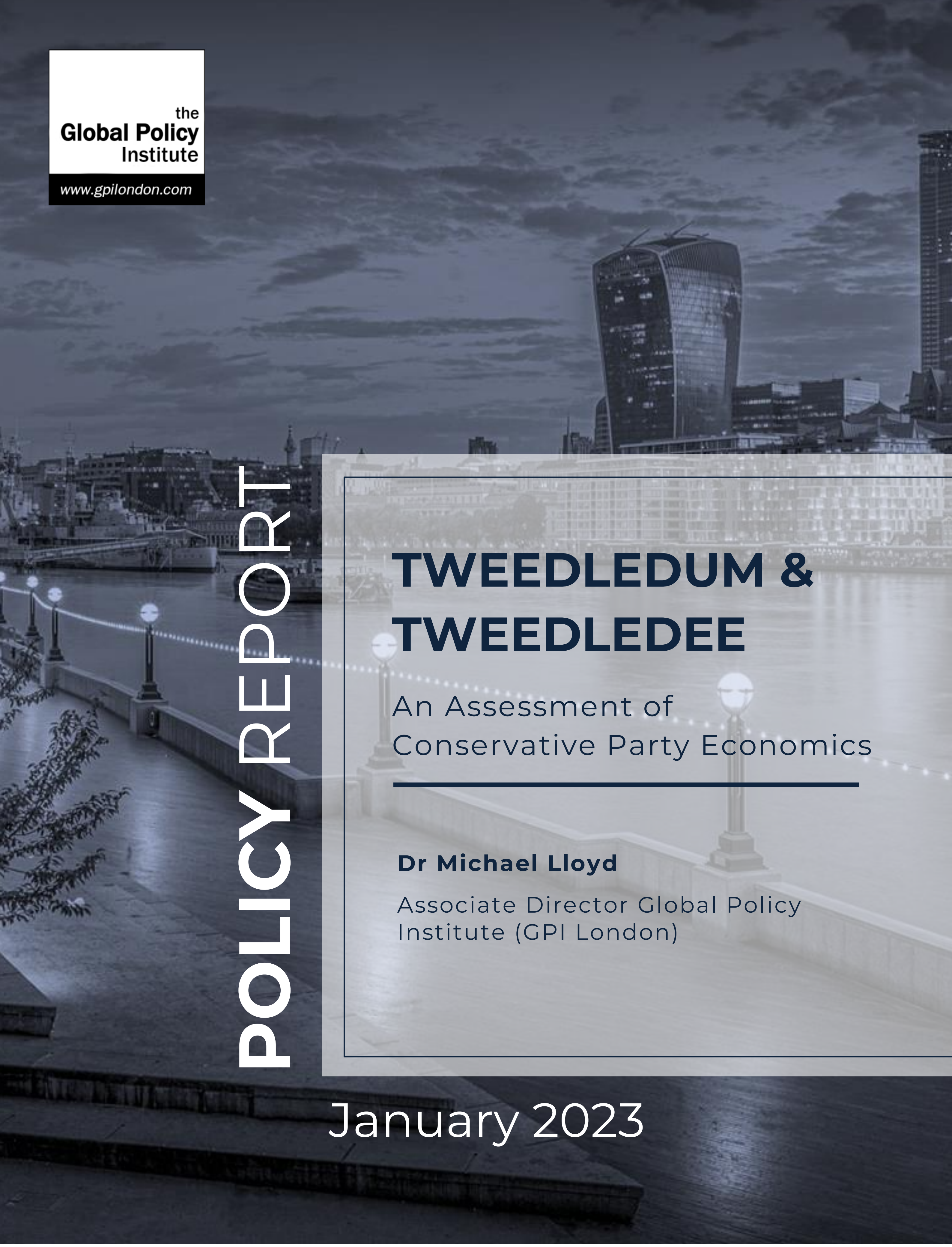

the Global Policy Institute

www.gpilondon.com

POLICY REPORT

TWEEDLEDUM & TWEEDLEDEE

An Assessment of Conservative Party Economics

Dr Michael Lloyd

Associate Director Global Policy Institute (GPI London)

January 2023

Policy Analysis *for a* **Changing World**

About the Global Policy Institute

The Global Policy Institute is a London-based think tank on international affairs. It was originally founded in August 2006 as a research institute at London Metropolitan University to analyse the issues of globalisation and to formulate innovative policy solutions. It is now an independent Institute based in the City of London, and draws on a rich pool of international thinkers, academics as well as policy and business professionals. The Institute gives non-partisan guidance to policymakers and decision takers in business, government, and NGOs.

