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UK ECONOMIC POLICY – FROM RESCUE TO RECOVERY

Berenberg Macro Flash

Downside risks warrant even more action

The aggressive actions by HM Treasury and the Bank of England (BoE) since early March have helped to contain the tail risks from the massive coronavirus recession. Of course, unemployment has risen sharply. It may peak at nearly 10% in the coming months. A modest wave of defaults also looks inevitable. However, these effects are comparatively benign relative to the c30% collapse in economic activity between February and April and to what would have happened without the massive policy support. Looking ahead, the risk of a potential second wave of the virus and a return of the nationwide lockdown clouds the economic outlook. Spending and investment could remain subdued if households and firms continue to save too much after the lockdown is eased.

With inflation and growth risks tilted to the downside, the potential costs of an economic policy error are asymmetric. The risks associated with providing too much stimulus are much lower than the risks associated with providing too little. In other words, it is better to do too much and pull back if and when the economy overheats than do too little and allow the economy to suffer a dangerous bout of deflation or fall into liquidity trap. The outlook warrants further aggressive stimulus to promote an economic recovery that goes well beyond the rescue measures announced already.

BoE – more QE, negative rates unlikely

We expect the BoE to add an extra £200bn to its asset purchases eventually. At least half of that may come at the next Monetary Policy Committee meeting on 18 June. Recently, the debate in the UK has shifted to whether the BoE will cut its policy rate below zero. While Governor Andrew Bailey has not ruled out negative rates, we view them as unlikely – at least in the near term. If the UK falls into a genuine liquidity trap in the coming months, it will hardly matter whether the bank rate is 0.1% or marginally below zero. A better policy solution would be to pursue yield curve control as the Bank of Japan has done since September 2016.

Promising to keep 10-year yields within a certain range – say 0.0-0.1% (currently c0.2%) – while HM Treasury ramps up debt-financed spending aggressively to boost demand could be a highly effective coordinated policy approach. Although it would open the door to open-ended asset purchases, the BoE would get more "bang for its buck" than with a negative interest rate. By setting expectations for benchmark yields within a certain range, the market would do much of the heavy lifting in terms of keeping rates within the range. More importantly, by preventing benchmark rates from rising if and when the fiscal stimulus pushes up equilibrium interest rates, monetary policy would become more stimulative over time.

Fiscal policy – don't listen to the hawks

The UK *Sunday Times* suggested that Chancellor Rishi Sunak could announce a new set of fiscal measures on 6 July, with more cash to retrain laid-off workers when the furlough scheme ends in October, increased infrastructure spending and measures to support UK tech firms. Probably, Sunak will rehash the £100bn in extra infrastructure spending planned before the pandemic. With more spare capacity in the construction sector than before thanks to the recession, it would make sense to try and spend most of the money within two or three years, instead of the initially envisaged horizon of five years. If the UK is suffering from excess saving in the months to come, tax cuts would not help much. Cutting VAT or corporation tax temporarily – which in some cases can be an effective way to give spending a boost – is likely to just boost saving further.

Most importantly, Sunak needs to send a big signal that he is prepared to get as aggressive as it takes to promote the recovery. Lowering deficits will only be safe once private demand is on a sustained rebound. Following the biggest contraction in economic output in modern times, providing for people who have fallen

on hard times and promoting a recovery that returns people to work should be the immediate and overriding priorities. If that involves persistent high borrowing for the next year until modern medicine wins the fight against COVID-19, then so be it.

For our latest update on the ongoing UK-EU trade talks see here

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