A pro-growth economic strategy

Policy Exchange

By Gerard Lyons, Warwick Lightfoot and Jan Zeber

A pro-growth economic strategy

By Gerard Lyons, Warwick Lightfoot and Jan Zeber

Policy Exchange is the UK's leading think tank. We are an independent, non-partisan educational charity whose mission is to develop and promote new policy ideas that will deliver better public services, a stronger society and a more dynamic economy.

Policy Exchange is committed to an evidence-based approach to policy development and retains copyright and full editorial control over all its written research. We work in partnership with academics and other experts and commission major studies involving thorough empirical research of alternative policy outcomes. We believe that the policy experience of other countries offers important lessons for government in the UK. We also believe that government has much to learn from business and the voluntary sector.

Registered charity no: 1096300.

About the Authors

Dr Gerard Lyons is a Senior Fellow at Policy Exchange. He is a leading economist, being an expert on the UK and world economy, global financial markets and economic and monetary policy. He has a portfolio of roles, as Chief Economic Strategist at Netwealth, on the Board of Bank of China (UK) and sits on the advisory boards at both Warwick Business School, and the Grantham Research Institute on Climate Change and the Environment at the LSE and Imperial College. Last year he was a contender for the role of Governor of the Bank of England. He was Chief Economic Adviser to Boris Johnson during his second term as the Mayor of London. At City Hall, among other things, he championed the London Living Wage and helped promote London's global position. Gerard played a leading role in 2016 Referendum, co-founding Economists for Brexit. He also has 27 years' experience in The City in senior research and business roles with leading international banks, including Standard Chartered where he was Global Head of Research and sat on the Bank's Executive Forum, Risk Management Committee and Global Markets Management Team, as Chief Economist and Executive Director at Dai-Ichi Kangyo Bank (DKB) International, then the biggest bank in the world, Chief UK Economist at Swiss Bank Corporation, beginning his career at Chase. Gerard has an excellent forecasting record. He has testified to committees of the US Congress and Senate as well as Parliamentary Committees in the UK, including giving evidence recently to the House of Commons Treasury Select Committee on the Covid-19 crisis. He served a five year term having been voted by other economists onto the Council of the Royal Economic Society and was made a Fellow of the Society of Professional Economists. His books include, co-author of *Clean Brexit*, described by *The Times* and *The Economist* as one of the best books on the subject and his first book, *The Consolations of Economics*, was serialised in the *Daily Telegraph* and named one of their business books of the year. His PhD is from the University of London. He is asked regularly to speak at major domestic and global economic and financial conferences and is a frequent press, television and radio commentator.

Warwick Lightfoot is Head of Economics and Social Policy at Policy Exchange. He is an economist, with specialist interests in monetary economics, labour markets, and public finance. He has served as Special Adviser to three Chancellors of the Exchequer, and a Secretary of State for Employment. Warwick was a treasury economist at the Royal Bank of Scotland, and has also been Economics Editor of The European. His many articles on economics and public policy have appeared in the Wall Street Journal, the Financial Times, The Times, The Sunday Times, the Daily Telegraph, the Sunday Telegraph, and in specialist journals ranging from the Times Literary Supplement and The Spectator, to the Investors Chronicle and Financial World. His books include Sorry We Have No Money — Britain's Economic Problem.

Jan Zeber is Deputy Head for Economics and Prosperity at Policy Exchange, where he primarily works on the Prosperity programme, helping to lead on a range of topics including corporate governance, competition and regulation. Prior to his current role he was a Policy Analyst at the TaxPayers' Alliance. He has worked for a number of other think-tanks as well as the private sector, producing legal and economic analysis in fields as diverse as the regulation of sharing economy in the UK and administrative justice reform in Kenya.

Published by
Policy Exchange, 8 – 10 Great George Street, Westminster, London SW1P 3AE

www.policyexchange.org.uk

ISBN: 978-1-913459-28-4

Contents

Executive summary

- A radical and ambitious rethink is needed in UK macro-economic policy thinking. There is an opportunity to move away from the austerity and orthodoxy of the past, towards a pro-growth agenda comprising the three arrows of: credible fiscal activism; monetary and financial stability with a new policy remit for the Bank of England; and a supply-side agenda.

- This policy approach would prove popular with the public based on polling conducted by Policy Exchange to accompany this paper[1]. Fear of tax rises is the number one concern associated with rising debt levels amongst the public - shared by 49 per cent of the respondents – trumping inflation, cuts to public services and burden on future generations[2].

- The public clearly do not want a return to austerity nor are they keen for tax increases – polling for Policy Exchange also shows 49 per cent of respondents want tax rises to be limited, compared with 23 per cent support for higher income taxes and 14 per cent support for other taxes rising.

- There is ample scope in the current economic climate, of low inflation, rates and yields for the UK to implement a sizeable counter-cyclical monetary and fiscal policy. High debt levels are financeable in this context, and austerity is not needed.

- The first arrow of policy is credible fiscal activism. Austerity should be avoided and tax increases are not necessary; neither is a near-term fiscal squeeze. We should retain a counter-cyclical stance, and to help the economy in the near-term, cut VAT and stamp duty on house purchases. The government debt to GDP ratio is likely to exceed 100 per cent post crisis. The key message to stress now is the low cost of debt, rather than its stock, and the likelihood this will continue for some time. This allows the government an opportunity to avoid austerity and increases the attraction of borrowing to fund infrastructure and investment. Even so, the government can retain confidence about the fiscal outlook by replacing existing fiscal rules with an aim to reduce this debt ratio steadily, over time.

1. To accompany this paper, Hanbury interviewed 2,475 British adults with a range of questions, on behalf of Policy Exchange.
2. 49% of the public answered "I will be paying higher taxes" when asked, "What in particular worries you about rising Government borrowing and public debt?"

- The second arrow is monetary and financial stability. We recommend a new remit for the Bank of England, replacing the two per cent inflation target with a four per cent nominal GDP target. This would help protect against higher inflation in an upturn, and guard against weaker demand in a downturn. There is a need to focus near-term on "pegs and regs": pegging ten year yields close to zero as this will be an important bedrock for funding the deficit and supporting longer-term investment and looking to ease prudential regulations in the near-term.

- The third arrow is to outline a supply-side agenda, with a focus on the "I's" of investment, infrastructure, innovation, incentives (tax) and ensuring inequality continues to fall.

- It is vital to not draw the wrong conclusions from this crisis. Although fiscal policy can be used effectively and counter cyclical policy is critical, there is no so-called magic money tree as governments cannot run large deficits continuously. Also, while the crisis has highlighted the importance of the public sector as provider of last resort, to support its position as lender of last resort, we still believe the case exists for a more efficient public sector, well funded and not a bloated public sector, with ever higher taxes. In order to boost the economy, policies must incentivise the private sector to grow and encourage entrepreneurship and innovation.

- As we have included a recommendation to merge national insurance contributions (NICs) and income tax, to simplify the tax system and to remove anomalies, it is interesting to note the polling data on this topic shows that such a policy would have the support of the public – polling commissioned by Policy Exchange indicates 50 per cent support for combining NICs and income tax.

Policy recommendations

1. The UK needs a pro-growth strategy based on the three arrows of credible fiscal activism, monetary and financial stability and a supply-side agenda.

2. In the current context, the opportunity is provided by the low cost of debt. The government should take advantage of low inflation, rates and yields to borrow, particularly through longer-term gilts. Also, there might be scope to issue gilts linked to economic performance in an unlikely event yields should begin to rise.

3. Aim to reduce the government debt to GDP ratio gradually, over time. Even though borrowing costs are low, it is important to have a credible strategy to reduce the debt burden in the future.

4. No austerity – this is not the right policy solution when borrowing is so affordable.

5. The Government should restate that the crisis has not diverted it from its pre-crisis agenda of levelling up the economy, proceeding with Brexit without a delay and addressing climate change with a net-zero carbon economy.

6. Use temporary tax cuts to help the post-crisis recovery, including reductions in the rate of VAT to stimulate demand and in the stamp duty on house purchases to aid the housing sector.

7. Cut social distancing to one metre to help those sectors – such as the creative sector – whose business model is threatened by the vaccine gap. Extend furlough payments and other schemes for these sectors. For other sectors, phase out help as the economy recovers.

