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Private sector recovery during fiscal retrenchment

By **Gordon Douglass, Christopher Lewis** and **Bridget Rosewell**

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For more information about this publication, please contact:
GLA Economics
telephone 020 7983 4922
email glaeconomics@london.gov.uk

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Executive summary

The scale of the fiscal consolidation announced in the June Budget implies spending cuts on a scale which has no precedent since those following the end of the Second World War. It is not therefore surprising that it has generated fears of a double dip recession and concerns over the potential implication for employment and unemployment and for suppliers to the public sector.

If the economy were a zero sum game then those fears would not be misplaced. And if the economy were indeed zero sum then such cuts would be even more necessary, since the burden of debt being accumulated would have no chance of being paid off in such a no-growth world.

Fortunately, this is not the world we live in. A growing economy is best placed to pay off debt and to be able to afford the public services that its citizens would like to see. Encouraging and maintaining such growth is the best route out of the problems we face and therefore the most effective route to growth needs to be chosen.

Some have argued that continuing spending and borrowing is such a route and that cuts must be delayed until growth is re-established. On this reading, public sector spending is a temporary substitute for private sector sources of economic growth. The risk of such a position is that such spending may itself crowd out the private sector recovery and that the borrowing required will eventually become unsustainable. The UK has already seen a large increase in spending and borrowing which has produced the largest peacetime deficit ever. It is not plausible to continue such support forever.

A small number argue that the public sector is more effective at generating growth in the first place. They argue that reducing spending shrinks the economy and increases the burden of existing debt. This implies that public services are just as capable of generating real economic growth as other investments. However, we know that public sector productivity has been falling even as more money has been spent on such services. Moreover, technical innovation and trade, the biggest drivers of economic performance are not in evidence. The government does not produce new products nor engage in international trade.

This paper shows that the scale of debt and associated interest payments are such that action to control them is essential. It also presents a summary of the literature on this topic which shows that fiscal consolidation can be managed and need not have more than a short term impact on growth.

It focuses on the dynamic potential of the economy. It shows the risk of crowding out private expansion, of the scale of interest payments and how previous recoveries after consolidation have benefited from the resurgence of investment and trade as well as consumption.

Clearly there will be painful choices to be made. This does not mean that they are wrong choices. Indulgence and cheap food has led us into a period of obesity. Dieting can be difficult and, equally, the wrong kind of diet can create problems. However, we know that it is the right response.

"This country has the largest peacetime budget deficit in its history – over 11% of GDP in the fiscal year to 2010. Although a large budget deficit is inevitable for a period after a crisis, it is also clearly unsustainable – our national debt, even relative to GDP, is rising sharply and will continue to do so for several years. It is vital for any government to set out and commit to a clear and credible plan for reducing the deficit. I would be shirking my responsibilities if I did not explain to you the risks of failing to do so.

Vague promises would not have been enough. Market reaction to rising sovereign debt can turn quickly from benign to malign, as we saw in the euro area earlier this year. It is not sensible to risk a damaging rise in long-term interest rates that would make investment and the cost of mortgages more expensive. The current plan is to reduce the deficit steadily over five years – a more gradual fiscal tightening than in some other countries. As a result of a failure to put such a plan in place sooner, some euro-area countries have found – to their cost – a much more rapid adjustment being forced upon them."
Mervyn King, the Governor of the Bank of England, 15 September 2010 in a speech to the TUC

Introduction

The UK (and by implication London) faces a period of fiscal consolidation by the Government to reduce this country's budget deficit and to stabilise government debt as a proportion of GDP. Some commentators have argued that this will lead to a double dip recession. Whilst the direct impact of reduced government expenditure will dampen growth in the short run there are positive indirect impacts from this action that will help to drive a private sector recovery across the UK and London. Total managed expenditure by the Government stood at £669.3 billion in 2009/10[1], which puts in context the scale of the Government's current planned spending cuts of £99 billion per year by 2015/16.

Public sector net borrowing has been increasing for most of the last ten years so cannot be blamed only on the 2008-09 recession. There was in fact a structural budget deficit during the years of strong growth and booming house prices before the recent recession. Government expenditure rose from 36.3 per cent of GDP in 1999/2000 to 40.9 per cent of GDP in 2007/08[2]. When times were good national debt was still rising as government expenditure exceeded tax revenues. If taxation does not cover government expenditure then it can only be financed by borrowing (either from future generations or from foreigners willing to buy our debt). And as our national debt increases so do interest payments on that debt[3]. Tax revenues that could otherwise be spent on government services or paying off the debt have to be diverted to paying this interest.

This note reviews the arguments surrounding these issues and the scale of the issues faced, as well as the problems and opportunities generated.

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[1] Source: Table B1 http://www.hm-treasury.gov.uk/d/public_finances_databank.xls, 30 September 2010.
[2] Source: Table B2 http://www.hm-treasury.gov.uk/d/public_finances_databank.xls, 30 September 2010.
[3] Assuming interest rates are not falling by such an amount to compensate for the higher level of debt.

Why government expenditure cuts are necessary

i) An untackled deficit could lead to a sovereign debt downgrade hitting confidence and causing higher borrowing costs that would negatively impact on the private sector

The rise in the size of the budget deficit is unsustainable and without tough plans to tackle it would have led to pressure for the UK's sovereign debt to be downgraded, as has occurred to other countries running sizable budget deficits such as Greece and Ireland. Such an outcome would be highly undesirable to the Government as it would push up its borrowing costs, which would have knock on effects on private sector borrowing costs and a negative impact on consumption and business investment. A sovereign debt downgrade would also hit consumer and business confidence slowing or even reversing the current recovery. In the case of other nations such as Portugal, the OECD has warned that high sovereign debt spreads could put their recovery at risk[4].

In response to the possibility of a sovereign debt downgrade the Chancellor of the Exchequer, in the emergency budget on 22 June 2010, announced a variety of measures to improve the weak state of the nation's public finances. These included: an increase in VAT to 20 per cent on 4 January 2011; a two-year pay freeze from 2011/12 for public sector workers earning over £21,000; a levy on banks' balance sheets from 1 January 2011; a rise in the capital gains tax rate for higher rate taxpayers to 28 per cent from 18 per cent; the generally lower consumer price index (CPI) inflation rather than retail price index (RPI) inflation being used for the indexation of benefits and tax credits from April 2011; capping the maximum allowance payable for housing benefit; and freezing child benefit for the next three years. The aim of these measures was to begin to reduce the budget deficit from the estimated 11 per cent of GDP in 2009/10 to 1.1 per cent in 2015/16 (see Figure 1). These measures will also reduce the size of the structural budget deficit. See Figure 2 for the historical structural component of the budget deficit. The Government aims to rebalance the UK economy away from its reliance on state borrowing and to encourage a private sector led recovery. Government spending is projected to fall from 48 per cent of GDP in 2009/10 to 40 per cent by 2015/16 with receipts forecast to rise from 37 per cent to 39 per cent[5] (see Figure 3). The majority of the fiscal consolidation will come from lower government spending (77 per cent) rather than from higher taxes (23 per cent). With spending on the NHS and international development aid protected, other government departments face reductions of around 25 per cent or more by 2015/16. The Comprehensive Spending Review, which will set all departmental expenditure limits, will be published on 20 October and will give details of the departmental spending cuts.

