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UK austerity is no model for the world

By Lawrence Summers

New York is more dependent on financial services yet its GDP is above its previous peak

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The British economy is the standout member of the Group of Seven rich nations. Over the last quarter the UK had economic growth at an annual rate of more than 3 per cent. In the same period the US barely grew, continental Europe remained in the doldrums and Japan struggled to maintain momentum. No surprise then that many have seized on Britain's strong performance as vindication of the austerity strategy pursued by the UK government since 2010, and as evidence to refute the idea of secular stagnation – that lack of demand is a constraint on growth.

Interpreting the UK experience correctly is important. As well as the domestic political stakes and the question of the country's future economic policy, Britain is of much wider importance as it bears on economic policy debates around the world. Unfortunately for those who feel vindicated given the strategy that has been pursued, properly interpreted the British experience refutes austerity advocates and confirms JM Keynes' warning about the dangers of indiscriminate budget cutting in the middle of a downturn.

Start with the current situation. While recent growth has been rapid, this is only because of the depth of the hole Britain dug for itself. Whereas in the US gross domestic product is well above its pre-crisis peak, in the UK it remains below previous highs and further short of levels predicted when austerity policies were first implemented. Not surprisingly given this dismal record, the debt-to-GDP ratio is now almost 10 percentage points higher than was forecast, and the date when budget balance will be achieved has been pushed back by years.

The most common excuse offered for such poor performance is an over dependence on financial services. Yet GDP in the New York metropolitan area, which is even more dependent on financial services than Britain, has comfortably outstripped its previous peak. While the euro area has performed poorly, trade statistics confirm that this cannot account for most of Britain's poor growth as export declines account for only a small part of the deterioration.

The US economy grew at an annual rate of 9 per cent for a number of years after the trough of the Depression in 1933. Such rapid growth in peacetime is unheard of in the US experience. Why did it happen? Only because of the depth of the Depression. No one has ever taken the pace of the US recovery from the Depression as evidence for the austerity policies that helped to induce it. Likewise, part of the story of British growth is simply one of catching up after a major crisis. Historically, deeper recessions are followed by stronger recoveries. Again New York's metropolitan area offers a powerful example: after falling relative to the rest of the US in 2008, it had more rapid growth thereafter.

Two additional points about the UK's growth experience require emphasis. First, the acceleration in growth has less to do with austerity spurring expansion than it does to a slowdown in the pace at which policy became more austere. Whether one looks at the deficit itself, or the various structural deficit measures prepared by national and international organisations, the pace of fiscal contraction has slowed over the past two years.This means that the brake on growth caused by fiscal policy is becoming more attenuated. So the turnround in growth over the past 18 months is as much evidence against austerity as it is pro-austerity.

Second, faced with the potential damage caused by the deficit reduction to demand and economic growth, the UK government has been forced to introduce a number of extraordinary measures to support lending. Most significant is the so-called Help to Buy programme to support property purchases. There are also programmes to reward banks for lending to small businesses and to get the central bank involved in export finance.

Especially in the case of Help to Buy, which manages to recapitulate most of the sins of the US government-sponsored enterprises, these programmes are highly problematic. The stated goal of the austerity drive was to improve confidence in Britain's standing as a sovereign borrower. Yet there is the basic fact that guaranteeing mortgages en masse is creating a huge potential government liability, as do other loan guarantee programmes.

Moreover, subsidised credit for housing risks reigniting bubbles as house prices in London have risen much faster than GDP over the past year. And, of course, all programmes for the benefit of homeowners rather than renters have perverse distributional consequences.

Britain's growth thus reflects a combination of the depth of the hole it found itself in, the moderation in the trend towards ever-deeper austerity and the effects of possibly bubble-inducing government loans. It may be better for the citizens of Britain than any alternative. It certainly should not, however, be seen as any kind of inspiration to other companies or countries.

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