IB Economics — IA commentary coversheet

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UK 'will need to cut taxes or boost spending at next downturn'

Effectiveness of monetary policy will be limited in next recession, say ex-BoE officials

Phillip Inman

Fri 7 Dec 2018 18.19 GMT

The government will need to cut taxes or boost spending when the next economic downturn arrives, according to two former Bank of England officials who said the central bank was low on firepower.

The former deputy governors Rachel Lomax and Sir Charles Bean warned ministers they will be unable to rely on monetary policy to combat the next recession now that interest rates are at historically low levels.

They said a stimulus package based on a cut in the Bank's base rate from 0.75% would only have a limited effect on borrowing costs and leave the Treasury with no option but to use its own finances to boost the economy.

The comments came a week after the Bank of England's governor, Mark Carney, said a disorderly exit from the European Union could plunge the UK into a deeper recession than

any seen over the last 100 years.

Carney said the scenario mapped out by Threadneedle Street to illustrate the worst possible outcome from a no-deal Brexit would push up unemployment and inflation while also hitting house prices.

Speaking at a monetary policy forum organised by Fathom Consulting, Bean, who is the chief forecaster at the Office for Budget Responsibility, said: “I do think we need to start thinking again about using fiscal policy more actively than we have in recent years.”

In a broader attack, Lomax said governments would need to adopt extra spending to aid the recovery and not follow the austerity programme of the last 10 years.

“It is a major puzzle to me that the reaction to the financial crisis on fiscal policy was the way it was,” she said, adding: “Governments have got scared of fiscal policy responses and if ever there was a case for it, it was then.”

Bean also said that if ministers were reluctant to borrow more, they could boost the economy in a downturn with public investment backed by tax increases, which would stimulate growth more than other measures.

Over the longer term, Bean and Lomax said, governments should consider taxing wealth, and property in particular, to reduce the need for higher government borrowing.

Bean said: “A wealth tax could target property, though there is now a serious debate about taxing land.”

Lomax said her work at the Treasury during the 1970s involved drawing up a wealth tax green paper for the then Labour government that was shelved. A critic of George Osborne’s austerity policies, she said the government and the central bank needed to have a more “joined-up approach” to tackling the next financial crisis or risk a long period of stagnation akin to the last 10 years.

“Monetary policy has become siloed since central bank independence in the 1990s,” she said. “There needs to be an examination of the winners and losers from various policies: a political economy approach rather than one where fiscal and monetary policy are separate.

“It’s true that there is some character from the Treasury is sitting listening to the [monetary policy committee], but I don’t see any evidence that leads to joined-up thinking.”

"UK 'will need to cut taxes or boost spending at next downturn' " [1]

Commentary

The article discusses the economic implications of Brexit and proposes that "using fiscal policy more actively"[2] should be the government intervention of choice "when the next economic downturn arrives"[3]. Fiscal policy is defined as all government spending and tax policies employed to manage an economy. An economic downturn (recession) is defined as a decrease in output of a nation, measured in real-GDP, over two consecutive quarters. This commentary focuses on syllabus topic 2.4.

The article discusses how "the [British] government will need to cut taxes or boost spending when the next economic downturn arrives"[4]. This is the use of expansionary fiscal policy as the government aim is to increase aggregate demand (AD), the overall demand for goods and services in an economy. Government spending is the combined expenditure on public goods, merit goods, transfer payments and all additional spending by the government which is mainly financed through direct and indirect taxes. The article argues that fiscal policy will be more effective than monetary policy to counter a possible recession as a "cut in the Bank's base rate from 0.75% would only have a limited effect on borrowing costs". Furthermore, if confidence in the economy is low, households and firms will not acquire a loan. Therefore, lowering the interest rate, will have little to no effect on growth and spending. Monetary policy is employed by the central bank in form of controlling interest rates and federal reserve requirements or the government in form of selling or buying bonds in order to increase or decrease AD by regulating money supply.

