A thin line

Special

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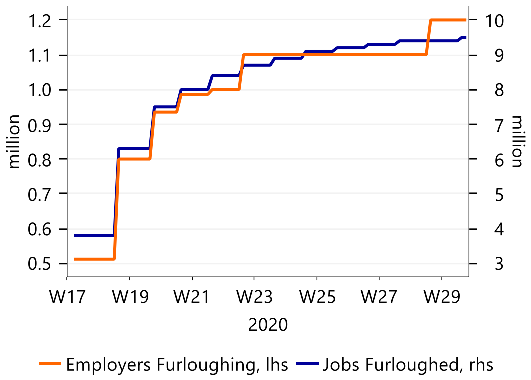
Summary

- The Coronavirus Job Retention Scheme has helped to keep UK unemployment at a low level. As the scheme is being tapered, unemployment will undoubtedly rise in the next few months
- Other labour market data, such as on vacancies, already point at significant labour market weakness. The Beveridge curve suggests that unemployment would already have been in the 8-10% range, if it weren't for the CJRS
- The UK's collective pay check will decline and uncertainty, due to the pandemic and to Brexit, remains high. This incentivizes the private sector to deleverage and to increase their savings
- An expansionary fiscal position could accommodate this process, while a contractionary fiscal position could lead to yet another austerity trap
- Yet accommodative fiscal policies face external constraints. History is not kind to countries that run persistent twin deficits; negative government bond yields and an increasingly not-so-Global Britain aren't helping either. This makes the pound a vulnerable currency
- The government may still see this as a risk worth taking, in particular if it simultaneously pursues an industrial strategy that aims to lower the UK's current account deficit

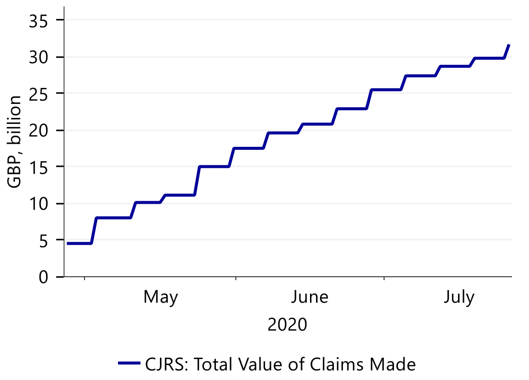
On 20 March 2020, the UK government announced the Coronavirus Job Retention Scheme ("CJRS") to help businesses maintaining their workforce. The grants allow employers to "furlough pay" their employees up to 80% of their usual wages, capped at a maximum of GBP 2,500/m. The policy measure has had a big impact: the latest data show that 9.5mn jobs have been furloughed by 1.2mn employers and that the total value of claims made amounts to GBP 31.7bn. As part of the government's 'back to work'-plans, this scheme is gradually scaled back and will eventually be closed in October 2020. The nonpartisan *Office for Budget Responsibility* estimated in its latest FSR that the CJRS total cost will be around GBP 47bn... **it's big money that has been of great help.**

Figure 1: 9.5mn jobs have been furloughed



Source: Macrobond

Figure 2: And GBP 31.7bn has been distributed



Source: Macrobond

The CJRS will be replaced by a Job Retention Bonus ("JRB"), a scheme that provides employers with a one-off GBP 1,000 bonus for each furloughed employee who is still employed as of 31 January 2021. The idea is that the JRB incentivises firms to keep previously furloughed workers on their payroll rather than making redundancies. **The jury is still out, but you would think that struggling businesses will need more than a one-off bonus to save jobs.**

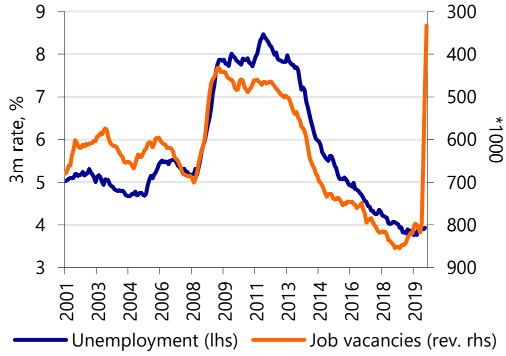
CJRS helped to stave off unemployment

Nonetheless, the government is right to be worried about the imminent rise in joblessness. A substantial number of redundancies and pay cuts have already been announced, and particularly in those sectors that are hit hardest by this crisis, e.g. retail, hospitality or culture.

