Prospects for growth in the world's four major economies.

The UK: Monetary, Fiscal and Exchange Rate Policy

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1. Introduction

This paper considers economic policy issues and the prospects for growth in the UK. The short-term context is important. At the time of writing, in September 2013, it appears that growth and prospects, especially for the second half of 2013 and for 2014, have markedly improved. Forecasters, often a lagging indicator, are beginning to revise up. George Osborne, the Chancellor of the Exchequer, declared on Monday 9th September that the UK 'is turning a corner' and that the UK was now on the road to a sustainable recovery. The shift towards optimism, from the deep pessimism earlier in the previous year, is palpable.

This paper shares the optimism about short term prospects. Many of the forward-looking indicators have turned up sharply, especially as compared with indications six months or a year earlier. But the recent improvement has followed a long period of very poor performance. Claims that the upturn indicates that 'economic policy is working' or that austerity has been 'worth it' are questionable and certainly premature.

This account starts by looking at UK performance over a slightly longer time period since the 'great recession' with some comparison with other major countries. It goes on to consider the strategy that has been followed by the UK, concentrating on monetary and exchange rate issues, before turning to fiscal policy. An open question is whether the UK government's concentration on fiscal consolidation and 'austerity' has been appropriate – or whether the policy itself has been a cause of poor performance. The penultimate section looks in more detail at the mix of policies adopted by the UK and their sequencing with a view to drawing out some more general lessons which may be relevant to other countries. The final section concludes.

2. Background: Poor performance and the recent improvement

Chart 1 shows the performance of the UK's GDP since 2007 in comparison to the United States, and to the Eurozone. (The forecast data are from Oxford Economics in September 2013.) The scale of the great recession is apparent in all three areas. The US recovery is considerably stronger and appears more 'normal' than the dismal performance of the UK and the Eurozone – though it is worth noting that the US recovery is, itself, much weaker and more delayed than would be expected on the basis of other post-World War 2 recessions.

The UK recovery essentially stalled in 2010 (Chart 2). Recently the crisis in the Eurozone has meant that that the UK has been doing slightly better than its continental neighbours, though especially in 2012 and 2013, the euro crisis has had a major effect on the UK as well. As noted, growth is expected to pick up substantially in the second half of 2013 and over the next few years.

Chart 1

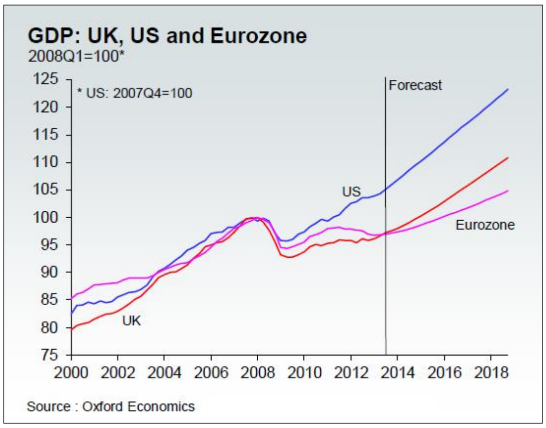
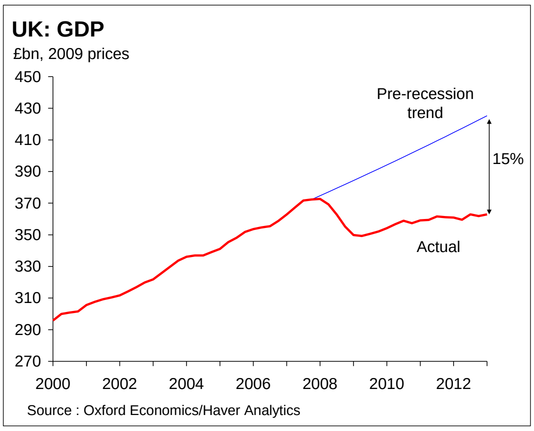


Chart 2



The productivity puzzle

Charts 3 and 4 show aspects of the UK's productivity puzzle. Essentially, employment has kept up as output plummeted. GDP per person employed has actually fallen since the previous peak in 2007. At the end of 2013, productivity was also about 15% below its extrapolated trend.

Chart 3

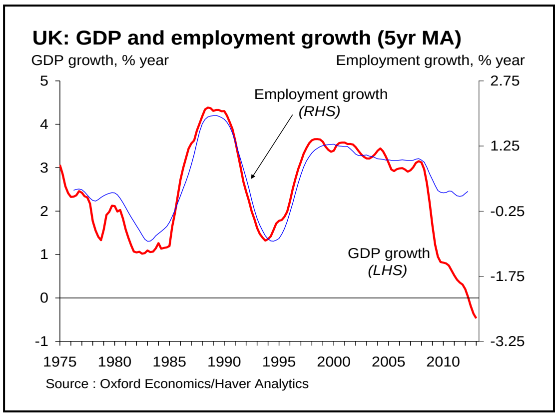
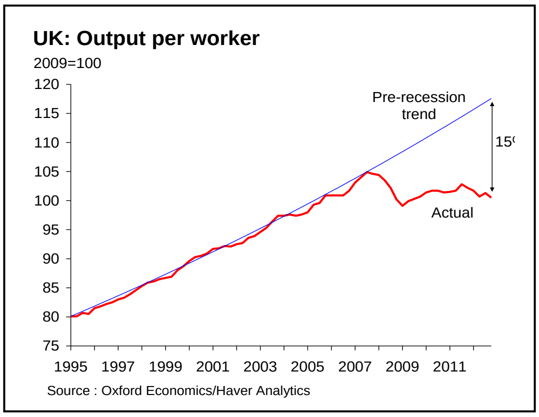


Chart 4



Unemployment and the degree of spare **capacity**

The bright side of the productivity growth collapse is that unemployment has risen rather little in the UK. This, however, has meant that the degree of slack in the economy is extremely difficult to assess, posing problems for economic policy makers. There is a wide range of estimates. On an optimistic view, productivity would be expected to recover as the economy recovers. At least until recently, the Bank of England has taken this view about potential output. (One reason for optimism about future productivity growth would be labour hoarding during the recession, which would be expected to reverse as output rises. Another would be doubts about the accuracy of some of the data). On the other hand, the Office of Budget Responsibility has been notably pessimistic, evaluating the current degree of slack as relatively small, and not expecting a marked pick up in productivity performance as the UK economy recovers. Clearly, any evaluation of the government's fiscal policy is highly sensitive to alternative assessments of the productivity puzzle.

