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Debt, consolidation and growth

Robert Chote

Annual meeting of OECD PBO and IFI officials
Paris, 23 February 2012

Outline

Very interesting paper. Will focus on UK approach to these issues rather than detailed critique of methods and findings

- Remit of the OBR
- The growth impact of fiscal consolidation
- Composition of the consolidation
- Debt thresholds and fiscal gaps

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Remit of the OBR

- We:
  - Produce five-year forecasts for the economy and the public finances
  - Assess whether the Government is on course to achieve its fiscal targets
  - Scrutinise the Treasury's costing of Budget tax and spending measures
  - Assess long-term sustainability and the public sector balance sheet
- But we do not:
  - Comment on the merits of specific tax or spending measures
  - Tell the government what fiscal targets to pursue
  - Assess the implications of alternative policy paths and measures
  - Give general economic policy advice

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UK consolidation: March 2010

- Significant consolidation already planned before OBR created

- Measures announced between November 2008 and March 2010 would tighten by 5.5% of GDP from 2011-12 to 2016-17
  - Using Institute for Fiscal Studies definition of measures

- More spending cuts than tax increases, but some left undefined

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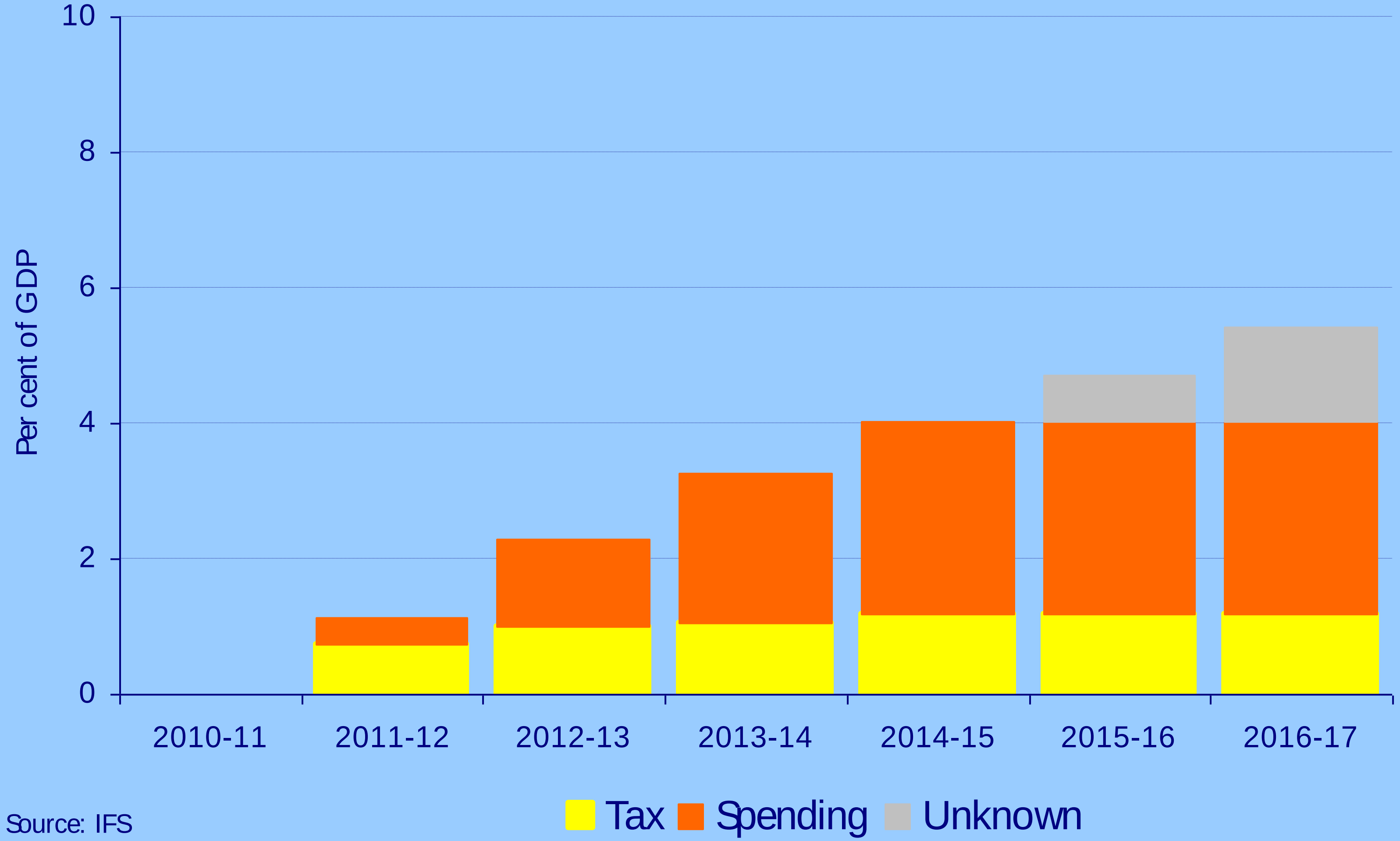
UK consolidation: March 2010



Source: IFS

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The Coalition’s July 2010 Budget

- **Coalition amended Labour’s consolidation plan to make it:**
  - Bigger – up from 5.5% of GDP to 6.5% of GDP
  - Faster – start in 2010-11 and complete by 2015-16
  - More focused on spending – 77% spend / 23% tax

