

Transcript

UK budget and global recovery programmes

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Linda: I'm Linda Yueh. I'm a fellow in economics at St Edmund Hall in the University of Oxford.

Martin: I'm Martin Slater. I'm also a fellow in economics at St Edmund Hall.

Jonathan: And I'm Jonathan Michie. I'm President of Kellogg College.

Linda: Today in this podcast we are going to take a look at the prospects for recovery from this recession.

We'll start by taking an assessment of the British economy on the back of a very notable budget that's been presented for this fiscal year. And then we'll broaden it out and assess what's happening globally to see if economic recovery is on the horizon and touch on some of the assessments made by the International Monetary Fund as well as taking stock of the measures from the G20 summit.

And so I think if I could ask one of you to just start us off with how the British economy is faring and whether or not we really are looking at a recovery.

Jonathan: Yes, the budget was presented as a budget for growth and predictions for growth next year and so on.

So I think it's useful to take a step back and just remind ourselves of the scale of the problems we're in because the large numbers of borrowing, the scale of downturn globally, has almost numbed us into thinking that the current predictions are run of the mill.

What was interesting about the budget is it really was confirmation that this does seem to be the worst recession since the 1930s and linked with the International Monetary Fund report and then we'll come on to later on the global scale. It does seem to be confirmation that this is the worst recession globally since the 1930s.

So I think it's important to make that point fast.

In terms of how long the recession will continue for, whether these green shoots of recovery really will deliver, obviously there are difference of forecasts. The UK Government is forecasting recovery next year but first, it's quite weak and secondly, not all the forecasters agree. And again, we'll come on to IMF's forecast which is that the recession will continue into the next year.

So by way of opening, I'd say that the picture's rather mixed. It is a prediction for recovery and growth next year but firstly, that's from a very low base. The economy across the world and in the UK is going to fall quite steeply this year.

And secondly it's quite uncertain the degree to which there'll be recovery next year.

Martin: Yes. I think there's a big difference between the financial sectors of the economy and the real sectors of the economy and the movement through the crisis for the financial sector is considerably in advance of what's happening to the real economy.

So in the last few months we went through the serious crisis phase for banks and the policy responses have been largely effective in getting us over the most dangerous part of that. And you can see news now emerging of banks patchily but gradually beginning to improve their results.

But the movement through the real economy is at a much earlier stage and unemployment is clearly going to get worse for a good few quarters from now, even if the current stimulus measures begin to take effect from the current time.

Linda: Yes, I think this recovery has to be premised on financial stability. There wasn't much which was said about it by the Chancellor and I suppose generally speaking the markets are looking at the banking system and thinking that there are some signs that the banking system perhaps have stabilised.

I suppose the contrary voice to this is by the International Monetary Fund, who argues that banks around the world, including British banks, have only written down around one third of their actual losses, meaning we're still going to see financial write downs and losses throughout this year.

And I suppose the second reason why recovery might be slightly later than what the British chancellor has projected is because a lot of the banking systems are clearly hinged on the health of the American banking system and the American banking rescue plan so far has had

mixed results. And also the major part of the plan, the P-PIP, the Private-Public Investment Partnership, doesn't even take effect until September. So we are not going to see the end of the cleanup of the banking system until at least the autumn of this year.

But that being said, the downturn in the economy projected for this year for Britain I think probably is about right, given that you're not going to see a finishing off of the banking crisis until later on this year.

So when the Chancellor revised his forecast from around a negative 1% contraction, which is what he said last November in the pre-budget report, down to negative 3.5%, that probably is pretty realistic and does meet generally the consensus forecast on how bad it will be in Britain.

And if that were true, this dwarfs the negative 2% contraction in the early '80s which was considered to be the worst recession for the British economy and, of course, has terrible echoes of the rescue of the British economy in the last '70s by the IMF. And certainly this would mean the worst recession since World War II; the worst recession in peace time.

