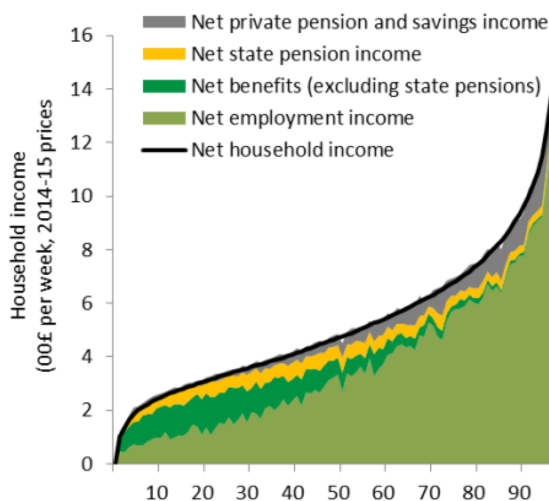
2016 Annual Conference
The UK and global economic outlook: More risk, less opportunity?

If influence over policy and the respect of the public are the key performance indicators, 2016 hasn't been a vintage year for the economics profession. In the United States and United Kingdom, the public chose in defiance of most economists – the same economists who have shaped their countries' policies and institutions over decades. Across much of the globe, the perception of stalling living standards has become a commonplace, undermining confidence in the central banks and finance ministries responsible for economic governance.

This context was evident during the Society's 2016 Annual Conference. From the opening remarks delivered by the conference chair, Sky News' Ed Conway, every speaker placed even more emphasis than usual on the tentative and uncertain nature of forecast statements, while the final session focused on the topic of scenario analysis as a specific antidote to overconfident central case forecasts. Some presenters also took the opportunity to address critics of the profession and its institutions more directly. Bank of England Deputy Governor Ben Broadbent devoted the opening of his speech to a defence of UK monetary policy against accusations that its post-crisis activities have contributed to widening inequality.

He first presented evidence on income inequality. The Prime Minister, in her speech to the Conservative Party Conference, suggested that monetary policy had not worked for savers: the implication was that lower term interest rates had harmed their income through the investment channel. Broadbent's responded with a breakdown of total household incomes which highlighted the dominance of labour earnings over all other income sources.

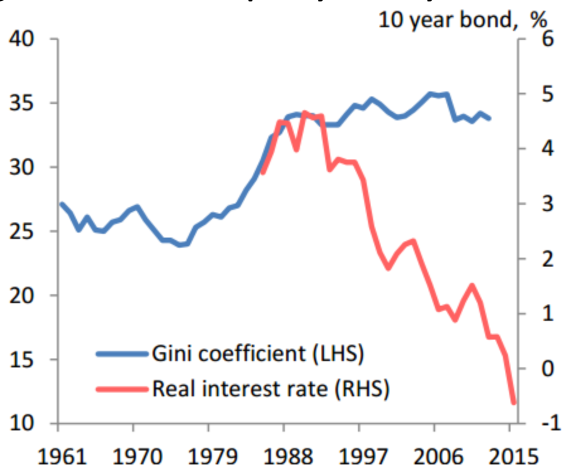
Figure 1: most income variation from wages



Source: IFS calculations using the Family Resources Survey, 2014–15 (Belfield et. al. 2016). All income sources are measured net of any taxes paid on them

Moreover, measures such as the Gini coefficient or the ratio of the top 10% of households to the bottom 10% have seen total income inequality flat or in decline since the end of the 1980s. The same can be said of the ratio of capital income to employment to income – so while capital income is clearly skewed to the wealthier, it does not appear to have outpaced wages. Perhaps the only measure which worsened during the 1990s was the share of income accruing to the top 1%; but this has been flat since the turn of the millennium.