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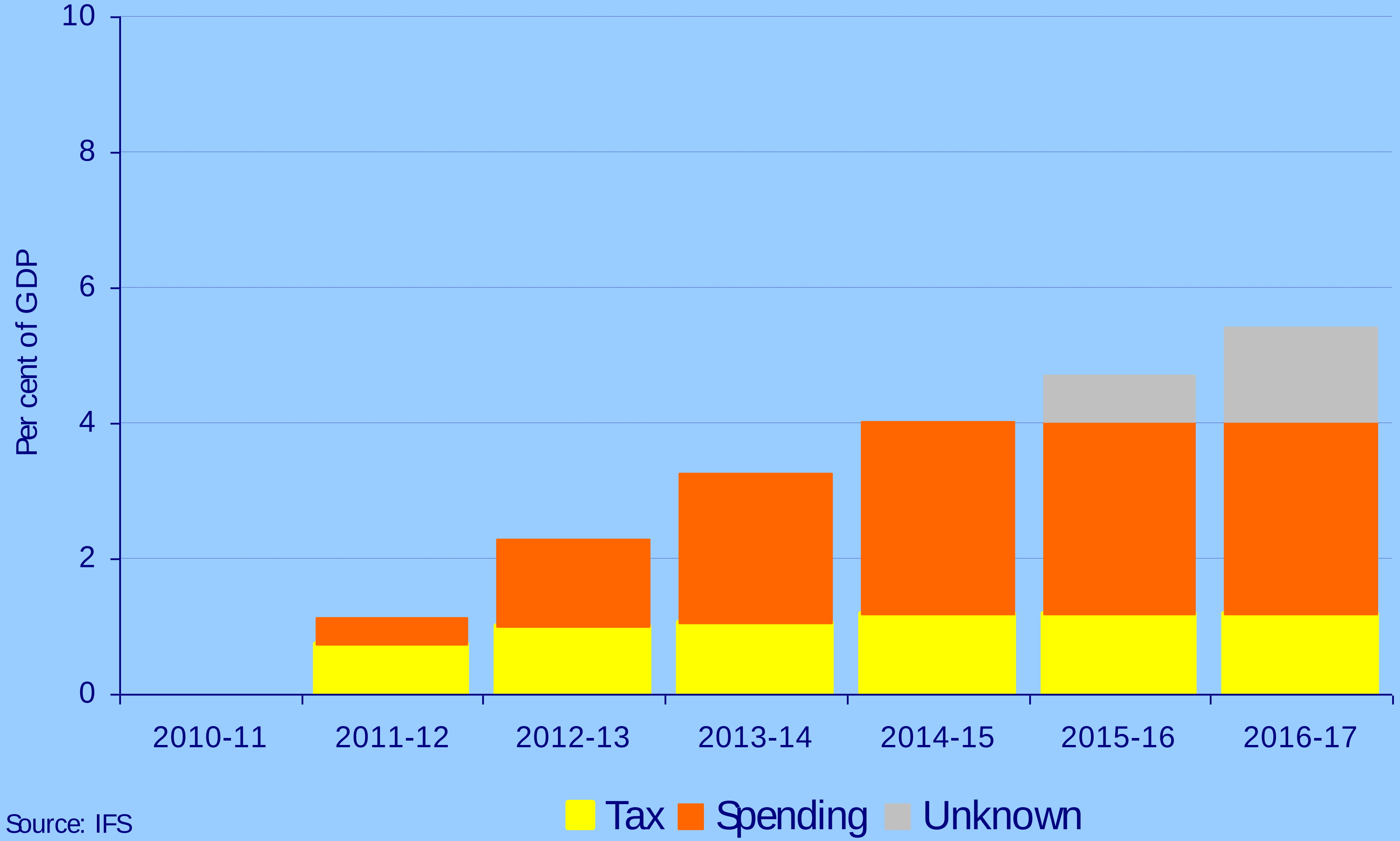
UK consolidation: March 2010



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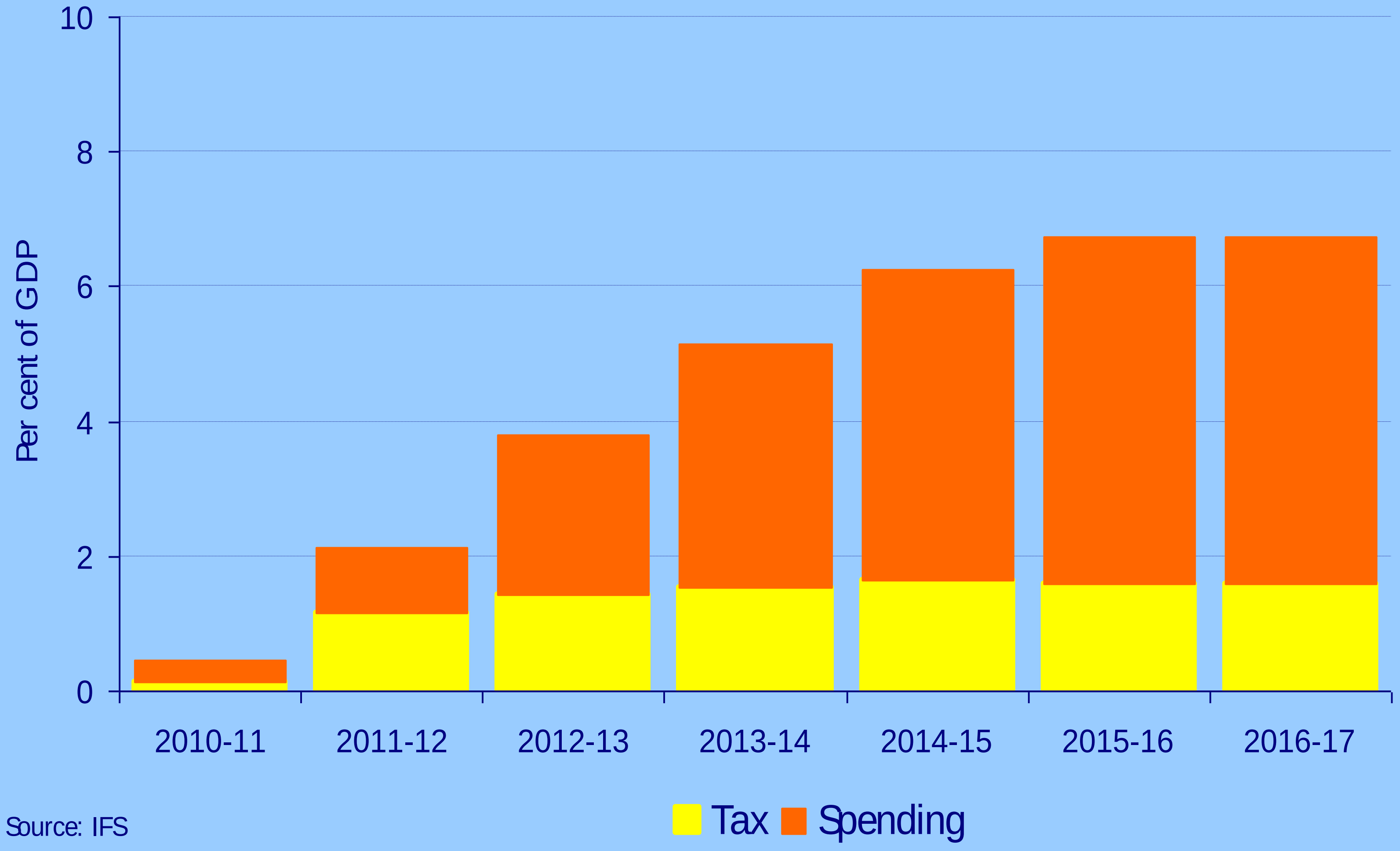
UK consolidation: July 2010



