UK Monetary and Fiscal Policy: Is Austerity Working?

Comments on Allsopp Presentation

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

Public Sector: Change in Cyclically Adjusted Primary Balance

- June 2010 Budget
- March 2012 Budget
• Unit labor costs partially offsetting nominal depreciation
• Weak external demand, especially from euro area