Tullett Prebon Research, a blog by Dr Tim Morgan

The IMF and the Emperor's new clothes

by Tim Morgan on October 9, 2012

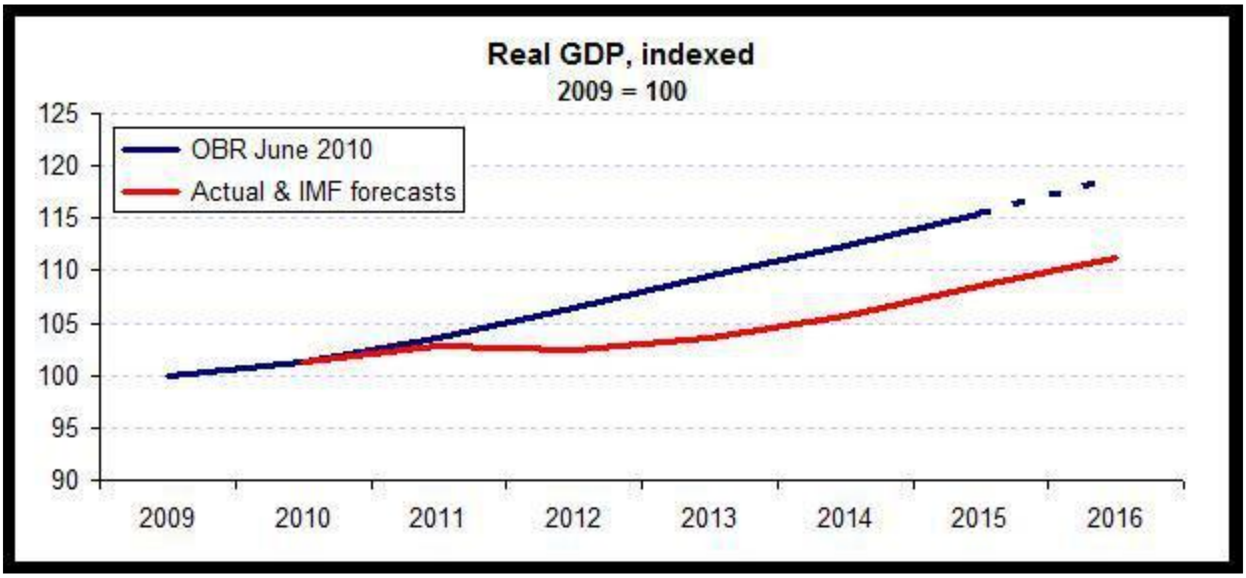
No-one should be too surprised by the IMF's latest downgrade of growth expectations for the UK, which certainly accords with projections that have informed our research for a long time now. But the downgrade – to contraction of -0.4% this year, and growth of +1.1% in 2013 – does highlight (embarrassingly, since it coincides with the Tory conference) the twin problems faced by the government. These related problems are low (indeed, at the moment negative) economic growth, and the emergence of clear evidence that the deficit reduction strategy is being blown a long way off course.

What should the government do about it? Though the IMF is always quick to praise but slow to criticise member governments' policies, one does not have to read too far between the lines of the latest pronouncement to draw the inference that, in the opinion of the IMF, ministers should be thinking in terms of softening their fiscal stance in order to stimulate growth. Though grist to Labour's mill, I think that such an inference rather misses the point. (In parenthesis, I have no idea why Ed Balls, who after all was 'Gordon's representative on earth' during Brown's disastrous conduct of the economy, is taken remotely seriously by anyone).

Looking back to the summer of 2010, the Conservative-Liberal Democrat coalition government did not make light of the problems faced by Britain, or of the inevitability of hardships to come. But ministers did promise that the coming years of austerity would pay off for the public, in two main ways. First, by the end of the Parliament in 2015, the deficit would be eliminated. Second, the British economy would make a brisk return to strong growth.

With the fiscal target looking all but impossible to achieve – and with Britain mired in a double-dip recession – it would be hard not to feel sympathy for George Osborne.

For a start, and as I have explained before, the chancellor has been let down very badly by his forecasters. If the economy had performed in line with the projections issued by the Office for Budget Responsibility (OBR) in June 2010, GDP would be 4% bigger today – and perhaps as much as 6.6% larger in 2016 – than now seems unlikely to be the case, as this chart shows;



The budget position might have been at least £40bn stronger this year if the OBR had been right. In fact, and after adjustment for the woolly accounting treatment of the post office pension fund, borrowing is now running about £11bn *ahead* of 2011-12 – and we're only five months into the fiscal year.

Second, the chancellor has had to live down embarrassing changes to his 2012 budget, changes which seem to have been imposed upon him for political reasons. Given the fiscal straits in which the country finds itself, I saw nothing wrong with Mr Osborne's plans for the taxation of pasties, caravans or charitable donations.

The IMF's not-so-veiled hints that the government should slacken its fiscal stance – code, perhaps, for reducing the pace of spending cuts – might make sense if government spending had actually fallen sharply. In fact, it hasn't. Expressed at constant 2011-12 values, the government spent £705bn in 2009-10, £707bn in 2010-11, and £696bn in 2011-12. In the first five months of 2012-13, public spending has been £7.7bn *higher* year-on-year – and data on the composition of GDP shows that this reflects increases in consumption spending, not just in transfers such as pensions and benefits. This is likely to make for further embarrassment for Mr Osborne when he presents his 2013 budget.

Though commentators tend to look at overall spending levels, the composition of expenditures is important, too, and markets are entitled to look askance at excessive current spending whilst taking a more measured view of investment. Certainly, something could be done to stimulate the economy through capital projects. Under successive governments, investment has declined sharply even though overall public spending has increased very rapidly.

At the Conservative Party Conference, ministers have outlined plans to make savings of £10bn in the benefits bill. This sum could usefully be put into the building of affordable homes for rent.