UK Monetary and Fiscal Policy: Is Austerity Working?

Comments on Allsopp Presentation

Nomura Conference at Brookings

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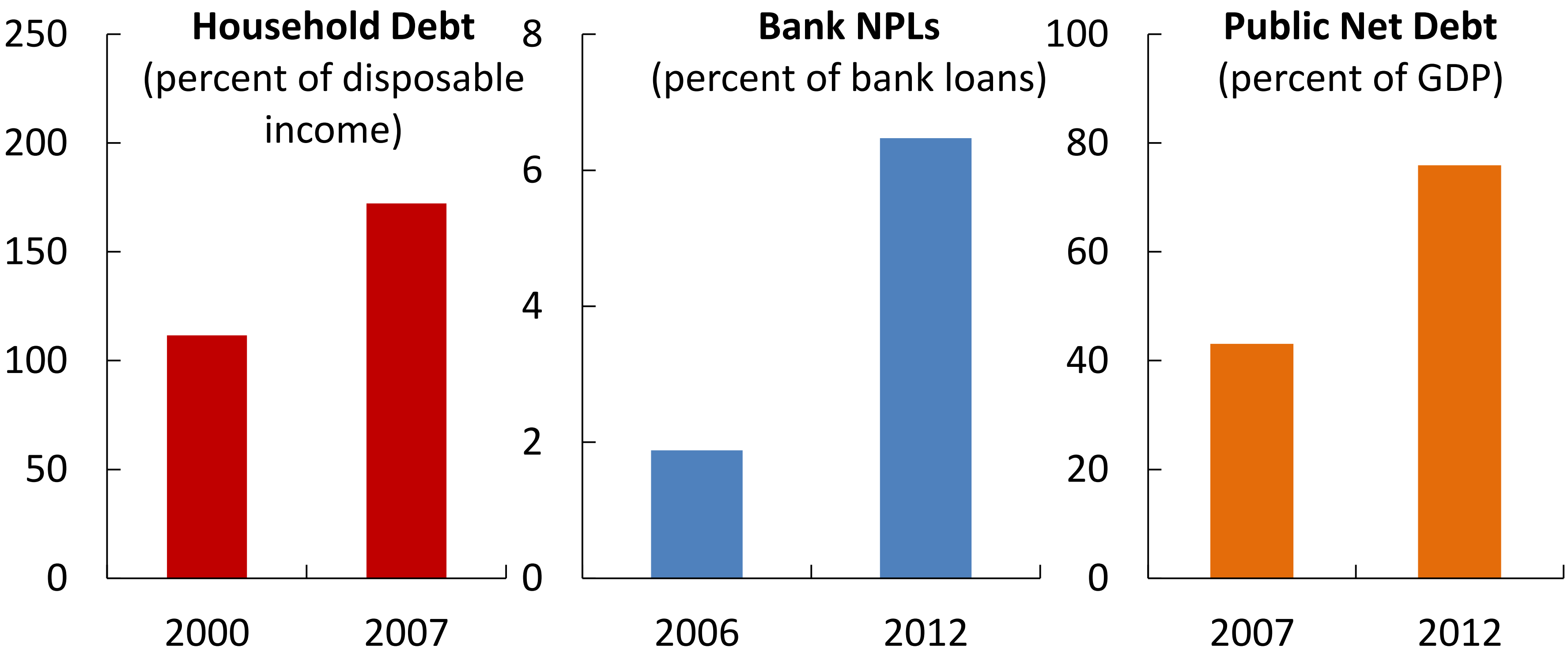
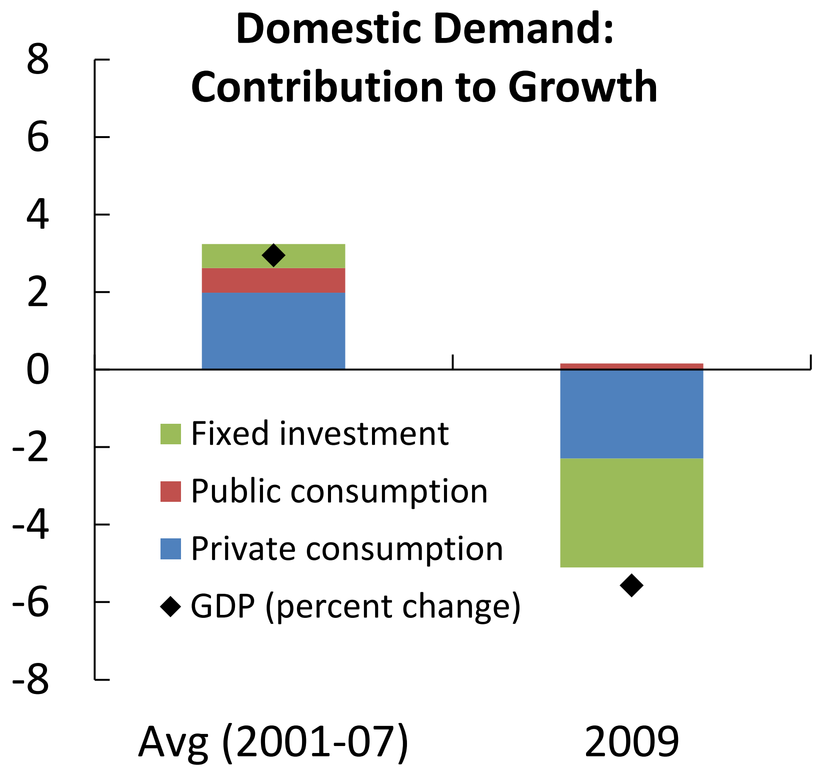
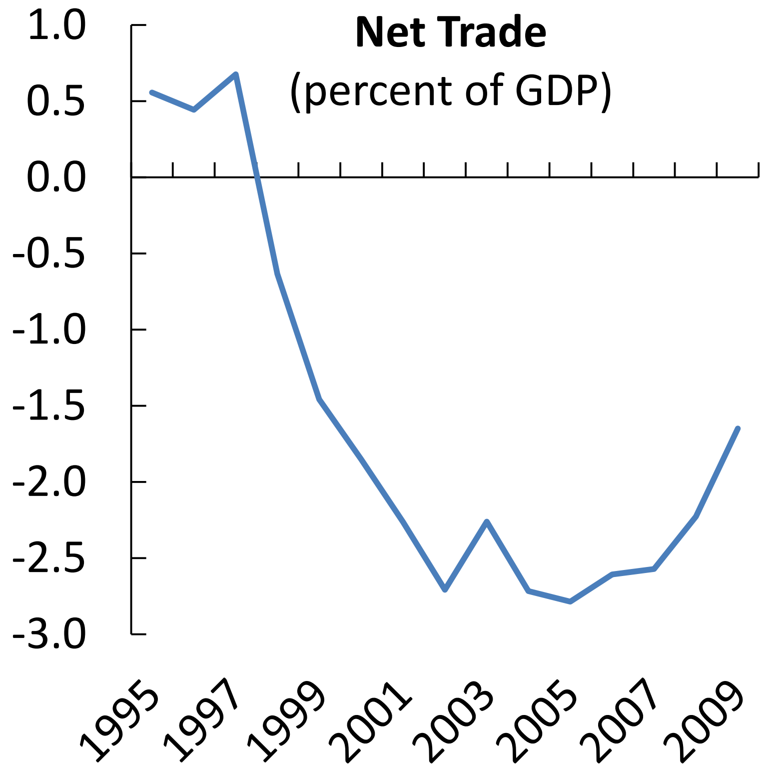
Background I: A balance sheet recession



