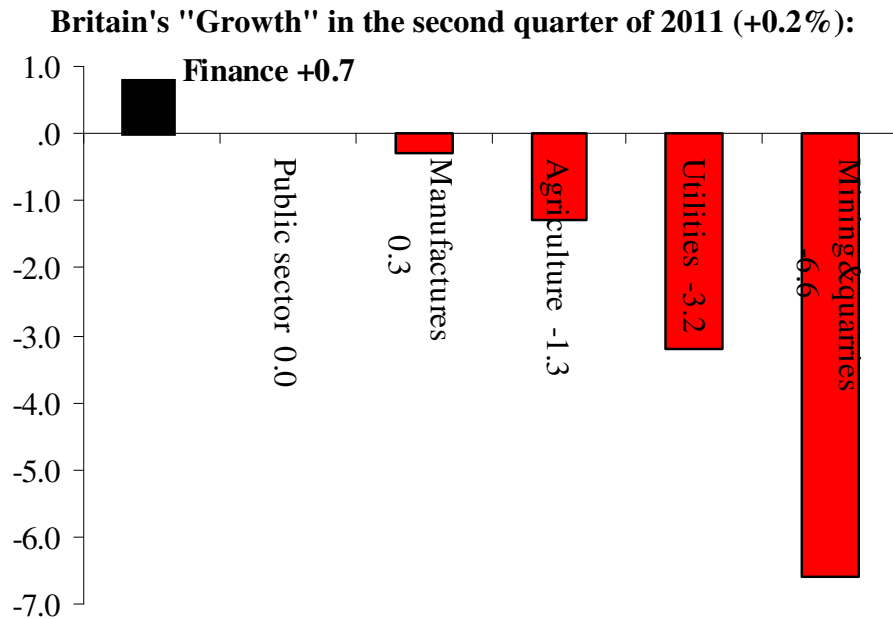


# epamphlet 01082011



Is this what we want,

OR

## A Brighter Economic Vision for Britain

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## A Brighter Economic Vision for Britain

“We have involved ourselves in a colossal muddle, having blundered in the control of a delicate machine, the working of which we do not understand.” John Maynard Keynes<sup>1</sup>

“As things stand, the banks are the permanent government of the country, whichever party is in power.” (Lord Skidelsky, House of Lords, Hansard Citation, 31 March 2011, c1359)

### 1. Why Plan B can't be about cutting

The UK depression has already lasted three years and is likely to last five years or more; ie, longer than that of 1930s.<sup>2</sup> Not only must Osborne's Plan A be reversed, but any Plan B must be about escaping from the on-going depression.

The prestigious National Institute for Economic and Social Research (NIESR) uses the term 'depression' to mean any period in which output remains below its previous peak, so the UK not only remains in a depression, but NIESR believes that the previous peak will not be surpassed until 2013 at the earliest.<sup>3</sup>

On the latest ONS figures, GDP growth in the second quarter (Q2) of 2011 is just 0.2%.<sup>4</sup> Although Britain may avoid a 'double dip' recession---defined as two or more successive quarters of negative growth---the increase in economic activity over the past year has been a negligible 0.7%; as the ONS says, the economy has flatlined. Even the downwardly revised forecast by the OBR of 1.7% for the current year is now unattainable. The UK is the only major economy in Europe not to have recovered the output lost after the recession of 2008---indeed, we remain 4% below peak output achieved in early 2008.

The real danger is of stagnating for years to come; ie, experiencing a fate dangerously similar to that of Japan after 1990. From Figure 1, it can be seen that after the Great Depression in 1930 and again during the 1979-83 recession, it took Britain 48 months (4 years) to return to its previous peak output level. NIESR is forecasting 61 months in the present case, and even this is based on forecasts of 0.5% growth