8. Faced with the dangers of a vaccine gap and the risks associated with this, including high unemployment, fiscal options need to be kept open in the near-term. This might necessitate innovative additional measures to help those most in need. One example might be a time-limited transfer payment that has to be spent within a prescribed period of time.

9. Use the crisis as an opportunity to simplify the tax system, combining national insurance contributions and personal income taxes.

10. We would advocate a four per cent nominal GDP target as an alternative to the current inflation target of 2%. This nominal GDP target would protect against inflation on the upside while protecting against weak demand on the downside.

11. In order to keep the cost of the new stock of debt in check, active yield curve control policies should be considered. We would peg ten year yields. Macro-prudential regulations could also be eased in the near-term.

12. The UK should keep an open mind in all areas of public policy. While the aim should be to lead in areas such as tackling climate change, we should seek to adopt best international best practice in other countries in managing the post-crisis outlook.

13. One lesson of this crisis is the case for a permanent secretariat of the G20. If so, push for this to be based in London.

Introduction and Overview

Three times previously, following wars, the UK has seen higher levels of debt to GDP. In the aftermath of the second world war, our debt to GDP ratio peaked at 258 per cent, before falling steadily, over time; the counterpart to this being financial repression. Now, the extent to which inflation stays low and to which international investors are supportive of UK gilts will be key influences on the policy stance.

Low borrowing costs create a likely lengthy window of opportunity to emerge from this crisis without being panicked into policy measures such as austerity, but it is possible that inflation and yields could rise, so it is not a risk-free option. Success depends upon a clear and credible policy approach.

The arguments and analysis in this paper aim precisely to articulate why a high level of borrowing in the present environment is sustainable. We do not suggest high borrowing should be a permanent state of affairs, and indeed advocate here a pro-growth strategy that would allow the economy to recover from this crisis, achieve higher, sustainable growth and in time allow debt to GDP to trend lower.

The opinion poll conducted for Policy Exchange suggests the Government needs to articulate clearly its policy on public borrowing. When asked, "How worried are you about increasing levels of government borrowing and public debt?", 21 per cent of respondents were, "very worried" and 54 per cent were "somewhat worried". Only 17 per cent said they were not at all worried.

There needs to be two clear exit strategies for government economic policy. The first is the exit strategy from the lockdown, based on unlocking in a gradual way, based on economic activity, with low risk areas first, and focusing on continued behavioural change, alongside testing and tracking and tracing. A quick-win to help the economy, while keeping the virus under control, would be to reduce social distancing to one metre. This would help the business models of several economic sectors, including pubs and restaurants.

The second is the exit strategy following the crisis. To put the UK economy on the right trajectory requires a pro-growth macro-economic policy framework based on the three arrows mentioned above.

While this crisis has illustrated, once again, the importance of the public sector balance sheet, the recovery that is necessary reinforces the obvious importance of policies to nurture and incentivise the private sector to grow.

There needs to be a sense of ambition and realism. Ambition about what can be achieved. This necessitates a pro-growth agenda. The UK's trend rate of growth is too low and needs to be raised by a radical supply-side agenda that boosts innovation, investment and entrepreneurship and reinvigorates the private sector.

Realism is also needed about the present position we are in, with high debt and high unemployment. There is a need to boost demand, restore supply-side capacity and ensure the confidence of people and firms at home and of international investors towards the UK.

Provided inflation remains low then unconventional monetary policy combined with unconventional fiscal policy can help deliver stronger, sustained growth.

The non-virus influences at home and overseas:

Post Covid-19 crisis, the government needs to not only learn the lessons of the crisis but also focus on delivering upon the key economic areas that were identified pre-crisis, namely: the levelling up agenda to address an imbalanced economy; delivering Brexit without a delay and repositioning the UK in a changing, global economy; confronting climate change with a focus on sustainable growth, achieving net zero carbon emissions by 2050. We see the crisis as reinforcing the importance of these issues.

This crisis has exacerbated divides, with lower income workers less able to work from home compared with those in higher incomes and disproportionately furloughed from their jobs. Also, with the focus on how many "key workers" may be in low paid roles, it is likely to have reinforced the importance of the levelling up agenda.

The narrative around the levelling-up agenda, pre-crisis, tended to focus on the regional divide, between London and the rest, mirroring the election rhetoric of the red wall and left behind communities. While this is important, the levelling up agenda should encompass more than this, reflecting the UK's multifaceted imbalances. There are world class parts to the economy, with The City, universities and the creative industries being examples. At the same time, we are a low wage, low productivity economy. In terms of the levelling up agenda, these might be seen in terms of place: not just London versus the rest, but divides between urban and rural areas, or between coastal and inland areas. Other imbalances might include homeowners versus renters, between skilled and unskilled workers, and now post-crisis, between the old and young and between the employed and unemployed.

If anything, the crisis should strengthen the case for not delaying the Brexit transition. The business community is already impacted by uncertainty linked to the virus and vaccine gap. Why compound this by delaying further the date of exit and without any reason to expect a different outcome? Also, any extension would further prolong the period the UK would be subject to new EU policies without any vote or veto, and at a time when many EU countries may also be experiencing economic stress, further incentivising them to adopt policies that may favour themselves at the expense of the UK. By not requesting an extension, this will reinforce the pressure on politicians to reach a trade deal before year-end, and that in our view would be the most likely outcome.

The case for addressing climate change is as strong after this crisis, as before. If the UK is to pursue a pro-growth agenda, sustainability should play a central role and the UK should continue to adopt a lead role in addressing climate change.

Non-virus global influences to consider

When it comes to global issues it is always important to adopt international best practice. This crisis, however, has raised questions about global policy coordination. Thus, one legacy of the crisis may be a focus on global cooperation. This was certainly the case in the wake of the global financial crisis, with added weight being given to the G20 and the Financial Stability Board.

One issue we think worthy of note post this crisis is the case for a permanent G20 secretariat. Pandemics, by their very nature, have a global impact, while the approach of governments, as we have seen, has been national. Reforming the World Health Organisation may be one approach, but as further global issues may be more wide-ranging than in the area of health, we would suggest strengthening the framework of the G20. The G7, by its very nature, is too narrow-based, not including big emerging economies.

While one can understand the political desire for a rotating presidency of the G20, the shortcomings of this were evident in the early stages of this crisis. Then, as the crisis was already spreading, the G20 in Riyadh issued a communique that failed to reflect the imminent danger of the virus and the need to coordinate actions. A permanent G20 secretariat might ensure that such key global issues are addressed in the most effective way. Financing such a secretariat should not be an issue, spread across its members.

If the case were made for a permanent G20 Secretariat, then the case for it to be based in London could be made, as it is a truly international city, with excellent connections. Also, given the current tensions between the US and China, it would merit being placed in a different, but important global country with international reach like the UK.

We should also expect the UK to continue to be impacted by the global trends that were in place prior to this crisis and which look set to remain important future drivers.

One was the drive towards the increasing use of technology, including Artificial Intelligence and machine learning, reflected in the focus on the fourth industrial revolution. If anything, this crisis, with its question marks over supply chains and increased focus on people working from home[3], may speed up, not derail, the move towards a fourth industrial revolution. That revolution is being seen across a swathe of areas, from the green economy, to the circular economy to the growth of financial technology. This should strengthen the case in favour of the UK adopting a pro-growth strategy, geared to technology and innovation, and increase

3. The opinion poll mentioned earlier in the Executive Summary, conducted by Hanbury Strategy of 2,475 people for Policy Exchange, showed that 40 per cent of respondents would reconsider the possibility of working from home as a result of the virus. Also, as an indication of how behavours may change, when it came to online shopping, 33 per cent said they were more likely to do more, while 57 per cent of respondents said they would conduct the same amount of on-line shopping.

the focus on the supply-side agenda, and infrastructure around broadband, 5G and future technologies.

Also, this will reinforce the jobs agenda. Previous industrial revolutions have led to an eventual increase in employment, but their immediate impact has led to jobs being shed, which if repeated this time would compound existing employment worries.

The other major global driver before the crisis was the emergence of the Indo-Pacific region. That raised many challenges, not least being the need for the UK to think globally in terms of future growth markets, and also the recognition that economies – in being competitive – could not compete on price alone, but needed to compete more on quality and non-price factors.

