

Rebalancing in the Dark

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Disclaimer: views expressed are the author's and are not necessarily those of the CBR

Outline

1. Rumsfeld uncertainty
2. Medium-term scenarios
3. Robust rebalancing strategy

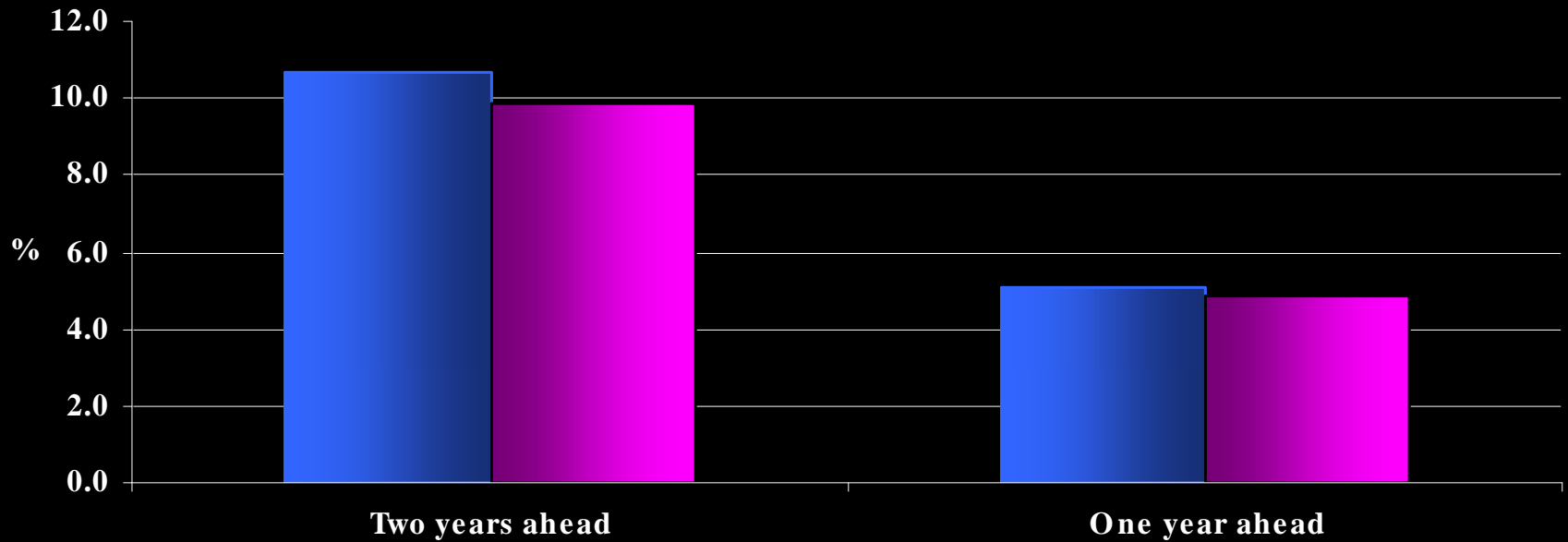
How much uncertainty?

