Briefing Note

Resolution Foundation

Have we lost our bouncebackability?

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Summary

Strengthening recovery at last, but we're still waiting for the bounce…

After years of disappointing on the downside, economic growth in 2013 surpassed the expectations of most economists. Back in December 2012, the average predicted growth rate for the coming year across the panel of independent forecasters surveyed by the Treasury was 1.1 per cent, covering a range from 0.4 per cent to 2 per cent. In the event, real GDP rose by 1.8 per cent.

A welcome surprise no doubt, yet the recovery remains muted relative to those experienced coming out the recessions of the 1980s and 1990s. Following past downturns, we have become accustomed to a period of catch-up growth, during which GDP has risen above its long-run trend, thereby closing the 'lost ground' created by the recession. In the 1980s, economic output returned to the point it would have been at in the absence of a downturn within nine years; following the 1990 recession this process of restoration took just six years.

Even as the output gap disappears, leaving a potentially permanent hole in UK output…

This time round however, output remains some 15 per cent lower than we might have expected it to be had the financial crisis never hit. And projections from the OBR and that same panel of independent forecasters suggest that we might be waiting in vain for a rebound. With the output gap projected to have closed by 2018 (for now at least – there is significant uncertainty on this point and the OBR itself has questioned its models) and growth expected to rise more or less in line with trend for the next few years, the downturn might ultimately have created a permanent hit to UK output.

And of course even this level of growth is not yet guaranteed. The strength of the economy in 2013 was primarily based on consumer spending. Yet household incomes have not kept pace with this spending, meaning that the recovery has instead been built on a willingness among households to draw down savings and take on new unsecured borrowing. There may be room for more dissaving – it is normal for savings to fall as the economy recovers and confidence returns, and the OBR (increasingly) factors this into its projections – but reliance on this source of growth cannot continue indefinitely.

By way of illustration of the extent to which growth hinges on dissaving, if we were to assume that the savings ratio was fixed at its current rate over the course of the OBR's projection period, then hitting the current forecasts for GDP would require either an increase in projected real-terms average wage growth from 1.4 per cent a year to 2.1 per cent, or an increase in the projected employment rate from 59.9 per cent to 62.2 per cent (equivalent to an addition 1.2 million workers). The former looks plausible but difficult given where we are; the latter would be unprecedented.

Of course business investment should play its part in economic recovery too, and there were signs towards the end of 2013 of a pick-up in such activity. But it is not clear whether it could increase sufficiently above expectations to fill any void produced by an absence of household income growth.

The Chancellor used this week's Budget to again talk-up the importance of rebalancing the economy and the latest OBR projections suggest that business investment will grow more quickly over the next four years than it thought back in December. Yet even these more optimistic forecasts are significantly below those published over the first half of the parliament.

If wages and incomes continue to stagnate – as some believe they will – and if rebalancing remains limited at best, then the projections for a bounce-free but steady recovery might prove overly optimistic.

Raising questions about what level of growth is achievable absent another credit boom…

Assuming the OBR and others *are* right, and we record no more than trend growth in GDP for the next few years, what are we to make of the lack of a bounce? Sluggish recoveries are common in the aftermath of financial crises, with the banking sector taking time to find its feet and a debt overhang pushing down on aggregate demand in the private sector. Certainly, while the supply of credit in the UK looks to be much improved in recent months, there hasn't yet been a take-off in borrowing (other than unsecured borrowing by households). Not surprising perhaps when we recall that the debt-to-GDP ratio across firms and households remains no lower than in 2006.

Borrowing may soon start picking up – the OBR certainly anticipates an increase in the household debt-to-income ratio over the forecast horizon – but the headroom for an expansion in debt is limited by our starting point. What makes this situation more troubling is the extent to which the pre-crisis economy appeared to be reliant on credit growth. Over the course of recent decades, household and corporate debt has regularly outpaced GDP growth. The debt-to-GDP ratio among private non-financial corporations increased from 28 per cent in 1980 to 79 per cent in 2009, while the ratio among households rose even more sharply, from 31 per cent to 108 per cent. At the height of the credit boom in the mid-2000s, households were making a net withdrawal of some £50 billion a year from housing equity. Much of this was generated by downsizing and last time sales, but advances to non-movers amounted to around £30 billion a year.

It is a phenomena experienced not just in the UK, but across a number of developed economies. The lack of inflation associated with the credit boom of the pre-crisis decade in particular supports the argument that growth would have been lower in the absence of the surge in borrowing.

Potentially supporting claims for structural stagnation…

It's just possible therefore that the true trend rate of economic growth is lower than we think. In the absence of a resumption of accelerating credit growth, the reality of secular stagnation might become manifest. In that context, projections for growth of around 2.5 per cent over the forecast horizon might represent a bounce after all. Once the catch-up period fades, we might face still more sedate economic expansion.

If true, policy makers face an unenviable dilemma. Re-stoke private debt and risk generating the same problems of instability encountered during the last boom, or wean the economy off its credit addiction but face permanently lower levels of real growth. And in all this, beware the effect of hysteresis: accept a slower rate of growth today and you might be reducing tomorrow's potential too.

Generating stronger growth rests first on dealing with the debt overhang…

The choice might not be so stark, but it is complicated by the fact that we haven't yet really got to grips with the overhang associated with the last cycle. The private sector has gone through some deleverage, but this has been offset by a rise in public sector debt and by growth in private leverage in other economies: globally we may still be over-leveraged. Unless household incomes rise faster than expected for a sustained period, someone will need to take some painful medicine.

Politicians of all parties have long-acknowledged that fiscal consolidation forms part of the treatment – and there will be plenty more of that to come in the next Parliament – but as yet they are unhelpfully silent on what happens to heavily indebted firms and individuals as interest rates start to normalise.

