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"How Can Government Get The UK Economy To Grow?"

The Rt Hon. Dr John Redwood, PC

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John Redwood explained why he thinks the policies that the UK Coalition are using to achieve economic growth aren't working, despite being based on a formula of fiscal cuts and monetary easing that has proved effective in the past. Redwood believes that the current debate between the Coalition and Opposition over Keynesian stimulus is inconsequential to bringing about growth compared to the issue of how to fix the banks.

In 1976, 1981 and 1993 UK governments took action to cut public spending plans as part of a policy geared to get the UK out of recession and financial crisis, and in each case the restrictive fiscal action was complemented by monetary easing. In order to stimulate economic growth the Coalition is today taking similar action in order to curb the public sector deficit and expand the private sector to "rebalance" the economy, which they believe is necessary to achieve economic growth.

Just as there is controversy over these policies today, the public and experts have opposed cuts in the past too. Most notably, in 1981 the Conservative party ignored the advice of 364 economists who wrote an open letter in opposition of their actions. Redwood pointed out that in each previous case the UK economy did proceed to recover (see his presentation for figures). This time round, however, it's not working - growth rate remains below 1% four years after the financial crisis in 2008.

Redwood highlighted that among the 3 main political parties in the UK there is actually a great deal of consensus about how to deal with the economic crisis. They agree that the deficit needs to be reduced to "rebalance" the economy, that monetary stimulus is necessary and helpful, and that national infrastructure plans should be accelerated.

There remains significant debate about the speed at which the deficit is reduced and the possibility of a Keynesian stimulus. The Opposition's view is that there is more scope to spend than the Coalition government believes and that borrowing more in the short term would boost demand and lead to lower levels of borrowing as growth accelerates, whilst the government argues that you can't get out of a debt crisis by borrowing more.
Their reasoning is that money can be more effectively spent by the lenders than the government, and that if borrowing worries markets, then it could put up interest rates leading to reduced economic activity. Redwood gave some empirical examples (see slides for details) in support of the government, showing that there is no correlation between the size of the deficit and growth - or at least no positive one.

Nevertheless, Redwood claims that this debate is marginal and distracts from the fundamental problem - the state of the banks. He believes that the key reason policy isn't having the desired effect is that in 2008 the excessive build up of credit in the banking system was corrected too violently by the authorities, threatening the banking system as a whole and ushering a period of banking retrenchment which has not yet been properly addressed.

If the banks are not in working order, then they can't play out their part in the government's plans by lending money to the private sector, which the government is relying on to kick start the economy. At the same time, and contributing further to this problem, the authorities have required banks to keep more cash and capital, and to take action to tidy up their balance sheets, which have been stressed by lending too much money to weak projects or against overvalued security in the good years. This has restricted the banks' ability to lend on the extra money created by the Bank of England.

The breakdown of the transmission mechanism - from banks to the real economy - is apparent to Redwood from the minimal impact the staggering and unprecedented £375 billion Quantitative Easing programme that the Bank of England carried out had on the UK economy. Redwood believes that the fact that this hasn't led to severe inflation suggests something very wrong. Aware that Quantitative Easing isn't solving the private sector problem the government has now instituted the £80bn funding for lending scheme, and £50bn plus National Infrastructure plan.

Redwood dismissed the idea that raising taxes on the richest might help to reduce the deficit, pointing out that tax revenues from them are only falling with rate increases and that, pragmatically, if all you care about is higher taxes from the rich, then you should lower rates because then they are more likely to pay up. He is unconvinced, too, that the answer lies in a series of supply side measures designed to make it easier for companies to do business and expand - as their problem is more a finance issue than a planning one.

A more effective growth strategy would, in Redwood's mind, include tougher action to sort out the broken banks. This could involve segregating the good and bad assets in banks to create confidence pools, and splitting the large state owned banks to create new competing commercial banks as quickly as possible. Redwood is adamant that the well used model of fiscal cuts and monetary policy can work to achieve growth, but that it needs to be allied with genuine monetary easing which is now broken.

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