1. Recession forecasting errors
2. Credit crunch impact?
3. Lessons from past business cycles

Recession forecast errors

Overprediction of 2009 GDP level, % of outturn

■ HM Treasury ■ Consensus



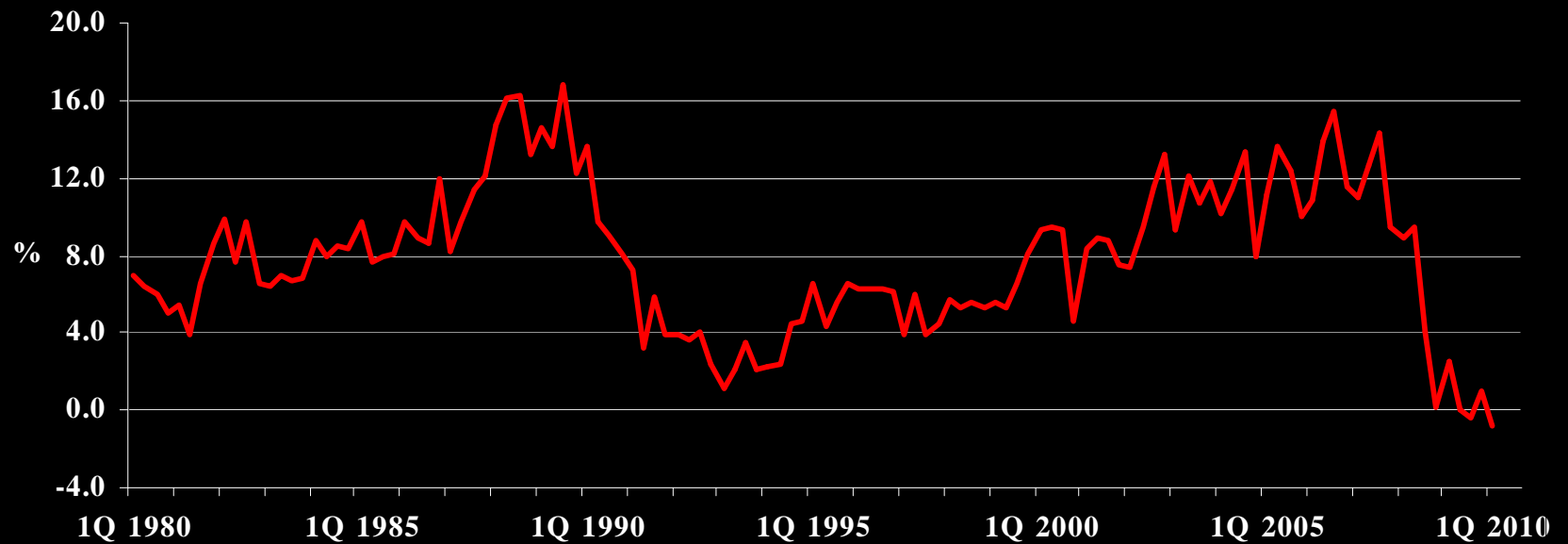
Bean's wealth calculation

1. Fall in consumption in advanced countries due to wealth shock (banks' write-offs)
2. But loss of advanced country GDP relative to potential "more than 10 times bigger" than (1)

“So we cannot come near to explaining the “Great Contraction” purely in terms of wealth effects.”

Credit crunch?

Bank lending to non-financial business & households, % of GDP



Recession puzzle of 2009

Percentage points unless stated	2008	2009
Output gap, % (new data)	-2.2	-9.3
Output gap, % (old data)	-1.8	-8.9
Identified factors:	-2.0	-5.2
Export shortfall	-0.4	-3.1
Wealth & confidence shocks	-1.6	-3.1
Stabilising fiscal policy	0.0	1.1
Unexplained residual	0.2	-3.7

Banking crisis “lessons” – two camps

- Camp 1 – permanent loss
(Reinhart & Rogoff & many others)
- Camp 2 – strong recovery
(Cecchetti, Mussa, Ormerod)

Rumsfeld uncertainty

- Deeply uncertain outlook
 - not fan chartable
- Credit crunch
 - large impact?
- Policy makers have to consider a range of sharply contrasting future economic conditions of seemingly equal prior plausibility

Two medium-term scenarios

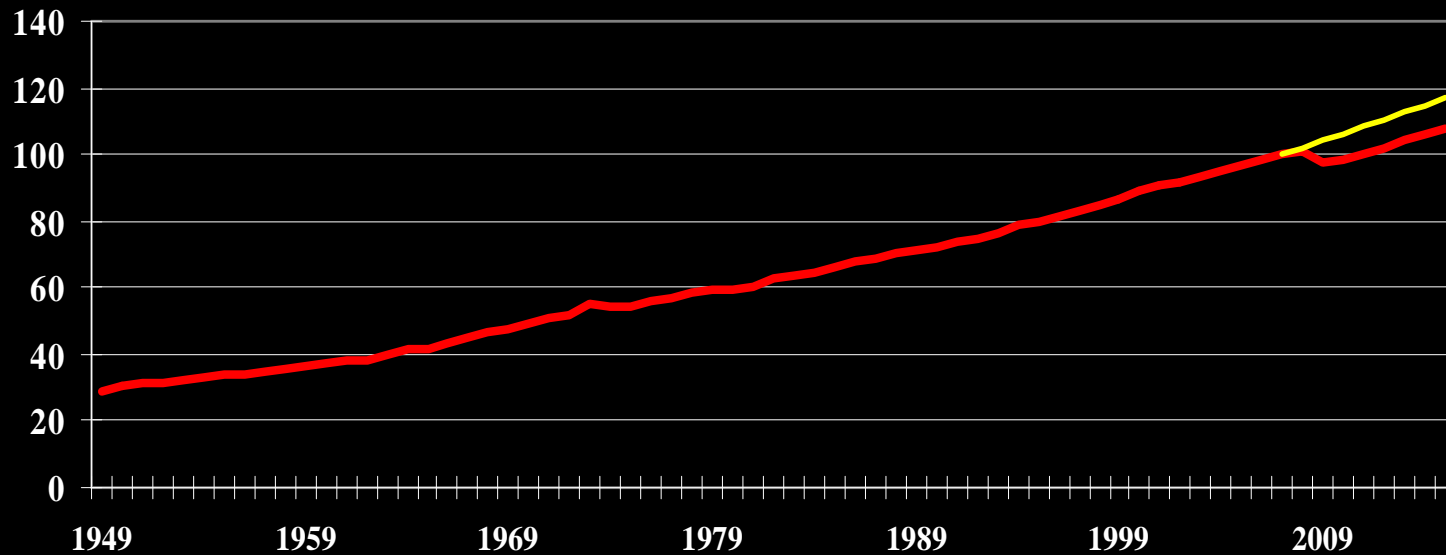
- **Fast & slow recovery scenarios**
 - updated for June Budget
- **Fast recovery scenario**
 - strong export revival, strong competitiveness response, credit crunch fades
- **Slow recovery scenario**
 - more limited export revival & competitiveness response, credit crunch persists

Scenario analysis – three steps

1. **Baseline – align with OBR forecast but query**
 - productivity assumption
 - import penetration assumption
2. **Impose alternative assumptions**
 - external trade & competitiveness impact
 - asset prices & credit crunch impact
3. **Model “fast” and “slow” recovery profiles**