This crisis, while potentially triggering increased near-term geo-political tensions between the US and China, is unlikely to alter these longer-term economic influences. We note below, the importance of seeing if there is any near-term deglobalisation, aimed at building slack into supply chains to cope with future pandemic risks, and if so, how this might impact wages and future inflation.

The economic influence of the crisis: deep recession

The UK and world economy are experiencing a deep recession. The question is how strong the rebound will be? This pandemic hit a world economy that was already looking vulnerable to any shocks. When economies are hit by such shocks, it is wrong to attach too much precision to economic forecasts. In the most stable of times such forecasts can be subject to a large margin of error, and more so now, given such instability.

The Office for Budget Responsibility (OBR) has a scenario of a fall of 12.8 per cent this year, followed by a rebound of 17.9 per cent next. A broadly similar profile is expected, it seems, by most forecasters[4]. In May, the average of the latest independent forecasts was for the economy to contract 7.9 per cent this year and to recover 6 per cent next year. Looking at annual GDP forecasts this might be considered a 'V-shaped' recovery, but this may convey the wrong impression and it is unlikely to be until towards the end of next year, at the earliest, that the economy will have returned to its pre-crisis level. However, it is generally expected that it will take longer for employment to return to such a level. This would imply that not all of the hit to the economy will be temporary and that there will be some permanent scarring effects from the crisis, in terms of firms going bust and jobs lost. Indeed, one of the biggest risks is that of mass unemployment, reinforcing the need for policy action.

Unlocking will provide a big boost to the economy. The length of the vaccine gap and how consumer and business behaviours will change after the crisis adds to the uncertain outlook. Social distancing and the desire of many groups of people to not expose themselves to perceived risks, may result in significant challenges to the business models of many firms. The table here shows employment by sector, prior to the crisis. Some parts of the economy will rebound naturally, as the lockdown is lifted.

4. See the HM Treasury monthly survey of independent forecasts, May 2020, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/886552/Forecomp_May_2020.pdf

The construction sector, employing 2.3 million people, may be one example. Other sectors, however, will find it hard to return to normality while social distancing persists. One example being the arts, entertainment and recreation sector, that employs about one million. To help ease the challenges facing such sectors, social distancing could be reduced from the UK's current two metres to the one metre adopted in many other countries and that is recommended by the World Health Organisation.

Sector	Total Employment (m)
Wholesale and retail trade	4.9
Human health and social	4.5
Professional scientific and technical	3.2
Administration and support services	3.1
Education	2.9
Manufacturing	2.7
Accommodation and food services	2.5
Construction	2.3
Transport and storage	1.8
Public administration, defence etc	1.5
Info and communication	1.5
Finance and insurance	1.1
Arts entertainment and recreation	1.0
Other services	0.9
Real estate	0.6
Agriculture fishing	0.4

Source: Office for National Statistics

There is also a need to be prepared post crisis for possible second round effects. For instance, the commercial real estate market looks moribund and could be hit hard, particularly if firms now rethink taking long-term contracts on buildings. A weak commercial and residential real estate market would be an additional problem for the economy.

Indeed, attempting to predict the exact effects of these changes on the economy is difficult and thus there exists a plethora of plausible scenarios impacted by various developments.

On the supply side, for instance, business models including employment plans will be impacted by the progress on the virus, including the unlocking process, the length of the vaccine gap and how social distancing and other guidelines on public behaviour evolve.

It is also challenging to predict the post-crisis path for consumption and investment

It is unclear what will happen to personal and corporate balance sheets. Faced with a collapse in demand and in income, many firms have taken on more debt as a result of the policy measures unveiled by the government. This may add to stress on these firms if growth weakens or rates rise. It may also strengthen the case for the government in the future to write off current debts or convert them to grants.

Meanwhile, there may be mixed pressures on personal balance sheets. For some people, there may be pent-up demand, as the lockdown may be suppressing consumption and this could rebound post crisis. In contrast, and more likely, the crisis could for many, lead to an increase in precautionary savings. Much will depend on what happens to employment and consumer confidence.

The policy response would vary according to the challenges, but in all likelihood the combination of demand and supply-side problems would necessitate demand and supply-side solutions. The COVID-19 crisis is not only a shock of unprecedented scale, with envisaged reductions in output sharper than experienced during the 2008 financial crisis or the Great Depression of the 1930s, but it is also unique in terms of its peculiarities. 'The Great Lockdown' has placed the UK and other economies in stasis, while Government measures such as the UK Job Retention Scheme and remittance of as many Government controlled liabilities as possible are simultaneously preventing firms from going into administration and laying off employees. What happens when the policy measures are phased out, or end, is thus unclear. This is particularly a challenge in sectors whose business model will be constrained by continued social distancing.

Furthermore, the fact that this health and economic crisis is global in nature will also exacerbate future uncertainty as the UK, as well as other economies, emerge from lockdown, particularly in a vaccine gap phase.[5]

There has already been a significant monetary and fiscal policy stimulus in response. This is justified based on the government lockdown and the scale of the economic collapse. Looking ahead, another critical influence is what happens to inflation.

Low inflation debate

Inflation has already decelerated, to an annual rate of 0.8 per cent in April. Zero inflation is possible in coming months. The Bank of England, in its May Monetary Report, foresaw consumer price inflation of 0.6 per cent in 2020 and 0.5 per cent in 2021 and back to its 2 per cent target by 2022. Thus, we are in a low inflation or disinflationary environment.

The UK is sharing in a global trend. Even on the eve of this crisis it is noteworthy that the April International Monetary Fund (IMF) Fiscal Monitor noted that inflation was below target in two-thirds of inflation-targeting countries. The crisis has exacerbated these previous trends.

In fact, the scale of the collapse in economic activity, surge in unemployment and the weakness of oil prices in recent months has reflected the risk of a deflationary environment, where there is a sustained fall in prices. If the world economy were to weaken further this would become a genuine possibility, but this is not the most likely scenario; we expect recovery instead. A deflationary environment, however, could

5. This global aspect may be highlighted by the experience of Sweden. It avoided a formal lockdown – although a voluntary lockdown appears to have taken place for some - but it is expected to experience an economic contraction of 6.1 per cent in 2020, which is broadly in line with the rest of the EU (-7.1 per cent) and the Eurozone (-7.7). See https://ec.europa.eu/info/sites/info/files/economy-finance/ecfin_forecast_spring_2020_overview_en_0.pdf#page=1

This is because in an interconnected economy the fortunes of one affects all others to a high degree, and this is particularly true of small, open economies such as Sweden.

trigger further cost cutting and not only delay the recovery the markets are anticipating but threaten an even weaker growth profile, including the risk of a depression. Deflation is not good for economies carrying high debt.

Just as deflation would be a worry so too would be a resurgence of inflation, and that is perhaps a bigger risk. It is important to appreciate the importance of this inflation issue.

Low inflation leads to low yields and borrowing costs and it reduces the risks that a central bank and government potentially take in monetising budget deficits to stabilise interest rates and accommodate a fiscal stimulus.

Low inflation allows interest rates and yields to stay low, implying not only that higher levels of debt are sustainable but the welfare cost of higher debt for future generations is minimised.

The implication for governments in the UK and other western economies would be that there should be no hesitation about running deficits if, given constraints on monetary policy, running deficits is required to maintain output at a level close to its potential in the short-term.

The issue of inflation will be an important aspect of the future policy debate. To what extent will some of the structural features that contributed to low inflation change as a result of this crisis? For instance, wage growth in the UK and other western economies has been suppressed in recent decades by a combination of: less bargaining power for workers, financialisation, technology and globalisation, with the latter reflecting intense international competition and also including the effect of a large increase in the labour supply under the UK immigration system.

There are four risks to higher inflation that merit attention. One is if the crisis triggered deglobalisation, as this would reduce competitive pressures and possibly add to higher wage growth and costs. However, as a service sector economy, many of these issues may not impact the UK directly. Two, is if the crisis damaged the economy's supply-side potential with firms going bust, in which case a post-crisis recovery in demand would trigger bottlenecks, push costs up and raise firms' pricing power. Three, would be the pressure from debt monetisation and stronger monetary growth; an area too often overlooked. Here the issue is if the central bank buys the debt directly from the government or through the market from the banking sector. Four, if as a result of these, inflation expectations rose. Currently, financial markets imply inflation expectations remain low, here and globally.