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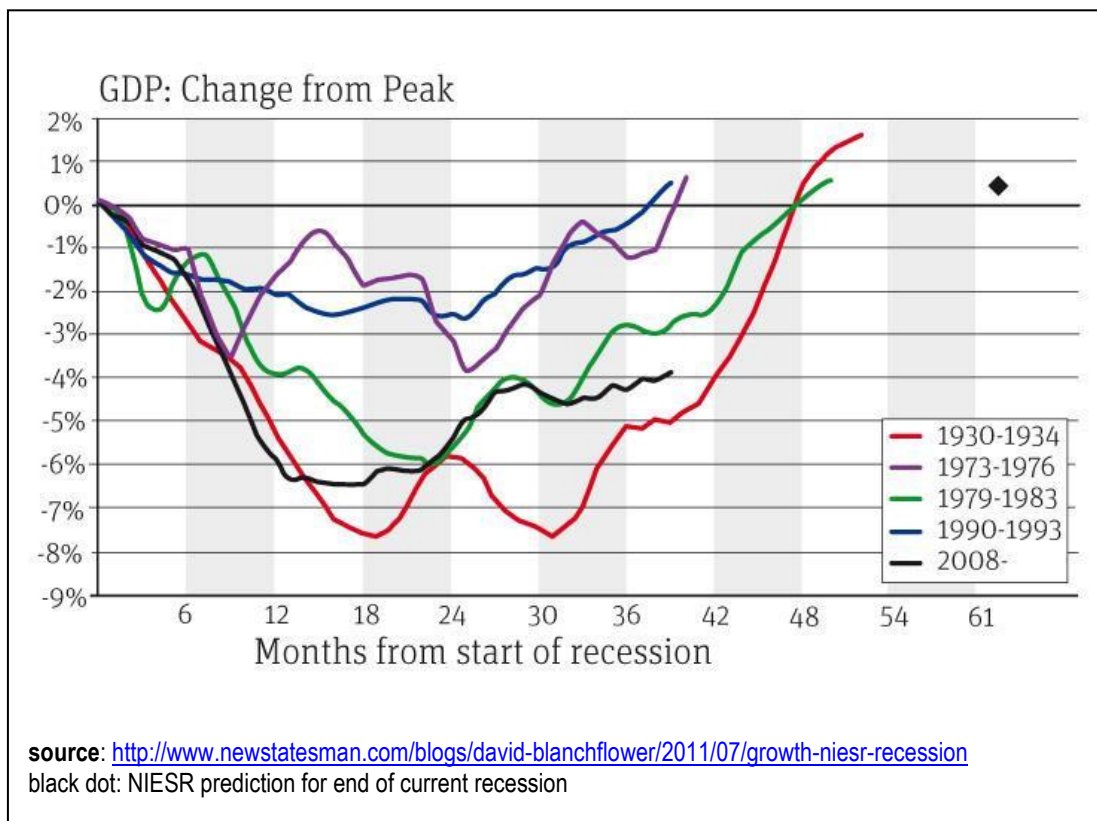
<sup>1</sup> See Keynes 'The Great Slump of 1930's': <http://gutenberg.ca/ebooks/keynes-slump/keynes-slump-00-h.html>

<sup>2</sup> See Philip Inman: <http://www.guardian.co.uk/business/2011/jul/07/uk-flat-growth-viewpoint>

<sup>3</sup> See ONS: <http://www.statistics.gov.uk/pdffdir/gdp0711.pdf>

<sup>4</sup> See Duncan Weldon: <http://duncaneconomicblog.wordpress.com/2011/07/08/2011-growth-a-case-of-diminishing-expectations/>; figures to be updated

in each of the two final quarters of this year. Unless these optimistic predictions are realised for the rest of 2011, we could be in for an NIESR-defined depression lasting five years or more.



Two things happen under such circumstances. First, consumers increasingly lose confidence in the prospect of decent jobs and significant income growth. Secondly, because investment remains low---particularly state investment because of the fiscal squeeze---infrastructure deteriorates, while private investment prospects become bleaker.

Britain might of course be rescued by a booming export sector, but given growing financial troubles in Europe where over half our exports go, the prospect of an export-led recovery look distinctly poor. Three years after the massive devaluation of sterling which accompanied the 2008 credit crunch, Britain's trade balance is still in deficit.

There has been much talk of the need for a Plan B. Labour's economic argument has been in essence that Osborne's radical austerity measures are prolonging the depression and harming the economy; the alternative, they argue, is something like Alistair Darling's 2010 plan: cutting at a slower pace and

distributing the pain more fairly. We argue below that a ‘slower cuts’ strategy will not work and---most important---is unnecessary.

Cutting public spending to appease the financial markets lest Britain be attacked like Greece, Portugal or Ireland was never a sensible strategy. As many commentators (particularly Martin Wolf of the FT) have argued, Britain was never remotely like Greece.<sup>5</sup> What the Greek crisis proves is that deficit reduction via draconian cuts can so harm the economy that financial markets lose all faith in a country’s recovery. In short, the medicine can kill the patient.

The message below is simple: austerity doesn’t work. In our view what is urgently needed in Britain is first, economic stimulus, and secondly a public-investment led strategy for growth, jobs, housing and sustainability. Therefore, the pamphlet discusses in turn the causes of the crisis, why austerity won’t work and, finally, a plan that will work.

## **2. Causes of the economic crisis and renewed slowdown**

For the ten years leading up to the global financial collapse of 2008, the UK and US economies grew at almost the same rate, about three percent per annum. This rate was significantly faster than for France, and substantially above that of Germany, still suffering from contractionary monetary and fiscal policies following unification.

There is no dispute about the cause of the 2008-2009 contraction, namely, a crisis in the United States and quickly spreading to the rest of the developed countries via the banking system. The simple average growth rate across all the OECD European countries, plus Canada, the United States and Japan was 0.8 percent in 2008 and -3.9 in 2009. The contraction suffered in each country had the same proximate cause: a contraction in economy-wide demand amid waves of bank failures. In some countries the contraction of export demand dominated, but in most it was the catastrophic fall in private investment. In the OECD as a whole the fall in investment (gross fixed capital formation) accounts for 80% of the entire fall in output during the recession.