Comparison with the Eurozone

The various crises in the Euro area have directly affected the UK due to its importance as the UK's main trading partner. Some of the slow growth (and the threatened 'double dip' in 2012) stems directly from this cause. Beyond this, the risk of a major Eurozone break up, with multiple and disorderly exits, seemed very large, especially in 2012. Though hard to model, or simulate, the major uncertainties clearly affected investor expectations and consumer confidence. These perceived risks have moderated greatly since the announcement by Mario Draghi, President of the ECB, of the policy of outright monetary transactions (OMT) in September 2012 - together with his promise to 'do whatever it takes'. The improvement of sentiment in the UK in 2013 may well reflect the attenuation of these major risks from Europe. Moreover the (imperfect) deal over the 'fiscal cliff' in the US at the beginning of 2013 boosted confidence in the UK as well as world-wide.

The problems of the euro area are very different from those in the UK, stemming as they do from inter-country imbalances and the difficulties of adjustment. Thus the UK, with its own currency and monetary policy, experienced a relatively large currency depreciation in 2008, relative to both the Dollar and the Euro (amounting to about 25%). Since the UK's exchange rate was widely perceived as over-valued before the financial crisis, the depreciation has been widely seen as helpful in rebalancing the economy towards a more sustainable pattern – despite the implied upward pressure on inflation (Chart 5). The same factors mean that government bond rates have been low, more or less tracking bond market developments in the US and in core Eurozone countries, such as Germany (Chart 6). This is true despite the UK's relatively large fiscal deficits, and relatively serious banking crisis.

Chart 5. Exchange rates

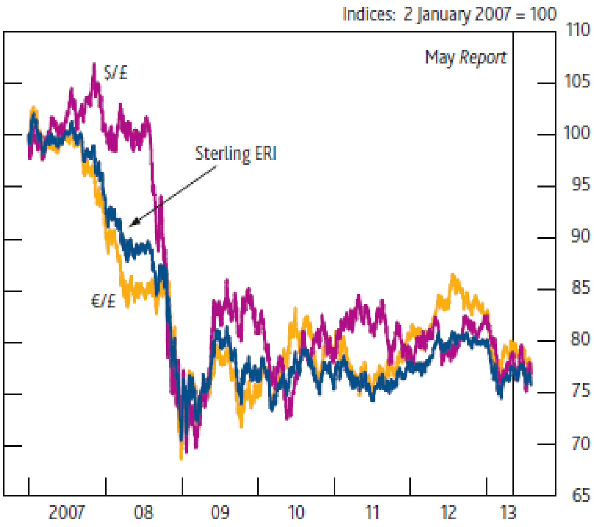
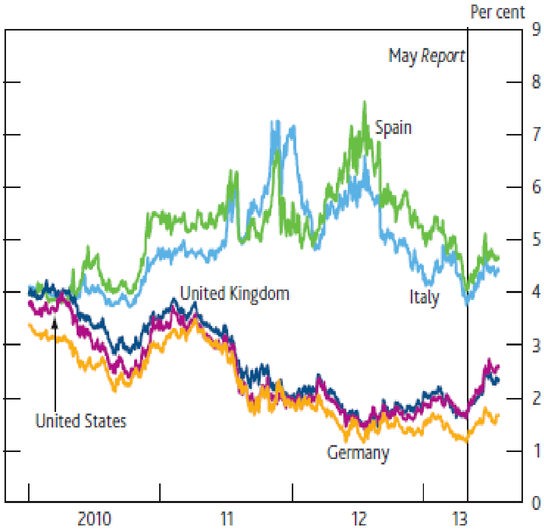


Chart 6. Bond yields (10 yr.)



Source: Inflation Report, August 2013

Chart 7 shows the effects on unit labour cost competitiveness in manufacturing and on relative export prices for the period since 1990. (The divergence between the two series is an indicator of the profitability of exporting). Indicators such as these suggest a large improvement in international competitiveness. The effect on exports and net trade has been slow to come through, however, largely due to the sluggish growth in the Eurozone. Forecasts suggest a pick up in net trade over the next few years as the US economy recovers, and as the crisis in Eurozone moderates.