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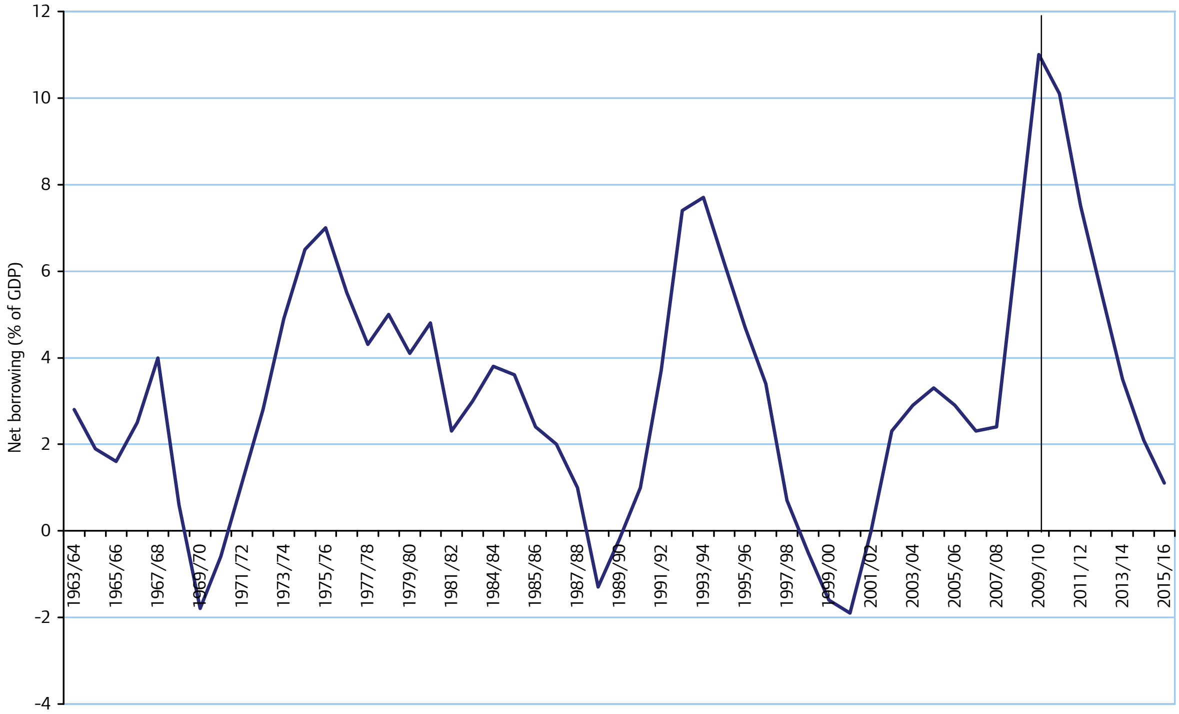
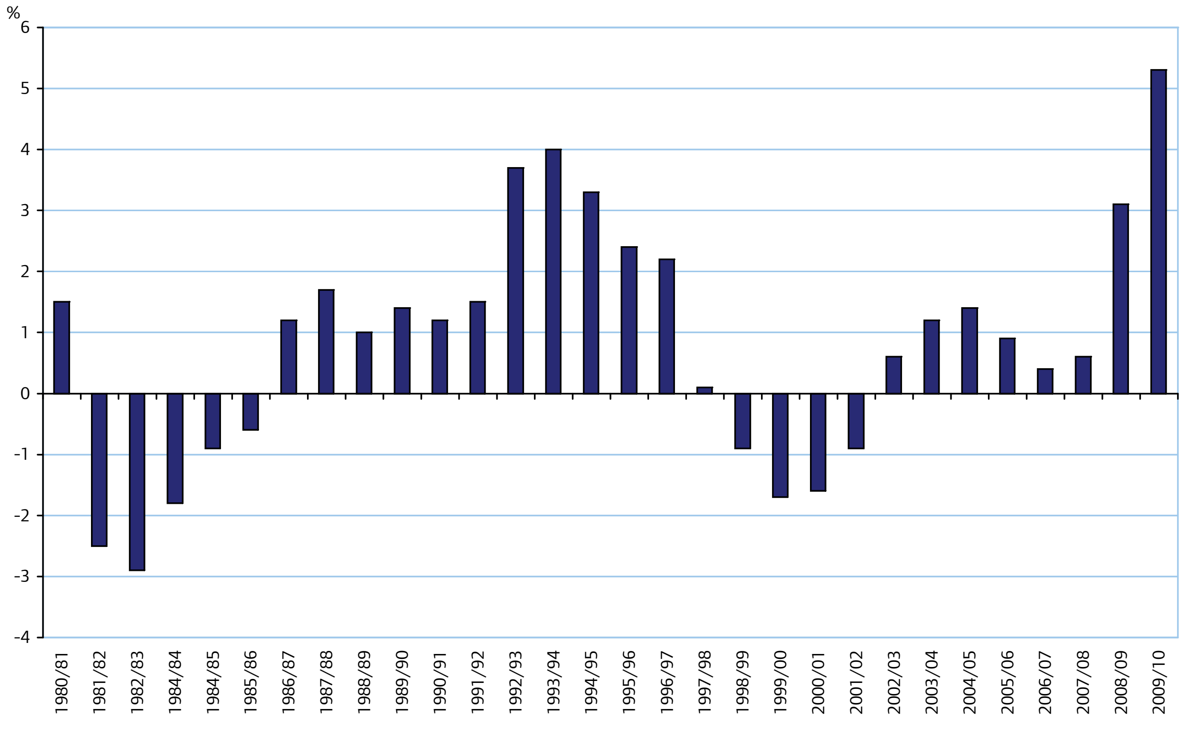
[4] OECD, 'OECD Economic Surveys: Portugal', September 2010.
[5] HM Treasury, 'Budget 2010', June 2010.