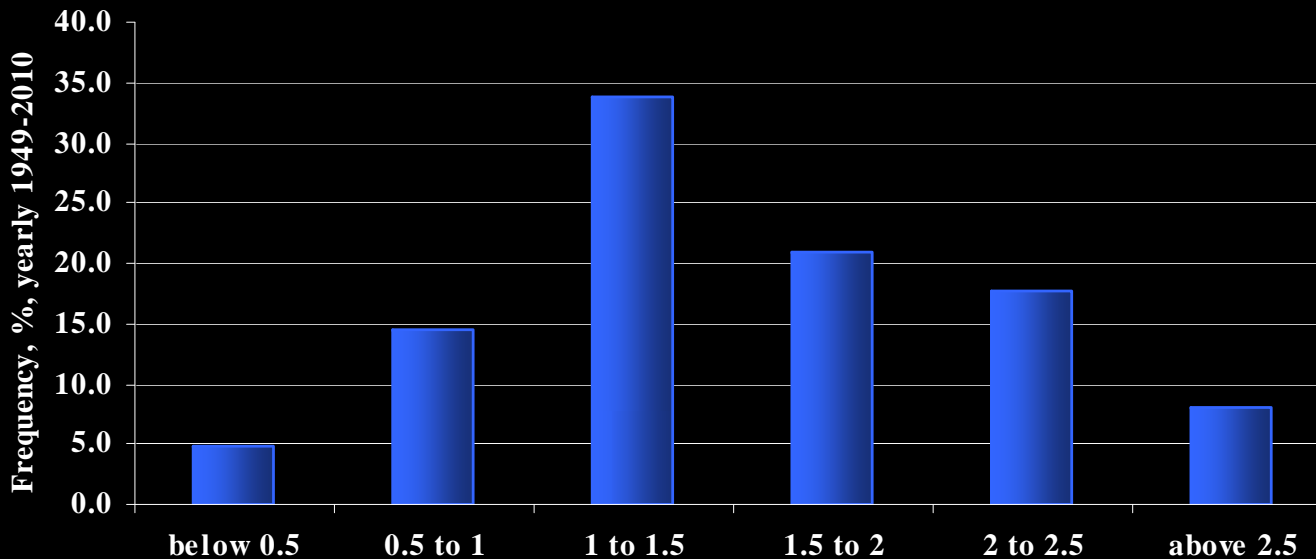
OBR productivity projection

- Productivity index (GDP per worker; 2007=100; OBR projection after 2009)
- mechanical projection: 2.0 % growth p.a. after 2007



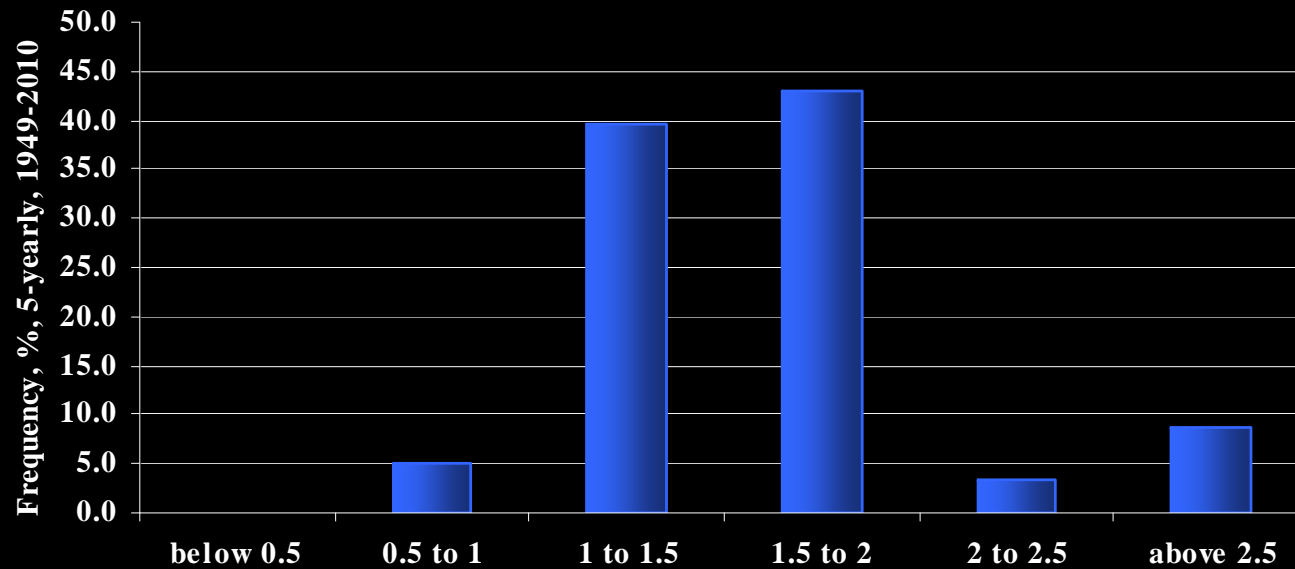
Import “elasticity” I

Annual import "elasticity" - import growth divided by private TFE growth



Import “elasticity” II

Import "elasticity" - overlapping 5-year intervals



HMT & OBR forecasts for 2010

Forecast for 2010	Volume growth, %		Import “elasticity”
	GDP	Imports	
PBR Dec 2009*	1.3	0.7	0.6
Budget Mar 2010*	1.2	2.3	1.4
Budget June 2010	1.2	5.5	2.3