Source: IFS

Interim OBR's assessment

- **Pre-measures and post-measures forecasts published a week apart**
- **Interim OBR used impact multipliers based on range of empirical studies:**
  - Capital spending 1.0
  - Public services spending 0.6
  - Welfare spending 0.6
  - Change in VAT rate 0.35
  - Change in income tax / NICs 0.3
- **All tapering to zero after 5 years.**
- **Apparent impact on growth (% year-on-year)**

	2010	2011	2012	2013	2014
Pre	1.3	2.6	2.8	2.8	2.6
Post	1.2	2.3	2.8	2.9	2.7

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- **But no explicit view taken of monetary policy response**

Extra tightening in November 2011

- OBR more pessimistic about output gap and growth in potential GDP
- Government no longer on course to hit fiscal targets on existing policy
- Government responded by pencilling in 1.5% of GDP of additional cuts in current public services spending in 2015-16 and 2016-17
- Takes total consolidation from 6.5% to 8% of GDP and pushes back completion by a year to 2016-17

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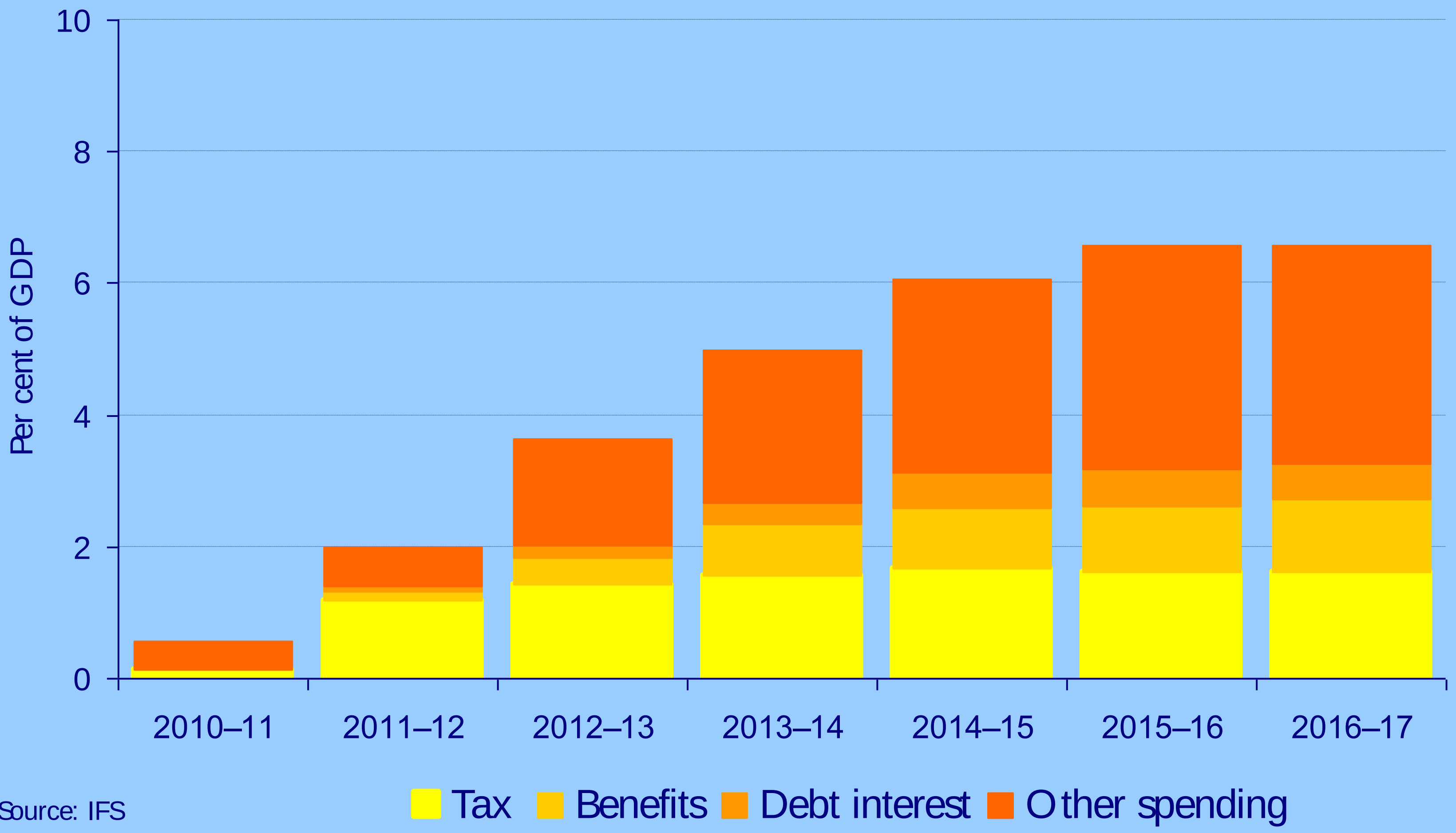
UK consolidation: March 2011



