Impact of loss of confidence in the UK on the domestic and global economy

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ABSTRACT

Purpose — *This research examines the effects of loss of confidence caused by tax cuts in the UK on the domestic and worldwide economies.*

Method — *The G-Cubed model is used to simulate a 5% shock to risk premiums in the UK. G-Cubed is a multi-country, multisector, intertemporal general equilibrium model used to analyse a range of policies in international commerce, tax reform, and environmental regulation. Combining the finest elements of three study fields—econometric general equilibrium modelling, international trade theory, and contemporary macroeconomics—is intended to close the gaps between them.*

Result — *UK currency surplus in non-shocked nations leads to exchange rate decline and capital flight, reducing the capital stock and raising interest rates. Loss of confidence prompts households to discount income, resulting in lower domestic consumption and increased savings, coupled with a decrease in private investment. The UK currency's decline improves net exports but eventually causes a drop in real GDP, with falling investment and consumption exceeding rising net exports. Capital outflows and depreciation lead to inflation, mainly in the short term. However, capital outflows from the UK benefit non-shocked countries by raising capital, investment, capital stock, consumption, and real GDP.*

Contribution — *The present study contributes to the academic literature by offering novel insights into the impact of loss of confidence caused by tax cuts on the economies in both, the UK and other countries, by employing G-Cubed model.*

Keywords: G-Cubed, monetary rule, tax cuts, loss of confidence

INTRODUCTION

Amid world conditions that are full of instability due to the COVID-19 pandemic and the energy crisis caused by the Ukraine-Russia war, governments in various countries have made various policies to overcome problems in their countries. One country that was quite affected by the crisis is the United Kingdom (UK). For example, in terms of economic growth, UK GDP in August 2022 fell 0.3% compared to the previous month. In addition, during July - September 2022, GDP fell by 0.2% (Office for National Statistics, 2022).

Steps taken by the Liz Truss Government to solve this problem is to provide tax cuts of as much as 45 billion pounds sterling. With this policy, the top earners will no longer have to pay the highest income tax rate, and the government will borrow a lot more money to lower energy prices for millions of homes and businesses in winter (Thomson & North, 2022).

Although this policy could theoretically increase economic growth and overcome a recession, in reality, this policy harmed the UK economy. The IMF said this policy could increase inequality in the UK and endanger monetary policy (Shahid, 2022). In addition, Moody's said that an extended loss of market confidence brought on by doubts about the government's budgetary policy that led to substantially increased financing costs might make the UK's debt more unaffordable in the long run (Cole, 2022).

The tax cuts might increase the budget deficit and the debt-income ratio of the UK. In addition to the current consequences on the economy, the rise of the debt-to-income ratio might have further repercussions that are qualitatively different. Notably, a country's increasing debt-to-income ratio may eventually cause investor confidence to plummet, which would then cause a dramatic decline in demand for the nation's assets (Ball & Mankiw, 1995).

Ball and Mankiw (1995) argued that the tax cuts would increase the budget deficit and make the budget not sustainable in the long run. So, it could cause confidence loss in the economy. A confidence loss collapses domestic asset demand. A drop in domestic asset demand causes a dramatic reduction in asset values, including the stock market. It also caused high-interest rates. As investors sell local assets, the value of the native currency decreases. As the currency depreciates, the trade balance goes abruptly to surplus, and capital flows out.

Such a drop in domestic asset demand may hurt an economy in various ways. Wealth declines when asset prices fall. Insufficient investor confidence and rising interest rates reduce physical investment and capital stock. This worsens actual wage declines induced by fiscal deficits (Ball & Mankiw, 1995).

Many further effects may ensue. First, a decrease in domestic asset demand would cause interest rates to jump, leading the debt to expand quickly. To avert a larger tragedy, the government must switch to primary budget surpluses, triggering a drop in consumption. High-interest rates remove the prospect of paying off debt slowly or growing out of it (Ball & Mankiw, 1995).

Second, the Latin American experience implies a trade surplus would be a severe sectoral shock. The sector's shock halted growth for a decade (Sachs & Larrain, 1993).

Third, the collapse of domestic asset demand might cause inflation via two pathways. A dip in the native currency would raise import prices, which might induce inflation. Also, in reaction to the budgetary crisis, the monetary authority may be pressured to create money and cause inflation (Ball & Mankiw, 1995).

Financial liberalization allows residents to invest in the country with the best predicted return. Free capital mobility explains shock spillovers across nations. Reinhart & Reinhart (2003) discover a substantial positive link between FDI flows to developing nations and US economic success. Warnock et al. (2001) found that US interest rates and economic growth affect developing market stock capital flows.

Capital inflows to developing nations boost private investment and local consumption, boosting economic development. Yet, an abrupt capital flow reversal might threaten developing country capital influx. Obstfeld (2012) claims that anticipation may cause a catastrophe even in a robust economy. People's expectations may effect money movements between nations. So, every country shock will change investors' financial capital allocation.

Obstfeld (2012) claims that perfect capital mobility drives investors to preserve uncovered interest parity, which might cause a rapid economic collapse. Financial capital's instantaneous movement eliminates exchange rate arbitrage. Yet, an exchange rate shock may cause a quick loss of reserve, raising interest rates and depreciating the currency.

Obstfeld (2002) says exchange rate shocks affect trade balance prices and volumes. Since imports are falling, trade balance may fall. In the long run, volume impact has eliminated price effect, thus exports to other nations grow and the trade balance becomes surplus.

Based on this, we may assume that global investors concerned about return would adjust their portfolio and direct investment to adapt to market risk perception. Risk premia and investment and capital funds will shift from developing to advanced nations as risk perception rises in emerging countries. Because of this, developing markets are anticipated to experience a substantial

economic downturn while advanced nations continue to grow. Emerging economies will stay below the baseline while mature economies will grow (Sugiyarto, 2019).

Many opinions exist on the appropriate kind of governmental response to the global disruptions of recovery. Fiscal policy and international collaboration were given less consideration as tools for managing the economy before the GFC. According to Obstfeld and Rogoff (2002), domestic monetary policy seems to bring about the best possible national benefit and eliminate extraneous effects, making coordination a second-order need. On the other hand, Oudiz and Sachs (1984) concurred that, in reaction to the global shock, policy coordination would produce benefits and welfare spillover. According to a recent research by McKibbin and Vines (2000), fiscal policy-based international collaboration is crucial. They demonstrate that greater GDP levels in the first year and lower unemployment would be advantageous for both nations with and without additional fiscal help (Eschachasthi, 2022).

