SLAM ON THE BRAKES

A slower economic recovery would be better in the long term, argues Rob Wood

Go for broke or slow and steady. Those are a bit like the economic choices facing the UK right now. A slower, less unbalanced recovery is the better option.

At present, economic policy is based on the idea that, once the economy starts moving, the recovery will broaden out and become more sustainable. Stronger growth will mean improving productivity and higher business investment. It is the triumph of hope over experience.

Mark Carney, the governor of the Bank of England, admitted last month that the recovery so far was unbalanced and unsustainable. It has relied heavily on stronger consumption and lower saving. That is eerily like the pre-crisis economic model.

Over the past year and a half, the household saving rate has fallen by about a quarter, as the Bank of England has tried to generate a recovery. Indeed, the central bank recently revealed that the 3.4% growth it is forecasting for this year depends on the saving rate falling further, to 3% by 2015. House prices are booming.

How could this become sustainable? If productivity growth improved enough, rising incomes in the future could pay for spending today. Policy is priming the pump. It is boosting consumption in the hope that animal spirits will return and a full-blown cyclical recovery will kick in.

There is likely to be some truth to the hope. Investment will improve as a result of stronger demand over the next year, for instance. But that cannot fix the structural problems in the UK, or remove the risks from this huge gamble policymakers are undertaking.

Before the crisis, the UK was hardly a high-investment country. Rather, consumption, whether by households or the government, was taking up an increasing share of the economy. Sometimes when the government spends more, it crowds out private spending. That may well have happened to investment. But monetary policy stimulated consumption. The saving rate fell from 8.4% in 1996 to 0.2% in 2008.

Some people disagree that there was a boom before the crisis. Indeed, ex-Bank of England governor Lord King once described the recession as a bust without a boom. But falling saving, a gaping trade deficit and surging credit tell their own story.

Huge stimulus assumes there is plenty of spare capacity in the economy or that it can be kick-started into strong growth. If that is not the case, huge stimulus is unadvisable.

Booming employment, companies reporting rising recruitment difficulties and inflation staying above the Bank of England's 2% inflation target for most of the past five years suggest relatively little spare capacity.

Policy is trying to get credit flowing again, through schemes such as Help to Buy. Really, it is missing the point. Credit, especially freely available household credit, was part of the problem before 2007. The big question the Bank of England needs to answer is whether the route it is following is worth the risk. Is driving down household saving close to zero in the hope that incomes will rise enough in the future the best approach now?

The central bank has set in train a strong cyclical recovery. Now it is time to think about the long term. The UK has low saving, low investment and a huge trade deficit. That will not leave the economy in a good position if the unlikely surge in incomes does not come about. A slower, but less unbalanced, recovery would be better in the long term. Otherwise, all we are doing is returning to the pre-crisis model of borrow and spend.

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