Figure 1: Public sector net borrowing as a proportion of GDP (including forecasts for 2010/11 onwards)



Source: HM Treasury, Public Sector Finances Databank, 30 September 2010

Figure 2: The structural component of the budget deficit (as a proportion of GDP)



Source: HM Treasury, Public Sector Finances Databank, 30 September 2010

Figure 3: Public sector current receipts and total managed expenditure as a proportion of GDP (outturn 1997/98 to 2008/09; estimate for 2009/10; forecast for 2010/11 to 2015/16)

Source: HM Treasury, Public Sector Finances Databank, 30 September 2010

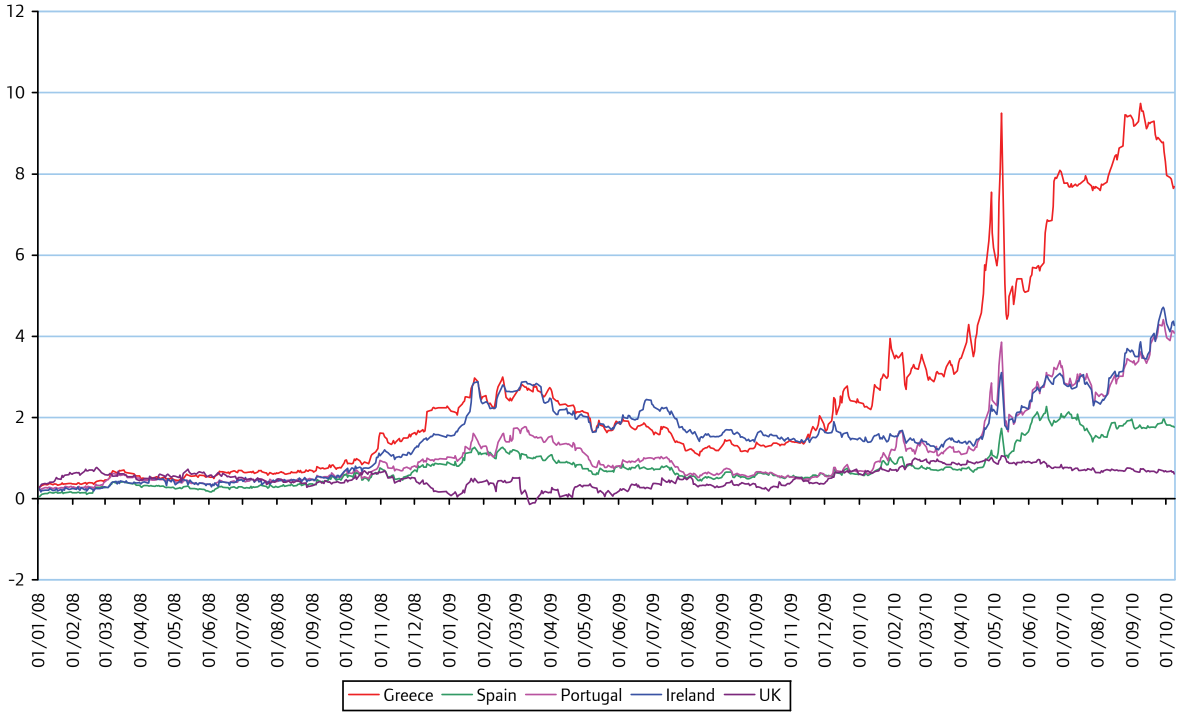
Ratings agencies responded positively to the emergency budget and planned austerity measures, with Moody's stating that the UK's AAA ranked credit rating was safe. Kenneth Orchard, an analyst at Moody's commented that "Moody's stable outlook... is largely driven by the Government's commitment to stabilise and eventually reverse the deterioration in its financial strength"[6].

The problem of high and unsustainable budget deficits is highlighted by Figure 4, which shows the spread on a number of countries 10-year government bonds over German bonds, which indicates the perceived level of risk in holding their bonds in comparison to German bonds. The German Government is considered the "safest" Eurozone Government to borrow and is often used as a benchmark for comparison. Concern over sovereign debt problems were raised in relation to Greece after it disclosed at the end of 2009 that its public accounts had significantly under estimated the size of its budget deficit. In May 2010 Greece required a bail-out from the International Monetary Fund (IMF) and Eurozone nations. The conditions placed on Greece and the austerity measures it must now follow demonstrate that tackling one's deficit voluntarily, like the UK is now doing, is far preferable to being forced to take draconian measures by international bodies such as the IMF. Other members of the Eurozone including Ireland, Portugal and Spain that have high government budget deficits have also seen the cost of their debt rise over the course of 2010 with a number of countries seeing their debt downgraded by rating agencies[7].

[6] BBC, 'Moody's hails UK austerity effort', 20 September 2010.
[7] BBC, 'Moody's downgrades Portugal debt', 13 July 2010.

Figure 4: Ten-year government bond spreads over German bonds, percentage points

Last data point: 08/10/2010



Source: EcoWin

Figure 4 also shows the spread between 10-year UK Government gilts and German Government bonds. Unlike with the Eurozone countries, the difference between the German and UK interest rate, as well as reflecting the default risk for holding gilts compared to German Government bonds[8], also reflects a currency risk from possible future exchange rate movements. As Figure 4 shows until winter 2009 the spread between German and UK bonds was small. However this then gradually increased until May 2010. Since then the spread between gilts and German bonds has stabilised and if anything gradually declined since June 2010. This is in sharp contrast with what has happened to Greek, Irish, Portuguese and Spanish Government bonds and indicates that markets view the fiscal prospects for the UK more favourably after the fiscal consolidation announced in the June Budget. If the UK gilt spread with German bonds had risen to the same extent as has occurred in Greece, Ireland and Portugal a private sector recovery in London and the UK would be in great danger. Greece and Ireland's economies are currently contracting while Spain and Portugal are experiencing anaemic growth.

[8] The higher the risk of default on the bond the higher should be the interest rate paid on the bond to compensate for bearing that risk.

ii) Cutting the deficit reduces government interest payments

With our large national debt comes vast interest payments[9] (see Table 1). Even after the fiscal consolidation measures announced in the June 2010 Budget interest payments are estimated to increase to £63 billion in 2014/15[10], which is about three times greater than the 2008/09 annual UK government expenditure on transport. This estimate of interest payments in 2014/15 was revised down by £4.2 billion compared to the Office for Budget Responsibility's (OBR) pre-June Budget forecast to take account of the fiscal consolidation announced in the June 2010 Budget[11]. By cutting the deficit the Government is reducing interest payments compared to what they would otherwise be, releasing money that can now be used to cut the deficit further or reduce taxation or increase government expenditure on services.