I think where the Chancellor's forecasts are a little bit more optimistic than others is certainly in his growth forecasts for next year and then thereafter. The Chancellor's predicting an over 1% growth in the economy next year. Most consensus forecasters think it's going to be around half of that. And the IMF again actually predicts recession next year for Britain.

And I suppose even more optimistic perhaps is the Chancellor thinks that by 2011 Britain is going to jump and exceed its trend growth rate, which is 2.75%, and start to grow at a very impressive 3.5%.

So it may well be the economy turns a corner at some point by the end of this year but I suppose the shape of the recovery and how growth in the next couple of years is a much more difficult task to assess.

And I think the growth forecast clearly has implications for the state of public finances in Britain because the budget projections of the level of borrowing hinges or is premised on the growth rates that he's expecting. And I suppose that's something else we ought to look at next, which is so the economy does recover, but what kind of borrowing are we going to look at over the next few years and what does it mean.

Jonathan: On the question about whether the economy will recover next year, one interesting point which doesn't seem to have been picked up at all, is the Government's intention to raise VAT again at the end of this year, at the end of 2009, which will be exactly the point at which it will be unclear whether in 2010 the economy is going to be able to recover or is going to carry on sliding downwards, as the International Monetary Fund has predicted.

So it will be interesting to see over the coming months and then crucially in the autumn when the Chancellor has to make his annual statement about Government finances, whether they actually do stick to that intention to raise VAT because on the one hand, as you say, borrowing levels are very high so there's going to be a pressure to raise taxes.

On the other hand if the economy still is faltering and looks like it may continue to have negative growth in 2010, then raising VAT then could actually exacerbate the problem.

And, of course, this is the basic points about Keynesian economic because if it did exacerbate the problem and made the recession worse then tax revenues would be lower and the deficit might actually expand still further.

So whether or not VAT will be raised as was said it would be in the budget will be interesting to keep an eye on.

Martin: Yes. And the debt levels are as predicted by the Chancellor. The most significant thing about them is that they are very, very long term bad projections and they will be very bad, almost irrespective of whether the real economy does indeed successfully pick up in the way the Chancellor does expect.

So the future for debt is obviously pretty bleak indeed, whatever the recovery comes along with.

Linda: Yeah, and I think when look at the projections at the moment Britain has a stock of debt of around £730 billion. And over the next two years alone the Government's planning to borrow over £300 billion which means that by the end of next year, 2010, Britain will have a stock of debt of £1 trillion. And that is considerable.

And just to pick up on a couple of points which were made, the Chancellor's projecting a minor fiscal stimulus this year. Because of the severity of the recession he has put in place minor measures, minor in the sense of being pretty small scale - a few billion here and a few billion there - but nothing like the 20 billion that he announced last November already.

So he's spending some money on helping the unemployed, helping savers, helping homeowners. But because he's projecting a recovery next year he's actually projecting fiscal tightening from next year onwards. And onwards to the end of his forecasted projection period, which is nearly a decade from now.

But if the economy doesn't recover next year it's very hard to see how the Government will tighten fiscal policy because that would only make the recession worse.

So the growth forecasts are looking optimistic for next year but I think we may well see an entirely different type of budget if they do prove to be optimistic and we find that the Government isn't going to tighten fiscal policy during a downturn.

Jonathan: Yes. In terms of how they'll get growth growing, if it doesn't start automatically, when they're so restricted in terms of how much money they can put in because of the debt levels, it may be that they are going to have to become more activist, more interventionist.

And there are some signs of this obviously with talk about the retiring industrial policy or a new industrial policy, new jobs and the whole 'Green New Deal'.

And I think there it's important to link the short-term measures which might be needed to get the economy going in the long term; measures needed for the safety of the planet on ecological grounds because the world economy has gone through long swings of 20 or 30 years of relatively fast expansion, and relatively slow growth and depression in the past.

And often the long periods of recovery and growth have been around a whole host of new technologies which have developed and then led to mass production and new infrastructures. These have been invested in across economies to meet those new consumer goods; whether it's motor cars and so on.