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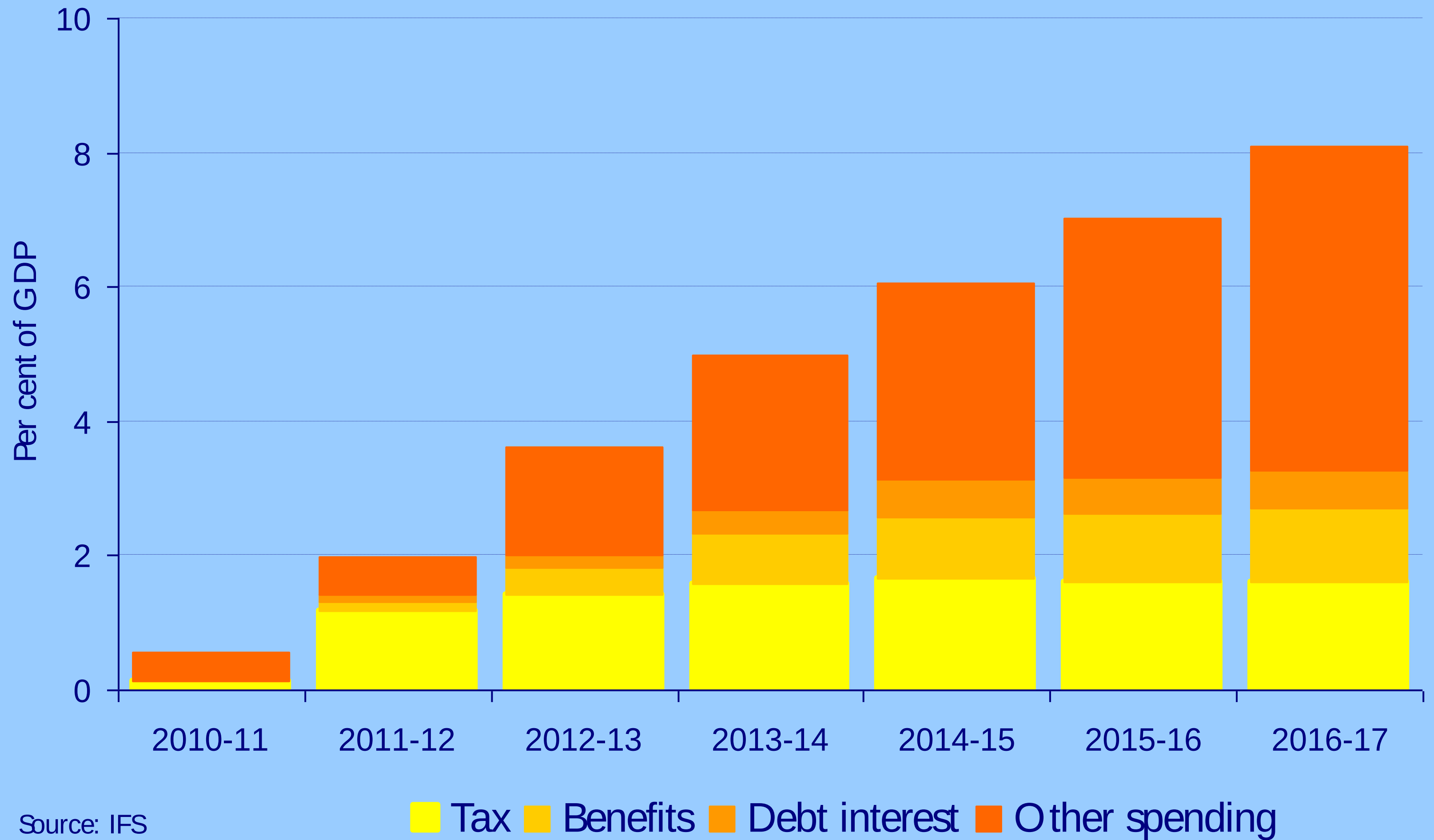
UK consolidation: November 2011



Source: IFS

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Extra tightening in November 2011

- OBR did not reduce aggregate growth forecast because Bank of England assumed to offset additional tightening at that horizon

- But did tweak composition – less G and more C and I

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Lessons

- **The right multipliers in July 2010?**
  - As paper notes, literature is “voluminous and far from settled”
  - Affected by global environment, monetary policy and market reaction
  - But we need to be transparent about assumptions
  - Helpful that they could be justified as plausible from literature

- **Presentation of monetary policy response is challenging**
  - Awkward for IFIs to predict or second guess behaviour of central bank
  - But need to take monetary policy into account
  - OBR has taken ad hoc approach to date
    - No explicit change in monetary policy assumed in June 2010
    - Monetary policy assumed to offset fiscal tightening in November 11
  - Would ideally like simple, transparent rule of thumb from fiscal policy to output gap / inflation and then to monetary policy.