Table 1: Central government gross debt interest (estimate 2009/10, forecast 2010/11 to 2015/16) (£ billion)

Financial year	Pre-June Budget forecast June 2010	Budget forecast June 2010	Change since Pre-June Budget forecast
2009/10	30.9	30.9	0.0
2010/11	42.1	43.3	1.1
2011/12	46.1	46.5	0.4
2012/13	54.2	52.4	-1.8
2013/14	60.6	57.8	-2.8
2014/15	67.2	63.0	-4.2
2015/16	-	66.5	-

Source: OBR Pre-June Budget forecast, June 2010 and OBR Budget forecast, June 2010

Work by Baldacci and Kumar finds "a pronounced increase in debt service costs over the medium term for the advanced G20 economies: given the average increase in debt of about 20 percent of GDP, debt service costs are likely to increase by more than 1½ percent of GDP in these countries"[12]. However, they conclude that "credible fiscal consolidation strategies that reduce uncertainty about sustainability can help cut borrowing costs for governments with large debt levels"[13].

iii) Fiscal consolidation frees up resources for the private sector

National income is made up of consumption, investment, government spending and net exports so that a simple reading would state that, holding everything else constant, a reduction in government spending would reduce national income. This would hold at the regional level for London's economy as well. However, such an analysis would be far too simplistic, as reducing government spending will have positive secondary effects on other sectors of the economy. These impacts will boost the economy in that a reduction in

[9] Defined here as central government gross debt interest.
[10] Source: Table C13 Office for Budget Responsibility, 'Budget forecast', 22 June 2010.
[11] Source: Table C14 Office for Budget Responsibility, 'Budget forecast', 22 June 2010.
[12] Baldacci, E. & Kumar, M. S., 'Fiscal Deficits, Public Debt, and Sovereign Bond Yields', IMF Working Paper, August 2010.
[13] Ibid.

government spending and government borrowing will place downward pressure on interest rates enabling businesses to invest at a lower cost and thus giving upward support to national income. Lower long-run interest rates will also support private consumption and put downward pressure on sterling boosting net exports. In addition as noted in the 2010 Q3 Quarterly Bulletin from the Bank of England "plans for fiscal consolidation removed a key source of uncertainty affecting sterling asset prices"[14], with the announced deficit reduction plan helping to improve financial market sentiment in June and July. Lower uncertainty supports asset prices, which gives businesses and consumers more collateral, supporting investment and consumption.

A further argument can be made that this fiscal retrenchment is necessary in order to encourage strong growth in the private sector, which otherwise would be 'crowded out' by excessive government spending and borrowing. Excess government spending competes with private sector demand for limited available finance, so if government spending is reduced the 'crowding out' argument suggests it would free up finance for use by the private sector.

iv) Research suggests that cuts in government expenditure is better than tax rises as a way to implement fiscal consolidation

The balance of academic studies into fiscal retrenchment suggests that of the options available for reducing budget deficits spending cuts rather than tax rises are likely to be more successful. The following few paragraphs describes some of the literature in more depth.

Economic research into the impact of fiscal consolidation highlights a number of factors that are both likely to make the policy succeed and mitigate the economic impact of the cuts. Price observes that "a number of arguments and empirical studies suggest that spending restraint (notably with respect to government consumption and transfers) is more likely than tax increases to generate lasting fiscal consolidation" and that "private and public saving do tend to vary inversely"[15].

Alesina and Perotti[16] find econometric evidence that indicates that "spending cuts in transfers and government wage bill have a better chance of success and are more (economically) expansionary", while "fiscal adjustments that rely primarily on tax increases and cuts in public investment tend not to last and are contractionary." Kumar et al. also observe that, "fiscal adjustments that rely on cuts in current expenditure have tended to be more durable than revenue-based consolidations"[17].They also discovered that in relation to "the macroeconomic effects of fiscal consolidations on economic activity, the case studies indicate that while adjustments tended to have a moderating influence on growth in the short run, it was not as pronounced as generally anticipated, and in a number of cases, the consolidations could even be described as 'expansionary'"[18]. Daniel et al. remark that, "fiscal

[14] Bank of England, 'Quarterly Bulletin 2010 Q3: Volume 50 No. 3', 20 September 2010.
[15] Price, R., 'The political economy of fiscal consolidation', Economics department working papers No. 776, OECD, 31 May 2010.
[16] Alesina, A., & Perotti, R., 'Fiscal Adjustments In OECD Countries: Composition And Macroeconomic Effects', International Monetary Fund Staff Papers, 1997, V44, pt 2, 210-248.
[17] Kumar, M. S., Leigh, D. & Plekhano, A., 'Fiscal Adjustments: Determinants and Macroeconomic Consequences', IMF Working Paper, July 2007.
[18] Ibid.

consolidation (on a cyclically adjusted basis) should ideally begin to kick in as the economy starts the expansionary phase of the business cycle, which would mitigate any contractionary first-round effects”[19].

Alesina and Ardagna[20] argue that, “spending cuts are much more effective than tax increases in stabilizing the debt and avoiding economic downturns. In fact, we uncover several episodes in which spending cuts adopted to reduce deficits have been associated with economic expansions rather than recessions”. Although it should be observed as noted by Konczal and Jayadev that the “overwhelming majority” of episodes examined in this work “did not see deficit reductions in the middle of a slump”[21].

[19] Daniel, J., Davis, J., Fouad, M., & Van Rijckeghem, C., ‘Fiscal Adjustment for Stability and Growth’, IMF Pamphlet Series, No. 55, August 2006.
[20] Alesina, A. & Ardagna, S., "Large Changes in Fiscal Policy: Taxes versus Spending", NBER Chapters, in: Tax Policy and the Economy, Volume 24 National Bureau of Economic Research, Inc., 2009.
[21] Konczal, M. & Jayadev, A., ‘The Boom Not The Slump: The Right Time For Austerity’, The Roosevelt Institute, 23 August 2010.

Tighter fiscal policy allows monetary policy to be looser than it would otherwise be

In relation to the economic impact of fiscal consolidation the IMF notes that, "a fiscal consolidation equal to 1 percent of GDP typically reduces GDP by about 0.5 percent within two years and raises the unemployment rate by about 0.3 percentage points"[22]. However it then observes that "central banks offset some of the contractionary pressures by cutting policy interest rates, and longer-term rates also typically decline, cushioning the impact on consumption and investment. For each 1 percent of GDP of fiscal consolidation, interest rates usually fall by about 20 basis points after two years"[23]. As a note of warning the IMF observes that when interest rates are already close to zero such further accommodation is more difficult, and that if all countries are performing fiscal consolidations the impact of the consolidation is likely to be more severe. However, even if interest rates set by monetary authorities are at, or close to, zero, monetary policy can still be loosened further through initiating or expanding a policy of quantitative easing to offset at least in part tighter fiscal policy. In relation to the balance of spending cuts to tax rises the IMF notes that, "fiscal contraction that relies on spending cuts tends to have smaller contractionary effects than tax-based adjustments. This is partly because central banks usually provide substantially more stimulus following a spending-based contraction than following a tax-based contraction"[24].