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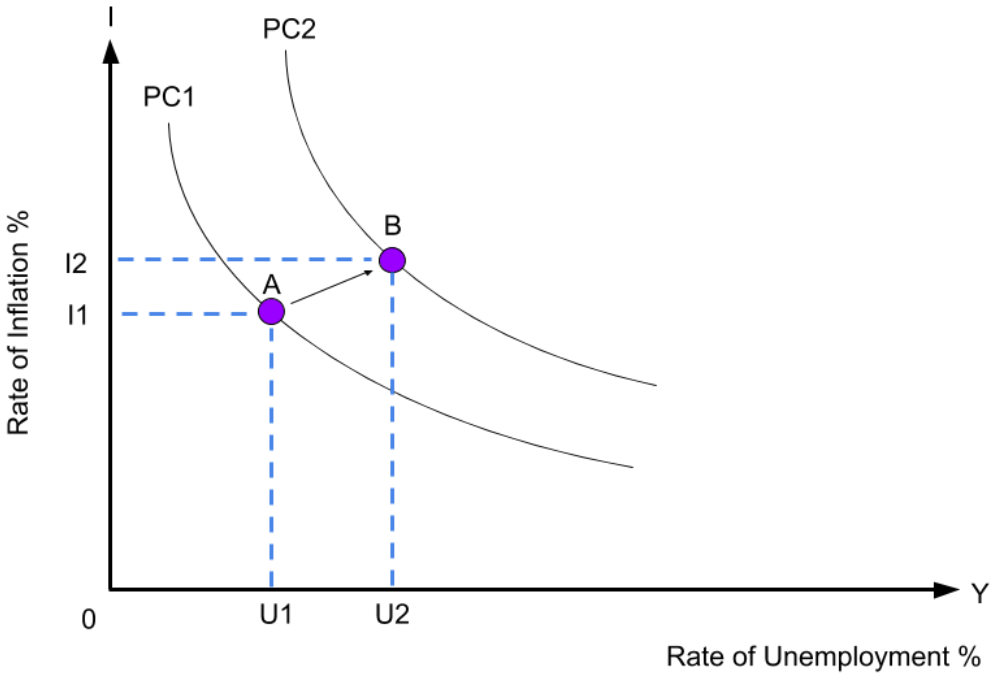
[1]Inman, P. (2018, December 7). UK 'will need to cut taxes or boost spending at next downturn'. Retrieved from https://www.theguardian.com/business/2018/dec/07/uk-will-need-to-cut-taxes-or-boost-spending-at-next-downturn

[2] Ibid

[3] Ibid

[4] Ibid

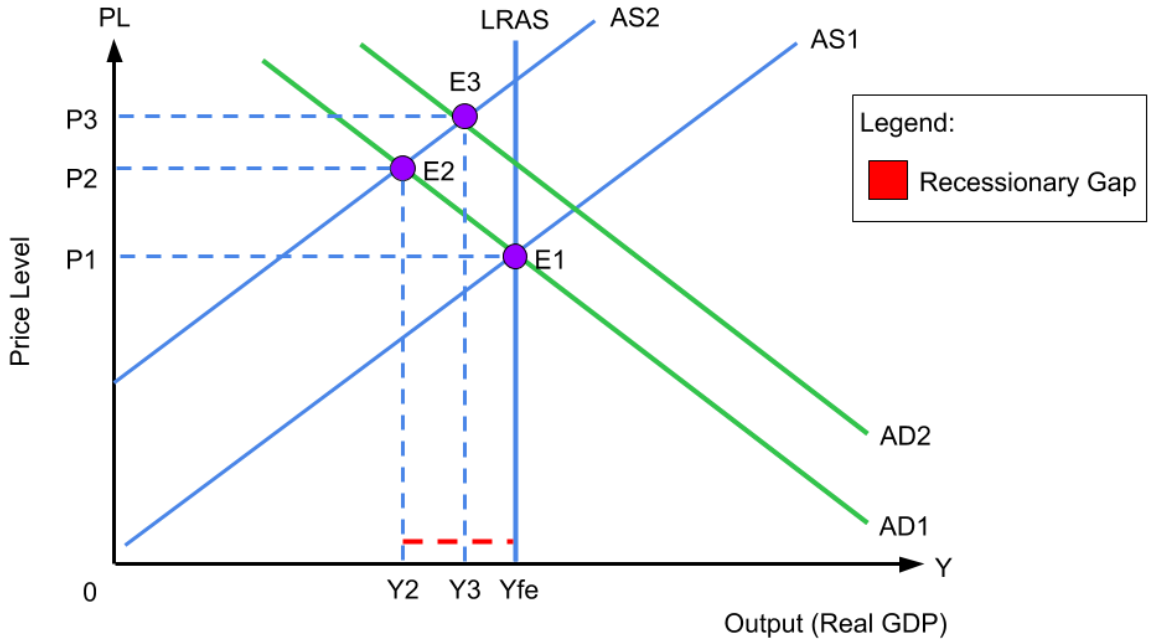
Diagram 1: Phillips Curve Shift illustrating 'Stagflation' in the UK post Brexit