In contrast with the United States, where the unemployment rate spiked higher in April, the United Kingdom hasn't seen a rise in its official measure of unemployment. In the three months to May –the latest official data point– unemployment remained steady at 3.9%, near its recent multi-decade low. But the data are flattered: the ONS counts furloughed workers –or self-employed who receive assistance from the Self-Employment Income Support Scheme (SEISS)– as employees. These schemes therefore suppress the rise in measured unemployment. But it's also the case that the CJRS or the JRB do little to keep businesses from pulling vacancies, or to stimulate hiring. **The schemes reduce flows *into* unemployment, but don't stimulate the flows *out of* unemployment.**

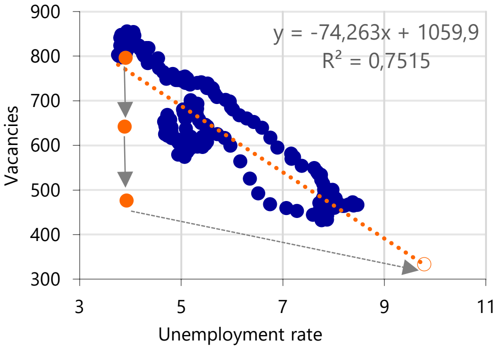
Job openings are also 'unaffected' by these schemes and therefore a better representation of the health in the labour market. It's concerning. The ONS estimates that in the three months to June 2020 there were an estimated 333,000 vacancies in the UK, or 1.1 vacancy per 100 employee jobs. This is by a large extent the lowest level or rate since the ONS started surveying vacancies in 2001 (see figure 3). This typically also precipitates a significant spike in unemployment.

Figure 3: The sharp drop in vacancies precipitates a significant spike in unemployment



Source: Macrobond

Figure 4: The Beveridge curve provides an indication of how many jobs are saved by CJRS



Source: Macrobond, RaboResearch

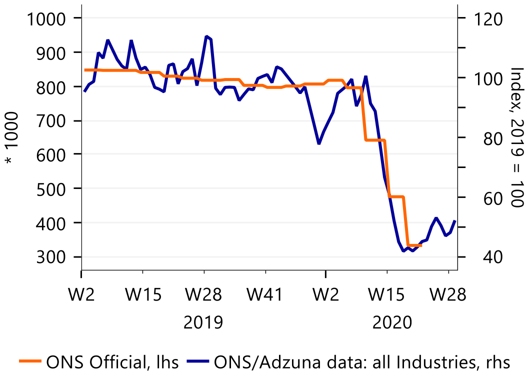
The Beveridge curve in figure 4 shows the inverse relationship between unemployment and vacancies. In the three months to March, the last labour market survey before the lockdown, there were 796,000 vacancies as unemployment stood at 3.9%. Since then the number of vacancies have dropped to 642,000, to 476,000, and then finally to 333,000 in the three months to June. Meanwhile, unemployment remained stable at 3.9%, as furloughed workers are not counted as unemployed. Figure 4 shows this in orange.

If we use the 'traditional' relationship of the Beveridge curve, we can infer that unemployment would already have been around 10% in June, or an extra two million people, if it weren't for the CJRS and the SEISS.

… but inflows have dried up

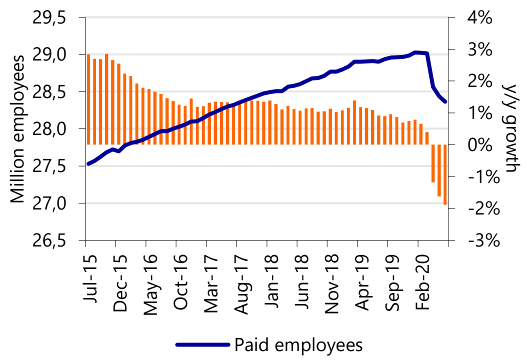
Things are moving fast these days, and the survey on vacancies had its cut-off point at 5 June. You would suspect that job openings would have picked up since then as the economy reopened, e.g. pubs, restaurants, hotels were given the green light on 4 July. We've seen such a rebound in the United States as well. A more timely signal is provided by the unofficial weekly vacancies data, which the ONS produces in partnership with *Adzuna*, an online job search engine. **These series indeed suggest that official openings have started to increase a bit as the economy reopened in June, but not to a very large extent: unemployment would still be in the 8-9% range.**

Figure 5: Has there been a slight pick-up in vacancies after the economy reopened?