Overall government cuts are likely to slightly dampen economic growth in the UK over the next couple of years as indicated by the OBRs forecasts for UK economic growth prior to and after the June 2010 Budget. In its pre-June Budget forecast it forecast growth of 1.3 per cent in 2010 and 2.6 per cent in 2011[25]. Its forecast for the June 2010 Budget taking account of the Budget's measures expects growth of 1.2 per cent in 2010 and 2.3 per cent in 2011[26]. However, growth is expected to be stronger from 2013 "as the economy adjusts back towards potential output"[27]. It should be noted that the OBRs forecasts envisage a rebalancing of the economy, with business investment becoming increasingly important during the forecast period and with net exports also providing a boost to the economy. Private sector growth is the least painful method of rebalancing the economy.

[22] IMF, 'World Economic Outlook: Recovery, Risk, and Rebalancing', October 2010.
[23] Ibid.
[24] Ibid.
[25] Source: Table 3.1 Office for Budget Responsibility, 'Pre-Budget forecast', 14 June 2010.
[26] Source: Table C3 Office for Budget Responsibility, 'Budget forecast', 22 June 2010.
[27] Office for Budget Responsibility, 'Budget forecast', 22 June 2010.

London has a larger private sector as a proportion of its economy than the UK

The composition of the London economy will affect how the balance between tax rises and spending cuts will impact on the capital's economy. Given the size of public sector employment as a percentage of London's workforce as shown in Table 2 and the relatively small share public sector expenditure makes up of London's economy (see Figure 5), it is likely that tax rises would impact disproportionately harshly on London's economy. This is also supported by the fact that in the past London has made a net tax contribution to the national finances with London providing a net contribution of between £14.3 billion and £19.4 billion in 2007/08[28]. Even if this contribution turns negative due to the recent recession it is still likely to be relatively small compared to the rest of the UK and when public finances do begin to improve it is likely that a large part of this improvement will be driven by London. Given the drag that government spending cuts will have on the national economy, the Bank of England is likely to respond by keeping interest rates lower for longer than would have been the case without spending cuts, providing an additional boost to London's economy. It should also be noted that recent work[29] that looked at how resilient the English regions are to economic shocks indicates that London may be more resilient to the shock of government spending cuts than other areas of England. For this reason and the likelihood that the Bank of England will attempt to offset (at least partially) the dampening impact of a reduction in government expenditure, it is possible that government spending cuts will have a significantly lower negative impact on London than on other regions (or on Scotland or Wales).

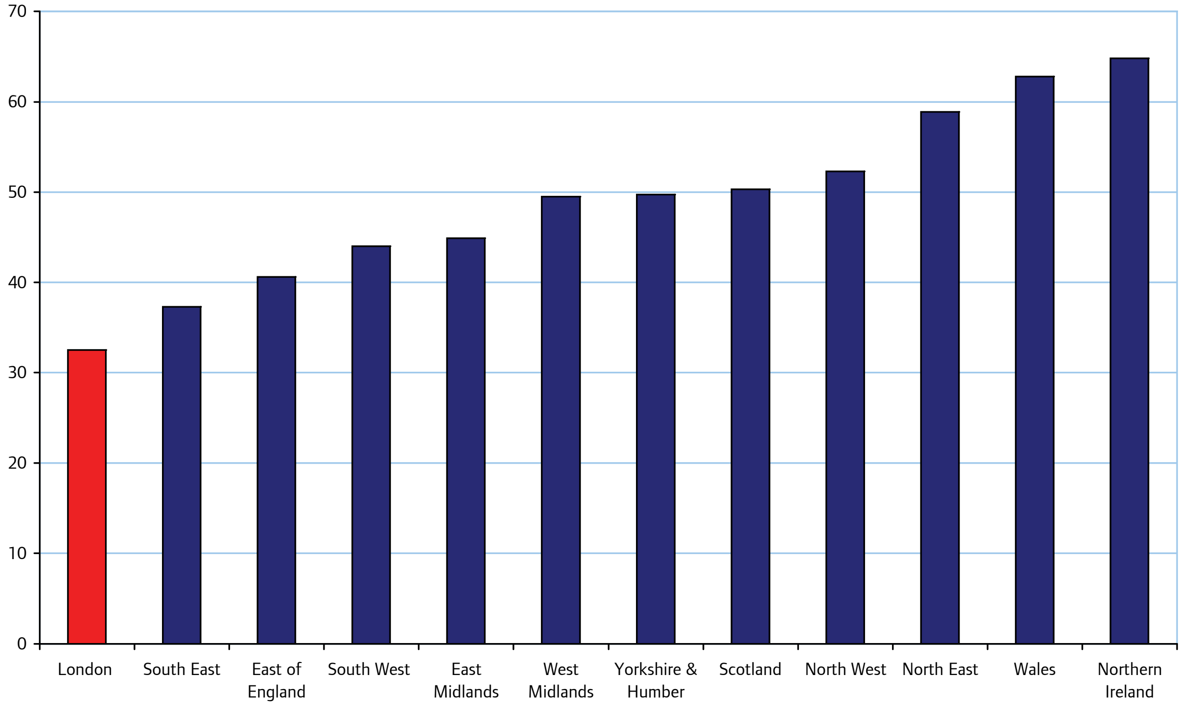
Table 2: Public sector employment as a per cent of total employed workforce (2008)

Government Office Region	Per cent
North East	32.2
North West	28.2
Yorkshire and The Humber	28.5
East Midlands	26.6
West Midlands	26.9
East	25.2
London	22.2
South East	25.4
South West	28.5
Wales	32.9
Scotland	30.0
Great Britain	**26.9**

Source: ONS, Annual Business Inquiry

[28] LSE, 'London's Place in the UK Economy, 2009-10', City of London, October 2009.
[29] BBC, 'Spending cuts 'to hit north harder'', 9 September 2010.