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Current UK debate: Plan A v Plan B

- **Should the pace of consolidation be slowed?**
- **Is there a temporary fiscal loosening large enough to give a material boost to the economy, but small enough not to push up UK's current low borrowing costs in a self-defeating way?**
- **Government says borrowing costs are low because it has a credible consolidation plan. Backtracking would push up bond yields**
- **The Opposition says borrowing costs low because we are outside the eurozone and because people are pessimistic about long term growth. Slowing the consolidation would boost growth and help cut the deficit**
- **Who's right? It's not for us to say! Multipliers can help with potential gains, but this is in large part a judgement market reaction**

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Consolidation and the policy mix

- Paper argues that consolidations should deploy “instruments that are friendly to long-term growth”
- Outside OBR remit to recommend what these should be (but bodies like the IFS would point to Mirrlees Review tax reforms etc)
- But we do have to assess the impact of chosen mix on potential GDP
- The timescale is a problem here – hard to ‘reward’ governments for virtuous structural reform by claiming that this will have reliable and measureable impact on potential GDP over a 5 year horizon
- More plausible over the longer term, but still hard to be precise given uncertainty over trend growth rate and impact of financial crisis
- Larry Summers would say boost demand before supply

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Use of debt thresholds in the UK

- UK had 40% public sector net debt to GDP target ceiling pre-crisis
- No real analytical foundation – roughly what Labour inherited in 1997
- Ageing pressures recognised, but no deliberate ‘pre-funding’
- Coalition target to have debt-to-GDP ratio falling in 2015-16
  - November 2011 forecast shows it peaking at 78% of GDP in 2014-15 and falling to 77.7% in 2015-16
- No attempt to define new desirable steady state
- Not for us to say whether there should be such a target

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Debt thresholds versus trajectories

- Are the sorts of cross-country studies reported in the paper a firm enough foundation to justify particular targets?
  - Direction of causality between debt and growth?
  - Contemporaneous relationship or lagged?
  - Are gross financial liabilities the measure to worry about?
  - Does composition (e.g. average maturity) matter more than level?
  - Level of debt or level of debt interest payments?
- Studies saying that a particular level is dangerous could be self-fulfilling if markets come to - or continue to - believe that
- But deficits and broad trajectory of debt may be more important
  - Note that fiscal gap calculation dominated by initial deficit
- Do markets focus on the delivery of a particular debt target (which is hard to predict) or a particular consolidation package?

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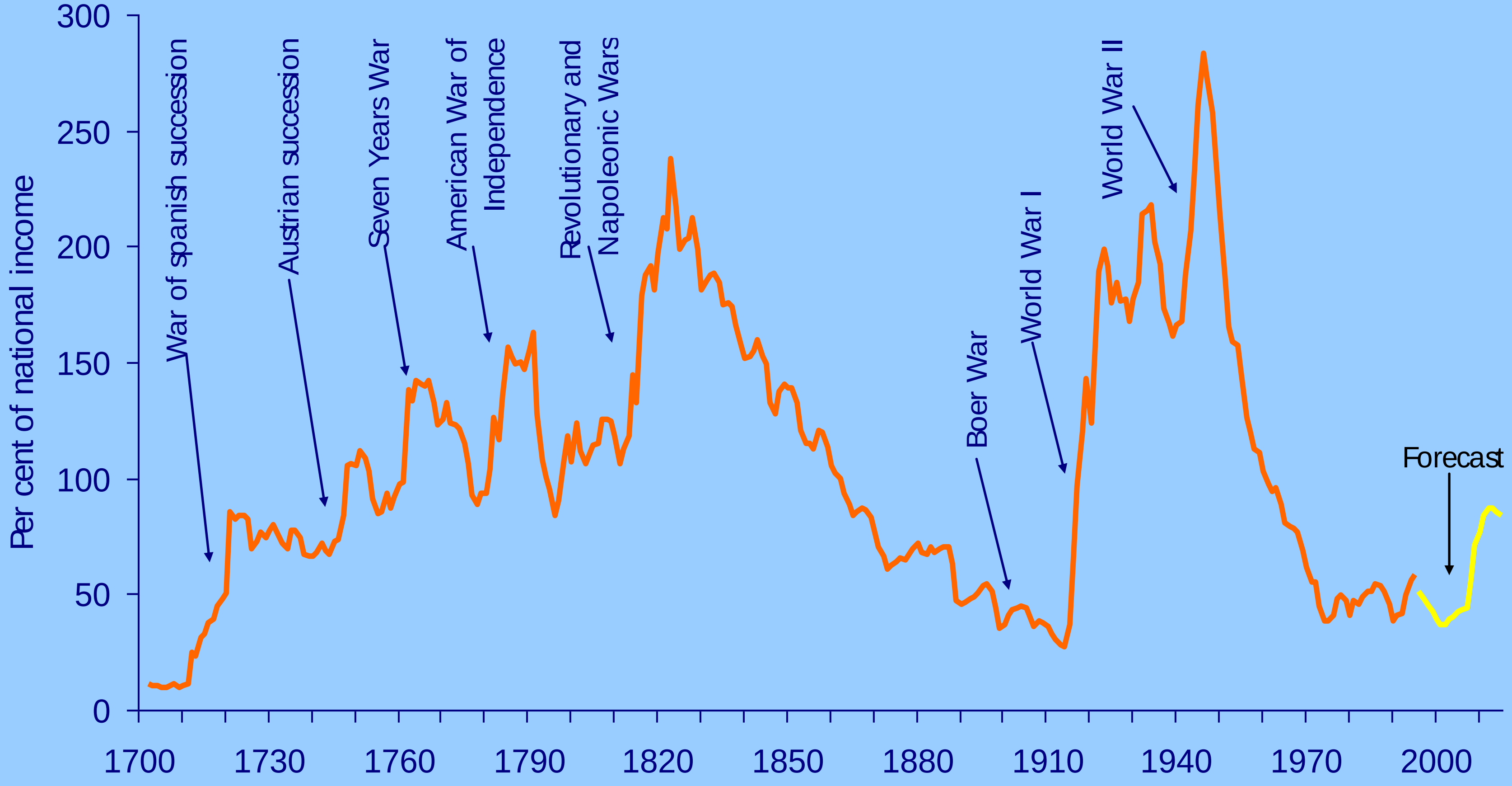
UK national debt since 1700



How much is too much? Is history much guide?