Global Policy Institute (GPI)

109-117 Middlesex Street,
London E1 7JF,
United Kingdom
Tel: +44 (0)20 8065 0324
Email: office@gpilondon.com
www.gpilondon.com

Legal Name: Global Policy London Ltd.
Charity No (England & Wales): 1012013
Company No (England & Wales): 02171962

TWEEDLEDUM & TWEEDLEDEE

An Assessment of Conservative Party Economics

Policy Report | January 2023

Dr Michael Lloyd

Associate Director, Global Policy Institute (GPI London)

Introduction

In September 2022 a new Conservative government led by Liz Truss embarked on a new path for economic policy, ostensibly challenging "Treasury orthodoxy", leaving aside the fact that they never defined what Treasury orthodoxy was. The initiative did not start well! Chancellor Kwarteng's statement in the UK parliament on Friday, September 23rd led to a run on the pound Sterling. The Bank of England then intervened by buying UK government bonds, with the bond market already experiencing depressed prices, linked to the US Federal Reserve's aggressive increasing of interest rates. The BoE intervention had little to do with supporting sterling (see next section). It was to protect the potential insolvency of some pension funds. A problem that had nothing to do with the Chancellor's statement.

The media, political commentators, and so-called economic and financial experts were guilty of substantial distortion of the content of the Kwarteng's proposals. There was much tendentious discuss of whether the previously suggested £30 billion "headroom" in the public finances had suddenly become a £70 billion "hole". These figures are unreliable different estimates that can be adjusted over short time periods. The media discussion concentrated on the announced tax cuts, rather than the less well-defined measures to increase economic growth. In fact, the major public finance impact was the cost of the Truss promise to cap energy bills for two years. Precipitate and ill-prepared though the Kwarteng announcement on September 24th may have been, it perhaps did not deserve the calumny that was heaped upon it.

The purpose of this paper is first to examine how far the Truss administration was really challenging UK neoliberal, austerity economic orthodoxy; second to suggest that the Sunak/Hunt government's return formally to this orthodoxy, and to the "balanced budgeting" approach that will impose short and medium-term social hardship and further economic damage, and third to suggest that a more radical and effective transformation of the UK's economic fortunes, taking account also of global factors, is certainly required.

The Truss/Kwarteng "Revolution" in More Detail

Given the apparent economic ignorance of commentators it is worth first clarifying the limited problems caused by the Truss government's initial mishandling of the communication on September 24th, and the subsequent distorted attribution of ensuing problems. The Truss/Kwarteng headline proposals caused some immediate disturbance in financial markets, with separate impacts on the currency market and on the bond market. Politically it was inept. However, the remedial action taken by the Bank of England (BoE) was to protect a large number of pension companies, whose use of highly leveraged LDI had led to severe immediate liquidity problems for some pension funds and providers of defined benefit schemes. On currency markets it should be noted that they operate in an era of floating exchange rates, where the level of exchange rates is not within the current formal writ of central banks.

Interestingly, given the apparent downward pressure on sterling, there was no mention of the effective use of the permanent "C6" exchange-rate swap facility - managed principally by the Federal Reserve as the key central bank of the six central banks involved (including also the ECB, the Bank of Canada, the Bank of Switzerland, the Bank of Japan, and the BoE) - to provide US dollars as required to stabilize exchange rates, in this case the £ sterling. It is likely that similar central bank support was provided to the Japanese Yen which also recently came under pressure. The Japanese central bank as another member of the C6.

