Deficit reduction is important, but it's not the end of the story. If we are to achieve real long term growth, government must come up with creative solutions to overcome the institutional and productive constraints on the economy.

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An obsession with deficit reduction has diverted attention away from the need to revamp the UK's industrial base. **Steve Coulter** *argues that the coalition government has belatedly turned its attention towards industrial policy with its 'growth review'; but there is little sign so far of effective and novel policies. Tomorrow's Autumn Statement will flag up lower growth and higher borrowing – what it also needed is action to indicate a way out of the UK economy's malaise.*

This week's Autumn Statement will be quite a contrast to the one delivered last year by Chancellor George Osborne. Then, barely pausing for breath, the newly minted coalition had already held an Emergency Budget and Spending Review. These set out a £98billion fiscal squeeze by 2015-16 – one of the tightest anywhere in the developed world, according to the IMF.

The plan was for this squeeze to be offset by an export and consumer boom, the latter fostered by ultra-low interest rates set by an obliging Bank of England. But what are the chances of this happening? And if, as now looks likely, the plan is going awry, what remains in the policy locker to pull the economy out of intensive care? We will learn more about this on Tuesday afternoon, but questions will remain.

Several things can nevertheless be predicted with some certainty. First, the Office for Budgetary Responsibility (OBR), the fiscal watchdog set up to lend some much needed credibility to official forecasts, will sharply downgrade its GDP growth projections for the second time in 12 months, probably to a little above 1% in both 2012 and 2013.

It's a sure bet that the growth downgrade will be blamed on the chilling effect of the eurozone debt crisis, but this is not entirely convincing. While eurozone bond yield spreads widened at around the same time as UK GDP slowed sharply in late 2010, the main driver of the slowdown is more likely to have been the cumulative effect of the three-year squeeze on UK households' real take-home pay, as recent Bank of England Inflation Reports have indicated. The OBR itself has suggested that the fiscal tightening which got underway at about the same time will depress GDP by 1% of GDP this year.

Second, OBR projections for borrowing and debt will surely be revised upwards in response to weakening growth. Although borrowing is currently on course to undershoot the March Budget projection of £122billion for 2011-12, recent monthly OBR public finance bulletins show the first signs of a collapse in tax revenues as rising unemployment and lower economic activity make their mark. The Labour Party points to independent forecasts implying a £108billion borrowing overshoot by 2014-15.

Of course, thanks to the flexibility built into the government's 'fiscal mandates', the OBR is likely to again declare that progress towards meeting these are just about on track – but it's certainly getting tighter. Of greater significance, but apt to be glossed over, is the likelihood that the OBR may lower its estimate of the output gap, implying that a greater proportion of the deficit is structural not cyclical and so won't disappear when the economy recovers. This would entail a further tightening being required to ensure the fiscal mandates continue to be on course to being met over the forecast period.

Equally important, it would also ramp up pressure on the government to come up with a convincing plan to repair the damage done to the economy's productive potential by the recession, something it has largely failed to do so far. Osborne, will obviously try to balance the gloom and embarrassment surrounding the forecasts by revving up his 'growth review', details of which will form the second part of the Autumn Statement.

The widely-trailed plan to increase bank lending to small and medium firms through government backing of private sector bonds has great merit, according to a recent post by Charles Goodhart and Jonathan Ashworth. Adam Posen, in another post, has also suggested institutionalising this process by creating a public bank to lend to SMEs. Either method could rectify the glaring drawbacks of the voluntary 'Project

Merlin' agreement with the major banks. Extra help for house-buyers and supercharging moribund infrastructure projects could also deliver a boost to the economy.

But this all feels like too little, too late. Fundamentally, the government lacks a long-term plan for growth and shows little appreciation of the institutional and productive constraints on the UKeconomy. As was argued in a recent post on this blog*: 'A problem with the obsession over fiscal consolidation is that insufficient attention has been given to the problem of longer term growth.'*

To be fair, peppered among recent government statements on the economy is a genuine admiration for 'Modell Deutschland', particularly the medium-size, family-owned manufacturing firms which power Germany's exporting prowess. Ministers seem keen to emulate this, but look set to learn the wrong lessons.

To take one example, around £1.5billion is being ploughed into apprenticeships to address glaring deficiencies in workplace training, but little thinking has been done on the skills they are meant to foster and the employment destinations of those doing them. German technical training is firm-led and overseen by networks of employer's associations. As these are closely involved in negotiating industry-wide skill categories and training protocols, the system ensures that vocational training meets firms' needs by keeping training programmes' content up-to-date. German employer's associations are absolutely pivotal in this system, yet they have noUKequivalent – the Local Enterprise Partnerships being set up are underfunded and lack real strategic oversight. Ultimately, policymakers are ducking hard choices about whether theUKshould continue being a service-led economy with a few niche sectors of hi-tech manufacturing, or if the future lies in hoisting more of its industrial base up the value chain to seize a larger share of the medium hi-tech markets dominated by the Germans.

Budgetary restraints mean the government has little money to throw around. But the institutional reform that is required to foster industrial upgrading does not require big spending. More attention to things like reform of product market competition, better mechanisms for technology transfer between universities and industry, and changes to corporate governance regimes to curb short-termism could transform theUK's industrial base relatively cheaply. Moreover, there is no reason why creative solutions to these issues cannot be gestated in government alongside the hard graft of deficit reduction. Deficit reduction is important, but it's not the end of the story.

Steve Coulter addressed some of the issues discussed in this blog in a recent paper for the Social Market Foundation: 'Manufacturing Prosperity'.