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Fresh-start Truss faces a 'sudden stop'

Truss aims for economic growth, but after Brexit and the pandemic, the country is staring down the barrel of a collapsing economy

'The scary thing about civil servants,' a Labour Treasury minister once told me, 'is the way they anticipate the levers you want to pull. They say: 'Minister, if you are thinking of pulling this lever, please let me apprise you of the following likely effects …"

That was in the depths of the Lehman Brothers crisis. Co-ordinating the UK Treasury's response at the time was a civil servant called Tom Scholar.

The first act by Liz Truss as new British prime minister was to sack Scholar, who had risen meantime to become the Treasury's most senior civil servant. He had led the institution through the pandemic and was fronting its response to the energy crisis, but his services were no longer required. It is hard not to conclude that Truss and her chancellor of the exchequer, Kwasi Kwarteng, intend to pull economic levers unimpeded by any appreciation of their complex effects, and indeed without any overall plan.

The first lever Truss pulled was an energy price cap — for households and businesses — which looks set to require £130 bn of extra borrowing over two years. Labelled the biggest fiscal event in British history, it is certainly the biggest state subsidy to the private sector since Lehman Brothers. The second — if Truss fulfils the pledges on which she won the Tory leadership after the demise of the former premier, Boris Johnson — is likely to be tax cuts for corporations and the middle class, amounting to £39 bn.

Unfortunately, such dramatic yanks on the levers of economic power can have unforeseen consequences. Indeed, in the wrong hands they can come to look like the actions of a doomed driver on a runaway train.

The warning signs

To understand why, we need to look at six dials on the dashboard of the UK economy: inflation, investment, trade, debt, sterling and the current account. They are all flashing red.

Inflation is currently 9.9 per cent — the highest for 50 years and set to peak at 13 per cent next year. As a result, real wages are falling more quickly than at any time since modern records began and consumer spending is contracting. There will, says the Bank of England, be a five-quarter recession, as it raises interest rates, ostensibly to choke off inflation and demand.

Investment rose rapidly in the years before the 'Brexit' referendum. But it stagnated after 2016, fell sharply during the pandemic and has barely recovered — despite huge tax breaks for capital expenditure.

The trade intensity of the UK economy is meanwhile declining, even as it rises among the rest of the G7.

As to trade, while the Brexit effect on investment was immediate, it was only after the end of the transition period in December 2020 that Britons began to feel the downside of leaving the European Union. Not only have exports to and imports from the EU slumped — goods and services — but exports to the rest of the world have fallen too, as Covid-19 has accelerated deglobalisation. The trade intensity of the UK economy is meanwhile declining, even as it rises among the rest of the G7.

Debt now stands at 100 per cent of gross domestic product. It will rise further, as Truss has signalled to the Treasury that it must focus solely on growth — and by implication not on deficit reduction or the rising cost of government borrowing.

Sterling, having lost a third of its value against the dollar since the Brexit vote, fell 4.5 per cent in August alone, making the UK the worst performer against the surging greenback. Analysts believe sterling will soon hit the $1.09 low last seen before the 1985 Plaza accord to manage dollar depreciation. And while, in a normally functioning economy, a weaker pound might boost exports, for an economy so heavily reliant on imports the impact, according to Credit Suisse, is 'unequivocally bad'. Not surprisingly, a senior Tory briefed yesterday's *Sunday Times* that Truss' team were 'getting in a panic about what is happening to the pound'.

The deficit on Britain's current account, indeed, stands at £51 bn — 8.3 per cent of GDP — with no sign of improvement. Analysts at Bank of America calculate that, at this rate, the UK's foreign-investment balance — British holdings of foreign firms versus foreign holdings of British firms — could mushroom to 200 per cent of GDP. The UK, in short, is becoming a land of profit outflows, while trade and the currency both decline.

No story, no money

The problem for Truss and Kwarteng can be reduced to this: achieving sustained 2.5 per cent growth long-term would require redistribution and investment. The wages share would have to rise, as raising demand without more credit implies shifting income towards those with greater propensity to consume. And profits would need to be recycled as investment, rather than dividends — and not in the British staples of coffee bars and Airbnb homes but in businesses that make and export goods and services.

