Austerity plan is failing, IMF tells Osborne

By Larry Elliott
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The message to George Osborne from the International Monetary Fund could scarcely have been clearer. It's time to think about a plan B.

Coming as it did on the eve of the fourth quarter growth figures, the intervention of the fund's chief economist Olivier Blanchard, was particularly ill-timed for the chancellor, but it was hardly a surprise.

The IMF has never been wildly enthusiastic about Osborne's tough austerity plan for the British economy and has been saying for at least a year that the Treasury should ease off if recovery falters. But up until now it has tended to avoid telling Osborne that his policy is failing.

No longer, it appears. "We said that if things look bad at the beginning of 2013 – which they do – then there should be a reassessment of fiscal policy", Blanchard said.

Fiscal policy involves changes to tax and public spending, and Blanchard noted that the chancellor has the perfect opportunity "to take stock and make adjustments" in the March budget, due in less than two months.

Three factors probably lie behind Blanchard's decision to go public with his concerns. The first is that the IMF, while supporting the need for budget deficits to be reduced, believes action should not be so aggressive as to derail growth. The second reason is that it has done some recent work on fiscal multipliers – the knock-on effects of tax and spending changes on the wider economy – and found them more powerful than it previously thought. The third reason, obviously, is that Osborne's forecasts of a recovery lurking just around the corner have proved totally wrong. The economy has flat-lined for the past two years and if the City is right about the fourth quarter 2012 growth figures there will be fears of a triple dip recession this winter.

The interesting question is whether Osborne will heed the IMF's advice. If he does, any loosening of policy in the budget is likely to be modest, and not just because of the political damage caused by the U-turn.

Osborne believes that any backsliding will come at a price. Looser fiscal policy will mean tighter monetary policy – perhaps not from the Bank of England but from the financial markets in terms of higher long-term interest rates. His advisers have pointed out that the IMF believes the fiscal multipliers are weaker in open economies such as Britain than they are in more closed economies such as the US or Germany.

The chancellor's problem, though, is that long-term interest rates may go up anyway. It is not just the IMF but the credit rating agencies who are worried about the absence of growth in the UK. A credit downgrade looks likely and, given the dire state of the economy, would be merited. Britain does not feel like a country that deserves its AAA status.

As for the fiscal multipliers, it might be the case that their impact is less powerful in the UK than in the US. But austerity is still having a dampening effect on the economy, and is making it harder for the chancellor to hit his deficit reduction targets. The IMF is right. It is time to take stock. It would be a risk for the chancellor to announce tax cuts and a slower pace of spending cuts in the budget. But it will be a risk – and probably a bigger one – if he does nothing.