*Mid-point forecasts. Imports ex. MTIC fraud. Elasticity – import growth divided by private TFE growth (inferred)

Rebalancing assumed

The forecast is conditioned on the assumption that:

“ the shape of the recovery in the UK economy embodies an orderly adjustment in the sectoral financial balances and a rebalancing of domestic and external demand supported by sterling’s depreciation. ”

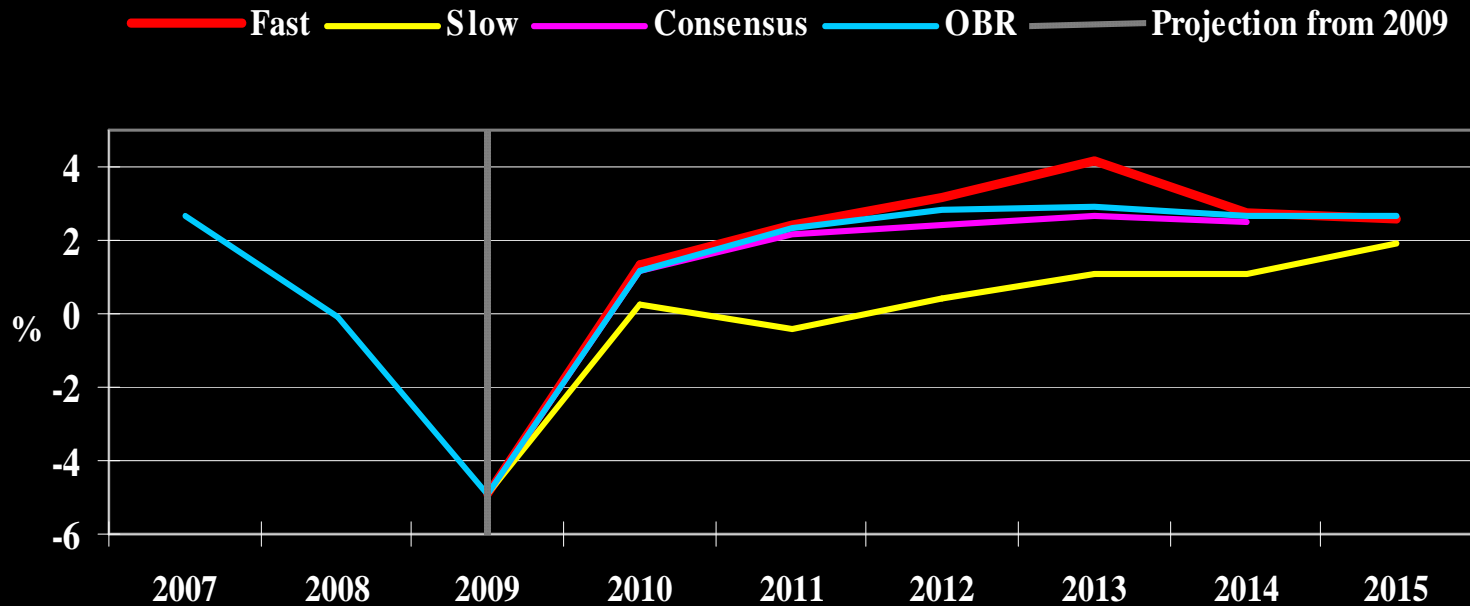
December 2009 PBR, A.42, page 146
See also March 2010 Budget B.42, page 157