Chart 7

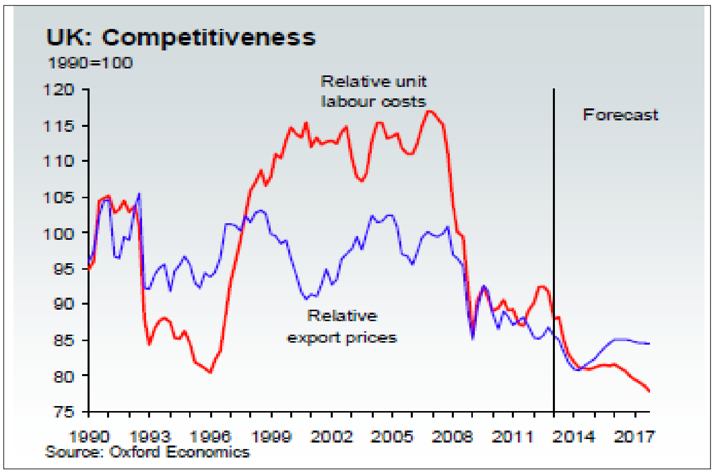
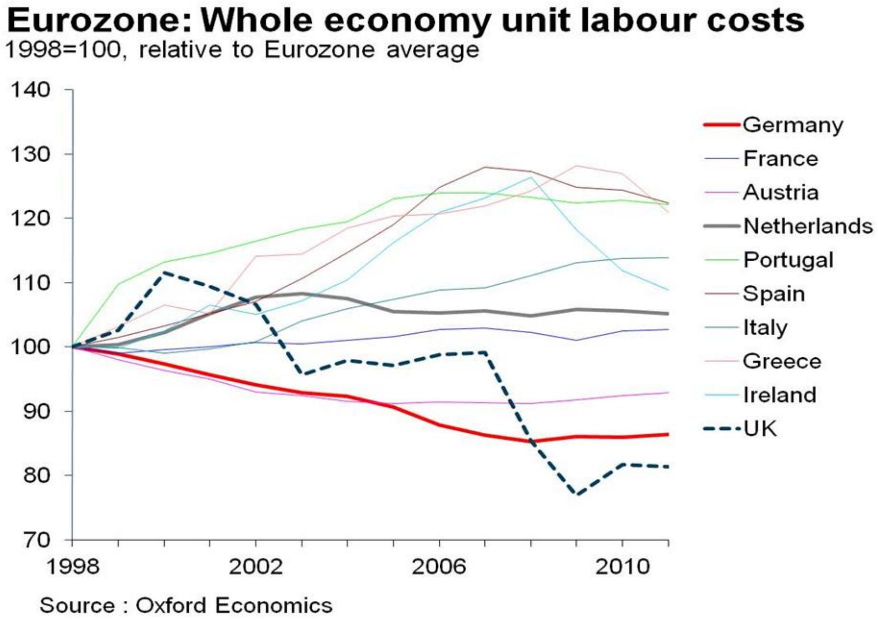


Chart 8 shows what has happened to relative (whole economy) unit labour costs in the Eurozone countries, since its inception. The extreme loss of competitiveness in the periphery countries, relative to Germany, is all too apparent. The Chart also includes similar data for the UK (the dotted line) – which shows that the UK's position has improved, even relative to Germany, over the same period.

Chart 8



The recovery in the UK

The signs of recovery in the UK, albeit from a very low base relative to historical trends, have been building up since the beginning of 2013. By September, forward-looking indicators, such as Purchasing Managers Surveys and Investment Intentions, had turned up sharply. Forecasts for the calendar year 2013 were being revised up. Importantly, net trade, which had made a negative contribution to GDP growth in 2012 is expected to contribute positively over the next few years. The recovery is being driven by a revival in consumption and in housing. The government's objective of rebalancing the economy towards exports and investment has not yet been met.

Table 1. Real GDP. Percent per annum

	2012	2013	2014	2015	2016	2017
UK	0.2	1.4	2.2	2.4	2.7	2.8
US	2.8	1.6	3.0	3.2	3.1	3.0
Eurozone	-0.6	-0.3	0.9	1.4	1.6	1.6
Japan	2.0	1.9	1.3	1.7	0.8	1.0

Source: Oxford Economics, September 2013

The table shows a forecast, from Oxford Economics, made in September 2013, for UK growth - in comparison with forecasts for the US, the Eurozone and Japan. In principle, it should incorporate the recent improvements in the UK, and many of the factors discussed in this background section. It is notable that the UK is expected to grow relatively fast, from the second half of 2013 onwards. The forecasters point, of course, to continuing risks. It is notable, however, that the risks appear to be roughly balanced - there are upside risks as well as risks on the downside. This is a clear change from the last few years, when most of the risks, some of which were very difficult to quantify, appeared to be on the downside – especially from the continuing difficulties in the Eurozone.

The shape of the UK recovery, and what might account for some of its features, is further discussed below.

3. Monetary Policy

In the period before the financial crisis the UK had one of the most successful inflation targeting regimes in the world. Inflation was controlled and growth was rapid, at least by UK standards. Mervyn King, who succeeded Eddie George as Governor in 2003, described the decade up to 2007 as NICE – Non-Inflationary, Constant Expansion.

The system of inflation targeting was introduced in 1997. Responsibility for inflation control and, *subject to that,* for macro-economic stabilisation was delegated to the Monetary Policy Committee (MPC) of the Bank of England, which operated with 'constrained discretion'. The Bank of England was 'instrument independent' but not 'goal independent'. The inflation target was set by the Chancellor. The inflation target was initially 2.5% for RPI(X): it was later changed to 2% for a different index, the Consumer Price Index, CPI, where it remains. A feature of the system was that fiscal policy could, at least in theory, concentrate on longer term issues of public finance and distribution. Changes in fiscal policy would be taken into account by the MPC along with other factors affecting the economy. (For example, a looser fiscal policy, other things being equal, would lead to higher interest rates as the MPC sought to fulfil its mandate of meeting the inflation target in the medium term)[1].

Monetary policy, the exchange rate and other asset prices

Though highly successful, there were signs of stress during the NICE decade. In particular, the sterling exchange rate rose very substantially at the start of the new system and remained high until the fall in 2008. The economy appeared unbalanced with, in particular, a poorly performing manufacturing sector. In the early 2000's, with recessionary forces emanating from the world economy, the then Governor (George) remarked, in 2002, that '… a two-speed economy was better than a no-speed economy'.