Figure 2: Income inequality broadly flat since real rates began to decline in 1990s



Source: World Bank and Bank of England

There's a clearer theoretical case that monetary policy affects how *wealth* is shared through the economy. Broadbent acknowledged the argument that lowering the discount rate on assets will have uneven effects if those assets are already unequally distributed, but saw little evidence in household surveys or domestic asset prices that the last decade has seen a significant worsening. His case here is more contentious; location-based disparities in house price appreciation are both known and large enough to create meaningful divergence between, say, the wealth of London homeowners and tenants in the regions. He suggested that bequests may ease existing wealth inequality between generations – though the implications for social mobility may indicate this as part of the problem, not the solution. That said, one can appreciate that even justified grievances today have their roots in decades of social and economic change, rather than the current era of monetary policy.

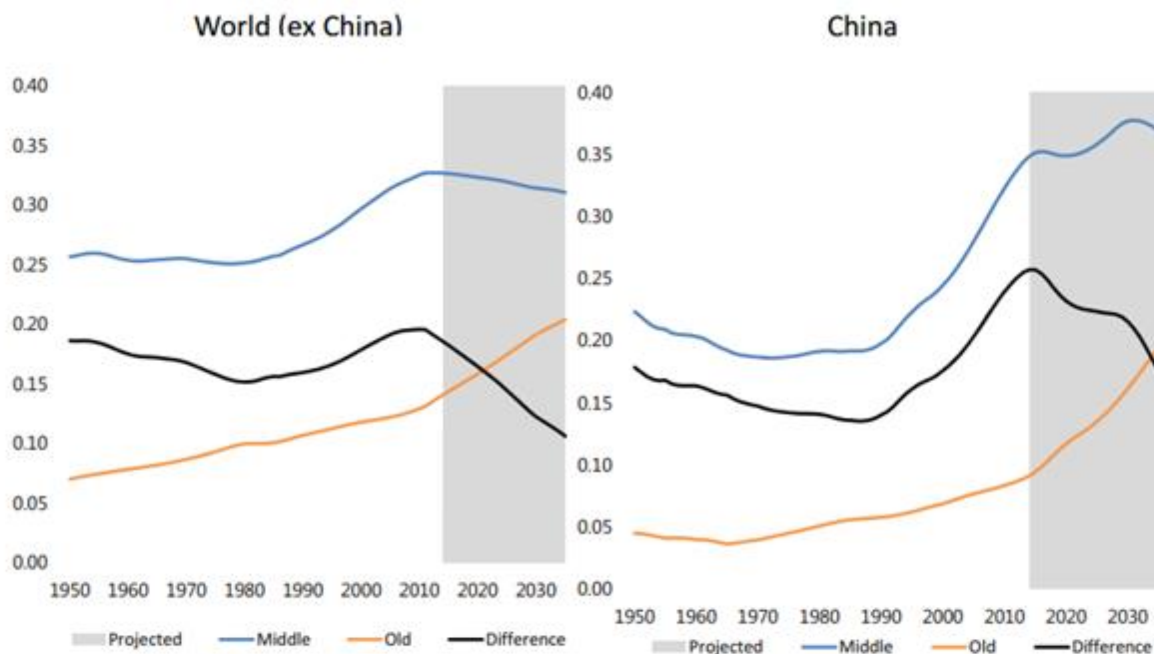
Broadbent also discussed how to analyse and respond to the recent declines in Sterling. The decline seen in 2016 has been on a par with those seen in 1976 and 2008. He noted that currency shocks don't fit the profile of volatility which the MPC can simply 'look through', given the evidence that pass-through effects into inflation are relatively slow-moving. The question, then, is whether to treat the source of the move as a demand shock, in which case easing is the order of the day, or a supply shock, in which case the required policy stance may be quite different. Broadbent's position, reasonably enough, is that it's too soon to tell. It stands to reason that among developed economies, the UK enters 2017 with greater uncertainty regarding the direction of monetary policy than any other economy.

In any case, the role of central banks in setting the overall path of real interest rates has been overstated; so argued the next speaker, Sir Charles Bean. In discussing causes and

consequences of the long-term decline in real interest rates, Bean expressed skepticism towards the idea that monetary policy can have such potent, sustained and global effects on the real economy.

