TIME FOR A PLAN C?

SHAPING UP TO SLOW GROWTH

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Time for a Plan C?

In October 2010 the Chancellor, George Osborne, presented what we might want to think of as 'Plan A'; the government's Spending Review, which fixed budgets for each government department up to 2014/15.[1]

The review announced an £81 billion cut in public spending in the remaining years of this parliament, with average departmental cuts of 19%.

Since the start of the spending review period there have been numerous calls for a 'Plan B'. This included a letter published in October 2011 and signed by 100 economists, which argued:

> "It is now clear that plan A isn't working… We urge the government to adopt emergency and commonsense measures for a Plan B that can quickly save jobs and create new ones. A recovery plan could include reversing cuts to protect jobs in the public sector, directing quantitative easing to a green new deal to create thousands of new jobs, increasing benefits to put money into the pockets of those on lower and middle incomes and thus increase aggregate demand."[2]

Since then in its annual green budget, the IFS Green Budget warned that however painful cuts had been to date, they amount to less than a tenth of what is planned by the 2016/17 fiscal year and that 88% of the cuts to benefits and 94% of the cuts to current public spending are still to come.[3]

Most recently data from the Office for National Statistics (ONS) showed the economy shrank by 0.2% in the first quarter of 2012 putting the UK into recession.

With increasing commodity prices, an ageing population, and an on-going crisis across the Eurozone affecting exports many now believe the UK should not expect to return to an economy growing consistently at faster than 2% a year for the foreseeable future.

The Plan C challenge is for policy makers, opinions formers and ordinary citizens to examine how we would cope, and even thrive, with long term slow growth. How can we adapt to a period of low growth very different from the era of high growth that we have recently experienced? Is there any way in which we can plug this gap? What can we do differently and are there are new things we should be doing?

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It is not difficult to list the problems arising from slow growth ranging from high unemployment to falling living standards and declining public service entitlements. Slow growth will mean more hard choices about public service and welfare entitlements. Faced with further retrenchment, will it be possible through public service reform to protect the most vulnerable and universal service standards and if so how?

Does slow growth require a more profound shift in policy, expectations and culture?

Might it even be possible for some things about our economy, society and culture to improve despite (or even because of) slow growth? This paper forms part of the RSA collection – Time for Plan C? – which will explore the implications of, and responses to, slow growth from the perspective of a highly respected and influential set of thinkers.

- **Paul Johnson**, Director of the Institute for Fiscal Studies on what will slow growth mean for fiscal policy.
- **Gavin Kelly**, Director of the Resolution Foundation on the implications of slow growth for living standards.
- Journalist **Deborah Orr** on the values that will get us through a sustained period of low growth.
- Economist **Vicky Pryce** on the implications of slow growth for the overall shape of the economy and particularly regional economies.
- **Nick Seddon**, Deputy Director of Reform on the implication of slow growth for public service reform.
- **Julian Thompson**, Director of Enterprise at the RSA on how we need to change the way we see the relationship between human capital and economic recovery.

Shaping up to slow growth

That will depend crucially on an understanding of the underlying causes of slow growth, the impact that this will have across the various sections of the community in the UK and an assessment of the likely effectiveness of various potential policy responses

Following the deepest recession since the 1930s, the UK economy is experiencing one of its weakest recoveries.

GDP fell in the last quarter of 2011 and again in the first quarter of 2012, putting the UK back into a technical recession. This may not last and indeed may even be revised away and the Office for Budget Responsibilty still expects a positive figure of some 0.8% for the year as a whole. But it has renewed attention on what may need to be done in the short term to get the economy moving again with talk of either 'Plan A plus' or Plan B. And this debate has intensified since the March budget which offered very little in terms of fiscal stimulus and hope for faster recovery. .That, in itself, would in any case be difficult to achieve in an environment where growth is being restricted by uncertain conditions abroad, particularly in the eurozone. The latest IMF forecast of a 0.3% fall in eurozone GDP this year, and growth of only 0.9% in 2013, will not help UK exporters who rely heavily on the continent for sales of goods and services. Even Germany, which had been Europe's locomotive is now forecast by the IMF to grow by just 0.6% in 2012 compared to 3% last year. Continued expansion in emerging markets will offer little respite as the UK's share of exports outside the US and Europe remains relatively small. The OECD too in its latest Economic Outlook of May 22, 2012 highlights the Eurozone crisis as being the most important downside risk to its world forecast -although it appears slightly more optimistic than many others for this year forecasting only a small decline of 0.1%.

