The sustainable investment rule economics essay

ASSIGN
BUSTER

The extent to which the macroeconomic policies of the British government are linked to the growth performances of the last 5 years.

what the government has been trying to achieve through its macroeconomic strategies between 2008 and 2012

Secondly what the impact of these strategies has been in the light of developments in both aggregate supply and, especially, aggregate demand.

You should take account of the policies also being pursued by the Bank of England during this period and you should use the IS-LM and the AD-AS models of the economy to structure your analysis.

The United Kingdom has been going through a fragile state trying to recover from the recession in 2008, during which the UK government showed a deficit of 2. 7% of Gross Domestic Product (GDP) which amounted to the total of £38. 7 billion. The general government debt was around 43. 2% of GDP, which totalled to £614. 4 billion (ONS, 2008). The government has been trying to achieve long-term economic stability and prospering growth in the UK's output through their macroeconomic policies (IFS, 2008).

In 2008 the Government's fiscal policy objectives were to support monetary policy by allowing the automatic stabilisers to help smooth the path of the economy and to ensure sound public finances.

The government adopted two strict set of rules in order to achieve their macroeconomic objectives which were:

‘ The Golden Rule’ which states that, over the economic cycle, the Government will borrow only to invest and not to fund current spending.

‘ The Sustainable Investment Rule’ which states that, public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. Other things being equal, net debt will be maintained below 40 per cent of GDP over the economic cycle.

These two rules set by the government were intended to: (a) work alongside one another in order to protect intergenerational fairness by ensuring that current generations pay for the public services that they consume, rather than funding consumption through borrowing that will have to be repaid by future generations; (b) and to eliminate the bias against capital spending.

The fiscal policy remained constant in 2009 to ensure sustainability and to support the economy. In March 2009, quantitative easing (QE) was implemented in the British economy to the sum of approximately £200 billion via an asset-purchase programme that occurred between April 2009 and February 2010(BBC, 2011). QE is the electronic creation of artificially created money by the BoE that is used to buy various financial assets, the majority of which are government debt gilts, and its purpose is to boost asset prices, raise spending and to keep the level of inflation below the 2% target (BoE, 2012). In theory this should result in the increase of the supply of money in an economy and improve the level of lending between banks (BBC, 2011). Despite this injection of £200 billion into the British economy, a sustained recovery was not in sight thus the BoE increased its QE programme by an additional £75 billion in October 2011. There was also

another £50 billion added in February and July 2012 respectively. As a result of this QE program, the BoE now hold approximately a third of the entire outstanding stock of UK government debt (Independent, 2011).

The efficacy of the QE program is subject to much debate. Whilst it is fair to state that In 2009 QE allowed market confidence to increase and decreased borrowing costs for the government and large firms thanks to the continual purchase of assets, there were disadvantages to this policy. One of the disadvantages was that funds were by and large redistributed in the financial sector, including commodity speculation. Commodity speculation had the unwelcome effect of indirectly increasing inflation by increasing import prices which led to a reduction in domestic demand for goods. However, the BoE insists that the QE policy was still worth implementing as it did foster economic activity and was required to prevent inflation for creeping above the 2 per cent level.

Since the Government elected a Conservative-Liberal coalition in 2010, the new government changed its position towards its fiscal policy and turned towards austerity measures, which included a series of sustained reductions in government spending and tax rises.

The goal of the Government was to achieve a ‘ cyclically adjusted current balance’ by the year ending 2016. The new government’s six-year borrowing reduction plan relies heavily on cuts to public spending (which was projected to be reduced as a share of national income from 47. 4% in 2009−10 to 39. 3% by 2015−16).

In September 2011, the inflation rate in the United Kingdom had reached 5. 2%, more than double the bank's target of 2%. This was a direct consequence of the BoE's decision to keep the national interest rate at a historic law in order to steer the domestic economy out of a recession and encourage economic growth. Despite the damaging effects on inflation, low interest levels combined with the additional QE funding allowed the British economy to not suffer a more severe recession and curbed the effects of the financial crisis. Unfortunately this came at a cost of creating further budget deficits and increasing the national debt level.

The Government maintained the 2 per cent inflation target for the 12-month increase in the Consumer Prices Index (CPI). The Monetary Policy Committee (MPC), a division of the BoE has complete operational independence as to how to maintain inflation levels and ensure they did not increase above the 2 per cent targeted inflation.

Since March 2009, the MPC has maintained the Bank Rate of inflation at 0. 5 per cent whilst also aiming to pump money back into the economy via the Asset Purchase Facility. This involves the purchasing of assets that are finance by the electronic creation of central bank reserves of £200 billion. In the 2011 Budget, George Osborne confirmed that this Asset Purchase Facility would continue for the forthcoming financial year.

Against the continued financial market disruption, the UK Government has tried to set up policies that would decrease the government's deficit by cutting down on spending and increasing taxes.

In the wake of the financial crisis, the BoE reduced its policy rate from 5 per cent in October 2008 to a historically low 0. 5 per cent.

Growth:

The UK economy experienced an overall peak decline in output of 6. 3% over five consecutive quarters in 2008-09, and recorded the largest annual fall since the second world war in 2009. The economy's underlying structures remain fragile, as highlighted by weak growth of 0. 8% in 2011 and a return to recession in early 2012. This is not surprising, with the UK in the midst of a rare, severe and protracted balance-sheet recession, following the collapse of a huge debt-financed asset bubble, and with important financial and trade links with Europe depressed by the worsening euro zone crisis.

Lower inflation is helping to ease some of the recent severe pressure on household incomes, but declining real wages, high indebtedness and energy costs, labour-market weakness, on-going fiscal austerity, constrained credit availability and a stagnant housing market will continue to hold back demand.

COST PUSH INFLATION: Raise of commodity prices and food

CONSUMER CONFIDENCE was low due to high inflation rates and low wage growth

Conclusion:

Nearly half a decade after the global economic crisis, the future of British economic policy remains uncertain. A plethora of factors such as record-low

interest rates, unprecedented central bank intervention and a considerable fiscal deficit have all contributed to the level of uncertainty regarding the health of the UK economy. Unfortunately the entire forecast period remains uncertain also with economic troubles both locally and internationally having a negative effect on household, national and bank balance sheets.

The path to economy recovery and its accompanying reduction in the budget deficit remains tricky. The private-sector debt overhang, unsteady financial sector and limited supply capacity all make the challenge of economy recovery all the more difficult as does the UK government's self-imposed fiscal reductions. Whilst the current Conservative government continues to slash the Budget, the effects of their policy and any subsequent economic improvement are yet to be seen.