All this is relevant for the level of yields and the ease with which the deficit can be funded. In international capital markets, recent years have witnessed the growing importance of international factors in driving yields, with a convergence across many different countries.

Policy response already significant

The UK was in a similar position to other western economies ahead of this crisis. Because monetary policy globally has acted as a shock absorber for the world economy in the wake of the 2008 global financial crisis, interest rates were already low and central bank balance sheets already sizeable going into this crisis. This limited – but did not remove – the scope for monetary stimulus globally, and thus added to the need for fiscal policy to be relaxed – even though many countries already had relatively high debt levels. There has already been a significant policy response here during the crisis that we have covered in a suite of papers.[6] One important facet of UK policy is to ensure that households and businesses enjoy the collective insurance response to a health, social and economic shock that only the state can provide. The state's balance sheet is the key policy ingredient.

Learning the correct lessons

Two wrongs do not make a right. This was a particularly important issue in the wake of the global financial crisis. Not running sound public finances is the first wrong, tightening in a downturn via austerity would be the second.

Part of the problem with UK macro-economic policy making is what happens in good economic times, when the economy is growing at a solid pace. In those times, the UK should ideally run budget surpluses. It usually doesn't. Since 1970 there have been only six years when the UK has run a budget surplus. This does not mean that there should be a policy aim to balance the budget over an economic cycle; often that constrains policy and leads to debates over the time period of the cycle.

The lessons include running surpluses in the good times to allow scope to relax government spending and to use the government's balance sheet in bad times.

While this is the ideal scenario, the interesting aspect of exceptionally low yields as now is that they lower debt service costs so much that this creates large room for fiscal manoeuvre; in the present environment it is the low servicing of the debt that is of prime importance.

Also, in a similar vein, the question needs to be asked whether, in good times, UK interest rates rise to high enough levels? But regardless of this, it is appropriate that when there is a recession – as now – that fiscal and monetary policy are eased. This is reinforced by the present set of circumstances, with a collapse in income and demand, a surge in unemployment, a government imposed lengthy lockdown of the economy and low inflation.

At the same time, support for counter-cyclical macro-economic policy measures should NOT be seen as an endorsement for widespread public sector encroachment into areas of the economy. The public sector should play a vital role in the economy, but not a dominant role.

While the crisis has highlighted the importance of the public sector as provider of last resort, to support its position as lender of last resort, we still believe that the case exists for a more efficient, properly funded public sector rather than a unsustainable public sector alongside high taxation.

Certainly one lesson from the crisis, which applies equally to the public and private sector, is to be better prepared for future such outbreaks. For instance, the opinion poll for Policy Exchange to accompany this paper

6. See for instance, the various papers released by Policy Exchange economics team since the beginning of the lockdown

showed that two in three people felt the UK was unprepared[7].

All efforts need to be focused on ensuring a strong private sector – to pay the taxes that fund public services – and to allow the UK to compete globally. There is a need to nurture a strong recovery of the private sector, particularly led by small and medium-sized firms.

The 1923 hyperinflation has since set the tone for German policy thinking, even a century later. Likewise, with the US and the 1930's Great Depression that has influenced the US response to crises since, and the desire to avoid a repeat of that period. We can reflect here on the challenges faced by Japan in recent decades. This has led to a pro-active monetary policy there and to big strategic influences and societal change, such as Industry 4.0 and Society 5.0. Such strategic thinking is necessary here in the UK. The UK, meanwhile, has all too often been heavily influenced by more recent economic times, namely the 1970's, when the fear of being the sick-man of Europe was followed by high inflation and the 1978-79 winter of discontent and the high unemployment and deindustrialisation of the early 1980's, before Thatcher's supply-side reforms kicked-in.

Radical change to a pro-growth agenda

This crisis should provide the trigger for a radical change in thinking over UK economic policy.

Post crisis, the UK needs a pro-growth economic strategy to see a sustained economic recovery that reduces unemployment and brings the public finances back into shape while avoiding austerity. It is important to stress that this is NOT a dash for growth that has bedevilled several Chancellors, Maudling, Barber, Lawson and Brown, who each oversaw a boom followed by a bust. Also, private sector borrowing and liabilities often grew out of hand at the same time.

This new macro-economic policy framework requires a break from the orthodox economic thinking that has dominated much of UK policy making. That orthodox thinking has failed to address deep-rooted issues in the UK such as the imbalanced nature of economic activity or key issues such as the funding gap for small firms, identified below. Another glaring failure of policy has been the housing crisis of recent decades. Furthermore, although inflation has been low, around its two per cent target, it is hard to claim the country has always achieved monetary and financial stability, given the bouts of asset price inflation and that we are still recovering from the aftermath of the 2008 global financial crisis that hit Britain harder than most.

As stated earlier, the pro-sustainable growth focus should be based upon a new macro-economic policy framework comprising three arrows:

7. In terms of preparedness, 32 per cent felt the UK was unprepared and 34 per cent very unprepared, while only 2 per cent viewed the UK as being prepared and 32 per cent somewhat prepared.

The first arrow

The first arrow should focus on credible fiscal activism. It should avoid austerity. Tax increases are not needed. Neither is a near-term fiscal squeeze. It should retain a counter-cyclical stance, and to help the economy in the near-term not only should tax increases be ruled out but there should be cuts in VAT and in stamp duty on house purchases. The key issue is to take advantage of the new paradigm of low rates and low yields, and low debt servicing costs. The government debt to GDP ratio is likely to exceed 100 per cent post this crisis, and representing the highest peak this has reached in peacetime. The low debt servicing cost allows the UK the scope to live with such a level of debt, and to fund infrastructure and long-term investments. Even so, we would suggest retaining confidence about the fiscal outlook by replacing existing fiscal rules with an aim to reduce this ratio steadily, over time.

Counter-cyclical policies matter

We are strongly of the view that policy can be used proactively now. That is both because we recognise the importance of counter-cyclical policy – be it monetary or fiscal – when an economy is hit by a shock and the private sector is unable to spend or indeed even supply as in recent months. Also, the macro-economic environment of low inflation and yields increases the potency or effectiveness of such policy action.

Lord King, the former Governor of the Bank of England made the powerful point in a Policy Exchange webinar[8], and it is one with which we concur, namely that the national debt is in effect a safety valve to be used in such difficult times.

The IMF, normally the international cheer leader for budgetary orthodoxy, has called for governments to do all that it takes to stabilise their economies and to address the health crisis. In the contemporary context that means focusing on fiscal rather than monetary policy as a source of stimulus, with monetary policy playing the role of an accommodating supporter rather than being the principal instrument in the macro-economic orchestra. At the time of their April Spring Meetings the IMF stated that, globally, government spending and revenue measures to maintain economic activity announced by mid-April 2020 amounted to $3.3 trillion and so-called below the line measures - loans, equity injections and guarantees - totalled a further $4.5 trillion. The IMF estimates that globally the increase in borrowing by governments will rise from 3.7 per cent of world gross domestic product (GDP) in 2019 to 9.9 per cent in 2020. Among western economies, the fiscal balance as a ratio to GDP is

8. Transcript from the webinar can be viewed via the Policy Exchange web site: https://policyexchange.org.uk/wp-content/uploads/Everything-is-different-now-transcript.pdf

projected to rise from 3.0 per cent in 2019 to 10.7 per cent in 2020.