This research aims to examine the effect of loss of confidence in the UK caused by tax cuts, which is illustrated by a permanent increase in the country's risk premium relative to the United States of America (USA) by 5% on the UK economy. In addition, this study will also examine how the influence of confidence loss in the UK on the economy of other developed and developing countries. This research is divided into several parts. This section is the introduction section. The next part is a literature review where I will explain the literature demonstrating the effect of confidence loss on the economy. Next, I will describe the G-cubed model used in this study. Finally, I will explain the simulation results.

METHOD

G-Cubed is a multi-country, multisector, intertemporal general equilibrium model used to analyse a range of policies in international commerce, tax reform, and environmental regulation. Combining the finest elements of three study fields—econometric general equilibrium modelling, international trade theory, and contemporary macroeconomics—is intended to close the gaps between them (McKibbin & Wilcoxen, 2013).

In this research, permanent loss of confidence boosts risk premium by 5%. Five percent risk premia indicate developing market investors need five percent greater returns than average. If significant investments have already been made, further investments will diminish the return. It pushes financial capital abroad. Consequently, the bond's interest rate should go up (Syema, 2018). McKibbin

(1998) argued that any country's interest rate (r_t^i) equals the US rate (r_t^{US}) plus exchange rate depreciation $(\,_t t_{t+1} - e_t)$ and risk premium (μ_t). The interest parity equation calculates nation risk premia as below:

$$(1) \qquad r_t^i = r_t^{US} + (\,_t t_{t+1} - e_t) + \mu_t$$

Alternatively, equation (1) could be presented below:

$$(2) \qquad e_t = \int_t^T (r_s^{US} - r_s^i + \mu_s)ds + \,_t e_T$$

The real exchange rate during any given period t is calculated by adding the expected future differentials of interest rate, the expected future risk premium on assets denominated in the home currency, and the real exchange rate equilibrium value during period T (McKibbin, 1998).

The Henderson-McKibbin-Taylor (HMT) rule determines monetary policy (Henderson & McKibbin, 1993; Taylor, 1993). The new modified HMT rule was created following the Global Financial Crisis (GFC) (Syema, 2018). Countries have the same equation but different parameters. Central banks may change the parameters of their policy rule. The modified Henderson-McKibbin-Taylor rule is as below:

$$(3)\; i_t^d = \beta_1 i_{t-1}^d + \beta_2(\pi_1 - \pi_t^T) + \beta_3(\Delta y_t - \Delta y_t^T) + \beta_4(ny_t - ny_t^T) + \\ \beta_5(\Delta e_t - \Delta e_t^T)$$

$$(4) \qquad i_t = i_{t-1} + \beta_6(i_t^d - i_t) + i_t^x$$

In equation (3) and (4), i denotes actual interest rate, π denotes inflation rate, Δy is output growth, ny represents nominal income, and Δe denotes the change in exchange rate. The variables desired and target levels are indicated by the superscripts d and T, respectively, while the exogenous interest rate component is denoted by the superscript x. 'i' could be changed exogenously in the short run by altering the exogenous component i^x (interest rate target). Also, 'i' could progressively adapt to the desired policy rate (i^d) (Zhang, 2021).

A separate set of parameter values may be used to simulate the unique monetary regulation for each nation as below:

Table 1. Parameters value

Countries	β_1 Lag interest rate	β_2 Inflation rate	β_3 Output growth	β_4 Nominal income	β_5 Exchange rate	β_6 Interest rate
GBR	1	1.5	1.5	0	0	0.2
USA	1	1.5	1.5	0	0	0.2
JPN	1	1.5	1.5	0	0	0.2
DEU	1	1.5	1.5	0	0	0.2
FRA	1	1.5	1.5	0	-1000	1
ITA	1	1.5	1.5	0	-1000	1
EUZ	1	1.5	1.5	0	-1000	1
CAN	1	1.5	1.5	0	0	0.2
AUS	1	1.5	1.5	0	0	0.2
OEC	1	1.5	1.5	0	0	0.2
KOR	1	1.5	1.5	0	0	0.2
CHI	1	1.5	1.5	0	-1	0.2
ROW	1	1.5	1.5	0	0	0.2
OPC	1	1.5	1.5	0	0	0.2
TUR	1	1.5	1.5	0	0	0.2
IND	1	1.5	1.5	0	0	0.2
INO	1	1.5	1.5	0	0	0.2
OAS	1	1.5	1.5	0	0	0.2
MEX	1	1.5	1.5	0	0	0.2
ARG	1	1.5	1.5	0	0	0.2
BRA	1	1.5	1.5	0	0	0.2
RUS	1	1.5	1.5	0	0	0.2
SAU	1	0	0	0	-1000	1
ZAF	1	1.5	1.5	0	0	0.2

Source: author's compilation (2022)

The output gap (actual – natural rate of production) and inflation are traded off in this paradigm. Inflation rate and output growth parameters (β_2 and β_3) in all nations except Saudi Arabia are 1.5, which implies if inflation or output growth rises by 1%, the central bank will raise interest rates by 1.5 %. Saudi Arabia maintains a strict exchange rate peg. Hence its monetary authority ignores inflation. Also, Saudi Arabia's significant bilateral exchange rate coefficient reduces inflation's effect. The actual interest rate parameter (β_6) reflects how quickly a central bank adjusts interest rates to attain the intended rate. Most central banks adjust 20% in the first year, while the European model anticipates quick adjustment. No country's nominal income parameter (β_4) is used. Each central bank has an interest rate lag (β_1) at value 1 (Syema, 2018).

A fixed-exchange-rate central bank has zero value for β_5. China has little affects on the currency rate. If the Yuan depreciates against the dollar, it will boost interest rates. Saudi Arabia is pegged to the dollar. France, Italy, and the other eurozone countries have unique monetary rules. Eurozone nations tie their

exchange rates to Germany's relative to the dollar. German central bank set the target for the output gap and Euro inflation. All European central banks target the German exchange rate relative to the US dollar and set a single interest rate (Syema, 2018).

The fiscal rule in the model states that as the government accumulates fiscal deficits and debt, consumers and companies are taxed to pay that debt (McKibbin & Stoeckel, 2012). This prevents government debt from exploding. The G-Cubed model considers the fiscal deficit exogenous and government expenditure endogenous.