And secondly on tackling the causes and consequences of our reliance on credit…

Whether we are able to reset the debt clock or not, the longer-term challenge is to avoid repeating the same mistakes over again. In part this is likely to require greater regulation of the credit market – beyond the measures already introduced in reaction to the financial crisis. We might particularly want to play a role in influencing the *mix* of credit, shifting away from investment in existing assets such as housing with its tendency to produce unsustainable bubbles, and towards more genuinely productive business investment.

We might also want to deal with some of the structural drivers of demand for debt. At the heart of this is a need for balanced and evenly shared growth. To the extent that some of the credit growth in the pre-crisis years was a reaction to income stagnation – with households using credit to plug a permanent gap between their desired and actual income levels – pursuing growth that is more evenly distributed is likely to matter not just from the perspective of equity, but also in terms of sustainability.

Losing our bounce will have serious implications for deficit reduction plans – as the output gap shrinks, so the amount of the deficit that is due to structural factors rises. But more fundamentally, we might just need to completely re-think where growth comes from in the absence of the steady drip of credit.

Recovery without the bounce

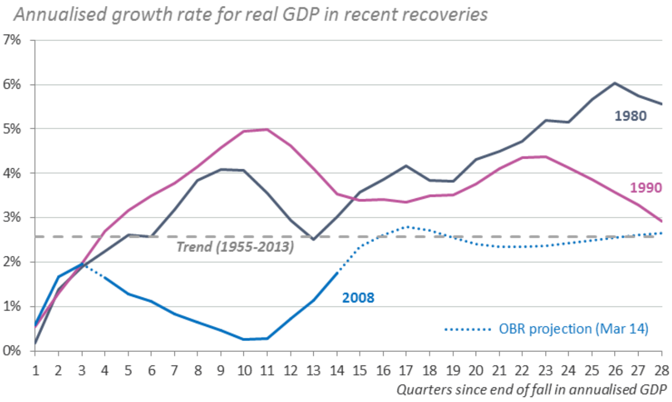
In this note we reflect on the OBR's economic outlook published alongside the Budget. With such uncertainty surrounding the prospects for GDP and the size of the output gap, we look in particular at the potential for recovering the ground lost since 2008, and on our reliance on credit in the pre-crisis years. To serve as a provocation, we speculate on the prospects for renewed growth in the absence of another credit boom.

Strengthening recovery at last…

Annual economic growth reached 1.8 per cent in 2013, its fastest pace since before the financial crisis hit in 2008. After such a sustained downturn the improvement is clearly welcome, yet the rate remains below the long-run average of 2.6 per cent and – as Figure 1 shows – further adrift still of the above-trend rebounds recorded during previous recoveries.

By this stage of recovery – 14 quarters after the resumption of GDP growth – the economy had been growing above-trend for eight quarters in the 1980s and for 11 quarters in the 1990s.

Figure 1: Year-on-year growth in GDP after recent recessions: UK 1980s, 1990s & 2008



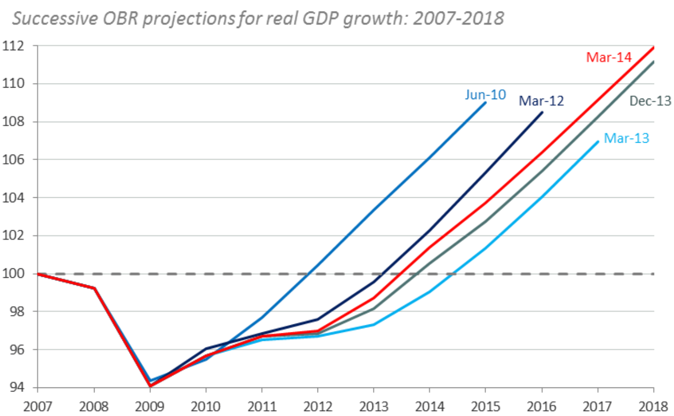
Source: ONS, *National Accounts*

But we're still waiting for the bounce…

Optimists might argue that the rebound is yet to come, but the OBR does not appear to agree. In its latest projections it suggested that growth would do no more than hover around the trend rate for the foreseeable future, an outlook broadly in line with the average across independent forecasters. As Figure 2 shows, the evolution of the OBR's thinking tells an interesting story.

- Back in June 2010 it projected that economic output would return to its pre-crisis level by 2012, but that a number of headwinds would leave growth only marginally above-trend for the duration of the forecast.
- By March 2012, in the face of persistently sluggish outturns, it pushed back the restoration date to 2014, but factored in faster subsequent growth, generating a period of catch-up towards the end of the projection.

Figure 2: Selected OBR projections for real GDP growth: UK 2007-2018



Source: OBR

- In March 2013, it produced its most pessimistic projection – delaying the point of recovery to 2015, while simultaneously reducing its growth forecast back to no more than trend.

- The March 2014 projection represents a slight improvement, with the upturn in growth experienced over the course of 2013 prompting the OBR to bring forward the point of recovery to 2014, but with a subsequent slowdown in year-on-year growth across the forecast.

Even as the output gap disappears…

And the OBR does not appear to think that there will be room for a rebound beyond the forecast horizon.

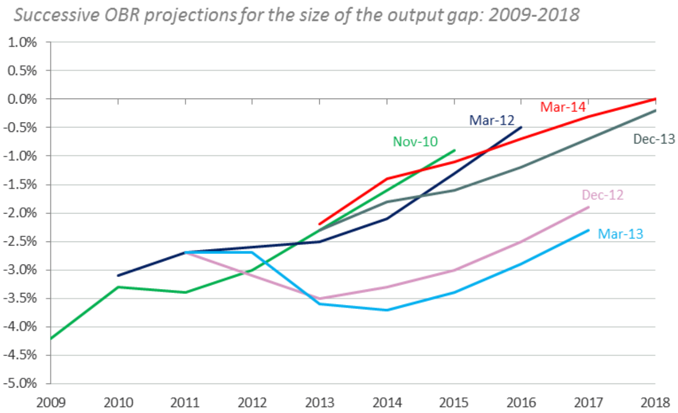
Figure 3 sets out the evolution of its estimates for the 'output gap' – the distance between potential and actual output. The smaller the output gap, the closer the economy is to its potential and therefore the less scope there is for rapid bounce back.

