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Is UK's return to austerity warranted?

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UK Chancellor (Finance Minister) Jeremy Hunt.

Jeremy Hunt, Chancellor of the Exchequer (Finance Minister), in his Autumn Statement announced the UK government's budget on Thursday, November 17. Unlike the crisis that arose from the Truss government's 'mini-budget', there were no major disruptions in financial markets this time.

It is clear that the UK government has adopted a policy of fiscal tightening, if not all-out austerity, in spite of the earlier experience in the aftermath of the Global Financial Crisis (GFC) of 2008. In 2011, just as the UK economy was recovering from the GFC with a 4 percent GDP growth rate, the then Chancellor of the Exchequer in the Cameron government, George Osborne, decided that 10 percent of the GDP fiscal deficit was untenable. Arguing that it is necessary to 'fix the roof when the sun is shining', the government decided to bring down the deficit to 2.1 percent within a period of three years through a program of 'austerity', namely, raising taxes and cutting expenditures.

The final word on the success or failure of Osborne's austerity program is still contested: for instance, **Niall Fergusson** argued that even though UK recovery was slow to begin, by 2018, with a revival in confidence, the UK was the second-best performer in GDP growth rates among the advanced nations. On the other hand, **Ann Pettifor** contended that by delaying UK's recovery from the GFC, austerity took a terrible toll on women and poor-income groups, and perhaps more importantly, altered UK's social fabric.

The UK is back at the crossroads. The COVID-19 pandemic and the Ukraine-Russia war has driven the country into stagflation with an expected contraction of GDP and a soaring inflation rate of 11 percent. While the policy responses to stagflation are still an enigma, Hunt has deflected attention from reviving growth and taming inflation to the burgeoning fiscal deficit *per se*, which he referred to as an 'eye-watering black hole' in public finances. Presently, UK's general government deficit stands at 7.2 percent of GDP while gross debt is at almost 102 percent of GDP. The £55 billion black hole amounts to some 2 percent of GDP. In his Autumn Statement he said that the government must give 'the world confidence in our ability to pay our debts', for which he must 'deliver a [fiscal] consolidation of £55 billion'.

However, are fiscal deficit targets and supposed lack of confidence that the UK may not 'pay back' its debts really valid concerns? In recent years, Modern Money Theory (MMT) has questioned myths spurned by mainstream macroeconomic on whether an economically sovereign country like the UK, which issues its own fiat currency that is legal tender, can default on debt denominated in its own currency. Japan is a stark case-in-point: with consistently high fiscal deficits of around 7 percent since the 1990s and a debt to GDP ratio in excess of 250 percent, interest rates have remained close to zero (negative at times) even as it struggles to ward off deflation. Compared to Japan's chronic problems, the situation in the UK is acute, arising mainly from the energy crisis that is presently engulfing Europe. Given the inelastic nature of energy demand, UK's economy may have to contract sharply before inflation can be brought under control.

Procyclical austerity measures are expected to result in living standards (real household disposable income) falling by 7.1% between 2021-22 and 2023-4, wiping out benefits from eight years of growth, and a return to pre-pandemic levels only by 2027-28. At the same time, additional unemployment will increase by more than 500,000, taking the total to 1.7 million by end 2024. To revive growth the UK needs countercyclical expansionary fiscal policy but the government has instead chosen tightening or consolidation. The tax burden is set to rise to 37.1 percent of GDP by 2024 from an average of 33 percent since the GFC of 2008. While allocations on education and health have been increased, these may be too little in real terms to restore UK's deteriorating public services.

Even though the forecasts for the UK economy are more optimistic from 2024 onwards, the moot question is whether self-imposed fiscal deficit targets should be the priority for the government at this juncture. The biggest concern that may have prompted this strategy is accelerating inflation, which is presently unrelenting. However, data from the US shows that the rate of increases in wholesale and consumer price indices may be slowing down. Perhaps the right strategy for the UK at this point would have been to wait and watch a little longer rather than close the black hole in a hurry.

At the same time, some may ask whether the Sunak-government had a choice in the first place. When Andrew Bailey threatened the Truss government that he would go ahead with his bond sales (or quantitative tightening) program in spite of the government's proposed fiscal loosening of £45 billion, bond yields rose sharply, leading to turmoil in financial and foreign exchange markets, ultimately forcing the Truss government to step down.

It seems that the 'meeting of the minds' that Governor of the Bank of England (BoE), Andrew Bailey had spoken of when he met with Hunt in mid-October was really a tacit agreement that the government would lower the fiscal deficit and not force the BoE to raise interest rates further to tame inflation. Hunt kept his word to Bailey, and tacitly to financial markets too, when he announced fiscal tightening measures in the Autumn Statement.

But was this really necessary? Obviously not. When Japanese Prime Minister, Fumio Kishida announced a massive fiscal package of ¥29 trillion earlier this month, there were no tremors in financial markets as the Bank of Japan supported the government's fiscal expansion with bond purchases to keep yields low. UK's financial crisis in October was essentially a credible threat by the BoE to the Truss government to control the fiscal deficit.

If, however, the fiscal tightening measures prompted by the BoE, end up being ineffective in bringing down the fiscal deficit and public debt as a percentage of (contracting) GDP, we may well see the UK returning to full-scale fiscal austerity after the general elections in 2024 that may be more in line with the economic ideology of the Conservative Party.

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