BOOST IT LIKE BIDEN

WHY THE UK NEEDS AN ECONOMIC STIMULUS ABOUT FOUR TIMES THE SIZE OF THAT CURRENTLY PLANNED, MATCHING THE AMBITION OF THE UNITED STATES, TO RE-START THE UK ECONOMY

Carsten Jung, **George Dibb** and **Parth Patel**

EMBARGOED UNTIL PUBLICATION AT 0001, WED FEB 17

February 2021

Find out more: https://www.ippr.org/research/publications/boost-it-like-biden

US president Joe Biden is in the news for his proposed $1.9 trillion stimulus package aimed at revitalising the United States' economy. He is right to extend economic rescue measures which will help the US economy recover after the pandemic and support struggling families. Closer to home**, the planned UK stimulus is less than a quarter of that envisioned by the US, adjusted by the size of the economy.** But we estimate that an ambition similar to that of the US would be needed to get the economy back on track, otherwise the UK economy risks falling into a 'stagnation trap'.

THE UK STIMULUS SHOULD BE SIMILAR IN SIZE TO THAT OF THE US

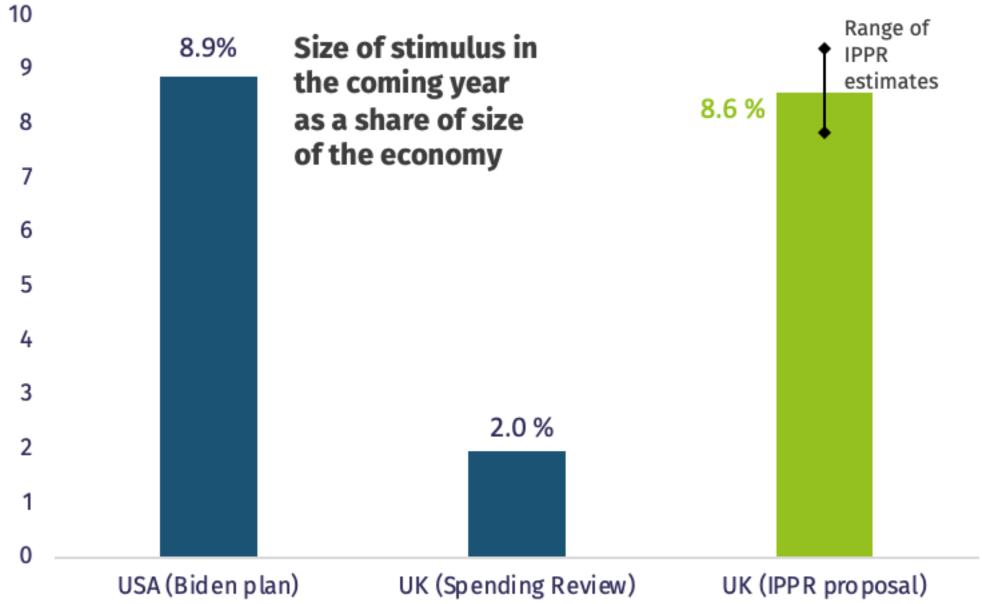
Countries that have sustained significant reductions in economic activity as a consequence of the coronavirus pandemic are faced with a similar challenge: will the economy bounce back on its own through pent-up demand, or will it require a stimulus? Our analysis suggests a similar answer to that reached by the US president; that too small a stimulus risks a sluggish recovery and could bring permanent economic scarring as a consequence.

Building on our previous work on stimulus, we argue Rishi Sunak should pass a bold recovery plan worth £190 billion or 8.6 per cent of GDP. So far, he has committed about 2 per cent of GDP (figure 1). Our proposed measures would be targeted at supporting those firms and households hardest hit by the pandemic, invest in public services and help the growth of 'future-proof' industries and jobs. At this March's budget, the chancellor should look to his transatlantic counterparts and pass support measures commensurate to the size of the economic peril the UK is in.

FIGURE 1

UK stimulus spending plans are less than a quarter of those advocated by the Biden administration (adjusted for size of the two economies)

Per cent of GDP



Source: IPPR analysis of [White House (2021)], [Roberts & Jung (2020)], [OBR (2020)], IMF WEO database.

