A day late and a dollar short?

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The recent outbreak of the novel coronavirus (now officially named Covid-19) has rather overshadowed Brexit of late! As of writing, the outbreak has been officially labelled a pandemic and has triggered a variety of responses across the globe. It is, of course, right that our primary concern should be over the health and welfare of those closest to us.

Nevertheless, the dramatic geopolitical and economic change that Brexit heralds is not going away and we shall see in the coming months how this plays out. More immediate (if more parochial) is the impact of the latest budget. As media commentators have noted, this was in many ways a budget of two halves: one dealing with the (economic) impact of the pandemic and the other with longer-term issues.

I cannot comment hugely on the Covid-19 preparations as this is largely outside my area of expertise, except to say that it will require a huge short-term commitment of resources to the health service and that it is likely to have a significant (albeit temporary) impact on economic demand.

What's less clear is the extent to which the various economic stimuli announced on Wednesday will have their intended effect – at least in the short term. After all, much of the hit to economic output is likely to occur on the supply-side rather than to demand – individuals who are isolated are unable to work, closing schools etc. will necessitate huge numbers taking time away from the workplace.

Meanwhile, banning large social gatherings (or, indeed, such events being cancelled of their own volition) will mean another hit to economic supply.

In contrast, what I want to talk about are the longer-term measures. Let us leave aside the £30bn headline figure, and look carefully at the bigger picture. Firstly, the chancellor is absolutely correct to note that

UK interest rates are at historically extremely low levels, and that borrowing is therefore timely.

However, interest rates have been at historically low levels for a decade, when Conservative chancellor George Osborne embarked on an attempt to rapidly reduce the UK’s budget deficit. That this was done when interest rates were at their lower bound (i.e. very near zero) suggests that this was undertaken for ideological rather than economic reasons.

The fact that the overwhelming burden of adjustment (over 80%) fell on public spending rather than tax rises rather reinforces this. These cuts –branded “austerity” by many in the media – took place across public services, although local government took a particularly hard hit.

What’s more difficult to conceive is why such cuts were popular. Political rhetoric suggested that the UK had “overspent” on its “credit card” and therefore had to rein in spending. This is an analogy that exasperates most economists. There are several dramatic differences between governments and households:

- People have a life cycle. Governments don’t. If I borrow, I only have a limited window within which to repay that debt (usually my working life, but in any event before I die). Governments live forever.
- Households are (individually) small. If I go on a spending spree then it will give a negligible boost to the overall economy (but make a big dent in my bank balance!) If the government goes on a spending spree then the economic effects are non-trivial.
- Government borrowing bears little resemblance to credit card debt. Borrowing to invest bears more resemblance to a mortgage than a credit card[1]. Like a mortgage, it makes sense to repay the debt over many years.
- Some current spending is on education or the maintenance of assets. Whilst not ‘investment’ (it’s an ongoing flow of spending to maintain something rather than a one-off), it makes little sense to cut back. Study after study shows that the value of education to the economy is very large, yet we reduced government expenditure on educating the next generation from 5.8% of GDP in 2008 to 4.8% of GDP in 2018[2].

In other words, government borrowing differs very substantially from household borrowing. Of course, governments cannot borrow in perpetuity (what we call the ‘intertemporal budget constraint’ holds), but they can borrow over long time horizons.

The upshot is that the *timing* of government borrowing really matters. When interest rates are near zero (we can argue what “near zero” means in practice, but I would suggest below 2% and certainly below 1%), the impact of monetary policy on aggregate demand is typically modest and uncertain. Such times are precisely when fiscal policy needs to be used.

Yet after 2010, the government of the day took precisely the opposite approach, engaging in a pretty dramatic fiscal retrenchment. In the longer-term, government debt should probably be on a gently falling trajectory[3] but this should be undertaken when interest rates are above the lower bound. Whatever one’s preferences over the size of government and unease about the level and trajectory of debt, the timing was badly wrong.

The package of measures that have just been announced are therefore to be welcomed, but the Institute for Fiscal Studies have already pointed out that many have been announced previously. The headline figures are therefore somewhat flattering and most departments will be left with spending that is sharply below where it was a decade ago. The upshot of all this is that the government’s fiscal stimulus is welcome, but should have taken place a decade ago. A day late and a dollar short.

[1] Technically there is a distinction, since mortgage borrowing is secured against an asset. Although government borrowing is “unsecured”, it is generally considered ‘safe’. My more general point – of borrowing to acquire an asset – still stands. The difference is that the benefits of these assets flow to the country as a whole – e.g. the road network – rather than the government.

[2] Eurostat, *General government expenditure by function (COFOG)*. 2020.

[3] The optimal trajectory is a matter of considerable debate.