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How do they get out of this mess?

Chancellor George Osborne and, right, Chief Executive to the Treasury Danny Alexander

In an exclusive survey for *The Sunday Telegraph*, 25 top economists give their opinions on the way ahead. **Edmund Conway** reports

Put 10 different economists in a room and you'll get 11 different opinions. So goes the old adage and although they quibbled over details, there is one thing all the experts who we consulted agreed upon in the first major survey of UK economists since the creation of Britain's new coalition Government: Britain's economy is still perched in a perilous position.

Some fear deflation, others inflation. Some worry that the euro area may not survive another week, let alone the full five-year Parliamentary term. Some think the Government has done enough to fight the deficit and maintain credibility, others are less sure. But from reading the full responses to *The Sunday Telegraph*'s survey, which run to the size of a novella, there is no doubting how high the stakes are.

Nor is there any question about how fast the consensus has shifted. A few years ago, if someone suggested that the bigger chunk of City economists would be forecasting that the euro would break apart in the not-too-distant future, or that the budget deficit would remain well over the £100bn mark for years, or that many would want to ditch the Bank of England's inflation target, you would probably think them mad. But that is precisely where we are.

Old assumptions about how economies work and how they should be run have fallen apart in a way we have not seen since at least 1992 and perhaps since the 1930s. It is what makes a survey like this, which asks economists not only about their forecasts but also about political economy – the way Governments should run their economies – so important. In our 10 questions, we attempted to cover the main bases of where Britain stands today, what Chancellor George Osborne and his new Chief Secretary to the Treasury Danny Alexander should do at the emergency Budget later this month and how the coalition Government should remodel UK Plc in the wake of the financial crisis.

Reassuringly, there were more than 11 answers.

ECONOMIC GROWTH

One of the first things George Osborne did after becoming Chancellor was to hand over the Treasury's power to make economic forecasts for the Budget to the newly-created Office for Budget Responsibility. This body will be given independence to set the forecasts that underlie the Budget – as well as judging the Chancellor on his fiscal plans – the idea being that this would remove any suspicions that the Treasury is massaging its forecasts to make its plans look rosier than they ought.

As it happens, though, the consensus among the 25 economists involved in the *Telegraph* survey was that the Treasury was almost spot-on with its forecast for gross domestic product growth of 1-1.5pc this year: the survey's verdict was 1.3pc. However, the verdict next year was far less sanguine, with the independent experts anticipating 2.1pc growth – more than a percentage point below the Treasury's forecast of 3pc-3.5pc.

THE DEFICIT

Everyone agreed that public finances remain the Government's number one challenge. Most, apart from David Blanchflower, the former Monetary Policy Committee member who was among the first to warn of the scale of the economic crisis some years ago, approved of both the coalition Government and its plan to cut £6bn of public spending this year.

There was broad-based consensus, too, that deficit cuts should comprise mainly spending reductions rather than tax rises. Most supported the Government's avowed plan to do this with £4 worth of spending cuts for every pound of tax raised, with a few exceptions. Doug McWilliams of the Centre for Economics and Business Research thought that every pound of deficit reduction should be through public spending cuts – intriguing, given that his institution was among the first to coin the 80-20 maxim, having studied previous episodes of spending cuts. He was joined by Tim Congdon of International Monetary Research, Stephen Lewis of Monument Securities and Peter Warburton of Economic Perspectives.

In the end, this all may be wishful thinking. As Vicky Redwood of Capital Economics pointed out, "achieving large spending cuts will be difficult – meaning that more of the adjustment will come about through tax rises than would ideally occur." Indeed, back in the early to mid-1990s, the Conservatives pledged to focus on spending cuts to reduce the deficit. In the event, Ken Clarke, then Chancellor, achieved only a 1:1 ratio of spending cuts to tax rises.

In general terms, the economists were also relatively warm towards the new coalition. Malcolm Barr of JP Morgan summed it up: "The nature of the coalition is what is demonstrative here, rather than any specific action they have taken. The fact that they chose to form the coalition was because there was a commitment across both sides to deal with the deficit, and a recognition that it would be a multi-year process."

Others are less sure. Tim Congdon of International Monetary Research said he is still unconvinced about their determination to reduce the deficit, while Andrew Lilico, Policy Exchange's chief economist, said: "I will not consider them serious until they abandon the pledge to ring-fence the NHS. It is impossible to achieve the spending cuts needed whilst maintaining the NHS pledge without imposing appalling cuts in the levels of benefits that would result in misery for many people in genuine need."