Source: ONS/Adzuna, Macrobond

Figure 6: A steep drop in employment in April followed by milder declines in May and June



Source: ONS/HMRC, RaboResearch

Finally, experimental statistics from the *Pay as You Earn* database, jointly released by HMRC and ONS, indicate that the number of paid employees in June was down 649,000 (2.2%) from March. The largest falls were seen right at the start of the pandemic, predominantly due to a spike in flows out of employment. The total number of payroll employees also fell in May and June, but this was primarily due to below-average inflows into employment (i.e. employers replacing people who have left and creating new employments) rather than above-average outflows (i.e. people (in-)voluntarily leaving paid employment). **Again this shows how the CJRS works: it helped greatly to limit <u>un</u>employment, but it does little to stimulate employment.**

As the CJRS will be phased out, investors will face the following question: will the recovery in the second half of 2020 be overshadowed by a sharp increase in unemployment, or will it "all be over by Christmas" as Prime Minister Johnson plans? Hopes are indeed for the latter, but logic says the former.

The fiscal pendulum swings back and forth?

Households and businesses have been told for decades that investor confidence is a pillar of support for the economy, and that sound government finances underpin this confidence. This neoliberal 'household model' of government finances appears to be common sense, but is actually built on flawed foundations. And even though many governments have adopted very loose fiscal policies to soften the direct economic blow of Covid-19, it may eventually prove too hard to really shake that belief.

This creates a risk: if the government retreats too soon, the economic recovery will be flattened before it has even properly started.

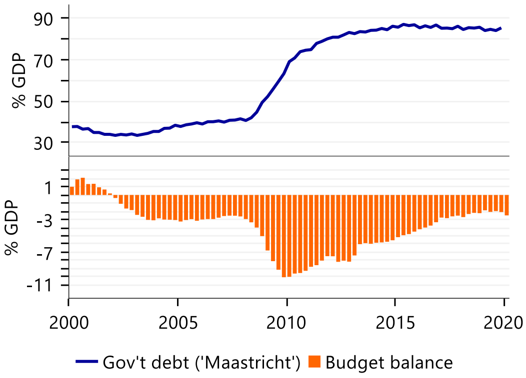
Sound government finances!

We've been here before. Following the financial crisis of 2007-08, a period of economic recession began in the UK. And as the budget deficit reached 10.1% in 2009 (figure 7), the coalition government of the Conservatives and the Liberal Democrats initiated an austerity programme.

The argument was that the government is effectively run like a private household and needs to get its books in order in more or less the same way. This resonated fairly well; intuitively, we all know that household budgets need to be balanced, because otherwise bad things happen. **And even though households can borrow temporarily to meet cash flow commitments and satisfy liquidity constraints, any loan must be paid back by eventually saving even more.**

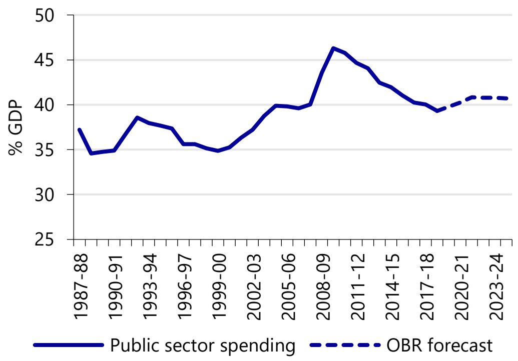
The household logic was simply extended to government finances: if revenues fall due to a downturn, fiscal adjustments should take the form of cuts in expenditures and temporary borrowing should be repaid as quickly as possible in order to regain a balanced book and 'sound' government finances. The expectations of lower future tax liabilities and interest costs would then boost confidence and spur growth by encouraging consumption, investment and exports. The underlying idea was that cutbacks would lead to growth, and the tragedies in Greece and other southern European economies –which euro-denominated borrowing was akin to foreign currency debt– were also used to hammer home the British government's message. The Chancellor of the Exchequer, Mr. Osborne, even said "*Greece is a reminder of what happens when governments lack the willingness to act decisively and quickly, and when problems are swept under the carpet. The result is sharp increases in interest rates, worsening recession, growing unemployment*".