Note I: for ease of comparison, GDP denominator chosen is 2019. The timeframe over which the stimulus is expected to apply is the UK fiscal year 2021/22. UK stimulus is calculated as additional spending above the March 2020 OBR forecast. US stimulus is taken as the size of the Biden proposal with the assumption (based on White House announcements) that it will be spent over the same time period as in the UK. Most of Trump's December stimulus will expire by Q2 2021 which is why we did not add it to the Biden stimulus.
Note II: the range of IPPR estimates reflect a range of plausible assumptions around the output shortfall in 2021/22, varied by +/- 1 percentage (see annex and Roberts & Jung, 2020). The UK's GDP shortfall is somewhat larger than that of the US as it was significantly harder hit economically – this is why the same amount of fiscal stimulus is less likely to cause inflationary pressures.

How do the US and UK plans stack up against those of other G7 countries? Other countries' stimulus announcements have lacked detail, so comparisons have to be taken with a pinch of salt. That said, **Japan in December 2020 announced a stimulus worth about 13 per cent of GDP**, with a view to delivering much of it over 2021/22. Depending its timing, this would be almost twice the size of the Biden plan and more than six times the UK's. Other G7 economies show somewhat lower ambition. Depending on the yet-to-be-announced stimulus timeline, **Canada could spend between 3 and 4 per cent of GDP** in 2021/22 – almost twice as much as the UK's current plans. Germany's discretionary measures are likely around 3 per cent of GDP in 2021. The EU-wide recovery package will add to this. In 2021 it is expected to add about 0.7 per cent of GDP of further stimulus. This would leave Germany's stimulus about twice the size of the UK's current plan.

We argue the UK should follow the lead of the US (and Japan) and pursue a bold fiscal stimulus. Conversely, countries pursuing a small fiscal boost in the face of a large economic slump risk a sluggish recovery and falling into the 'stagnation trap'. In the remainder of this briefing we underscore this argument, (i) explaining why we think a Biden-type ambition would address looming risks to the UK economy and (ii) discussing common concerns raised against a sizeable stimulus.

OUR PROPOSED STIMULUS WOULD ADDRESS SERIOUS RISKS TO THE UK ECONOMY

In IPPR's central forecast of the UK's Covid-19 epidemic (see box), the economy will likely be largely reopened by June, though probably with continued international travel restrictions. Such reopening might lead some to ask if the economy might bounce back quickly, without much further support. However, **a swift and 'automatic' bounce back to normality is very unlikely, as the economic scars from the pandemic run deep (table 1)**.

TABLE 1

A sizeable stimulus could help avert the 'stagnation trap'

	No further stimulus	IPPR proposed stimulus
Stimulus in 2021/22 (as share of 2019 GDP)	2.0%	8.6%
GDP gap over 2021/22	9.7%	5.2%
Scarring of the economy (as share of GDP)	3.5%	1.5%
Unemployment at Q2 2022	10.2%	6.1%
Business investment back to pre-pandemic level	2023	2021
Debt to GDP ratio at Q2 2022	119%	118%

Source: Chancellor's Challenge updated with latest IPPR scenario (see annex).
Note: the no further stimulus scenario assumes that most support measures (e.g. the job retention scheme) are ended in March and April 2021 as is currently planned.

The downside risks of providing too little fiscal support are stark. In particular:

- First, in a 'no stimulus scenario', the UK risks being stuck in a '90 per cent economy', where GDP remains on average 10 per cent below its potential over the next fiscal year. This will be the case even with a significant rebound in spending by some consumers. While high earners have increased their savings over the pandemic which they can now draw on, low earners have reduced their savings. At the same time, average household income is set to fall in 2021 and poverty will increase with the reversal of pandemic welfare measures. Without further support, many households will thus not increase their spending.