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Scenarios – GDP growth

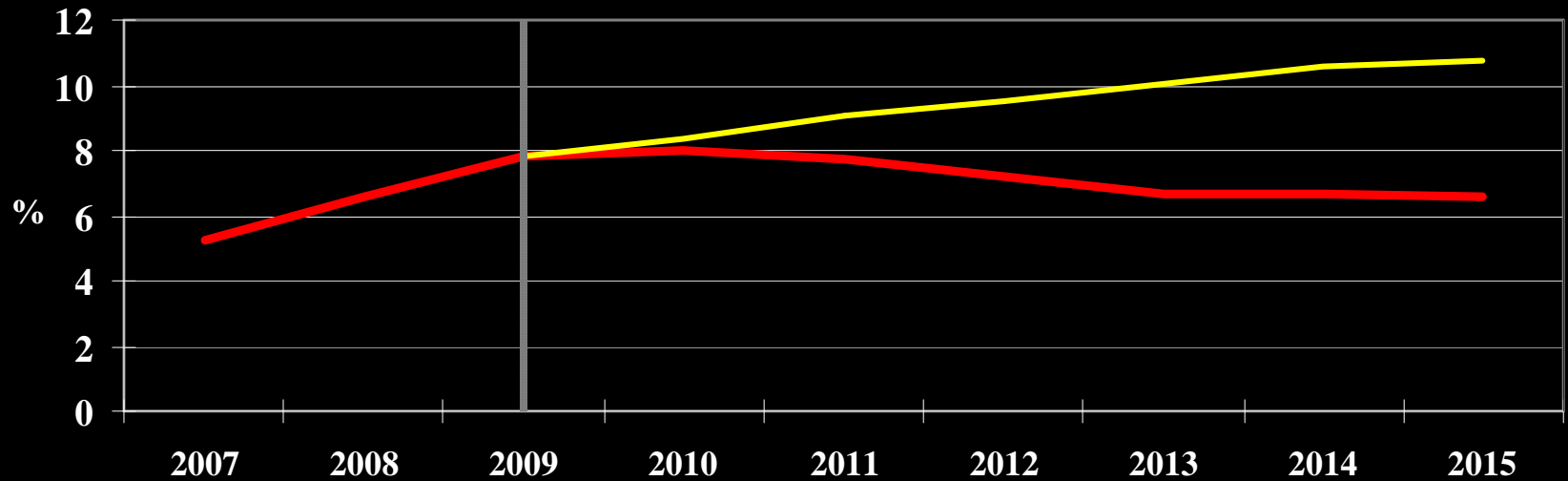
GDP growth projections



Scenarios - unemployment

Unemployment rate, end-year, %

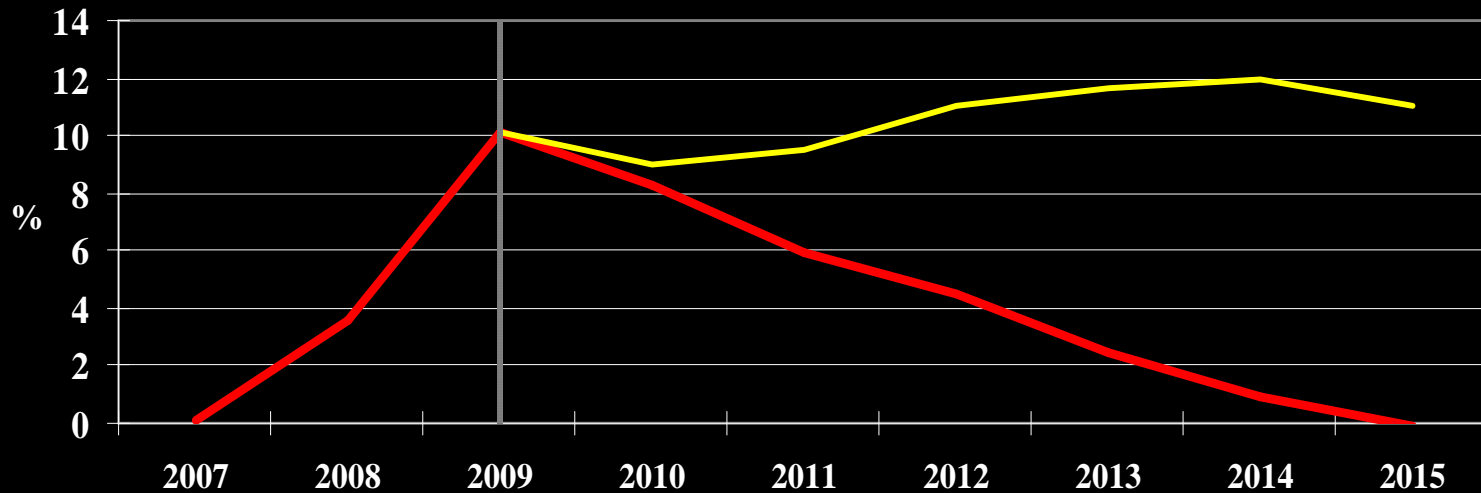
Fast recovery Slow recovery Projection from 2009



Scenarios – private financial surplus

Private sector financial surplus, % of GDP

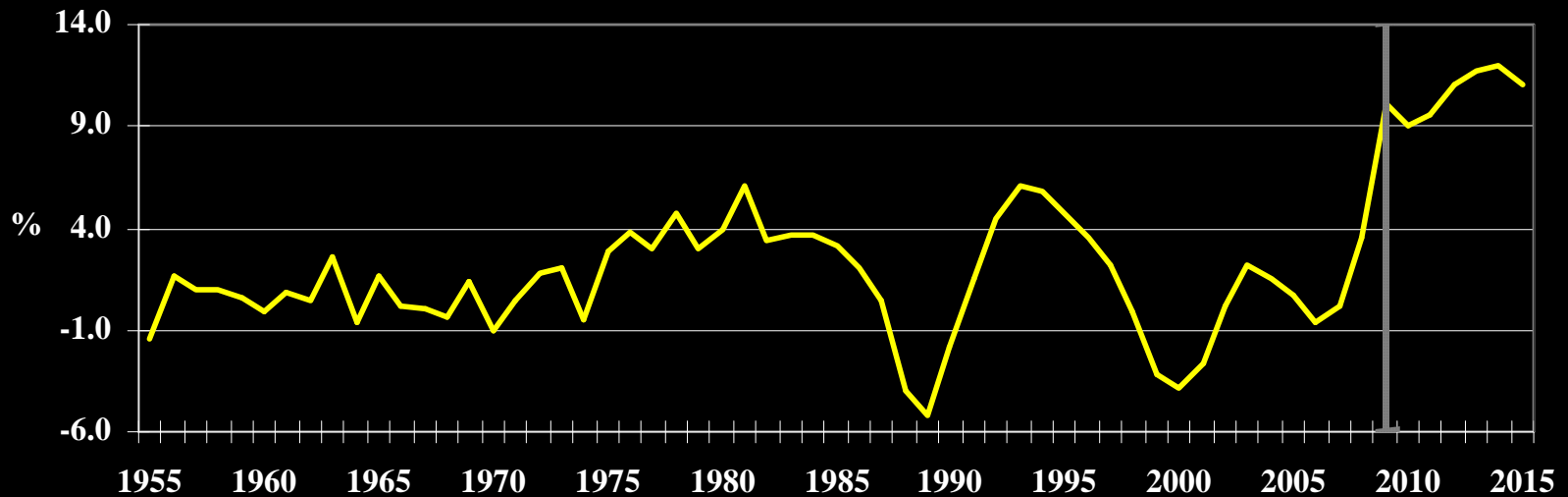
— Fast recovery — Slow recovery — Projection from 2009