> Old assumptions about how economies work and how they should be run have fallen apart

The issue of how to cut back the welfare state echoed throughout the responses to the survey. All the statistics and studies suggest that Britain's welfare state is fast becoming unaffordable. Gerard Lyons, chief economist at Standard Chartered, said: "The benefits system needs an overhaul of draconian proportions. Money needs to be allocated to areas that benefit the economy, particularly the hard infrastructure, such as roads and rail, and the soft infrastructure that boosts skills, such as apprenticeships and sufficient university places."

The problem is that these tough questions are likely to cause ruptures in the already fragile coalition. Both the Conservatives and Liberal Democrats agree in theory that swingeing cuts are necessary. They differ significantly on how to achieve them. Howard Archer of IHS Global Insight pointed out that there are already "signs of serious tensions emerging over hiking capital gains tax" that shows "just how difficult it will be to take the extended major strong action required to bring the deficit down to a sustainable level".

INFLATION AND DEFLATION

Something strange is happening to British inflation. Charlie Bean, the Bank of England's deputy governor, summed it up earlier this week: while Europe and the US face the phenomena of falling or stagnant prices, Britain has seen inflation (at least measured by the Retail Price Index) hit the highest level in 18 years. Some of this can be put down to the weakness of the pound, but not all. There are suspicions that Britain has an inflation problem and some fear that if prices are not brought under control soon, the spiral could become self-propelled, with employees demanding higher salaries and pushing inflation still higher. Indeed, of the 25 economists surveyed, 11 felt inflation was the biggest risk to the economy over the next five years, outnumbering the nine who thought deflation posed a greater threat.

There was a similar disparity between those who expected the Bank of England to raise interest rates imminently and those who thought it would wait far longer. Intriguingly, just as many thought that the Bank would delay any rate increase (or reversal of quantitative easing) until 2012 or beyond as thought that it would raise the cost of borrowing this year. There was even one economist (Andrew Lilico) who expected the Bank to loosen policy even further, with another £200bn bout of quantitative easing in the coming years, but to combine that with an increase in interest rates to 2pc. His suspicion is that this will trigger a period of high inflation that will, by late 2012, necessitate interest rates of up to 10pc. Terrifying indeed.

In such circumstances, and with so much insecurity over inflation, it isn't surprising that the majority of economists advocated maintaining the Bank's 2pc inflation target. Though most owned up to reservations with the target, which is seen by many as inflexible and inadequate, there was a general feeling that merely to fiddle with it would undermine faith in the Bank's inflation-bashing image, which would, in turn, trigger a price increase. As Ross Walker of RBS said, "I don't think there is any need to alter the target – indeed, to do so might encourage misplaced concerns that this is a back-door attempt to inflate our way out of debt."

His comments were echoed by Philip Shaw of Investec, who concluded: "Credibility is everything at the moment."

However, Neil Mellor of Bank of New York Mellon advocated a change, saying that the Consumer Price Index, the measure targeted by the Bank, "fails to properly reflect movements in property and asset prices and was as much a part of the recent boom/bust as it was for Japan in 1990... A looser mandate akin to the Fed's should be adopted and statisticians should concoct an index that does greater justice to the swings in non goods and services prices."

Malcolm Barr of JP Morgan said that this debate misses the point and represented "the worst tokenism", adding: "People are trying to deal with a big issue by fiddling at its edges. You should keep the CPI as it is and say we'll deal with the asset prices separately. I'm very sympathetic to what Adam Posen [a member of the Monetary Policy Committee] says, which is that you need to use the tax system to tackle asset prices and credit growth."

Jamie Dannhauser of Lombard Street Research said that ultimately the Bank should target nominal GDP growth – in other words, growth plus inflation.

THE EURO

Britain may not be a member of the single currency, but given that the area is the UK's biggest trading partner, our economic health is inextricably linked to the currency's fate. And perhaps the most remarkable finding was that more of the economists expected a euro break-up of greater or lesser proportions during the next Parliamentary term.

This is a massive turnaround, given that few would countenance such a prospect even a few months ago. Former Bank of England policymaker Danny Blanchflower said it was "hard to see the euro surviving in its current form", adding: "The political implications are likely to be far reaching – Germans are opposed to paying for others and may well quit. Citizens in countries like Ireland are paying more per capita for the package. Greece may well not be able to avert a default."

David Owen of Jefferies put a 35pc probability of a euro break-up, but said its survival would likely come at the cost of a default by one of its member states. Peter Warburton of Economic Perspectives said that in five years' time the euro would be "a refuge of the weak, not a fortress of the strong", with Germany possibly leaving the area and other central European nations joining. Doug McWilliams of the CEBR said: "It may not even survive the next week."