Although it was obvious that the Great Recession emanated from the private sector including the banks, the Tory-led Coalition in May 2010 launched a propaganda campaign to convince the public that it was

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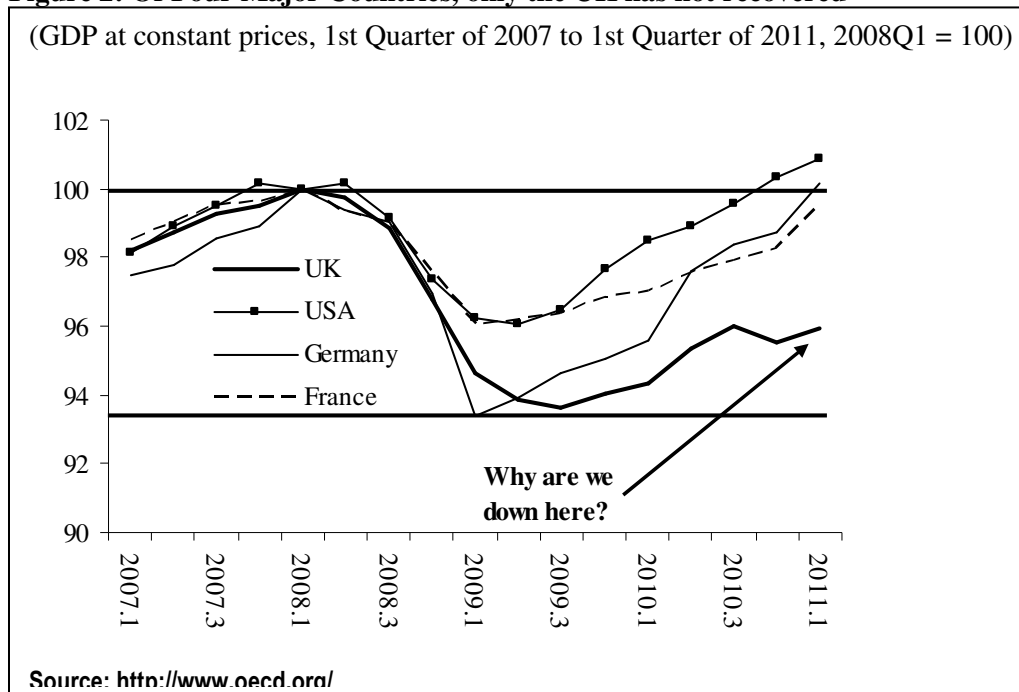
<sup>5</sup> See <http://www.ft.com/cms/s/0/119c59ac-b6c3-11df-b3dd-00144feabdc0.html#axzz1RpGmNMrc>

the irresponsible fiscal policy of the outgoing Labour government that was the true culprit. The most impressive aspect of this malign fairy tale is that many people believe it. Indeed, even many progressives, if not explicitly accepting the fiction of a feckless Labour government, do so implicitly by conceding the need for cuts and bickering over their size.

Falling demand results in falling output, which in turn results in falling private employment. To reverse this process, it is necessary to replace the falling private demand with public sector demand. But the Tory-led government has done the opposite.

The unfolding consequences of Coalition economics are obvious from Figure 2 which shows the changing levels of real GDP for the same four countries from just before the global crisis to the first quarter of 2011. Of the four, only the United Kingdom remained below the pre-crisis peak level of output. The United States and France, with the smallest declines (about four percent), were back to their peaks by the end of 2010 (the USA) or beginning of 2011 (France). Germany, with the deepest and faster decline, regained its peak level by early 2011.

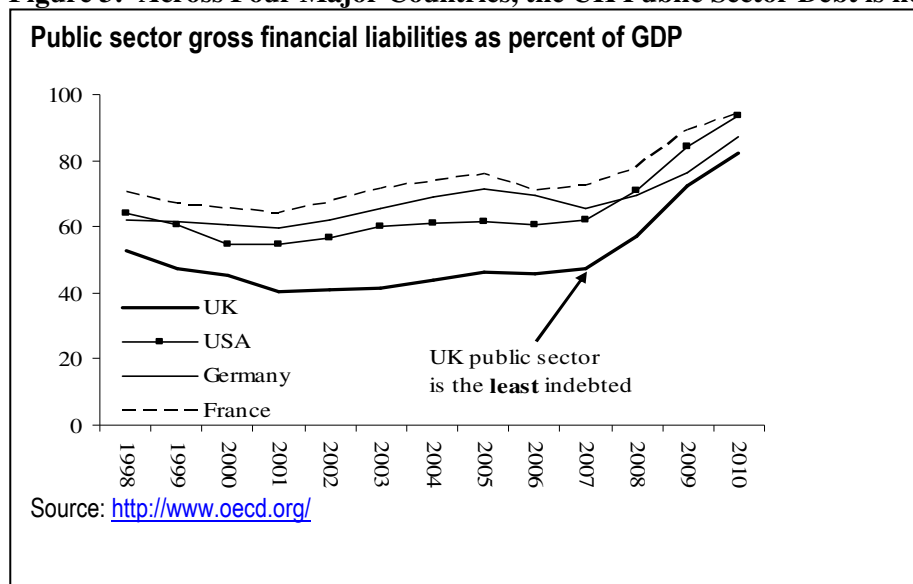
**Figure 2: Of Four Major Countries, only the UK has not recovered**



But three years later Britain alone remains far below its peak GDP level. At the end of May, the British Chambers of Commerce predicted that growth for 2011 would be 1.3 percent, and 2.2 percent in 2012.<sup>6</sup> If in defiance of Tory-led Coalition policies, the UK economy were to expand at these rates, at the end of 2012, over four years after the crisis, output would still be below the peak level in 2008. It is conceivable that if the Tory Coalition manages to stagger on to the end of its term, when elections come in 2015 GDP will be at or below where it was when it took office in May 2008.