Private surplus – slow recovery

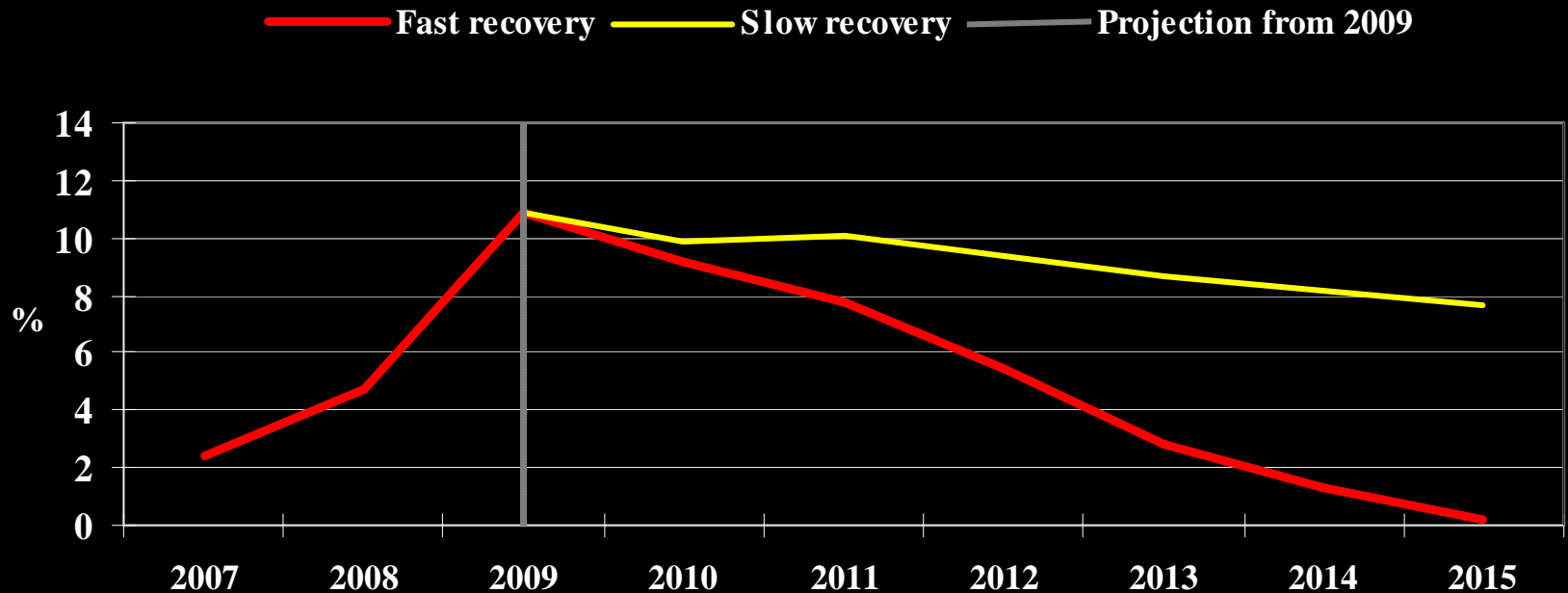
Private sector financial surplus, % of GDP