> Britain may not be a member of the single currency, but our health is linked to its fate

Gerard Lyons of Standard Chartered said he anticipated a "two-speed euro": "No one country may want to leave the euro by itself, but I would expect that – after two years of recession bordering on depression – the countries in difficulty may collectively decide that it is better to be outside than inside and the loss of face from leaving may be mitigated by the fact that there may be a group of them."

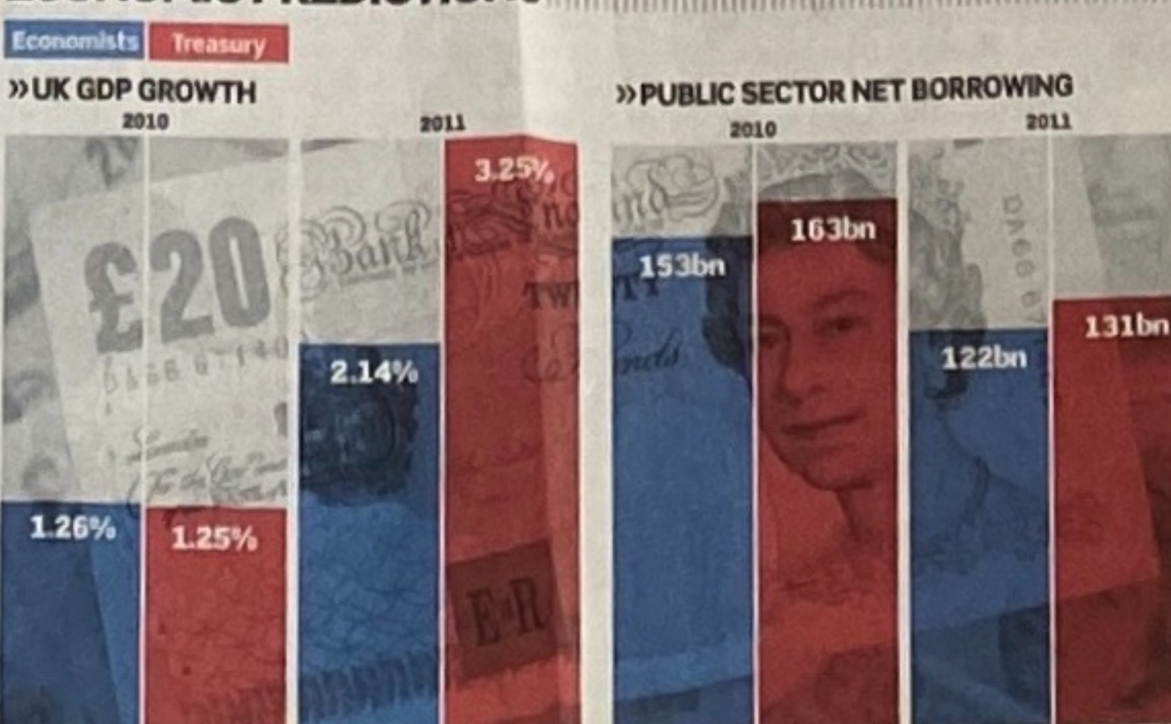
Those who predicted that the euro would survive said this was based more on political than economic considerations. Not promising in the slightest for those (including the Liberal Democrats) who have always supported the plan for a single European currency.

● *The survey was carried out over the past week. The full responses will be posted online at telegraph.co.uk on Monday*

THE ECONOMISTS WHO RESPONDED

Alan Clarke *BNP Paribas*
Andrew Lilico *Policy Exchange*
Howard Archer *IHS Global Insight*
Douglas McWilliams *CEBR*
Ross Walker *RBS*
George Magnus *UBS*
Gerard Lyons *Standard Chartered*
Martin Gahbauer *Nationwide*
Simon Hayes *Barclays Capital*
Neil Mellor *BNY Mellon*
Stephen Lewis *Monument Securities*
David Blanchflower *Dartmouth College*
George Buckley *Deutsche Bank*
Malcolm Barr *JP Morgan*
Ian Harwood *Evolution Securities*
Simon Ward *Henderson Global Investors*
David Owen *Jefferies*
Philip Shaw *Investec*
Stuart Green *HSBC*
Vicky Redwood *Capital Economics*
Peter Spencer *Ernst & Young Item Club*
Tim Congdon *International Monetary Research*
Peter Warburton *Economic Perspectives*
Jamie Dannhauser *Lombard Street Research.*
Azad Zangana *Schroders Investment Management*

ECONOMIC PREDICTIONS



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