



Westcott Seminar

Seven lean years - why Western households have moved to parsimony from plenty Understanding the current economic crisis

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We invited Sam Fleming to speak to the House about the current economic crisis on 17 October. This is the text of his talk.

The notion of cycles is deeply engrained in our understanding of the world. Be it the seasons, the harvest, the rise and fall of great powers, or indeed the fluctuations of the economy between growth and recession.

That prophet of popular music and of eccentric eyewear Elton John described this phenomenon in the *Lion King* as the “the circle of life, and the wheel of fortune, which keeps the great and the small on the endless round.”

An earlier rendering came from Joseph, when he interpreted Pharaoh’s dream of seven fat cattle and seven good ears of corn being consumed by a gang of scrawnier cousins. This signaled, he said, that seven years of plenty would be superseded by seven lean years, so it was time to batten down the hatches. Plentiful harvests do not last forever.

The same perception applies in the world of economics. You cannot have perpetual growth; eventually companies and people will rein in their spending, fearful of darker times ahead. Expansion will be followed by contraction.

It may seem odd to think now, as we survey a truly neck-jerking series of twists and turns in the economy, that some policymakers and businesspeople until quite recently believed that it was possible in fact to abolish economic cycles.

The most celebrated example is Gordon Brown with his claim to have stifled boom and bust. But I recall also a businessman I sat next to at a dinner in 2006 who stopped me cold when I mentioned the words “business cycle”. This term was meaningless and outmoded, he declared. A relic of a different age, he argued that we were now engaged on a golden stairway to ever-greater prosperity.

He, and Mr Brown, were fabulously wrong. Sir Mervyn King, the BoE governor, cited the Pharaoh’s dream a speech in July, when he warned that we are only partway through a barren period for the economy. “Failure to tackle the imbalances during the seven years of plenty before 2007 threatens seven

lean years thereafter for at least part of the world economy,” he told an audience of the City’s great and good. That part included Britain.

I’d like in this talk to explain how we came to the current juncture, and what the outlook will be for ordinary people - who may include your parishioners in the coming years. I’m afraid that I agree with Sir Mervyn’s basic message on this; we are in for some lean years ahead. To understand why, you need to look at the boom that preceded this bust.

WHAT HAPPENED BEFORE

Labour was elected to the soundtrack not of Elton John, or Andrew Lloyd Webber, but D-Ream singing ‘Things can only get better’. Peter Mandelson et al probably didn’t expect it at the time, but they were actually proven to be right, and for a surprisingly long time.

Britain saw an extraordinary surge in prosperity from 1997 to 2007, with un-interrupted economic growth and high employment, as Mr Brown repeatedly told the House of Commons. There were three principal reasons for this.

1) One was the property boom.

House prices more than doubled between 1997 and 2007. Instead of education, education, education, the mantra of the age became location, location, location. The value of the mortgages held by UK citizens in 1997, when Tony Blair entered Downing Street, was 421 billion pounds. Ten years later it was nearly 1.2 trillion pounds.

That was partly down to the view that a shortage of supply of property and well-managed economic policy meant there was no reason why house prices wouldn’t steadily rise in perpetuity. Wrong on that score.

It was also a consequence of a boom in the banking sector, with looser and looser lending conditions imposed on those who wanted to borrow – companies and consumers – and an explosion in the amount of debt banks themselves were willing to take on.

RBS, for instance, had a balance sheet of 2.4 trillion pounds on the eve of its rescue by us the taxpayer – nearly twice the entire annual output of the UK economy.

The upshot of the era of easy money and rising property values was people felt increasingly well-off, and so they were willing to spend more. And spend they did.

2) The second reason was the cost of living did not rise very much in the late 1990s and 2000s – something that has changed dramatically since then, with inflation at 5 per cent.

This was something people like Sir Mervyn liked to take credit for: he argued we had a sensible central bank that had inflation on a tight leash. That was not the real reason, however.

What happened in the 1990s was a massive shift in manufacturing activity to low-cost emerging countries like China, India and elsewhere, as they were integrated into the

global economy. The global pool of available labour doubled in size. These people's wages were a tiny fraction of those here, and the workforce was and is very hard-working.

They churned out huge supplies of very cheap products. That was terrific news for consumers. Our incomes went further.