Essentially, the system in the UK had no way of dealing with the exchange rate issue. With one instrument – the short term interest rate – the MPC's mandate required it to focus on the complex trade-offs between inflation control in the medium term and the stabilisation of output. (The MPC did, technically, have the power to carry out exchange market

[1] Charles Bean described this policy assignment as Stackelberg leadership by the Treasury. (Bean, 1998).

intervention, but only to a small extent. The facility was never used). Exchange market intervention might have been used – but that would have been a matter for the Treasury.

There were other worrying issues of a financial nature. In particular, the period up to 2007 saw sharply rising house prices, as well as worryingly large increases in household indebtedness, and increasing leverage elsewhere. There were suggestions that the MPC should take these problems into account, and 'lean against the wind' (LATW). Such a policy would, as with the exchange rate, run into the problem of trying to meet multiple objectives with a single instrument. It was also argued that the interest rate was far too blunt an instrument to deal with such problems. Purists would argue that the Financial Services Authority (FCA), or the Treasury, could and should have intervened. (Macro-prudential policies, and the setting up of the Financial Policy Committee (FPC) in the Bank of England are further discussed below).

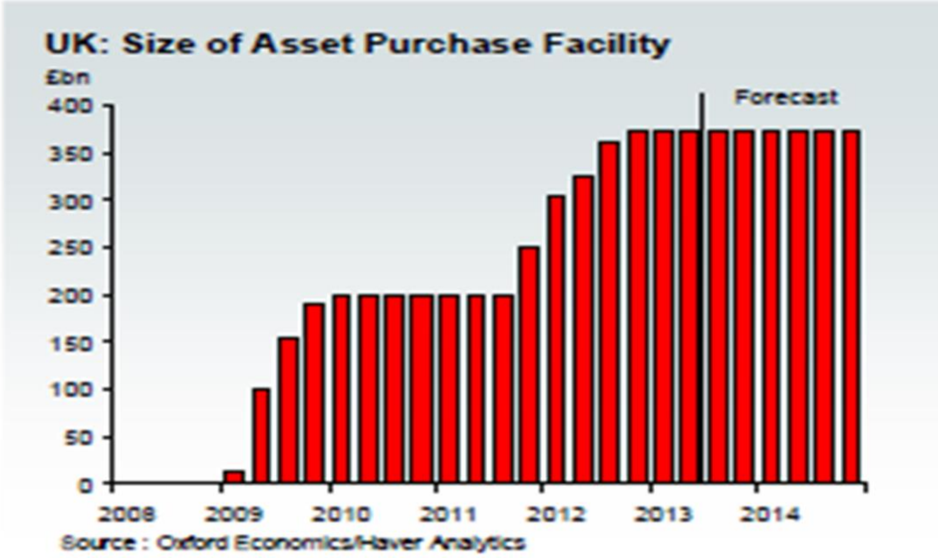
Everything changed as the world financial crisis and the recession developed. The policy rate was cut very rapidly, to reach ½ % - where it remains. At the same time, as discussed above, the exchange rate fell sharply by 20 - 25%. These policy moves were not sufficient to prevent the UK falling into its worst recession since the inter war years. In the process the budget deficit rose to reach over 11 percent of GDP in the fiscal year 2009/10.

Quantitative easing

With interest rates effectively at the Zero Lower Bound (ZLB) – taken to be ½ % in the UK – the Bank of England, in common with other major central banks, moved to 'unconventional' monetary policy, especially in the form of quantitative easing (QE). QE 1 was started in 2009 building up to £200 billion. A second round of easing, QE 2 started towards the end of 2011 as growth continued to be disappointing. As of September 2013, quantitative easing is on hold, as other forms of unconventional monetary policy – especially forward guidance – are being considered (Chart 9).

The efficacy of QE has been much debated. Broadly, it appears that QE 1 may have lowered long term interest rates by about 1 percentage point. There is more scepticism about QE 2, with many arguing that there are diminishing returns to this policy instrument.

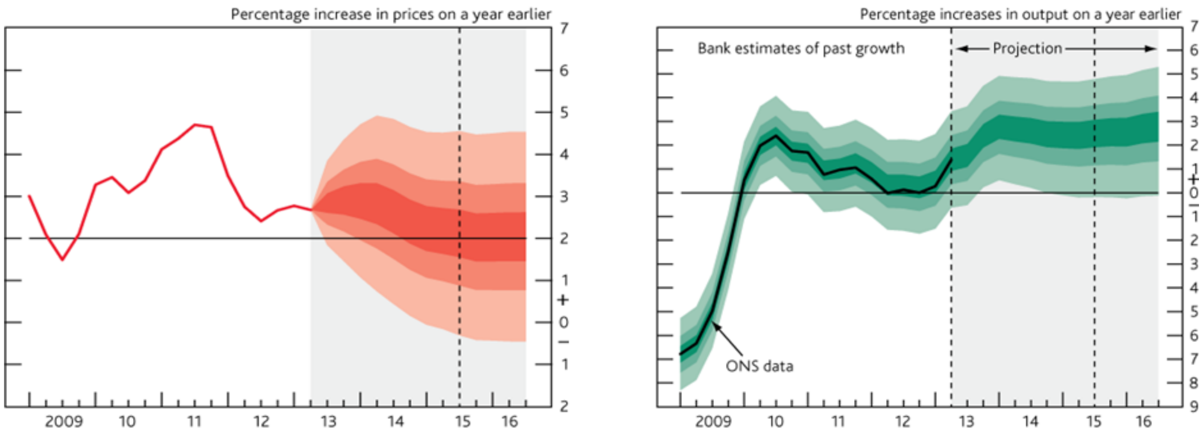
Chart 9



Recent MPC performance

In the course of the recovery, UK monetary policy became controversial – mainly because of persistent over-shooting of the inflation target. The MPC has resolutely 'looked through' above target inflation since 2010. Many argue, however, that credibility has been dented. Many speeches and comments have vigorously defended the policy - see especially David Miles (2011)[2] 'Monetary Policy in Extraordinary Times', Bank of England/Speeches. Explanations for the considerable overshoots include: a larger than expected pass-through from the exchange rate depreciation; administered price rises (especially VAT changes, and tuition fees); oil and other commodity price rises. Chart 10, taken from the Bank's August *Inflation Report*, shows the considerable scale and persistence of the overshoot.