— Slow recovery — Projection from 2009



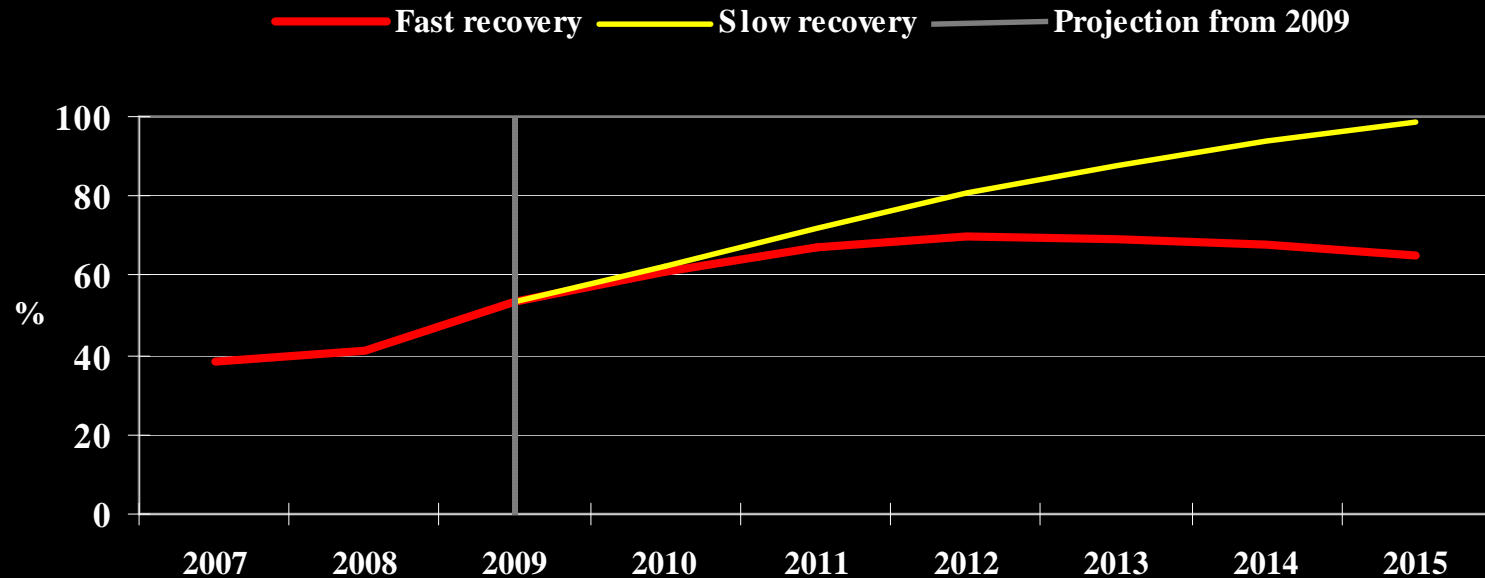
Scenarios – budget deficit

Budget deficit, % of GDP



Scenarios – government debt

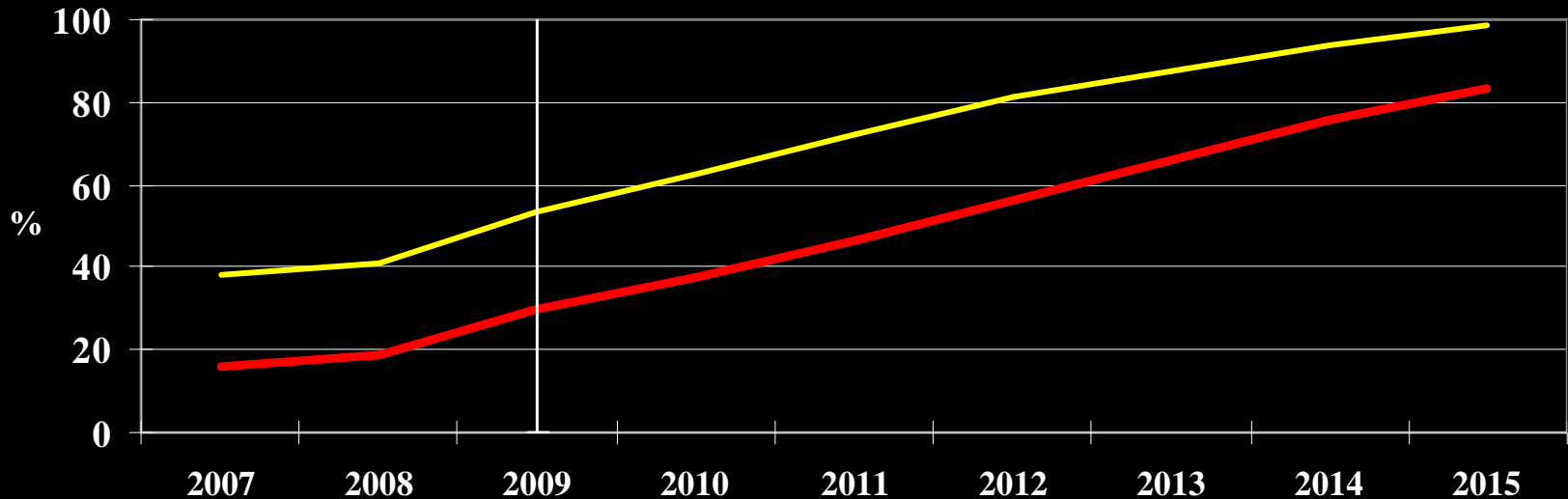
Government debt, end-year, % of GDP



Private financial wealth & public debt

Private financial wealth & government debt, % of GDP

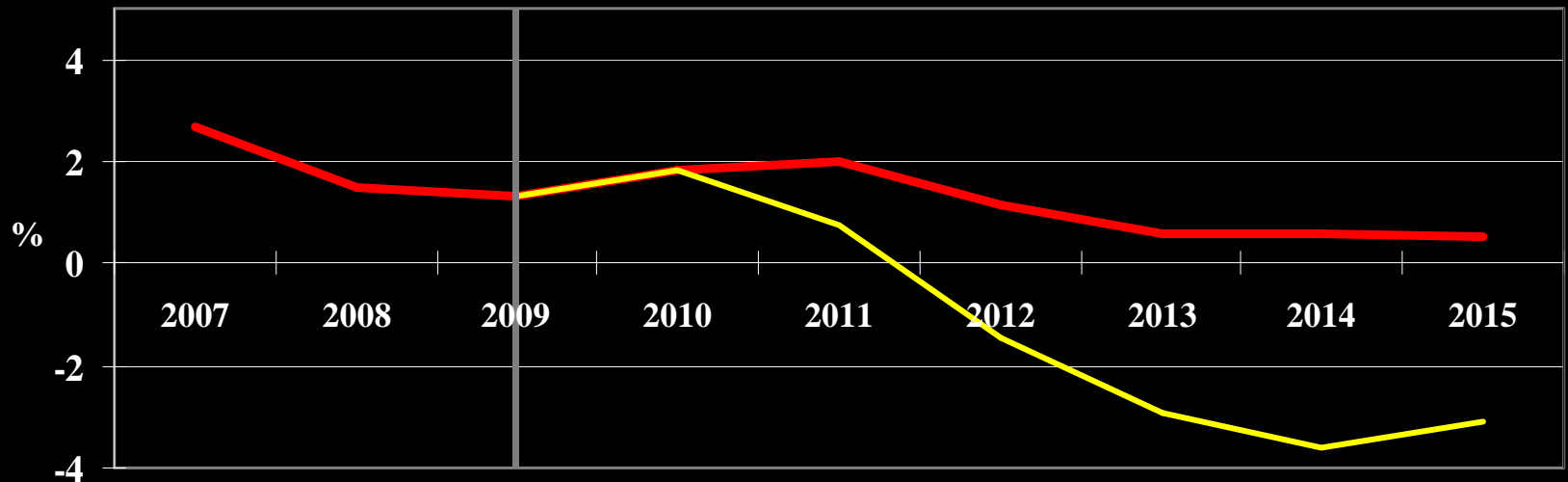
— Private financial wealth — Government debt — Slow recovery projection from 2009



Scenarios – balance of payments

Current account of balance of payments deficit, % of GDP