The crucial difference between Britain and the rest is that only Britain adopted an early policy of government cuts. All the others continued stimulating the economy until depression was over- although we shall see if economies such as the US can withstand their own shift to ‘fiscal tightening’ when it is adopted.

**Figure 3: Across Four Major Countries, the UK Public Sector Debt is not High**



Equally, the notion that stagnation is the necessary consequence of deficits and debt inherited from a profligate Labour government is nonsense. As Figure 3 shows, of the four major countries, the ratio of public sector debt to GDP is and has been lowest in the United Kingdom. At the end of 2007 just before the global crisis, gross debt of the UK public sector was slightly less than fifty percent of GDP, which was well below the Maastricht criterion of 60 percent. Public debt for Germany and the United States was slightly over sixty percent, far above the UK relatively and absolutely, and the French percentage was close to two-thirds. Even the French statistic was modest compared to Italy (113 percent) and Japan (167 percent). The average across all Euro zone countries and all OECD countries was just over seventy percent.

<sup>6</sup> See <http://www.bbc.co.uk/news/business-13589362>

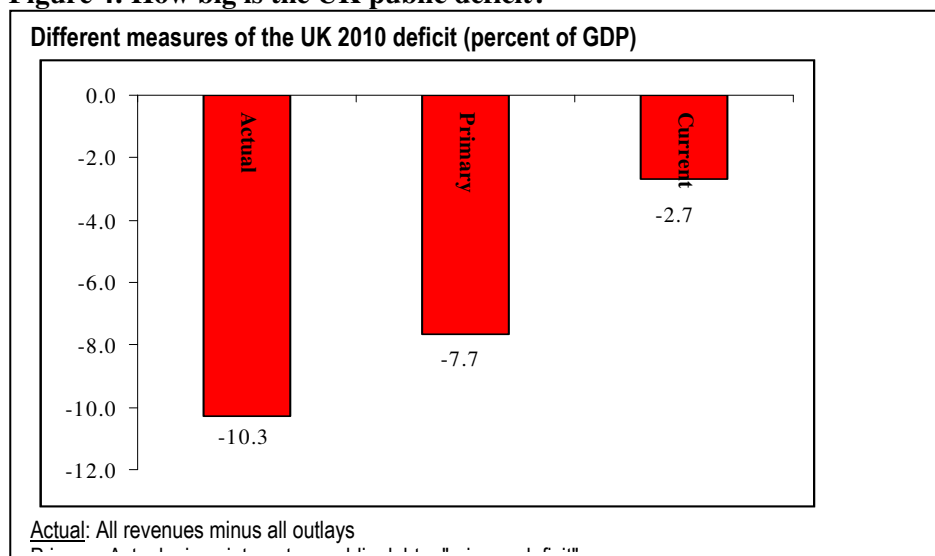
After 2007, twenty-eight of the thirty-one OECD countries experienced increases in the ratio of public debt to GDP (the exceptions being oil-rich Norway, Sweden and Switzerland). UK public debt rose from just below 50 percent at the end of 2007 to 82 percent of GDP at the end of 2010, with the USA experiencing a similar percentage point increase.

It is crucial to note that these ratios refer to gross public debt, ignoring public sector assets. If one uses the OECD measure of public assets (e.g., foreign exchange reserves, gold in the central bank and public enterprise net value), the UK net public debt increased from 29 percent of GDP in 2007 to only 56 percent in 2010. The failure to distinguish between the two---or even provide economic rationale for using gross debt---reflects the uninformed character of the debate over public debt in the United Kingdom and elsewhere. Chiefly, it reflects definitions used by bankers and accountants, not economists. But regardless of whether one uses gross or net as the measure of indebtedness, the UK public sector is not highly indebted.<sup>7</sup>

### 3. What do we mean by ‘the deficit’?

Just as the Tory-dominated debate fails to distinguish between gross and net debt, the Coalition's treatment of deficits flounders on confusing different economic categories of public deficits. Almost all of the Coalition references to ‘the deficit’ refers to total expenditures minus total revenues, or the ‘general deficit’.