Despite the short-term crisis, it should have been possible, with the removal or postponement of some of the more egregious elements of the mini-budget package, for Kwarteng to remain in post. However, Truss panicked and proceeded to pursue a serious of U-turns, including sacking Kwarteng and thus exacerbating the crisis. The reversals were mainly announced by the new Chancellor Jeremy Hunt.

Hunt, in common with the political economic establishment, including commentators like the IFS, did not distinguish between a *sustainable* fiscal position and one dedicated to simply "balancing the books", as if the government is in the same situation as a household (though even households borrow for periods). The Truss apparent challenge to Treasury and BoE economic and monetary orthodoxy lasted less than three weeks.

The Pernicious Influence of the UK Media

The Conservative press initially lavished praise on Truss and Kwarteng and then turned on them This reversal was noted in a Guardian article of October 16th https://www.theguardian.com/media/2022/oct/16/from-best-budget-to-a-dead-parrot-how-tory-press-turned-against-liz-truss.

On September 24th the Daily Mail headline read "At last, a real Tory Budget". On November 13th, the Daily Express headline was "Rishi Revives Thatcherism to the Rescue".

The BBC coverage was especially critical of the economic approach of Truss and Kwarteng and, on the other hand, almost sycophantic in its praise of the balanced budget orthodoxy of Sunak and Hunt.

In all the media coverage - replicated in other news areas - reportage gives way to opinion-forming by specialist journalists. In the case of the print media the opinions are those representing the editorial line, often reflecting the views of the ownership. In the case of the regulated broadcast media, it is the establishment/orthodox views that tend to be reflected. The 24-nour news cycle leads to a substantial amplification of the views, leaving the public with little room for any reflection or counter argumentation. Social media represent a variety of views, though essentially there is an inchoate overall position represented, of varying intellectual quality.

The essential populist, fickleness of the main Conservative-leaning media was exemplified in its reflection of the core beliefs of the "establishment" in their swing from varying levels of support for the Truss/Kwarteng approach to a Damascene conversion to the "rightness" of the Sunak/Hunt reverse approach.

Admittedly, it may be argued that to an extent this above media reaction partly reflected the "conflicted" views of different sections of the parliamentary Conservative party, whose preferences were polarised between Truss and Sunak.

The broad Truss/Kwarteng approach of setting the economic policy objective as sustainable economic growth was not wrong. It was, however, clumsily delivered into an already febrile global monetary environment, especially into bond markets exacerbated by a self-centred, hawkish monetary policy of the US Federal Reserve, ignoring international impacts. For the UK as an open economy running significant balance of trade and budgetary deficits, the launch of an unexplained, abrupt growth policy, based also on a naïve tax-cutting policy - while promising to maintain public expenditure - was almost bound to have disastrous short-term financial market impact.

Squabbling among Neoliberals: The Sunak Counter-revolution

It is important to recognize that the UK political economy since the late 1980s has been increasingly financialized.

In the 1980s, the UK, under Thatcher, adopted a variant of neoliberalism, in the sense of the state's role being aimed at being small in size and protective of the private market sector as the singular efficient allocator of resources. The era of Thatcher's household economics applied to the national economy and balanced budgeting took hold. Meanwhile, the course was set for the further financialization of the economy and a gradual reduction in the share of GDP allocated to real wages.

The Sunak/Hunt version of neo-liberalism reiterates a restricted size for the state, linked to a balanced budget and an aversion to increased net national borrowing, despite the relatively low debt to GDP ratio of 97%. It might also be argued that the timidity in the face of money market pressures indicates a strengthening of the neoliberal belief in the efficacy of markets and resistance to challenging inefficient markets. Unfortunately for the achievement of a, equitable *real* UK economy, despite some financial sectors in Edinburgh and Leeds, this has also meant the

The Truss-Kwarteng version of neo-liberalism "on speed" was too politically libertarian and economically radical than the "one-nation" Tories, and other Conservative party groups, were willing to contemplate. Nonetheless, all the major UK political parties remain supportive, to a greater or lesser degree, of the neoliberal and increased financialization agenda established during the Thatcher era. This is not to deny the value of the financial services sector to the UK economy, simply to point to the structural economic problems created by the financialization/rentier perspective of the financial sector and successive governments.

