Prospects for Growth in the World's Four Major Economies

The UK: Monetary and fiscal policy mix; currency depreciation

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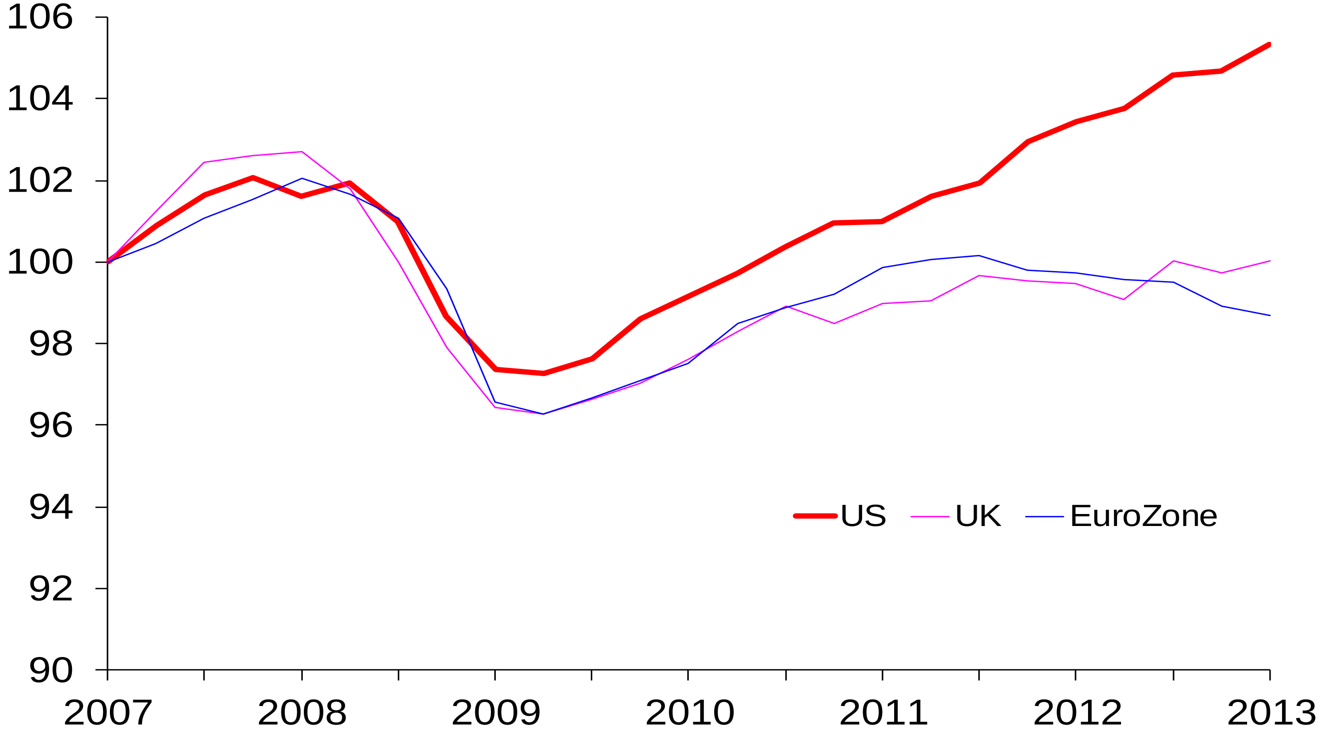
Outline

- Background
  - Overall performance
  - Comparison with US and Euro area
  - The current situation: reviving confidence?
- Monetary policy and the exchange rate
- Fiscal policy: is austerity working?
- What accounts for the shape and timing of developments in the UK
- Prospects and issues
- Conclusions

