NATIONAL INSTITUTE OF ECONOMIC AND SOCIAL RESEARCH:
PRESS CONFERENCE
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Opening remarks by the Director

Good morning. Welcome to the *National Institute of Economic and Social Research* for the release of our Autumn 2021 *Global Economic Outlook* and our *UK Economic Outlooks.* We increasingly think that a large part of the COVID19 crisis is now behind us. But in its wake the crisis has left many questions about regional and national resilience, as well income inequality, that policymakers must address. The call for better forms of cooperation has more often been made than answered but with more than 5mn measured deaths and countless lives disrupted, a new approach and institutional capability must be found.

The Global Economic Outlook: Lifting the Pandemic Cloud

The battle against Covid-19, which has to date claimed some 5mn lives, seems now to be proceeding well in advanced countries but in an uneven manner globally. However, just as every victor of a war must try to win the peace, our global fight has exposed many frailties in the international economy. Our immediate problem is that of global dislocations in aggregate demand and supply.

Macroeconomic policies have rightly sought to offset the impact of stringent government lockdowns in response to the pandemic. These policies, both monetary and fiscal policies were both massive and rapid, and they greatly tempered the loss in global income in 2020 and 2021 for those countries that were able to deploy them. However, such policies operate with both long and variable lags. The path that we must now steer involves how to remove this stimulus without risking recession or boom. The historical record suggests that it will be challenging indeed to avoid post-crisis volatility in economic performance as we try to thread many of the pieces of our normal economic life back to together into a more normal pattern.

The most obvious sign of dislocation is to be found in the current worrying escalation in inflation with the US in the vanguard. While it is our view that this inflation will not lead to a damaging wage-price spiral, it remains a strong risk to our central case. The central bank playbook advises caution and gradualism in the face of shocks. However, the main risk to inflation risks solidifying is a collective failure of central banks to act. The main weakness in the central bank armoury is a direct result of the developing central bank toolkit. Quantitative easing has blurred the traditional demarcation between fiscal policies, their funding by taxes or bond issuance, and central bank policies. Not only have central banks relaxed governments' budget constraints, but also governments have responded by issuing into this extra fiscal space.

The next steps in the playbook are well-rehearsed. There will first be open mouth operations about the need to secure price stability. The central banks will then signal that there will be small incremental moves in policy rates. We may also see unwinding of QE, with some tapering of purchases or the stock of QE falling in line with bond redemptions. We may then puzzle at why so little is being done with inflation rising to a multiple of its target. Further, we will ask ourselves if this lack of decisive action is because baby steps will be enough to control a very temporary price level shock or because central banks are unsure about the impact of changes in the stance of policy in such a heavily indebted and fragile world economy? In the latter case, we would have entered the world of fiscal dominance and signalled the possible end of our regime of central bank independence. This will leave households and firms with a choice when planning ahead as they will not be able rationally to bet on the former case alone. Thus, the dispersion in beliefs will undermine the attainment of continuing credibility.

We have also changed some other things permanently. The monetary and demand stimuli have further escalated a secular rise in asset prices and government debt. Countries without a credible monetary and fiscal settlement risk facing sharp increases in the costs of borrowing and may now be constrained from responding to future shocks. At the same time, countries that are net suppliers of primary commodities will benefit from a sustained

increase in demand as the terms of trade move in their favour. Any removal of stimulus that risks being abrupt, as we found out during 2013's Taper Tantrum, could also impose considerable negative spillovers on countries relying heavily on exports to advanced economies. The resulting increase in long term rates could ultimately be helpful in re-orienting economies away from consumption-led growth, but might also provide another sharp dislocation lying in wait for the heavily indebted because risk premia would spike. The risks are central banks tightening too little and seeing higher inflation and inflation expectations becoming entrenched, and doing too much and provoking a major asset price adjustment and consequent sharp slowdown.