The shift in its projection over the past 12 months is marked. In its latest assessment this week, it estimated that the output gap was significantly smaller than it believed in March 2013, and that it would be closed entirely by 2018.

Of course, the OBR's estimate has moved around considerably over time and it is has questioned the appropriateness of its own models, reflecting the high degree of uncertainty underpinning a concept that can never be measured with any accuracy. And not all forecasters share their assessment. Figure 4 presents a range of estimates of the size of the output gap in 2014 across a selection of independent forecasters.

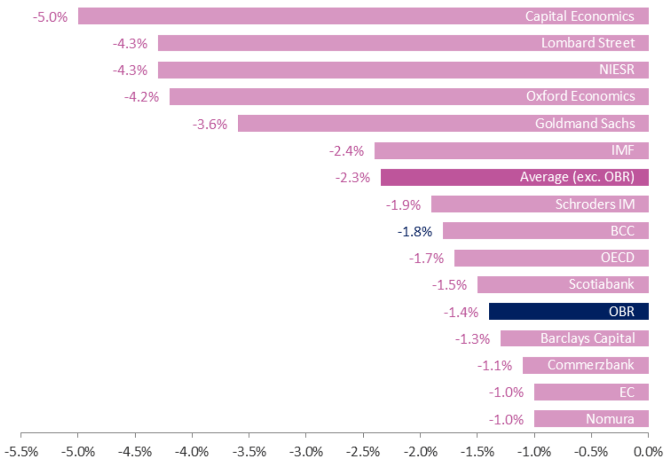
Nevertheless, if the OBR is correct, and the output gap closes by 2018, then the implication is that the any above-trend growth in the years beyond this would require a pick-up in the productive capacity of the UK economy.

Figure 3: Selected OBR projections for the size of the output gap: UK 2009-2018



Source: OBR

Figure 4: Alternative estimates of the size of the output gap in 2014



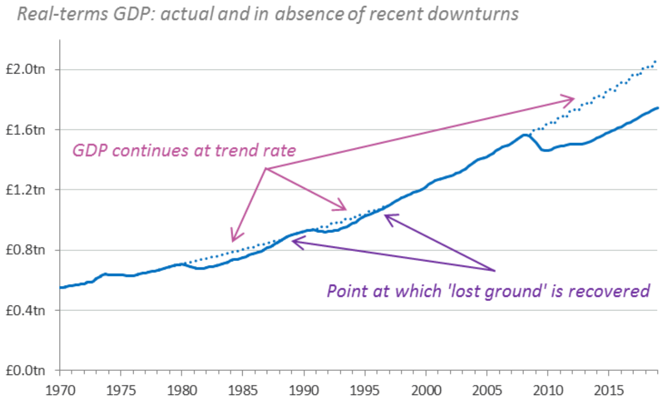
Source: HMT & IFS

Leaving a potentially permanent hole in UK output…

The potential absence of any above-trend rebound raises the prospect that the UK will face a permanent hit as a result of the downturn of recent years.

Figure 5 compares actual GDP over the course of the last three recessions and recoveries with the level of economic output that would have been achieved had each downturn been replaced instead by trend growth. It shows that the lost ground associated with the 1980s recession was made up within nine years, while the 1990s hit was overturned within six years. In contrast, this time around the gap stands at just under 15 per cent and is set to persist on the basis of OBR projections for growth.

Figure 5: Gap between actual and trend GDP after recent recessions: UK 1980s, 1990s & 2008



Source: ONS, *National Accounts*

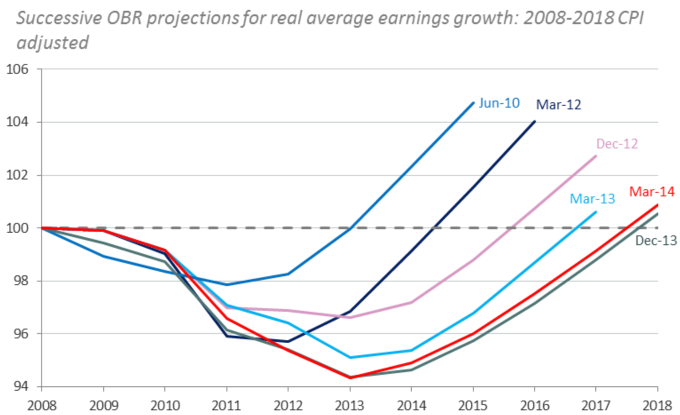
Which might yet get bigger if household income growth continues to prove elusive…

Even this level of performance is open to question given that it rests predominantly – as ever in the UK – on the willingness of households to consume: a willingness that is likely to be severely tested if wages and household incomes continue to stagnate.

While employment levels have out-performed expectations, average wages have fallen consistently in real terms over the past five years. As with GDP, the OBR has been forced to push its projections further and further back, as shown in Figure 6. Having been projected in June 2010 to return to their pre-crisis peak in 2013, average earnings in 2013 remained some 5 per cent below this level.

According to the latest projections, the pre-crisis level is now not set to be restored until some point in 2017 – a lost decade for pay.

Figure 6: OBR projections for real average earnings growth: UK 2008-2018



Source: OBR

In truth, the situation may be worse still. The CPI measure of inflation used in this analysis takes no account of the rising mortgage costs associated with expected increases in interest rates. Repeating the exercise using a constructed RPIJ measure of inflation – which *does* cover mortgage interest costs, but which is not directly projected by the OBR – results in a much shallower recovery in average wages on the basis of the March 2014 outlook.