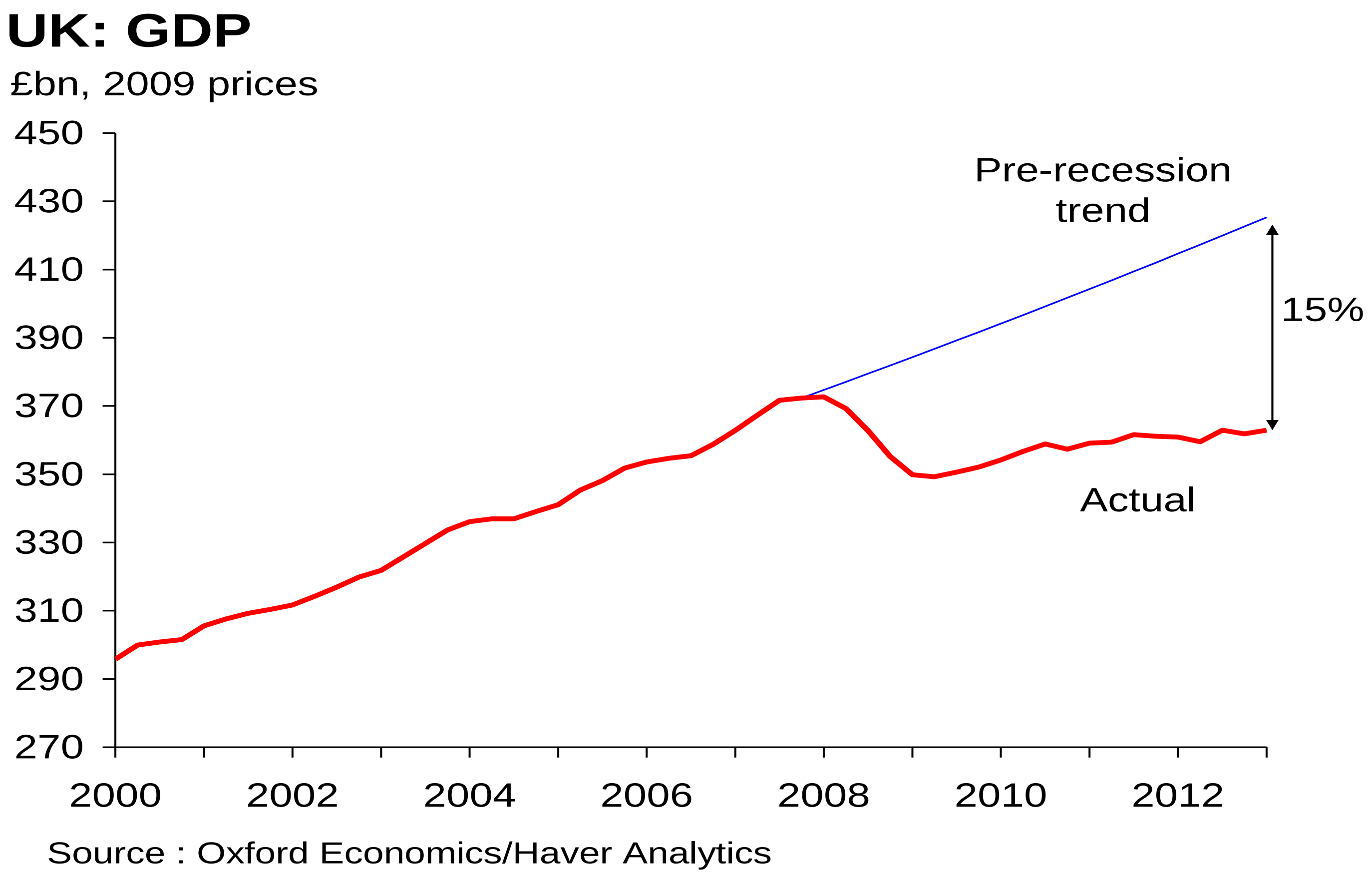
GDP performance compared

Index: 2007Q1 = 100

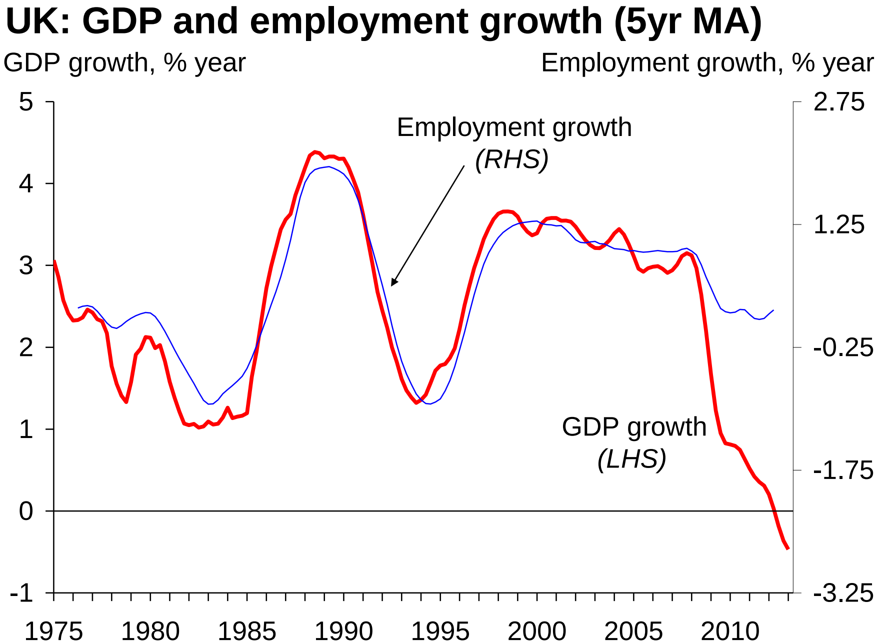


Source: Oxford Economics

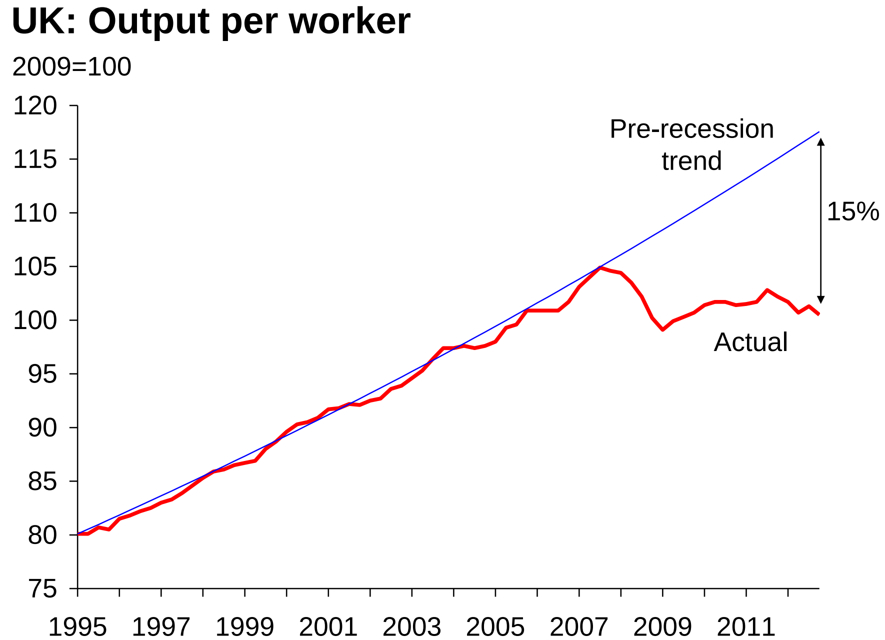
GDP is still 15% below the pre-recession trend