**Figure 4: How big is the UK public deficit?**

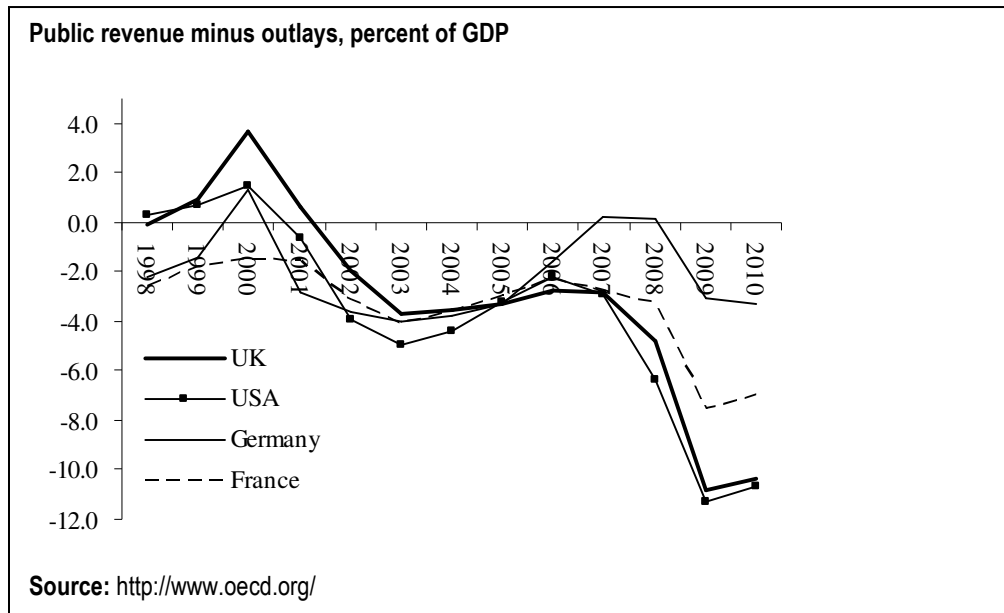


<sup>7</sup> See <http://fatasmihov.blogspot.com/2010/03/gross-debt-net-debt-and-future-debt.html>

The most important measure of the deficit is the ‘primary deficit’, defined as public expenditure excluding interest payments on the public debt, minus total revenue. This measure indicates the addition to the stock of debt. Any intelligent discussion of deficit reduction must refer to the primary deficit, because interest payments on the debt are contractual and cannot be directly reduced by policy measures. In 2010 the overall budget deficit of the United Kingdom was 10.3 percent of GDP, and the primary deficit was 7.7 percent (see Figure 4).

But using the primary deficit as a measure of fiscal sustainability is still misleading since it suggests that all debt accumulation represents a dead-weight burden. Part of public expenditure, namely capital expenditure, creates assets; eg, new transport, education and health facilities. Even the bitterest critic of the public sector would admit these are productive assets. By analogy, when a business borrows money to build a factory its net assets are unaltered, its increased debt (borrowing) is matched by an increased asset (factory). The same applies to public investment in a railway, a school or a hospital. In 2010 government investment of all types was about £70 billion or five percent of GDP.<sup>8</sup> Therefore, the *net* debt creating deficit on government current account was only 2.7 percent of GDP.

**Figure 5: General Government Financial Balance, Four Major Countries**



Public deficits increase either because expenditure rises or revenue declines, and the gap depends either on a conscious change in policy or an automatic adjustment. Automatic declines in revenue and

<sup>8</sup> See [http://www.hm-treasury.gov.uk/pespub\\_economic\\_functional\\_analysis.htm](http://www.hm-treasury.gov.uk/pespub_economic_functional_analysis.htm)

automatic increases in expenditures following an economic downturn are what economists call ‘automatic fiscal stabilisers’; ie, they serve to dampen the domestic shock caused by a recession. Figure 5 demonstrates this conclusion to be obvious beyond dispute. The general government deficit of all four countries we have been considering displays a clearly cyclical pattern.

Figure 5 illustrates what economists have known for at least 75 years: economic decline increases deficits and economic growth reduces them. In the short run growth is determined by aggregate demand, and it is aggregate demand that the Tory-led Coalition seeks to reduce through expenditure cuts. The Coalition policy of expenditure cuts is, therefore, a programme to *increase the shock* caused by the crisis.

The Coalition’s obsession with the public deficit is a thinly disguised attack upon the public sector. What the United Kingdom requires is a purposeful economic programme of recovery that will lead to sustained, high-quality growth.

