Macroeconomic Policy Beyond Brexit

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Introduction

IF YOU ask a macroeconomist how macroeconomic policy should change as a result of Brexit, the chances are they will reply by saying it is a daft question. Leaving the Single Market and Customs Union of the EU will have a negative effect on UK productivity and, therefore, inevitably living standards, that the conventional tools of monetary and fiscal policy can do nothing to prevent or reverse. In this chapter I want to suggest this is rather old-fashioned thinking. What the global financial crisis (GFC), austerity and now Brexit have shown us is that sharp negative shocks to the economy can have additional permanent effects if they are not offset quickly and strongly by macroeconomic policy. One reason the UK has had a poor productivity performance since the GFC is that macroeconomic policy tools have failed to do this. To the extent that Brexit itself will reduce growth in living standards, it is imperative that we do not compound this by repeating the macroeconomic policy mistakes of the last decade. This chapter looks at where we have gone wrong and how we can do better after Brexit.

Productivity

Unless we stay in both the Customs Union and Single Market, Brexit will make trade with the EU substantially more difficult. Brexiters talk about making new trade agreements with countries outside the EU, but in reality, we are likely to lose more agreements with those countries by leaving the EU than we are likely to gain. Even if trade with third countries did increase, gravity equations—empirical relationships that look at the extent of bilateral trade—tell us that trade with third countries will never compensate for the trade lost to the EU simply because the EU is on our doorstep. That is what the government's own analysis tells us, and it reflects every serious academic study.

Less trade with the EU means that the UK economy becomes less open. That reduces productivity (how much output you get from a given labour force) because you lose some of the gains of specialisation. There is also good evidence that less open economies (in terms of goods and migration) have slower productivity growth than more open economies. Productivity growth is the main determinant, in the medium and long run, of growth in living standards.

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All this is about resources available to the economy, rather than how those resources are utilised. The macroeconomics of monetary and fiscal policy is about resource utilisation: how to avoid booms that bring higher inflation and busts that increase unemployment. Therefore, the conventional view argues that monetary and fiscal policy can do nothing to counteract the trade lost as a result of Brexit and the productivity decline that produces. There may be many other ways of trying to compensate with policies to boost productivity, but all of these policies could have been done without Brexit, and their impact will have little to do with Brexit.

This conventional view misses an important point which more and more macroeconomists are beginning to take seriously. Following shocks like Brexit, if you get your macroeconomic policy seriously wrong this can make the permanent impact of those shocks worse. This is illustrated by what has happened to UK productivity since the GFC. The literature on what is called the UK productivity puzzle is huge, and I cannot do justice to it here, but I can give you my own interpretation of the evidence.

If you look at productivity growth across the globe,[1] it started slowing in the 1980s and the slowdown gradually intensified until and perhaps beyond the GFC. The UK managed to buck this international trend. Many factors could explain the UK's relatively good performance, such as the Thatcher governments' labour market reforms and the impact that joining the Single Market had on our service exports. The UK continued to experience productivity growth above our European neighbours under the Labour government.[2] This relatively good performance was across the board, and not an artefact of a financial sector bubble. Government policy may have had some role in this, by strengthening competition policy, supporting innovation, expanding university education, improving regulations and possibly higher immigration.

While our productivity performance was better than France and Germany before the GFC, the opposite has been true since then. By some accounts, UK productivity growth over the last decade is worse than it has been for a century. Why this reversal of fortunes? A lot of discussion treats this poor UK performance as something that has been constant since the Great Recession. But if we take a closer look at growth in each quarter compared to a year earlier (see Figure 1), a more interesting pattern emerges.

UK productivity growth did recover after the recession, but growth was lower in 2011 and was then negative in 2012. Growth began to pick up in 2014, but then came to a halt again at the end of 2015. We can make sense of this pattern if we stop thinking of productivity growth as something that is independent of major policy changes. Productivity growth is normally strong in business cycle recoveries because demand grows rapidly, forcing firms to invest in new technology to meet that demand. However the UK recovery after the Great Recession was unlike any other for the last hundred years: we hardly saw any output growth before 2013. A big factor behind this poor recovery was austerity. Why would austerity reduce productivity