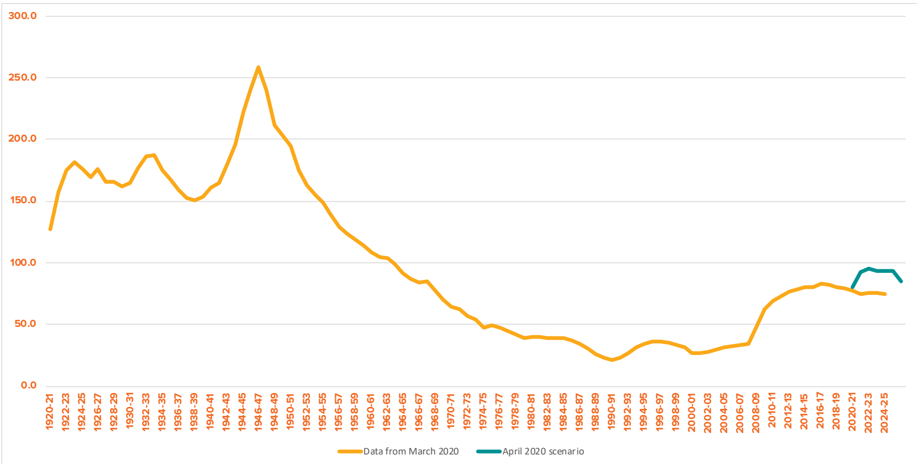
As a result, global debt levels are set to rise – and from levels that had already increased in the decade following the global financial crisis. The UK, as it seeks to borrow more, needs to be mindful of this global context.

The UK, as noted above, will finish this year with a budget deficit approaching 15 per cent of GDP. Government debt will be above 100 per cent of GDP. The Government has unveiled a series of policy measures to help stimulate the economy. Initially these were not sizeable enough and then they became too complex. Eventually the measures became bigger and easier to access. As the OBR has pointed out the net addition of fiscal measures is about £123 billion and if one includes the loss of revenues, the deficit will likely increase to £298 billion this fiscal year.

On the fiscal front, we believe that the government should view the increase in debt as a result of the Covid-19 crisis as the way one would view rising debt as a result of a war, that is it is understandable and as a result it should be reduced, gradually over time. To repeat the point made in the introduction, we can draw lessons from the past, particularly in the wake of world war two when the debt to GDP ratio was around 258 per cent. In terms of the ratio, debt to GDP, the focus should be on the denominator, growing the economy. Meanwhile, as stated, low borrowing costs allows us to borrow cheaply. But that does not mean that one should be complacent about the build-up in debt, and the aim should be to reduce the ratio of debt to GDP over time, steadily. But there is no need to panic. That is because it is the low yields and low debt servicing charge that removes the immediate worries associated with high debt levels.

This argues for the government to outline a clear, credible plan of action, aimed both at placating worries about policy and at ensuring that people, firms and investors retain confidence about the UK's economic outlook.

Public Sector Net Debt (PSND) % GDP - March 2020 vs April 2020 scenario



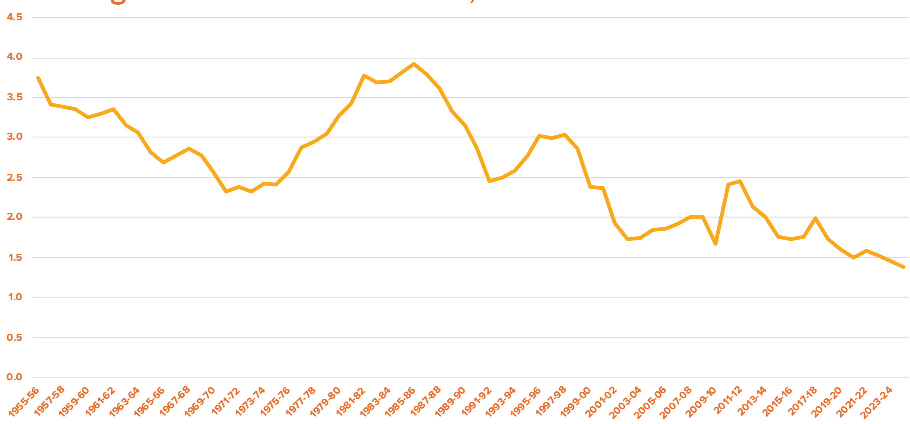
Source: OBR[9]

9. Historical PSND data and baseline 2019-2020 to 2023-2024 forecast from OBR Public Finances Databank, https://obr.uk/data/, April 2020 scenario forecast from OBR Coronavirus Reference Scenario April 2020, https://cdn.obr.uk/Coronavirus_reference_scenario_commentary.pdf

The phrase magic money tree came to the fore in 2017 general election. It was a political slogan. Meanwhile, modern monetary theory is an economic theory. But they may both, loosely, be thought of as conveying the idea that the policy stance can be used generously to address all economic problems and issues.

There is no magic money tree. What we have is a set of circumstances where inflation, rates and yields are low. In Japan, as we have seen, they have stayed low for decades, even though the economy has seen not unreasonable growth, taking into account its declining population, in recent times. In the UK, we should take advantage of this environment, especially as there is a strong case to try and boost the economy's longer-term performance. There are many things we could invest in where the return will exceed, and hopefully by some margin, the rate at which the government can borrow, while also recognising that there are many institutions and funds who are looking for longer-term assets in which to invest, against their longer-term liabilities.

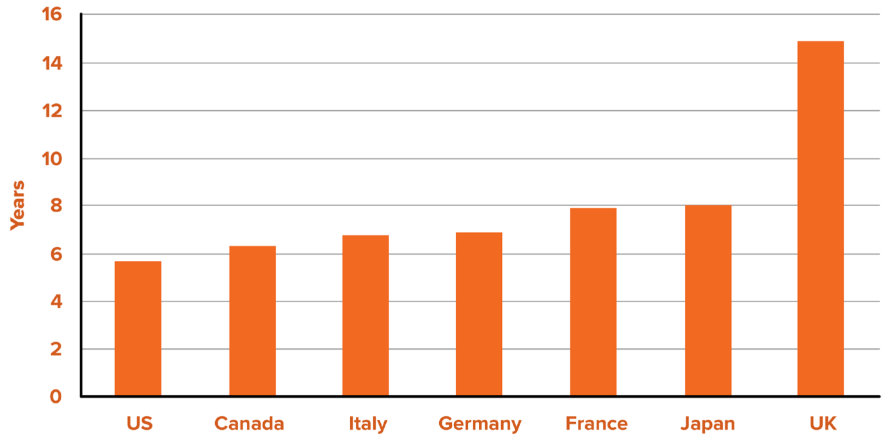
Central government debt interest, net of APF % GDP



Source: OBR

Such policies must be viewed in the context of the time. In present circumstances the government is well placed to use fiscal policy and debt finance. As the graph above shows, the cost of servicing the present stock of UK public debt has trended down significantly, to around 1.5 per cent of GDP, a low level by any measure, and falling.

There is no reason why the economy could not manage a future stock of debt that involves, for instance, a debt service charge twice this level. Moreover, the risks that arise from higher future interest rates can be mitigated by a central bank committed to managing the yield curve and even if rates had to rise the UK enjoys some protection given the long duration of its debt which has an average maturity of 15 years, versus, for instance, six years in Italy or Germany.



A low rate, low yield and low inflation environment provides increased scope to run larger deficits and to fund this via borrowing, and even monetary financing. The deficit can be financed in three ways: via higher taxation; via increased borrowing, with a focus on borrowing from the non-bank financial sector as to minimise the monetary consequences; or via monetary financing.

Consistency between monetary and fiscal policy is important, particularly as debt levels rise, and there must be due regard taken of the ability to fund deficits and of the monetary consequences of doing so[10]. While the inflation outlook is key, also of some relevance may be technical factors in markets. There has already been a flight to quality, which combined with central bank easing of policy, has pushed bond yields lower. The Bank for International Settlements has examined some recent experiences of market volatility reflecting technical changes in the make-ups of markets that may add, in their view, to pressure upon central banks to absorb sales of government debt directly[11] [12].

So the critical question in deciding whether to finance public spending through taxation or borrowing is the government's debt service charge and the speed at which the government is incurring debt service costs in relation to potential growth of its tax base and future tax revenue based on broadly unchanged tax policies. The key is realistic judgements about the future cost of borrowing, the trend rate of growth, inflation and the revenue yield of the tax system. These determine whether the stock of public debt is growing at a faster rate than the public finances and the economy can sustain.

Since 2007, the UK's stock of public debt has risen while the cost of servicing it has come down. Since the Great Recession the UK has run substantial annual budget deficits. These have resulted in a significant rise in the stock of public debt in relation to GDP. Yet debt service charges in relation to national income are very low in historical terms and debt can be easily financed as interest rates and bond yields are at historic lows.