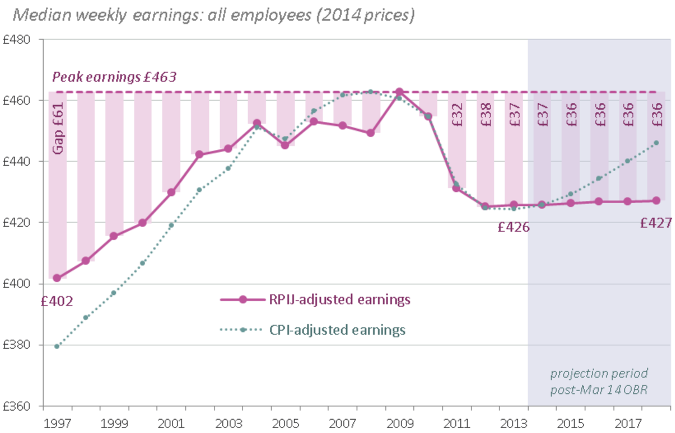
And of course, this is an *average*. If we consider what might happen to median – or typical – wages instead, then the picture looks even gloomier.

In Figure 7 we project median weekly pay on the assumption that the historic trend between the mean and median holds in the recovery period. Measured against RPIJ inflation it suggests that wages will be little changed in the coming years. Using the CPI measure of inflation instead, wages rise, but slowly.

Not surprisingly, we see this disappointing story for wages feeding through to household incomes too.

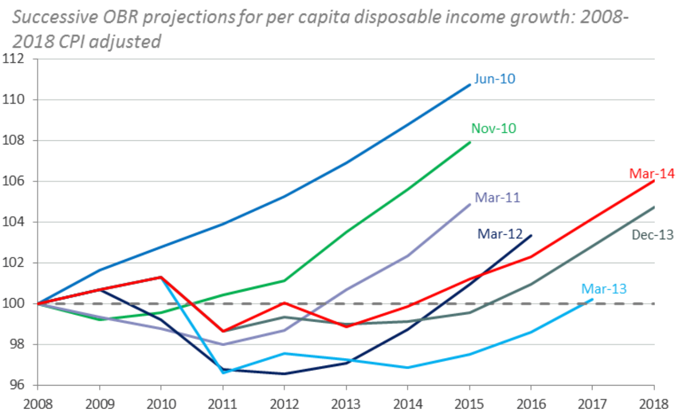
Figure 8 sets out successive OBR projections for per capita disposable income. It is worth noting that this is an imperfect measure in terms of capturing changes in living standards, because it represents all non-market, non-government income and therefore includes parts of the economy that do not reflect the position of households, such as the income of religious institutions and universities.

Figure 7: Projections for real median earnings growth: UK 1997-2018



Source: RF modelling based on OBR and ONS data

Figure 8: Selected OBR projections for per capita household income growth: UK 2008-2018



Source: OBR, *Economic and Fiscal Outlook*

Nevertheless, the comparison presented in Figure 8 is internally consistent, and shows the extent to which the OBR has downgraded its assessments for income growth over time. Prior to the implementation of fiscal consolidation, it forecast in its June 2010 outlook that household income would continue to grow year-on-year in real terms. In its November 2010 assessment it subsequently projected a brief period of stagnation in incomes followed by relatively rapid recovery. The latest projection suggests that per capita household income will pick-up from this year onward, but at a slower rate than previously projected.

The gap can be plugged in part by running down savings…

Despite the stagnation in incomes to date, private consumption has recovered strongly in 2013. As Figure 9 makes clear, growth in consumption has outpaced income growth since 2010, particularly so over the past 12 months. This mismatch suggests that households – buoyed by rising employment, growing confidence and (for some) rising house prices – are spending more in *anticipation* of an improvement in their financial situation.

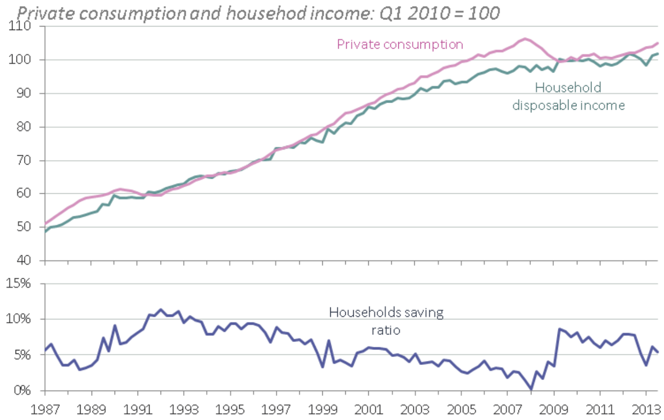
Plugging the gap in the meantime requires some combination of borrowing money and drawing down on savings. The saving ratio, which measures the gap between spending and incomes and therefore captures changes in both savings and debt, has therefore fallen: from a peak of 8.6 per cent in 2009, to 5.4 per cent in mid-2013 (with a brief spike related to income movements by a minority in reaction to the reduction of the 50p tax rate in April).

And it is set to fall further. As Figure 10 details, the OBR has consistently projected a reduction – natural during recovery as confidence returns – but the scale of the forecasted decline has tended to increase over time. In its latest outlook, the OBR projects a fall in the saving ratio to just 3.2 per cent by 2018.

Ultimately, reliance on a falling saving ratio must come to an end, but the work required to protect the ratio while still achieving projected levels of growth in the coming years is not insignificant.