Arguably though the key question is not what happens in 2012, or even 2013 but rather what rate of growth will be realised over the medium term, and whether the UK will face, as Japan and Germany did from the early 1990s, many years of weak growth . As this series of RSA papers signals, this is the time to also look at Plan C, what policies may need to be developed to cope with a prolonged period of slow improvement in output and prosperity? And what should that Plan C consist of?

That will depend crucially on an understanding of the underlying causes of slow growth, the impact that this will have across the various sections of the community in the UK and an assessment of the likely effectiveness of various potential policy responses. With so many imponderables involved in pinpointing the main areas of risk, this is an arduous task.

Likely constraints on growth

The most likely cause of a prolonged period of slow growth would be a failure to resolve the fundamental issues underlying the eurozone

The worrying scenario for Europe in the short to medium-term is one where all countries try to reduce government spending and increase taxation at the same time

crisis. Market sentiment ebbs and flows with a slight strengthening in confidence early in 2012 following agreement on the fiscal pact slowly unwound, first by renewed concerns about Spain and then by the results of the Greek elections. However, regardless of the short term position and whether it improves,, the problems of unsustainable debt levels in many countries will continue to be a drag on growth. The fundamental flaws in the governance and support infrastructure that was put together when the euro was created, will take time to put right.

The cost to Europe of failure to agree and implement a credible and lasting solution, continues to rise as the markets remain concerned by the inability of the politicians to act decisively. The fact is, however, as we are seeing over the response to the problems currently faced by Greece that European politicians will continue to be guided by the views of their domestic electorates rather than the greater good of the eurozone. A full economic, fiscal (and political) union – one that redirects resources on a regular basis from rich countries to the more needy ones and that accepts that the richer countries need to reduce savings and expand spending to help the weaker members at a time of crisis – will not happen in the short term. Indeed, it might never happen. The likelihood is that we will see a series of further crises that are met by a succession of 'sticking plaster' or 'just good enough' solutions, which may be further steps down the road to full economic and political union but will not be presented as such for political reasons. The 'democratic deficit', created by the various attempts to impose tight controls on weaker countries by the stronger ones, and forcing the emergenece of technocrtatic governments rather than elected ones for periods of time to pacify the markets carries its own risks in relation to potentially leading to political and social unrest, which may well derail the euro project anyway.

As the IMF has said, the worrying scenario for Europe in the short to medium-term is one where all countries try to reduce government spending and increase taxation at the same time. When individuals, companies and financial institutions are all de-leveraging at the same time, government de-leveraging just adds to the downside risk. The closest parallel might be Japan, where a failure to tackle fundamental weaknesses in the economy – most notably in the financial sector – contributed to its 'lost decade'.

For the euro area, the issue at the front of politicians' minds is the need to get government spending under control and tackle debt levels in a number of countries, which will involve the eurozone standing collectively in some way behind the debts of its members. But there are also fundamental issues of productivity and competitiveness (that Japan also faced) that need to be addressed. Differences in economic performance and competitiveness explain why the eurozone is in its current mess. This involves politically difficult and contentious measures such as attempts at labour market deregulation, opening up sectors to competition, drastic reform of public services and cuts in welfare payments. But without extra help to smooth the path, weaker countries like Greece and Portugal will remain condemned to a long-term future of low or no growth within the eurozone or – more likely – they will choose, or be forced to, leave the eurozone.

As the UK is not part of the euro it can set interest rates and fiscal policy independently. The pound can appreciate or depreciate and this provides additional flexibility in a crisis. Nevertheless, continued

uncertainty in our major trading partners harms the UK because of its effect on the demand for exports and because of the broader dampening effect on business confidence.

