The impact of the Comprehensive Spending Review

Economists disagree on the likely impact of the proposed changes in the pattern of government spending. The media keep talking of cuts whereas in fact government spending over the next four years in total will rise by 5%. However if the economy grows faster in nominal terms than 5% a year, the share of government in GDP should fall from the current 47% to a level of 40% over the next few years. It is worth recording that in 1997 the share of government was 36.6% of GDP.

I am one of those economists who believe there is no alternative to the current policy. The reason I have this view is that for the government to keep spending at the rate that was established in 2007, the cost of raising that money would be one and a half percent higher than today. This means that long-run interest rates instead of being just under 3%, as they are now, would be 4.5% and in my view rising.

The government has to cut its deficit because of the impact that a 4.5% long run interest rate would have on the mortgage holders in this country. We know from the FSA that 48% of UK households with a mortgage have no money left after interest payments and normal living expenses. We are talking here around 6 million households. The current spending plans as announced will reduce the effective spending power of these households by around £500 a year over the next four years. A 1.5% increase in the mortgage rate would reduce their spending power by around £900 a year over the next four years. The average debt per household including mortgages is £58k. It is clear to me that the governments plan is preferable to the alternative.

Government has no money of its own. The only money it has is that which it taxes from its people. The current administration realise that the limits of taxation both direct and indirect have been reached. They also know that in a slow or no growth economy tax receipts do not increase. That is why the reduction in borrowing is primarily being achieved by reductions in planned expenditure.

The money that government taxes and spends is actually produced by entrepreneurs running businesses. But the original source of this money is bank lending. This is where I am most concerned. If we look back at the last recession from 1992 onwards bank lending grew at an annual average rate of 5% in the first five years and then subsequently at 8% and then from 2003 onwards at 10%. Since August last year each month the rate of increase in bank lending has slowed until in September of this year it actually fell by 1.6%.

This money supply data tells me that there will be a recession next year. It will not be caused by the current government's spending plans. Instead it will because of a lack of growth in money both in the UK, the United States and Western Europe throughout this year. (There is a lag of about 9 months between changes in lending and changes in nominal GDP).

Is there anything that can be done to increase the money supply? Well there is quantitative easing. This is when the central bank creates money and with this new money it buys existing government securities. The new money flows into the banking system's balance sheets and then it is hoped that they parcel this new money up and lend it to SMEs and also for new mortgages. In fact although quantitative easing has allowed long-run interest rates to fall below 3%; most of the new money created has either flowed back to government through the issue of new debt or flowed overseas, as the investment arms of the banks take positions in high yielding currencies. In particular the Brazilian Real is being subject to substantial speculative purchases. Indeed the Brazilian government have announced a 6% tax on the purchases of Brazilian assets by overseas agents.

The reality is that we in the West will most likely experience a mild recession next year (real GDP minus 1%), and then very low rates of growth (under 2%) until around 2015. By then the Western Banks should have much stronger balance sheets, (that is unless Greece defaults) and lending should be growing strongly.