Fingers crossed, chaps, and stick to Plan A

As George Osborne and his peers in Europe and the US know, any alternative is fraught with difficulty

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Is it time for Plan B? It is not just in Britain that this question is asked with increasing urgency by politicians, businessmen, homeowners and anyone else concerned about the economic outlook. The world is clearly suffering a slowdown and the prospects of recovery from the record-breaking recession that followed the Lehman bankruptcy are now more uncertain than at any time since the spring of 2009. If this slowdown turns into a downward spiral, is there anything that economic policymakers can do?

Let us begin with Britain, where the threat of a double-dip recession looms larger than in any other leading economy because of an unusual combination of severe public spending cutbacks, a still-overvalued housing market and the historic dependence on financial and government jobs. While the International Monetary Fund gave broad support this week to the Government's economic strategy, its endorsement was hedged with two crucial caveats.

First, the IMF suggested, to the consternation of those who have been demanding higher interest rates, that if there were to be any change in British monetary policy this year it would most likely be in the other direction — towards greater monetary stimulus. Specifically, the IMF argued that if the British economy slowed further, the Bank of England ought to follow the example of the US Federal Reserve Board and print more money, a policy described by central bankers as quantitative easing, but nicknamed by the markets QE2.

If further monetary stimulus fails to revive economic growth quickly enough, the IMF offers a second and even more controversial suggestion: that the Government should suspend its budgetary targets and introduce temporary tax cuts, "targeted to investment, job creation or

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low-income households". Such temporary tax cuts should be balanced with bigger long-run cuts in public spending "to safeguard fiscal sustainability and market confidence".

Whatever its economic merits, the politics of such an IMF-inspired Plan B would be explosive.The combination of tax concessions for employers with further cuts in social welfare would horrify Liberal Democrats even more than it would delight their Conservative coalition partners.

For this reason, George Osborne will simply cross his fingers, just as the Bank of England will hope for an economic rebound, rather than accept the loss of face implied by voting for QE2.

Such hopes of an economic rebound may not be entirely forlorn. In February and March the entire global economy was hit by four separate shocks: soaring oil prices caused by the turmoil in North Africa, a breakdown of manufacturing supply chains due to the earthquake in Japan, the renewed threat to the European financial system resulting from the Greek crisis, and the European Central Bank's premature decision to start raising interest rates.

Economists and investors initially shrugged off the impact of these shocks, but businessmen and consumers were more prudent. Corporate investment, hiring and retail spending were all cut back in the spring to reflect the new risks facing the world economy.

The good news is that the shocks turned out to be less powerful than originally feared. Civil war has not spread to Saudi Arabia and as a result the oil price has subsided instead of jumping to $150 or even $200, which seemed perfectly possible two months ago. Supply chains have been restored after the Japanese earthquake. And the financial crisis in Europe, though nowhere near a permanent resolution, has been brought under control for the time being. The upshot is that the global economic recovery could regain its momentum.

But what if the economic slowdown sets off a vicious circle of falling consumer spending, weaker business activity and cutbacks in employment and investment? In that case, new economic strategies will be needed not just in Britain but around the world. Unfortunately the political obstacles to these alternative strategies are even more daunting in the US and Europe than in Britain.

In the US, further quantitative easing is much less likely because of

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the dollar's role as the global reserve currency. If the Fed decided to print more money, this would infuriate China and would almost certainly cause another upsurge in global energy prices. Any possible benefits would be negated by the resulting loss of spending power among US consumers and the risk of a global crisis caused by Chinese resistance.

A better option for the Fed would be to target credit directly at the US housing market. The continuing collapse of house prices, caused by the forced sale of repossessed homes, has been the main reason for the unusual weakness of the present recovery. The Fed could buy up distressed mortgages or even foreclosed homes, just as it directed credit to bust banks and bankrupt car companies in 2008.

In designing this kind of targeted credit policy, the Fed could learn from the ECB, which has supported the weakest parts of the European economy by lending to Greek and Irish banks and their customers, while retaining confidence in the euro by running a fairly tight monetary policy. Given the political polarisation in Washington, however, it is hard to imagine the Fed or any other government agency obtaining congressional approval for measures of this kind.

In Europe, the political challenges are even greater. The essential element of Plan B was spelt out last week by Jean-Claude Trichet, the President of the ECB. To resolve its financial crisis, the eurozone will need to accept some collective responsibility for the national debts of its member countries. Over time, the present ad hoc mechanisms for guaranteeing debts and imposing fiscal discipline will need to be replaced by a federal finance ministry that could borrow money in the markets on behalf of the entire eurozone and supervise the national tax and spending policies of member governments.

If EU leaders admitted that their ultimate plan was a full fiscal union, the European financial crisis might be quickly resolved, but it is politically inconceivable until the crisis in the eurozone gets much worse.

No wonder politicians everywhere prefer to cross their fingers and pray for an economic rebound rather than think seriously about Plan B.