In addition, of course, the UK faces domestic economic challenges that pre-date the emergence of the eurozone crisis in 2010. The UK still faces the challenge of how to bring the public finances back towards balance. The planned cuts in government spending will, according to the independent Office for Budget Responsibility (OBR), make a zero or negative contribution to growth in every year up until 2016.[6] Higher taxes will continue to reduce disposable incomes at a time when concerns over debt levels and job security are already constraining household spending, which is by far the largest component of GDP. The OBR sees household consumption growth picking up sharply from 2014, as inflation is reduced and real incomes start improving. But this is by no means guaranteed; it is quite possible that the combination of higher taxes, high debt levels and weak confidence, could limit growth for a much longer period.

Against this background it is no surprise that companies are reluctant to invest. Firms reliant on external finance, particularly for more risky innovative investment, may face significant difficulties accessing the funds they need for some time, because the banks need to consolidate their balance sheets in order to reduce their exposure to risk and meet new regulatory requirements. We are already seeing a more prudent, risk-averse banking sector. This will be good news for the taxpayers, who have funded the bank bail-outs in the UK, as the partly nationalised banks return to profitability and move back to the private sector, and as the risks of future bank failures decrease. But it will be – and already is – bad news for businesses and households as lending to them reduces, despite the (slightly schizophrenic) demands of the government for those same banks they are trying to de-risk to, at the same time, expand their lending, particularly to small and medium sized companies.

Consequences of slow growth

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There is no way of getting out of the fact that in this scenario 'living standards' will be continuously squeezed; there will be slower growth in personal disposable income to fund consumption and slower growth in government spending on public services. The point at which the structural and cyclical deficit is eliminated will be further delayed.

Less economic growth means more difficult decisions. Debates about how to balance the fruits of growth between tax cuts and extra spending on public services will be more contentious when there is less growth. The challenges facing the government will be heightened by the fact that slow growth will not be spread evenly. Certain groups will be hit harder than others and, inevitably, there will be concern about the widening gap between winners and losers. In particular, with demand growth slowing, unemployment will remain higher for longer, with the prospect that youth unemployment rises further above one million.

Sustained slow growth also affects savers of all ages and, in particular, those of working age because of the likely impact on pensions. Other things being equal, a slower real growth rate means a lower rate of return on the secure assets that pension funds like to invest in. Over a long period of time, that means a slower build up of pension

pots, lower annuities and either smaller pensions in retirement, or less consumption for those of working age because they are saving more for their retirement.

There will also be sectoral effects. Assuming the slow down in growth occurs at the global or European level, the high valued-added technology and/or highly skilled sectors, in which the UK has a comparative advantage, are likely to be better able to respond and withstand a period of weak economic activity. This will inevitably add to the competitive pressures facing other sectors. It is likely that those regions with more high-value production will fare better than others, and the higher skilled will fare better than the lower skilled. Regional disparities will therefore increase, as will income disparities between people in work, as well as between those in and out of work. The re-balancing of the economy, that most governments wish to achieve, will be that much harder. Stronger, competitive sectors will do even better comparatively than before, the South East may well move even further apart from the North.

It might be argued that slower growth will ease the environmental pressures facing the UK and the world as slower growth leads to less consumption of energy and natural resources. This may be true in the short term, but ultimately the solution to these problems will occur due to innovation and changes in technology. This requires investment by government and business that will be harder to fund.

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But the real worry about any period of slow growth is that it will not, in fact, allow some of the imbalances built into the system to be worked out. To achieve this in the global context we would require strong international institutions and cooperation that has been lacking so far. The chances are that the current trends will continue and, if anything, may be exacerbated as at a time of weak growth countries become more nationalistic and protectionist.

While countries running trade and/or budget deficits will be forced to continue tightening fiscal policy, there is little chance that those running a surplus will respond willingly to pressures to relax monetary policy, spend more and relieve the burden on others. China, for example, has in recent times reined credit growth back in because of concerns about domestic inflation; although there are indications that it has recently changed tack because of concerns about global market conditions. Germany does not seem prepared to move from being a country of savers to one of spenders, or even partially so. Therefore, the most likely result will be that the trade imbalances that have plagued globalisation for a while, will remain.

