National Institute Economic Review (2022), 260: 1, 1–3
doi:10.1017/nie.2022.30

COMMENTARY

FIXING THE MIX

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We are entering the end game for this Parliament and so it is now time to focus on the policy horizon.[1] In the run-up to the next election, the government's pieces will be moved by our fifth Prime Minister since the announcement of the advisory referendum on EU membership in February 2016. The rapidity in turnover of political leadership tells us starkly that there are deep problems with our economic and social performance, relative to expectations and to that of our main trading partners. The overriding narrative is of a kingdom of nations that have taken a huge step backwards in international standing and in the fulfilment of domestic objectives. At this historic moment with the accession of Charles III, we are not this time faced with post-war reconstruction, industrial decline, the need to deregulate or the need to hitch our colours to the rise of the City. It is more a problem of how to bring the country and devolved nations together and aim for economic and social progress for all. That implies both broadening our regional focus and narrowing our gambit to what institutions and policies the UK needs as a small open economy in order to deal with a global economic situation we must take as given and no longer made in our image. No new IMF or World Bank would, for example, offer the UK a seat at the top table, which was certainly the natural order in the first half of the twentieth century.

This relative decline has accelerated since the financial crisis, following which the British economy has been becalmed. Income per head has hardly grown and those in lower income brackets have suffered from more insecure employment alongside limited improvements in well-being. The past year has exposed these problems as the economy is suffering, once again, from a shortage of options in the face of shocks. The injections of monetary and fiscal demand during the Covid lockdowns were still swilling round the system when supply chains started to fail and energy and food costs rose, first in line with a world economic recovery and then because of Russia's invasion of Ukraine. Rising food and energy costs have most affected the poorest households and are acting to drag down demand, as well as further exacerbate income inequalities. It is quite clear that fiscal policy should be used to smooth the income shock also across lower income brackets. While it is important that fiscal policy does not hide behind arbitrary fiscal rules, following the Mini-Budget of 23 September, it has become patently obvious that the institutions underpinning economic competence, HM Treasury, the Bank of England, the OBR and the DMO should not be undermined in a populist putsch. Their expertise will respond best when challenged by a clear vision accompanied by rigorous analysis of the UK's underlying problems. That is the gambit that political leadership must adopt.

In our constrained fiscal space, the narrative (at least since the OBR was established in 2010 if not longer) has said 'There Is No Alternative' but there certainly has been. And that constraint has pinned down much of the rest of macroeconomic policy in the wrong place on the board. Such an alternative

[1]This Commentary was revised on 27 October. It represents the author's personal views, not necessarily those of the National Institute of Economic and Social Research. The ideas have been formed as a result of the UK Productivity Commission and the UK2070 Commission. I am grateful for comments and discussions with Adrian Pabst, Stephen Millard, Andy Westwood, Vincent Goodstadt, Tim Besley and Bob Kerslake.

will involve a commitment over the long run to public investment, which has languished at around half the level required for some 40 years now. Public investment in physical and digital infrastructure, as well as in human capital and the NHS would not only boost current demand but also ensure that the correct initial conditions were in place for the private supply of goods and services to thrive. The private sector would be further likely to respond elastically if we moved back to freer international movement in labour and provided a more stable environment for foreign and domestic investment. Political volatility is no friend of investment. But well-targeted public investment is ultimately a friend of the supply side.

In order to improve economic performance, we need to move away from the observation there is little room for fiscal manoeuvre when the weather turns unpleasant because the choices we have then made are largely responsible for the UK's economic doldrums. Since 2008, these fiscal policy choices have asked too much of the Bank of England. The Bank has been asked to fix the mix by having to stoke up sufficient levels of demand to meet the inflation target. Fiscal policy has been set on too constricted a course, in a world of tighter financial regulations and considerable scarring in the real economy, with insufficient attention paid to supporting the supply side. The result is that excess demand in the shadow of Covid has produced the largest spike in inflation for 30 years. While bringing inflation back to levels consistent with price stability is the immediate macroeconomic priority, it would be a significantly easier task if HM Treasury provided an appropriate cushion for the poorest households, who have also suffered most during Covid. Equity alone demands that we pay attention. But efficiency makes the siren call.

Let me develop the supply side. The well-documented poor performance in UK productivity is just another way of saying that we are not generating sufficient prosperity across the country and that real wages have tended to stagnate. Our track record makes the current adjustment in real wages, which must fall because the costs of our raw materials, foods and energy have gone up relative to the value of our domestic production, even harder to bear as the impact falls disproportionately on households with lower incomes. Actually, we estimate that the impact on those households could easily be reduced with no deterioration in the medium-term sustainability of our fiscal position, particularly if we moved from a price cap on the average household to a sliding price cap that raised marginal costs for households that used more energy, which tend to be the better-off households. Politics and economics ought to be closely aligned. And because they have not been, our recent experiences provide a good example of why a fiscal rule can also lead to amplifying rather than dampening the economic cycle. The right response to a temporary negative income shock is to smooth it with more debt borrowed from our better-off futures and a slower movement to higher tax if there is a structural deficit. Indeed, the current inflation shock had, on balance prior to the interventions this autumn, improved our overall fiscal position as nominal tax revenues have increased relative to fixed cash expenditures.

But it is critical, though, that inflation does not persist and is not expected to persist, as that would raise public borrowing costs and pose much more of a problem for fiscal sustainability. And here we turn to the question of the Bank of England. Rightly we should celebrate the 25$^{\text{th}}$ anniversary of the central bank's independence, as the Monetary Policy Committee had hit its objective over its lifetime, with inflation at around 2 per cent. But it is now set to face its most difficult task, even with the insulation of reputation: to drain excess demand from the economy, including the liquidity generated by huge asset purchases under Quantitative Easing, without check-mating an economy that is facing the ragged edge of Brexit, a compression in trade and a lack of direction. It can only achieve this if the Bank continues to be charged with the sole mandate of reaching the safety of price stability. It does not need a broader remit or to be given further objectives, though more dialogue and discussion on complex trade-offs would help us understand better the choices that are faced at every meeting.

Indeed, fiscal policy could learn very well from the Bank of England framework by adopting a measure of the well-being of the British people as its own objective and remembering that deficits are an instrument and not a target of policy. An appropriate target for fiscal policy would be to work towards a significant increase in well-being for all working families across the nation. This would imply assessing policies at fiscal events through the lens of what that will imply for all families across the income brackets over the medium term and prioritising policies that support medium-term growth. For that to happen, HM Treasury along with the OBR will have to re-think how it assesses the returns to large-scale public investment, the employment it creates and the impact on general government net worth. At the same time, politicians will have to develop better ideas on how to use public money and be prepared to commit to long-run plans, which may ultimately mean handing over public investment schemes to some amalgam of the National Infrastructure Commission, the UK Investment Bank and an Industrial Strategy Council with an assessment of its implications for the supply side by the OBR. Let the politicians define the objectives and then be sufficiently confident to allow the experts to play the game.

Cite this article: Chadha, J. S. (2022), 'Fixing the mix', *National Institute Economic Review*, **260**, pp. 1–3. https://doi.org/10.1017/nie.2022.30