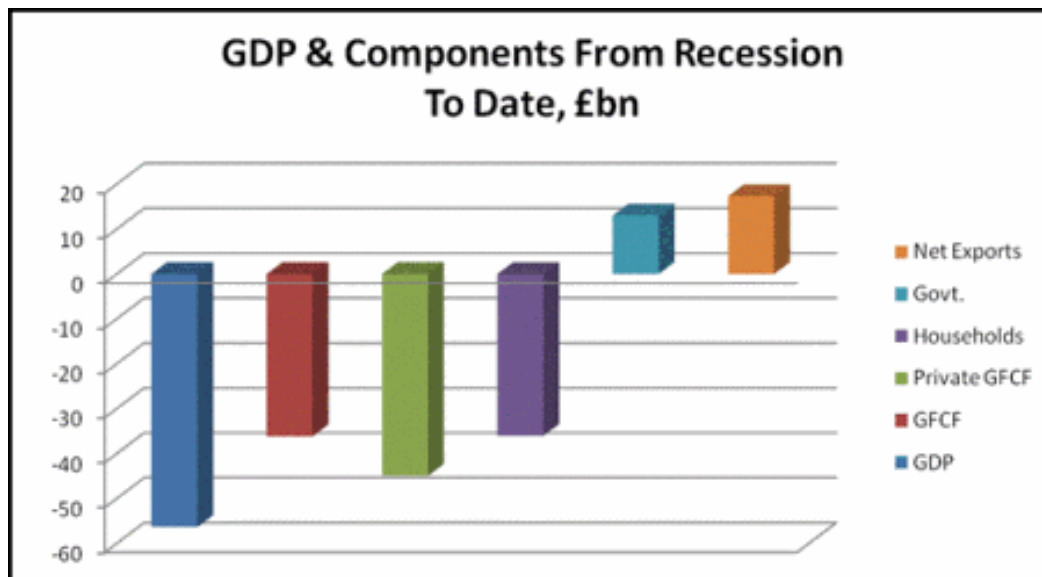
#### **4. A Strategy for Growth**

So far, we have mainly focused on the scale of the crisis and the inability of current policy to rescue the economy from it. There is no mystery as to the needed remedy – growth.

The collapse of private sector investment now accounts for 80% of the total output lost since the recession began in 2008. GDP in Q1 of 2011 is £56.3bn below its peak level in Q1 of 2008 and the fall in private sector investment (gross fixed capital formation) is £44.9bn as shown in Fig 6. No sustained recovery can take place without breaking that pattern.

Thankfully we have recent experience on how that can be achieved. Until George Osborne announced his Comprehensive Spending Review in 2010, the economy had grown by 2.5% over exactly a year. The main source of this recovery was government spending, both current spending (for example, teachers’ and nurses pay) and investment (items such as refurbishing schools and hospitals). In the course of the recession and recovery these two streams of government spending increased by a combined £18.1bn, of a total recovery of £32.8bn, 55% of the total expansion.

**Fig.6 GDP and Its Components Q1 of 2008 to Q1 of 2011**



Crucially, the recovery began two quarters after government spending started to increase significantly. One quarter later in Q1 of 2010, the private sector investment strike began to break. Private sector investment rose by £17.9bn in 2010. But government policy put that whole process into reverse. Government investment fell immediately once the Tory-led Coalition took office. The economy contracted two quarters later and private investment fell further one quarter later, in Q1 of 2011. It follows that a major rise in government investment is decisive in promoting and sustaining any recovery.

The key areas for that investment are housing, transport, infrastructure and education. In addition, a qualitative reduction in carbon emissions is required which can only be achieved via investment.

There is a chronic investment deficit in these areas. 2010 saw the lowest level of homebuilding in 83 years---even though there are 1.8mn households on council waiting lists and 300,000 unemployed construction workers. The World Economic Forum's Global Competitiveness Index places Britain outside the top 25 countries for a host of factors including the availability of scientists and engineers and the overall quality of infrastructure. Britain even lags landlocked European countries in the quality of access to ports. Britain alone cannot alter the trend in global warming. But by investing heavily in

renewable energy, new technology and energy generation and conservation, it can become a world leader in those technologies and create hundreds of thousands of new jobs.

It is widely argued that the size of the public sector deficit precludes any rise in public investment, let alone on the scale required (a minimum of £45bn to make up the shortfall to date; more to recover the previous trend in growth). However the public sector deficit is a symptom of this profound economic crisis not its cause. In a normally functioning market economy, households should be net savers and companies net borrowers. The surge in the public sector deficit arises because companies are not borrowing to invest but are now large net savers. Some agent is obliged to be a borrower under that circumstance. This is the cause of the surge in public borrowing- the refusal of private companies to borrow for investment.

Previous experience also shows that by reviving growth, the deficit also falls. In the Financial Year (FY) 2009/10 the public sector deficit was £157bn. The Treasury forecast it would rise to £178bn because the Labour government was increasing spending. What actually happened was the opposite- the deficit fell to £143bn in FY 2010/11. This is because increased government investment produces economic growth which in turn encourages private sector investment. Tax revenues rose sharply as a result. The deficit fell sharply because of growth. How is growth to be financed today?

## **5. Funding Investment**

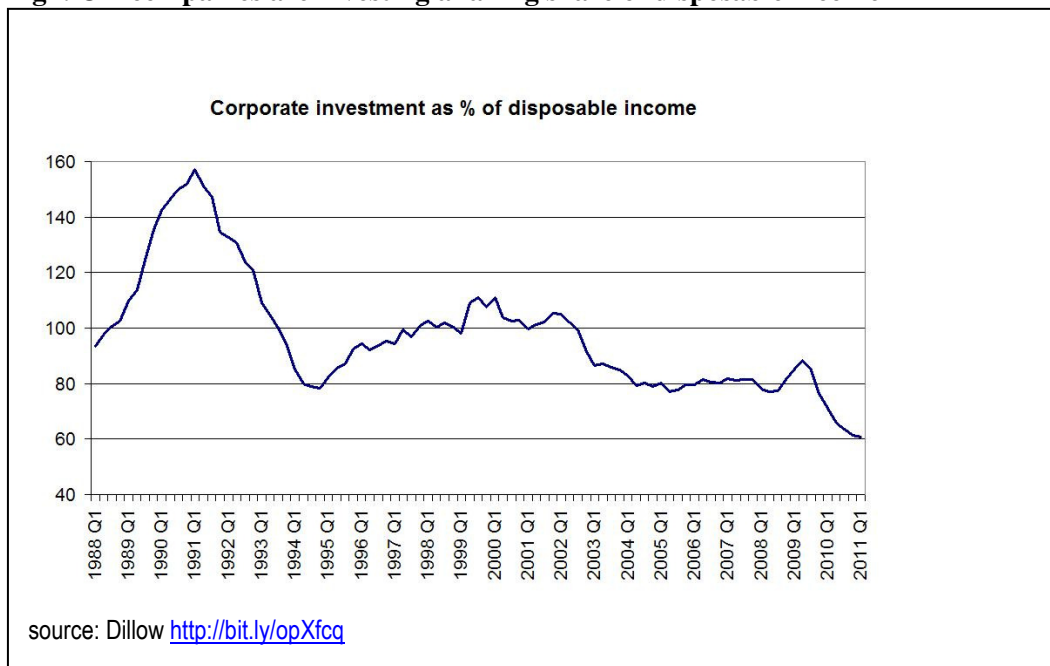
Like the US, Britain has slipped into what Keynes called a 'liquidity trap'; ie, a situation where interest rates are already so low that they cannot be cut further to stimulate the demand for new investment. In Britain, the situation is compounded by extreme fiscal retrenchment which further dampens private investors' incentive to invest---or 'animal spirits' to use Keynes's phrase.

