Centre for European Reform

Talk of 'exit' is premature

by Simon Tilford, 22 September 2009

The governor of the Bank of England (BoE), Mervyn King, has had a mixed financial crisis. He assumed that financial stability flowed from monetary stability – which we now know is not the case – and was very slow to recognize the extent of the crisis. He has also taken the UK into unchartered waters with the embrace of so-called quantitative easing (QE). QE involves the electronic creation of new money by the central bank in the form of purchases of government and private sector bonds. QE aims to drive down long-term interest rates and encourage bank lending. The BoE has now spent around £150bn, in the process buying not far short of a quarter of the UK's entire outstanding stock of government debt. It is far from clear whether QE will work. It is possible that the banks will simply sit on the cash rather than lending it, as they did in the early 1990s when the Bank of Japan employed a similar strategy. But King is right to argue that dramatic action is warranted by the economic outlook, which is much worse (and not just in the UK) than the general consensus.

The BoE governor has repeatedly warned that commentators and economists are not paying sufficient attention to the difference between 'growth and levels', and that the threat of inflation is extremely remote. He is clearly right. A couple of quarters of modest economic growth following peak-to-trough contractions of around 5 per cent is neither here nor there. It certainly does not represent a return to business as usual. Of course, it is positive that the recession is over. But that the economy has been stabilized at all has been the result of massive monetary and fiscal stimulus. The underlying dynamic remains very weak. On most growth projections it will take the EU economy several years to return to pre-crisis levels of GDP.

No sooner has the recession ended than we are being overwhelmed with talk of a rapid bounceback in economic growth and hence for the need to craft 'exit strategies' to prevent an upsurge of inflation. This ignores what has happened. The gap between what we can produce and what we do produce is now enormous. With consumption and investment set to remain very weak, it will take many years to close this gap. To talk of exit strategies in such a situation is dangerous and potentially deflationary. It is going to feel like a recession for many years. Demand for labour will take a long time to recover, not only because it will take time to recoup the lost output but because labour productivity will also rise over this period. Fewer workers will be needed to produce a given amount of output. The result threatens to be mass unemployment. The outlook for investment is also very poor. The combination of excess capacity and undercapitalised banks will conspire to keep investment weak for quite some time.

Of course there are mighty long-term fiscal challenges facing most EU economies. If bond investors start to believe that governments have lost control of their public finances, long-term interest rates will rise, hitting growth. But a premature exit would do more harm than good, as it would almost certainly derail the recovery, in the process weakening fiscal positions. If no-one else is willing to spend, then the state has to. Any country exiting before a self-sustaining recovery has taken hold will essentially be guilty of free-riding on the demand being generated by deficit spending elsewhere. Germany has already indicated that it intends to tighten fiscal policy steadily following the election and is now constitutionally obliged to reduce its fiscal deficit to 0.35% of GDP by 2016. Such a move will only work if others keep spending and Germany can rely on rebuilding its trade surplus for economic growth. This is a zero-sum game. If everyone behaves in this way, the impact on Europe's economy will be dire.

Similarly, a premature move to raise interest rates in an effort to head off a largely imaginary inflation bogeyman would risk scuppering the recovery by increasing the cost of capital and boosting the already excessive strength of the euro. The European economy needs very low interest rates for an extended period of time to keep capital cheap and to stimulate activity to close the output gap. The risk of snuffing out the recovery now (in the process exacerbating the weakness of public finances) is far greater than a spike in inflation later on. Stagnation and debt deflation pose greater risks to the European economy than inflation.

Simon Tilford is chief economist at the Centre for European Reform.