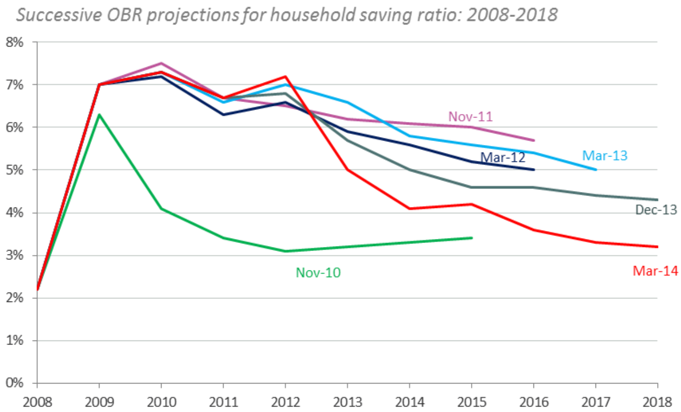
As a thought exercise, we can consider how much faster wages would have to increase if we were to hold the saving ratio constant, while allowing all other variables – including employment and overall growth – to move in line with OBR projections. Figure 11 shows that this would require average weekly wages to reach £529 in 2018, rather than the £510 projected by the OBR. This is an annual real-terms growth rate of 2.1 per cent – achievable by historic standards, yet some way higher than the OBR's figure of 1.4 per cent.

Figure 9: Indices of income and consumption and households saving ratio: 1987-2013



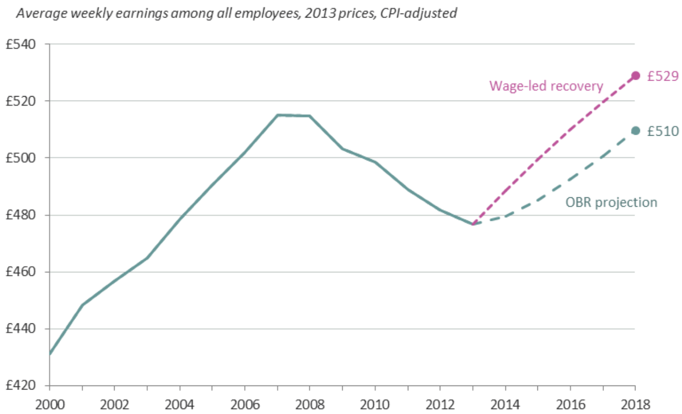
Source: ONS, *National Accounts*

Figure 10: Selected OBR projections for household saving ratio: UK 2008-2018



Source: OBR

Figure 11: A wage-led recovery scenario, holding the saving ratio constant: UK 2000-2018



Source: RF modelling based on OBR & ONS data

If we instead held wages in line with OBR projections and allowed employment to move, we would require an increase in the employment rate in 2018 from the OBR's figure of 59.9 per cent to 62.2 per cent. This is a level higher than any recorded since the 1970s.

And business investment can play its part in economic recovery too…

Despite a determination among politicians in the aftermath of the financial crisis to 'rebalance' the economy, reducing our reliance on consumer spending and boosting instead the roles played by investment and by trade, Figure 12 shows that there has been little change in the mix of contributors to overall output.

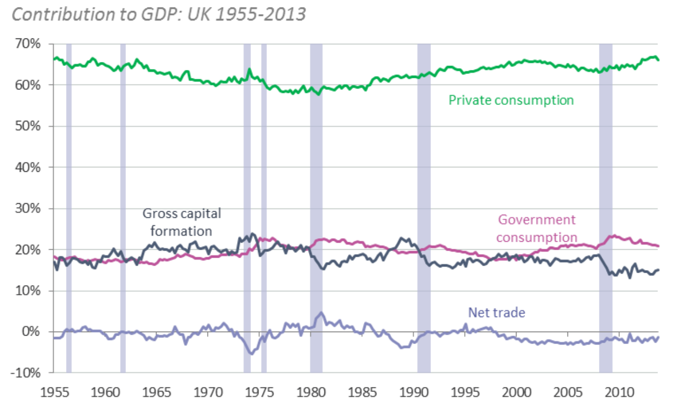
Indeed, the share of GDP accounted for by consumption has *increased* slightly since the downturn.

And, if we look in Figure 13 at the contributions made by each of these elements to *growth* in GDP (rather than just the stock) we see that consumption has consistently proved the driving force of recovery over the last two years.

However, gross capital formation (public and private sector capital spending) has made a positive contribution in the latest two quarters. Encouragingly, it contributed 1.2 per cent of the overall 2.7 per cent annual growth recorded in Q4 2013.

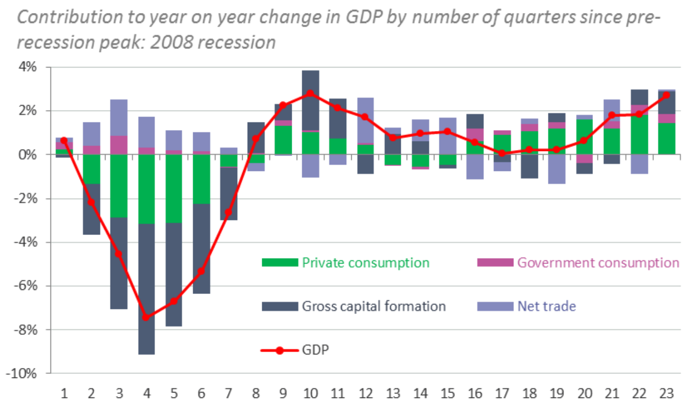
And, whereas for much of 2013 the overall capital formation figure reflected businesses stockpiling output rather than investing in new capital, Figure 14 shows that gross *fixed* capital formation (which is where business investment sits) was a significant positive contributor to growth in the final quarter of the year.