And it could well be the Green New Deal could actually lead into a whole era, 20-year generation of economic expansion across the globe in quite a different direction.

But that won't necessarily happen automatically and the sort of figures and initiatives announced so far maybe aren't enough. Certainly they're dwarfed by what's being done in some other countries like Korea.

But it may be that if the UK economy doesn't recover next year, as has been suggest, that that's the way governments of whatever colour will have to go to be interventionist in the money they put into the economy to get things moving.

Martin: But one of the things the figures do illustrate very clearly is how little room for manoeuvre governments do have in terms of explicit fiscal stimulus.

Last year there was an injection of I think 25 billion but even a figure of 25 billion is relatively small compared to the indebtedness levels that we're talking about at the moment.

And across the world, when people look at the fiscal stimuluses put into place in different countries, one will see that they are, of course, tend to be only of the order of 1%, 2% or 3% of GDP.

It's fairly clear, I think, from what the Chancellor said that the idea of at least putting up measures explicitly as a fiscal stimulus instead of, perhaps as Jonathan was saying, directing what one might think would be otherwise desirable measures, which may also help in this kind of thing.

It seems that it's very unlikely that a government like the UK is going to be able to put up a further explicit fiscal stimulus, as indeed several commentators have made that point in the last few weeks.

Linda: I think the Bank of England has warned against similar measures. And I think that does suggest how bad the borrowing levels are going to be.

The government in their pre-budget report, they've pretty much stuck to what they said they were going to spend on in terms of these stimulus packages. The 25 billion over two years amounts to just about 1.4% of GDP. The measures announced in the budget itself adds to that. Adds another, probably, it's thought, about 5 billion or so.

So the entire stimulus therefore for the next couple of years is 2% of GDP. This is considerably smaller than what the Americans are putting in and it's a lot smaller than what the Chinese and the Japanese and the Koreans are putting in.

The Americans are a different story but the other countries putting in big stimulus is because they're surplus economies. They actually have the capacity to be able to put in more stimulus measures and to try and fuel their recovery. Although I suppose we don't want to start talking about Japan. That is a different kettle of fish. Their stimulus measures are going to push the debt to GDP ratio up to 198% and I must say that sounds absolutely terrible.

But bringing us back to British debt levels, can an economy like Britain, which is not the United States with its reserve currency status, meaning that the dollar tends to be very desirable as an international investment vehicle. So the Americans find it cheaper to borrow.

Is Britain in danger of returning to becoming the pariah on global government debt markets? Can this economy sustain a debt to GDP ratio which, according to the Government's projections, will be 79% of GDP by 2015?

Jonathan: One bright spot in terms of the relative position of the UK economy, of course, is that all the other economies are in a similar position with the global recession in that debt levels have gone up and will go up in almost all the industrialised countries.

I think two other factors are worth thinking about in terms of the long-term debt and whether you can service a debt because it should be said that's the real problem and danger with letting debt levels go this high. If you can't afford the interest payments each year then you have to borrow to pay the interest payments and so the debt starts moving out of control.

But then two key factors are what interest you're paying on the debt and also what's happening to inflation.

And what's happening to interest rates, that's interesting because I think people thought maybe interest rates got so low because it's the worst recession since the 1930s and then they'll raise rapidly for a sign of inflation.

But it may be an inbuilt requirement really on governments to try to keep interest rates low for quite some time because the danger of

higher interest rates means that these debt levels just become unworkable; the interest payments would just be too expensive.

But then the other side of that coin is inflation, at least on one measure of inflation in the UK, the retail price index, we're actually in negative territory already. Rather than prices rising, prices are actually falling already.

Of course that's good for us consumers if prices are falling but one of the problems and dangers for the economy as a whole with prices falling is it means if you've got a debt which is generally fixed in money terms - if you owe someone £100, or if a government owes someone £1 trillion - and if all prices fall then in real terms that debt has doubled.

And put conversely, how economies have sometimes got out of high levels of debt historically has been when inflation's been relatively high; maybe 10% a year, 15% a year for 10, 20 years. And it can erode, reduce, the real level of debt.