Figure 7: Budget deficits remained stubbornly high between 2010 and 2015



Source: Macrobond

Figure 8: Even as the government slashed its expenditures



Source: Office for Budget Responsibility

The Keynesian view was a minority view at the time, but already concluded that "expansionary austerity" would be self-defeating. The spending cuts would instead cause a fall in aggregate demand and lead to lower economic growth, requiring even more cuts etc. etc. And although much of the focus was primarily on the short-term cyclical impact of the crisis, mainly the slow recovery, in the ensuing decade we eventually learned that the series of spending cuts harmed the long-term growth potential of many of the austerity-pursuing economies through sharp reductions in (public) investment and a gradual erosion of the capital stock. One would only have to look at the UK's productivity record to see how deep these economic scars are. Moreover, in this special, we discussed how the obstinate focus on sound government finances globally contributed to structural underspending and disinflation.

Indeed, at RaboResearch, we have long been of the view that the global financial crisis left deep scars on the global economy, most so in developed economies, with lower growth, lower wages, lower inflation, lower productivity, and increased populism in its wake.

... are they making a comeback?

The politics have started to respond as well, and we've seen some big swings in the fiscal pendulum. The Conservatives have seemingly re-oriented their focus from small-state austerity to an industrial strategy that should promote manufacturing, growth and innovation. The aim is to undo much of the damage that has been done, to improve the relationship between the state and society, and, to repay the trust of the new Tory voters in Labour's once-solid red wall. The shift in strategy was also evident before the pandemic struck: see also this 'Looking Glass' report.

So while the direction of travel looked clear, the debate on how the fiscal costs of this crisis should be dealt with is slowly taking shape. There are some suggestions that there eventually have to be a return to fiscal retrenchment and that austerity will make a comeback. The Daily Telegraph already reported in May that the HM Treasury again went as far as to warn that the country could face a "sovereign debt crisis" unless the economy recovers quickly. Barring some very good news regarding Covid-19 vaccines or treatments, we think that a quick recovery is very unlikely.

We could therefore be in for a clash between 10 and 11 Downing Street – even as Chancellor Sunak was exactly handed this job to enact some of PM Johnson's substantial spending promises.

Even though the UK government made a relatively successful foray into the world of *Modern Monetary Theory*, as the CJRS and other measures were effectively funded by the Bank of England's APF, it wouldn't at all be surprising if calls for fiscal prudence get louder before the important Autumn budget. **The mood may indeed change: in the first weeks and months the government had to respond to a fast-moving and inherently uncertain situation, with proponents and opponents rallying round the flag. Now it actually has to shape a longer-term policy and sell this to the broader public and to financial markets. This will be a challenge.**

Expansive austerity is an illusion…

The financial crisis and its aftermath have demonstrated that economies will get in trouble if the private and the public sector slam on the brakes simultaneously: expansive austerity is an illusion. The framework of the sectoral balances, which describe the factual relationship between government budget deficits, private saving and external deficits, tells us why.

Box 1: Sectoral balances – in short

The sectoral balances are a framework for macroeconomic analysis of economies and were developed by the late Wynne Godley, a British economist. The analysis is based on the principle that when the government sector has a budget deficit, the private domestic sector and the foreign sector together must have a surplus, and the other way around. This three-sector balance results from the well-known savings identity, and is defined as:

$$(S – I) = (G – T) + (X – M)$$

Or, in words, the net savings of the private domestic sector (savings –/– investment) are equal to the public sector borrowing requirements (spending –/– tax revenues) plus the current account balance (export –/– imports). If one of these sectors has a deficit, at least one of the others must have a surplus: this is an economic identity that should always hold true.

In a normal situation, you'd want the private sector to run a surplus, as households in particular want to save for the future and to build on their wealth. This however means that there has to be an offsetting combination of government deficits *and/or* current account surpluses: the private sector as a whole relies on spending by the government, or on its net sales of goods and services to foreigners. In the Netherlands or Germany, which are known to run policies that suppress private consumption, this is reflected in massive current account surpluses. In the case of the UK, which instead is really used to consuming more goods than it produces itself –a result of a housing-driven consumption boom and inadequate investment in skills, education and capital– **government deficits are effectively essential to sustain private sector wealth**.