- Second, even the most optimistic forecasters anticipate significant long-term 'scarring' effects of the pandemic – leaving the potential of the economy between 1.5 and 6 per cent lower than before. Such scarring is likely to be greater, the longer the recovery takes to materialise. Years of slow growth could lead to a vicious cycle of business bankruptcies, layoffs, and depressed demand. **We call this the 'stagnation trap'. But this huge drag on economic prosperity is not inevitable.** Our proposed package includes a proposal to invest up to 2 percentage points of GDP more in green and future-proof sectors. This can reallocate capital and labour into sectors that have the potential to grow, and thus reduce scarring.
- Third, currently more than 4 million people are on furlough, with support ending at the end of April. Far from bouncing back, without a stimulus, we estimate that three quarters of them would still need jobs support in Q2**. Conversely, our stimulus would reduce the need for job support by up to 50 per cent over the next year**. We argue that further jobs could be retained if government provides a part-time subsidy for businesses to hold on to workers while the economy recovers.
- Fourth, even one of the most optimistic 'bounce back' forecasters (the Bank of England) sees **unemployment** peak at 7.5 per cent - an increase of almost 1 million compared to today. The OBR's central scenario sees unemployment only falling below 5 per cent in 2024. As Biden argues for the US case, **it does not have to be this way. We estimate a stimulus could bring unemployment back to 5 per cent by Q2 2022.**
- Fifth, 600,000 businesses in the UK, employing 9 million people, are at risk of collapse without further support. Moreover, business investment is currently more than 20 per cent below pre-pandemic levels and might not reach those levels again until mid-2023, dragged down by continued uncertainty. **A stimulus must include business support measures supporting the retention of jobs and facilitating business investment.**
- Sixth, demands on public services will remain high throughout 2021/22, to support vaccine rollout, recover normal health and care services, and support for local government with the continued fallout of the pandemic. **A stimulus should include a clear commitment to spend whatever it takes to support the health emergency across all levels of government.**

To summarise, even the most optimistic 'no stimulus' scenarios involve significant economic disruption in the short term and see long-term growth and prosperity diminished (table 1). **With the US in a very similar situation, Joe Biden's central judgement is that shoring up the economy now reduces the risk of permanent damage while coming with very much manageable risks in turn.**

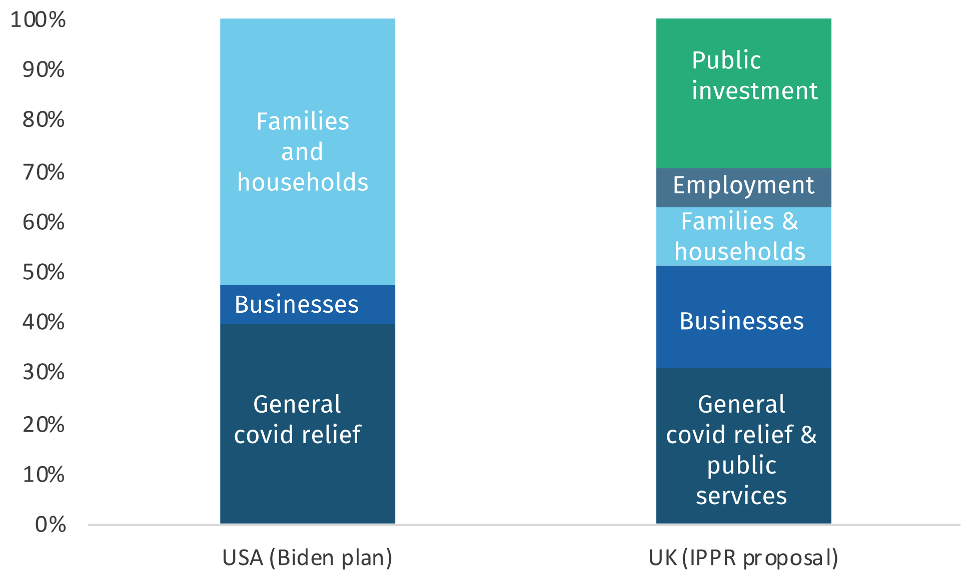
Similar to the Biden proposal, **our proposed stimulus is calibrated to address these downside risks to incomes and growth. It would close the GDP gap by 2022 rather than allowing costly, sluggish recovery.**

In the *Chancellor's Challenge*, we spelled out our suggested policies in detail and showed how its individual components sum to the proposed overall size needed. The components fall into the broad categories of employment support, business support, support for families and households, public investment. Covid-19 relief and a boost to public services spending (figure 2).