So looking at how UK economy and the other economies are going to be able to pay the interest payments on these huge levels of debt, two very important factors are whether interest rates can be kept low and whether prices are allowed to fall, whether inflation's allowed to stay negative or whether, actually, governments and central banks will have an interest in actually getting inflation back up to positive levels: actually have inflation as a good thing rather than a bad thing.

Martin: Yes. Sadly I think - historically, the way governments tend to get out of indebtedness like this really two. One is inflation and the other is that one just waits around hoping for the economy to turn up.

Clearly the UK has had rather higher levels of indebtedness at some times; particularly the years immediately after the Second World War. And largely that did inflate away over the post-war period.

The Clinton administration managed to reduce its indebtedness again largely by the good fortune that the economy picked up at the right time.

So I think the history of large indebtedness really being got down by some determined and successful government policy isn't a terribly optimistic one.

Yes, I think there is a danger obviously that the governmental finances are running the same kind of risk as personal finances ran in the last few years.

If one looks back at the problems of personal indebtedness over say the last five, ten years, of course there were Cassandras who did say that the indebtedness is getting out of control and always the optimistic response was that "Well yes of course are more indebted than they were in the past but the markets seem to be happy with this. Interest rates are low; there's a great deal of liquidity; lots of suppliers of finance and that's okay."

And, of course, as we've seen that's okay so long as the markets continue to think that way. But it's very easy suddenly to hit a problem where interest rates go up, the liquidity miraculously evaporates and, of course, the government is getting itself into the same kind of situation.

At the moment, it looks as though the government is not having too much difficulty financing this kind of level of borrowing. Interest rates are very low, the markets don't have very much better

alternatives to put their money into at the moment. So, so far, no great problems have emerged.

But it's indeed quite possibly, as Jonathan says, that supposing some time in a year or two interest rates go rapidly up and the markets get considerably more jittery about sovereign indebtedness, that the UK government would then essentially get itself into a very similar problem so the one that Northern Rock got itself into where it finds itself very difficult to roll over this large stock of debt that is inevitably to get up to these levels.

Linda: I'd agree with all of that. I think if interest rates went to, say, 10%, which was the level the British were servicing its debt in the 1980s, we would have real problems. And the gilt markets apparently shot up with these new borrowing figures when they were revealed. So the ten-year gilt now, the interest rate on it is 4% with a growth rate of under that.

The rule of thumb of having your growth rate exceed your interest payments, making debt affordable, is usually what we use for developing countries and I'm slightly concerned that Britain's going to struggle with the expenses of debt interest payments.

So last year's debt interest payments were around £34 billion, which exceeds the entire defence budget. So we're not there yet. So those interest rates stay low. But I think that is something that is going to matter a great deal.

And I also agree deflation is another problem. I mentioned earlier that Japan has a massive debt to GDP ratio. That's in part due to deflation because the real value of indebtedness keeps rising when you're in a deflationary stance.

And I suppose I would add one more factor to how governments deal with indebtedness. One way to deal with it is through inflation and, specifically, monetising the debt.

So you essentially have gilts on offer at the moment of about £220 billion that have to be sold. The Bank of England is actually going to buy up £150 billion worth of indebtedness; not just gilts but also corporate bonds and commercial paper. So, in a sense, the Bank of England is going to inflate the economy by 10% this year and that will certainly keep inflation high in the system.

And, I suppose, that would be another area that the Bank of England's very concerned that its attempts to revitalise the credit market doesn't get viewed as a way of inflating away government indebtedness. And I think that's certainly something which markets, I would imagine, are very concerned about.

And talking about indebtedness and comparing it to other countries, I think it's a nice segue to look at whether or not the global recovery is also on the horizon.

So part of the reason why the growth forecast by the chancellor was so optimistic was that he was relying on the global economies pulling the British economy, helping it to come out of recession. And he made the point that Britain is a very open economy, which is true, and he also made the point that the world economy's expected to double in the next 20 years, which will help the British economy.

