Tullett Prebon Research, a blog by Dr Tim Morgan

Divide (the deficit) and prosper?

by Tim Morgan on July 20, 2012

The Treasury's latest cunning plan (which involves the government guaranteeing up to £40 billion of infrastructure investment) is the newest attempt to reconcile two seemingly-contradictory macroeconomic observations. We can borrow very cheaply – but only so long as we don't…

Right now, the government can borrow at unprecedentedly low rates of interest. On the face of it, this makes a compelling case for borrowing to invest in infrastructure. This could inject much-needed growth into the economy. It could also, of course, help reconstruct Britain's slow and expensive railways, replace our current strips of potholed tarmac with a road network worthy of a modern developed economy, and build much-needed social housing.

On the other hand – and even with the 'Quantitative Easing' effect – interest rates would not remain low for long if the government went back on its plan to reduce the deficit. The markets are rewarding the coalition government for its commitment to restoring sound public finances, though spending cuts have actually been pretty modest so far.

The infrastructure guarantee scheme is an attempt to bridge these contradictions, the logic seemingly being either (a) that markets ignore guarantees, since no actual spending is involved, or (b) that these new guarantees are a drop in the bucket when set beside £1.2 trillion of banking guarantees, which markets seem to have ignored (perhaps unwisely).

This is certainly a better idea than the £80 billion on-lending scheme. Pushing additional borrowings at hugely indebted consumers looks futile (at best), and promoting lending to businesses which the banks (presumably) previously ranked as poor risks isn't much better.

Might there be a better way of reconciling (vital) spending restraint with (attractive) borrowing opportunities? One idea might be to split the deficit into two.

New legislation – a National Investment Act? – would create a new infrastructure -financing authority or IFA (and yes, I know I'm actually suggesting a new quango!). Legislation would be required, to guarantee that NONE of this money would find its way into anything other than capital assets. ("Sorry, Ed and Ed, but you can't waste a single penny of this on your pet projects"). It would be vital to assure markets that no future government would channel any of the borrowed investment capital funding into current spending.

The UK would report two deficits – a current account and a capital account balance, both of which would be subject to strict separation. Investment would be undertaken directly (with no repeat of the iniquitous PFI dodge), and projects would include a swathe of new house-building, refurbished roads (with no road-pricing), refurbished railways and super-fast broadband.

I always welcome comments, but never more so than on this idea. Idealistic, off-the-wall, over-theoretical? Or a way of reconciling (vital) current spending reduction with (equally vital, and very affordable) infrastructure renewal, with a major economic pay-off?