Households overly indebted, banks with impaired balance sheets, and deterioration in public finances

Background II: The need for rebalancing





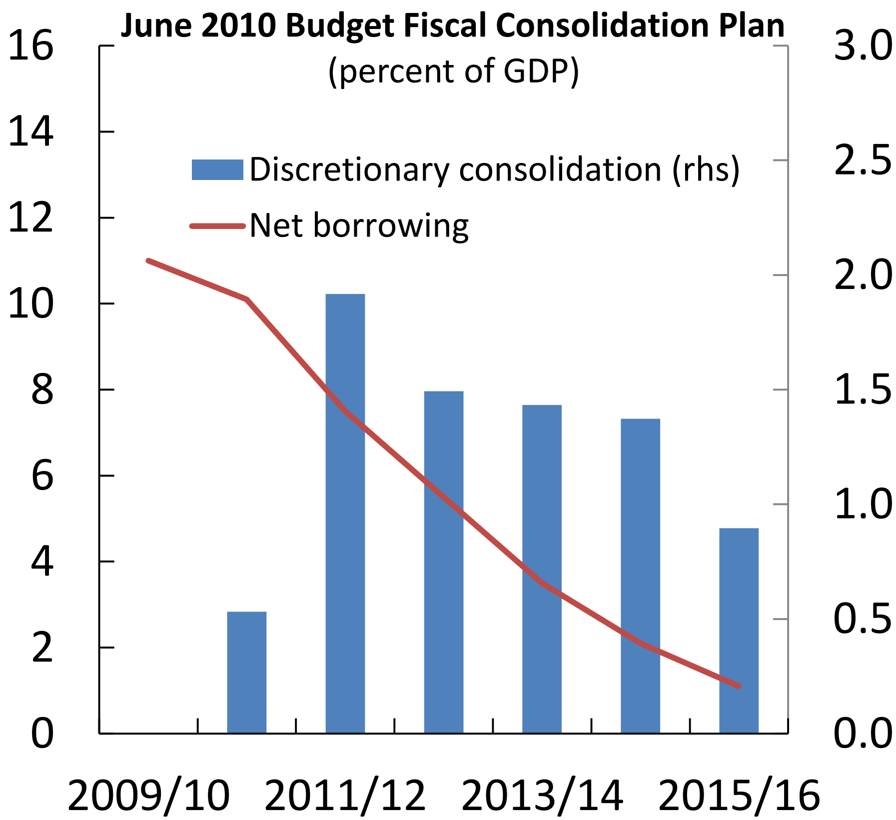
Dual rebalancing required:

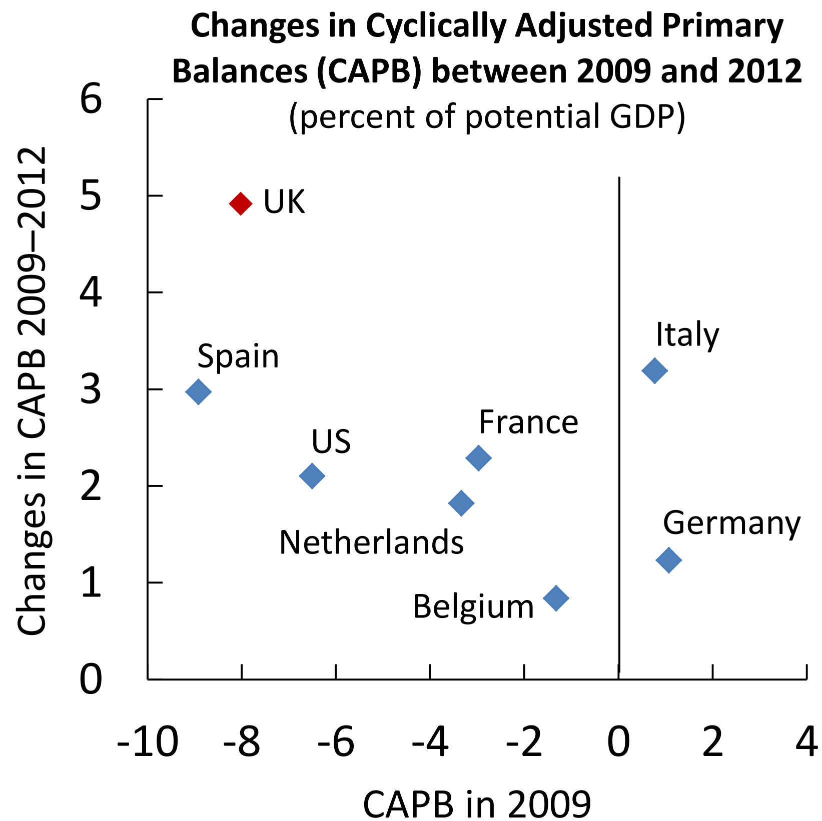
- handover from public to private demand
- higher investment and net exports

Standard Prescription: Tight fiscal, easy monetary

- Tight fiscal and easy monetary would crowd in private demand; added benefit from depreciation to stimulate net exports
- But at ZLB this prescription is problematic—rate cuts insufficient to support demand

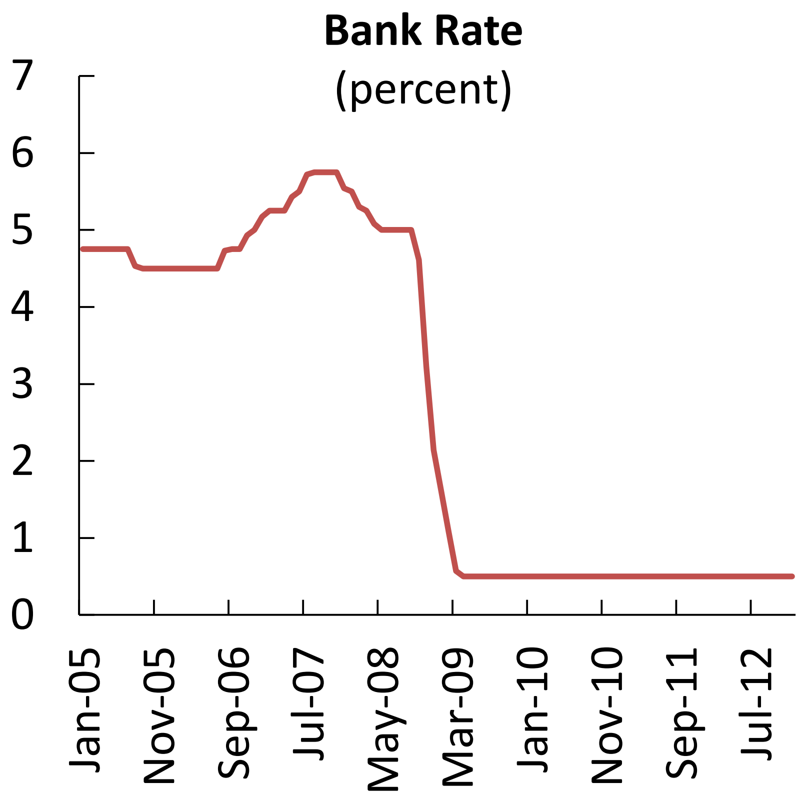
What has the fiscal policy response been?

