The Telegraph

George Osborne delays the fiscal pain but it will still be ferocious

The Chancellor is right to stop us living so far beyond our means, but he has yet to grapple with the chronic pathologies of the British economy

George Osborne's austerity bark has always been worse than his bite, and a good thing, too Photo: Reuters

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47 Comments

George Osborne has wisely pulled back from a fiscal cliff and a welfare crisis next year but the austerity measures planned until the end of the decade will nevertheless be draconian.

Citigroup and RBS both estimate that net retrenchment will be 3.5pc of GDP over the coming three years, roughly what we have already endured since the**Lehman crisis**. Much of it is from higher taxes – normally the reflex of Labour or the French socialists.

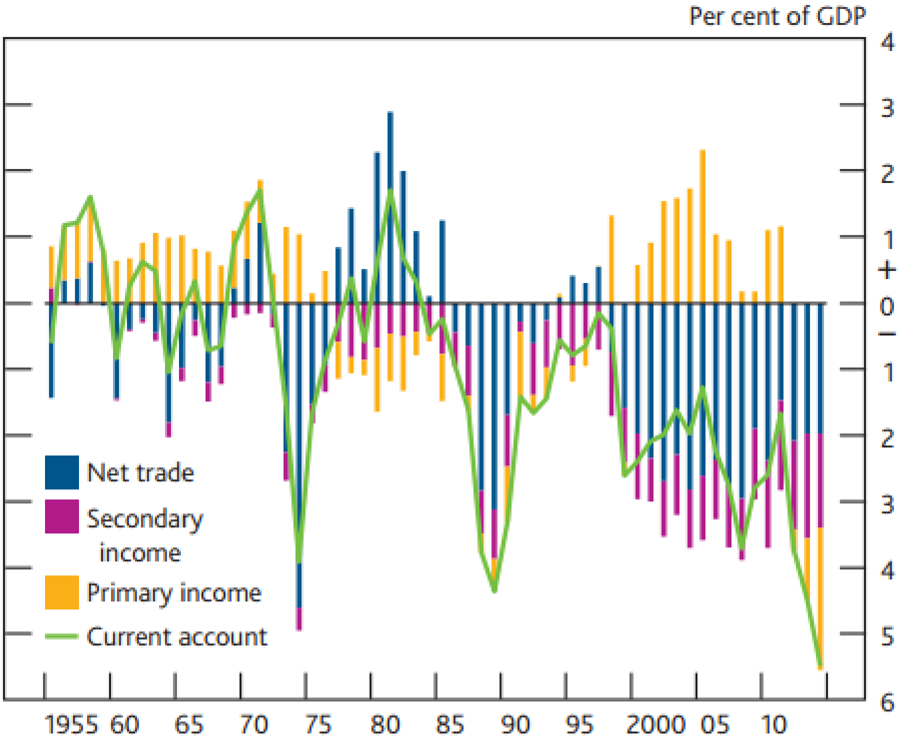
This is in stark contrast to the eurozone, where policy is finally on a neutral setting after the bloodbath of 2011-2013. The US is even going into a period of net fiscal stimulus as state and local governments launch a blitz of spending.

Unfortunately, Britain needs its bitter medicine. Cyclically-adjusted net borrowing is 3.4pc of GDP this year, the highest in the Western world. This is courting fate at such a late stage of the economic cycle, leaving no safety margin against an external shock or a global recession.

The current account deficit is the worst in the OECD club at 5.1pc of GDP. The country is systematically borrowing from global investors to fund a lifestyle beyond its means. The **Bank of England warned in its Stability Report** that the deficit leaves the UK vulnerable to a sudden cut-off at any time, if the mood changes.

Chart A.17 The UK current account deficit has widened in recent years

Decomposition of the UK current account[(a)]



Sources: ONS and Bank calculations.

“We’re selling off assets to finance excessive spending,” said Philip Rush from Nomura. “Foreigners may be comfortable to do this now but what happens if the economy rolls over or there is a vote for Brexit?”

Plundering the family silver has led to a slow deterioration of Britain’s "net international investment position", now -25pc of GDP and ever closer to the danger line of 30pc flagged by the International Monetary Fund.

Fiscal contraction is one way to deal with this, so long as the axe falls on over-consumption, and not on the pockets of spending that boost productivity.

Osborne’s latest retreat on welfare ensures that it will not go beyond the correct therapeutic dose and bring the economy to a screeching halt. The lesson from Europe’s double-dip recession is that fiscal overkill is counter-productive, since the contraction of nominal GDP causes the debt ratio to rise even faster.