RESULT AND DISCUSSION

This study simulates a permanent increase in the risk premium in the UK by 5% due to loss of confidence. Besides showing the effect of the shock on the UK economy, this study also presents how 10 other economies were affected by this policy. The economies presented in this study consist of developed and developing countries, including the USA, Japan (JPN), Germany (DEU), Rest of Euro Zone (EUZ), Australian (AUS), China (CHN), India (IND), Indonesia (IDN), Oil Exporting and Middle-East (OPC), and rest of the world (ROW). The simulation results are displayed until 2040, with 2018 as the baseline.

Figure 1. Trade weighted exchange rate
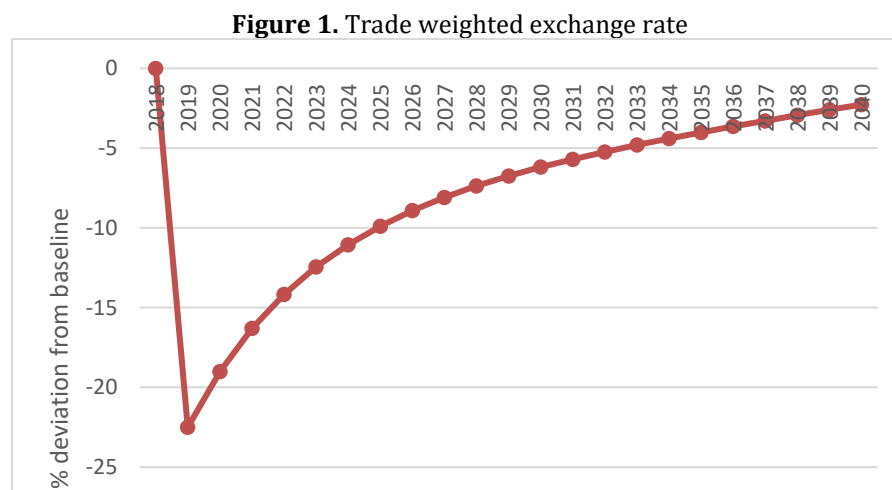
Source: data processed (2022)

The outcomes for the UK currency's trade-weighted exchange rates are shown in Figure 1. A significant amount of money leaves the UK economy due to the rise in risk. The different currencies suffer a severe depreciation as a result of this

outflow. Since risk premiums in the UK are rising, money is moving to safer locations abroad.

Figure 2. Capital stock (UK)
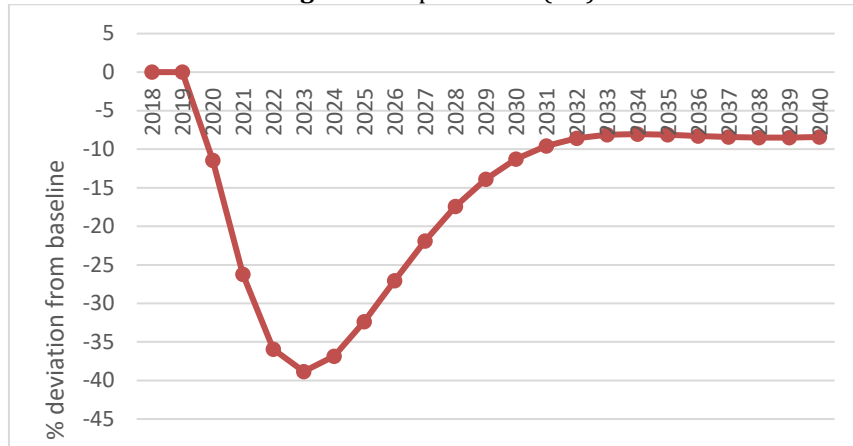
The UK's capital stock has fallen dramatically, as seen in Figure 2. The capital stock drops by up to 37% below the baseline level in short- to medium-term.

It makes sense why the exchange rate dropped. The UK's currencies will be oversupplied in the non-shocked nations due to capital flight. The exchange rates of these currencies will decrease as a result. Despite tending to rise over time after dropping, the exchange rate has been below the base rate for decades.

Since the capital inflow from the UK, the trade-weight exchange rates have risen among the non-shocked economies, as shown in Figure 3.

Figure 3. Trade weighted exchange rate (other countries)
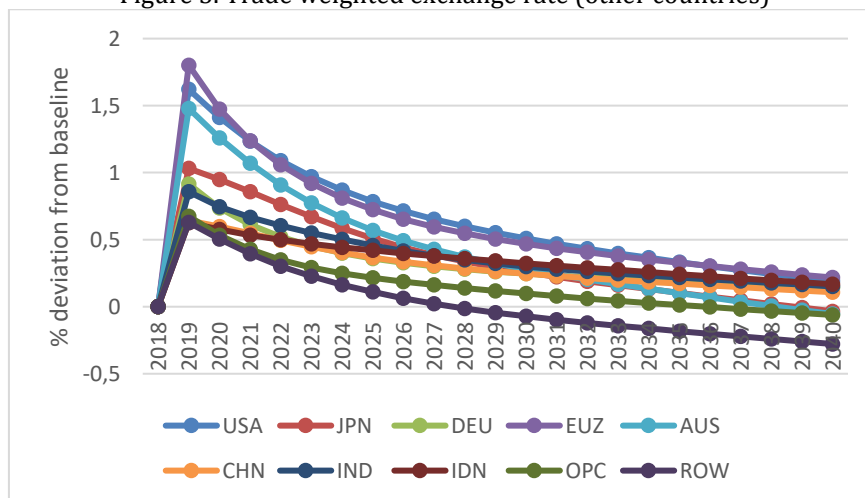
As seen in Figure 4, the capital outflow also results in a significant rise in real interest rates and a general decline in asset values in the UK. Since investors are selling bonds in the UK, it is anticipated that the price of bonds will decrease, which will cause real interest rates to rise. Additionally, a lower capital stock owing to national risk will result in a higher marginal product of capital, resulting in a higher interest rate. Also, as the demand for bonds declines, the rate of long-term bonds increases (Figure 5).