Productivity puzzle gets ever more puzzling

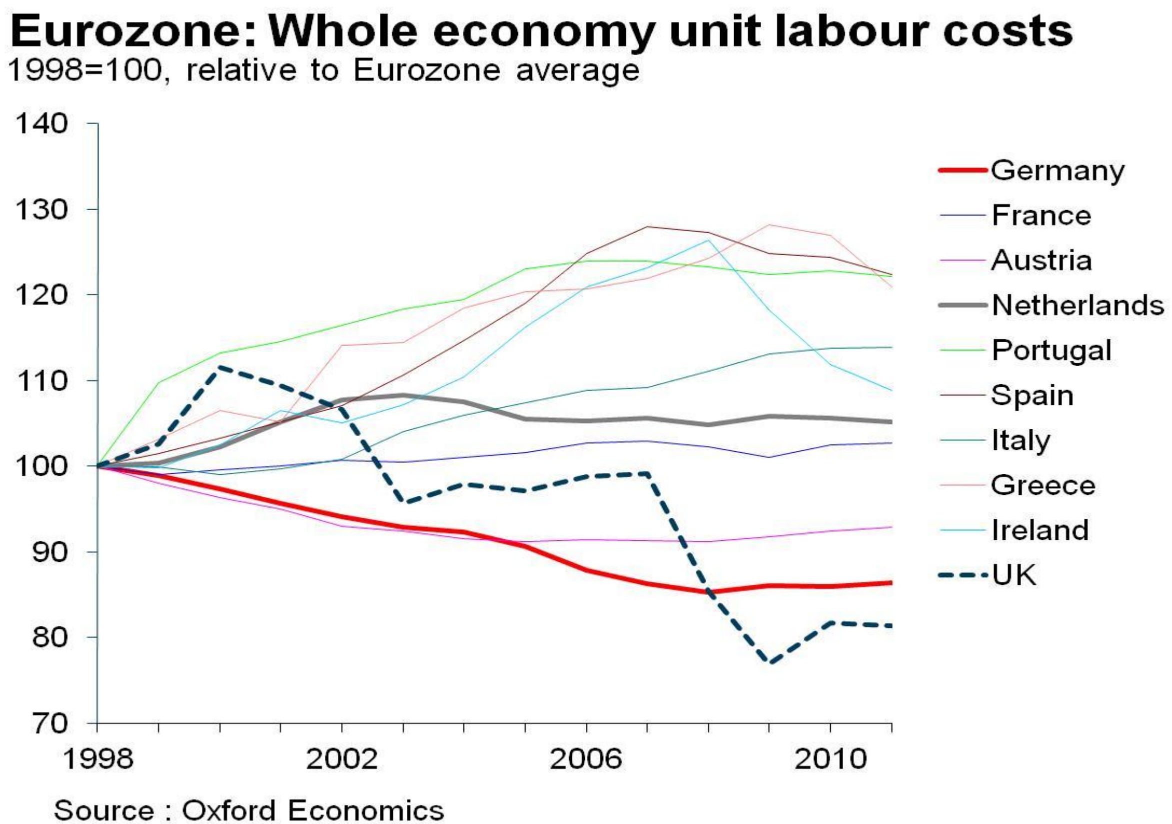


Source : Oxford Economics/Haver Analytics

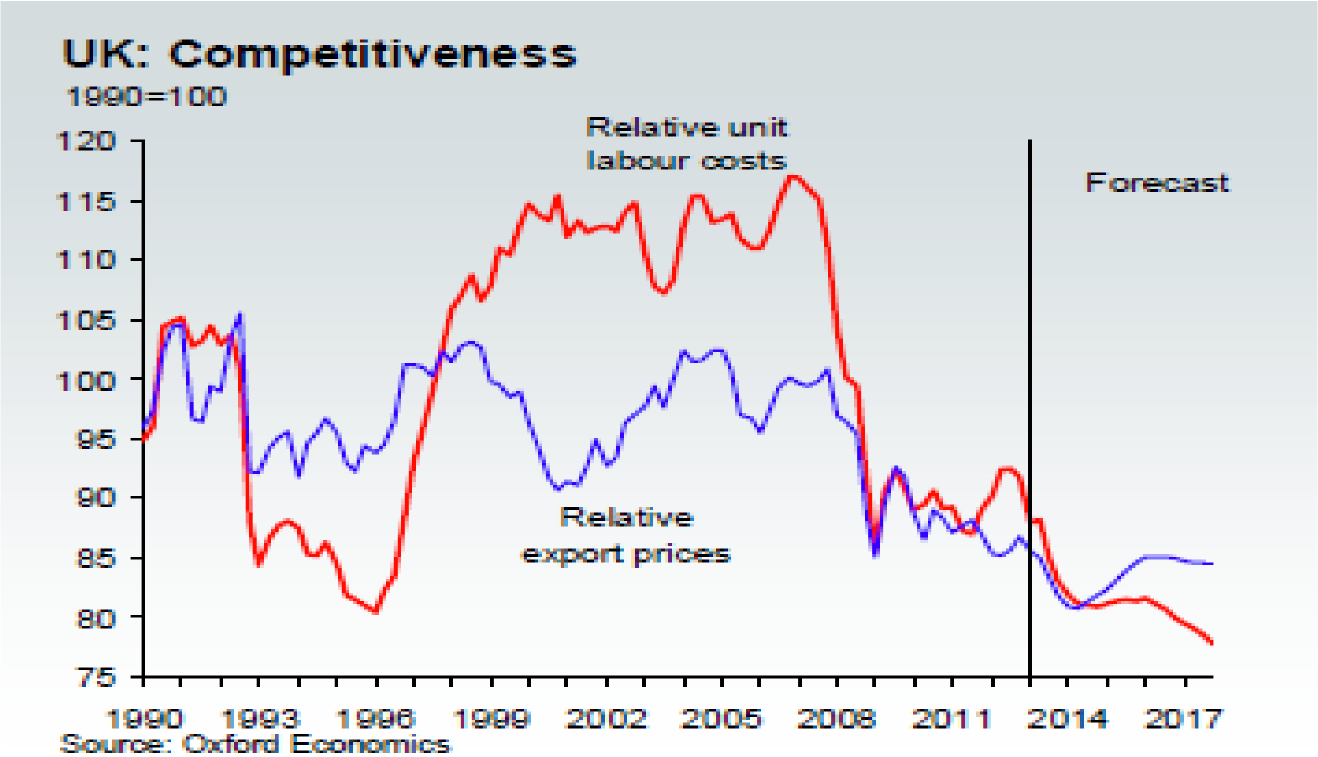


Source : Oxford Economics/Haver Analytics

Euro are problems a quite different from those in the UK.
Note that the fall in the exchange rate, as the recession hit, resulted in whole economy unit falling even relative to Germany



UK unit labour cost competitiveness improved in the early 1990s
As did profitability. Note the low cost competitiveness in the period 1997 – 2007.
Cost competitiveness since the recession is comparable with early to mid 1990s



Source: Inflation Report August 2013

Bond yields similar to US and Germany; Contrast with southern Europe

Chart 1.5 Sterling exchange rates

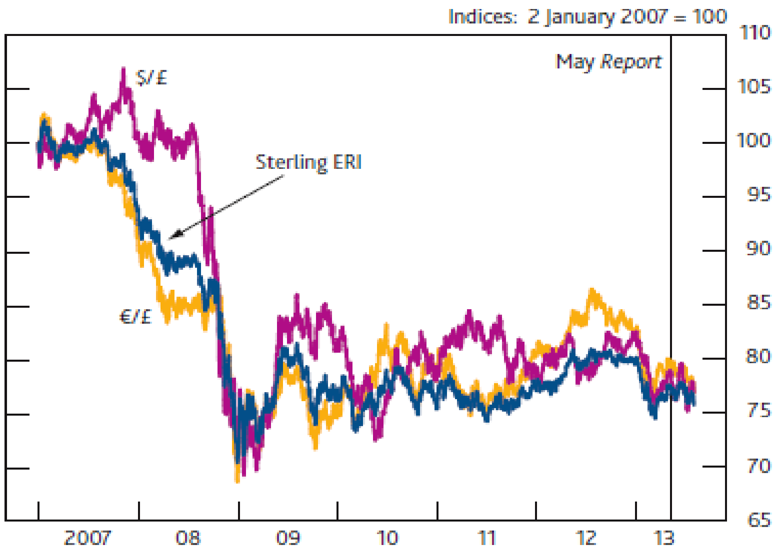
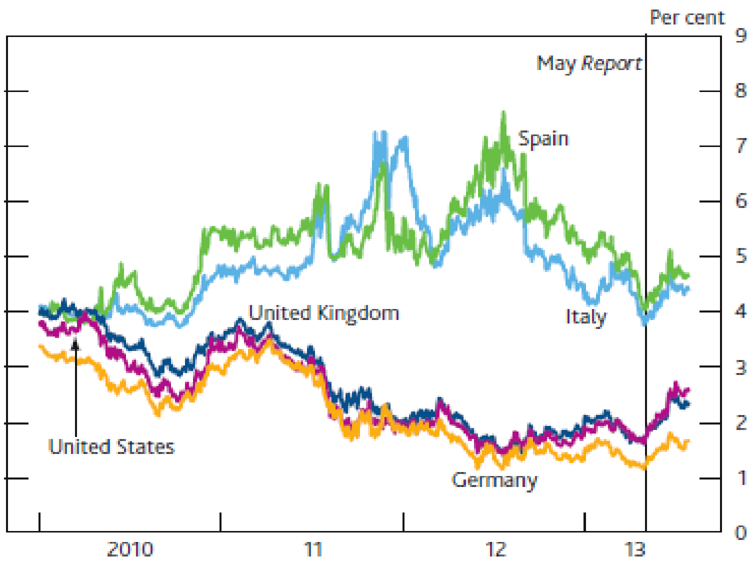


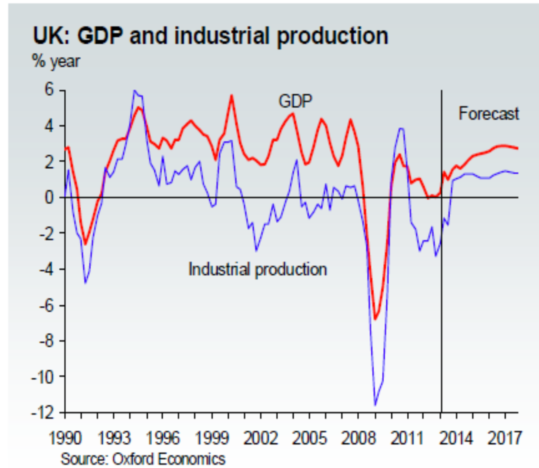
Chart 1.4 Selected ten-year government bond yields

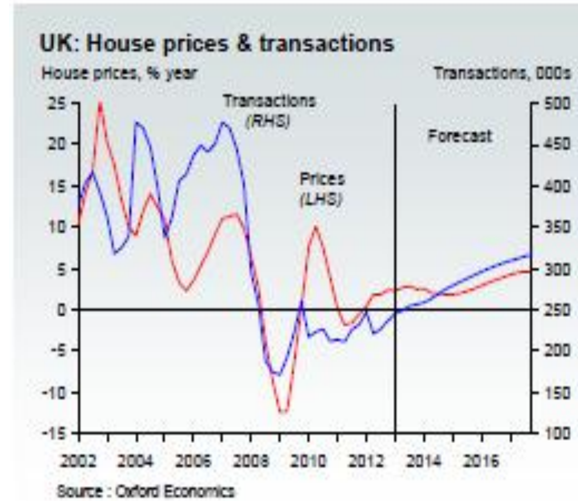


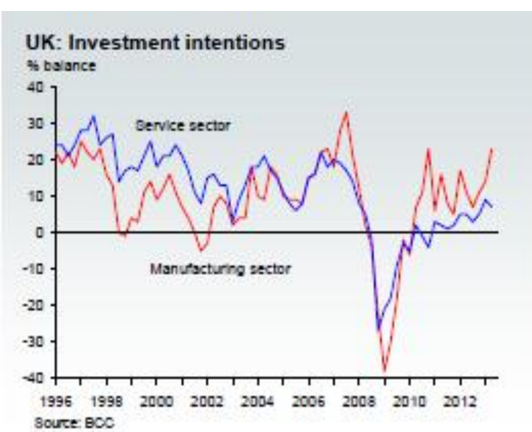
Source: Bloomberg.