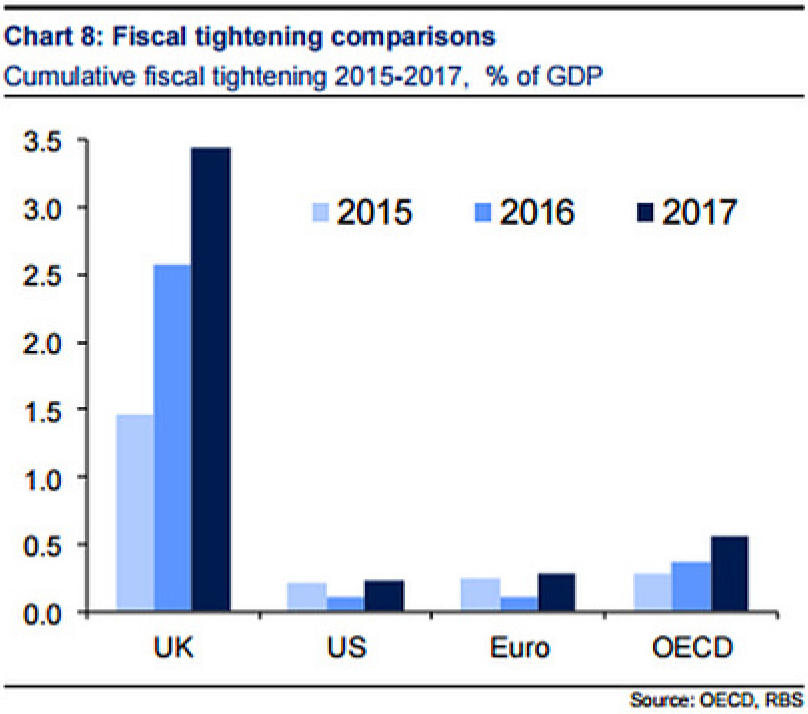
One can only smile at Osborne’s mellifluous suggestion that he can ditch two-thirds of the spending cuts penciled in a recently as March, yet still achieve a budget surplus of £10.1bn by 2019-2020. Nomura says the shortfall is covered by statistical jiggery-pokery. A policy tweak by the Bank of England will alone furnish the Chancellor with £7bn a year by the end of this parliamentary term.

The Bank will retain its stock of assets until inflation reaches 2pc – instead of 1pc as planned earlier – and this is not expected until 2021. It will continue recycling its coupon payments to the Treasury.

Further magic comes from putative VAT receipts. They will now be £3bn a year higher by end of the cycle.

More money has been conjured from low Gilt yields as far as the eye can see, a hostage to fortune at a time when elite global funds are switching out of sovereign bonds precisely because they fear that yields will jump as the US Federal Reserve tightens in earnest.

Osborne’s austerity bark has always been worse than his bite, and a good thing, too. He has ended up pursuing a well-measured policy of fiscal belt-tightening almost by stealth, as befits a fundamentally "liberal" Chancellor known to extol President Lyndon Johnson and the US Great Society.



Whether the world will give him three or four more years of prosperous calm to repair Britain's defences is an open question, one that divides the brightest minds in the hedge fund industry.

The tentative signs are that the worst of the emerging market recession earlier this year is already over, clearing the air for another late-cycle burst of growth, much like the episode from 1998 to 2000 after the Asian financial crisis.

The eurozone is recovering. Fiscal spending in China has surged by 36pc from a year ago and this will paper over a lot of cracks. The commodity crash is worth $1.5 trillion of net stimulus for global consumers.

What Osborne has failed to do yet again in this **Autumn Statement** is to grasp the nettle of reform and start to sort out the chronic pathologies of the British economy. That means a shift in the entire tax and regulatory system to reward output, to curb our proclivity to import and to raise the rate of savings and investment.

It means a radical assault on Britain's dire productivity levels, our lack of skills and our bad infrastructure, even if this means that the deficit comes down more slowly in the short run. We know the problems. They are listed in the World Economic Forum's **index of competitiveness**.

The UK ranks 126 for savings, 63 for maths and science in schools, 62 for days to start a business, 57 for procedures, 44 for government procurement of hi-tech products, 42 for business costs of crime, 33 for work incentives, 30 for quality of roads and so on.

What we have is a typical British story: manufacturing stagnation and dismal exports, with economic growth once again reliant on a deeply unhealthy property market. Household debt ratios are about to take off again. We all know how this will end

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Osborne's housing pledges

£2 billion
The Chancellor is doubling the housing budget to £2 billion to fund the building of more houses

400,000 homes
The number of new homes pledged by 2020

5 housing associations
The right-to-buy scheme will be extended to housing association tenants beginning, from midnight, with a new pilot in five housing associations

3%
Increase in stamp duty for buy-to-let properties and second homes, from next year, which the Chancellor said would raise almost £1 billion by 2020