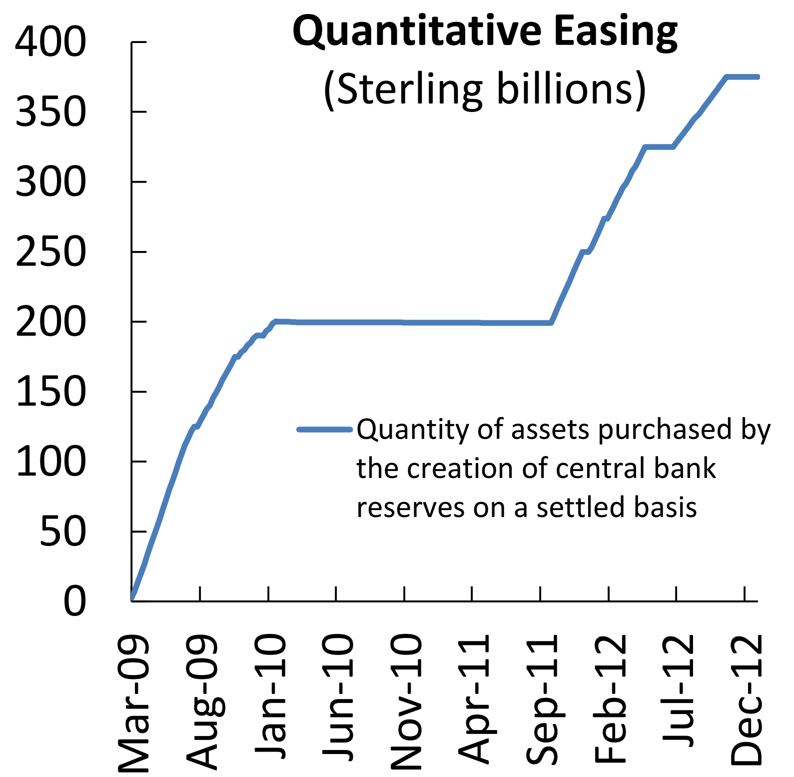




Frontloaded fiscal consolidation plans—among tightest in advanced economies

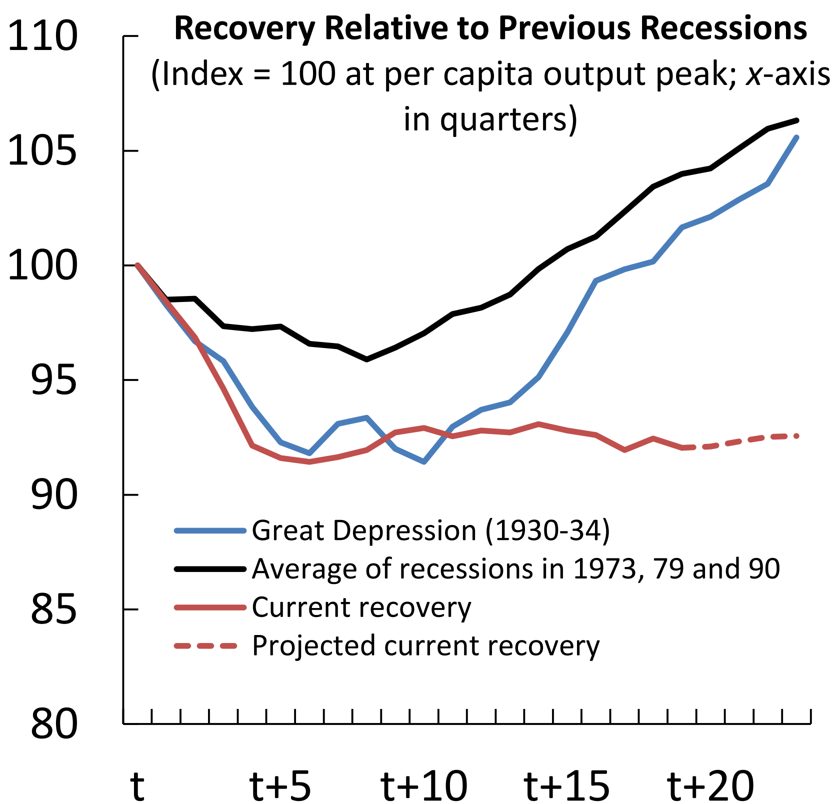
What has the monetary policy response been?