Figure 5: Public sector expenditure per region as a share of GDP (2008/09)



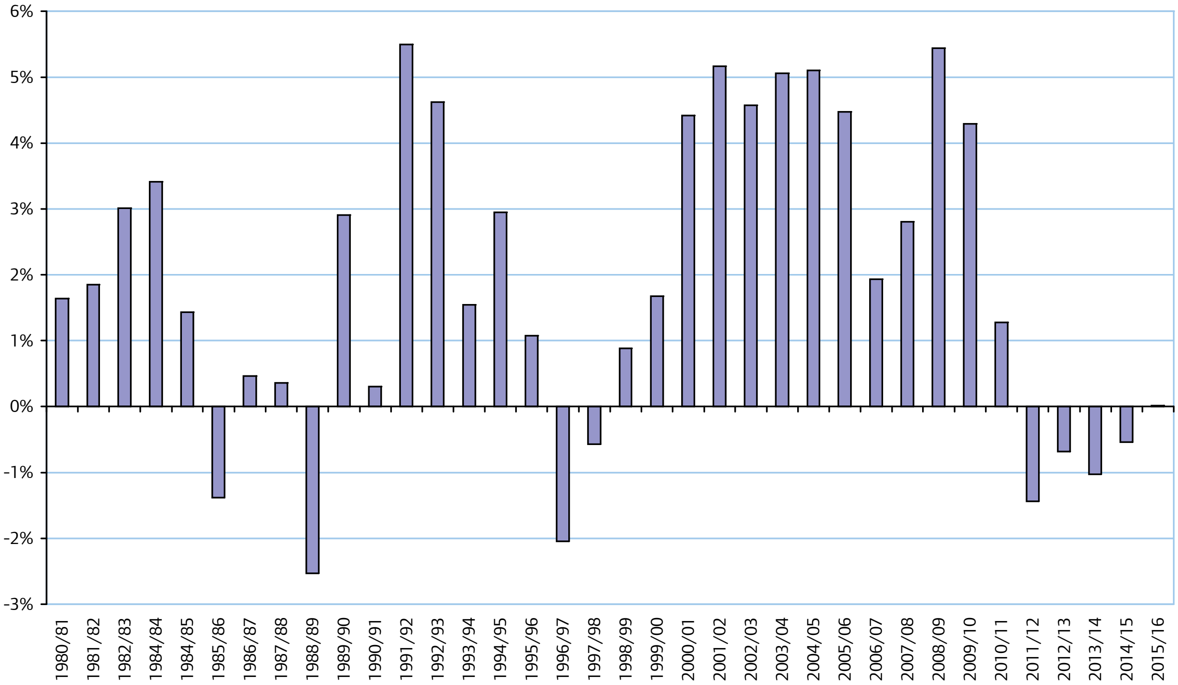
Source: CEBR[30] (calculation based on data from Public Expenditure Statistical Analyses (PESA) 2010, ONS and CEBR prospects service)

[30] CEBR, 'Forecasting Eye Special', 26 April 2010.

Business investment has grown strongly in past periods of fiscal consolidation

The last period of significant fiscal consolidation, which occurred in the mid-to-late 1990s after the 1992 General Election, saw both large tax rises and spending restraint (see Figure 6).

Figure 6: Annual percentage change in real government total managed expenditure (2008/09 prices)

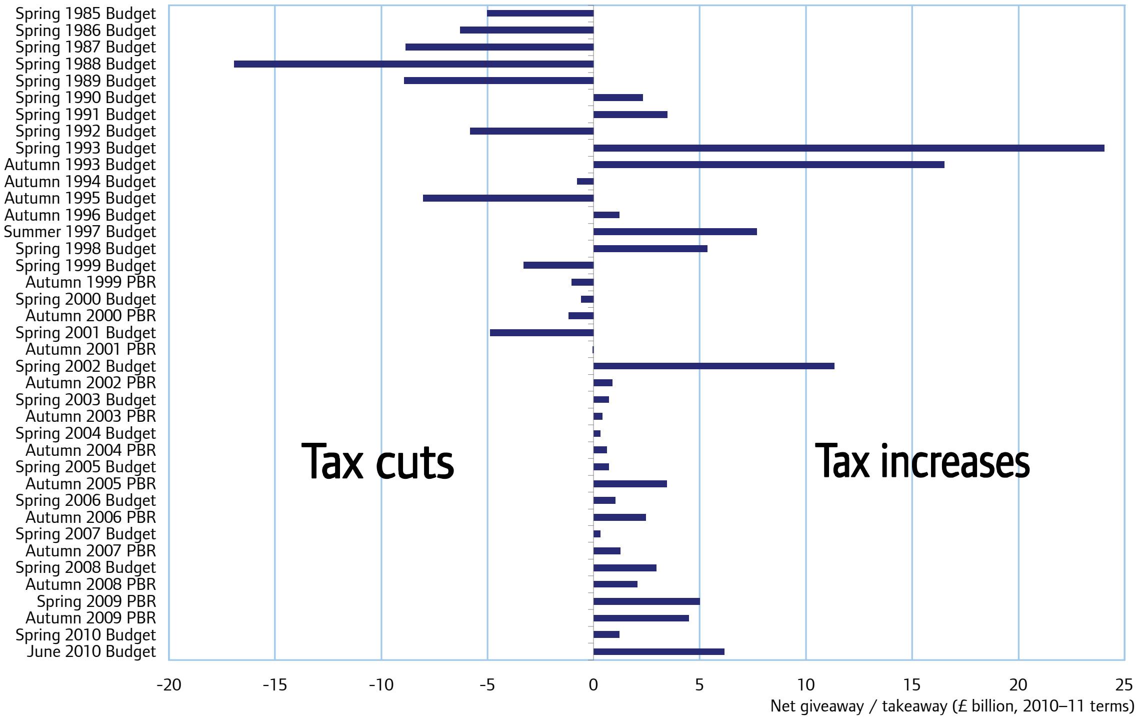


Source: Office for Budget Responsibility, Budget forecast; HM Treasury; and GLA Economics calculations[31]

Figure 7 shows the net long-run fiscal impact of the tax measures announced in each Budget and Pre-Budget Report since Spring 1985. The Spring 1993 Budget delivered a net tax rise of £23 billion a year followed by the November 1993 Budget, which delivered a further £16 billion of tax raising measures. This fiscal consolidation reduced public sector net borrowing as a proportion of GDP from 7.7 per cent in 1993-94 to -0.5 per cent in 1998/99 (see Figure 1).

[31] For 2009/10 onwards the forecast total managed expenditure data given in table B1 of http://www.hm-treasury.gov.uk/d/public_finances_databank.xls, 30 September 2010 has been deflated by the GDP deflator given in table C5 of the Budget forecast.