The current share of investment in UK GDP is less than 15%, lower than the historical average which even in boom times was too low and too skewed towards residential investment. What is worse, as will be apparent from the accompanying figure, although the earnings of the UK business sector have recently risen, a falling share of retained earnings is going to investment. The share of capital spending

out of retained earnings in Q4 of 2010 was only about half its historical average---or the lowest since records began in 1987---and did not improve in Q1 of 2011.<sup>9</sup>

The reluctance of firms to invest is bad news for the Conservative-led coalition on several counts. Not only does investment drive growth but it drives wages: it embodies new technology which stimulates productivity growth, particularly in manufacturing, an area in which Britain has fallen behind. With firms holding onto a growing proportion of their retained earnings it means that the ‘hole in government finances’ cannot be closed. This is true by definition from the national income identity which says that a rise in private savings must be reflected by a fall in public savings (a larger deficit). In the absence of an export boom, both sectors cannot increase their savings without national income falling---which is likely to make business even more reluctant to invest its savings! And indeed, with no export-led boom in sight, national income is at best stagnating.

**Fig7: UK companies are investing a falling share of disposable income**



The decline in private sector investment now accounts for 80% of the entire loss of output since the recession began in 2008---£44.9bn in falling private investment of a total fall of £56.3bn to Q1 of 2011. Therefore there can be no idea of a sustained recovery without an increase in investment.

<sup>9</sup> See Chris Dillow, ‘Investment dearth worsens’(28 June 2011): <http://bit.ly/opXfcq>

Since the private sector is unwilling to invest some mechanisms must be found where the public sector can temporarily take over that investment function. One obvious route is to increase government borrowing since its cost is currently below zero in real terms. However, there would be a political hue and cry over such a course. An alternative is Quantitative Easing (QE) by the Bank of England, but since this is outside the remit of government, the focus should be on what government can do.

The government already has majority shareholder control over both Lloyds-TSB bank and RBS (as well as Northern Rock). It is widely accepted from the Vickers' Independent Commission on Banking that the core Tier 1 capital ratio---meaning roughly, the cash reserves of the banks---should rise to a minimum of 10%. Note that Lloyds-TSB's core capital ratio is precisely at the 10% level according to its most recent report for Q1 of 2011.<sup>10</sup> But the same is not true of RBS, which based on risk-weighted assets of £538bn, has core capital of 11.2%.<sup>11</sup>

The above implies that these risk-weighted assets could increase by 12% (the ratio of 11.2 to 10) without pushing the risk limit below the agreed norm. This amounts to £65bn, significantly more than either the decline in investment or the fall in GDP since 2008. RBS could therefore simply be instructed to invest in those sectors prioritised by the government for an increase in investment, eg. housing, transport, infrastructure and education. The jobs bonanza created by this investment would sharply increase taxation revenues and lower welfare payments. The consequent improvement in government finances could be used to pay down the deficit or to increase investment further, or some combination of the two.

To ensure the lowest risk-weighting for the loans and so increase the actual amount of permitted lending, government participation can be deployed in the form of government guarantees. This would incur no cost at all to the government in terms of new borrowing, but government finances would benefit from the very substantial increase in activity generated. This could be directed through a National Investment Bank, which would be the ultimate owner of the assets.

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<sup>10</sup> See [http://www.lloydsbankinggroup.com/investors/financial\\_performance/company\\_results.asp](http://www.lloydsbankinggroup.com/investors/financial_performance/company_results.asp)

<sup>11</sup> See [http://www.investors.rbs.com/results\\_presentations](http://www.investors.rbs.com/results_presentations)

There is already serious support for some form of national investment bank.<sup>12</sup> A Government Commission on banking reform chaired by Sir John Vickers has endorsed the notion in its interim report,<sup>13</sup> but the ‘Green Bank’ announced in May by Nick Clegg falls far short of what is needed.<sup>14</sup>

What could a British Investment Bank (BIB) do? The answer is fourfold. It could help to ‘green’ the economy by helping to expand renewable energy sources and to increase energy efficiency. Chris Huhne would be happy since his under-funded ‘Green Bank’, unable to borrow until 2015, would gain a new lease of life. Secondly, a BIB could help rebalance the economy by concentrating on new investment in manufacturing. Since most of what Britain manufactures is exported, this would help Britain’s external balance as well.