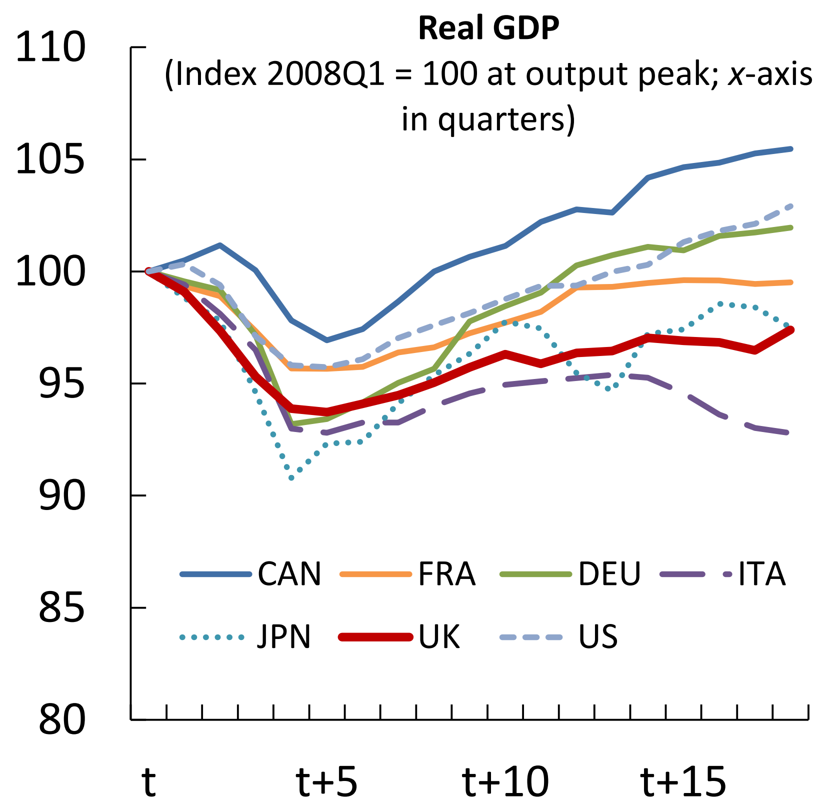




- Policy rate cut quickly, and asset purchases from 2009
- Also, Funding for Lending Scheme (2012), formal forward guidance (2013)

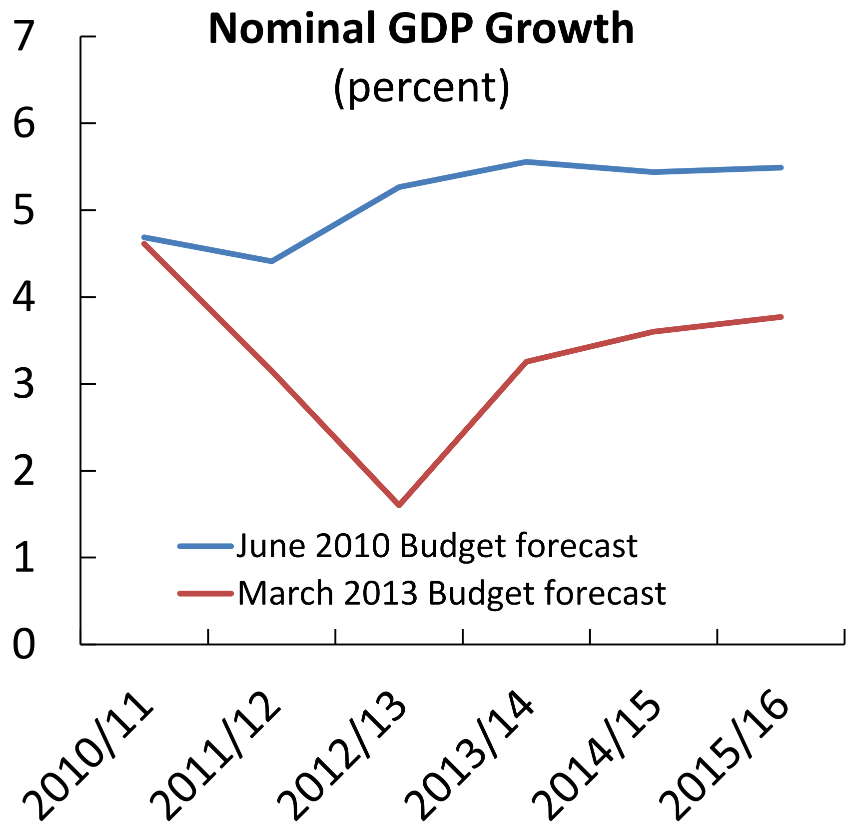
How has the economy responded?

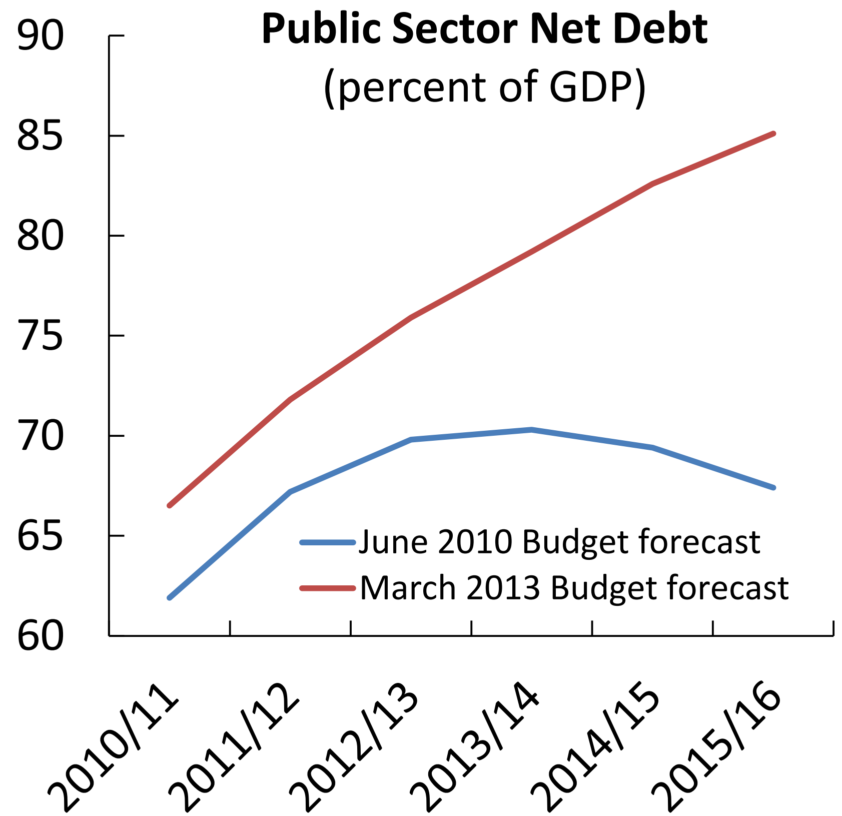




- UK recovery weak relative to previous recessions and other economies
- Level of output still substantially below pre-crisis peak, even with recent stronger growth