Figure 7: Net estimated long-run fiscal impact of tax changes by statement since Spring 1985

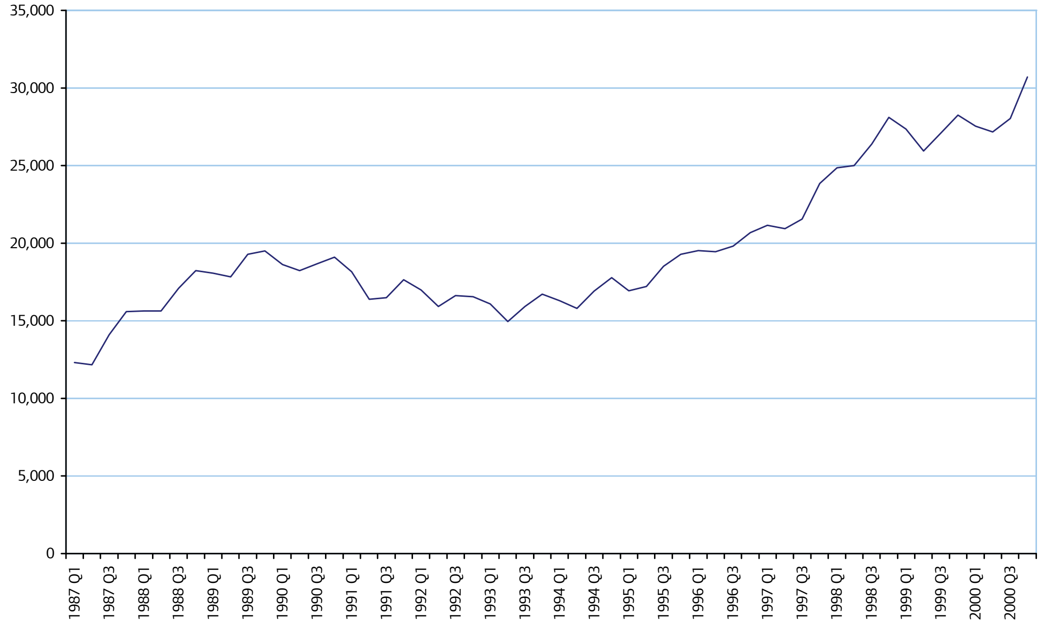


Source: Institute for Fiscal Studies[32]

Although the scale of public spending cuts is likely to be of a size that is unprecedented since those cuts seen following the Second World War, some indication of how the economy might recover can be gleaned from examining the recovery post the 1990s recession and during the fiscal consolidation of the mid 1990s. In that recession the UK economy recorded five successive quarters of negative GDP growth from Q3 1990 until it came out of recession in Q4 1991. Initially, business investment continued to decline slightly reaching a low point in Q2 1993. Business investment then bounced back rapidly during a period of government fiscal tightening, rising more than two thirds between 1993 and 1998 (see Figure 8). During the mid 1990s business investment provided essential support for the UK economy during a period of fiscal consolidation. This support will also potentially be available for the economy following the recent recession and during the period of fiscal consolidation that the economy now faces. This gives grounds for some optimism that the economic effect of the looming spending cuts can be offset to some degree at least by higher business investment.

[32] Chote, R. & Emmerson, C., 'Taxes and elections: are they by any chance related?', The Institute for Fiscal Studies, March 2010.

Figure 8: Total business investment (chain measure (2006 basis), £ million) (1987 Q1-2000 Q4)



Source: ONS

Another indication of the business aided nature of the 1990s recovery is shown in Figure 9, which shows business start-ups as measured by VAT registrations in both London and the UK in the recovery period following the early 1990s recession. As can be observed these picked up quite markedly in both London and the UK providing additional evidence for a potential business led recovery during the forthcoming fiscal retrenchment.

Figure 9: Business start-ups [(by VAT registrations for the UK and London (1994-2001)), index 1994 = 100]

Source: BIS[33]

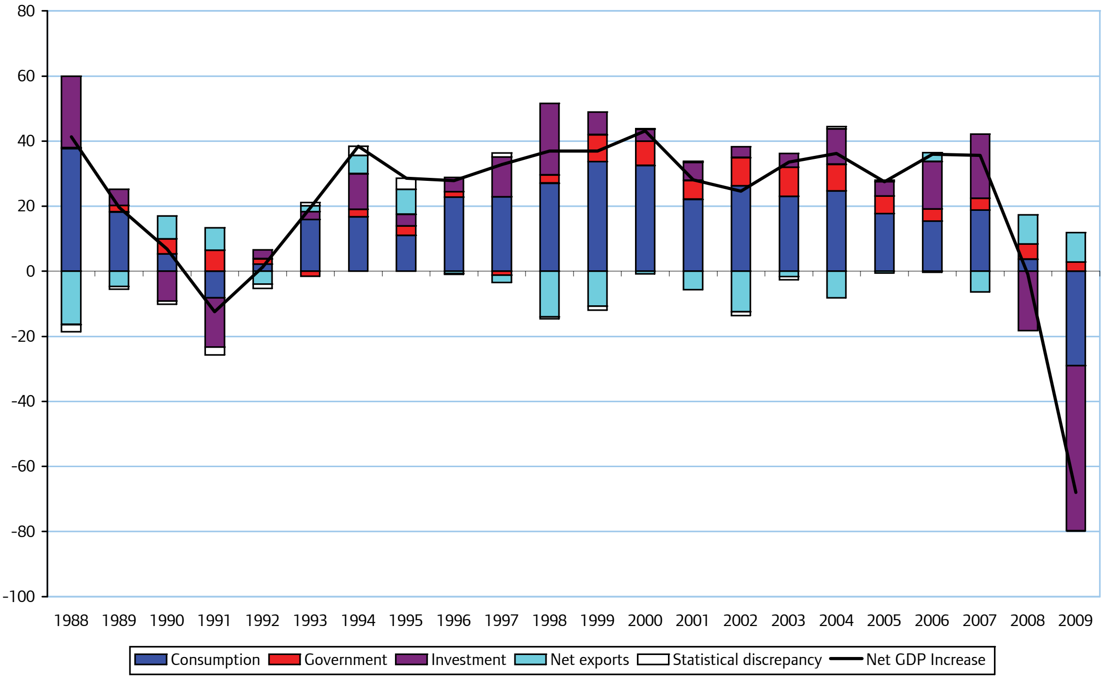
[33] http://stats.bis.gov.uk/ed/vat/VATStatsTables1a1e2007.xls

This recovery can be driven by the private sector like the one in the mid-1990s

Taken together an examination of the contributions to increases in GDP (see Figure 10) shows that the initial recovery phase from the 1990s recession was driven by investment, net exports and consumption. This occurred during a period of fiscal consolidation that enabled monetary policy to be loose and the exchange rate to be weak. It was only from around 1999 that government spending became an important contributor to increases in GDP.