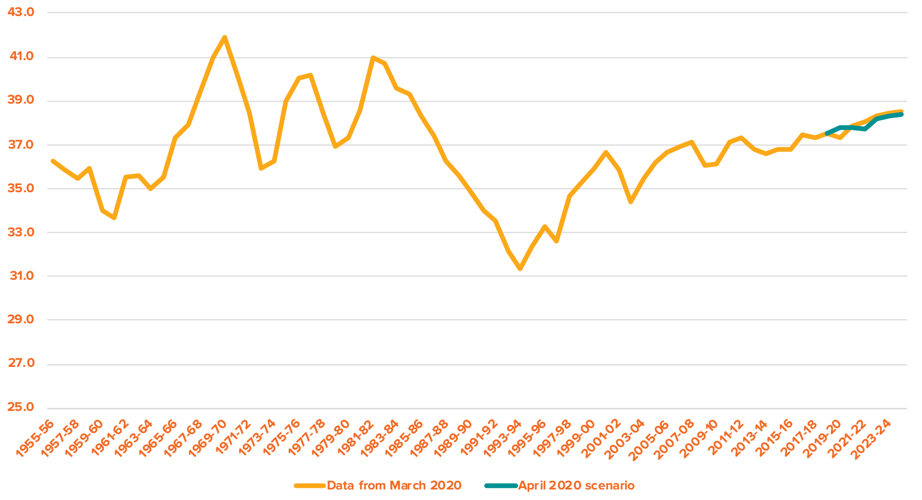
In emerging from the crisis, austerity is not the route to take. The last thing the economy needs as it emerges from the lockdown is higher taxes

10. These fundamental questions, including the ultimate constraints of a fully funded debt, were set out in the seminal Sargent Wallace article in 1981 Some Unpleasant Monetarist Arithmetic Federal Reserve Bank of Minneapolis Quarterly Review/Fall 1981. They vividly captured the potential monetary challenge that a monetary authority would confront in extreme circumstances where fiscal policy is conducted without any regard to its ultimate monetary consequences. They noted that a monetary authority trying to fight current inflation can only do so by holding down the growth of base money and letting the real stock of bonds held by the public grow. If the principal and interest due on these additional bonds are raised by selling still more bonds, so as to continue to hold down the growth in base money, then, because the interest rate on bonds is greater than the economy's growth rate, the real stock of bonds will grow faster than the size of the economy. This cannot go on forever, since the demand for bonds places an upper limit on the stock of bonds relative to the size of the economy. Once that limit is reached, the principal and interest due on the bonds already sold to fight inflation must be financed, at least in part, by seigniorage, requiring the creation of additional base money. Sooner or later, in a monetarist economy, the result is additional inflation'.
11. Andreas Schrimpf, Hyun Song Shin and Vladyslav Sushko, 'Leverage and margin spirals in fixed income markets during the Covid-19 crisis', BIS Bulletin No 2, 2 April 2020, https://www.bis.org/publ/bisbull02.pdf
12. Another factor that may be considered here is the deadweight costs refer to costs associated with public spending distorting price signals by taking money away in taxation and reallocating it through public spending that leads to inefficiencies, for example through public spending crowding out the private sector in a given area, and where these have to be balanced against the social benefits of public spending.

or spending cuts, either of which would dampen demand.

Tax receipts have been relatively stable over the last decade, around 37 per cent of GDP. Following the global financial crisis, it required a rise in taxes such as VAT, higher NICs and new taxes such as the bank levy, bank payroll levy, apprenticeship levy and the carbon price floor. Based on this one might conclude there is little room for fiscal manoeuvre on taxes now. [13]

Public Sector Current Receipts (PSCR) % GDP - March 2020 vs April 2020 scenario



Source: OBR[14]

One of the challenges is that there is a case to cut VAT in this recovery in order to stimulate demand. The Labour Government in 2008 did so after the financial crisis, cutting VAT in the first year after that crisis, then quickly raising it, and Chancellor Osborne put it up further to hold-up receipts. Another challenge is whether the UK tax base is becoming too thin, with the main downward pressure on the size of the UK tax base coming from a falling labour share of income, in addition to higher personal allowances and falls in excise duty tax base, due to technological and behavioural changes such as less drinking and smoking and more efficient cars.

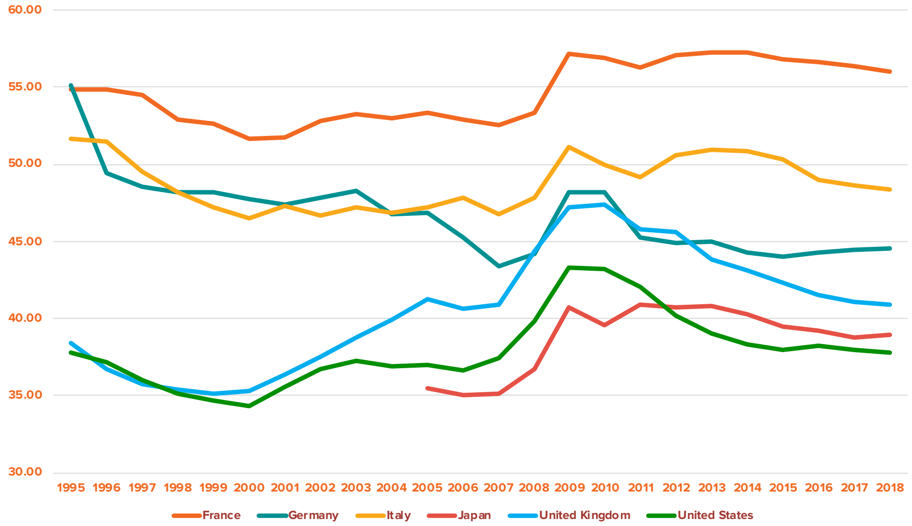
The danger is, in such a context, there will be a desire to introduce new taxes. New such taxes were mooted before the last election, including a one per cent tax on housing and wealth taxes. We would be strongly against them, both in terms of closing near-term fiscal gaps and in terms of their longer-term impact on behaviours.

Economics highlights that incentives matter. Thus, the case for keeping taxes low, both as a reward for behaviours, such as work, and to allow the UK to compete and to be viewed as an attractive country in which to invest. This is not a new debate, and we will not repeat all aspects of it here, but in the past it has been captured that if taxes do not rise then growing the economy or ensuring the public sector is run more efficiently come to the fore.

13. https://policyexchange.org.uk/wp-content/uploads/2017/06/Driving-down-emissions-How-to-clean-up-road-transport.pdf

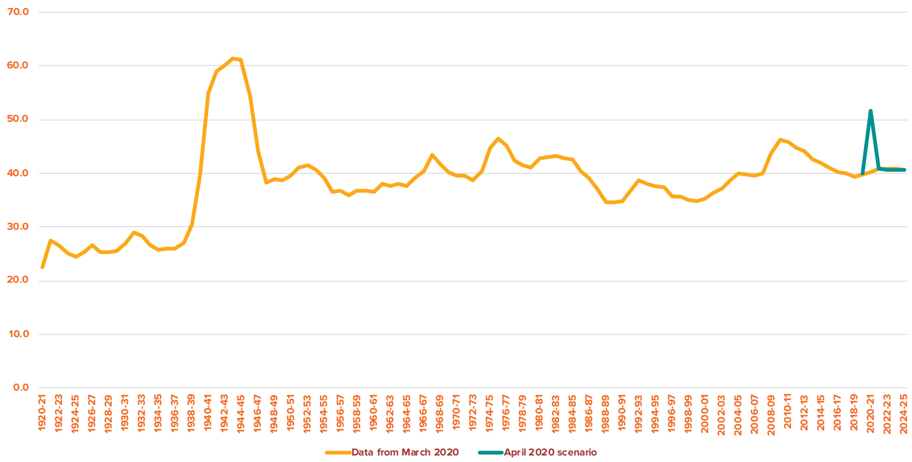
14. *Supra* note 8

General government expenditure % GDP



Source: OECD

Total Managed Expenditure (TME) % GDP - March 2020 vs April 2020 scenario



Source: OBR[15]

Will there be a need to do even more?