Instead, he drew on the analysis of his former boss, Lord King, to identify three more structural causes: unusual increases in the quantity of income saved globally (dubbed the "savings glut" by former FOMC Chairman Ben Bernanke); a decline in willingness to invest in productive projects from public and private sectors; or a sharp shift in the supply-demand balance for safe-haven assets such as government bonds. The "savings glut" is most persuasively seen as a result of demographic pressures, as longer prospective retirements necessitate more saving in middle age – indeed the ratio of the middle-age cohort to retirees has been correlated with savings rates across countries. Importantly, this ratio is now peaking globally, indicating a possible reversal in savings pressures.

Figure 3: Past and projected population shares by age cohort



A high-profile argument for a dearth of productive projects has arisen from Robert Gordon's *The Rise and Fall of American Growth*. Bean gave a cautious reception to Gordon's case that technological advances are simply less transformative than they used to be; he responded that estimating the long-term impact of today's innovations is a speculative exercise and highlighted a few entertaining historical examples of failed futurology. It may be, though, that these innovations have structurally reduced the capital intensity of today's productive activities, or that demographic changes are altering the types of goods and services we demand away from investment-heavy sectors.

The government bond supply-demand argument has to take account of the substantial increase in supply of such assets as deficits increased during the financial crisis. Possible sources of increased demand include: FX reserve accumulation by Emerging Market

economies; regulation of banks, pensions and insurers; disaster-hedging by investors; or QE. It seems that the biggest drops in yields occurred before QE was even on the agenda, but the other candidates are ones which have been in play for many years.

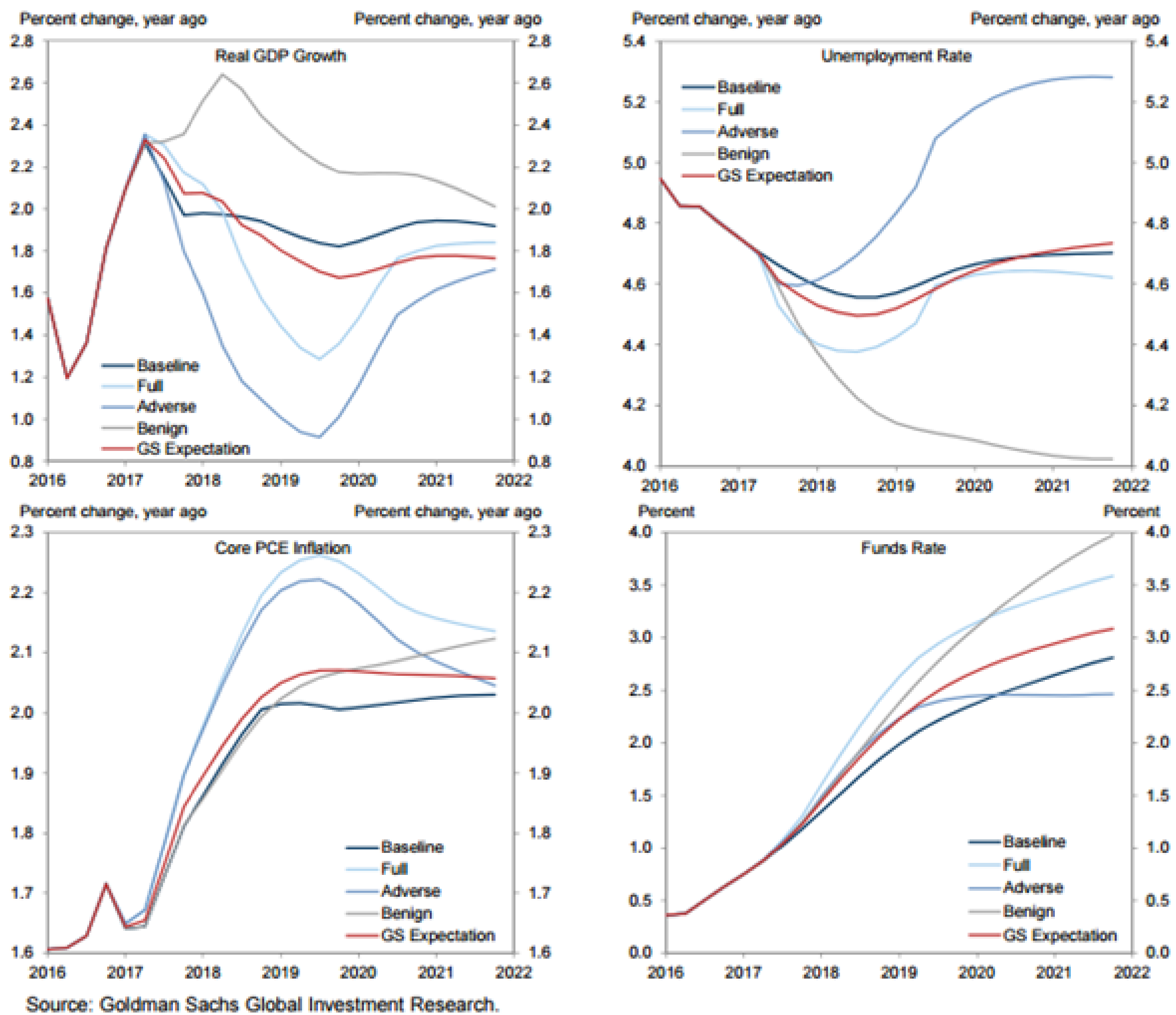
Looking forward, Bean felt that the structural downward pressure exerted by demographics and crisis response was likely to diminish. The high degree of persistence in rates, though, made it likely that the problems of the zero-lower-bound would continue to challenge monetary policymaking.