Chart 10. Bank of England Inflation Report August 2013: Fan Charts



[2] http://www.bankofengland.co.uk/publications/Documents/speeches/2011/speech475.pdf

Generally, inflation pressure has been high, especially in relation to goods. There is some question as to whether the rate of inflation in services has bee overstated, given the behaviour of earnings rises in the sector – which have fallen sharply relative to price rises. The Bank argues that inflation expectations remain well anchored.

The new Governor, Mark Carney, took over on the 1st July, 2013 – accompanied by considerable 'hype'. He was expected to favour 'forward guidance' as a way of maintaining the expectation of low interest rates. Forward guidance was made explicit in documentation released with the August inflation Report. A feature of the new framework was the publication of 'trigger' points for a change in monetary policy, the most important of which was for unemployment – with the trigger at 7 percent. The policy appears to have been unsuccessful so far, with market expectations of a bank rate rise being brought forward, and some falls in gilt prices. This could reflect developments in the US, increased worries about 'trigger points' or increasing optimism about the growth prospects for the UK economy. One conclusion that can be drawn, is that it may be difficult to alter the perceived 'reaction function' of an institution such as the MPC by forward guidance.

Longer term issues

As in other countries, the crisis has led to considerable questioning about the role of monetary policy, with broad consensus that new instruments are needed to deal with imbalances and financial stability. In particular, it is suggested that macro-prudential instruments are needed to help prevent excessive risk-taking in booms as well as generally tighter financial regulation.

In the UK the responsibility for financial stability has moved back to the Bank of England 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 interaction between the MPC and the FPC will work. The assignment issues are further complicated since the delegated independence of the MPC is already diluted given dependence on the fiscal authorities in times 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 inter-relationship between the MPC and the Treasury in place before the 'great recession' will be influential. 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, though it is perhaps more likely that any such action would be the province of the FPC.

Finally, it has been suggested that nominal income targeting (as opposed to inflation targeting) has advantages in situations when the economy is in liquidity trap conditions and seems stuck at the ZLB. Such a policy change seems unlikely in the UK, given the well known difficulties with it (not least due to the (un)timeliness of nominal GDP data). The supposed advantages of such a policy are that the authorities would be committed to more expansionary policies, and for longer, when coming out of recession. Such a commitment could be achieved in other ways.

4. Fiscal Policy

The previous labour government, first elected in 1997, adopted two fiscal rules. The first, known as the 'golden rule,' was that current borrowing should balance at zero over the economic cycle. The second, known as the 'sustainable investment criterion' limited net government debt to less than 40 percent of GDP. (Public investment was not limited by the 'golden rule'. The second criterion essentially put a limit on public investment as well). In practice, the golden rule allowed some flexibility, depending on how the economic cycle was defined. For a discussion of fiscal policy over this period see Simon Wren-Lewis (2012).

This fiscal framework was blown apart by the dive into recession in 2008/9. Given the depth of recession, a counter-cyclical fiscal stimulus of about 2% of GDP (that is, relatively small) was delivered in 2009 (mainly via a cut in VAT). Most importantly, the automatic stabilisers were allowed to operate and the budget deficit soared. During the election period in 2010 – which led to the Conservative/Liberal Democrat coalition in May – the main political parties put forward different proposals for fiscal consolidation. The differences between the parties were, however, not huge, though the conservative proposals were more aggressive and more immediate.

The incoming government presented an emergency budget on 22nd June 2010, which appeared to have relatively little effect on spending or confidence. The Spending Review, in October 2010, announcing serious cuts in public spending, appeared to have a much larger effect on consumer and business expectations and confidence. In January 2011, Value Added Tax was raised from 17.5% to 20%.

The new Government made important changes to the fiscal framework in the UK, though features of the previous system were maintained. Initially, the government set out its mandate for fiscal consolidation in terms of two targets or objectives. The first was to balance the cyclically adjusted current budget 5 years ahead (i.e. . (Note the emphasis on the current budget was retained – so public investment was excluded from the target). The second was to have public sector net debt falling in the fiscal year 2015/16. As before, this second target, was likely to operate as a constraint on public investment.

A major change in the framework was the setting up of the Office of Budget Responsibility (OBR) as an independent institution, or 'watchdog'. The OBR is responsible for forecasting and assessing whether the government's self-imposed fiscal mandate was likely to be met. Thus the OBR has relatively little role in policy formation since it takes the government's own policy objectives as given. Essentially, it is designed to remove forecast bias. The OBR was established at the time of the emergency budget and, got off to a weak start. It got into gear with the publication of its first Economic and Fiscal Outlook in November 2010.

Though the OBR is not *per se,* a policy making body, it can have, and has had, important effects on fiscal policy. For example, if the OBR has a pessimistic assessment of future prospects, this will affect projections for public deficits and debt – and, other things being equal, require additional austerity, if the government is to meet its mandate. Another extremely important aspect is that, given that targets are set for the cyclically adjusted current budget, the OBR's assessment of the degree of slack in the economy will influence the policies needed to fulfil the forward-looking mandate. As noted above in discussing the 'productivity puzzle' the assessment of potential output and the degree of slack in the UK is highly uncertain and contentious[3].

