Why we're doomed - or why the cuts can't work

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A perceptive blogger recently asked the question 'To Whom Do We Owe This Money, Exactly?' It was right to do so. It comes to the core of all questions about the deficit.

To whom do we owe this money? Why have the lent it? Can it carry on? If so, how?

The answers are not straightforward. Macro economics is not.

One answer about to whom do we owe the money is, of course, ourselves. Quantitative easing was an exercise in the Bank of England lending money to banks who lent it to the Treasury, all via the gilts market as the EU bans direct lending of this sort. It's just a shame, as I have noted here, that we added in the rather expensive and unjustly enriched as a result middleman. We need Green quantitative easing instead.

More importantly though, as Martin Wolf in the FT noted last June:

In 2010, according to the International Monetary Fund's latest forecasts, the private sectors of every large high-income country will run a huge excess of income over spending. This is forecast at 7.8 per cent of gross domestic product for these countries as a group, at 12.6 per cent for Japan, at 9.7 per cent for the UK, at 7.7 per cent for the US and at 6.8 per cent for the eurozone.

What we are seeing, in short, is an epidemic of private sector frugality — just as many economic doctors recommended. Yet such thrift entails either current account surpluses or fiscal deficits.

To put it simply: the private sector is saving, and in large amount. What part of the private sector? Well, two parts are doing this. One part is homeowners who are paying down debt on their mortgages, which has the same effect as saving. After all, reducing borrowing is in net terms saving. Secondly, and as importantly, the world's major corporations are increasingly sitting on enormous piles of cash that they will not use to a) pay tax b) pay to shareholders c) invest productively. The greatest brains of free enterprise are clueless what to do with their monkey right now.

At this point I need to introduce the work of Wynne Godley, as Martin Wolf does, and as Malcolm Sawyer does here.

Godley would have argued that cuts cannot have any impact on the deficit at this moment because the national income accounting identity of a budget deficit is:

Budget deficit = Private Savings minus Private Investment plus Current Account Deficit

In other words the deficit is only within the control of the government to the extent it can manipulate private savings, private investment and the trade current account. The government can seek to cut - but doing so will not matter to the deficit per se unless behaviour elsewhere is changed as a result. Cutting by itself will have no impact on the deficit. It can't because it's not an isolated action: the deficit is a residual of other behaviour.

The trade current account, we can safely assume, is not going to get much better, if at all, over the next five years. We are in deficit and will remain that way. Export led growth is not going to happen when most of our trade partners are themselves in deep crisis.

In that case we are down to private savings and investment to solve the budget deficit issue. It's important to note here that savings and investment are entirely different beasts. Savings are cash put aside. Investment is the act of creating new productive capacity in the economy - whether by training, creating infrastructure, or by redesigning products and services. It's also important to realise that these are independent variables. Investment is not dependent upon saving, it is only dependent upon credit. It can be funded from borrowing and banks are not dependent upon having savings (in large degree) to make loans.

Savings are rising right now, as Wolf has noted. And all the evidence is that this trend is increasing, rapidly. That's the message being delivered by lower consumer spending. Saving is up. And rationally so in the face of uncertainty when assessed at an individual level.

Now that could of course be overcome if there was increasing investment. But there isn't - corporations too are cutting back spending. And again rationally so for each of them in the face of declining consumer spending.

As a result the rational acts of savers and investors in increasing saving and reducing investment matched by a continuing current account deficit guarantee that spending cuts won't cut the deficit. They can't. It's what Keynes called the paradox of thrift: the very things needed to boost the economy are denied to it at the time when they're needed i.e. less saving and more investment are needed now and the private sector is not going to deliver either.

Osborne assumed both would be available as a result of cuts. He has acted on the belief that if only the state is cut the private sector will rush in to fill the void, feeling more confident that they and individuals will pay less tax in future and so will rush out to spend and invest now to celebrate their higher net earnings in the bright tomorrow that cuts offer to them by way of increased take home pay / ate tax profits.

As all the evidence suggests, Osborne is wrong. That is not how people are reacting to cuts. They're doing as Keynes predicted and not as Osborne thought likely. Fear of losing your job is a much more powerful sentiment than belief that you should borrow now to spend your increased earnings (which you may or may not enjoy depending on whether your job is cut or not) now.

So we have a situation where current government action cannot resolve the deficit because the cuts programme is increasing savings and reducing investment. And the deficit can continue precisely because individuals who save and corporations who do not invest are lending their cash to the government to fund the deficit - which is why, incidentally, 90% of the Uk deficit (at least) is home funded, giving a lie to Osborne's claim we are so dependent on the international bond markets.

In that case if solving the deficit is the priority - and for many reasons it is - then alternative action is needed. Plan B you might call it. And that would be designed to reduce private savings at present, or increase investment, or both, without impacting on the balance of trade. That's the course for deficit reduction. And when put in this way it is clear that Osborne has got almost everything wrong.

To reduce savings people need to have confidence that they will have a job. So increasing employment has to be the priority. That suggests cuts are exactly the wrong way to go: indeed, because the marginal cost of employing people in state led activity is at present very low since benefits are saved and tax is paid by those working for the state creating short term state programmes (and even long term ones where appropriate to increase investment) is very obviously the right course of action at present, and reduces the deficit because those in work either spooned or at the very least create a mood of optimism that stops others saving, which reduces the deficit. This is the Green new Deal, of course.

And investment has to be stimulated. This is why I have suggested a programme for requiring that payments into pension schemes - currently wasted on speculation which is a savings act, not an investment act, must be compulsorily used to fund investment in new wealth and job creating activity to ensure that the deficit is cut.

Will this impact on foreign exchange markets? Not if it stimulates domestic growth. No, it won't. It might do the exact opposite. And nor will it impact inflation - because these are self funding arrangements.

Those issues can be addressed separately - this blog is long enough.

But the point is that the only economic credibility left is to be found in rejecting a cuts programme, per se and in redirecting money to productive activity. That is Plan B.