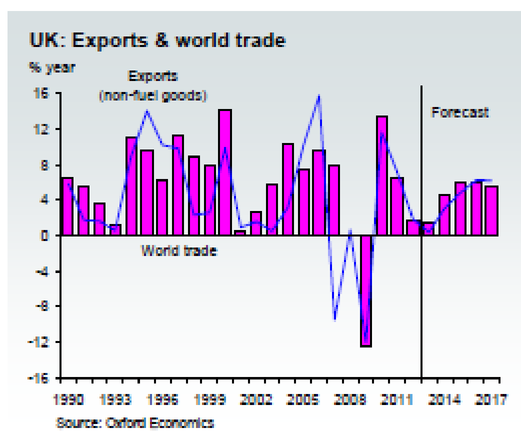
(a) Yields to maturity on ten-year benchmark government bonds.

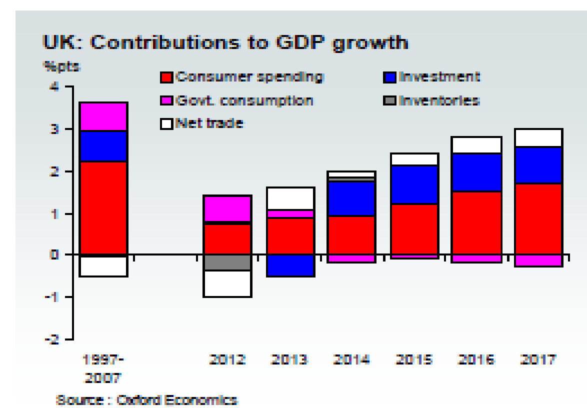
Signs of recovery? Some forecasters revising up qukit rapidly







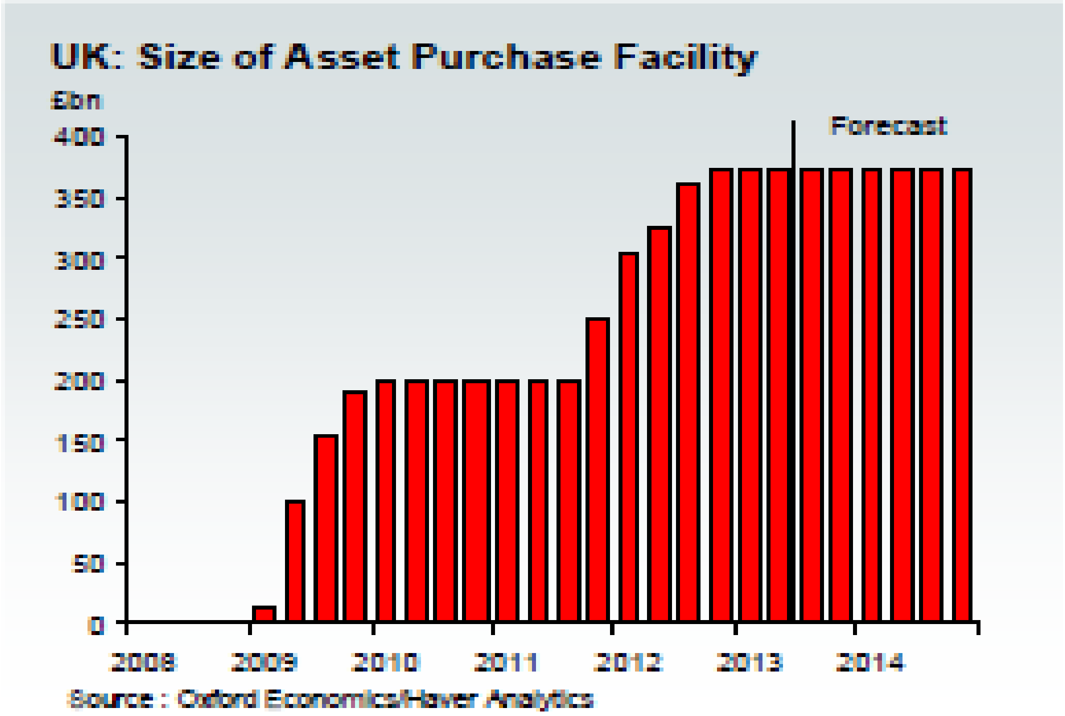




Monetary policy and the exchange rate

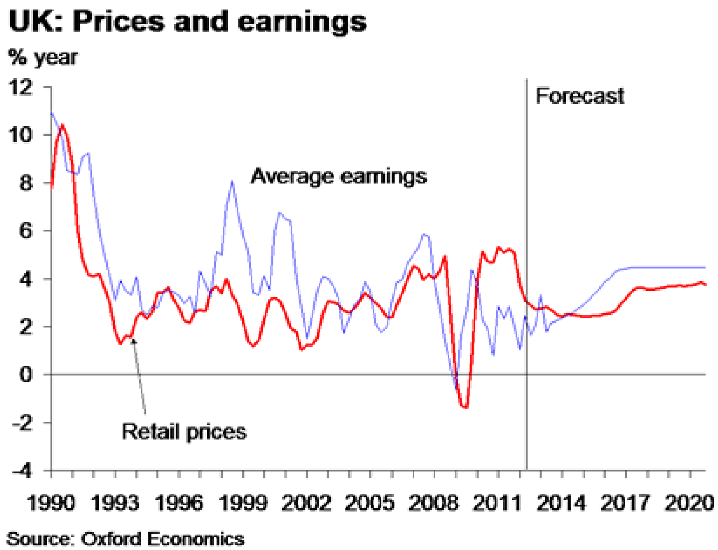
- The present system of flexible inflation targeting was introduced in 1997
  - It appeared to produce an instant improvement in credibility – visible in the gilts market
  - An awkward side effect was a substantial rise in the exchange rate – largely ignored by the MPC
  - There was an issue about 'imbalances'. The Governor (George) remarked that a two speed economy was better than a no speed economy.
- During the NICE decade to 2007 (King) the system appeared to work startlingly well
- As the financial crisis and the recession developed, the policy rate (bank rate) was cut very rapidly to reach ½% - where it remains.
- During the process, the exchange rate fell by about 20 – 25% (30 % on a ULC cost basis)
- Recognising the ZLB, quantitative easing was introduced in 2009 (QE2) and increased again - starting towards the end of 2011 (QE2). See Chart.
- Estimates vary about the effectiveness of QE. Broadly, it appears that QE1 may have lowered gilt yields by about 1 pp. there is more scepticism about QE2 – due to diminishing returns.