Figure 4. Real interest rate (UK)
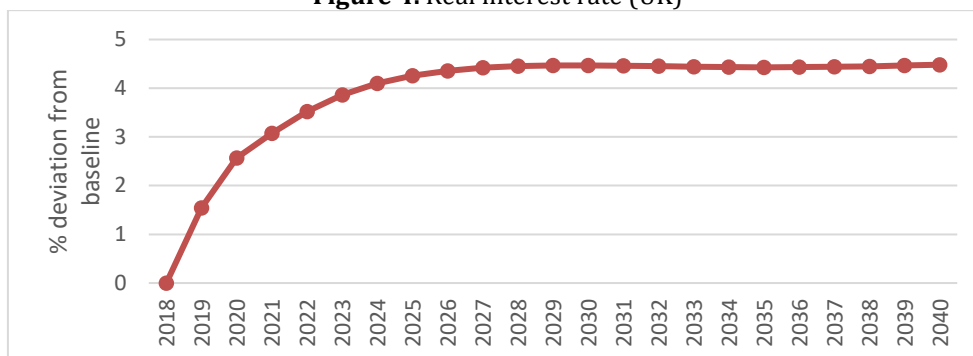
Source: data processed (2022)

Figure 5. Long-term bond rate (UK)
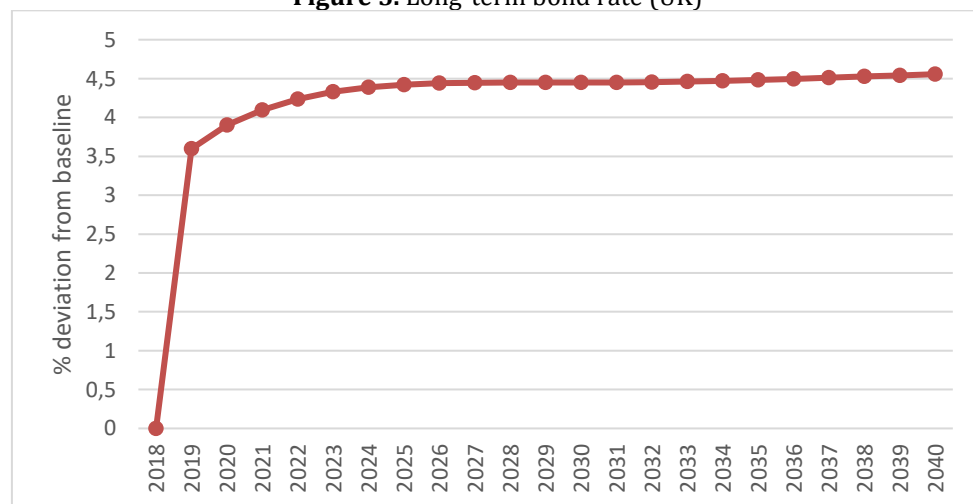
Source: data processed (2022)

In Figure 5, long-term real interest rates in the UK are permanently higher than the baseline. In addition, Figure 6 illustrates how interest rates in other economies decline and permanently stay below the base level due to the capital inflow and decreasing the marginal product of capital.

Figure 6. Real interest rate (other countries)
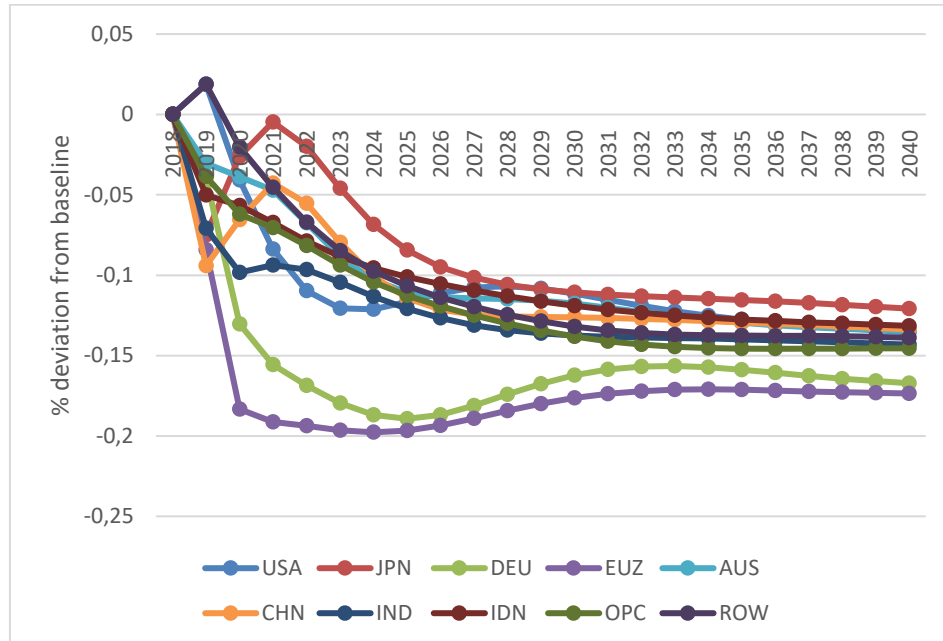
Higher capital stocks in the unshocked nations (Figure 7) indicate reduced marginal product of capital and low-interest rates. Bond rates also decline (Figure 8) since there is an excess supply of long-term bonds.

