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Should the UK Adopt Money GDP targets? Transcript

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Should the UK adopt money GDP targets?

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Welcome back. It is over two months since my last lecture and quite a lot has happened.

Actually this lecture has become increasingly relevant as the economy has developed in recent weeks, though for once I can't pretend that I actually predicted this.

What I want to talk about is how the authorities should control the UK economy in a time of recovery. It is important because how they do it will determine the pace of economic growth, the rate of inflation and the interest rates that affect our savings and mortgage payments as well as the ease with which people can get jobs. It also will have an impact on the social problems associated with unemployment.

This is the most policy relevant of my lectures and I am glad that senior policy makers have asked for advance copies of it.

The background to all of this is the theme of globalisation. The key points of my previous lectures are critical to the argument.

First, the scale of growth in the emerging economies which are 'supercompetitive'. Because they have developed more quickly and with rather more authoritarian political structures they have not developed the high cost base that we have in the developed economies –look at Singapore and Hong Kong which are already developed economies today but which still have relatively low cost bases.

Wage moderation and falling government imposed costs will be part of the policy response in the Western world. But also we will probably have to devalue our currencies relative to those in the emerging world which will push up import prices and particularly primary product prices in terms of our own currencies.

Second, our lack of competitiveness and the difficulty in correcting this through conventional means will constrain the growth in the traditionally rich Western economies in the medium term. Devaluation is the traditional way out when an economy is not exporting enough because of lack of competitiveness but the scale of the possible devaluation is limited by its inflationary effects.

Third, inflation is now more driven by commodity prices and government policy – eg on housing planning - than by labour costs as traditionally was the case when I first came into economic forecasting 39 years ago.

As a consequence of my first three points we will tend to have a growth shortfall and upward pressure on inflation compared with where we have been in the past.

The problems are augmented by the fact that investment in skills and other forms of capital is partly endogenous to the economy in the sense that it is a function of past rates of economic growth so a prolonged period of slow growth has a knock on effect on the economic growth potential in the future just as a sustainable period of faster growth enhances potential.

The critical question is how do we react to this?

The UK economy appears currently to be recovering strongly.

Perhaps some of the perception of a recovery is psychological because the recovery comes after a prolonged period of little or no (and occasionally negative) growth. In the circumstances any recovery would look impressive. But even allowing for this, there is what looks like a fairly powerful recovery taking place in the UK.

Most economic forecasters have a bit of egg on their face and we have more than average. And since I have drawn attention to Cebr's and my exceptional forecasting track record in the past it is only fair that we put up with the embarrassment that emerges when we get our forecasts wrong.

Actually getting our forecasts wrong occasionally is a learning process. The economy doesn't stay the same and so the appropriate models for forecasting the economy need constantly to evolve. One of Cebr's strengths is our error correction procedure where we carefully analyse our forecasting mistakes and try to see what we can learn from them. The analysis of what has driven the recovery which I am presenting here is the result of our error correction process resulting from our underprediction of the pace of the recovery.

My first exhibit is lifted from a recent speech by Charles Bean, Deputy Governor of the Bank of England and former Chief Economist. In his speech to the annual conference of the Society of Business Economists on 22 October this year he drew attention to the extent to which the economic news had surprised forecasters on the upside.

For the technically minded, the Bank of England staff have set up an index which looks at 14 data series and measures the extent to which the outturn data for these series has surprised the consensus of economists' expectations, obviously scaled by the standard deviation for each of these series. What this measures is whether the news is better or worse than had been predicted.

Of course it might be measuring how good the news is or it might be measuring how bad the predictions are!

My guess is in this case probably both!

The series shows that at the present time the upside surprises are unprecedented as you can see in the chart. This applies to the UK (which is the blue line) but not to either the US or to the Eurozone.

My second exhibit is the series for business confidence.

The top series is from the ICAEW (Institute of Chartered Accountants in England and Wales) and Grant Thornton business confidence series which surveys the top accountants and finance directors in the UK and the measures their optimism.

The bottom series is the BDO poll of poll of polls which averages the results for business confidence of all the main business surveys.

Both are prepared by Cebr.

What they show is that business confidence has been consistently gaining momentum and is now at a high and very much in the range of pre-recession peaks.

My next exhibit is consumer confidence. The best index is the Yougov/Cebr Heat index which of course we help analyse with our friends from Yougov who work just round the corner from us. This has also recovered sharply. But there is a difference between business confidence and consumer confidence.