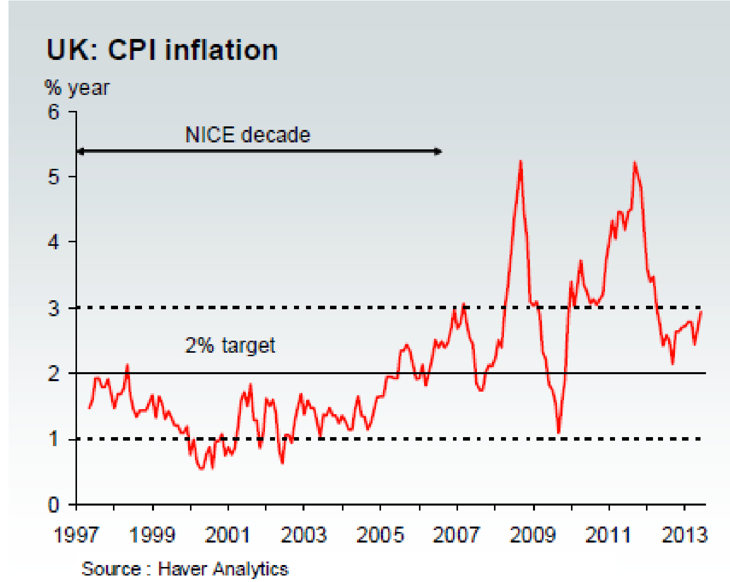
Quantitative easing on hold – whilst other instruments (forward guidance) are evaluated

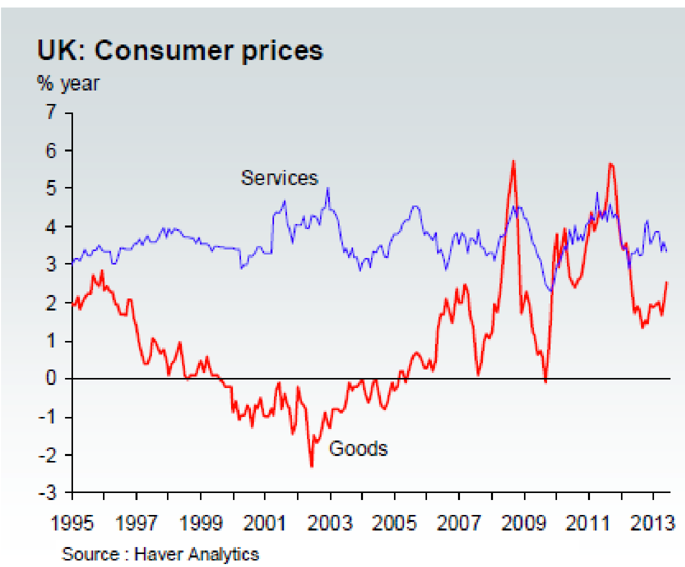


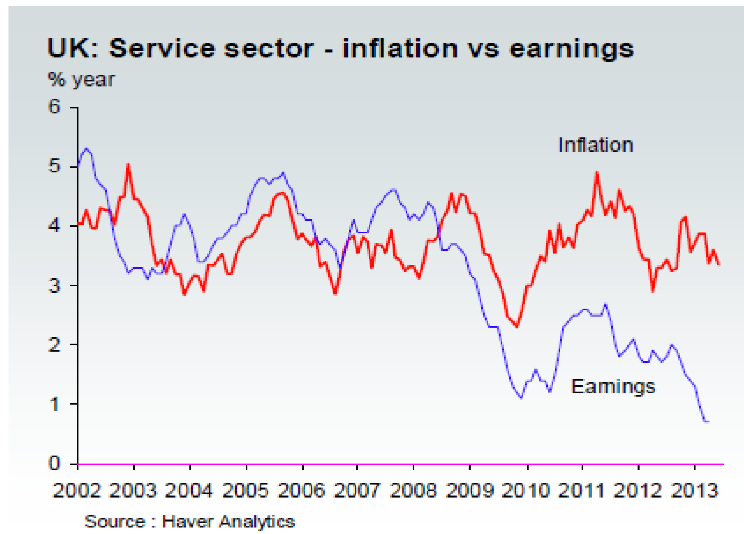
MPC performance

- The MPC has resolutely ‘looked through’ above target inflation in the last several years. It has also been overoptimistic on growth. Many argue that credibility has been dented, though many speeches and comments have vigorously defended the policy. (See, especially Miles). Explanations include: a larger pass through than expected from the exchange rate, administered price changes (especially VAT rises)
  - Vat was cut in December 2008 by 1 pp, reversed in Dec 2009, and raised (to 20%) in January 2011.
- Other influences include oil, gas, and other commodity price rises, and tuition fees.
- Generally, inflation pressure has been high, especially in relation to goods. There is some question as to whether service price inflation may be overstated given the behaviour of wages in the sector. The Bank argues that inflation expectations remain well anchored.
- The new governor, Mark Carney, took over on 1st July, 2013 accompanied by considerable ‘hype’. He was expected to favour ‘forward guidance’, which became explicit in documents published at the time of the August Inflation Report.
- This appears to have been unsuccessful ‘ so far, with market expectations of the expected date of a bank rate rise shortening and some falls in gilts prices.
- This could reflect developments in the US, increased worries about ‘trigger points’, or increasing optimism about prospects for the UK economy.


UK: Prices and earnings
% year
12
10
8
6
4
2
0
-2
-4
Forecast
Average earnings
Retail prices
1990 1993 1996 1999 2002 2005 2008 2011 2014 2017 2020
Source: Oxford Economics

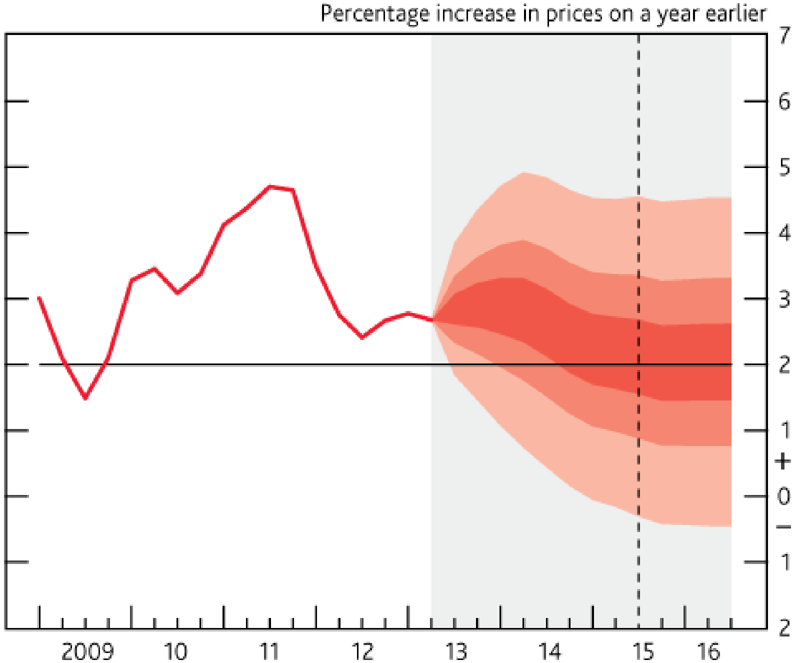

UK: CPI inflation
% year
6
5
4
3
2
1
0
NICE decade
2% target
1997 1999 2001 2003 2005 2007 2009 2011 2013
Source : Haver Analytics


UK: Consumer prices
% year
7
6
5
4
3
2
1
0
-1
-2
-3
Services
Goods
1995 1997 1999 2001 2003 2005 2007 2009 2011 2013
Source : Haver Analytics