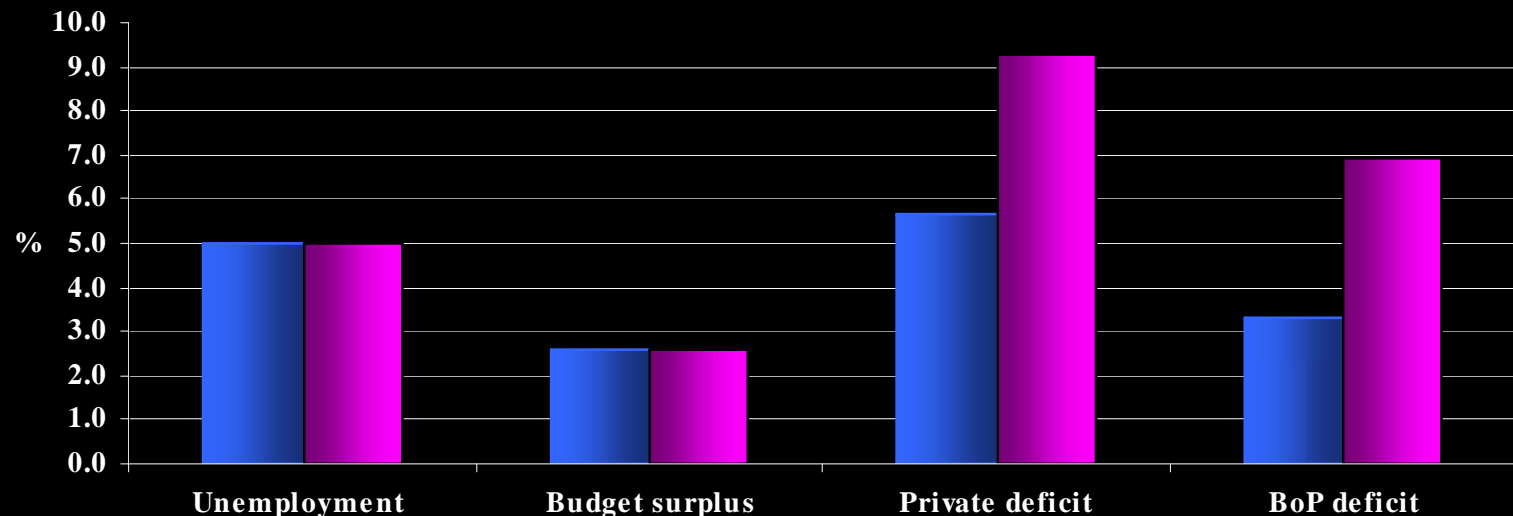
— Fast recovery — Slow recovery — Projection from 2009



“Full-employment” financial balances

"Full employment" financial balances, % of GDP in 2015

■ strong trade performance ■ moderate trade performance



Scenario lessons

- Optimistic OBR
- Fast recovery with latent balance of payments problem
- Slow recovery trap

Policy challenges

- Keeping the recovery going
 - is monetary policy enough?
- Encouraging a balanced recovery
 - supporting resource reallocation
 - raising future competitiveness
 - resisting currency appreciation