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OBR approach to debt analysis

- **Forecasts for PSNB over 5 years in order to assess progress to target**
- **More detailed balance sheet analysis in Fiscal Sustainability Report**
- **Use of Whole of Government Accounts to paint fuller picture**
  - Public service pension liabilities (sensitivity to discount rates)
  - Public-private partnerships
  - Contingent liabilities and provisions
- **But ability to tax means flows tell a more helpful policy story than stocks**
  - 50 year fiscal projections on unchanged policy
  - Highlights importance of demographics and healthcare
  - Sensitivity analysis e.g. ageing, migration, productivity
  - Structural primary balance at end of medium term forecast is key
- **Fiscal gap calculations a useful tool, although interpretation of existing policy requires caution over international comparisons**
  - ‘Once and for all tightening’ supplemented by other paths

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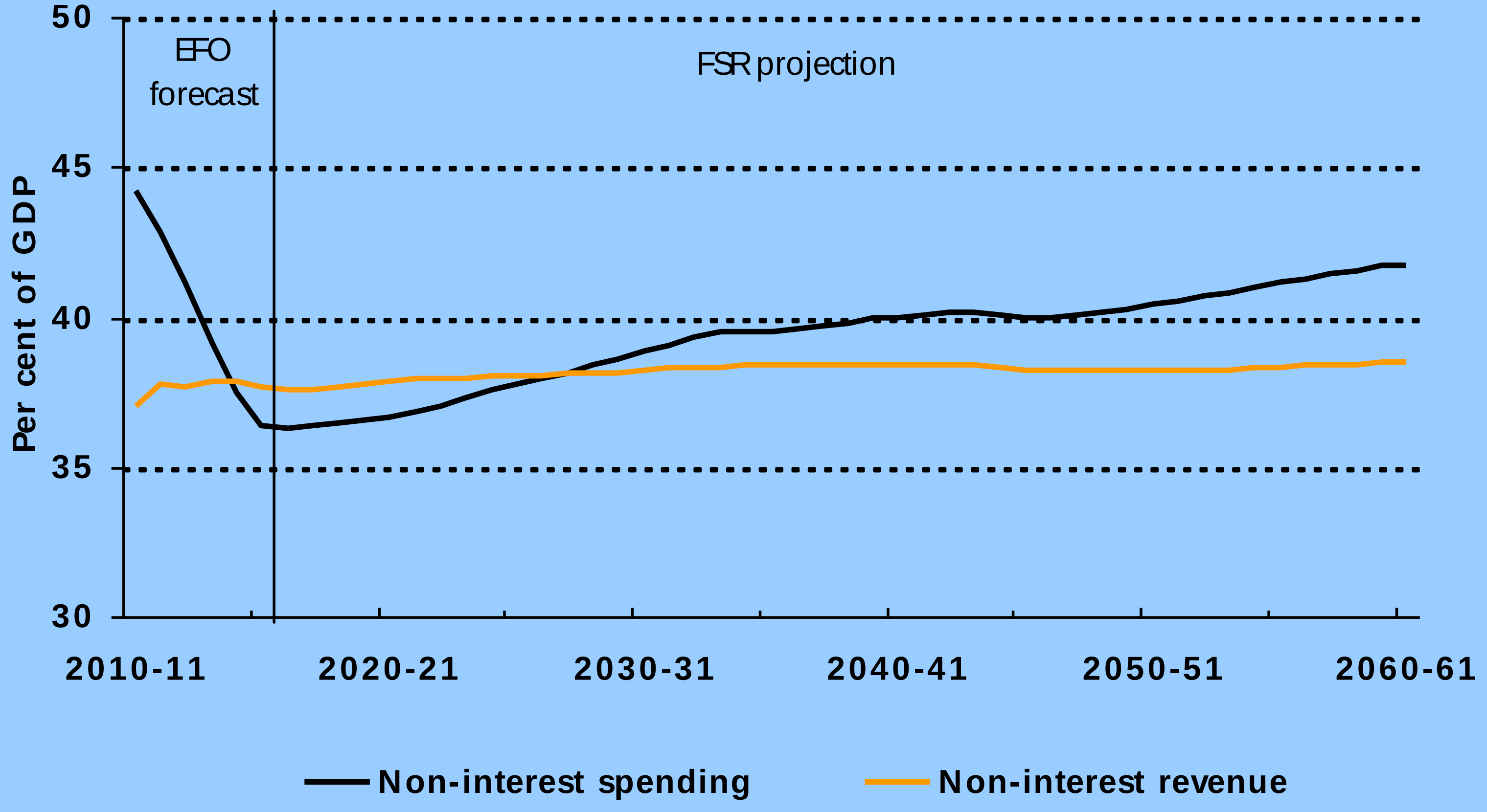
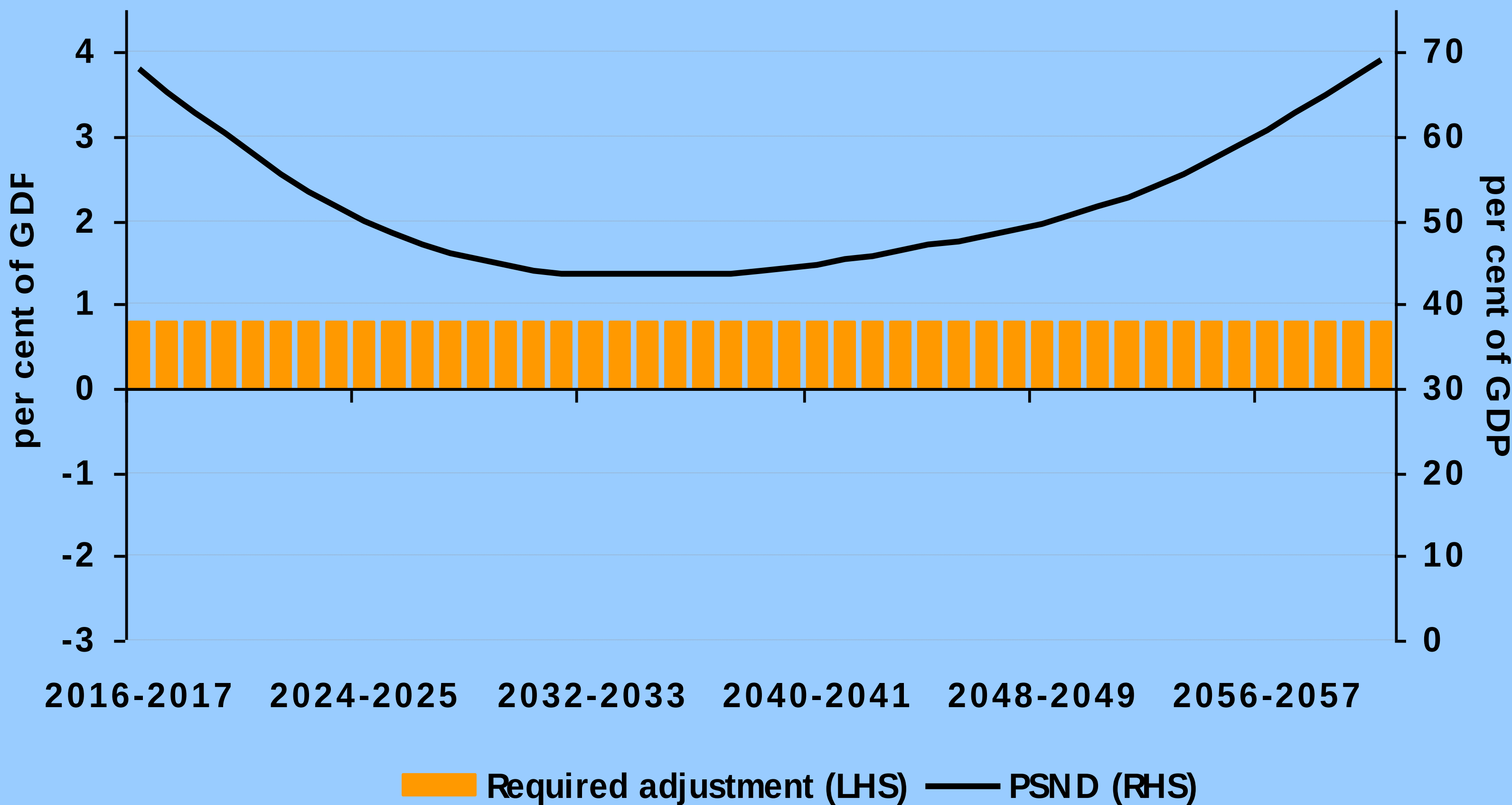
Revenue and spending projections