**Figure 7.** Capital stock (other countries)
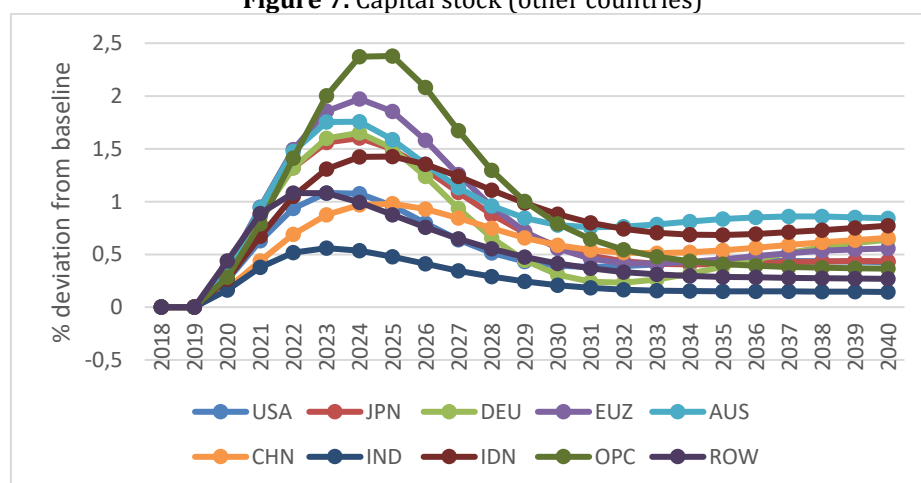
Figure 8. Long-term bond rate (other countries)
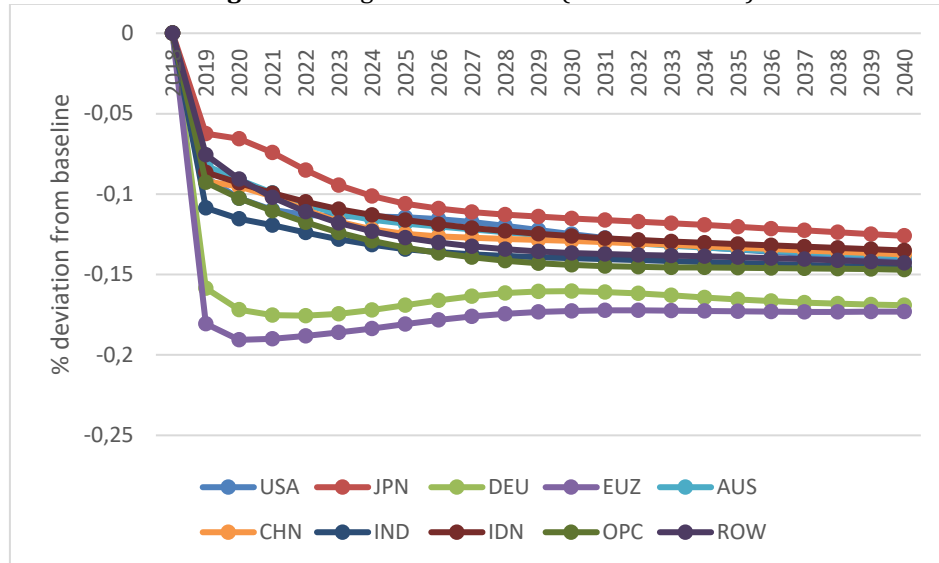
Then, the consumption trends in the UK and other economies are shown in Figures 9 and 10. Households discount their anticipated future income at a greater rate when there is a decline in confidence in the UK. Households reduce spending when lifetime wealth's current value declines. From the UK baseline level, consumption drops by around 9% over the short term. Forward-looking agents save more in anticipation of a worse scenario in the future as a precursor. In the long-term, nevertheless, consumption will return to normal. Contrarily, in non-shocked economies, consumption increases instantly in the short term and then declines gradually over time, eventually returning to baseline.
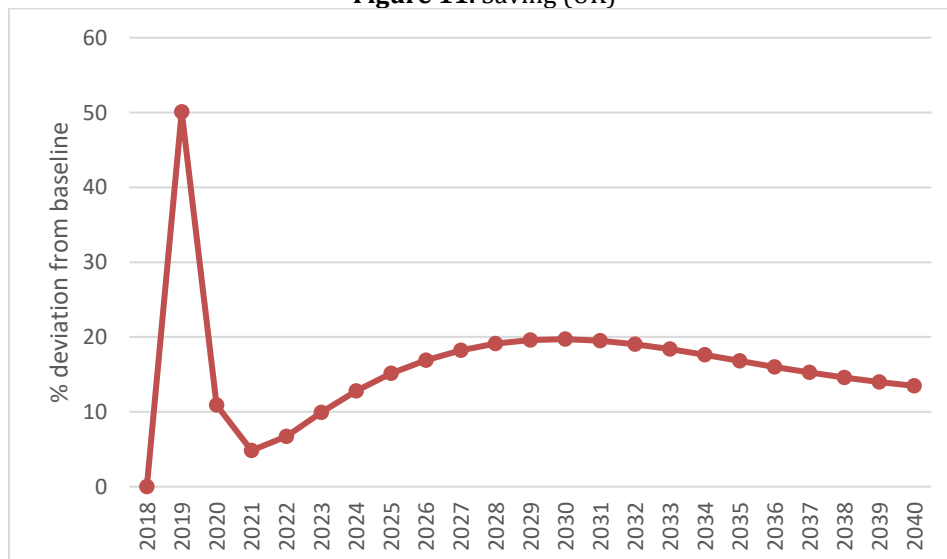
Figure 9. Private consumption (UK)
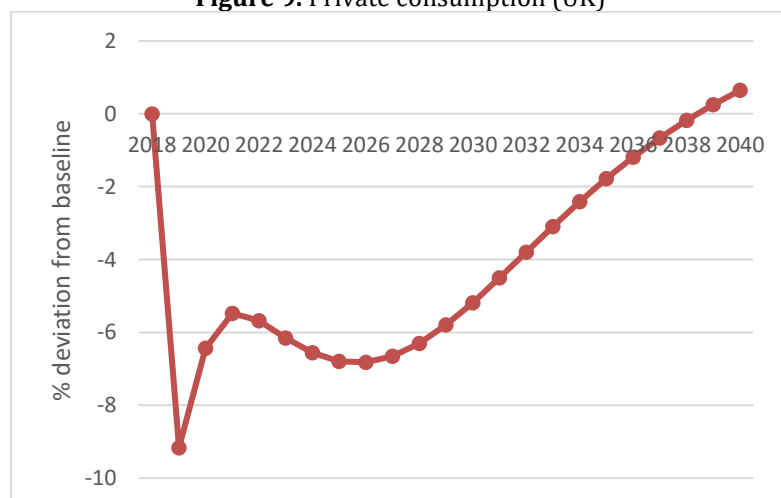
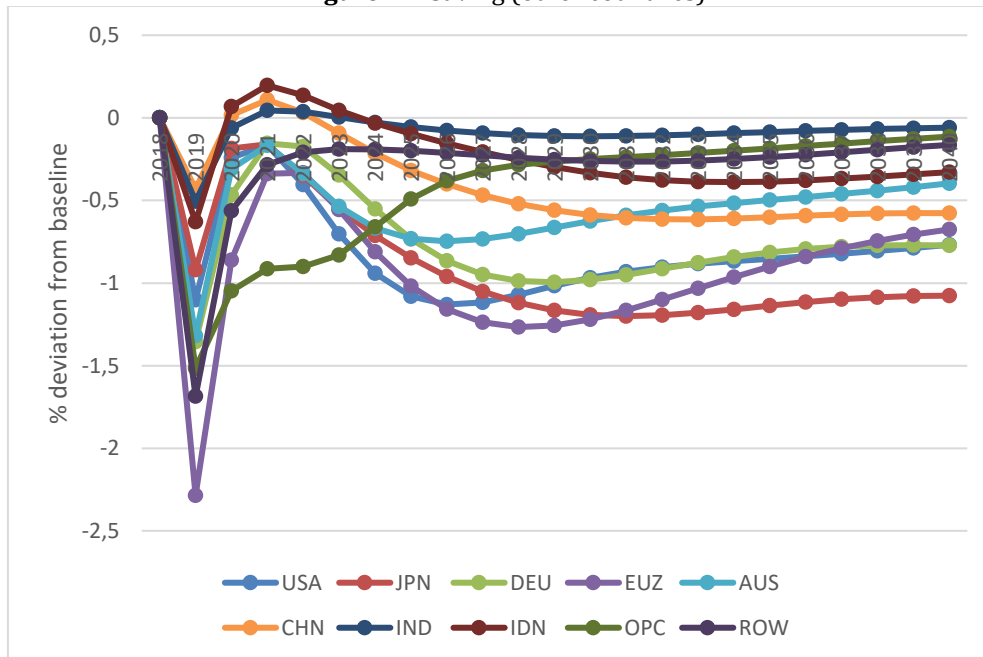**Figure 10**. Private consumption (other countries)
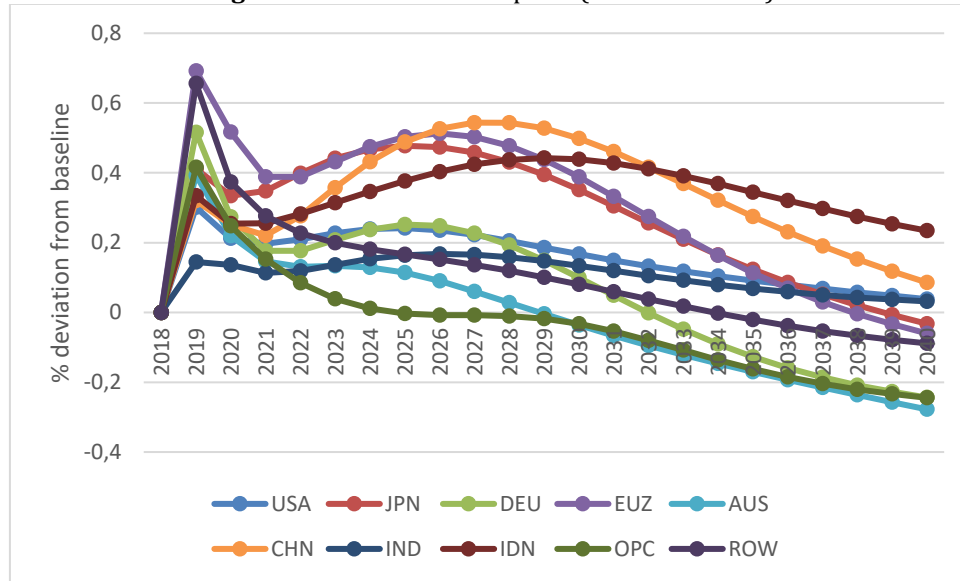
Source: data processed (2022)