In addition, the differential growth paths across the regions of the world economy, in particular the relatively strong growth in emerging markets, will continue to place pressure on commodity prices. Input costs have remained unsustainably high in the west, putting a drain on profits. The IMF expects modest falls in aggregate (non-oil) commodity prices in 2012 and 2013 but that is after increases of 26% in 2010 and 18% in 2011. The result is that commodity prices are still much higher than they should be at this time of the cycle and will not drop sufficiently to kick start a new period of investment and expansion.[4]

Policy response

Given the serious problems that slower growth causes, the task of creating policies that promote growth in the longer term is going to be key. Of course, one immediate practical problem facing any policymaker is that the underlying, sustainable rate of growth is difficult to estimate and, by the time we know we have entered a slow growth phase, it may be too late to do much about it. This means that the prudent approach would be to spend time now designing and be ready to implement a Plan C response given the significant risk we now face.

Over the short term there is limited scope to do much except keep to an accommodating monetary policy and tinker with fiscal policy, accepting that fiscal consolidation will take longer to achieve. More spending on housing tends to work counter cyclically, there may be more innovative ways of implementing quantitative easing and of using the government's ability to borrow cheaply long term to become much more involved in financing infrastructure. All this will help but will not, by itself, be enough.

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Time for a 'shift change'?

What will need to be accepted is that policy across the board should place more emphasis on economic expansion. Every initiative needs to be judged against a growth test, be it in terms of productivity, competitiveness or potential job creation that can be sustained and reinforced over the longer term. Decisions made under more optimistic assumptions about the economic environment might now have to be revisited, particularly where they involved a trade-off between economic and other policy objectives.

This cannot be done in a vacuum. Government will need to take the public along with it and there should be a broader debate about what we, as a society, value and where we want to allocate more limited resources. Most economists will argue that the best precondition for prosperity and (possibly) happiness, is growth and full employment and that will have to be the focus of long-term policy. But this will need to be set against the shift in society's values against capitalism's excesses in terms of outcomes, such as intense economic volatility, the disastrous consequence of badly regulated markets, excessive remuneration and increases in inequality. Policy moves would have to take on board current debates, which are trying to define responsible capitalism and a more benign move to greater globalisation.

So for the growth message to be effective, it will have to be developed in a much more collaborative way than we are used to and ensure that people understand the benefits of what is proposed. Yes, difficult decisions were made in the recent Spending Review, but that was presented as a one-off response to a crisis. If the public is to accept a further and more prolonged period of austerity, and if we are to avoid plans being reversed at every election, we need a more open and inclusive debate on where our priorities truly lie.

Government will have no other option than to give a higher priority than it has in the past to those types of public spending that increase growth potential. This might be at the expense of politically protected spending that does less for growth potential. So a government seeking to do something about a low-growth economy might be maintaining (even

increasing) public spending on skills, research, innovation and so on. But the implication is that other spending areas would take a smaller share of a more slowly growing pie. How well do education or even health spending support economic growth? Should defence remain a priority? Social security and pensions will be in the firing line as they are principally transfers from taxpayers to recipients, rather than investments in future growth. How acceptable will private sector provision of public services be? Not an easy subject, as we have already seen in relation to the government's proposed NHS reforms. But the debate will have to take place regardless.

A good example of a country looking into the chasm and taking a bold step was Finland in the early 1990s. Alongside a recession, they had a major structural shock with the economic collapse of the former Soviet Union, its major trading partner. There was a deep fall in GDP and the prospect of slower growth due to loss of markets. Finland chose to maintain its level of spending on research and development, and thus accepted deeper cuts than would have been made otherwise in other budgets. Now you can argue the situation is different in the UK because it is a much bigger country and Finland's decision amounted to a (lucky?) gamble on a single company, Nokia. But it gives us a useful pointer.

In the run up to general election scheduled for 2015, the likelihood is that all the political parties will need to think about which commitments and promises can be made and which must be dropped. These decisions are inherently political. It would be wise if the political discussions – of principles and tactics – came out of a more broadly based, inclusive, constructive and non-partisan debate on the need for growth, how to promote it and what to do if difficult times are with us for a while.

Endnotes

1. Government, Spending Review 2010
2. Ed Balls, speech at the Fabian Society, 14 January 2012
3. "100 leading economists tell George Osborne: we must turn to Plan B". *Guardian*, 29 October 2011.
4. Table 3.4 in the OBR Economic and Fiscal Outlook, March 2012

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