I suppose a couple of issues I would probably raise there is that doubling figure is premised on the global economy growing at over 3%, which is, indeed, possible because that's about what the global economy has been growing at in the post-war period.

But whether or not it will grow at that rate in the next couple of years, I think the IMF's latest world economic outlook certainly doesn't think that. They think the global economy is poised to contract for the very first time in the post-war period this year and next year growth in the global economy will be less than 2%.

Now 2% positive growth sounds good but when you're talking about the global economy, typically any growth less than 3% is considered to be a global recession because growth rate of 3% and over takes into account the population growth in the world.

So according to the IMF the world isn't going to recover until 2011. So the immediate reliance on the world as an engine for the Chancellor might also be problematic.

Jonathan: Yes. And at the G20 talks and agreements all the discussion and debate in the media was about which part the world would go done to try to get the world economy going again. Would it be fiscal stimulus or would it be regulation of the banks to sort out the mess?

And the outcome was a bit of both. People saying "Yes, we needed some fiscal stimulus but it was no good just going back to the state of affairs that created the problem in the first place and there would have to be proper regulation, including clamping down of tax havens which would bring in more tax revenues and so on."

What will be important will be to see what happens on both of those fronts. The fiscal stimulus has been announced by a number of countries: America, Korea doing serious amounts of stimulus. Other economies though, to be fair to them, Germany and so on, having quite good inbuilt automatic stabilisers; so actually automatically giving generous unemployment pay etc so that they

are actually giving a fiscal stimulus although the media was portraying them as in the other camp.

But in terms of regulating the banks clamping down on the behaviour that created the problem in the first place, clamping down effectively on the global tax havens, including whole countries such as Switzerland and how much extra tax revenue that would bring in to the major counties. A lot of that is still unknown, the extent to which that will be successful and when it will start kicking in.

Martin: Yes. I think the extent of the recovery of the world as a whole is one that makes the forecasting of the recovery of particular regions rather difficult because what we're seeing is that different regions are moving through this problem at different rates. You've got the US which was first to hit problems and therefore might be first to move out of it in the end, followed by the UK, then by Europe, then, shall we say, emerging Far East economies.

The US problems, of course, largely start in the financial sector and they move through to the effect on domestic consumption through consumer indebtedness and pretty much the same is true of the UK.

The problems of countries like Germany and, indeed even more so, the Far East and emerging countries are not so much questions of domestic consumption but their problems emerged at a later stage when their exports effectively collapsed.

So if you're looking at it from the point of view of the US and the UK you are thinking "Well yes, maybe we might be beginning to see the beginning of the end of this", but this probably heavily depends on one's assumption about things not going to get any worse in

Europe and the Far East. If that happens, then one's possibly in for another round of crises.

And similarly, if you're looking at this from the point of the Far Eastern and the European exporting economies then you're probably fairly heavily dependent on a view that the US is going to improve and that's going to stop your exports going down any further.

So there's quite a serious interrelationship here, which could go well or could go badly.

Linda: I think that sums up the G20 summit. I think there was a recognition the world is extremely interconnected. And, in fact, when we see what they agreed at the summit as a precursor to global recovery, since that was the aim. You get all these countries in a room - they represent 90% of the world's GDP - what they're going to do will have an effect, clearly, on how the global economy is going to fare.

There was a lot of talk about having a new round of stimulus measures, discretionary stimulus spending, as the IMF and the Americans were pushing for; not counting things like automatic stabilisers. They're parts of fiscal policy that rise automatically in a recession of which Germany has a great deal because of the generous welfare state.

And we know that that wasn't a result of the summit. There was just very strong opposition against that from the Germans and the French, who held their own press conference to discuss the things they thought were going to be important.

And I suppose my view on that had always been countries are at different stages in this crisis. They will take measures which are suitable for their own national economy.

So even though it's true that the IMF projected that if all the countries coordinated when they stimulated their economies, part of that spills over into another country's exports and you would get a boost to global growth. They expect that boost, whatever spending is done, by around a third. So they would have increased global growth by a third more than if countries had just spend on their own timeline.

