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The UK needs less nostalgia for its imperial history – and just get on with it

If Mexico's 1994 downturn became known as the Tequila Crisis, should the UK's 2022 omnishambles be called the Gin Crisis?

Jay Newman and Richard McNeil 12 HOURS AGO

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The UK isn't a banana republic, yet, but whether the nation, the pound and gilts retain their historic stature or whether it becomes just another dicey, badly-managed, and fiscally-irresponsible country hangs in the balance.

Followers of the emerging markets will remember the late Rudi Dornbusch — a keen and trenchant observer of what works and what doesn't when it comes to managing sovereign finances. Since the 1970s we have seen a series of what might be called "Dornbusch moments."

As a country issues more debt than it can afford to repay, at some point markets get jittery. Debt prices crash, the currency goes into free fall, and, even though interest rates spike, nobody seems willing to lend to the sovereign at any price, except, eventually, the IMF — and then, only with strict conditionality.

Few of today's market participants will recall that, in 1976, hard on the heels of Dornbusch's seminal work, *Expectations and Exchange Rate Dynamics*, the UK turned to the IMF for a bailout. At the time, this was not a huge surprise.

As Richard Roberts wrote in *When Britain Went Bust*, the UK was the biggest user of IMF funding from the mid-1940s through the mid-1970s, after exiting second world war with large debts and an uncompetitive exchange rate. Still, in light of recent developments, prime minister Rishi Sunak might well reflect on his predecessor James Callaghan's frank admission at the 1976 Labour conference in Blackpool:

> "We used to think that you could spend your way out of a recession, and increase employment by cutting taxes and boosting Government spending. I tell you in all candour that option no longer exists, and that insofar as it ever did exist, it only worked on each occasion since the war by injecting a bigger dose of inflation into the economy, followed by a higher level of unemployment as the next step."

In the years since 1976, policymakers have been reminded repeatedly and painfully of the speed with which financial markets abandon their infatuation with countries whose accounts are unbalanced.

Unfortunately, unlike in 1976, the IMF is no longer a stalwart guarantor of predictability and confidence in its clients' policymaking. For example, the big lesson from the recent debacles in Greece and Argentina is that, in the face of massive borrowing without a strong plan and political will, even an official lender of last resort can only postpone disaster.

But debt and currency crises can be managed successfully. Here's where the first lesson for the UK from emerging markets kicks in.

Against long odds, Mexico's handling of the so-called Tequila Crisis in 1994 was a standout success. Mexico had allowed its current account deficit to grow unsustainably following the rapid inflows of foreign capital associated with successful privatisations. When the Fed began to tighten in 1994, Mexico found itself trapped in the "impossible trinity" of a managed exchange rate, a free capital account, and an independent monetary policy. In the run-up to presidential elections, Mexico haemorrhaged international reserves, and, eventually, was forced to devalue.

In its plan for recovery, announced in March 1995, Mexico committed to a free float, tightened monetary policy, trimmed spending, increased the VAT by 50 per cent, and raised fuel taxes, aiming to increase the fiscal surplus by over 2 per cent of GDP.

Minimum wage increases were set at 18%, per cent, considerably below projected inflation of 42 per cent. In the short run, those were extremely painful measures, but they restored market confidence in Mexico's policymaking. Perhaps most importantly: Mexico capitalised on Nafta, which enabled extremely rapid and sustained growth in exports.

Those who foresee tough times ahead for the UK are right to worry. It's easy to blame Liz Truss' missteps, but it is worth bearing in mind that in contesting the party's leadership, she and Sunak presented clearly different policymaking approaches, and the Tories *chose* her so-called growth plan. Sunak is Prime Minister today because of revulsion in the markets in response to the "mini" budget. It remains to be seen how many minds actually have been changed by the events of the last month.

There have been massive changes in the structure of the British economy since second world war, and in particular since the mid-1970s. The UK has deindustrialised, an ever-greater share of its economic output has become linked to a London-centric financial services industry that already had begun to suffer from Brexit — even before these recent developments. Trade imbalances have become chronic, demographics are a challenge, and expanded energy production has been stymied by the political process, even though the UK is an island of coal and shale gas surrounded by a sea of hydrocarbons.

To make matters worse, unlike Mexico joining Nafta in the 1990s, the UK has withdrawn from the EU — the largest, most valuable free-trade zone on earth. Viewed in hindsight, the assertions of "Brexiters" like Boris Johnson that any fall-off in EU trade would be recouped via trade with the British Commonwealth seem, at best, quaint, or, more apt, an early sighting of the "moron risk premium".

But the lessons from Mexico's macroeconomic performance over the past 25 years are real.

First off, Mexico accepted that it could not regain policymaking credibility through mere rhetoric, that it could not control terms of trade, and that access to free trade with the world's largest trading partners was its surest avenue to economic growth. Mexican policymakers figured out where it could be competitive, actively courted investment in those sectors, and have since avoided allowing its fiscal situation to get out of hand. Of course, Mexico has its own multitude of problems. But it's striking how financially disciplined it has remained. Even in the wake of Covid-19, Mexican accounts have remained, relatively, in decent shape.

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The UK has enormous strengths and massive societal infrastructure, even if it has recently failed to capitalise on them: a centuries-old commitment to the rule of law and property rights, a sophisticated (if sometimes weak-kneed) central bank, first-rate financial and educational institutions, enormous human capital, and a deep cultural affinity for trade and finance. But, dogged by hostility to immigration, and a stifling regulatory regime — particularly as applied to the housing and energy sectors — productivity has languished.

The UK needs less nostalgia for its imperial history; and more deliberate policies aimed at becoming a beacon for global talent, incentivising entrepreneurs, broadening the base of economic activity, chainsawing red tape, significant investments in energy production, trading with the widest possible group of partners (including the EU) and, of course, swift, steady and disciplined fiscal management.

Politicians in the US repeat an epigram, often attributed to Churchill, that one can count on Americans to do the right thing, after they have exhausted all other possibilities. They usually mean to describe the untidiness of democratic and legislative processes, and to reassert their faith that those processes ultimately yield the best outcomes for society. The stakes are high for the UK; it's time to follow the Mexican example and just get on with it.