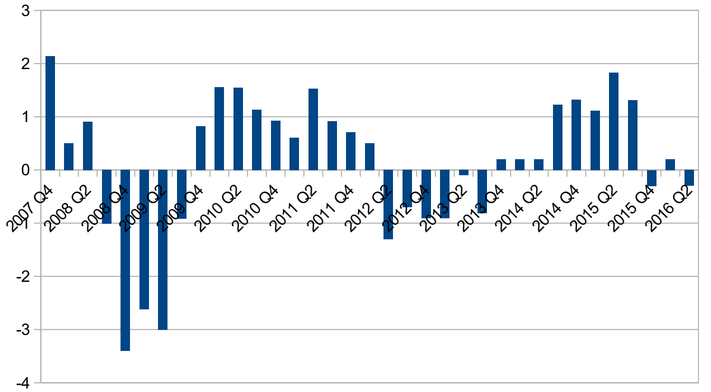

Figure 1: Growth in UK output per hour, quarter on previous year's quarter, %

Source: ONS

growth? Austerity reduced the growth in demand, which in turn reduced the need to invest in new techniques to meet that demand. Once the economy finally started growing again in 2013, productivity growth began to pick up.

So what led productivity growth to stall at the end of 2015? The obvious answer is uncertainty about the EU referendum: the unexpected Conservative win in 2015 raised the possibility of Brexit. In my view, at least part of the story behind weak UK productivity growth is uncertainty about the UK recovery because of austerity and Brexit uncertainty.

The implication of our recent experience is that if you screw up macroeconomic policy you will have lasting negative effects on the UK's productivity growth and therefore, inevitably, its prosperity. But the reverse should also be true. If macroeconomic policy puts the emphasis on sustainable growth and tries to minimise disruptive shocks, it will create an environment that encourages productivity growth and therefore growth in living standards.

So where did macroeconomic policy since the GFC go wrong? Why did it fail to combat the negative demand effects of the GFC and Brexit uncertainty, such that levels of productivity are now permanently lower than they might have been? I will start with monetary policy, because according to what I call the 'consensus assignment',[3] it is the stabilisation policy of choice.

Monetary policy

If you ask many monetary policy makers, including those at the Bank of England, how well monetary policy has been conducted over the last decade, they will typically say their performance has not been too bad. In the context of a slowest recovery in centuries and a deviation compared to previous output trends currently exceeding 15 per cent and growing, that seems an extraordinary response. They will justify that response by referring to inflation, and saying that the decline in output was beyond their control, which I have already argued is incorrect. This suggests that having inflation as the primary target has made UK macroeconomic policy worse over the last decade, with apparently permanent costs.

We can see that happening at specific instances in time. A clear example was when the European Central Bank raised interest rates in 2011. The recovery from the recession caused by the GFC had hardly begun, but a temporary uplift in inflation largely caused by higher oil prices led them to raise interest rates. The same almost happened in the UK, with three out of nine Monetary Policy Committee members voting for a rate increase. The US did not make the same mistake (even though core inflation briefly rose above 2 per cent), but it is notable that the US central bank has a dual mandate (inflation and employment).

This suggests that to continue with inflation as the primary target could jeopardise a macroeconomic policy that focusses on strong growth, and quickly offsets any negative shocks. There is a danger that the Bank of England will overreact to temporary increases in inflation, which will blunt a recovery and cause a permanent loss in productivity. However, a simple dual mandate of the US type gives insufficient indication of where the central bank's priorities should lie. I would favour changing the Bank's mandate to be

to maximise output growth subject to maintaining inflation within 1 per cent of its target by the end of a (rolling) five-year period

This mandate allows the central bank to ignore temporary increases in inflation, and focus on sustainable output growth. This can be rationalised by thinking about what the costs of inflation are. Modern macroeconomics examines how, if prices are sticky, inflation can lead to distortions in the allocation of resources because sticky prices are changed at different times. According to this reasoning, inflation in flexible prices, like exchange rates or commodity prices, is not costly. So it seems to make sense for monetary policy makers to ignore temporary movements in inflation, and instead focus on medium term inflation which will reflect changes in sticky prices.

There are other microeconomic arguments for allowing greater variability in inflation compared to output variability. Inflation a per cent or two above target inconveniences everyone a little, but falls in output can have relatively little impact on most but can mean spells of unemployment for a few. There are standard economic reasons why we should care about large costs for a few over small costs for the many, even if on average those costs are the same.

There is another argument for shifting the emphasis from inflation to output. When the inflation target is low, like 2 per cent, this leads to asymmetric risks for monetary policy makers. Running the economy too hot will lead to higher inflation, which can be dampened quite quickly with higher nominal rates. However, running the economy too cold can be much more serious, for two reasons. First, because wages are rigid downward (few like giving or receiving negative nominal wage increases), it is often unclear that the economy is running cold. Second, even if it is recognised, the existence of a lower bound for nominal interest rates means that the central bank's ability to deal with this can be impaired. Putting the emphasis of the central bank's mandate on growth rather than inflation is one way of counteracting that asymmetry.

