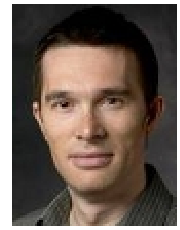
Moody Blues for the Chancellor

2/25/2013



John Van Reenen *examines the economic and political implications of Moody's stripping the UK of its AAA credit rating last Friday. While the move may have little direct economic significance, it is nonetheless totemic, reflecting deeper structural problems in the UK economy. It is also politically damaging for a Chancellor who staked his reputation on preserving the AAA rating. Much now hinges on the decisions made in next month's budget, both for the UK's economic vitality and for George Osborne's own political future.*

The loss of the UK's AAA rating from Moody's has little direct economic significance. In theory it could lead to higher UK borrowing costs as we look less creditworthy. But in practice losing the AAA made no difference to the US or Japan or even, more recently to France. There may be more pressure on Sterling, but this would be a benefit to exports. Given how useless the rating agencies were in the run-up to the crisis, giving top marks to asset backed securities that turned out to be "toxic rubbish", it is no wonder their judgements are not taken too seriously.

But the loss of the rating is like the canary in the mineshaft – it reflects the real problem that the UK economy has shrunk by over 3% since 2008. This is a worse growth performance than the Great Depression with lacklustre growth forecast ahead on current policies. The government cannot duck its responsibility for this awful performance as the speed of austerity has been too swift. There would have been benefits from a more sensible profile were deficits paid back when the economy's recovery was more secure. Even the IMF has recognised that austerity in a recession is counterproductive when interest rates are near zero and other countries are also fiscally contracting. As Jonathan Portes, Director of NIESR has remarked, this is like the Pope telling you to come to terms with your homosexuality.

As the Chancellor never fails to point out the UK's poor performance is also caused by the Eurozone crisis. But what he does not mention is that Euro policy-makers have followed broadly the same austerity agenda as the UK government. Peripheral countries have little choice in this matter if they want to remain in the Eurozone, but even countries with lower deficits and less fragile banking sectors like Germany and the Netherlands have refused to allow stimulus at home "to encourage the others" in their enforced Plan A. When all countries co-ordinate on austerity there is no export market to sell to and hence a continuation of a European-wide recession.

So the short-run solution is for the Chancellor to use the opportunity of the Budget to think again about the profile of deficit reduction, in particular to reverse the cuts to public investment. In the longer-run, more radical policies need to been undertaken to secure an increase in investment in human capital, infrastructure and innovation. Last month, the LSE Growth Commission reported on what such a growth strategy would look like .

The political fallout for the Chancellor from the downgrade may be more acute. In 2010 he sold austerity to the nation so that "we will maintain Britain's AAA credit rating." That turned out badly. But in next month's budget he has the opportunity to turn things around.

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