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Agenda

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Why is the economy stalling, and what can be done?

The UK economy remains in the doldrums, with few signs of the long-awaited recovery. Current austerity measures in the UK and key export markets in the EU may well make matters worse in the next few years. Chris Riley, Oxera Associate and former Senior Economist at the UK Treasury, discusses whether changes in macroeconomic policy might help, including one idea floated recently by the incoming Governor of the Bank of England

Whatever proves to have happened to GDP in the first quarter of this year, and whether or not the UK is technically in a triple-dip recession, its economy has been essentially flat for two years. The sharp recovery in the third quarter of 2012 was largely a reflection of special factors, rather than an indication of underlying growth, and output duly fell back again in the fourth quarter. Employment has been growing, to general surprise, but this is largely the result of falling productivity, which does not bode well for the future.

Growth is stalled by weak demand at home and abroad

There are two main problems in the short term: domestic demand remains weak as the personal and public sectors both seek to reduce their indebtedness at the same time, while our exporters are heavily focused on stagnant or falling European markets. The UK does not suffer from the straitjacket of euro membership, and growth in the rest of the world should provide markets for its exports. But despite falling real wages and a favourable exchange rate, the UK's industry does not seem able to grow in the face of weak domestic and European demand. Companies are not investing, because they do not have confidence that robust growth will resume any time soon. So how can macroeconomic policy help?

Excessive focus on austerity is making matters worse

The UK Budget in March 2013 did not help much. Governments across much of the developed world, especially in Europe, are locked into austerity policies which reinforce each other in reducing demand and output. The International Monetary Fund (IMF) has suggested that GDP multipliers—the proportionate change in national output resulting from a cut in the structural budget deficit—could be in the range of 0.9–1.7 in these circumstances, well into the range where further austerity actually makes public debt problems worse by reducing the size of the economy, risking a vicious cycle of further cuts. The Chancellor of the Exchequer, George Osborne, has wisely chosen to avoid tightening policy further in the near term in the face of the weakening UK economy, choosing instead to extend the process of further cuts over a longer period. Nevertheless, the government is still planning to take an extra ⅔–1% out of the economy each year, on average, over the next five years. The risk of a 'lost decade', or maybe more than a decade, like that suffered by Japan in the 1990s, cannot be ruled out. Near-term forecasts are being progressively revised down, and the recovery forecast by the Office for Budget Responsibility (OBR) in later years does little to close the gap between the output produced by the UK and even the OBR's rather pessimistic estimates of potential GDP.

The classic approach of rebalancing macro policy—tightening fiscal policy while loosening monetary policy—does not really work in the current circumstances because the scope for looser monetary policy is now much reduced; interest rates are at rock bottom, and there are probably diminishing returns to unconventional measures such as quantitative easing. Encouraging the personal sector to borrow more, perhaps to invest in housing, does not look promising, given the need for this sector to reduce its debt after heavy over-borrowing and the resulting asset bubble in the run-up to the crash of 2008. The attempt to stimulate such borrowing announced in the March 2013 Budget has been widely criticised as counterproductive. And exhorting companies to borrow and invest more, when the corporate sector as a whole is running large financial surpluses and confidence remains weak, is also unlikely to be very effective. The government's Funding for Lending scheme is to be extended, but with no guarantee that it will be any more successful than before.

Borrowing more to invest in infrastructure would make sense

By contrast, additional government borrowing to finance worthwhile infrastructure investment—in its widest sense, including, for example, education—makes perfectly good sense in the next few years while borrowing costs remain historically low (actually negative in real terms) because of weakness in the economy. As long as longer-term plans to reduce the deficit remain convincing, this would be most unlikely to undermine confidence in the UK's fiscal position in financial markets. And it is easy to demonstrate that, with negative real interest rates, only modest returns in terms of higher potential output and tax revenues would be needed to ensure that such investment is entirely self-financing over time. If, as some argue, there is much more spare capacity in the economy than current OBR estimates suggest—perhaps because tight fiscal policies are themselves reducing potential output (a phenomenon known as 'hysteresis') —the need to tighten fiscal policy may be less than the government's approach implies anyway. It would help greatly if we could persuade other countries with essentially manageable fiscal positions that over-emphasis on austerity is likely to be counterproductive.