The UK's measures to protect businesses in the first phase of the economic crisis appear to be ambitious yet they have turned out to be complicated and difficult for individuals and firms to access. A significant proportion of the UK's assistance to firms is presently planned to be channelled through the commercial banking system. Firms and small business are reluctant to borrow and for some their debts may already be high.

Moreover, banks are not a reliable vehicle for the scale of lending needed. A commercial, fractional reserve banking system is not set up to lend to businesses that have the potential to go bankrupt and impair bank balance sheets by resulting in losses on loans that will not be recouped. This is an economic crisis where only the state can act as a lender, insurer

15. *Supra* note 8

and customer of last resort. Banks may legitimately ask, therefore, what will happen if many of the firms to whom they have lent as a result of this crisis do not repay?

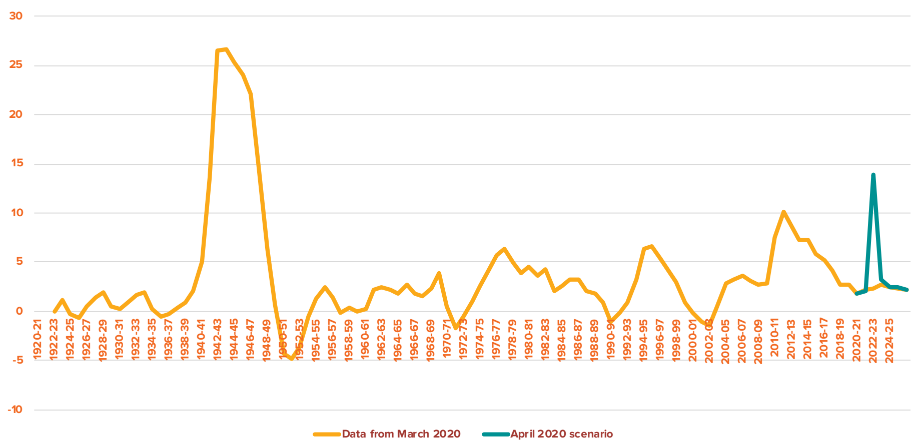
The clear inference from this is that as well as keeping open the need for further measures on a greater scale if they are required – which would be the case if the economy disappointed - the UK Government should also keep open the use of direct grants and subsidies to support businesses and recognise that this assistance may have to be channelled to firms and individuals by the public sector outside of the conventional banking system.

There must also be recognition that a regime of piecemeal grants sector by sector will not work, because as supply and demand chains breakdown so do payment chains and the consequences will not be easily or neatly captured a sort of a priori list of potential sector such as hospitality, transport and so on the economic damage from loss of business activity will systemic and endemic.

Whereas some of the recent debate is about austerity, there may in fact be the need for further fiscal support even in the early stages of recovery.

The huge increase in government borrowing is not resulting in a matching long-term liability that will saddle future generations with costly and unmanageable debts. The deficit falls back quickly in 2021-22 as temporary policy costs end and the economy recovers, returning to the March Budget forecast.

Public Sector Net Borrowing (PSNB) % GDP - March 2020 vs April 2020 scenario



Source: OBR[16]

The OBR note that 'this contrasts with the financial crisis, after which a large structural deficit persisted and debt continued to rise as a share of GDP until 2016-17'.

This reflects that much of the economic damage has been triggered by the lockdown – initially voluntary and then official – and thus unlocking

16. *Supra* note 8

allows recovery and a better outlook for the public finances.

By 2024-25, net debt is 10 per cent of GDP above that Budget forecast. At the time of the March Budget UK debt service changes were at their lowest level in relation to GDP in modern economic history. The OBR now expects the cost of servicing the national debt to fall by a further 30 per cent compared to the March Budget forecast, with the cash cost falling from £34 billion to £24 billion. This fall reflects low inflation and low rates and the market expectation that this will continue, reflected in the shape of the yield curve, with low yields. This reduces the cost of government borrowing; also lower RPI inflation than expected at the March Budget reduces the cost of the UK's index linked debt.

The Office of Debt Management should review the opportunities to issue different forms of bonds in the way that the UK led the way as an advanced economy in introducing indexed linked debt in the 1980s. Until that time indexed linked debt had only been issued by developing economies. One potential source of debt finance that ought to be looked at is one that has been discussed in the past but not adopted, namely the issuance of bonds that pay a coupon tied to the rate of economic growth and the underlying taxable capacity of the economy.

The environment of low output should imply higher fiscal multipliers, meaning higher than usual for fiscal policy. That said, fiscal multipliers are always uncertain, particularly in this unprecedented economic environment.

The push back, of course, is that just because monetary policy has been exhausted should not create the justification to exhaust fiscal policy too. The two contraints on the use of fiscal policy are the cost of debt service charges on future tax receipts and public debts being a source of inflation. International interest rates have fallen and debt service charges on public debt have become more manageable. In lower interest rates we mean the cost of serving pubic debt has fallen to record lows depite the fact that that the stock of public debt has risen in many advanced and emerging economies.

Given the scale of the present economic shock and the very low level of interest rates and the cost of servicing debt as a proportion of national income, the level of public debt should be allowed to subside over several normal economic cycles. This would take account of the medium and long-term benefits of containing public debt. [17]

In this macro-economic context, monetary policy must be consistent with fiscal policy.

17. This would also recognise the ultimate constraints of a fully funded debt set out in the seminal Sargent Wallace article in 1981 Some Unpleasant Monetarist Arithmetic Federal Reserve Bank of Minneapolis Quarterly Review/Fall 1981.

Arrow two – ensure monetary and financail stablity

The second arrow is monetary and financial stability. There will be many facets to this. Currently the Bank of England's Monetary Policy Committee's remit is to achieve a two per cent inflation target and subject to that support the government's economic policy. We favour a re-examination of this remit in the present economic environment and given the need to have a post-crisis sustainable pro-growth agenda.

Monetary policy has moved into a more political area already

The actions and performance of the Bank of England are central to the country's economic performance and are key to the success – or otherwise – of this government's economic strategy.

The Bank of England, like many other central banks, may be independent but the last decade should lead people to ask what does that really mean? If anything, central banks have taken a more central role in economic policy, impacting all areas of life and, as their balance sheets have grown, they have moved into areas that should fall under political accountability.

Over the last decade, monetary policy became the shock absorber for the global economy. This resulted in interest rates falling to low rates and an explosion of central bank balance sheets. In recent years, however, this triggered a debate as to whether there was sufficient ammunition left in monetary policy to respond to any future shock. This crisis, however, has already witnessed significant easing in monetary policy globally, with the likelihood of further easing ahead. In the US, for instance, the ability to use the central bank's balance sheet is a key aspect of the policy response. Meanwhile, looking at Japan over the last quarter of a century, one can see that – at even low interest rates – monetary policy can be used extensively.

During the Great Recession, monetary and fiscal policy effectively became fused. The expansion of the central bank's balance sheet and the bond purchases at the heart of the unconventional monetary policies have only been made possible by taxpayers underwriting the ultimate risks involved. The decisions were inherently political.

The fact that monetary policy has often been sensible does not – or should not – divert attention from the need for greater scrutiny and political oversight of the Bank. This is particularly so now, as monetary policy has played such a vital role, through QE, in contributing to asset price inflation and wealth inequality. The combination of very low interest rates and asset purchases has had significant distributional implications arising from the inflation of asset prices and the collapse in returns for savers. Also, as the distinction between fiscal and monetary policy has become a grey area, especially as the APF, which is a subsidiary of the Bank, and which has now become a large holder of gilts is indemnified by the Treasury. The Bank has genuine constraints on its independence as it is ultimately dependent on the taxpayer and the Treasury for support of its balance sheet and open market operations. The Treasury also drives the process that selects the Governor, Deputy Governors and committee members, and sets the central bank's target.

Perhaps it is no surprise that, earlier this year, speaking at a Bank hosted conference on inflation targeting, the outgoing Governor of the Bank of England, Mark Carney, reiterated a previous point he had made, namely that periodic reviews of a central bank's target, objectives and procedures are beneficial, and that the UK should follow the example of the US, which regularly carries out such reviews. If anything, the present crisis makes it more pressing. It offers an opportune occasion to look again at the work of the central bank, the conduct of monetary policy and the wider coherence of monetary and fiscal policy within macro-economic demand management.

