its debts.

If things do work roughly like this, the US will start to rebalance fiscal policy from 2013 without drastic actions that would jeopardise economic recovery before then. By 2013, the economy should have enough momentum to withstand higher taxes and cuts in public spending. In short, 2013, not 2012 or 2011, would be the right time for big reductions in public borrowing. This cod-Augustinian message — "Lord, make me solvent but not yet" — is easy to ridicule, but it is the sensible, moderate message conveyed by the IMF analysis, by the rational voices in Washington and even by S&P, which suggests that a downgrade will probably be avoided because the fiscal outlook will improve in 2013.

Compare this with the policy in Britain: budget cuts implemented too drastically and too early, snuffing out economic recovery; savage reductions in public services hardly debated in the election and imposed haphazardly without proper planning; no mandate at all for serious reforms in the two spending programmes that genuinely do threaten to bankrupt the Government — state pensions and the National Health Service.

No wonder Washington is nostalgic for Gordon Brown already. On the present performance, this view may soon be shared in Britain.