The former is close to its all-time high. The latter is at its highest since the recession started but the long term analysis of the longer running series suggests it is now close to about its average for the pre-recession period.

What is interesting about all three series is their timing. The turnaround started in all of them around the turn of this year. The line upwards has been pretty straightforward since. So although forward guidance has not been a bad thing, since it was only instituted in August and most of the recovery in confidence came before it happened, it can hardly be said to have been the main cause of the improvement in expectations. I like the style of the new governor of the Bank of England, Mark Carney. But it is important that expectations about him are not excessive. And you can see that most of the improvement in confidence happened before he arrived in the UK.

This is perhaps the point to pay tribute to the former Governor of the Bank of England, Mervyn King, now Lord King. He has been heavily criticised, occasionally by me. And I think he was worried about moral hazard (which is the technical term for the long term consequences of bailing out failing banks through creating a presumption that that banks will be bailed out in future) far too late into the banking crisis. Also he has been one of those heavily in favour of placing restrictions on banks post crisis when the real problem has been getting them to lend, not encouraging them not to lend. But of all the people in the economics sphere of public life he has had by far the best grasp of what has been going on in the economy and it is important to note that the recovery started on his watch. And I believe that the recovery was as a result of the monetary measures with which he was associated – though this is jumping a little forward in the lecture. I hope he enjoys his well-earned retirement and gets to watch more cricket – a passion that he and I share.

The current Cebr forecast is that UK economic growth this year will be 1.5% and next year 2.7%. But the econometric relationship between the ICAEW Grant Thornton Survey and GDP growth for the fourth quarter of this year suggests growth of 1.3% or an annual rate of 5.2% for the quarter. If this correlation holds, GDP growth this year will be even higher than our official forecast – I estimate roughly 1.6% for this year as a whole and 3% or even more next year.
A question that many people ask is whether this is the wrong type of growth, depending too much on consumer spending and on an unsustainable fall in the savings ratio.

The answer is partly yes – it is not a perfect growth mix.

Consumer spending looks to be up by 2 per cent this year compared with real disposable income that has been roughly flat. So it has been financed through a falling savings ratio, which has come down from 7% to 5%.

But even on these figures, though the data is a bit erratic and depends on one's view about what is happening to stockbuilding, I would judge that the role of consumer spending is slightly less than in previous recoveries. More importantly, the business survey data suggests that the mix is changing fast now and the recovery is becoming more business led and significantly more so than usual.

A component of the concern is the housing market. It is true that house prices are rising – as is the price of commercial property. Indeed our econometric analysis suggests that the property price inflation is a major component of the rise in confidence, especially consumer confidence.

So far, all that has happened, even in London, is that house prices are gradually rising into line with the high prices of property occupation already demonstrated by the rental market.

Outside London, the position is even more subdued. There will be a point some time next year or the year after when if the recovery continues to gather momentum property prices will move above the norm. But the main reason for high property prices is not cheap money, it is the shortage of property which I mentioned in my Gresham lecture in January this year. Until we sort out the UK planning system which gives too much control of the local supply of property to those who have a strong vested interest in creating a shortage, we will have excess property prices in the economically successful parts of the country. And mansion taxes are a silly way of dealing with the problem that the user cost of property is too high. They simply replace one form of excess cost for another.

Exports are more of a problem. We start the recovery from a position of trade imbalance. In the UK we have been behind the curve in reorienting our exports towards the fast growing emerging economies, though things have started to improve in the past year, from a low base. We are way behind not only Germany but also Sweden and the Netherlands in this.
In the current set of circumstances where the world economy is led by the supercompetitive East, the balance of payments is likely to be the long term constraint on growth.

So until we can improve our export performance, our long term trend for growth is around 1¾%, significantly down from where it was considered to be ten years ago. My judgement is that the trend rate of growth pre-recession was about 2¼% though Gordon Brown and his cohorts in the Treasury did a huge amount of damage by planning on the basis of 2¾%. It is interesting that the bankers who did a certain amount of damage to the economy had their knighthoods stripped off them, whereas the civil servants who in cahoots with Mr Brown did about twice as much damage to public funds were actually given knighthoods…it just shows how the public sector rewards its own and discriminates against those found guilty of something as below the salt as working in business…

Because the economy starts from a position of being well below capacity, above trend growth can continue for a while without raising the warning bells, though the balance of payments position looks highly likely to deteriorate. I suspect we can only manage about two years before warning bells start to ring. It is fortunate that we only have less than two years to go before the next election…

Charles Bean in his SBE Conference talk draws attention to the Funding for Lending Scheme and the European Central Bank’s announcement of Outright Monetary Transactions which shored up market confidence in the Eurozone.