Consequences for public finances



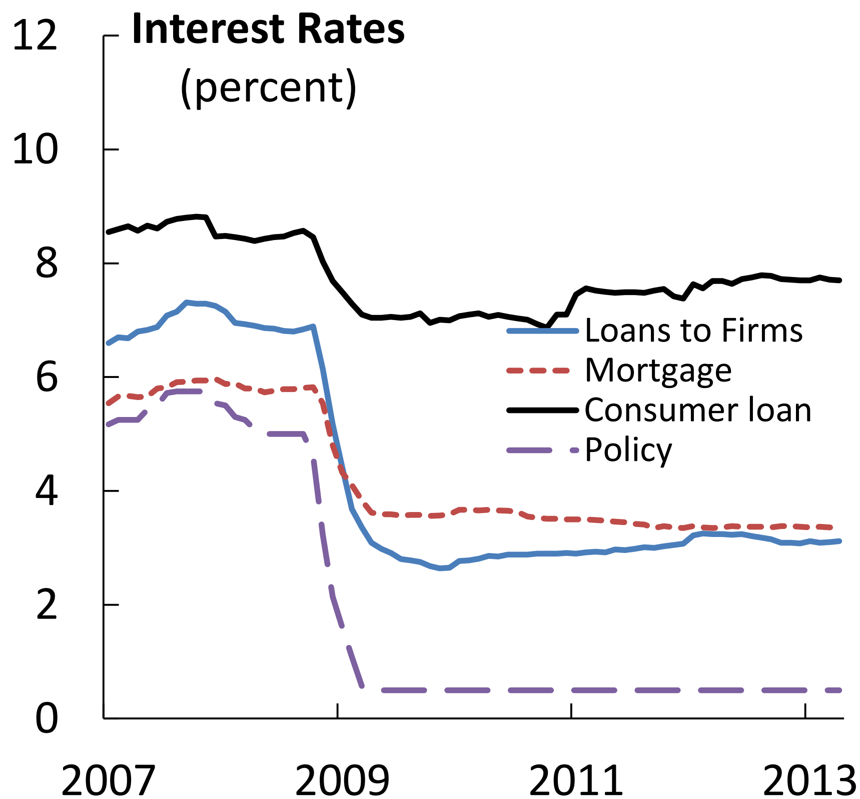


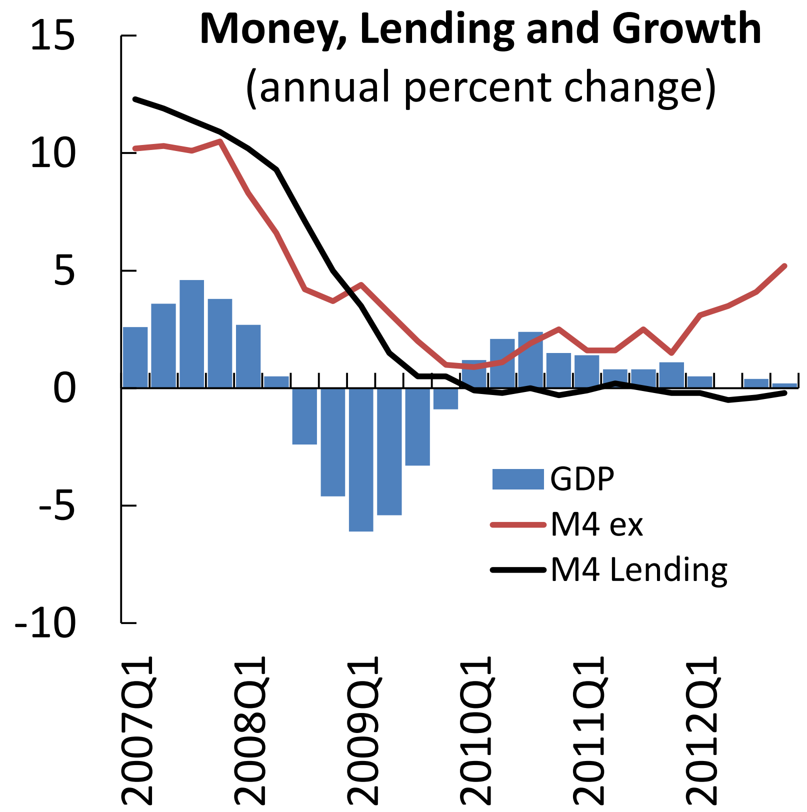
- Nominal growth well below authorities' forecasts
- Debt and deficit reduction much slower than anticipated