FIGURE 2

Our proposed stimulus includes support for businesses, workers, families, public services and public investment

Per cent of total stimulus spending



Source: Brookings (2021), Jung & Roberts (2020).

COMMON CONCERN 1: CAN WE AFFORD IT?

Many would agree with the need for a stimulus, but they worry 'we cannot afford it'. But this profoundly misunderstands the macro-financial context we are in. Perhaps to the bafflement of some observers, eminent institutions concerned about fiscal discipline have recently been advocating a sizeable debt-financed stimulus in response to this crisis – including the International Monetary Fund (IMF) and the OECD. For instance, in reference to advanced economies, the head of the IMF said in January 2021: "We do need more stimulus. In the United States, fortunately, there is fiscal space to do so," adding that she favoured "sizable support".

What caused this shift of view on stimulus? There are two reasons. On the one hand, a recognition of the risk of being stuck in a **scarred, low-growth economy**. On the other hand, the **ultra-low interest rates** on government borrowing (figure 3). The upshot being that deficit spending is the *fiscally responsible* thing to do.

FIGURE 3

The drivers of the shift in macro-economic policy making: deficits can be good

As we outlined in the previous section, a stimulus in this period is likely to have particularly high returns if it can prevent the economy from falling into a 'stagnation trap'. There should thus be significant positive returns from a big stimulus. Even if returns were small, the current ultra-low-interest rate environment means they would be self financing, meaning they would pay for themselves (see annex).

Indeed, **ultra-low interest rates** mean that providing a large stimulus is *very* cheap (which in turn is due to the low growth prospects that the UK and other economies face). The ability of the government to borrow and spend has improved tremendously, as financial markets are willing to **lend to the state at negative interest rates**. The UK state can currently borrow for 30 years at about minus 1 per cent in real terms – this means investors are *paying* the state 1 per cent each year in real terms to take their money over 30 years. The world, some might say, is upside down.

It is for these reason that we estimate, even in the short-term, **government debt (as a share of GDP) would *fall*, not increase, as a consequence of our stimulus package**. (Note that, as we show in the annex, this holds even if fiscal multipliers are significantly smaller than one.)

This explains why mainstream macroeconomists argue that there has never been a better time to borrow and boost the economy. The IMF's chief economist has said that "fiscal stimulus is not just economically sound policy but also the fiscally responsible thing to do”. In other words, not only can we afford it, it will be beneficial even in purely financial terms.

COMMON CONCERN 2: WILL THE STIMULUS MONEY BE EFFECTIVE?

Some are wondering whether it is too early for government to move from providing rescue measures to delivering a big economic boost, and whether the effectiveness of a stimulus could be affected by renewed lockdowns. In fact, our proposed stimulus serves both purposes at the same time: provide continued rescue support while also boosting growth. And we argue this strategy is robust to various different epidemic scenarios.

In the box below, we discuss three plausible epidemic forecasts, each of which includes significant relaxation of restrictions by the summer. Our downside forecast (short-lived immunity and/or widespread viral variants capable of high degrees of immune escape), which is of low probability, sees a return of restrictions later this year. Even in this scenario, virtually all components of our stimulus are needed:

- Firstly, emergency measures to support vaccination, public services (especially health and care services) and local governments are crucial in any scenario – even more so if there is a requirement to update vaccines later this year in light of strains capable of immune escape. **So this part of the stimulus would have to be larger, not smaller, in the event of a severe further wave of Covid-19 later this year.**
- Secondly, targeted transfers to families and households will be key to bolster demand as the economy recovers, and particularly so if the economic growth is limited by further restrictions. **This element would also have to increase in the event of further restrictions to limit Covid-19 spread**.
- Thirdly, public investment will be key to stimulate demand and foster the growth of future-proof sectors (e.g. in health and social care and green industries). Investment in these sectors will be key for redirecting labour markets away from sectors hit by the pandemic, including those still diminished by social distancing. For instance, investing in filling the large amount of vacancies in social care (which will be needed even with continued social distancing) can help create new opportunities for workers from other sectors. Therefore, **this investment part of the stimulus too is even more needed if there are further restrictions later this year.**
- This leaves business and employment support. If there are further enforced restrictions this winter to limit Covid-19 transmission, some of **this support may have to shift, in case some sectors are enduringly affected by an ongoing pandemic**. Emergency support might then need to be transformed to help people transition to other

sectors. The change might be more one of different types of support rather than less support.