What should the inflation target be? Another lesson from the GFC is that a low target like 2 per cent risks central banks hitting the lower bound for interest rates quite frequently. A number of economists have suggested raising the inflation target to 4 per cent to ensure this happens less often. While it is hard from a political point of view to raise an inflation target (because many people think it implies lower real incomes), the form of rule suggested above will in effect raise average inflation to above 3 per cent even if the formal target stays at 2 per cent.

I would augment this rule if nominal interest rates hit their lower bound in a way suggested by ex-Fed chair Ben Bernanke.[4] When rates hit their lower bound, it is advantageous to promise lax monetary policy in the future, because this will lead forward-looking firms to spend more or cut prices less today. This could be achieved by converting the inflation target into a path for the price level, so that any undershoot in inflation today requires an overshoot later. Thus

when interest rates hit their lower bound the mandate should be to maximise growth subject to not exceeding by more than 1 per cent a price path consistent with the inflation target.

Although higher average inflation and this additional clause reduces the chances of hitting the lower bound for interest rates, that possibility still exists. Proposals to avoid the lower bound completely, such as negative interest rates or helicopter money, require a lot more analysis before they will become acceptable to the academic or central bank communities.

The main instrument central banks currently use when rates are at their lower bound, quantitative easing (QE), is just too unreliable compared to either interest rate changes or fiscal policy. To maximise the pressure on fiscal policy makers to stimulate the economy when rates are at their lower bound, I would take up the suggestion from Ed Balls and colleagues and require the Bank to send quarterly letters to the Chancellor indicating the stimulus they think is needed when rates are at their lower bound.[5]

Fiscal policy

Fiscal stimulus in response to interest rates hitting their lower bound happened in 2009, but went into reverse in 2010. Ostensibly, this reverse was because of worries about whether the markets would continue to buy government debt. For a country like the UK that has its own currency, this fear was and continues to remain groundless. The fact that the UK has a central bank that can buy government debt means that the UK government can never be forced to default. One thing QE shows clearly is that creating money to buy debt is not inflationary in a recession. The evidence we have suggests there was no impending crisis in 2010. Comment by City folk is not evidence. This is why macroeconomic textbooks say you should have fiscal stimulus in a recession, with no qualifications about the level of debt. There is no consensus macromodel which says that governments with their own currency should be cautious about using fiscal expansion in a recession. Instead, there is a general view that demand-induced recessions can always be ended using a combination of monetary and fiscal policy.

This is not to say that we should be unconcerned about government debt. Instead, it is about priorities and timing. In a recession, the priority is to end it as soon as possible. That may lead to a substantial increase in government debt, but it is absolutely the right thing to do. The reason is very simple. In a recession, trying to cut debt (austerity) wastes resources. Earlier, I suggested that it may also stop productivity increases because firms no longer need to invest in better production techniques. The time to worry about debt is when cutting spending or raising taxes need have no impact on demand and so waste no resources, because its impact on demand can be offset by cutting interest rates. The one time that cannot be done for a country like the UK is when interest rates are at their lower bound.

That was why Jonathan Portes and I suggested that any fiscal rule should have what you could call an interest rate lower bound knockout.[6] As soon as interest rates were likely to hit their lower bound, the normal rule should be suspended and fiscal policy should do whatever it takes to boost demand such that the central bank is able to raise rates again. That could raise government debt substantially, but once interest rates are at more normal levels, debt can be reduced. Basic economic theory suggests the optimal way to reduce government debt is slowly. This means that the fiscal rule outwith zero lower bound periods should target the deficit over a rolling five-year period.

Another argument we make is that public investment should be independent of the main fiscal rule. In other words, the fiscal rule should focus on current rather than capital expenditure. One reason for doing this is that otherwise, it is politically attractive to try and meet deficit targets by cutting investment rather than current spending, and this will lead over time to a deterioration in the supply side of the economy. It is especially important that public investment is not artificially constrained in a post-Brexit future, because public investment is an important means of both directly improving productivity and also facilitating private investment.

The fiscal rule I describe here is similar to the Labour party's fiscal credibility rule. Labour's rule targets a current balance of zero over a moving five-year period (assuming the knockout does not apply), which is similar to the coalition government's original rule (although in that situation the knockout should have applied!). However, Labour's rule also targets a falling debt to income ratio over a five-year period. My own view is that this last target is unnecessary, and could put unnecessary constraints on public investment. With the extent of recovery highly uncertain, a terrible recent record of productivity growth and very low interest rates, now is not the time to constrain public investment because of some arbitrary debt ratio target.