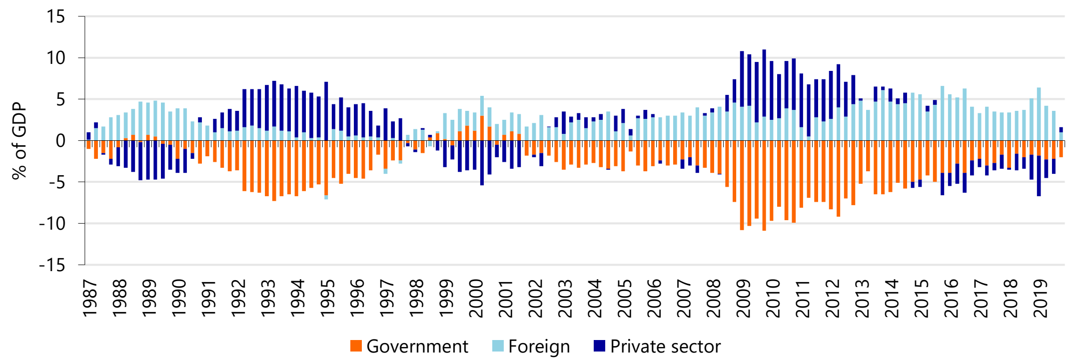
The sectoral balances therefore demonstrate a critical concept: **if the current account is sticky, government deficits are effectively the mirror image of private sector savings**. So when the private sector deleverages and tries to save money, which it is currently doing because of the pandemic's uncertainty, the government deficit will have to rise and stay at an elevated level to allow this to happen without crashing the economy.

In closed economies, government deficits help the private sector to save and accumulate net financial assets. In open and liberalized economies, it quickly becomes a little more convoluted, especially if there is a simultaneous current account deficit. A current account deficit needs to be financed externally, and only economies that find willing buyers for their capital are able to run a persistent twin deficit. In this note we argue that this is only available to a happy few, and the UK is not one of them. If investors don't want to play along, the alternative is a sudden stop –driven by a plunge in the exchange rate– that forces the adjustment in the current account.

The UK's sectoral balances

Let's again take a closer look at the UK's sectoral balances. The *Office for National Statistics* publishes [these accounts] on a quarterly basis; the latest available data point being 2019Q4. Figure 9 shows the three main sectors' net lending (+) or borrowing (-) position as a percentage of GDP. Striking is the sticky nature of the current account deficit; 2019Q4 was in fact the 85th consecutive quarter in which the UK had been a net borrower from the rest of the world. **This is what happens when consumption is structurally prioritised over investment.**

Figure 9: Sectoral balances for the United Kingdom



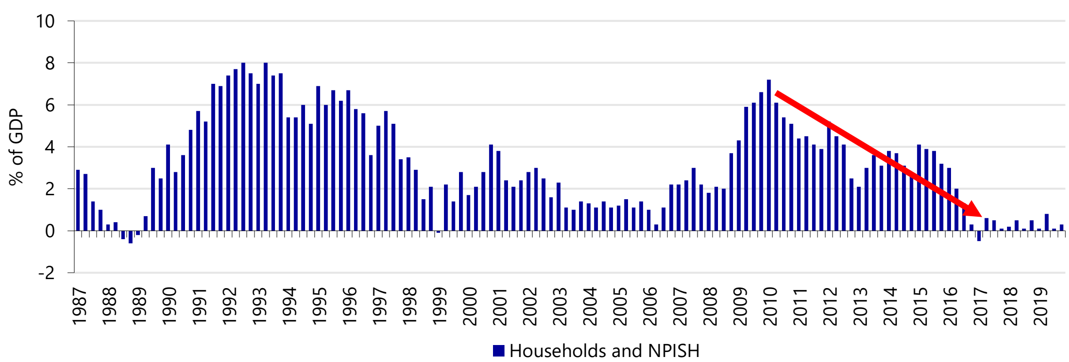
Source: ONS, RaboResearch

Given the stickiness of the current account deficit (light blue), there is a really strong link between deficits run by the government (orange) and the net savings of the total private sector (dark blue). So when the government embarked on its austerity path in 2010 to reduce its deficit, knowing all too well that the structure of its economy couldn't magically provide for a boom in exports of goods and services, it was quite clear that *a)* imports of goods and services had to collapse – which is unlikely barring a sudden stop, or *b)* the private sector surplus had to decline. Figure 9 shows quite clearly that *b* is what happened.

Figure 10 then shows that households bore the brunt of the declining private sector surplus: the growth in household wealth had been declining steadily until 2017 Q1, when households even had to decumulate assets (i.e. they spent more than they earned). There hasn't been any real recovery since. In fact, a sustained period of stagnating household wealth usually leads to weak growth and eventually a recession – which we viewed as inevitable as Brexit kicked in, but was eventually brought forward by a pandemic.