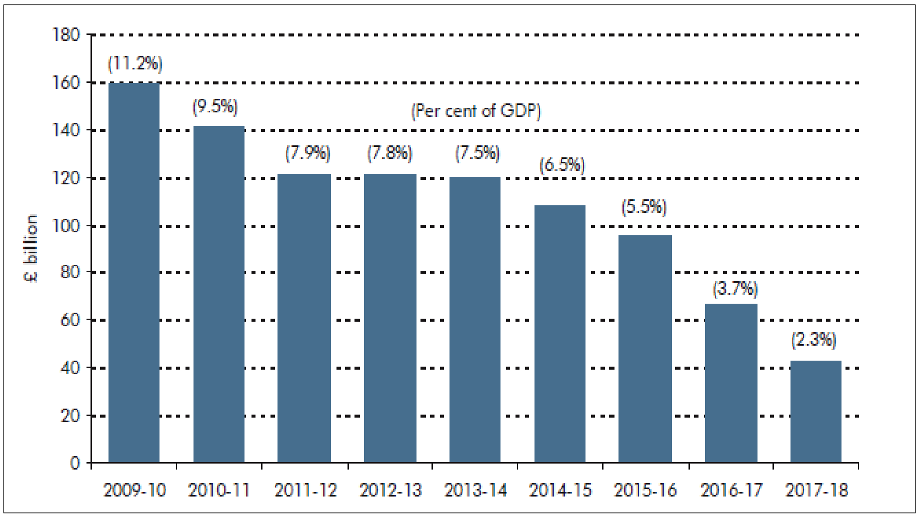
Is austerity working?

The government set itself ambitious plans for fiscal coordination in its self-imposed mandate. Clearly, with the slow growth of the UK economy in 2010- 2012, the mandate became harder to meet. The most recent OBR assessment (March 2013), judged that the austerity programme was broadly on track to meet target for the cyclically adjusted current surplus in 2016/17 – that is, one year late. Similarly, Public Sector Net Debt was forecast to start falling in 2017/18 having peaked the year before at about 88 percent of GDP. Thus, compared with the start of the programme, there has been considerable deterioration. Thus, in November 2010, Net Debt was projected to peak at 70 percent of GDP in the fiscal year, 2013/14. Thus the expected peak has moved outward and upwards. On the other hand, if the recovery takes hold and persists, the peak in the debt ratio could be lower, and be reached sooner.

Chart 11, also from OBR in March, shows what has happened to (actual and anticipated) overall public sector net borrowing. It is clear from the chart, that fiscal consolidation effectively stalled between 2011 and the first half of 2013. This is despite greater and more sustained fiscal austerity in the UK than in most other major countries.

[3] In its March 2013 Economic and Fiscal Outlook, the OBF estimated the output gap in 2012 at 2.7% GDP. It also reported a range of assessments from other forecasting institutions and firms, ranging from 0.8 percent of GDP to 6.0 percent of GDP.

Chart 11. U.K. Public Sector Net Borrowing (excluding Royal Mail and Asset Purchase Facility Transfers)



As to whether the policy is working, the jury is still out. One story is that, despite major shocks, especially from the Eurozone crisis, which account for the stalling recovery and poor performance, the strategy is intact. And, as noted, the Chancellor of the Exchequer (Osborne) has claimed that the recent pick means that the UK has 'turned the corner'. Indeed, there is a stronger claim: that the current recovery shows that the overall strategy of fiscal consolidation is working. Over time, deficit reductions have been less than anticipated. But with a pick up in growth in train (uncertain) of course, the strategy is broadly intact.

The alternative view, which comes in various guises, is that the strategy involved too much consolidation, too early – i.e. whilst private sector deleveraging was still going on. The focus of the target on the cyclically adjusted deficit limited the damage (broadly, the automatic stabilisers were allowed to operate), but not to a sufficient extent. Proponents of this view have, typically, been in favour of a 'plan B' for the UK, calling for more public investment, especially in needed infrastructure (e.g. in the energy and transport sectors), which is argued to be particularly appropriate given extremely low borrowing costs for the government. Public investment is not included in the mandate for the current budget – but an increase would affect the timing and extent of the peak in National Debt (unless, that is, the stimulus 'worked' and public borrowing fell).

The shape and timing of developments in the UK: deleveraging.

The mood of optimism that has gripped the UK has markedly changed the political and economic discourse. Until recently, disputes about the UK's macroeconomic policy were mainly about the timing and degree of fiscal consolidation – or austerity. But the recovery in the UK, without much change in the austerity programme, changes the questions and the debate. Does recovery in the midst of a consolidation programme mean, as sometime suggested, that the strategy has worked? Or would the recovery have happened anyway? And would less austerity have led to an earlier up-turn?