Figure 12: Contribution of expenditure components to GDP: UK 1955-2013



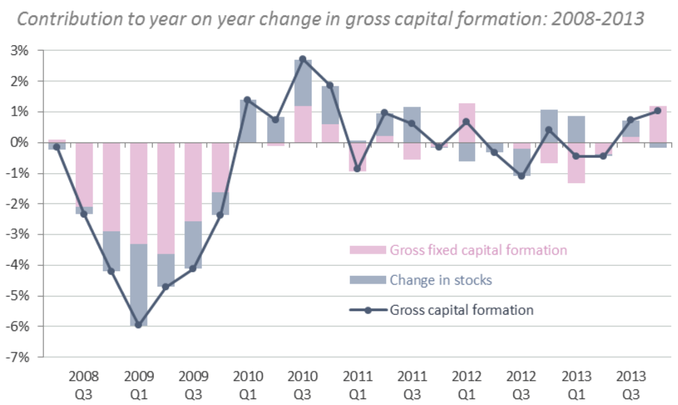
Source: ONS, *National Accounts*

Figure 13: Contribution of expenditure components to year-on-year growth in GDP: UK Q2 2008 – Q4 2013



Source: ONS, *National Accounts*

Figure 14: Contribution to year-on-year growth in gross capital formation: UK Q2 2008 – Q4 2013

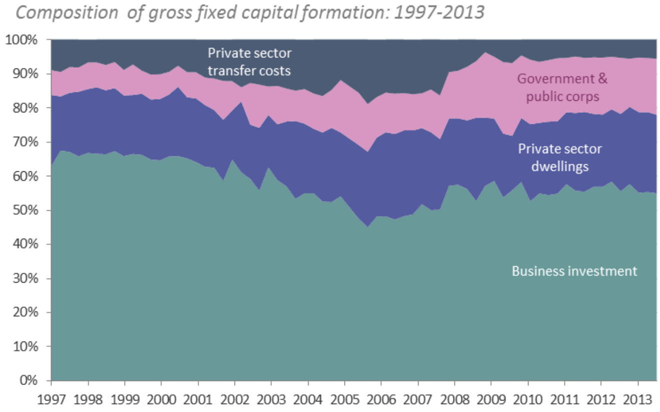


Source: ONS, *National Accounts*

Looking more closely at the gross fixed capital formation element however, Figure 15 shows that business investment accounts for around half of the total; a share that has declined over time.

Investment in private sector dwellings (including improvements to existing property as well as new dwellings) and government and public corporation investment have instead formed an increasing share of the total.

Figure 15: Contribution of investment components to gross fixed capital formation: UK Q2 2008 –Q4 2013



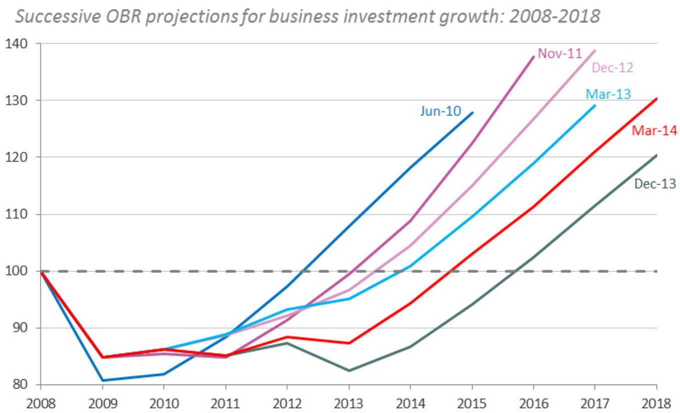
Source: ONS, *National Accounts*

Despite the pick-up in Q4 2013, annualised business investment remained 1.2 per cent down year-on-year. In contrast, annualised investment in private sector dwellings was 4.4 per cent up.

To the extent that capital formation has played its part in the recent improvement in the UK's economic fortunes then, it appears to have been driven until recently by a build-up of unsold stocks within firms and by developments in the housing market.

That's not to say that other forms of capital formation won't soon follow. The upturn at the end of 2013 and a range of positive indicators from business surveys – such as Markit's *new orders index* which records demand for new investment goods such as IT, plant and machinery and has recently grown at its fastest rate for 20 years – have contributed to a projection for business investment from the OBR that is improved relative to the December 2013 position. Again though, we've been here before as Figure 16 shows.

Figure 16: Selected OBR projections for business investment growth: UK 2008-2018



Source: OBR

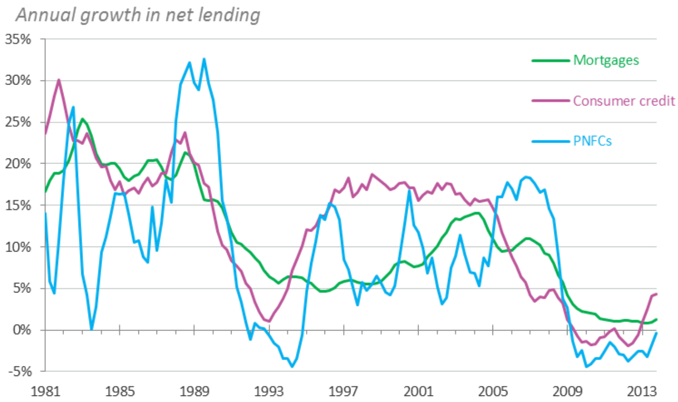
But borrowing to fund spending and investment remains subdued…

One of the factors believed to have held business investment back until now has been the lack of borrowing by private non-financial corporations (PNFCs).

As Figure 17 shows, net lending (in cash terms) to the sector has been falling year-on-year since 2009. That is, firms have been repaying more than they have been borrowing. The chart also highlights the relatively subdued level of lending to individuals.

While there is some evidence of a pick-up in unsecured borrowing over the course of 2013, growth in net mortgage lending remains flat and close to zero. The implication is that the decline in the saving ratio presented in Figure 9 has – to date – primarily been a function of households drawing down on existing savings, with some additional unsecured borrowing.