Above all else, it was reversing fiscal stimulus in 2010 (austerity) that prevented a strong and quick recovery from the GFC and helped create the UK's productivity slowdown. Much the same can be said about Brexit uncertainty that began in 2015. This uncertainty was bound to reduce demand, because investment would be put on hold. Yet, rather than offsetting this impact using a fiscal stimulus, we had further austerity instead. (Interest rates were cut after the vote, but only slightly because they were already close to the lower bound.) As a result GDP per head actually fell in the first quarter of 2018.

Many on the left want to go much further than I have suggested, and abandon fiscal rules altogether. I have heard these rules called neoliberal. Fiscal rules (and subsequently fiscal councils like the Office for Budget Responsibility) became popular to counteract what economists called deficit bias: the tendency before the GFC among many economies (but not the UK) to gradually increase the debt to income ratio over time.

There are sound economic reasons for wanting to avoid deficit bias. For example, rising debt needs higher debt interest payments to service it, which in turn increases taxes which have disincentive effects. Fiscal rules are a restraint on governments either cutting taxes, or raising spending to gain political popularity, or to satisfy interest groups, much as Donald Trump has done recently. But this is a medium/long term problem, and it is never a problem that should stop the government doing all it can to end a recession.

Nominal wages as a macroeconomic instrument?

There are two ways in which governments could, directly or indirectly, put upward pressure on nominal wages beyond influencing aggregate demand. The direct instrument is the minimum wage. This had been set by the Low Pay Commission under Labour, but George Osborne in 2015 decided to increase the minimum wage by more than the Commission had recommended. The indirect instrument is to encourage greater unionisation by various means.

Why would you suggest using either as a macroeconomic policy instrument? The background has been a period of unprecedented decline in real wages in the UK. Many have blamed the currently weak position of the workforce and declining unionisation for this. However, we can almost completely account for low real wages with three factors: stagnant productivity already discussed; two depreciations in sterling which raises the price of imported goods; and rises in indirect taxes associated with austerity. The profit share of corporations has remained relatively static over the last fifteen years.

Many might find it counter-intuitive that weak nominal wages are not responsible for weak real wages. However, this may simply reflect that firms are passing on low nominal wages into low prices to maintain competitiveness. There may nevertheless be a route by which low nominal wages could cause low real wages, and that is if low nominal wages encourage firms to substitute labour for capital, or put off productivity improvements.

There is some evidence that increases in minimum wages can encourage automation.[7] At first sight this seems to contradict the idea that low nominal wages have simply been passed on into lower prices. But raising the minimum wage, or growing unionisation in a few sectors, is different from an increase in wages across the economy. Some firms may be reluctant to raise prices in the former case because it raises their relative price against goods not subject to this wage push, and so may choose to automate instead.

However, we have to be cautious here. The received wisdom, in the UK at least, is that a moderate minimum wage does not lead to significant declines in employment, which appears to imply no labour-saving productivity gains. Significantly higher minimum wages may increase productivity, but they are also likely to raise inflation, and thereby effectively raise the NAIRU (the level of unemployment at which inflation stays constant). It is possible to argue that any new restrictions on migration from the EU, by creating labour shortages, will itself encourage growth in labour-saving productivity. However, an alternative for any such firm is to simply move production abroad.

My own view is that stimulating demand in a high employment but low productivity environment is a far more effective way of stimulating productivity growth than trying to engineer higher nominal wages. In other words, the best way of stimulating wages is through additional demand making the labour market tight, which will provide a strong incentive for firms to invest in productivity improvements, improvements that would then lead to higher real wages. There are other and better reasons to have a minimum wage and stronger unions than an attempt to boost productivity.

Conclusion

I have argued that the last decade has exposed serious flaws in the way macroeconomic policy is done in the UK, and have suggested how to remove those flaws. Implementing these proposals will not reverse the damaging impact of the loss of trade that Brexit will bring, but they could allow the UK to return to having reasonable growth and productivity levels rather than the stagnation we have experienced since the GFC.

There is one final political economy link between past macroeconomic policy failures and Brexit that it is important to note. The biggest macroeconomic policy failure I have discussed is austerity, and there is some evidence of links between austerity and the rise in UKIP, which helped influence both the decision to hold a referendum and the referendum result itself.[8] More generally, the links between economic stagnation and the rise of populism and xenophobia are clear.[9] Brexit will reduce future UK productivity growth, and therefore future UK living standards. The political health of the UK may also depend on not compounding the impact of Brexit by repeating the macroeconomic policy mistakes of the last decade.

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