Nominal GDP target

We support the idea of a nominal GDP target and would set it at four per cent. This should replace the two per cent inflation target. This would be consistent with the government's aim of delivering transformative, longer-term growth. It would allow policy to act as a more effective economic stabiliser. This would help protect against higher inflation in an upturn, and guard against weaker demand in a downturn.

This makes more sense in a low inflation environment, and allows the central bank to support fiscal policy and ensure financial stability.

It would be consistent with reducing the debt to GDP ratio, steadily, over time. And it would be supportive of growth, without threatening inflation. The trend rate of growth has continued to decelerate to around 1.25 per cent, while the inflation target has been set at two per cent. The low inflation of recent years has triggered a general debate as to whether central banks should set higher inflation targets. We would favour a four per cent nominal GDP target, as this would help protect against inflation on the upside and against weak demand on the downside. A four per cent target would be accepted as credible by financial markets, and seen as getting the balance right between inflation and growth.

Also the move towards more contemporaneous measures of economic activity – away from quarterly data released with a lag towards monthly snapshots of GDP – would remove one of the criticisms of money GDP targets, namely the data on GDP is available only with a lag. The availability of such real-time data would remove a key hurdle.

A money GDP target would provide a macro-economic framework that constrains both inflation and deflation and provides an objective that supports demand and output.

Pegs and regs

Monetary and financial policy must be consistent with fiscal policy, supporting growth while achieving monetary and financial stability. There is a need to focus near-term on pegs and regs and looking to ease prudential regulations in the near-term. Policy rates should be kept low.

We also argue in favour of yield curve control, with the Bank keeping ten-year yields pegged at low levels. Ten year yields should be pegged close to zero as this will be an important bedrock for funding the deficit and supporting longer-term investment. This should be supported by central bank buying of gilts, through the market, from both the bank and non-bank sector.

One success of UK policy, as noted earlier, has been the long maturity of UK debt, which averages 15 years. The UK will, however, issue a record amount of debt. It is important to keep investors on side. Since the global financial crisis, the Bank has seen its holdings rise from nothing, to now a sizeable 23 per cent, via the APF. This could rise further. If it buys this in the secondary market from the non-bank sector it has no implications for bank lending or monetary policy, but if it buys it directly from the Treasury or through the market from banks it will impact different components of the money supply. Depending on the economic environment and the scale of purchases this will have implications for nominal growth. In addition to the Bank's 23 per cent, 27 per cent is held by overseas investors and 50 per cent by domestic investors, including banks and funds. Pegging long-term rates to control the yield curve makes sense in current circumstances.

The Bank of England should with the Treasury explore additional tools and novel applications of existing policy instruments such as quantitative easing. It should review the full range of assets that it purchases so that it is not necessarily confined to undertaking asset purchases solely of bonds. It should review the manner in which it purchases gilts through the market. There may be circumstances where it would be appropriate for the central bank to take gilts directly from the Office of Debt Management avoiding the market.

Just as monetary policy should be aligned with fiscal policy, micro and macro prudential measures should be aligned with monetary policy too. There is a need to change regulations to help the recovery. For instance, first time borrowers cannot take advantage, always, of low borrowing rates as prudential regulations stress test borrowers for higher rates that are unlikely; if anything such tests should not prevent people from borrowing but direct them towards taking out fixed and not variable rate loans. The point is, regulations are too intrusive where they should not be, on personal behaviours.

The Macmillan Gap

In emerging from this crisis, there is an elephant in the room that cannot be overlooked: the need for the UK banking sector to play a bigger role in the domestic economy. When one looks at the City, its international competitiveness is important, but too often overlooked is how it can and should play a more proactive role in contributing to a more balanced UK economy. A key facet of this must be the need to close the funding gap that faces small and medium sized enterprises (SMEs) in the UK.

This was first identified as the Macmillan Gap in 1931. Last year, this gap was estimated as £22 billion[18]. If pressed, the Treasury usually argues that this is a demand problem. We doubt that. There is much to suggest that UK banks do not help the real economy sufficiently, lending to the mortgage market swamps any lending to the SME sector.

On the climate change agenda the Bank of England has been at the forefront of the global debate, and there the use of prudential policy may be of use.

In other areas, the Bank could seek to learn from other central banks in emerging market economies that have had more experience of managing uncomfortable crises such as the present one. Among the matters that ought to be considered and the scope that the central banks has to stimulate monetary conditions through direct supply of money and credit into the economy rather than simply relying on changes in the price of money. This should include the direct financing of company balance sheets outside of the banking system and direction of bank lending and credit to sectors that need it but may not be in a position to obtain it through the conventional banking system and channels of credit.

The role of the central bank balance sheet should be considered in relation to the affordability of long-term debt. There are two costs to debt as a policy instrument: firstly, its effect on interest rates and debt service costs, and secondly, the dangers that debt and monetisation of debt present in relation to inflation. In a world of anchored prices, very low nominal interest rates and negative real interest rates, these constraints are much less significant. [19]

18. See Bank of England, 'An open platform for SME finance', 20 June 2019, https://www.bankofengland.co.uk/-/media/boe/files/research/an-open-platform-for-sme-finance
19. The extraordinary interest rate position is highlighted in a Bank of England Working paper Eight centuries of global real interest rates, R-G, and the 'suprasecular' decline, 1311-2018.

Arrow three – supply-side measures

The third arrow should focus on outlining a supply-side agenda. This may take time to be implemented, but takes into account the issues already identified prior to this crisis and new challenges unveiled during it, with a focus on the "I's" of investment, infrastructure, innovation, incentives (tax) and ensuring inequality continues to fall.

Of these, investment is critical. Defence and science can figure more in the post-crisis focus, as part of this increased investment drive. We will focus on this critical area, the supply-side framework in our subsequent sister paper to this.

The UK should also support a growth strategy rooted in improvements in the economy's supply performance with an approach to taxation that matches its ambition. Broad principles rooted in an appreciation of the deadweight costs of taxation and the potential malign consequences for incentives to work, save and invest that hinder the supply side should inform the approach to tax policy.

It goes without saying that the tax system should be progressive, favouring those on low incomes.

Other key principles are neutrality, a broad tax base, marginal tax rates that are as low as possible and a tax system that avoids the double taxation of income and saving hindering capital accumulation in the medium and longer term.

Tax policy should focus on raising revenue from buoyant sources of recurrent flows of expenditure and income. This means avoiding taxes on capital and saving that would aggravate the double taxation of saving that is inherent in any tax system that makes extensive use of the taxation of income. It means avoiding the contentious taxation of property, capital and wealth. These would yield little in revenue and suffer from the vagaries of capital valuation which vitiate the taxation of wealth and capital as reliable sources of tax receipts that can fund flows of expenditure. The doubling of claims for inheritance tax over payment this year illustrate the difficulty of valuation and the taxation of capital as a reliable source of revenue.

In constructing a fiscal policy to stimulate demand in this crisis and in the context of very low interest rates that changes costs and modifies the trade-off between borrowing and taxation, policy makers should take the opportunity to carry out an ambitious and radical tax reform to improve incentives.

The UK has been a low growth, low wage and low productivity economy. It is also a very imbalanced economy. But as we survey the present carnage from this crisis, we should not overlook that it is also a very flexible and adaptable economy, which in the past has allowed it to respond positively to economic shocks.

Conclusion

The UK is enduring a health and economic crisis. Despite near-term uncertainties we believe that a new macro-economic framework can help the UK achieve stronger future growth.

A new macro-economic policy framework is needed, as outlined here, based on the three arrows: of credible fiscal activism; monetary and financial stability based on a new remit for the Bank of England; and a supply-side agenda.

Low borrowing costs create a likely lengthy window of opportunity to emerge from this crisis without being panicked into policy measures such as austerity, but it is possible that inflation and yields could rise, so it is not a risk-free option. Success depends upon a clear and credible policy approach.

The present economic environment has reduced the government's borrowing costs and its debt service ratio and should be sufficient to allow it flexibility to pursue a pro-growth agenda in the aftermath of this crisis.

£10.00
ISBN: 978-1-913459-28-4

Policy Exchange
8 – 10 Great George Street
Westminster
London SW1P 3AE

www.policyexchange.org.uk