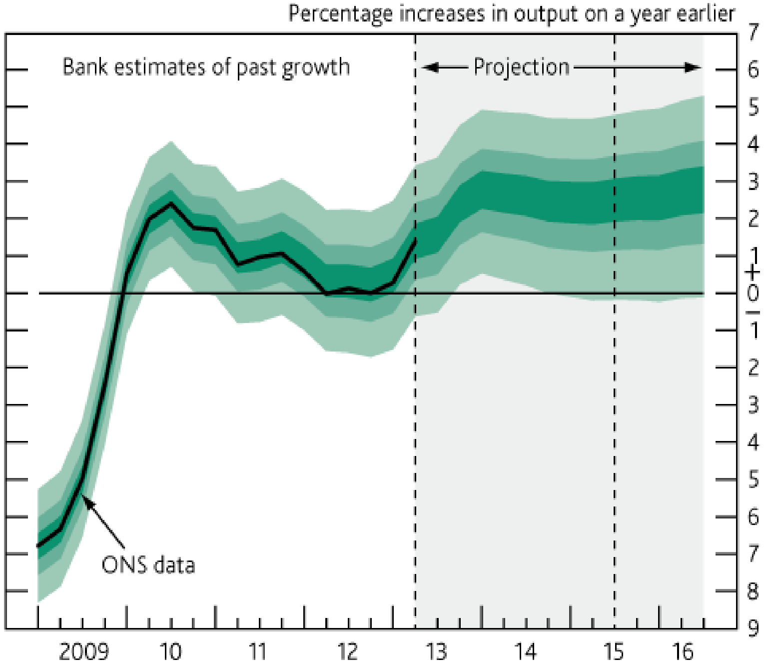

UK: Service sector - inflation vs earnings
% year
6
5
4
3
2
1
0
Inflation
Earnings
2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013
Source : Haver Analytics

Bank of England. Inflation Report August 2013

CPI



GDP



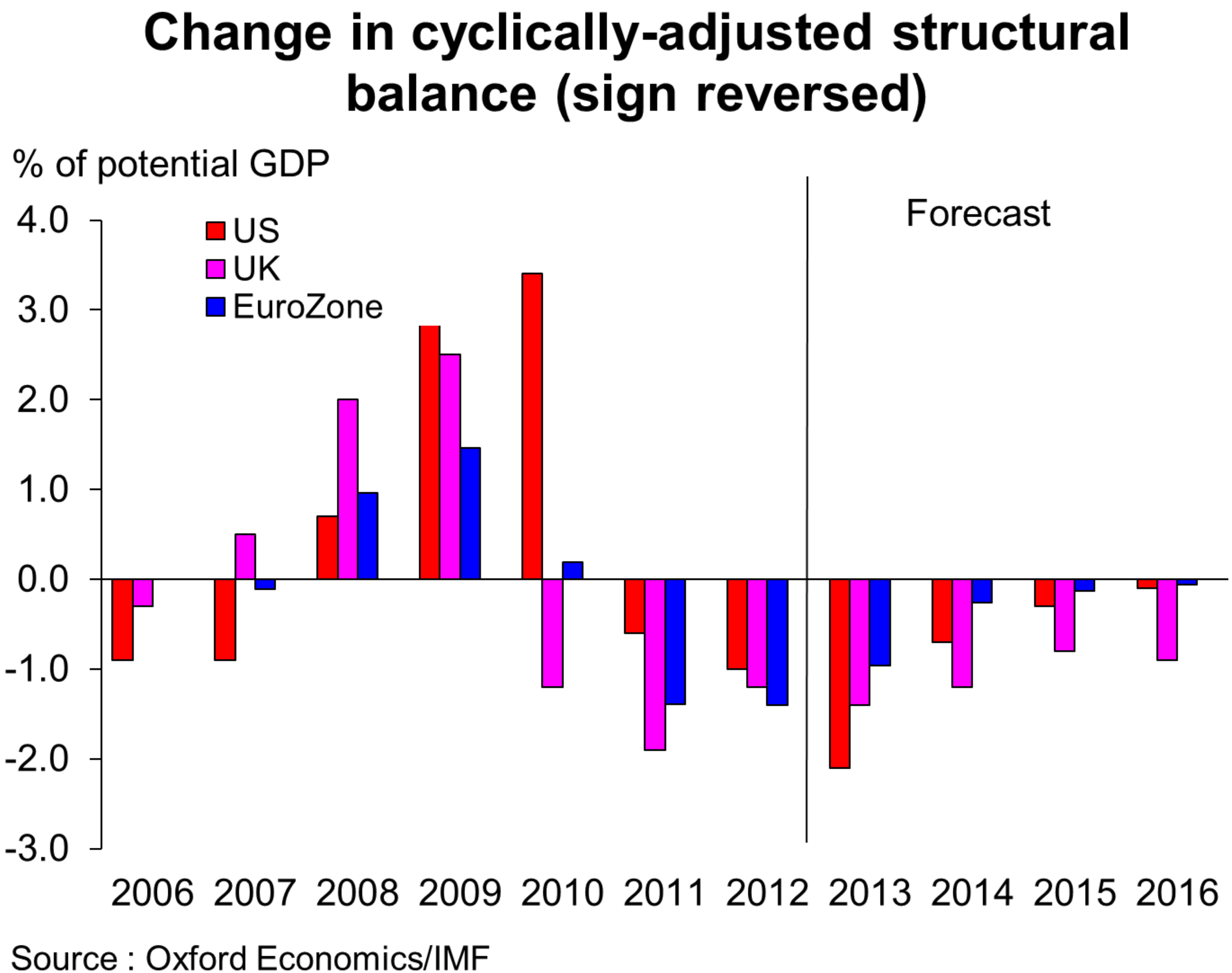
Longer term issues

- As in other countries, the financial crisis has led to considerable questioning about the role of monetary policy.
- In the UK, responsibility for financial stability has moved back to the B of E and a new financial policy committee (FPC) has been set up, responsible inter alia, for macro prudential policy. It is not yet known how the FPC will interact with the MPC. Moreover, the independence of the MPC is diluted given dependence on the Treasury in periods of unconventional monetary policy.
- Coordination issues between the FPC and the MPC have yet to be resolved, though it is likely that the assignment model of the interrelationship between the MPC and the fiscal authorities in place before the 'great recession' will be influential. (Stackelberg, Bean).
- The idea that the MPC should lean against the wind (LATW) to head off bubbles and other financial problems is still influential in some quarters.
- Nominal GDP targeting (as opposed to inflation targeting) seems unlikely given the well known difficulties with it.

Fiscal Policy: is austerity working?