In sum, our suggested stimulus is essential for the economy and livelihoods, and even more so if the pandemic takes a turn for the worse. It is only business and employment support that might have to be adjusted (though not necessarily reduced) in the unlikely event of renewed significant restrictions later this year to suppress Covid-19 spread. All in all, the risk of doing too little far outweighs the risk of doing too much. Joe Biden has understood this. Rishi Sunak should follow his lead.

COMMON CONCERN 3: WILL THE STIMULUS RAISE INFLATION?

Especially in the US context, some have raised fears that a stimulus could raise inflation. We argue that this is not a concern in the UK case for six reasons:

- Firstly, it's important to emphasise the UK situation is different to that in the US in one respect. UK GDP slumped by almost 10 per cent in 2020, whereas the US only fell by about 4 per cent. As a result, our proposed stimulus is smaller than the US one compared to the output shortfall. (On the other hand, the US needs to make up for its low level of social insurance through stimulus which in the UK is more automatic – so a like for like comparison would need to disentangle these.). **This means that the same amount of stimulus (as a share of GDP) in the UK is expected to lead to less inflationary pressure than in the US.**

- Secondly, we calculated the stimulus needed to narrow the output gap, not to overshoot it. Even in the most optimistic bounce back scenarios – such as the Bank of England – unemployment increases to 7.5 per cent, **suggesting large amounts of spare capacity**, so the economy would without stimulus likely face deflationary pressures, not inflationary ones.

- Thirdly, the average short-term multiplier in our calculations is just over 1 (based on IMF, 2020). If, as some assume, the multiplier is lower than this, the stimulus will lead to less inflationary pressures.

- Fourthly, as outlined in the previous section, our proposed investment drive is aimed at increasing potential in certain sectors of the economy (such as low-carbon housing, clean transport, social care and health). Investing in these sectors **will increase the supply potential in the economy, attenuating price pressures**, lowering the risk of above-target inflation.

- Fifthly, similar to other countries, **the UK has undershot its inflation target two thirds of the time in last 5 years** (with a large part of above-inflation episodes being Brexit-related). Most recently inflation has come down below 1 per cent and financial markets are projecting no increase in inflation expectations (Bank of England 2021).

- Finally, **the risks from above-target inflation are lower than the risks from below-target inflation.** With years of low growth and low inflation, advanced economies, including the USA, run the risk of being stuck in a 'stagnation trap', similar to Japan has been since the 1990s. Once a country is stuck in such a situation, there are few tools (other than fiscal and monetary stimulus) to get out of it. Conversely, we have the tools – central bank interest rate policy – to moderate inflation in the unlikely case that a temporary stimulus leads to persistent over-heating. In fact, the UK – with its low nominal growth in recent years – could even benefit from some moderate overshooting inflation in the short-term. In sum, the risk of deflation and of a 'stagnation trap' currently outweigh the risks of temporary mild inflation caused by a temporary stimulus.