The BoE takes Charge of Fiscal Policy

What has been striking in the aftermath of the downfall of Kwarteng (and hence Truss) has been the part played, overtly, by the Bank of England (BoE). Perhaps incensed by the apparent attempt of Kwarteng to ignore the Bank was the sight and sound of Bank spokespersons (including previous BoE incumbents) "weighing in" against the Kwarteng mini-budget.

The BoE, initially, had to intervene to deal with a short-term crisis affecting pension funds who were receiving collateral margin calls for cash from their counter-parties when faced with a sudden acceleration of the increase in bond rates, attributable, it was alleged, to the market impact of the mini-budget. In fact, not all pension funds were affected. Those that were hit had badly managed their liquidity-driven investments (LDI) allowing substantial leverage to occur, affecting a large proportion of their assets, without having secured protection from their banks to access extra cash. (N.B. There is some evidence that insurance companies took a more prudent approach in this latter respect). These problems for pension funds have been an accident waiting to happen, with the Pensions Regulator having failed to take appropriate regulatory actions over the past three years, including those relating to risk factors linked to sudden bond market movements. In practice, though pointing to inadequate regulation. The problem appeared to have been rapidly resolved with, initially, only 6% used of the £65 billion notionally committed to the intervention by the BoE. Subsequently, the total intervention, ostensibly to remedy the pension fund over-leveraged LDI problem appears to have been £19 billion.

Discussions between the Governor of the BoE and Hunt as the replacement Chancellor were clearly more cordial than with Kwarteng. The new Chancellor took steps towards a substantial fiscal retrenchment, thus likely to reduce to a more modest proportion the interest rate rise planned by the Bank to offset the previously announced fiscal expansion. This new cordiality reflected a return to monetary orthodoxy and monetary and fiscal policy pointing in the same direction, unfortunately the wrong way as far as economic growth was concerned.

The messaging from the Bank, following the unwarranted November decision to raise rates by 0.75%, to 3%, indicates confusion about the bank's view about the potential trajectory of the inflation target and hence of the likely evolution of interest rates over the next 12 months. Given that their view in August was for a moderate, gentle evolution of rates, and that little had changed materially to affect that view, except for some outlandish wage claims, mainly in the public sector, rather than high settlements, the abrupt 0.75% rise was difficult to justify, except for an exaggerated desire to follow financial market expectations. The December rate increase was limited to 0.50%, though again, given the risks of reducing investment and lowering growth a 0.25% would have been ample. The February rise of 0.5% continues the same policy trend. Given the fiscal consolidation, earlier interest increases by the Bank, and continuing pressure on household budgets - and hence the consequential lowering of aggregate demand - it is not clear that any rise in rates at this time can be justified.

The ostensible motivation for the raising on interest rates at a time of impending serious recession appears to be based principally on the view that the supply shocks that have hit the economy have quasi-permanently damaged the supply potential of the UK economy and require the suppression of aggregate demand to meet the lowered productive capacity of the economy. This appears to be a policy action without strong supportive evidence, especially given the familiar time lags involved.

There is another looming problem, affecting both the Bank and the Treasury and the Debt Management Office (DMO), namely, the problem reported by the OBR in four key paragraphs.