While it is true that households can easier sustain a deficit when interest rates are low, which they will be for the foreseeable future, it is a situation that is simply not durable if the government is not pursuing policies that aim to reflate the economy.

Figure 10: Weaker GBP -> austerity -> Brexit uncertainty -> weaker GBP = stagnating households

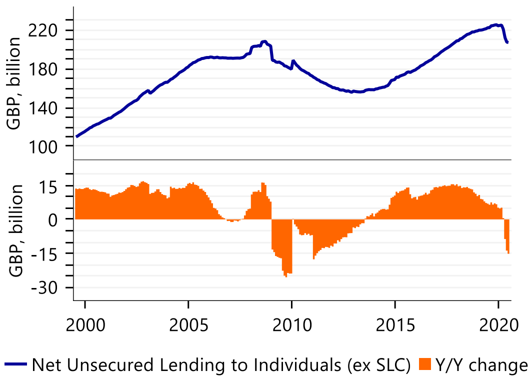


Source: ONS, RaboResearch

... but MMT also threads a thin line

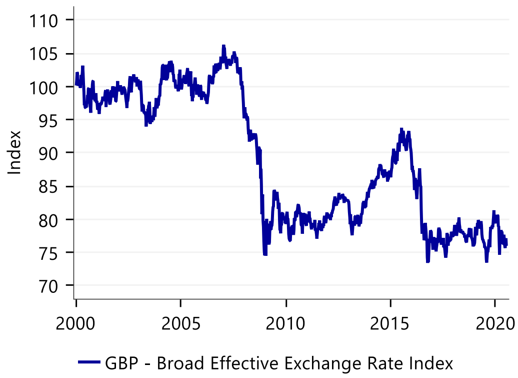
In order to do get to a durable economic recovery, as difficult as it seems with the Brexit shake-up and a potential second wave of the virus ahead of us, households need all the support they can get from an expansionary fiscal position. Note that consumers had been racking up increasingly higher levels of debt (credit cards, personal loans and car finance) in recent years in order to maintain their spending as real incomes were squeezed. Total borrowing even surpassed levels recorded before the 2008 financial crisis. Recent data show that households are now making good on these promises to pay (figure 11), net unsecured lending to individuals is down GBP 18bn since February, which shows that **the liquidity constraint is already doing its work: as uncertainty on future incomes rises, deleveraging starts to take place.**

Figure 11: Households are making good on their promises to pay



Source: Macrobond, Bank of England

Figure 12: The pound is vulnerable if markets become less sanguine than they are now



Source: Macrobond

If fiscal policy remains expansive over the next few years whilst rates stay near their historical lows, the UK is in for a period of financial repression. The aim would be to inflate away the real value of the debt. This requires that market-determined interest rates are effectively abolished, that the central bank remains engaged in yield curve control, and that it tolerates a period of above-target inflation. To some extent, this is already happening as the Bank of England has been purchasing billions of government bonds every week, which forces savers to buy government debt at yields below the expected rate of inflation.

At the same time, our analysis on MMT shows that this policy also has its clear limitations. The government has the power *domestically* to run expansionary fiscal policies if it chooses, but it doesn't have the power *internationally* to force foreigners to accept the newly-minted money. Given the reality of negative nominal government bond yields and the UK's persistent current account deficit, i.e. its structural reliance on foreign capital, that makes the pound quite vulnerable if markets become less sanguine than they are now.

This means that the UK's policy makers thread a thin line, there are no easy ways out. But if it wants MMT to work, the benefits of the expansionary fiscal policy *have* to accrue domestically in order to reflate the economy, meaning in turn that the structural current account deficit *has* to be addressed. This can be done by moving forward with a post-Brexit industrial policy, with massive investments in domestic infrastructure with all sorts of local input requirements, by raising household incomes, and by suppressing imports relative to GDP.

Finally, it's worth highlighting that such a policy doesn't fit well with the government's strategy of a 'Global Britain', nor with an EU-UK FTA in which the UK fully subscribes to the EU's level playing field and state aid rules. It also exposes the inherent conflict between free trade and policy/regulatory sovereignty: **it will be very difficult to strike a comprehensive trade deal if the UK wants to regain (EU) or retain (US) sovereignty *and* actively pursue policies to reflate its own economy and find a way out of this crisis.**

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