Figure 17: Annual growth in net lending to individuals and private non-financial corporations: UK 1981-2013



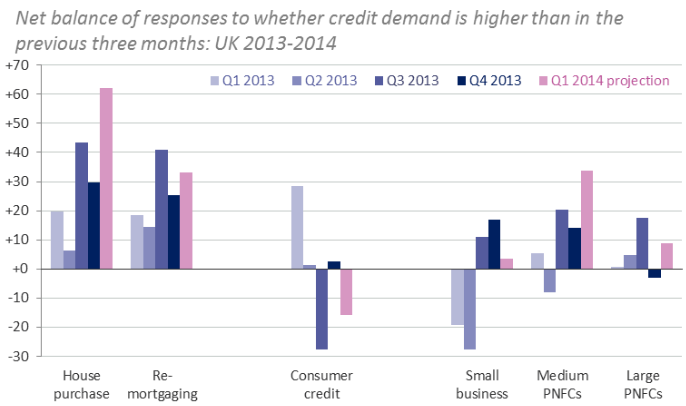
Source: Bank of England

Which owes as much to a lack of appetite as a restriction in access…

Of course, a large part of the drop-off in lending to firms and households in the immediate post-crisis period was associated with the closing of the credit taps. But supply has been improving steadily over recent months, alongside a growth in confidence and the introduction of schemes such as Funding for Lending and Help to Buy. As a result, spreads between the base rate and the rates charged to customers have narrowed significantly across all products, underwriting standards have been relaxed somewhat – with the re-emergence of mortgages with loan-to-values in excess of 90 per cent for example – and lenders are once again competing for market share. The lack of pick-up in borrowing set out in Figure 17 must therefore rest in part on a persistent lack of demand for credit.

But the picture is highly uncertain. Figure 18 shows the balance of lenders reporting an increase in demand for different types of credit over the course of 2013, along with expectations for the start of 2014. It suggests that demand for secured credit *has* been increasing, but that a majority of lenders are reporting a *decline* in demand for unsecured lending. Demand among companies appears to vary by firm size, but the trends are far from consistent.

Figure 18: Change in credit demand in different markets: UK 2013-1014



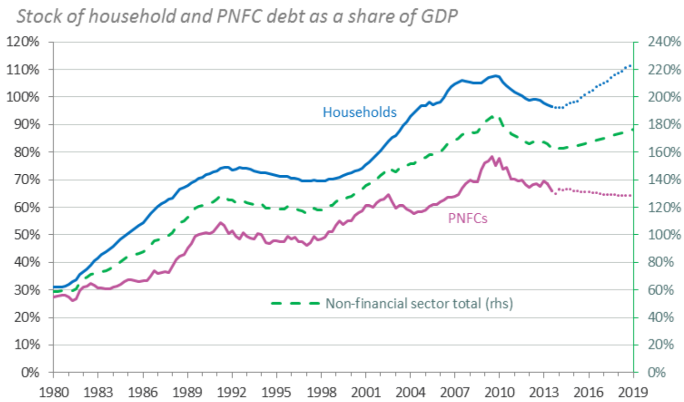
Source: Bank of England, *Credit Condition Survey*

And appears unlikely to accelerate in the same way it did before the financial crisis…

With access to credit easing and signs of an increase in the demand for funds – at least among some firms and individuals – we might expect the stock of debt to pick up over the course of the next few years.

In cash terms, that would fit with the OBR's projections for non-financial sector debt. But, as detailed in Figure 19, it does not expect such borrowing to accelerate beyond GDP in the way it did during the 1980s and 2000s.

Figure 19: Non-financial private sector debt-to-GDP ratios: UK 1980-2019



Source: Bank of England & OBR

Among households, its projections *do* imply an increase in borrowing that outpaces GDP growth, with the debt-to-GDP ratio reaching 112 per cent at the start of 2019 – higher than its 2010 peak level. In contrast however, borrowing among PNFCs is projected to rise more slowly than GDP. Taken together, these projections suggest that the overall debt-to-GDP ratio in the non-financial sector will rise to 176 per cent; up from its current level, but still below the 2009 peak of 186 per cent.

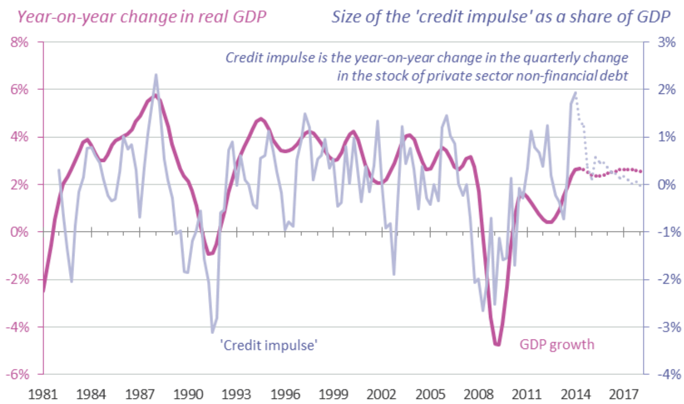
Raising questions about what level of growth is achievable absent another credit boom…

For some, this absence of accelerating credit growth goes a long way to explaining why the economy has lost its bounce. The argument goes that because GDP is a flow rather than a stock, generating growth in output (or, more accurately, private demand) requires not just growth in credit, but an acceleration in that growth – a 'credit impulse'.

As Figure 20 shows, the credit impulse in the UK has tended to track GDP growth relatively closely in recent decades, in line with the theory. That is, periods in which credit growth has accelerated have been associated with periods of GDP growth; while periods in which credit growth has slowed down have been associated with periods of falling GDP.

Both GDP growth and the credit impulse (as implied by the OBR's projections for borrowing) are set to be relatively flat for the next few years.