So that being said, that didn't come off as a success. But I think what they did achieve was probably realistically what you would expect with a gathering of countries. They would agree to put money into things which are actually joint efforts.

So things like putting more money into the International Monetary Fund, \$750 billion, of which \$250 billion was an increase in special drawing rights which are this unit of count the IMF uses which is premised on different currencies, four different currencies. And, of course, that's the global version of quantitative easing. Special drawing rights, which are the world's currencies increased tenfold by this measure.

And the other \$500 billion, \$0.5 trillion, were essentially credit lines being extended by the G20 countries to be put into the IMF to lend to emerging economies particularly which were in trouble.

So they were trying to forestall another round of banking crises in places like Eastern Europe and Central Asia, the Baltic States which would, in turn, drive another banking crisis in the West because a lot of Western banks are clearly exposed in those

markets, particularly in Eastern Europe. And the IMF's already bailed out over a dozen countries since this crisis began.

And, of course, the rest of the money, the rest that make up the \$1 trillion pledged at the summit, was about \$250 billion to the World Bank and other development banks to facilitate trade credit. So again, it's credit guarantees to try and help exporters which are suffering from the credit crunch.

And then, I suppose, the final bit of that is about \$106 billion in developmental aid, \$6 billion of which might come about through IMF sale of gold.

The reason I'm going into these figures is that aside from about the \$106 billion, the rest of it isn't real money into the economy.

They're credit lines and credit guarantees which may be drawn down and may not be repaid but in terms of a global stimulus that really wasn't probably what the Americans and the British were looking for.

But what these measures do do is, of course, try and safeguard against the second round of banking crisis which would then plunge the rest of the world back into another set of financial problems, which then, of course, forestalls global recovery.

Jonathan: Yes. In terms of the state of the financial institutions globally and, of course, a lot more money's been pledged for the International Monetary Fund and a lot of people see the IMF as part of the problem rather than the solution. And there has been an acknowledgment that does that need to be reformed? But we have to wait and what, if anything's, delivered on that.

In terms of the US financial institutions and the consensus which seemed to have been developed around the G20 summit that things had to move forward rather than just go back to how things were when this crisis was generated, it's interesting that some of the US financial institutions are trying to pay back the money they got off the American government so that they can go back to their old ways and not have government interference in the way that they operate and the bonuses they pay themselves and the fact the US Government refuses to take that money unless they get some guarantees as to how they're going to behave.

In terms of the UK it was interesting in the budget speech the Chancellor did refer to the need to encourage diversity of ownership in financial institutions and, in particular, to encourage mutual financial institutions which was, historically, an important part of UK financial institutions but there was a lot of demutualisation during the Thatcher years of the 1980s where the mutual organisations basically took people's money in savings and then lent it back to them to buy houses. They were turned into private banks and even the ones who remained as mutuals were encouraged to participate in these innovative financial instruments.

So I think in terms of the UK financial institutions it would be very welcome if government actually delivered on that, encouraging mutual organisations.

Linda: Thinking about the global picture, do either of you think that we are looking at a global recovery in the next couple of years? It's a big question but I think it's certainly one worth trying to contemplate.

Martin: Well, I think it is difficult because of what I said earlier. I think things could go seriously in either direction. These problems have been a long time in their gestation and they will take a long time to recapitalise the global financial system and to bring the effects of that back through onto the real economy.

So I wouldn't be looking for a very sudden global upturn running through the next year and then hoping that the global economy will resume a fairly rosy path.

In the long term, of course, you do still have, on the optimistic side, that path is very big drivers of China and India which, in the long term, one cannot but believe that they will generate a lot of demand for the world economy. But the timing of this is, as always, very difficult to call.

Jonathan: I think it is very important to acknowledge and stress that these things are, by their very nature, uncertain and not just unknown but unknowable because a lot of economic activity depends on confidence and people's expectations about what are the consumers going to be doing, other businesses are going to be doing in terms of investment. So it is very, very hard to predict. In the best of all possible worlds it's hard to predict.