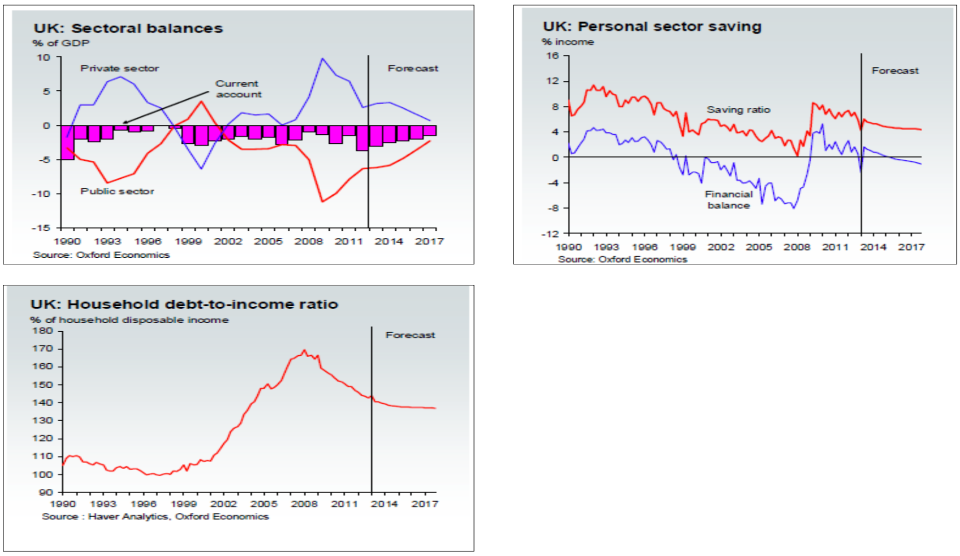
It is common to ascribe the ‘great recession’, in the UK and globally, to a large ‘deleveraging shock’, or, alternatively, to a ‘balance sheet recession‘- the term used by Richard Koo (2003). The focus on stocks and on stock/flow interactions is not new. Keynes (1937) described the problem [of recessions] as arising from a ‘desire for wealth as such…’. An excess demand for ‘wealth as such’ translates, in more familiar flow terms, to an excess of desired savings over investment, seen as attempts by the private sector to build up assets, or reduce debts (deleveraging) by curtailing spending.

When such a (disequilibrium) downturn starts, a standard policy response is to cut interest rates to stimulate investment and cut desired savings. In the ‘Great Recession, though interest rates were cut more or less to zero (the ZLB) the monetary stimulus was overwhelmed and deleveraging continued. The desire to save and to deleverage went up (rather than down) as the economy fell into recession. There was no respite from changes in the current balance of payments (or net trade) since the shocks were essentially global.

The only possible counterpart to private sector deleveraging was a rise in the government deficit, which in the UK, rose to over 10 percent of GDP. Most of this rise reflected the ‘automatic stabilisers’ – especially the fall in tax revenues as output fell. This happened around the end of the first quarter 2009. Since the UK and other countries ‘bottomed out’ around that time, we can deduce that the offset from the budget deficit was sufficient to balance the economy in flow terms. The sectoral balances panel in Chart 12 shows what happened to public and private sector (flow) balances in the UK. Note that the near mirroring of public and private sector data is no accident; it reflects the accounting identity that the sectoral balances of the three sectors, private, public and overseas necessarily sum to zero. The picture of the private sector moving to large surplus, mirrored by a massive rise in the public deficit is fairly typical of financial crises. There were similar, though somewhat smaller, movements in private sector and public sector positions during the UK’s earlier crisis of the early 1990s.

The second and third panels in Chart 12 indicate flows (savings and the financial balance) for the UK personal sector . The jump in savings at the start of the recession and its gradual fall since, is very apparent. The jump is savings and its gradual decline since mirrors movements in the public sector deficit. The third chart shows an indicator of the stock of household debt, which shows that a substantial amount of ‘deleveraging’ has occurred since the crisis. The company sector in the UK (not shown) has been in large financial surplus and has been deleveraging. The problem here has been a lack of investment spending, matched by a build-up of cash and liquidity. There is ample scope for a revival of investment should confidence improve.

Chart 12. Leveraging and deleveraging in the UK



The cumulative effects of public deficits

This sub-section returns to the question of what can account for the marked improvement in short term prospects given that austerity policies are still continuing. As noted above, the conventional story is that the recovery was held back, in the last few years, by adverse developments from abroad, especially, but not exclusively, those emanating from the Eurozone. The change in the UK can be seen as arising from improved confidence as the risks from the Eurozone decline and as actual growth in Europe picks up a bit (it is still very weak, but perhaps not as weak as previously anticipated). A further important international factor is the anticipated, positive, spill-over effects from the developing recovery in the US.

A rather different view of the profile of growth in the UK since 2010 and the recent up-turn, would lay greater stress on the profile of deleveraging and balance sheet effects. According to this story, the deleveraging shock was a ‘stock’ rather than a ‘flow’ effect, which would operate over a number of years as households and companies tried to adjust their balance sheets. Essentially, the private sector needed to lower its debts and raise its net assets by a substantial amount over time. The extent that that could happen is limited, by accounting identity, to the amount of public sector borrowing – which cumulates as long as deficits persist. In ‘stock terms’, the extent to which the public sector has been the counterpart of private sector ‘deleveraging’ is indicated by the quantity of public sector debt outstanding.

The cumulative effects of high public deficits are likely to be extremely powerful. A budget of 10% of GDP is the counterpart to 10% deleveraging by the private sector. If maintained over two years, the figure rises to 20% of GDP. Over 3 years, £30% - and so on. Essentially, there is a limit to how much deleveraging 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.

But what happens if the fiscal authorities try to lower the budget deficit too quickly? Then, the on-going deleveraging in the private sector would be frustrated. But the attempt, by households and companies to deleverage would lead them to cut expenditures, and slow growth, or even cause renewed recession. But the story does not stop there. The lower growth would lead to lower tax revenues (as well as rises in social security payments) and raise the public deficit compared to plans and expectations. The induced higher deficit, would allow more deleveraging to happen, so long as the government does not raise taxes or slash expenditure, to meet its targets come what may. In fact, in the UK, with the primary focus on targets for the cyclically adjusted current budget, the downward spiral should be avoided.

This pattern looks very like what has happened in the UK. Annual forecasts have had to be revised down, and the deficit reduction targets have not been met. But the very fact that the policy has failed in its own terms, carries the seeds of the up-turn which should arise when the cumulative deleveraging has run its course.