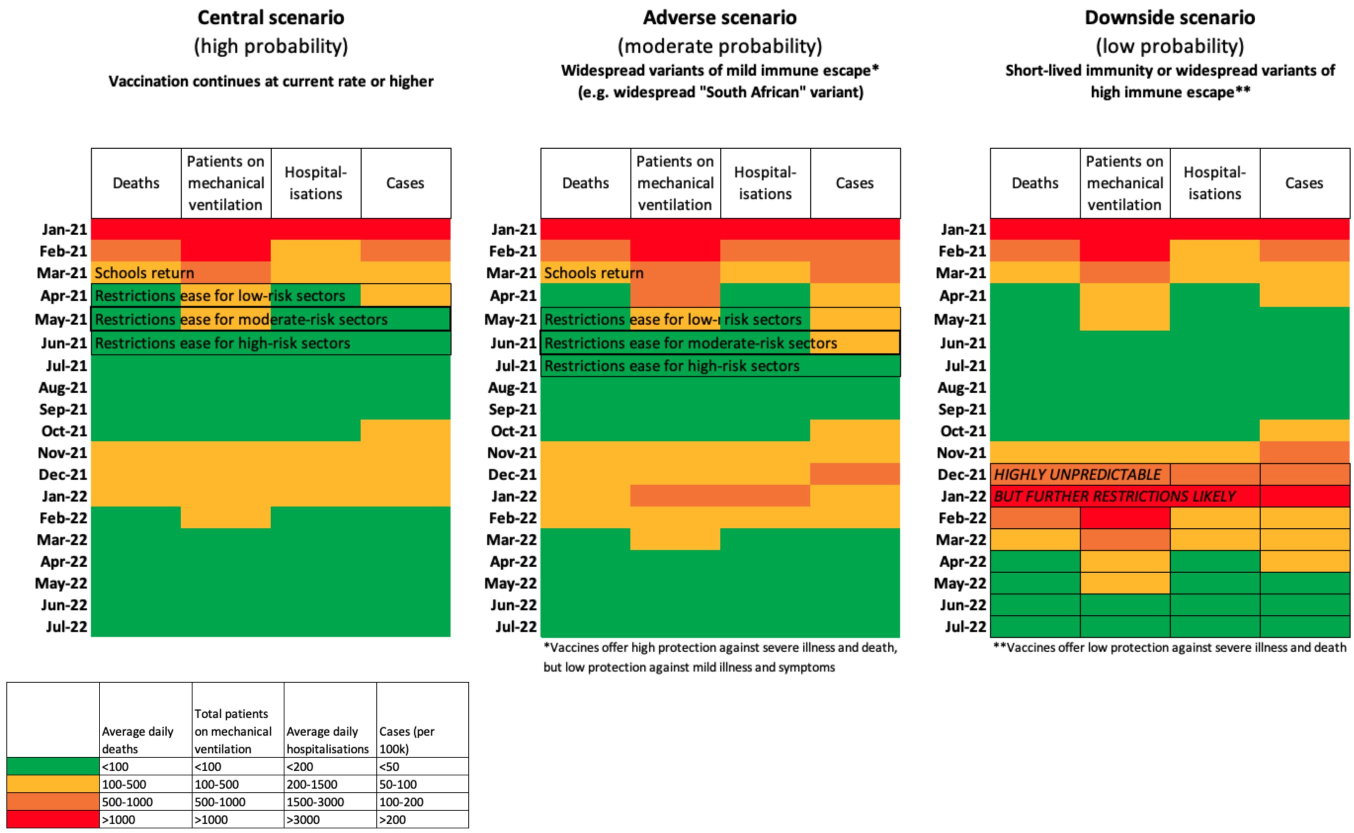
Box: Covid-19 epidemic forecasts

In Figure A we forecast three possible profiles of the UK's Covid-19 epidemic for the next 18 months in terms of cases, hospitalisations, mechanical ventilation requirement and death. In each scenario, restrictions are largely relaxed by the summer, due to the impacts of immunity (from Covid-19 vaccines and natural infection) and the seasonality of coronaviruses. We foresee a sector-by-sector approach to the relaxation of the national lockdown, which may vary by region. We expect this will be largely based on a sector's Covid-19 transmission risk. Education is an exceptional case for obvious reasons, and we expect schools to return in March 2021 in each of the scenarios below. We also expect travel restrictions or conditions of some form to be present for the next 18 months.

Our central scenario (high probability) forecasts vaccination continuing at its current rate or higher. We expect restrictions for low-risk sectors to be largely relaxed by April 2021, with further relaxations for higher risk sectors in May and June 2021. There will be a further wave of Covid-19 later this year; it is possible this may occur in the Summer as restrictions are lifted, but it is more probable to occur in the Winter given the seasonality of coronaviruses. In either case, we do not expect this wave to be severe due to high levels of population immunity, primarily through high levels of vaccination. Further restrictions are unlikely in this scenario.