It's ironic in the current state of affairs where politicians around the world always start off saying "What an unprecedented situation we're in," and then give their forecast. When asked "Where did you get that from?" they say "Oh, well look what happened last time. We recovered quite well."

Whereas the point is this is unprecedented and, as Martin says, in two particular ways.

The first is the banking system and financial institutions have wrecked themselves. So we're not just coming out of a recession in the normal way. Something's got to be done about that.

And secondly, given that this is the worst global recession since the 1930s, there will be large-scale unemployment which itself then has a dampening effect on people's expectations because people considering investing, in particular the consumer goods industries, will think "Is consumption really going to rise when we've got these high levels of unemployment?"

So no doubt there will be a recovery sooner or later but those factors, the state the financial institutions are in and high levels of unemployment, pose a danger of it being a weak recovery.

And it's always important to remember that just because a recovery's started, doesn't mean that it will be self-sustained. There's always a danger of it falling back into recession or even being pushed into recession by bad policy decisions.

That was actually done during the last global recession, or depression, in the 1930s. By 1937 when people thought things were going okay they then cut back spending, increased taxes and actually created another mini recession.

And one other point in terms of the global economy and recoveries is quite interesting to reflect up in terms of the fact that inflation's actually gone negative, prices are now falling. In the old days economists thought that would be all good news and, indeed, that's how the textbooks showed that economies would get themselves out of trouble; if you weren't selling your goods, where your prices would fall and then you'd sell more and you'd pull yourself out of recession .

And, in fact, that was one of the misapprehensions that Keynes challenged in his book in 1936, 'The General Theory'. That was one of the central points he was getting across, that actually, although it all looks very well in theory, that's not actually how the world works.

And one of the reasons was it's not very easy just to cut all prices and wages by 50% because A, it's difficult to get prices to go in some cases but secondly, people are nervous about accepting a 50% wage cut. Apart from anything else, they're not really sure whether prices will fall by 50% or if other workers will accept a 50% wage cut.

So if inflation's predicted to go to negative 3% in the UK, if inflation actually became significantly negative in the UK and other countries and the response was then to try to cut wages to keep them constant in real terms, that's a very difficult thing to do and was one of the things Keynes was warning about. That's what caused the General Strike in Britain in 1926; the idea that it didn't matter if your goods weren't selling, you just cut wages, cut prices and get out of the problem. It's just not that simple in the real world.

Linda: I think the other global picture is that there's going to be some countries which will grow; big emerging economies like China and India, which is just fairly insulated from the financial crisis. And I see other regions suffering much worse than the rich countries. So this is smaller emerging economies either because they became very indebted externally or because they simply don't have a domestic market to support their own growth until the West recovers.

So I think historically, although it's very hard to say things historically in this crisis, emerging economies are both more volatile and take longer to recover from a crisis than rich economies.

So I think the global economy will begin to probably chug along next year, so long as there isn't another round of a banking crisis, but it will be driven by big emerging economies. And we may well see the Western economies, after they sort out their banking crisis, beginning to slowly to recover.

And I think that probably raises another issue that has been bandied about, which is when the Chancellor talks about, and coming back to Britain, but I think the same could be said for the US and Western Europe, is it likely that Britain will return to a trend growth rate of 2.75%? Or was that driven in the last decade and a half by things like the financial sector which is unlikely to resume its place in the economy? Or perhaps you two think it might resume its place in driving GDP.

We know the Chancellor in the budget said that 27% of all tax revenues come from the financial sector and he expects that won't be the case going forward. The independent think tank, the Institute for Fiscal Studies, projects that Britain has a structural deficit now equivalent to 0.4% of GDP, nearly £6 billion hole every year because of the fact that the financial sector isn't going to be the driver going forward.

So I just talked about China and India growing at a fairly good clip but in the West, will we be growing at a very good clip back to what we were before this crisis?