While we reflect this month on the need to focus on limiting climate change, we can at the same time consider what role international co-operation can play in limiting the distributional effects of changes in the policy stance. From the need to support the COVAX initiative to the new SDR allocation, we will need to think carefully about how to reconstruct the monetary and financial architecture so that more countries can deploy their monetary and fiscal tools in a manner to achieve enduring price and financial stability, which ultimately underpins global prosperity and growth. Currently, too few can and too many may not be able to do so; we run the future risk of even fewer being in a position to do so. If increasing numbers of countries cannot commit to price and financial stability with institutions and tools, this dislocation may trigger a prolonged bout of inflation that may run out of control. The resulting inflation will wreak havoc on the world economy. It is not a risk we should take.

UK Economic Outlook: Emerging from the Shadow of Covid-19

The British economy's relative decline has been highlighted by a sequence of events that will be seen as historically important. The financial crisis laid to rest our notion that it was sufficient to build a national plan on a burgeoning City of London. The referendum on Brexit told us that openness to European trade and migration alone did not allow our economic structures to deliver sustained increases in prosperity across the country. Life under the

pandemic has further exposed the need to redevelop our public provision of health, social care and transport infrastructure, as well as a reconsideration of the revenues to finance that. While it is not the duty of the state to replace private sector activity and impinge on its plans unduly with taxes, the state (local and national) does have the obligation to support and enable the private sector to generate jobs and prosperity across the nation. In that it has repeatedly failed.

As we reach the end of 2021, we are emerging from the Covid cloud, albeit gingerly. However, it is by no means certain that we will avoid returning to some restrictions on our mobility; certainly, the threat that we might do so will continue to affect household and business confidence. Economic activity is facing a persistent negative supply shock, which means that we cannot produce all the goods and services we would want at prevailing prices. Alongside that, there is much pent-up demand as signalled by the stock of household savings. Two fundamental judgements in the short run are how quickly these disruptions to domestic and global supply sort themselves out and how quickly households return to their more normal propensities to save. If we think the disruptions will iron out by Christmas and consumers will quickly run down their savings, we might well think that our problems are behind us. However, if we think that disruptions will persist and firms and households will continue to act with caution, we may be faced with economic stagnation.

As this Outlook makes clear, we believe that short run supply problems faced by the UK will persist and are likely to be exacerbated by Brexit. This is because EU exit has acted to reduce the pool of labour, contributed to lower levels of firm investment than might otherwise have been the case, and led to some contraction in the size of our traded sector. Of course the squeeze on less well-off households is now well over a decade old long, predating Brexit, and has primarily resulted from an inability to address our productivity shortfall, which is our long term supply constraint. In this sense demand and supply are meet each other at the same point where low skills and low wages are associated with low levels of demand and constrained supply. Our problems are not insurmountable but prompt and consistent interventions by the state

to support training, labour mobility, house building may act to alleviate some of the costs of adjustment to that high wage-high skill economy for which we yearn.

Structurally, we think there are large shortfalls in the capital stock – human, physical and otherwise – in many parts of Britain. The government needs to address these with a prolonged period of regional regeneration that asks hard questions of our local government system and domestic finance. The National Infrastructure Bank should help address these shortfalls and fill the gap left by the European Investment Bank. However, it is early days, and the scale of its ambition may not match that of the task in hand. The supply shortfalls can only be offset by years of investment in public services with a sustained fiscal intervention. However, when placed alongside negative real interest rates, there is at the same time now a serious inflation risk that requires tighter monetary policy. Inflation nearing 5% will surely risk of escalating inflation and wage expectations, particularly as firms seek to mark-up after the Covid crisis. Failure to act soon may lead market participants to conclude that the Bank of England's preferences for output growth have trumped those for price stability, which is its primary statutory goal. Alternatively, to conclude that the Asset Purchase Facility's balance sheet may not be able to bear considerably higher policy rates. We have proposed a way of unwinding QE without exposing the facility to large losses and potentially dislocating gilt markets with large scale and lumpy redemptions. We hope that the MPC will take note.

It is becoming clear that over the past ten years, we adopted the wrong mix of monetary and fiscal policies. The latter being too tight and the former too loose. It is time to rip up our sheet music. Fiscal policy should promote public investment and the buildup of national assets; monetary policy should concentrate on restoring interest rates that will provide more incentives for firms and banks to deploy their capital productivity. Start again.

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9th November 2021