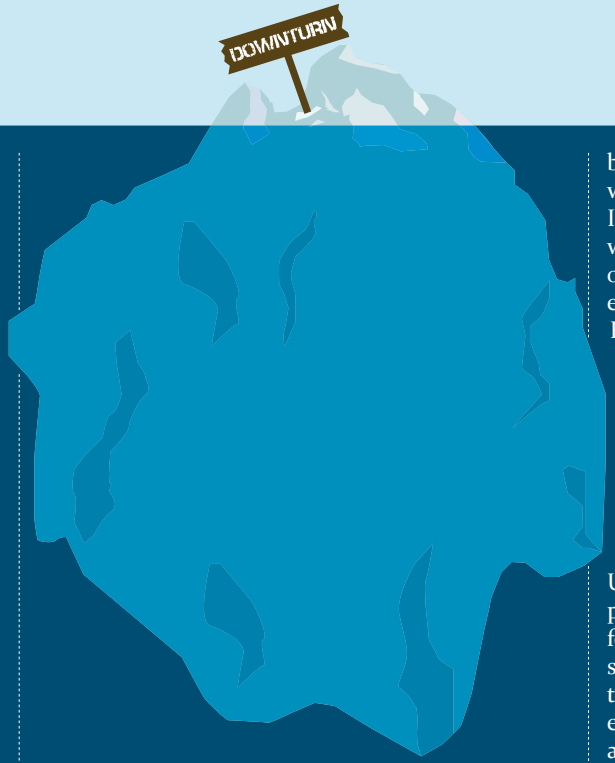
Is the UK short on lifeboats?

In the event of a downturn, policymakers may find they lack the means to stage a rescue, argues Kallum Pickering



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If the UK economy was heading for a downturn, is there the policy firepower to prevent it? If one thing keeps the chancellor of the exchequer and the Governor of the Bank of England awake at night, this is surely it.

There is little doubt that Chinese affairs are the foremost concern for the global economy currently – how quickly is the world's second-largest economy slowing and what can its authorities do about it? Well, almost whatever they want. China has a central bank rate of 4.6%, over $3.5 trillion in foreign reserves, a $40bn per month trade surplus and a high savings rate, to name but a few of its possible policy options. However, run the same exercise in the UK and far less comfort can be taken.

Both the UK Treasury and the Bank of England expended vast amounts of resources arresting the fallout from the 2008 financial crisis. This was a sensible thing to do; conditions would have been far worse had the UK endured the fiscal cuts Mr Osborne first pledged, or if the Bank of England, paralysed by fear of the unknown, had hesitated with quantitative easing (QE). The trouble is, in the sixth year of an expansion that has averaged 2% per annum, far from being prepared for the next market downturn, the fiscal deficit is 4.5%, government debt to GDP is 90% and rising, and the base rate is at 0.5%. The lack of policy headroom is a serious vulnerability for the UK.

Say what you want about substandard growth rates and risks abroad, the fact of the matter is that the UK economy is at a fairly mature stage in its expansion and yet it is not in a strong position to respond to the downturn that will become increasingly likely as time goes on.

Regarding monetary policy, there is far more headroom despite the policy rate currently being at a historical low of 0.5%. The base rate is not the only policy tool available. There are a number of things the Bank of England could do if necessary.

Firstly, because expectations play such a large role for monetary policy and the Bank of England is expected to raise rates in early 2016, the Bank of England could use language to push back expectations for the first hike; this would have the effect of policy easing. Indeed, this has been done twice in 2015, with good effect. Furthermore, the Bank of England could employ unorthodox easing measures to boost credit. Funding for Lending, which is in place to raise lending to the real economy, could be expanded or other similar programmes initiated. Finally, QE, an asset purchase programme that targets money supply growth rather than interest rates, could be expanded from its current stock of £375bn.

Despite the numerous risks, the UK economy does look set for a decent period of around 2.6% growth annually for the next couple of years at least. This should be sufficient to allow Treasury to get the deficit to a safe level so as to expand policy if necessary, albeit not aggressively, since the overall debt will probably still be large. Similarly, with the Bank of England on track to begin raising rates in February, interest rates are likely to be 2% in late 2017, so there should be room enough to cut if needed. Major unforeseen shocks aside, the UK should be OK. But this strategy is an unnecessary gamble and could largely have been avoided, if not materially minimised, with better policy coordination and fiscal discipline. Usually, when governments play a game of risk with history, they sometimes win, but occasionally, a book is written about it.

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