So what are the costs if policy gets it wrong in the way described. Essentially, the implication is that more attention to growth (and less stringent targets for deficit and debt reduction) initially, would, on this reasoning, have promoted recovery sooner, with less pain along the way. And because of the stock flow interactions, the peak debt level might be very little affected. Indeed, many would argue that, with better growth and less threat to jobs, the scale of deleveraging might well have been smaller. And, with better growth prospects, business investment would probably have been higher. In short, less austerity, especially in the early stages of the adjustment, might well have speeded up fiscal consolidation and the rebalancing of the economy.

But what about the Bond market? Many would argue that looser policies would trigger a sell off, and high interest rates, if not worse. But the facts of experience work against this worry. There has been no sign of bond market jitters in the UK. Interest rates are at record lows. This is just what should be expected for a country with its own currency and monetary policy, where the solvency of the state is not in doubt.[4] There will, of course, always be commentators who will argue that it is austerity that has caused the low interest rates on government borrowing, and that a less rigorous approach to fiscal consolidation would have been 'punished' by a sell off in the bond markets. In the view of this author, the national and international evidence in favour of this proposition is extremely weak.

It is suggested above that over-enthusiastic public sector austerity is likely to prolong the adjustment after big shocks, such as those that initiated the great recession. And excessive austerity is very unlikely to make long term fiscal sustainability any easier. For that,

[4] Japan has, for many years, been an important (but frequently ignored) example of low bond market interest rates coinciding with an extremely large and rapidly rising public debt.

expectations and confidence have to improve, and there has to be a revival of private investment (so that claims on private capital can substitute for claims on the public sector).

In fact the dangers are much greater than just delay and the prolonging of recession – and are very well illustrated in the UK. As noted, the prolonged recession in the UK has led to a collapse in productivity growth (the 'productivity puzzle'). The real danger here is that due to hysteresis effects, and low investment, the deterioration of potential output becomes permanent. For the UK that means that the costs of getting policies wrong have probably been very high. Productivity is at least 15% below where it would be according to the previous trend (see Chart 3). If this is permanent, the present value of the loss to the UK is enormous (especially if future losses are discounted back to the present at the exceptionally low interest rates that have become the norm in the UK).

And, it could be worse. The loss of potential output, makes fiscal consolidation even harder. There is a danger that inappropriate policies become self-fulfilling, or worse.

5. Concluding remarks

The history of the UK since the financial crisis and the great recession exemplifies the problems faced by many other development countries. The recession was very large and only partially offset by aggressive monetary policies and a relatively small discretionary fiscal offset in 2008/9 (about 2% of GDP, according to IMF figures). Importantly, however, the automatic stabilisers have, on the whole, been allowed to operate, limiting recessionary forces, but at the expense of some overshooting of targets for fiscal consolidation. The recovery since 2010 has, in fact been extremely weak, with output in 2013 around 15% below an estimate of potential based on the extrapolation of previous trends. The social and political cost of this failure has been limited by very poor productivity performance (the productivity 'puzzle') which means that employment and unemployment have been much better than might have been expected. The extent to which productive potential has been permanently destroyed is hard to assess, which means that estimates of the current degree of slack – the output gap – are very uncertain. There is a danger that pessimism about supply potential feeds into further calls for fiscal consolidation.

There are strong signs of improving prospects, but from a very low base. The improvement no doubt reflects the reduction of shocks and uncertainties (especially from the Euro area and the US) as well as deleveraging by the UK private sector. Prospects remain, however, very uncertain.

The UK's policy mix has, broadly speaking, been 'conventional', involving fiscal 'good housekeeping' (i.e. austerity), stabilisation and inflation control delegated to the monetary authorities, and toleration of a relatively large depreciation. With interest rates at their lower bound (ZLB) 'unconventional' policy instruments have also been used (quantitative easing) and other changes are being tried. Despite extremely expansionary monetary policy and depreciation, the performance of exports and investment has, so far, been poor.

The situation in the UK exemplifies a problem faced by many countries: how to control deficits and debt, on the one hand, and promote growth/stabilisation, on the other, with, effectively a single instrument – fiscal policy. Fiscal austerity risks worsening recessionary forces (and could possibly worsen fiscal difficulties in the medium term, if potential supply is damaged). On the other hand, going for growth first postpones needed fiscal action. The problem is unfamiliar since the normal 'assignment' would be for fiscal consolidation to be combined with the use of monetary policy to support output and growth. (This strategy is essentially blocked off when interest rates are at the ZLB)[5]. Thus, the use of fiscal instruments to promote both growth and fiscal consolidation is likely to involve extremely difficult dynamic trade-offs.

Essentially, the policy problem appears to be one of sequencing. After large shocks and in the absence of other instruments, fiscal policy more or less has to be accommodating or expansionary, initially. After that, if attempted fiscal consolidation is too fast, there is the risk of prolonged recession or slow growth. It has been argued above, that the cumulative effects of public deficits and the counterpart to private sector deleveraging will nevertheless support a recovery - even if delayed. A better policy, however, would be to support growth initially until expectations have improved and deleveraging by the private sector is well under way. Fiscal consolidation would then be much easier - especially if private investment revives.

In the UK, there has been much discussion of the possibility of a 'Plan B' –as an alternative to continuing austerity. Most proponents of such a plan favour additional public investment (e.g. on energy and other infrastructure). In principle this is allowable under the coalition government's fiscal mandate. It would, however, raise public debt. Those in favour of such a change in policy typically point to the fact that interest rates on government borrowing are extremely low, and that infrastructure investment creates a real asset that could subsequently be sold on to the private sector.

Until recently, most of the debate about macroeconomic policy has been about the extent and timing of fiscal austerity. With signs of recovery, attention seems to be shifting to the real performance of the economy and the effect on living standards. The 'productivity puzzle' suggests that the UK faces serious structural problems looking forward which may not be easy to fix by adjustments to the macroeconomic framework.

[5] In Japan, aggressive quantitative easing is being used to promote growth and inflation.

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