The shift of the Phillips Curve from 'PC1' to 'PC2' in 'Diagram 1' illustrates how "the worst possible outcome from a no-deal Brexit would push up unemployment and inflation"[5], also known as stagflation. Note that this commentary assumes a no-deal Brexit. Unemployment is the measure of individuals in an economy that are part of the workforce but are not currently employed. Inflation is the percentage measure of how prices for goods and services in an economy increases. As seen in 'Diagram 1', the economy no longer operates at 'A', where the rate of unemployment is at 'U1' and the rate of inflation is at 'I1'. Instead, the economy has now operates at 'B' where unemployment has increased to 'U2' and inflation has increased to 'I2'. Here, the economy is experiencing inflation without growth due to a decrease in Aggregate Supply (AS), the overall supply for goods and services in an economy.

[5] Ibid

Diagram 2: Classical Model illustrating Stagflation and Expansionary Fiscal Policy through shifts in AS & AD



'Diagram 2' illustrates stagflation through the shift in AS. Analysis begins at 'E1' where the economy is operating before the recession. As implications of a "no-deal Brexit would push up unemployment and inflation"[6], AS shifts from 'AS1' to 'AS2'. Output is reduced from 'Yfe', at full employment, to 'Y2', creating a recessionary gap from 'Yfe' to 'Y2'. Here the economy would enter a recession and is now facing increased unemployment. Furthermore, inflation occurs as the price level increases from 'P1' to 'P2', creating equilibrium at 'E2'. An increase in government spending and/or a decrease in taxation would counter the recessionary effect on AD by shifting AD from 'AD1' to 'AD2' where the deflationary gap is reduced to the difference between 'Yfe' and 'Y3'. The new equilibrium is at 'E3'. The economy may not be back at full employment but it has partly recovered from the recession so that employment is rising and the economy is producing more output than at 'E2'.

The use of fiscal policy, proposed by the article, would function as an injection into the economy that stimulates growth, thus reducing unemployment, provided that the money is spend and not saved. In addition, "if ministers were reluctant to borrow more, they could boost the economy in a downturn"[7] without having to spend less on public goods and transfer payment as this would negatively affect development. However, the government should not "consider taxing

[6] Ibid
[7] Ibid

wealth and property"[8] or "tax increases"[9], as this could have negative effects such as capital flight, where financial assets and capital leave the economy due to higher costs for firms and households, and brain drain, where highly qualified individuals emigrate. Capital flight would cause further cost push inflation as more industries leave Britain, causing more stagflation by shifting AS inward. Therefore, although "taxing wealth and property"[10] or generally increasing taxes would boost the government's tax revenue in the short run, it would only harm the economy in the long run, making the measure counterproductive.

Words: 748

[8] Ibid
[9] Ibid
[10] Ibid