Yet Trussonomics is dead set against income redistribution, and — with the Brexiters in command — incapable of creating a stable and predictable climate favouring investment.

In the worst-case scenario, which is being openly debated in the broadsheets and analysts' notes, we have the makings of a classic sterling crisis, via a 'sudden stop' of international financial flows into the UK, where foreign investors refuse to go on funding government borrowing.

In 2016, the then governor of the Bank of England, Mark Carney, warned that, with its current-account deficit, Brexit could test 'the kindness of strangers' on which it relied to finance the shortfall. Their patience may now be running out.

The Deutsche Bank analyst Shreyas Gopal warned on 5 September:

'With the current account at risk of posting an almost 10 per cent deficit, a sudden stop is no longer a negligible tail risk. The UK is increasingly at risk of no longer attracting enough foreign capital to fund the external balance. If so, sterling would need to depreciate materially to close the gap in the external accounts. In other words, a currency crisis typically seen in [emerging markets].'

One can pull the shiny levers of spending, borrowing and tax cuts. But

without a realistic story to tell global capitalism the risk is of a combined slump in the value of the currency, sustained inflation, capital flight and — hence — the end of the government's ability to go on borrowing.

Since the 'sudden stop' theme has emerged in the financial pages of the *Times* and the *Financial Times* in the past week, we have to assume it has been on the minds of Treasury officials briefing the new government. So what can be done?

Hope on the horizon

Truss' problem — shared with her predecessor — is that, having achieved Brexit, the Conservative Party has no strategy for the direction of the UK economy. Even as borrowed money was poured, first into the pandemic response, now into energy subsidies and higher defence spending, it remains an article of faith that there should be a 'small state' with 'low taxation'.

Johnson repeatedly promised a 'high-wage, high-skill, high-productivity economy' but took no concrete steps towards achieving it. To do so would of course have entailed copying public institutions in mainland Europe — such as in high-productivity Germany the federal KfW development bank and regional banks and the *Fraunhofer* research-and-development institutes, allied to the apprenticeship system organised collectively by chambers of commerce and co-determination by worker representatives at firm level.

It would demonstrate to the world, in the most graphic terms, that the UK had no post-Brexit economic strategy and set back trust in British governance for decades.

The absolute no-brainer is to end all talk of invoking article 16 of the Brexit withdrawal agreement to suspend its Northern Ireland protocol. That risks simultaneously triggering a trade war with the EU and the end of all trade talks with the United States, given the attachment in Congress and the White House to the 1998 Belfast agreement — which the president, Joe Biden, can be expected to reaffirm when he meets Truss on Wednesday. It would demonstrate to the world, in the most graphic terms, that the UK had no post-Brexit economic strategy and set back trust in British governance for decades.

Beyond that however, the UK needs a government that understands how to wield state power over the economy. To achieve the kind of growth that would pay for the borrowing into which the UK has been forced

would require massive and rapid public investment across the board — not just in infrastructure but in the green energy transformation and above all in skills.

Alongside that, there would have to be massive redistribution. As the *Financial Times* points out, Britain's poorest families have 20 per cent less disposable income than their counterparts in formerly Communist Slovenia. As for those on median incomes, 'On present trends, the average Slovenian household will be better off than its British counterpart by 2024, and the average Polish family will move ahead before the end of the decade.'

While state-directed investment is a lost art in Anglo-Saxon economic discourse, and it takes time, state-mandated redistribution could however be begun as early as this week's emergency budget. Using public-sector pay rises, increases in the minimum wage, hikes in universal benefits and price caps on transport, food and housing alongside energy, the government could implement an immediate change — ending the job insecurity, low pay and swingeing housing costs which make life in Britain so unattractive for everyone from the Polish plumber to the British engineering graduate.

With the Truss government only two weeks old, all we can be certain of is that it will pull none of the levers such a strategy would require. If it pulls the plug on the Brexit agreement, however, it is quite capable of bringing doom upon itself — and a British population numbed by the unanticipated shocks it has already suffered.

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