In contrast with private consumption, the UK's savings increased due to the consumption fall, as seen in Figure 11. Also, in other economies, saving decreases with the rise of private consumption (Figure 12).

Figure 11. Saving (UK)

Source: data processed (2022)

Figure 12. Saving (other countries)

Figure 13 illustrates the dramatic short- to medium-term decline in private investments in the UK. In the short run, the private investment decrease to about 55%. A lower steady-state level of investment is required to sustain the UK's capital stock as a result of the persistently increased risk. A persistently reduced real GDP growth clearly manifests the permanently smaller capital stock (Figure 14).

Figure 13. Private investment (UK)
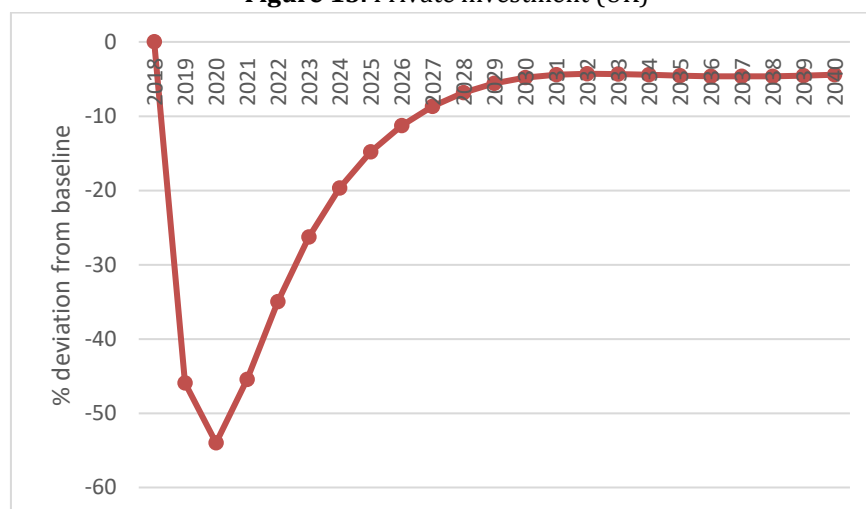
Figure 14. Real GDP (UK)
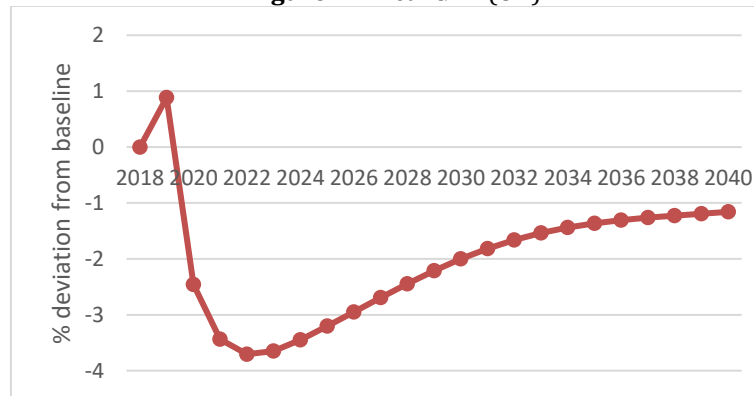
It seems to sense that real GDP will decline. The cost of capital rises as a result of capital outflow, and private investment declines in the UK. A reduced aggregate demand results from households beginning to spend less in anticipation of a worse scenario in the future. Additionally, the marginal product of labour declines due to a decreased capital stock brought on by capital outflow. As a result, weaker consumption and investment restrain GDP growth.

Conversely, real GDP rises and sustains above the base level over the long run in non-shocked economies. The cost of capital falls, and private investment grows in other economies as money from the UK relocates to other nations (Figure 15). As seen in Figure 15, the greatest change in investment is experienced by the oil-exporting and middle-east countries. Additionally, the income impact raises aggregate demand, and higher investment and consumption lead to higher GDP (Figure 16).