Net exports of goods and services picked up after 1992 for a couple of years on the back of the large depreciation of sterling following its exit from the ERM. This recovery in net exports provided additional support to the economy as the public finances were retrenched. A similar large depreciation of sterling occurred in 2008 and the pound has remained competitive since. Tight fiscal policy accompanied by the loose monetary policy that it enables should keep downward pressure on sterling providing some support to the economy from net exports over the next few years.

Figure 10: Net real GDP increase and the contribution of the components of GDP to its change (2006 prices, £bn)



Source: ONS, Table A2 United Kingdom Economic Accounts Q2 2010

The current recovery still has a long way to go. However, statistics from the ONS indicate that although annual growth in government spending provided some support to the economy at the beginning of 2010 (see Table 3) the private sector is also recovering. Business investment picked up in the first two quarters of 2010 from its low in Q4 2009. Other sectors of the economy that are heavily private sector based have also begun to recover such as business services and finance, manufacturing, and distribution, hotels and catering. Thus it should be remembered that although government spending cuts are likely to dampen the speed of the economic recovery for a couple of years other sectors exist that will drive the recovery. In the longer term a rebalancing of the economy towards the private sector and business investment will provide a more sustainable growth and productive path for the economy.

Table 3: UK domestic expenditure growth

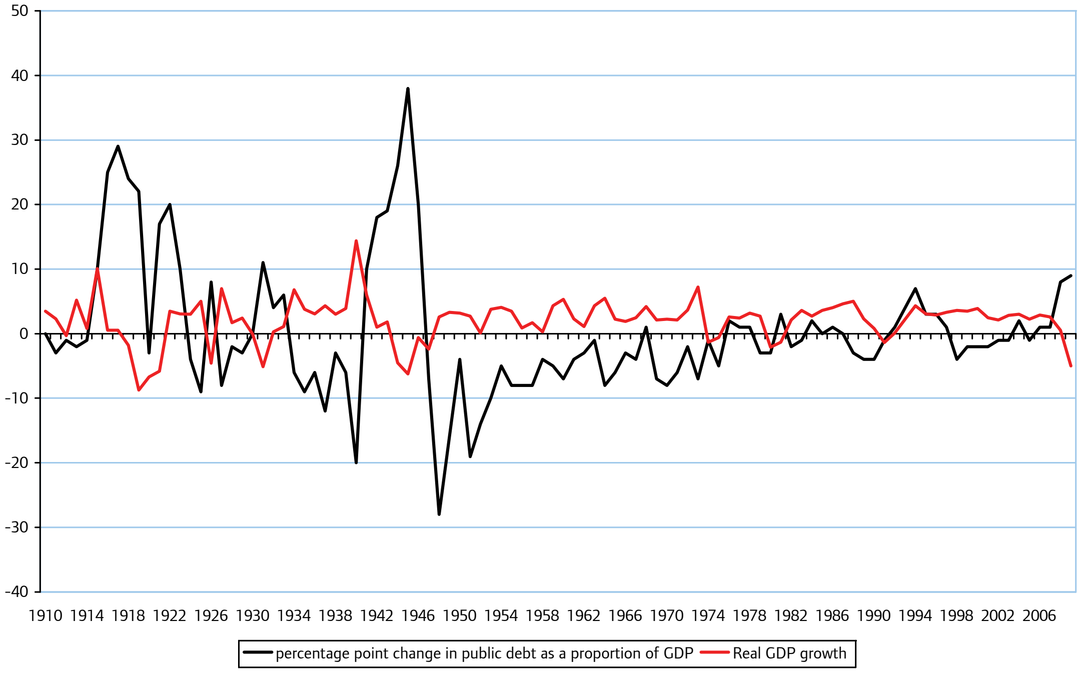
Annual % change

	2009				2010	
Expenditure	**Q1**	**Q2**	**Q2**	**Q4**	**Q1**	**Q2**
Households	-4.2%	-4.1%	-3.7%	-1.4%	0.0%	1.4%
Non-profit institutions	-3.0%	-2.8%	-1.6%	0.4%	-2.7%	-1.0%
General government	2.7%	1.1%	0.4%	-0.3%	1.0%	1.9%
Gross fixed capital formation	-13.8%	-18.7%	-13.9%	-14.0%	-3.4%	3.7%

Source: Office for National Statistics (as of end-September 2010)

Furthermore, reducing government debt as a proportion of GDP does not mean that national output will decline. Figure 11 shows that although government debt was falling as a proportion of GDP throughout most of the post Second World War period until the mid 1970s real GDP continued to expand. There is no reason why later in this decade the UK cannot experience both a reduction in national debt as a proportion of GDP and a growing economy.

Figure 11: Real GDP growth and annual change in public debt as a proportion of GDP (real GDP, annual % change; annual change in public debt as a proportion of GDP, percentage point change between years)



Source: Chick and Pettifor, The Economic Consequences of Mr Osborne – Fiscal Consolidation: Lessons from a Century of Macro Economics, table in Annex 1, pp18-21[34] *and GLA Economics calculations using this table*

[34] Chick, V. & Pettifor, A., "The Economic Consequences of Mr Osborne – Fiscal Consolidation: Lessons from a Century of Macro Economics', 6 June 2010.

Conclusion

A period of fiscal consolidation will not be easy. However, it will enable a rebalancing of the UK economy and encourage a private sector led recovery in which higher business investment will play its part. The IMF completed its 2010 UK Article IV consultation mission in September and believes that the benefits from the Government's fiscal consolidation plans outweigh any adverse effects on near-term growth[35]. The IMF stated that "market reaction to the adjustment plan has been positive" and that "the Government's strong and credible multi-year fiscal deficit reduction plan is essential to ensure debt sustainability. The plan greatly reduces the risk of a costly loss of confidence in public finances and supports a balanced recovery. Fiscal tightening will dampen short-term growth but not stop it as other sectors of the economy emerge as drivers of recovery, supported by continued monetary stimulus". The IMF expects the economy to recover at a moderate pace with companies beginning to increase investment as the demand outlook strengthens.

[35] The IMF, 'United Kingdom—2010 Article IV Consultation Concluding Statement of the Mission', 27 September 2010.

GLAECONOMICS

Greater London Authority
City Hall
The Queen's Walk
London SE1 2AA

Tel: 020 7983 4922
Fax: 020 7983 4674
Minicom: 020 7983 4458
Email: glaeconomics@london.gov.uk

www.london.gov.uk/mayor/economic_unit

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