NATIONAL INSTITUTE OF ECONOMIC AND SOCIAL RESEARCH:
PRESS CONFERENCE
Tuesday 8th February 2022
Opening remarks by the Director

Good morning. Welcome to the *National Institute of Economic and Social Research* for the release of our Winter 2022 *Global Economic Outlook* and our *UK Economic Outlooks.* We produce these Outlooks at a time when we increasingly think that a large part of the COVID19 crisis is now behind us. But that very crisis has posed many questions by revealing differences in regional, national and international resilience, as well leading to an increase in income and wealth inequality, which policymakers must address. Our main immediate concern though is for central banks to act and ensure price stability and for fiscal frameworks to be modified to be able to deal more flexibly with economic shocks.

The Global Economic Outlook: Picking up the Pieces

The two-year interruption to the normal pattern of world trade and growth may finally be coming to an end this Spring as we seemed to have shrugged off the most dangerous variants of COVID-19. The stimulus from monetary and fiscal policies that limited the impact of lockdowns on the global economy and supported the strong recovery from the sudden stop of the pandemic must now be re-oriented. The immediate priority is to address burgeoning levels of public debt and substantially negative short term real rates. It does look more than a little like the global level of public debt traces out a demand curve relative to its price – put simply governments have gobbled up ever more debt as it has become progressively cheaper to issue. And each country will now face a different set of constraints and feasible set of policy choices to achieve adjustment and an enduring financial stability.

The main policy concern is that of price stability. We expect OECD inflation to go significantly above 5% this year, which will be the highest since 1999. It is, of course, widely understood that much of the inflationary

impulse seems related to a sharp rise in energy prices and from supply chain tensions that are pushing up transport costs. As such they reflect the costs of getting back to normal and placing factors in the right place to meet demand and, as such, might be thought of as a temporary tax on trade. But the size of the shocks and the extent to which they are likely to spread to other goods and services over time means that they expose the fallacy of continuing with ultra-accommodative monetary policies. It is more probable than not that inflation will overshoot orthodox notions of price stability and the problem faced is not so much of whether to tighten policy but how to do so when presented with an asset price bubble and financial markets that do not seem to like taking much risk.

The Federal Reserve, for example, must now seek to regain control over inflation with a rapid (by recent historical standards) tightening in monetary conditions. The Bank of England has just embarked on a clear tightening cycle and we expect Norges Bank, the Bank of Canada and the Bank of New Zealand to follow suit. Though it is not expected that the Bank of Japan or ECB will do anything like as much and this may promote some exchange rate volatility. Ending the dozen year bull market in fixed income markets will be no simple task and we can expect tantrums. Advanced economies though will tend to continue to have recourse to borrow from capital markets to help smooth adjustment and deal with any hiccups along the way. To help support the use of such an option, some further thought needs to be given to the flexibility of fiscal frameworks and the work of fiscal councils.

Many emerging markets are not quite so lucky. Those with high external debt and anticipated to have low growth, for example South Africa, Brazil and Mexico, will remain exposed to financial market stress, particularly should investor risk sentiment deteriorate because of increased inflation pressures in advanced economies. This problem will be amplified for many emerging economies with the commencement of tighter monetary and financial conditions in advanced economies, and with the impending retreat from the central bank holdings of large stocks of asset purchases. It is under circumstances of monetary policy tightening in the past that some emerging countries have been tipped into a full-blown crisis with the experiences of

both Argentina and Russia prominent in the memory. We draw particular attention to the current issues facing Turkey at present where shocks do not seem to be being met with orthodox responses and many of the conditions for a crisis seem to be amassing.

In many ways the world economy is now heading into very dangerous territory. The initial set of responses to the pandemic were well formulated but also rather obvious. The lockdowns introduced to slow the progress of COVID-19 were public health measures and so the same public needed monetary and fiscal support to limit the economic damage. But that could never be open ended and has left both a public debt hangover and a sequence of monetary impulses that have not yet been absorbed by higher nominal GDP. It will be firm aim of monetary and fiscal authorities to ensure that as much absorption as possible finds it way into real output rather than an undermining of the nominal anchor. It is therefore critical that commitments to price stability are both honoured in word and in practice.

UK Economic Outlook: A Bridge to Normality

Towards the end of 2021, the British economy finally returned to the level of activity it obtained just prior to the emergence of the COVID-19 crisis at the beginning of 2020. We have thus endured two years without any economic progress and considerable social strain while the new virus ripped through our modern way of life. While it is still "not over for any of us until it ends for all of us", we can start to let our hopes of a return to some semblance of normality dominate those of the despair we have felt at times since early 2020. So, what are the priorities for that normality in a medium-sized advanced economy? They must involve addressing the shortfall in the provision of public goods such as digital infrastructure, vocational education, health and social care, as well as the trade deals we need in light of Brexit. Meaningful regional regeneration must be an objective to help focus the national attention. Ultimately, we think meeting those priorities will require a radical re-design of our political institutions and a re-consideration of regional power.

The main immediate problem we face is a dislocation between supply

constraints in the economy, which are both short run because of supply chains but also long run as our productivity growth as continually stalled, and strong demand that has been pumped up by loose monetary policy. Fiscal policy should concentrate on building up net worth in the public sector and less on the budget balance per se. And monetary policy needs to regain its focus on price stability. Bringing these into line with prompt policy action will be the main task we face but a dense cloud of uncertainty that hangs over the policy arena, which originally formed during our Brexit wrangling but seem to have grown even thicker over time.

We have previously underlined in triplicate that monetary and fiscal policy are in the wrong space. The escalation in public debt accompanied by a shortfall in public investment can allow the deferral of tax rises to give full rein to tax smoothing but then also requires a re-ordering in the organisation of our fiscal affairs. The framework needs to allow flexibility, but of the kind that responds to shocks and not adds to them. The question of whether to implement an ad hoc national insurance increase announced in September 2021, hypothecated to meet social care needs, has meshed in a tussle between the Prime Minster, the Chancellor, and newly elected MPs. We need flexibility to deal with economic not political shocks and what we have witnessed is no way to run fiscal policy. As I write in the second month of 2022, we still do not know the date of the Spring Budget, which hampers economic assessment of the Chancellor's plans. And at the same time the Monetary Policy Committee of the Bank of England urgently needs to address the questions that are being asked about the credibility attached to its inflation target, with inflation set to accelerate to 7% later this year and policy rates expected only to shuffle up to around 1.5% towards the end of 2023. This anticipated response looks unlikely to prevent a stubborn overshoot in inflation. The monetary framework pushes us to focus on the next iteration in interest rates rather than the path of Bank Rate over time and the likely responses to risks as they unfold.

While aggregate policy is the focus of attention, its failures matter for our regions and devolved nations. The huge gaps in regional economic performance cannot be plugged with a one-off commitment of a tiny amount

of recycled money as signalled by the White Paper on Levelling Up, which has been published much later than the original date prior to Christmas but still seems to have been pushed out quickly to meet political expediency. Regions lacking robust centres of local demand or high levels of human capital are both more vulnerable to economic shocks and less resilient than we typically find in other advanced economies. This means that the inflation shock will be more likely to inflict enduring damage to household well-being in our poorer regions because of labour market mismatches and a lack of firm dynamism. The risk is that a further widening in economic prospects may not only but support the further devolution and the development of more local government powers but threaten a break-up in the Union with Scotland first to leave. But will the people have sufficient patience to wait while these obvious reforms are introduced? We are used to the problems brought about by economic uncertainty, things get delayed, but what if that continues to interact with political uncertainty. Will things fall apart because normality delayed is normality denied?

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