Central banks' responses to this obstacle themselves have limits; time inconsistency restricts forward guidance to being "more Delphic than Odyssean", while QE has itself generated practical issues such as distributional and financial stability worries. Bean's conclusion is that the time has come to look beyond monetary policy to conventional government activity, specifically to discourage excessive saving and support public and private investment. The subsequent discussion noted that whether through "Trumponomics" or more subtle easing of global austerity, this may be an idea whose time has come.

Dr Jan Hatzius, chief economist of investment bank Goldman Sachs, continued with the themes of a potential economic turning point, and the scope for government policy to make an impact – specifically through the election of Donald Trump as President of the United States. Hatzius began by arguing that the global economy had already entered a reflationary phase before polling day. With activity indicators across several regions pointing to improving activity through the third quarter, the US in particular seemed poised for a pickup in inflation. Unemployment was already forecast to reach the NAIRU during 2017, while healthcare costs increased consistently through 2016.

Assessing how the Trump era should alter this forecast is challenged mainly by the difficulty in identifying which policies the new Administration truly wants, and practically is able, to enact. Faced with such uncertainty a range of forecasts seems the only sensible approach. In Hatzius' analysis the range is generated by applying a sliding scale of ambition to quantifiable pledges made on the campaign trail, in the areas of fiscal expansion, monetary policy adjustment, tariffs and net migration.

Figure 4: GS scenarios for the impact of new US policies under Trump



Hatzius concluded that the range of possible outcomes for growth ranges widely, depending on whether Trump's successes tilt more towards demand-expansionary (fiscal loosening) or contractionary (trade and net migration) policy. One can be more confident that the net impact on inflation and unemployment should be to increase and decrease respectively. The impact of Federal Reserve policy is subject not only to these unknowns, but also to the plausible lags between fiscal expansion and monetary impact, and even the influence the White House can exert over appointments at the central bank. Overall, one is struck by just how little can confidently be predicted about the new policy landscape at this point; perhaps one of the lessons of recent years is that being clear about what we do not know is an important public service for economists to offer.