FIGURE 4

Three scenarios showing different future paths of the pandemic



Our adverse scenario (moderate probability) forecasts a widespread variant capable of some immune escape (e.g. widespread "South African" variant), such that vaccines offer high protection against severe illness and death but offer low protection against mild disease and symptoms. In this scenario, the impact of lifting lockdown is greater, as vaccines have a diminished effect on transmission (but are still highly protective against hospitalisations and death). Therefore, we expect restrictions to be lifted later, when case rates are low enough for it to be done safely. There will be another wave of Covid-19 later this year, and although we do not expect any significant further restrictions (as hospitalisations and deaths will not reach alarming levels), the public's behaviour is likely to be different as Covid-19 case rates will be significantly higher than in the central scenario.

Our downside scenario (low probability) forecasts short-lived immunity to Covid-19 or a variant capable of a high degree of immune escape, such that previous vaccination does not protect against severe illness and death. In this scenario, there is likely to be a severe further wave of Covid-19 that requires enforced restrictions, and potentially a further lockdown, while vaccines are being updated.

ANNEX

How we estimate the size of the stimulus

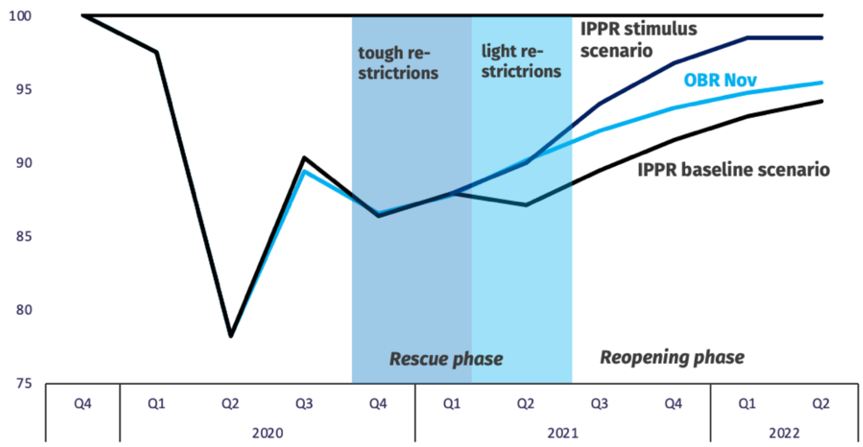
We estimate the need for fiscal stimulus based on GDP shortfall implied by our baseline scenario and assuming that the continued social distancing requirements suppress potential GDP by 3.5 percentage points over the rest of the year (IMF 2020a, p. 13). See further details in Roberts & Jung (2020), pages 25-26. The output shortfall has been updated with our most recent recovery scenario.

Our IPPR baseline scenario assumes the loosening of restrictions consistent with the central scenario (Figure A) which we used for our stimulus calculations. Our recovery scenario is a lagged version of the OBR November 2020 scenario, which assumed slow reopening in the new year. We move this reopening backwards in line with our central health scenario, incorporating ONS Q4 2020 growth outturns data and assuming that the lockdown in the three months of Q1 2021 have the same economic effect as that in in November 2020.

Figure A

The UK economy risks being stuck in a 90 per cent economy

Per cent of pre crisis GDP trend



Source: IPPR analysis of OBR (2020), ONS (2021) and IPPR health scenarios (see box in the main text).

How a deficit can benefit public finances

Deficit spending can benefit public finances, if either there are large multipliers or if the growth rate is bigger than the interest rate paid on public debt. The below calculations show a situation where the interest rate growth differential is 2 per cent. That could hold for instance where real growth is 2 per cent and real interest rates on government debt are minus 0 per cent. In this case, a deficit of

5 per cent would not decrease public debt to GDP, with a multiplier of 0.5. And with a multiplier of 1.2 it would decrease public debt-to-GDP by almost 4%.

Relatedly and slightly more technically, some argue that because of the pandemic, fiscal multipliers are lower than they would be in a usual recession. For instance, people might save additional income rather than spending it. But as the below shows, even low spending multipliers mean that the stimulus could be net beneficial for the economy and public finances.