**Figure 15.** Private investment (other countries)
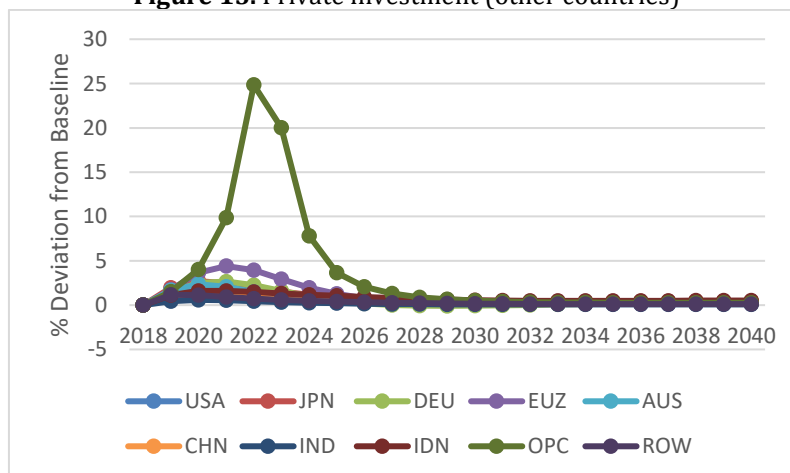
Figure 16. Real GDP (other countries)
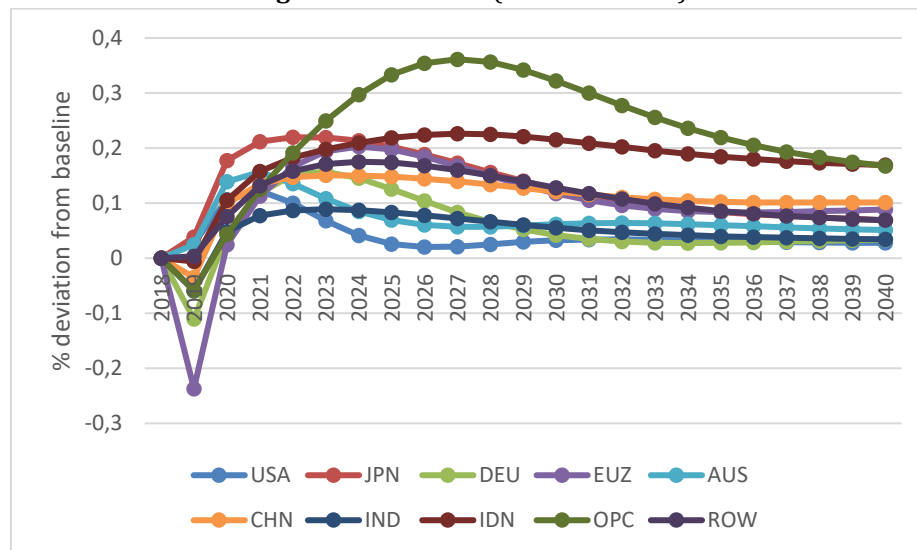
While UK currency depreciation increases the competitiveness of exportable commodities, it also raises the price of imports. Over the next two decades, the trade balance will improve as a result (Figure 17). In contrast, the non-shocked economies have a worsening trade balance as imports become more affordable and exports more expensive (Figure 18). The UK's real GDP shrinks less than its investment and consumption do. The beneficial trade impacts partly outweigh the detrimental financial spillover effects.

Figure 17. Trade balance (UK)
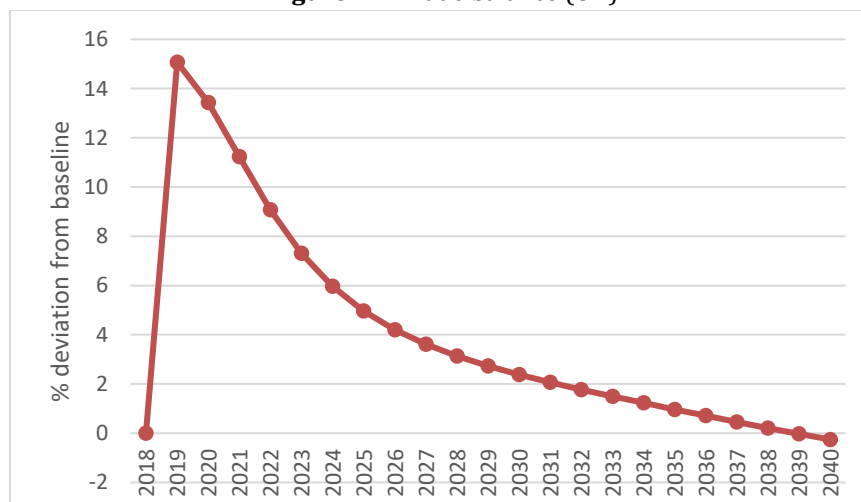
Figure 17. Trade balance (other countries)
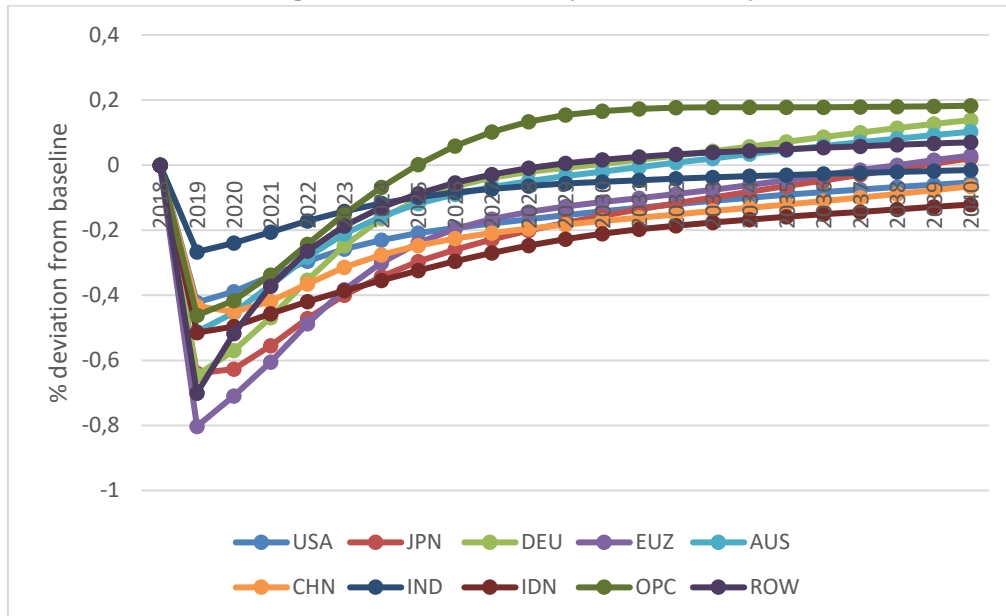
Source: data processed (2022)

The UK is anticipated to experience increased inflation as a result of the capital exodus (Figure 19). Domestic goods prices ought to be declining, given that the economy is shrinking. However, the decline in the exchange rate causes a considerable increase in the price of imported commodities, which encourages economic inflation. However, since the central bank complies with HMT rules, it implements a tightening policy to address the inflation increase. Thus, inflation is experienced just in the short term.