Timing the response: one-off



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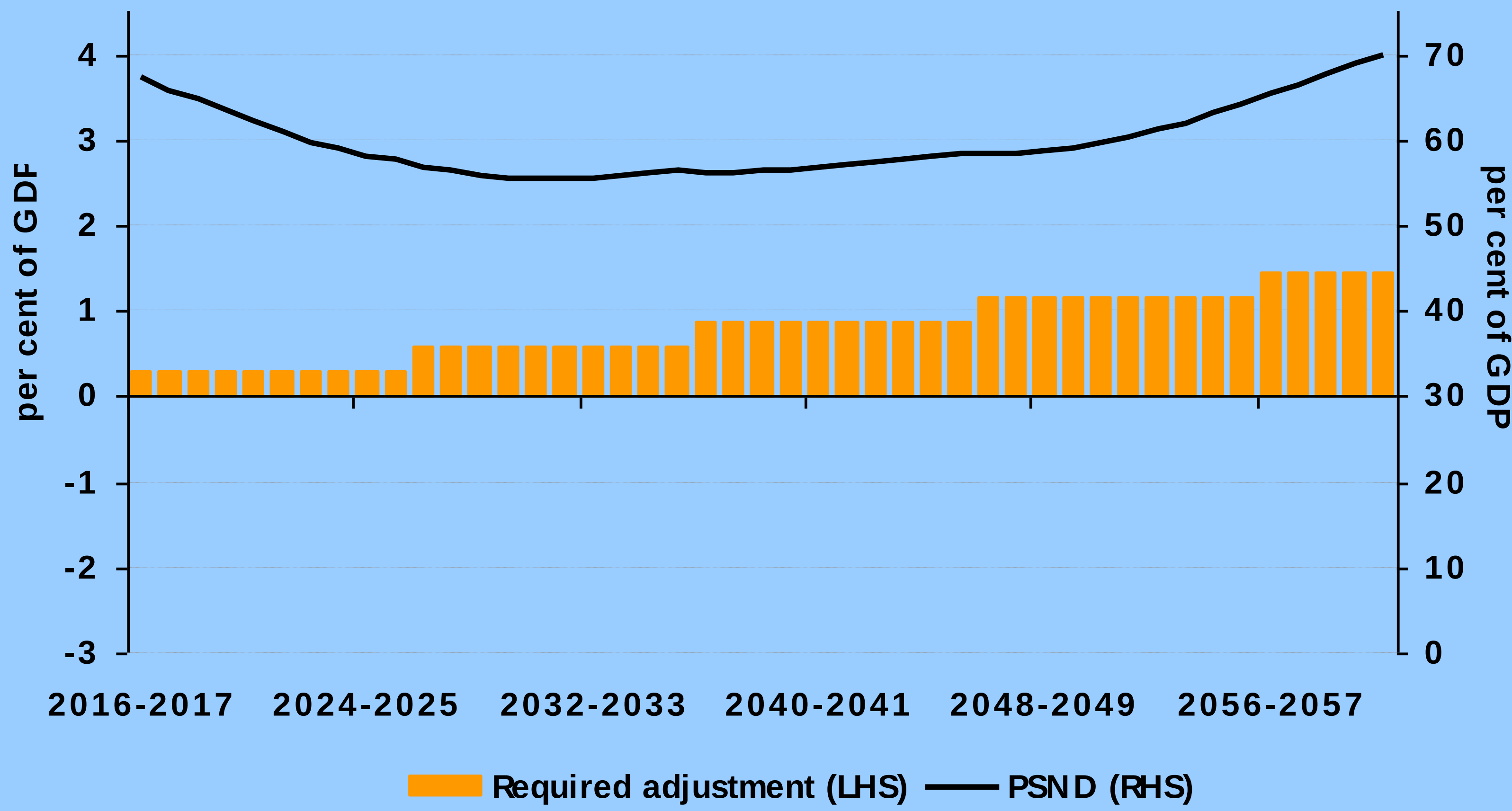
Timing the response: decade by decade