> From its start in March 2009 to March 2022, the APF (Asset Purchase Facility) paid lower interest on its liabilities (Bank Rate paid on reserves) than it received on its assets (coupons paid on gilts), making cash profits and remitting a total of £120 billion to the Treasury, reducing the central government net cash requirement. Bank Rate has now risen above the average interest rate earned on the APF's gilt holdings. This raises debt interest spending net of the APF and, when added to losses that are crystallised as gilts redeem or are sold, will mean cash starts flowing from the Treasury to the APF.[28] Across the forecast, the Treasury pays £133 billion to cover these losses,[29] more than reversing the previous 13 years' gains. The impact on measured debt is somewhat less than this because the losses associated with the redemption of gilts that were purchased at a premium has already been recorded in PSND. Netting off these and other smaller effects, flows related to the APF raise debt by £61 billion (2.1 per cent of GDP) between March 2022 and March 2028.[30]

The severity of the problem is described by the OBR:

> The overall maturity of the debt stock has shortened over time (largely as a result of the quantitative easing operations of the Bank of England that in effect swap long-dated gilts for floating rate reserves). This reduced the median maturity of public sector debt from seven years before quantitative easing began in 2008 to less than two years today. That means nearly half the effect of a rise in interest rates is felt within a year today, rather than only a quarter if the maturity structure of debt in 2000-01 still prevailed. And the combination of the higher debt stock and shorter maturity means that every percentage point increase in short-term interest rates adds £13 billion to spending over the following year, rather than just £2 billion if the stock of debt sensitive to such rates were still at its 2000-01 share of GDP.
>
> The debt stock that is inflation-linked has risen in step – also almost quadrupling from 6 per cent of GDP in 2000-01 to 22 per cent today. This means that every percentage point increase in RPI inflation raises spending by £6 billion, rather than £2 billion if index-linked debt were still at its 2000-01 share of GDP.
>
> A far larger overall debt stock, which has almost quadrupled from 28 per cent of GDP in 2000-01 to 102 per cent in 2022-23. That means a 1 percentage point rise in the effective interest rate paid across all debt

> adds £26 billion to spending, whereas it would add only £7 billion if debt were still at its 2000-01 share of GDP.

In fact, prior to the launching of QE as a means of redressing deflationary pressures, the average maturity of UK public debt was 14 years, that is higher than the 2008 figure provided in the OBR report quoted above. The reduction of the current stock of bonds via quantitative-tightening by the BoE, needs to be accompanied by conversion of short-term bonds to longer-

The Bank has begun the process of selling off its stock of financial assets accumulated over a decade of QE. This should be done over a longer period by not renewing as the term date is reached. The Kwarteng/Truss plan would have required an expansion in gilts sales. A less aggressive gilt disposal by the Bank would have made this possible, without exceeding the capacity of the bond market.

A Genuine Transformation of UK Economic Policy

The Problem

The above sections have indicated the persistence of both neoliberalism, financialization, and the UK political economic fiscal policy position of seeking a balanced budget, as opposed to a sustainable budgetary position in the medium-term. This balanced budget "obsession" is shared by German neoliberals. It is also not challenged by the UK Opposition parties.

Any genuine transformation of economic policy in the UK is required. While not ignoring certain external constraints imposed by the global political economy on the UK as a relatively open economy, these constraints should not be exaggerated.

One problem, raised by many on the political left during the Osborne austerity years, is the decline in the share of real wages as a share of national income compared to the profits share. The fall has been around 10 percentage points over the past 30 years, even after adjustment for measurement problems. Moreover, there has also been increase in the proportion of the profit share taken by financial profits, as opposed to industrial profits, representing the increasing financialization of the UK economy. To varying degrees this trend is seen in the majority of Western economies, especially the UK and the US, starting from the late 1980s when the neoliberal political ascendancy was initiated. The trend towards greater financialization has been accompanied by structural changes in relation to GDP.

In the USA, for instance, manufacturing represented only 11% of GDP in 2020. Services represented 79% of GDP, with around 25% of that figure represented by the financial services, insurance, and real estate sectors (FIRE), 22.3% in 2020.

Gross profits of manufacturing in the US represented 45% of the total and FIRE some 15% in 1980. By 2010 the manufacturing share had fallen to 20% and the FIRE sector share had doubled to 30%. It is also worth pointing out that investment banks and hedge funds also tend to dominate the shareholding and loan funding of large manufacturing companies, owning by some estimates 15% of the equity of the majority of all large US companies, not simply manufacturing. Similar trends may be observed in the UK economy.