I think he is right on both counts, though the Euro problem still remains and will enter the political sphere when we will see whether the Germans are prepared to bail out the weaker countries in the Eurozone on a long term basis and whether the weaker countries are prepared to accept a degree of control by the Germans over their public finances. I’m covering the Euro issue in my February lecture so I won’t say anything more now.

But Charles Bean, who is being very proper as a public servant, only refers to the continuing headwind which is the need further to consolidate UK public finances.

In fact there is a whiff of the goose being fattened for Christmas about the UK economy – actually there is no real structural tightening of the budget planned for the remainder of the 18 month period till the election. Our forecasts assume that there will be a reasonable amount of cyclical decline in the budget deficit over the next two years but that whoever wins the election will want to put the brakes on and achieve further consolidation in the two years following. By 2017/18 on our forecasts the deficit will be about £40 billion – not ideal but substantially improved from its £150 billion peak. The Debt to GDP ratio should peak around then and start edging down.

But my experience when there is an unexpected revival of confidence is that there are monetary causes at the root. And this would be consistent with Charles Bean’s explanation of the importance of the Funding for Lending Scheme and the fall in the banks’ funding costs. It is important to understand that Funding for Lending is just an enhancement of Quantitative Easing and would be impossible without Quantitative Easing. The official description of Funding for Lendind is that ‘the Bank and HM Treasury launched the Funding for Lending Scheme (FLS) on 13 July 2012. The FLS is designed to incentivise banks and building societies to boost their lending to the UK real economy. It does this by providing funding to banks and building societies for an extended period, with both the price and quantity of funding provided linked to their lending performance' .

The other element in how QE has impacted on the economy is shown by Cebr's econometric research which indicates a very close link between the property market and consumer confidence. The recovery in the housing market, which I believe to have been linked to both QE and Funding for Lending, is I believe at the root of the improvement in consumer confidence.

What I am saying is that Quantitative Easing has been a success and a critical factor in the economic recovery which we see today. Without it we might have had an anaemic recovery but nothing like what we see today. And perversely it might have had to rely even more on the consumer!

But it is important to take two things into account. First, QE has only operated with a delay and has taken time to have its beneficial effect.

Second, it is an addictive medicine and will prove very difficult to escape from.

Fortunately it looks as if the economy does not need any more doses of this medicine in the present cycle.

The government's Banking Reform Bill is likely to come into effect in early 2014. This in conjunction with Basle 3 is likely to mean essentially that Banks will have to set more money aside as a safety net to match their lending. This means that their lending will be constrained as they absorb the implications of this reform. In turn it means that over the next 5 years, there is unlikely to be so much money around that overfunding (which is the technical term for reversing QE) will be required until around 2018.

One of the problems of getting out of QE is that only when it is wound back is the true cost revealed. In the UK, QE has happened through the Bank of England buying government bonds at prices that are artificially high both because of the state of the economy and because of the distortion to the markets that the bond buying programme represents. When QE is unwound, it sells them back at prices that are pushed down by the opposite mechanisms. What this means is that the bonds are likely to be sold back at lower prices than those at which they were bought.

I guess we are talking about a likely loss on the bonds of about £7 billion if they are redeemed at par and possibly nearer to £40 billion if they are redeemed at market rates. But the likely timing means that we are probably at the low end of the range in terms of the losses on the book since most of the bonds will be redeemed near to their redemption dates.

'Forward guidance'

Let me now turn to 'forward guidance' and its implications.

First, what is it?

It is the guidance from the Bank of England that they will not raise Bank Rate or unwind QE until unemployment has fallen to 7.0%. Last Wednesday's figures showed that this measure of unemployment had fallen to 7.6%. If it continues to fall at its current rate it will reach 7.0% in Q2 of next year. But if growth accelerates then this point could be reached more quickly.

There are overrides on the guidance. First if there look to be threats to the inflation outlook that might push it in the medium term above 2.5%. Second if medium inflation expectations become unanchored. Third if there are threats to financial stability identified by the Financial Policy Committee that cannot be dealt with by other means.

I think that the Bank got a bit unlucky in its forward guidance. This was specified in terms of unemployment when the unemployment rate had been stable for a number of quarters and was not expected to adjust quickly.