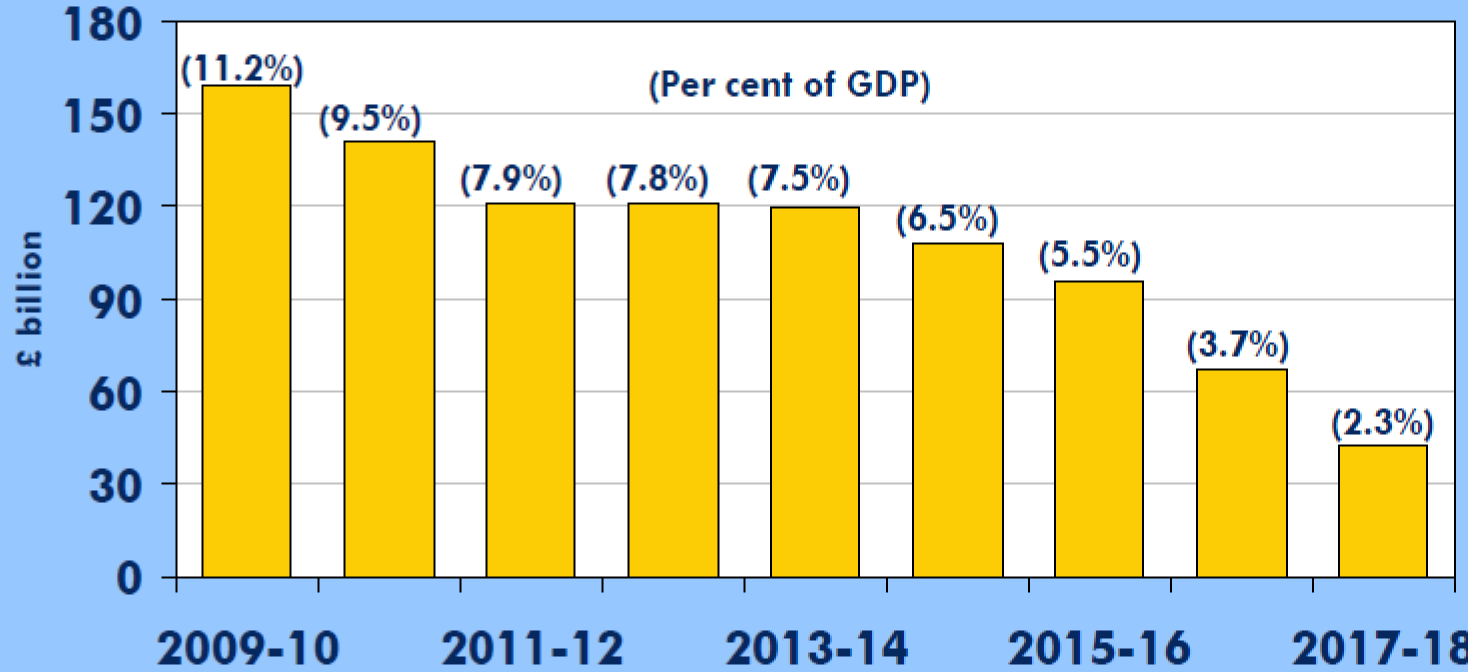
- History: the previous government's golden rule and sustainable investment criterion (net debt/GDP < 40%).
- Blown apart by the dive into recession. Fiscal stimulus about 2% GDP in 2009 (ie relatively small). Stabilisers allowed to operate. Arguments over degree of austerity during election period 2010. But differences not huge.
- Emergency budget – rather little effect. Spending Review seemed to have much greater effects on expectations
- The OBR, established at the time of the emergency budget, got off to a weak start, but got into gear with the publication of its first Economic and Fiscal Outlook in Nov 2010.
- The OBR is a major change in the UK's fiscal framework. In fact however, its role is relatively limited, confined to forecasting and analysis in relation to the government's own fiscal mandate. Initially the governments mandate was, first, to balance the cyclically adjusted current budget 5 years ahead and second, to have public sector net debt falling in 2015/16. Thus the OBR has little role in policy, other than in analysing whether the governments target are likely to be met. Essentially, it is designed to remove 'forecast bias'.

Fiscal tightening in the UK relatively early and prolonged.



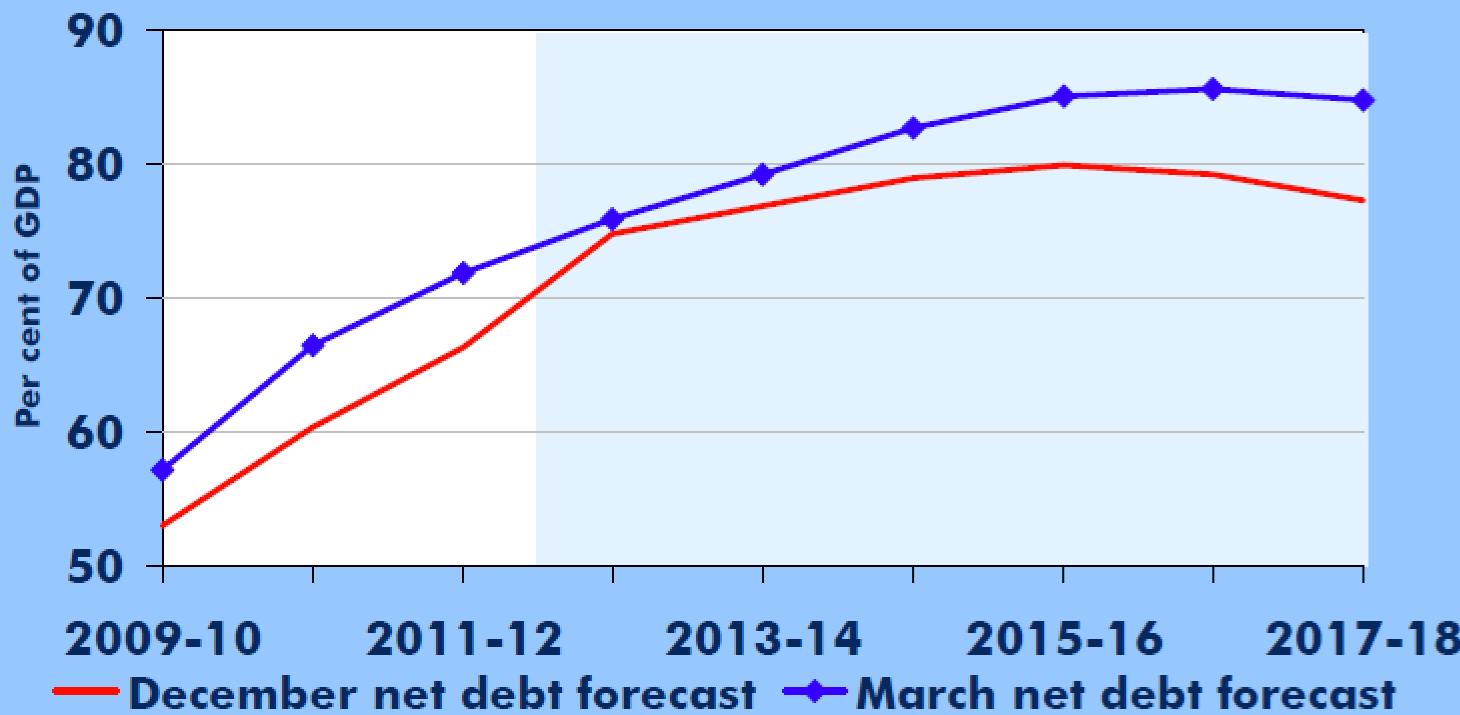
Public sector net borrowing

Excluding Royal Mail and APF transfers



Office for
Budget
Responsibility

Public sector net debt



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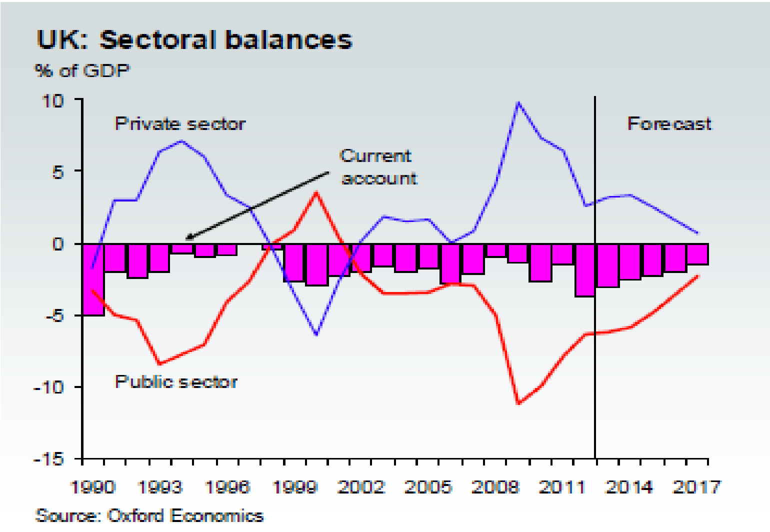
Is austerity working?