Explanatory factors for weak growth

1. Net trade: weak demand from euro area; competitiveness issues
2. Sectoral factors: decline of financial services; North Sea oil production
3. **Monetary transmission: impaired credit creation because of bank weakness**
4. **Fiscal: impact of fiscal consolidation itself**

Weak monetary policy transmission

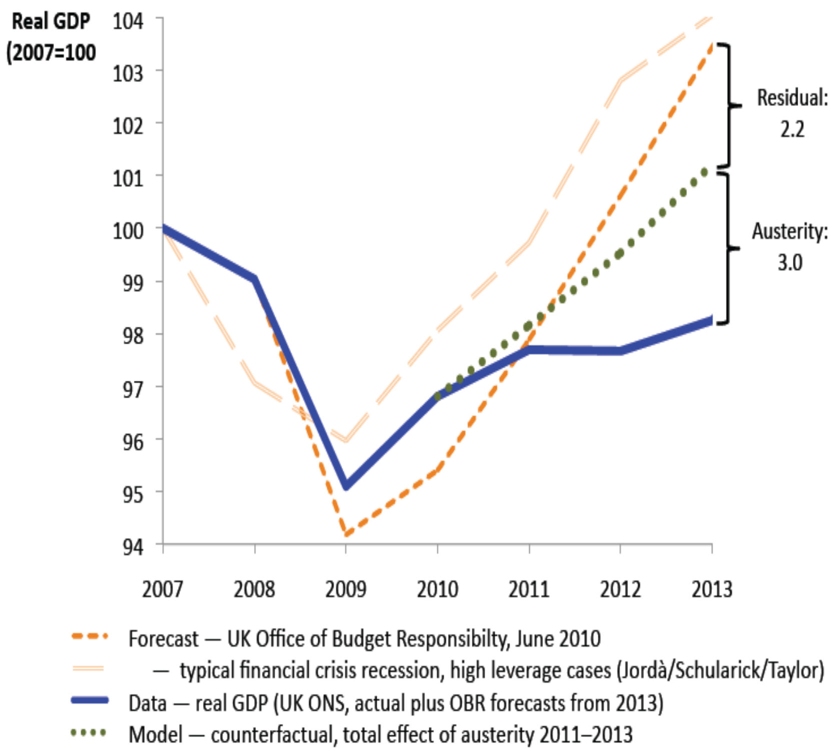




- Weak transmission of rate cuts through to lending rates
- Declining credit despite broad money expansion from QE

Fiscal multipliers and output losses

- OBR: multiplier to be about 0.5 (UK's openness, independent monetary policy, flexible labor market). Then cumulative output loss of 2.5 percent from consolidation.
- But current context: multiplier higher? (large output gap, liquidity trap, credit constraints).
- Counterfactual exercise in Jordà and Taylor (2013) in chart on right
- Asymmetric multiplier and hysteresis effects: optimal to delay consolidation (Fletcher and Sandri 2012, extending De Long and Summers 2012).