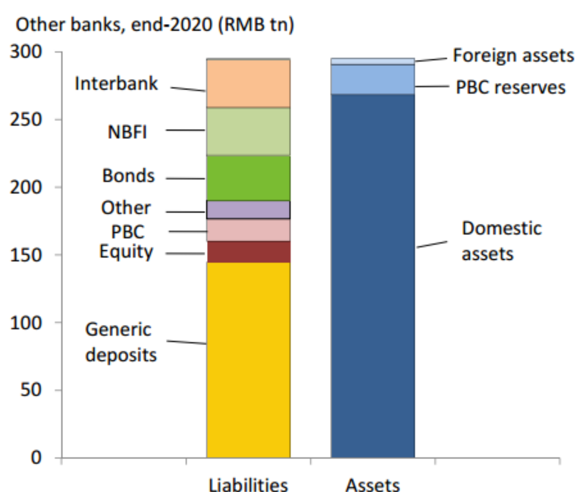
Dr Jonathan Anderson, founder of the specialist consultancy Emerging Advisors Group, carefully sidestepped any temptation to forecast China's economic downfall. He acknowledged that China's economic activity is relatively weak across a range of trade, retail, housing and credit metrics. However, there remain important limits on our ability to forecast aggregates in China over more immediate timeframes. Structural changes in trade and the goods/services balance have diminished the usefulness of many indicators. Common activity indicators which have served observers well in the past are now too skewed towards construction and heavy industry, while credit-based analysis sometimes

overlooks the likelihood that the marginal productivity of productivity of credit has collapsed, complicating analysis of the impact of a credit bust.

Looking to the longer-term, Anderson was able to highlight a significant fault line in China's development which should be a focal point for those expecting a crisis. While many look at China's aggregate debt expansion and see domestic credit assets reaching 250% of GDP as a threat, Anderson warned that the liability side of banks' balance sheets tends to be where the trouble starts. As credit penetration continues to deepen through the economy, lending market share is being won by every sector apart from the 4 biggest banks. These other players, particularly smaller banks, are therefore expanding their liabilities at a tremendous rate in order to fund these activities.

On current trends, by 2020 more than half of small/medium sized banks' funding will come through wholesale markets – a familiar picture to observers of failing retail banks in the UK, Europe and the US during 2007-8. Anderson was at pains to point out that this vulnerability can persist for many years – but again this seems like the kind of humility which economists need to accept as the price of public credibility. The lack of a calendar entry does not mean we have not been warned.

Figure 5: estimated asset/liability profile for small/medium banks by 2020



Source: Emerging Advisors Group

In the last session, Dame DeAnne Julius of University College London explained how the tool of scenario analysis could be used in an archetypal business economics setting – planning for corporate decision-making. The most important business decisions often arise in anticipation of discontinuities – structural changes or binary events, when traditional macro models struggle. Drawing on her experience at Shell and BA, Julius explained that scenarios are most helpful in planning for unlikely but serious developments. A successful process will challenge groupthink, develop and clarify leading indicators of change, and create a common language for thinking about the future.

The process seeks the design of 2-4 "plausible, challenging and internally consistent" stories about what might happen over a set period. Developing these scenarios requires a research phase which draws on input from exceptional external contributors, as well as honest

dialogue between the internal team at all levels of seniority. This should draw out the driving forces and identify which ones are pre-determined or inescapable. The last stages are to define the junctures which divide one scenario from another, and finally build the narratives which make the paths plausible and capture the imagination. Julius used as case studies the constructs which BA used to define the evolving global passenger market in the mid-1990s, and with which Shell described the geo-political environment in 1992.

In the face of significant challenges to its public standing, the profession of economics will soldier on. This year's speakers exhibited the qualities which will be needed if economists are to earn continued influence over public and private decision-making: wariness of over-precise forecasting, a commitment to sharing arguments and evidence, and a blend of openness to hear criticism with a willingness to respond robustly when the case supports it.

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