Time to change the inflation target?

Various commentators have argued for a shift in the government's approach to macroeconomic policy, with some suggesting a switch to targeting nominal GDP or raising the inflation target. The latter would need to be a temporary measure, to apply before a resumption of robust growth takes hold, because it would be hard to argue that permanently higher inflation is desirable. It would work largely by reducing real interest rates, encouraging private consumption and investment. At the same time it would devalue existing public debt, reducing the scale of the fiscal problem, albeit at the expense of investors. In effect, the Bank of England is already pursuing such a policy informally, with inflation well above target over the last few years (in the face of price shocks from world commodity prices and indirect tax increases) and expected to remain so for the next three years.

But pursuing this approach further does beg the question of how to achieve an increase in inflation above the path currently expected. Raising aggregate demand through more expansionary fiscal policy has been ruled out by the government, for better or worse, while, as already noted, there is little scope to ease monetary policy further. A faster rise in wages, as some have advocated, may increase inflation but only at the cost of reduced national competitiveness—unless, of course, it is warranted by higher productivity growth, in which case inflation would not be affected.

Or even use a different kind of target?

The rationale for adopting a nominal GDP target—an idea floated in recent months by various commentators, including the incoming Governor of the Bank of England, Mark Carney—is quite similar. The aim would be to increase the growth of nominal demand from its current rate of around 3% a year, but this, too, raises a number of issues. As with a higher inflation objective, there would be the question of how to achieve it. And unlike CPI or RPI inflation, data for nominal GDP is available only quarterly, well after the quarter in question, and subject to significant revision. Monthly adjustment of interest rates in response to new information, as was common before the unchanged level sustained in the past few years, would be less easy to pursue as a consequence.

There is also a question about whether such a target would be appropriate in particular circumstances, and in practice it would need to change as our understanding of the potential growth rate of the economy changes. If a change observed in the split of nominal GDP growth between output growth and inflation proved to be the result of a change in growth potential, which might not be apparent at the time, it would be desirable to change the nominal GDP target rather than accept a permanently different inflation rate. For example, if higher wage settlements led to a sustained increase in domestic inflationary pressures, this would tend to reduce competitiveness and growth potential, but might leave nominal GDP little changed. It would nevertheless warrant a reduction in the target. A nominal GDP target would therefore be reasonably robust only if economic changes were generated solely by swings in demand, while supply conditions and the growth in productive potential were stable and predictable—not an assumption that has been given much credence by events over the last decade.

In practice, it is therefore necessary to focus separately on both inflation and output—and hence the composition of nominal GDP—as the Bank of England has effectively been doing, and its remit to target inflation in a flexible way should reflect this. At Budget time the Chancellor published a review of the framework of monetary policy which examined various options for change,[1] and updated the Bank's remit. The new remit reasserts the primacy of the inflation objective, pursued in a flexible way, and requires the Bank to set out clearly the trade-offs it has made in deciding how long it will be before inflation returns to target while 'giving due consideration to output volatility'.[2] It also makes clear that the Committee may wish to issue explicit forward guidance, including using intermediate thresholds—such as nominal GDP—in order to influence expectations about the future path of interest rates. The Chancellor has also asked the Monetary Policy Committee to provide an assessment of how intermediate thresholds might work in the UK. This seems a sensible approach.

Conclusion

While commentators differ about the role that more active demand management can usefully play in steering the economy, few, if any, regard it as being the only requirement under current circumstances. Policies that improve supply performance are also vital if sustained economic recovery is to be achieved. The Budget has taken some steps in this direction, as have previous Budgets, but the impact of such measures typically takes a considerable time to come through. They are unlikely to affect the short-term prospect significantly.

Chris Riley

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[1] HM Treasury (2013), 'Review of the Monetary Framework Policy', March.
[2] Osborne, G. (2013), 'Remit for the Monetary Policy Committee', March 20th.