The corollary of this substantial and significant structural change in Western economies is a severe distortion in the distribution of income, and specifically wealth across the populations of these countries. Without fundamental reform in many areas, the growth of debt and hence the rentier sector will resume as before, with a mere slowdown for a few years. The economic pain will instead again be borne by taxpayers and wage-earners, rather than those creating fictitious capital.

The Remedy: A Beginning

Achievement of a radical transformation of the above situation will be long and arduous. Short of a revolution, it will take a few decades. In what follows the focus will be on a short-term remedial agenda for the UK to make some progress on the longer-term task.

Some indication of what is required has been provided in the above short analysis of the failed Truss/Kwarteng economic agenda. There is a certain irony in suggesting, from a left-of centre perspective, that what is required is to set as a prime government economic policy objective is 'optimum economic growth rather than nominal fiscal balance'. Put another way, it is to abandon a balanced budget approach in favour of a policy based on a sustainable fiscal balance.

The UK economy requires a far more systemic long-term plan to raise productivity and economic growth in a sustainable and an equitable manner.

All that may be done in this short article is to indicate some of the key elements of such a plan (this is not meant to be an exhaustive list). These are:

- selection of a priority list of five-year physical infrastructure projects which are targeted on both production facilities and connectivity between key urban areas (not necessarily cities} focussed outside Greater London (such as film studios for producing advanced computer games, for instance Teesside is a centre of excellence in gaming technology and design).

- investment in human capital projects in the areas of training, skills education, and health, with priority given to those with pay-offs within five years (such as further education colleges)
- the expansion of the “catapult centre network” providing technology and innovation support to businesses, allied to the re-establishment of nine English regional development agencies with substantial investment budgets.
- setting up a state investment bank (with English regional and Scots, Welsh, and NI branches, specifically targeted on investment in and support for medium-sized and growth-oriented UK businesses.
- separation of the Treasury into an economics ministry and a finance ministry.
- absorbing the Bank of England into the economics ministry to achieve synchronicity between fiscal and monetary policy, and replacing inflation targets with price stability, based on nominal GDP targeting.
- consideration to be given to renationalizing the water, transport, and energy utilities.
- Alignment, clarification / creation of an integrated industrial strategy, trade policy and foreign policy.

Conclusion

Whatever the clear failings of the Truss/Kwarteng approach in September, in challenging Treasury, and implicitly BoE, orthodoxy, the approach was valuable to the extent of pointing to the need to challenge these orthodoxies, often based on inadequate theorizing and structured New-Keynesian economic modelling. Ironically, the short-lived Truss premiership has led to an unfortunate reassertion of the failed balanced budget economic model used in the Osborne era, and to the strengthening of the twin orthodoxies.

Instead of endorsing the inadequate Truss/Kwarteng approach, I have tried to present the key elements of a more sustainable economic growth model from a left-of-centre perspective, taking account also of the mandated climate change objectives. What is required is an increase in real wages, an expansive fiscal policy, and a modified monetary policy that eschews direct inflation-targeting in favour of nominal GDP targeting.

Although people should not fear increased in government borrowing - and reject the notion that there is some arbitrary debt/GDP ratio that should not be exceeded - any prudent economic growth plan should observe two concerns. First, there will be a short-term constraint on fiscal expansion that is imposed by the availability of physical resources, especially human resources, and this will generate inflationary pressures. Second, that there should be a medium-term plan to moderate the expansion of government debt, in a manner that is sustainable, though does not hinder the achievement of the economic growth objectives and hence place excessive pressures on the short-term fiscal position, with tax revenues unable to support strong essential public service provision.

The Truss/Kwarteng episode shows the need to change the expert discourse on what can and what cannot be done. This is also a matter of both public education and understanding as well as institutional and policy change.

GLOBAL POLICY INSTITUTE (GPI)

Policy Analysis *for a* **Changing World**

109-117 Middlesex St,
London E1 7JF,
United Kingdom

Tel: +44 (0)20 8065 0324
Email: office@gpilondon.com
www.gpilondon.com