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Stimulus and risk – why the Keynesian borrowers are wrong

by Tim Morgan on March 21, 2013

I've been pretty critical about the government's economic policy, but nothing that George Osborne or his colleagues have done can compare for sheer irresponsibility with Labour's siren calls for even more borrowing. The Keynesian prescription is mistaken (and highly dangerous) for three main reasons, which we can categorise as 'experience', 'logic' and 'risk'.

There can be no denying the seductive attraction of a Keynesian ("borrow more to stimulate growth") solution. Increased government borrowing, Keynesians argue, would boost the economy so, although it would increase deficits in the near-term, it would enhance tax revenues on a longer perspective, resulting in an eventual reduction in borrowing. Superficially, it's a very persuasive argument but, if it sounds too good to be true, that's because it is.

The first weakness in the Keynesian argument is experience. To listen to Ed Balls, Paul Krugman and others, you could almost believe that government hadn't already given it a try. The reality is that stimulus has already been tried, on a scale unprecedented in peace-time, and has been an abject failure. Over the four fiscal years from 2009-10 to 2012-13, government borrowings have totalled £565bn at 2012-13 values, equivalent to 37% of GDP. If you add quantitative easing to this, the stimulus total rises to over 60% of GDP, or an average of 15% for each of the four years, The problem, then, is not that government hasn't tried Keynesian stimulus, but that it has been tried by the bucket-load – and hasn't worked.

The second big snag which the Keynesians can't overcome is logic. A phenomenon visible both in the UK and the US is that, in the years before the banking crisis, ever more debt was needed to buy each £1 or $1 of growth. Now, of course, that ratio has almost turned negative, with debt rising whilst the economy stagnates. One, at least, of the reasons for the failure of debt to deliver growth is that what we face now isn't a destocking recession (which can respond to stimulus) but a deleveraging recession (which can't). Any stimulus poured into the economy by the government is used by the private sector, not to increase demand, but to reduce its own indebtedness. Trying to cure a deleveraging recession with stimulus is like pushing on a string.

But the killer answer to the stimulus merchants is surely risk. On the Treaty basis used by our European comparators, public debt already stands at 91% of GDP, and even the government expects it to push through the 100% barrier in the coming three years. Bad though that sounds (and is), it doesn't begin to capture the true scale of British indebtedness. Taking government, household and business debt together, aggregate indebtedness is over 500% of GDP. Even if we deduct the foreign banking exposure which goes with the turf of Britain's role as a global financial player, aggregate debt is still well in excess of 400% of GDP, a level which, amongst the major economies, is exceeded only by a single country – Japan – which has been described as "a bug in search of a windscreen".

There's no urgency about paying off this debt, but servicing it is the critical issue. Government debt interest payments are already set to rise from £47bn to £71bn over the coming five years, but each increment of just 1% in overall rates would add £12bn to this figure. Households with mortgages are even more exposed – though rates are now at rock bottom, one in eight mortgages is already in forbearance, and a 200bps rise could imperil as many as half of the remainder.

If you follow through on what an interest rate rise would mean, the increase in government borrowing costs would either drive the deficit upwards or other spending down. Higher rates would hit house prices hard, creating huge banking losses, and the slump in mortgage-payers' disposable incomes would not only have a gravely damaging impact on GDP but could also create another wave of bank losses in commercial property. The government knows that balance sheets – its own, and the banks' – are in no fit state to cope with anything remotely like this.

Of course, this analysis could be used – and rightly – by the government's critics to argue that trying to stimulate the private housing market is dangerous. It is. But taking risks with interest rates would be dangerous to a different order of magnitude. Just as people in glass houses shouldn't throw stones, countries living deeply in debt should take no risks with interest rates.