Martin: Well, the long-term trend rates of growth have a history of being very, very stable and the y are stable despite the fact that in the UK there have been very large sectoral shifts. So we have been moving into manufacturing, out of manufacturing, into finance, maybe out of finance.

There is something very difficult to buck in these kind of long-term trends.

So yes, it may be the case that the financial sector is not going to grow anything like as fast as it did in the last few years.

But, of course, one of the consequences of the financial sector growing as it did was that other sectors were squeezed out. And, of course, if the financial sector's not performing that particular function then other sectors will grow.

People do indeed think that, of course, if the financial sector is not earning large export revenues and propping the exchange rate up then this, of course, enables manufacturing, which has had a rather hard time of it in the last few decades, actually to pull back a bit.

So yes, I'm not sure if it's very easy to make predictions about changes in the long-term trend rate of growth and I don't think economists have predicted them very well in the past.

But merely, I think, because the particular sector we have relied fairly heavily on for a few years is not going to do very well isn't necessarily going to mean that the trend rate of growth is going to change by that much.

Jonathan: Yes. And I think it's certainly possibly that the UK economy, as with other economies can recover onto a sustainable long-term rate of growth again. But I think it is going to require a diversification of the

economy away from the financial sector. And I think the Chancellor's right about that.

And actually this has long been recognised as a problem for the UK economy, that the peculiar nature of it being so dependent on the financial sector, which has created two problems really. One is, as Martin said, other sectors get squeezed out in all manner of ways in terms of investment or people.

At Oxford University here we see our brightest graduates who would expect to go, and in other countries would go, into manufacturing and business services and so on going into the financial services sector in order to develop incredibly complicated financial instruments that they'll be able to sell to people around the world and I think they would be able to understand them.

So there is the problem about the UK economy needing to diversify into new manufacturing sectors. This doesn't mean old industries, but the green technologies and so on.

And the other longstanding problem which needs to be tackled is therefore the relation between the financial sector in the UK economy and the manufacturing and the other sectors, which has been quite peculiar in the UK.

In other economies, Germany and other economies, financial sector developed historically in order to service and support the manufacturing sector and the rest of the economy. Whereas because of the history of the British economy that's not what the City of London was there to do, as far as they saw it anyway. They had bigger fish globally to fry than that.

And there have been all sort of commissions and enquiries set up over the years and the decades to investigate what could be done

about that; whether if financial institutions were starving, British manufacturing companies would finance, which is interesting given the credit problems companies are suffering at the moment.

But interestingly the conclusions on balance over the years have been that it wasn't so much that the UK financial institutions weren't providing finance to British manufacturing firms. It was the nature of the provision was quite different from elsewhere.

So in Germany, France, Holland, Japan the banks would provide finance and would take a real interest in that company and would give certainly very long-term loans, maybe even take equity in the industry, put a non-executive director on the board, whatever.

Whereas with Britain it would be very hands off. They'd just say "Yes, have an overdraft" and that would be it, which allowed some inefficient industries to carry on without having either financial sector or the Government pointing out that they needed to be investing in new technologies, as was happening overseas.

But it's also very risky because it meant that at the first sign of the downturn those overdrafts can be withdrawn overnight and those companies can be bankrupted, as has been witnessed again in this recession, as always is in recessions.

So I think the UK economy can recover but it does need a diversification away from the financial subsector to the real economy of manufacturing; the new developing, in fact, developing new green technologies and other manufactured goods.

Linda: Yeah, I would tend to agree with that. I think rich countries have to keep on top of skills and innovation and technological progress. That's how they sustain a good long-run growth rate.

And I suppose that's probably a good point to end this podcast is to say hopefully what this crisis has done is caused that diversification in the British, and also probably the American, economies and caused them to take another look at the mix of what constitutes the drivers of their economy.

And there's no reason why we should expect a falling standard of living so long as talent and the right incentives are in place to keep the economies innovative and creative.

I am intentionally trying to end this on a positive note. So we'll stop there.

END AUDIO