But since it was announced it has become clear that even at the time of its announcement unemployment was falling a lot quicker than the Bank had expected. And indeed the claimant count, which is a narrower measure of unemployment – a less erratic monthly series but one that is of course subject to distortion when welfare changes are taking place – has fallen to 3.8% and by 0.4% between July and October. If the broader measure falls at this rate it will reach 7.0% in Q1 next year.

At the moment there is very little clear idea about when base rates will rise. When forward guidance was announced the Bank of England thought that it would not be till 2016. But already only three months later it seems highly likely that the 7.0% target will be reached in 2014 and possibly even early in the year.

A broader anchor for policy is needed.

The concept of targeting Money GDP is generally associated with the Nobel Prize winning economists James Meade and James Tobin .

In the UK it has been strongly supported by the eminent economics commentator Sir Samuel Brittan, most recently in his Financial Times column on 12 July this year .

And many commentators around the world seem to be moving in favour including the Business Secretary Vince Cable.
The idea is that rather than having a target for inflation, the MPC should have a target for the growth in GDP in cash terms - ie not the real GDP which is a concept with which we are familiar but the actual cash amount of growth before being deflated for inflationary effects.

My judgement is that in normal times when the trend rate of GDP growth is predictable and close to past experience inflation targets which we currently have are more manageable operationally than Money GDP targets.

But in today's world after the upheaval of the emergence of the fast growing eastern economies and the uncertainty about the inflationary consequences, a more flexible approach is needed.

Indeed, it is pretty clear that a more flexible approach has actually been officially adopted in practice since inflation has been persistently above the 2% official target other than two relatively brief periods in 2007 and 2009 for the past 8 years. As a result the inflation target has lost a degree of credibility and we are left guessing.
Forward guidance was an attempt to provide more information but – as with any policy based on just one variable – it runs the risk that that variable can change its relationship with the economy as has indeed taken place in the past 3 months.

Money GDP targeting is not without its problems which is why in more stable times I probably would not recommend it.
The biggest of these is that the data appears late and are subject to considerable revision.
More fundamental are what specific targets and bands to choose and how to cope with past under or overshoots.
My current target number would be about 5% growth of GDP in cash terms with a band of plus or minus 1%.
I would be flexible about coping for under and overshoots depending on their reason and whether they risk inflation becoming endemic. That is the real curse which one wants to avoid since when inflation becomes embedded, eliminating it is highly costly.

I have set out a broader framework for MPC targeting that I believe would provide a better framework than either the Bank's unemployment based forward guidance or the inflation target.

What does this mean for interest rates?

I explained in my December lecture last year why I believed that the long term trend for interest rates around the world was that they would be in a lower band than previously because of the scale of Chinese savings – which are currently 6% of world GDP and still rising.

But the UK is facing a rapid recovery starting from a position where the balance of payments is already in substantial deficit. Growth that is too rapid would – because of our weakness in exporting to the growing markets – worsen this balance, ultimately to a point where it would be likely that the sliding pound could collapse.

To prevent the risk of too rapid a fall in the exchange rate, it would make sense for the MPC to move relatively early.
My recommendation would be that if the growth acceleration for Q4 predicted from the results of the ICAEW/Grant Thornton Survey takes place, in which case unemployment is likely to be close to 7.0% in Q1, there will be a strong case for preventative action at the February 2014 Monetary Policy Committee meeting with a 25 basis point increase.
I don't think this will signal a return to high rates but rather that an early movement would actually lower the next likely peak in rates. And I am looking for Bank Rate to be around 3% on average through this cycle. This doesn't mean a 2.5% rise in mortgage rates because spreads should narrow.

Monetary targeting is properly a subject to be proposed by the Chancellor and ratified by the Treasury Committee of the House of Commons. But it is inconceivable that it could be put forward without consultation with the new Governor.
In conclusion can I say how flattering it is for us Brits to have one of the world's preeminent central bankers accept the offer to work in this country. I'm sure we all wish him the best of luck with his remit, whatever targeting approach is taken.

My next lecture is horribly soon! It is in the same place at the same time on Wednesday 11 December. The slightly provocative title is 'Was Karl Marx always wrong?' He predicted what he called technically the exploitation of workers though a labour surplus leading to rising profits. This didn't happen in the century after he predicted it but is happening now – I would argue largely as a result of globalisation. The lecture is going to look at to what extent this is a problem and whether any attempts to solve it would make matters worse or better.

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