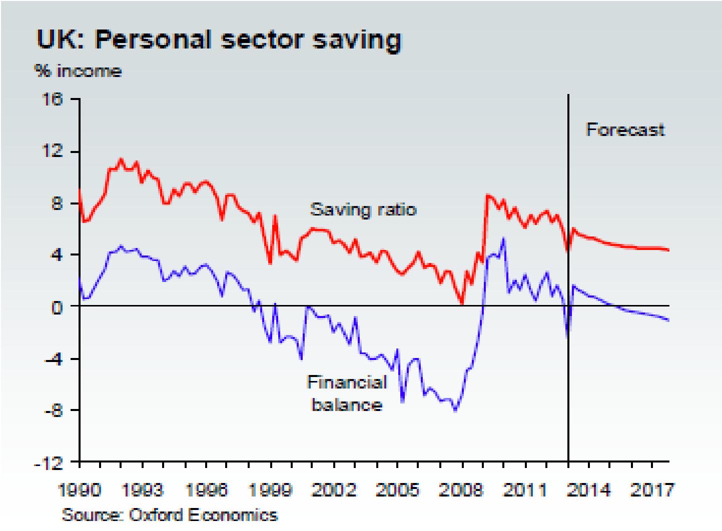
- The jury is still out
- One story is that, despite major shocks, especially from the Euro area cries, which account for recent slowdown and poor performance, the strategy is intact , and the UK has ‘turned the corner’(Osborn, 9th Sept 2013)
- Over time, deficit reductions have been less than anticipated – due to slow growth. With a pick-up in growth (uncertain of course) the strategy is, broadly, intact.
- The alternative view, in various guises, is that the policy involved too much consolidation, too early – i.e. whilst deleveraging was still going on. The target for the cyclically adjusted current balance limited the damage, but not to a sufficient extent.
- The anticipated peak in debt levels his risen through time, as well as being pushed further into the future. (According the OBR net debt peaks at about 86% GDP in 2016/17). In the Nov 2010 EFO, net debt peaked at 70%, in 2013/14.
- Many of those in favour of a ‘plan B’ in the UK favour public infrastructure investment, with very low borrowing costs.
- Public investment is not included in the fiscal mandate for the current budget balance – but an increase would affect the timing and extent of the peak in net debt. (Unless the stimulus ‘worked’ and deleveraging fell).

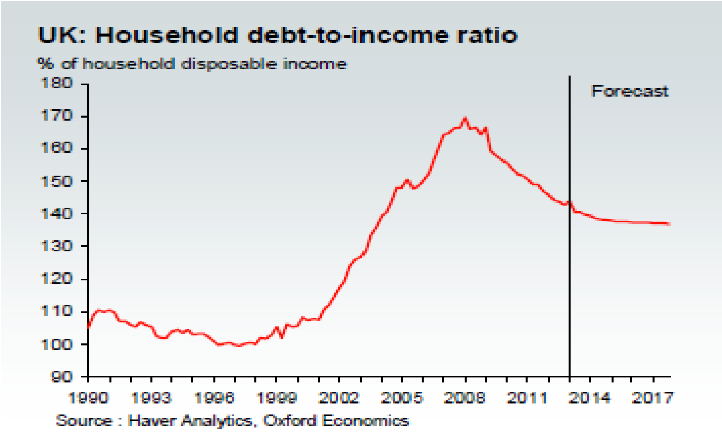
The shape and timing of developments in the UK: deleveraging

- It is common to ascribe the great recession to a ‘deleveraging shock’. Alternatively, as a ‘balance sheet shock’ (Koo). The focus on stocks is not new. Keynes (General Theory Chapter 16) described the problem [of recessions] as arising from a ‘desire for wealth as such’. An excess demand for ‘wealth as such’ translates, in more familiar flow terms into an excess of desired savings over investment, seen as attempts by the private sector to build up assets or reduce debts by cutting spending.
- A standard counter to such a situation is cuts in interest rates – which were overwhelmed. As conditions deteriorated investment went down and savings went up. There was no respite from changes in the current balance (or net trade) since the impacts were global.
- The only counterpart to private sector deleveraging was the government balance which in the UK rose to over 10% GDP. This happened fairly early in 2009. Since the UK and other countries bottomed out, arround that time, we can deduce that the offset was sufficient in flow terms.
- The flow relationships are illustrated in the sectoral balance chart. (Fairly typical after a financial crisis, but, of course, the swings between public and private sectors were very large).
- The second and third charts indicate flows (savings) for the personal sector and a stock indicator of household debt. The company sector (not shown) has been in large financial surplus and has been deleveraging. The problem here has been a lack of investment – not helped by uncertainties over the euro crisis. There is ample scope for a revival of investment.

Leveraging and deleveraging in the UK







UK performance

- UK performance has, in fact, been very poor – not much better than bumping along the bottom. Nevertheless, there has been a marked turn towards optimism - which may or may not be well founded.
- A possible explanation is the cummulative effects of high public deficits. There were stock aspects of the deleveraging shock which arguably, were bound to take time to work off. (Otherwise the short term (flow) shock would have been much larger). A budget deficit of 10% is the counterpart to 10% deleveraging by the private sector. If maintained over two years, the figure rises to 20% of GDP. Three years, 30 %, and so on. Essentially, there is a limit to the amount of deleveraging that is needed – indebted households pay off their debts, company cash flows and liquidity improve. This cumulative feedback system is powerful. It means that economies tend to revive eventually – even if the shock is very large.
- By the same argument, worries over explosive debt paths (in a situation where public indebtedness is offsetting private sector distress) are overblown. OBR projections for the Net Debt to GDP Ratio peak at about 85%.
- The amount of 'deleveraging' needed after a shock to the system is extremely difficult to even guess at, and is likely to be highly sensitive to expectations and confidence along the way. Economic revival would be expected to lower the expected fiscal cost (if it can be called a cost)
- The traditional worry over high public borrowing is a sell off in the Bond markets, or even a balance of payments crisis. For a country like the UK, with its own monetary policy and currency, these fears have spectacularly failed to materialise.

Concluding remarks

- The performance of the UK economy has been very poor. 15% below previous trend level; unknown destruction of productive potential; output gap difficult to assess.
- Strong signs of improvement due to reduction of shocks and uncertainties (e.g. Euro area, US) and deleveraging. Prospects very uncertain of course.
- UK policy mix ‘conventional’: fiscal ‘good housekeeping’; stabilisation and inflation control delegated to monetary authorities. Depreciation. Large difficulties due to ZLB.
- Problem: How to control deficits and debt, on the one hand, and growth/stabilisation, on the other with one instrument? Growth is endogenous to fiscal policy. Unfamiliar dynamics. May be non-minimum phase?
- But cumulative deficits (= private S – I surpluses) are very powerful. (US, UK and elsewhere). Up-turn to be expected, but major risks (including up-side).
- Could policy have been more expansionary (or later)? Would have led to faster rise in net debt – but (possibly) lower peak? Less hysteresis and long term damage?
- Low level of output (and productivity puzzle) suggest serious economic problems looking forward, unless growth speeds up a lot. Inflation response, starting from here?
- Competitive improvement very helpful despite effect on price inflation. Cost inflation has been very low, with declining real wages. Real interest rates are negative.