GEORGE OSBORNE MUST HOPE HIS GAMBLE PAYS OFF

By Alf Young

HAVING unveiled the most severe and sustained package of cuts the UK economy has experienced in living memory, George Osborne is now in Seoul, South Korea for a critical meeting of the G20 group of nations. He goes, he told us on Wednesday, as representative of the most indebted economy round that table, but as the Chancellor whose bold actions have pulled us back from the brink of national “bankruptcy”. The pain of adjustment, living within our means like any “solvent household”, will persist for years to come. But fiscal credibility has been restored. Thanks to him, bond markets are not going to treat the UK as the next Greece or Ireland.

Mr Osborne clearly thinks that is the necessary and sufficient condition for a revival in the UK’s economic fortunes. As the state shrinks at his hands, private sector enterprise will take up the slack, creating new wealth and more jobs. He has no Plan B. The country needs “a decisive plan”, not reams of risk analysis and groaning shelves of contingency planning. That unblinking conviction that his is the only remedy, that there is no other way to make Britain strong again, is why so many commentators have characterised his approach as such a massive gamble. He is betting the house on being proved right.

What if he’s wrong? What if the pain of the cuts further dents confidence in an already fragile economy and jeopardises growth? What if the need to wean us all off our debt-laden consumption of recent decades and replace some of that froth with an export-led renaissance founders on the resistance of the world’s surplus nations, like China, which are still growing strongly and like becoming richer by producing more and more of the goods we buy? The Chancellor hints the Bank of England can step in, keeping interest rates lower for longer or extending its programme of printing new money.

This week the Bank’s Governor, Mervyn King, told a business audience in the West Midlands that the imbalances in world trade are beginning to grow again. “The major surplus and deficit countries are pursuing economic strategies that are in direct conflict,” he went on. There was much talk at the recent IMF meeting in Washington of currency wars as individual economies try to manipulate their currencies to achieve a competitive advantage.

Unless there is action in the collective interest, King went on, “it will be only a matter of time before one or more countries resort to trade protectionism as the only domestic instrument to support a necessary rebalancing. That could, as it did in the 1930s, lead to a disastrous collapse in activity around the world. Every country would suffer ruinous consequences - including our own.”

Mervyn King sees the G20 as “the natural forum” in which to strike such a bargain. But he warns that turning these regular round-tables into a forum for decisive agreement requires “a revolution”. Is George Osborne, as he sits there in Seoul, reflecting on the ruinous consequences for his deficit reduction strategy if, over the next four or five years, King’s fears about a resurgence of protectionism materialise and global growth goes back into reverse?

Ever since it came to power, the Coalition has bent every sinew trying to pin the entire blame for the state of our public finances on the government that preceded it. It's as if the great banking crash and the worldwide recession that followed had never happened. As a politician who, in opposition, was promising to "share the proceeds of growth" and match anything Labour tried to do in spending more on health and education, George Osborne's own hands are hardly clean when it comes to who threw Prudence out with the bathwater.

There is almost universal agreement that Britain's current deficit is unsustainable and has to be addressed. But this Chancellor is wrong to project the pace and scale of his cuts package as unavoidable. It is a choice. We have lived through such choices before. As the graph shows, the size of the British state (as measured by total state spending as a percentage of GDP) grew rapidly in the early years of Margaret Thatcher's time of in office, shrank again in the late 1980s, grew more modestly in the Major years, shrank again up until the millennium under Blair and Brown, then peaked again last year (slightly below the Thatcher summit) but should still be around the 40% mark by 2015.

The pace of contraction this time is dictated by the scale of government borrowing in the wake of the banking crisis and the resultant recession. But the precise pace the Coalition has opted for is not inevitable. It is its choice. A choice dictated, we are told, by the prospect of national bankruptcy. But, as Martin Wolf of the Financial Times has pointed out, on that definition the UK has been technically bankrupt for much of its history since 1700.

The Coalition's solution is to cut back spending in real terms over a four, or possibly, five year period. Apart from £18bn of welfare benefit cuts and another assault on departmental administration which could see 490,000 jobs go, the deepest cuts will come in future capital spend. That target was already in Labour's plans. But the scale of the shrinkage in capital budgets planned by the Coalition is remarkable. Overall such budgets will fall, in real terms, by 29% by 2014/15. In Scotland the equivalent cut will be an even more draconian 38%.

On the day the Chancellor unveiled his Comprehensive Spending Review, the latest Scottish GDP figures were released. As ever they are a bit behind the curve. They only cover the April-June quarter of this year. However, after revisions had turned flat-lining in output in the first quarter into a 0.2% fall, the second quarter turned in a healthy 1.3% rise in overall output. The biggest gainer in the quarter by far was construction, rising 10.4%.

Against the kind of cuts now pencilled in for public capital budgets over the next four years, that increase will soon look like a distant dream. The private housing market is already softening. Social housing provision faces a period of turmoil under the Coalition's plans. Apart from an ongoing commitment to some big transport projects, the infrastructure spending cuts now planned through to 2015 are bound to have an adverse impact on overall economic activity going forward.

That linkage is relatively easy to read. How the other welfare and departmental spending cuts translate into reduced demand in the wider economy is much harder to chart. But it is difficult to avoid the conclusion that, unless and until increased private sector activity kicks in, these cuts overall will tend to push overall GDP down. Can, as George Osborne intends, Bank of England interventions in monetary policy take some of the strain?

Well, as we also saw this week, the Bank's monetary policy committee is now split three ways on what to do next. One member wants to raise interest rates immediately, another wants another £50bn slug of quantitative easing. The rest are sitting on their hands. And what of the prospects for those 490,000 workers from the public sector finding jobs elsewhere.

The new independent Office for Budget Responsibility has just released more of its pre-budget forecasts on employment. Back in June it saw trend employment in the UK increasing by just 600,000 by the end of 2015. And it thought the labour market participation rate across the UK, currently 62.9%, would actually fall to 62.3% over the same timeframe. We will find out at the end of next month, when it releases its latest forecasts, what it thinks now.

George Osborne, the gambler with no plan B, will be hoping for a rosier forecast than that, if his big bet is ever to pay out.

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