But there was a price. You need to earn your way as a country. If you want to buy lots of things from overseas, you need to sell things abroad as well. Britain has been running trade deficits uninterrupted since 1998, however. That means we had to borrow more money from abroad. We racked up yet more debts in our drive to consume.

3) The third problem was the government became rather too willing to borrow as well.

It's an uncomfortable fact that after the banking crash of 2008, Britain was running a budget deficit – the gap between taxes and spending – that was briefly worse than that of Greece, effectively a bankrupt nation.

Mr Brown preached prudence, but throughout a major economic boom he still spent more money than the government took in in taxes – with only a brief period of surplus around the turn of the last decade. When the banking crash came and the economy went into recession, the budget deficit ballooned. The government's total debt is £15,000 for every citizen in the country.

WHAT ARE THE CONSEQUENCES?

I turn again to the teachings of Elton John: "All of us are agreed as we join the stampede, you should never take more than you give." No individual can borrow forever. The same goes for countries and governments.

Eventually confidence in the economy broke down – the trigger being a crisis in the banking sector caused by a mortgage boom in the United States. We are now facing a long, hard slog.

We need to export more and import less. Individuals need to start reducing their debts and boosting their savings. The debts, public and private, need to be paid off – on that score George Osborne is right.

The question, really, is how. And how quickly. This is a subject of huge debate: Osborne vs Balls. The same battle is going on around the world.

Some economists fear that rather than trying to pay all this debt off, Western governments will seek to inflate the debts away by printing lots of money. Quantitative Easing.

This approach is currently being pressed by the Americans on the euro area governments, as a way of tackling the woes of Greece, Portugal, Italy and Spain.

What does this mean for the ordinary person in the street? Well, to go back to the Pharaoh's dream, we are in the midst of some very lean years. Fat cattle are off the menu.

- 1) We are seeing low wage growth, because we are in a period of less rapid economic expansion. We may indeed be on the cusp of a second recession, in part because of the damage being done by the euro-crisis. People have debts to pay off. They need to save more. The High Street shopping centres will lose some of their bustle. Our standards of living are suffering.
- 2) At the same time, living standards are rising rapidly in the East, and that could lead to more inflation. It drives up demand for raw materials – China is now the biggest consumer of energy, having overtaken the US. The result is higher costs for everyone – one example is the current controversy over gas and electricity bills. More people around the world are competing for scarce resources. The squeeze on UK wallets is the fiercest for decades.
- 3) The government will as we all know be far more parsimonious for many years to come. Government workers are getting laid off in hundreds of thousands, both in Westminster and across the country, in local authorities. Services are being cut back. Welfare reform will leave many people worse off. The national debt must somehow be brought back down to earth.
- 4) Alongside that, unemployment is I am afraid likely to rise further. We are already seeing this, with 8.1 per cent joblessness. This is not the end. Explanation.

I'm sorry this has not been particularly uplifting. More Four Horsemen of the Apocalypse than Coat of Many Colours.

But I think it's important to present the reality of things. There is a seminal book by Ken Rogoff and Carmen Reinhart entitled *This Time Is Different*. Their look at hundreds of years of data shows that history is littered with debt booms and busts, which are followed by often long periods of subdued recovery. Greece, for instance has spent half of the period since 1800 in some sort of government debt default. We shouldn't be too surprised to find them facing the same thing again.

In Britain, we were told before the crash of 2007-09 that *This Time Was Different*. It should have been a warning to us all. It wasn't. All the policy intervention – interest rate cuts and big fiscal stimulus packages – can't hold back inevitable retreats in economic output, and setbacks in living standards. We have believed in the ability of the Gordon Browns and Sir Mervyn Kings of the world to prevent bad things from happening to the economy. Even Pharaoh would recognize that as a false dream.

But I can also end on a tentative note of optimism. The reason is in the title. It is the case that, historically, big financial crashes tend to lead to very prolonged subdued periods of growth. We are facing some lean years. But they won't last forever.

Eventually companies will start wanting to invest again. So will individuals. And recoveries, when they come, often arrive when we aren't expecting them. We would be immensely helped if the US, still the world's biggest economy, turned a corner. We must hope that the euro-crisis is resolved quickly.

But let's not forget that accompanying this gloomy period in Britain is an historic rise in living standards in many emerging nations, who still live in relative poverty. The UK itself has considerable strengths – including its scientific base, language, universities, and its strong institutions – including dare I say the Church of England. The lean years won't last forever, although I suspect they'll be with us for a while to come.