Thirdly, a BIB should focus on: support for small and medium sized businesses (SMEs), which employ 60 per cent of our private sector workforce----firms like Sheffield Forgemasters for example. Finally, a BIB would be tasked with renewing Britain’s poor economic and social infrastructure, everything from new schools and social housing to high-speed rail transport. Britain’s new housing starts have fallen away to nearly nothing, a major reason why house prices are rising again; Britain spends half as much per capita on schools as France, and Britain has fallen behind quite lamentably in its transport infrastructure.

A major investment push in these areas alone (and there are more) would not only create jobs but would help stimulate private investment. Mr Osborne’s belief in the ‘crowding out’ view of public investment has apparently blinded him to its far-more-important ‘crowding in’ effects. In a phrase, a BIB could help direct funds towards those sectors most in need of renewal, while at the same time providing incentives for complementary private investment.

A key feature of the BIB would be the appraisal of investment projects not merely on the basis of private profitability but, most importantly, on the basis of wider national profitability. The BIB could act as a powerful instrument for offsetting negative externalities (cases of market failure) and promoting positive externalities.

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<sup>12</sup> See Skidelsky, R and F Martin (2011), ‘For a National Investment Bank’ *New York Review of Books*, 28 April-11 May.

<sup>13</sup> See Richard Stevens: <http://www.progressonline.org.uk/columns/column.asp?c=528>; for the interim report see <http://s3-eu-west-1.amazonaws.com/htcdn/Interim-Report-110411.pdf>

<sup>14</sup> See <http://www.progressonline.org.uk/columns/column.asp?c=528>

How much would it cost? Clearly, either the Treasury could provide initial seed capital or the publicly owned-banks could use own-funding as suggested above. But having done this, the BIB would mobilise the bulk of its resources in two ways. First, like its European counterparts---the Luxembourg-based European Investment Bank, the Nordic Investment Bank in (based in Finland) or the *Kreditanstalt für Wiederaufbau* (KfW) in Germany---it would be able to raise capital in the market—where the cost of capital is at historically low rates. Germany’s KfW raises nearly 90% of its capital in the market, some EUR 60-70bn per annum.

Equally, the BIB would draw in private sector investors as partners in particular projects. Moreover in accomplishing the latter objective, the BIB would benefit from the leverage provided by having its own resources. It need not resort to PFI-style bribing of the private sector with elaborate contractual promises guaranteeing an unending stream of future super-profits.

In the present context, the idea of creating a BIB is hardly radical. Britain already owns a sizeable chunk of banking real-estate which comes with a well-healed management. In the words of George Magnus of UBS: “A national infrastructure bank that facilitates and channels the excess money in our economies towards, say, new and alternative energy technologies, and the type of infrastructure that might revolutionise manufacturing processes is a worthy pursuit.”<sup>15</sup>

The longer the UK economy stagnates, the greater will be the pressure to formulate a Plan B. The BIB idea has already been advanced in several quarters and carefully discussed.<sup>16</sup> An under-funded ‘Green bank’ headed by Sir Adrian Montague, the City grandee, and unable to invest effectively until 2015 is not the answer. The answer has already been given by Ed Miliband who, during the 2010 leadership race, said:

‘I think we can't just go back to business as usual when it comes to the banking system. If we think we're just going to end up back in a situation of the private sector banks with just a bit

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<sup>15</sup> See <http://duncanseconomicblog.wordpress.com/2010/10/26/the-deficit-currency-wars-global-imbalances-the-social-democrat-solution/>

<sup>16</sup> See for example Gerald Holtham, 'A National Investment Bank Can Raise our Growth', *Financial Times*, 27 October 2010; <http://www.ft.com/cms/s/0/ab0d79a4-e1fc-11df-a064-00144feabdc0.html#axzz1NSdUEIpM>; also see Robin Blackburn [http://www.radicalphilosophy.com/default.asp?channel\\_id=2187&editorial\\_id=29358](http://www.radicalphilosophy.com/default.asp?channel_id=2187&editorial_id=29358); Lord Hollick in House of Lords; <http://www.theyworkforyou.com/lords/?id=2011-03-31a.1346.4&s=speaker%3A13222#g1396.0>; on Europe’s lead, see Anatole Kaletsky ‘Creative Europeans 4, Anglo-Saxon Cutters 0’, *The Times*, updated 25 May 2011.

more regulation, then I don't think that that's the right way forward. We've got to look at all of these options, not just mutual ownership by the way, public ownership, because that's what they do in other countries like Germany where they've succeeded in building a bigger industrial base.' (reported in Stevens, see fn 12)

In our view, Ed Miliband is absolutely right. A publicly-owned British Investment Bank is a central component of any strategy designed to help Britain escape from recession and regain prosperity.