Figure 20: GDP growth and the 'credit impulse': UK 1981-2019

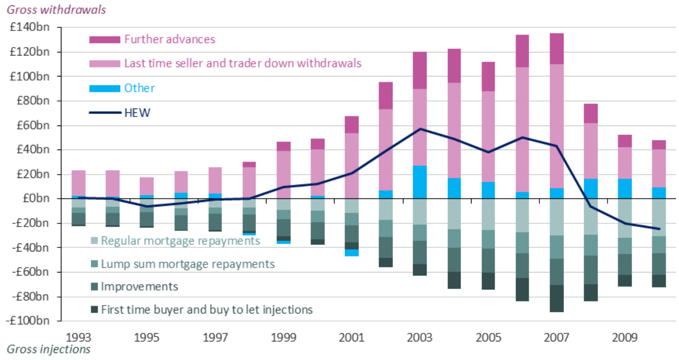


Source: Bank of England & OBR

The suggestion is that the sustained but unspectacular growth recorded not just in the UK but across developed economies in the pre-crisis 'Great Moderation' years was only achieved thanks to growth in private leverage, as evidenced by the lack of inflation associated with this period of credit expansion. Simply put, we couldn't have grown at the rate we did in the absence of the credit boom.

Figure 21 provides a potential example of the credit impulse at play, going some way to explaining the role played by access to mortgage credit in fuelling consumption in the pre-crisis years.

Figure 21: Housing equity withdrawal by type of injection and withdrawal: UK 1993-2010



Source: Bank of England

Between 1998 and 2007, net withdrawals of funds from the housing market grew from zero to around £50 billion a year. In large part this was driven by the realisation of equity gains associated with last-time sales and trading down – which are likely to have transferred directly into financial wealth in most instances – but a sizeable category of 'further advances' also contributed to the overall withdrawal.

While there is no record of what such advances were used for, the suspicion is that they played a large part in sustaining consumer spending even as wages stagnated during the final years of economic growth (as shown in Figure 7).

Potentially supporting claims for structural stagnation…

Reduce the headroom for credit growth – as we have done in our post-credit crunch and still highly-leveraged world – and we are faced with a new, lower trend rate of economic growth. And that way lies secular stagnation.

This raises a potential dilemma:

- Re-stoke private credit as a means of establishing a stronger trajectory for GDP and making up the lost economic ground of recent years and we risk returning to the financial instability that was ultimately at the core of the crisis of 2008.
- Accept that credit can no longer play the same role in our economic story and we face a new – lower – equilibrium rate of growth.

And straddling this dilemma is complicated by the potential for hysteresis: if we accept a lower short-term rate of growth in the face of the debt overhang, then we might eventually generate lower long-term growth potential.

Generating stronger growth rests first on dealing with the debt overhang…

The right balance is particularly difficult to find in the immediate aftermath of the financial crisis. Rather than reducing overall leverage since 2008, we have tended to shift it around sectors. Thus, falling private sector leverage in advanced economies has been offset by increases in public sector deficits and by a growth in private leverage in emerging markets. At some point though the music has to stop, and the debt overhang faced up to.

All potential policy responses involve uncomfortable trade-offs. It is right that automatic stabilisers and fiscal expansion were used as a means of moderating the fall-out from the financial crisis, but the inevitable period of fiscal austerity that has followed has had an obvious depressing impact on demand. And it is a long process, one that is set to define the political and economic landscape in the UK for at least another parliament.

Likewise the unconventional monetary policy of recent years, with interest rates in the UK sitting at an historic low of 0.5 per cent for five years now, is likely to have been a necessary reaction to the crisis. But it is one that buys breathing space rather than dealing directly with the leverage problem. In the absence of income growth, households are unable to take advantage of the window of opportunity created for them by paying down their debts, raising the prospect of repayment difficulties in years to come as interest rates start to normalise (though the Bank of England has indicated that 'normal' might be lower than we're used to in the coming years). Unlike the continued fiscal challenge, the political parties have so far been very quiet about how they might meet this monetary challenge after the next election.

With the overhang still very much in place, more radical policy options such as monetary financing of deficits – much talked about in 2008 and 2009 but seemingly taboo today – might return to the table, particularly when we consider the global nature of the overhang.

And secondly on tackling the causes and consequences of our reliance on credit…

Yet even if we are able to re-set the clock on debt, we will need to deal with the link between growth and credit if we are to avoid re-visiting the same problems over and again. Adair Turner has set out a number of potential ways forward – while accepting that none of them are easy – that range from tightening regulation of credit markets still further than has occurred since the crisis, to dealing with global current account imbalances.[1]

One of the most encouraging options relates to an ambition to influence the mix of debt held in the economy. While investment in residential and commercial property has its place, recent history suggests that we have directed too much finance towards existing assets, creating bubbles and instability. This raises the prospect that, by switching an increasing share of bank lending towards genuine business investment – using tools such as risk weights, tighter regulation and changes in

[1] A Turner, *Escaping the debt addiction: Monetary and macro-prudential policy in the post-crisis world*¸ Centre for Financial Studies, Frankfurt, 10 February 2014

tax incentives and barriers – we might simultaneously be able to live with a lower level of borrowing and generate more sustainable growth.

Alongside managing the allocation of credit, we can also try to reduce our reliance on debt by dealing with one of the key drivers of credit demand in recent years: namely income stagnation. Faced with earnings and incomes that flat-lined even as the economy (and house prices in particular) grew, the suspicion is that, rather than borrowing to smooth consumption over the life-cycle, many low and middle income households instead borrowed to plug a permanent gap between their actual and desired income.

Tackling this problem of income stagnation and seeking to Influencing the debt mix would clearly require a more interventionist approach than has been favoured in the UK in recent decades, but getting to grips with our reliance on credit is likely to form one of the key challenges of economic policy in the coming decades. The Chancellor's stated focus on helping the 'makers, doers and savers' in this week's Budget certainly has much to commend it, but the test of whether his latest initiatives produces true rebalancing or not is still to come. Given the scale of the potential dilemma facing us, it is likely to be a theme that future Chancellors find themselves grappling with again and again.

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