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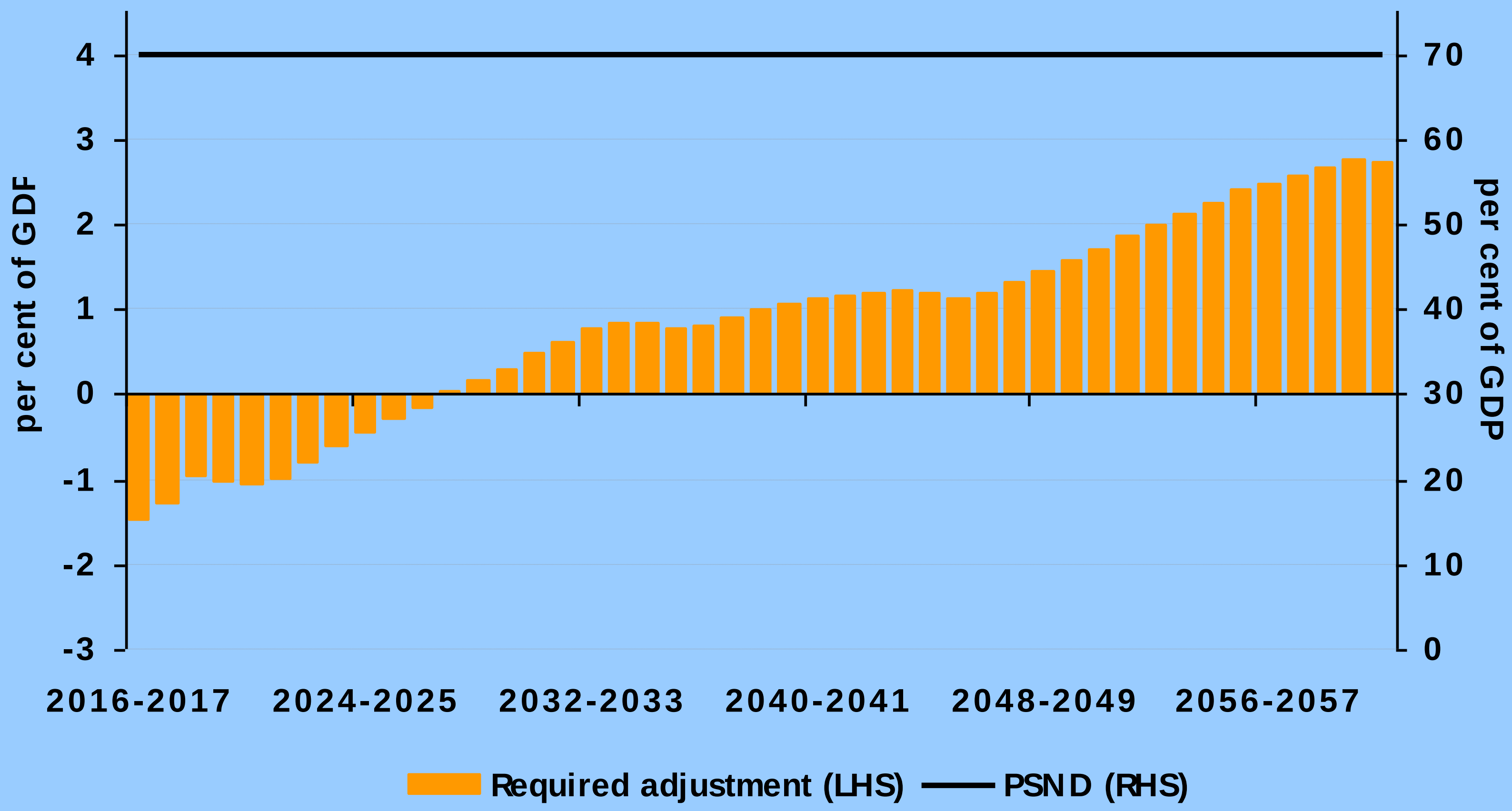
Timing the response: holding debt flat



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Conclusion

- **Very interesting paper, highlights important issues**

- **UK public debate very focused on speed of consolidation**
  - Big doubt over multipliers, but need to use them and to be transparent
  - Market reaction to a change of course very hard to predict
  - Challenge how best to deal with monetary policy reaction

- **Policy mix matters for growth, but hard to quantify the rewards of virtue**

- **Debt thresholds**
  - No real analytical basis claimed for choice of UK targets
  - Direction surely as important as levels
  - WGA allows broader approach, but flows more helpful
  - Defining ‘unchanged policy’ and use of fiscal gaps not straightforward

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