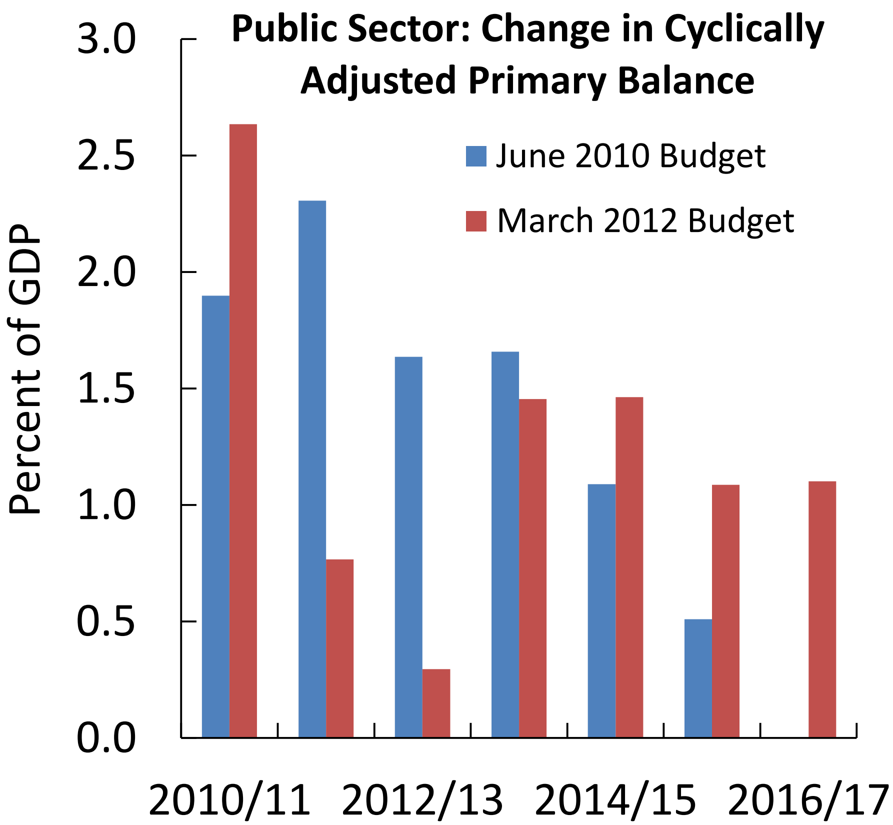


IMF staff policy recommendations

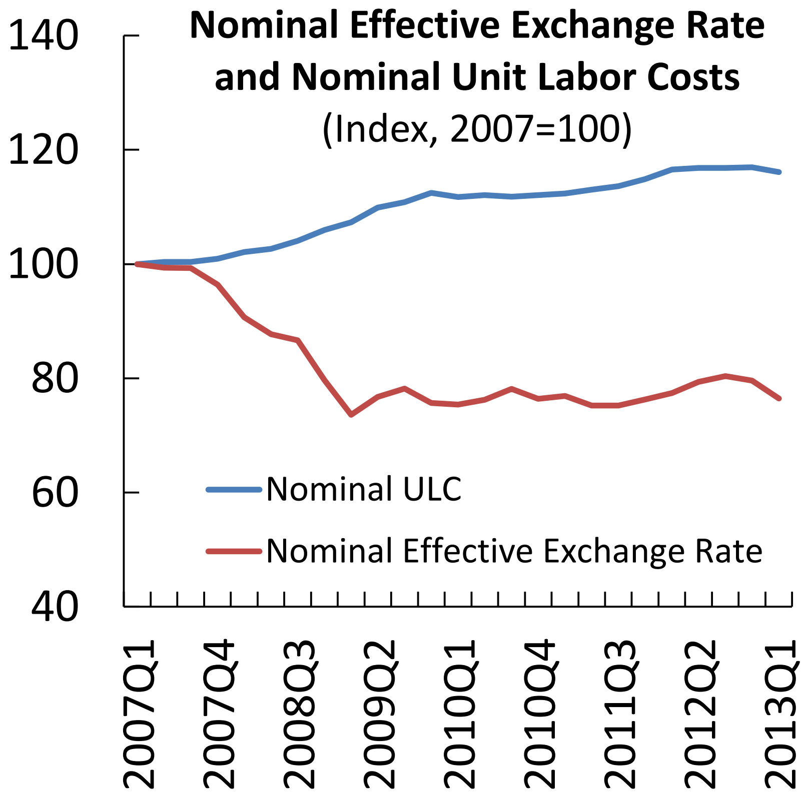
- Economy is still well below potential, below pre-crisis peak.
- Recent momentum is encouraging, but is a rapid, strong and sustainable recovery assured?
- Need for a multi-pronged strategy:
    1. Monetary accommodation
    2. Bank balance sheet repair
    3. Offsetting drag from fiscal (bring forward planned infrastructure spending)
    4. Structural reforms

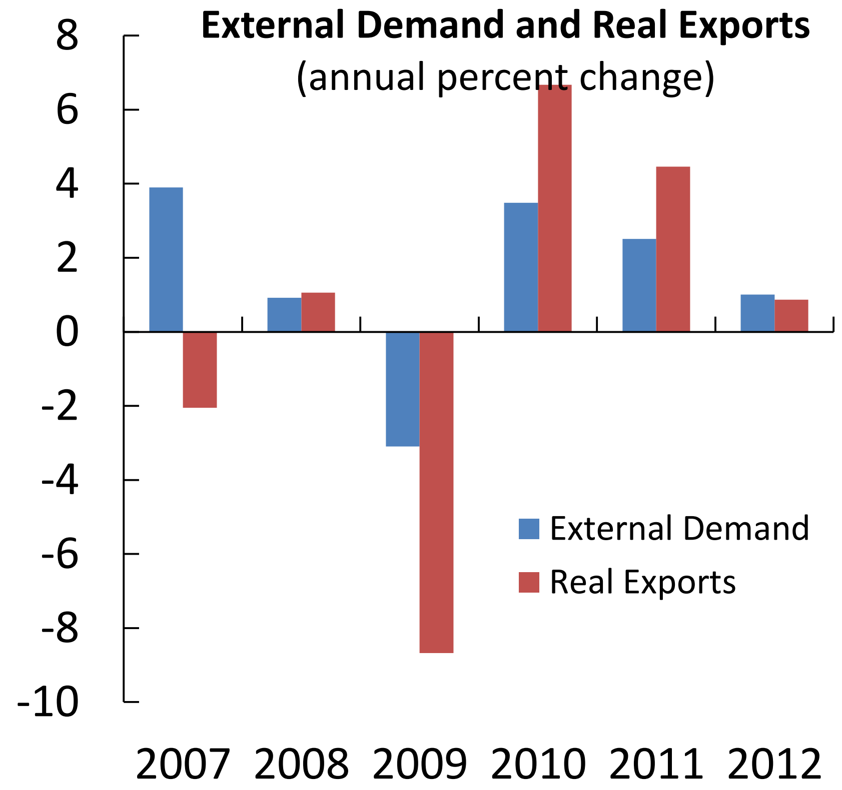
Supplementary slides

What has the fiscal policy response been?



Competitiveness problems and weak external demand





- Unit labor costs partially offsetting nominal depreciation
- Weak external demand, especially from euro area