Figure 19. Inflation (UK)
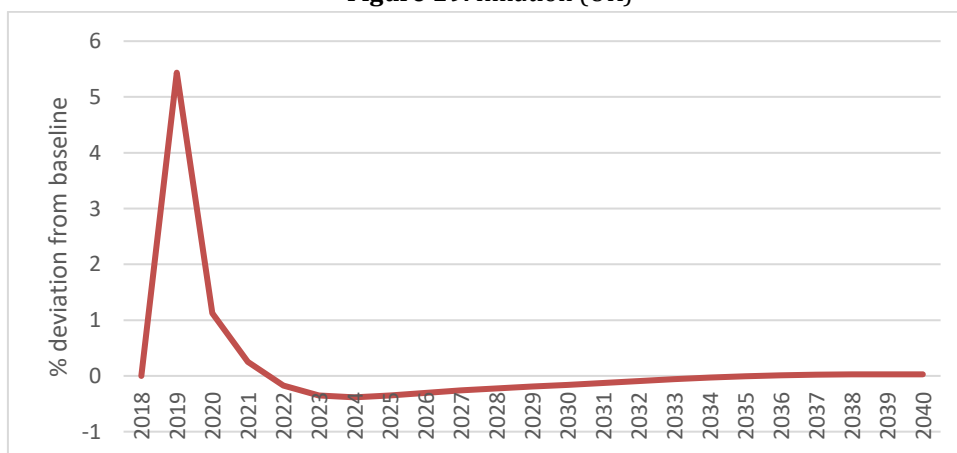
Source: data processed (2022)

Conversely, inflation declines in unshocked economies (Figure 20). Also, it is just experienced in the short term since the central bank of non-shocked countries also follows the HMT rule. As long as the central bank maintains its inflation objective, it always wins over inflation.

Figure 20. Inflation (other countries)
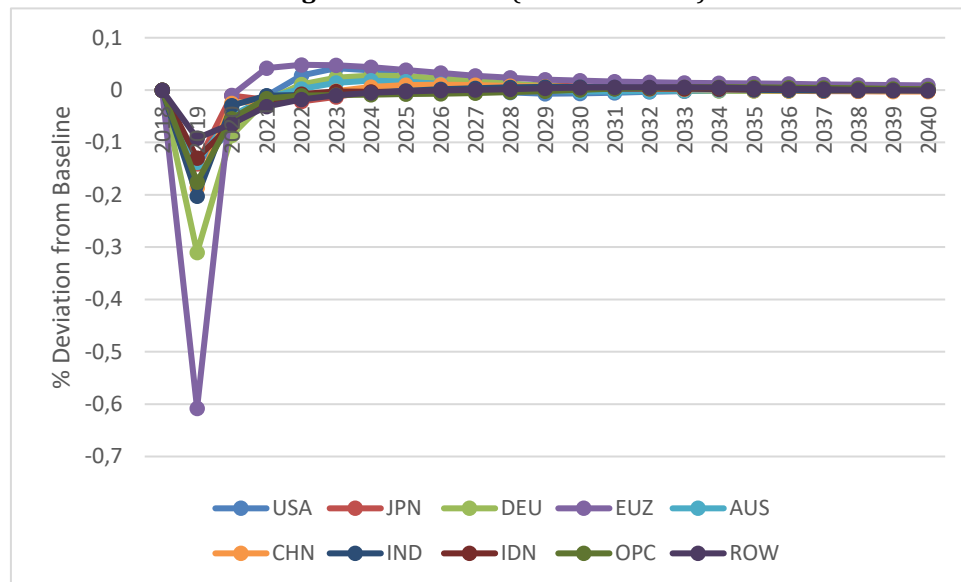
Source: data processed (2022)

Discussion

The tax cut has a detrimental impact on the UK economy. Because of the capital flight, the exchange rate falls because to an excess supply of UK currency in non-shocked nations. The presence of a smaller capital stock raises the marginal product of capital, causing the interest rate to rise.

Additionally, the UK's lack of confidence causes families to discount income at a larger rate. As a consequence, household consumption decreased while saving increased. The subsequent lack of confidence reduces private investment. On the plus side, the UK currency's devaluation raised net exports. Yet, because the fall in investment and consumption surpasses the gain in net exports, real GDP likewise declines in the long run. Lastly, capital outflows and currency devaluation have made imported commodities more expensive, resulting in inflation, particularly in the near term.

Non-shocked nations, on the other hand, gain from the shock in the UK induced by capital inflows from the UK. This infusion of capital enhanced investment, capital stock, consumption, and, as a result, real GDP. Likewise, in the near run, the non-shocked economies incur deflation. The results of this study are in line

with the results of previous studies where tax cuts can adversely affect the economy as explained by Ball and Mankiw (1995).

CONCLUSION

This study aims to look at the impact of the loss of confidence caused by the tax cuts in the UK on the UK and global economy. Using the G-Cubed model and simulating a risk premium shock of 5% in the UK, the tax cut has a negative impact on the UK economy. Due to the capital outflow, the exchange rate depreciates as a result of the excess supply of UK currency in non-shocked countries. The existence of a reduced capital stock results in an increase in the marginal product of capital and causes an increase in the interest rate.

Furthermore, the loss of confidence in the UK results in households discounting income at a higher rate. This resulted in a decrease in household consumption and an increase in saving. Then, the loss of confidence also causes private investment to decline. On the bright side, the depreciation of the UK currency increased net exports. However, because the decline in investment and consumption outweighs the increase in net exports, real GDP also declines in the long run. Finally, capital outflows and depreciation have made imported goods expensive, which has resulted in inflation, especially in the short term.

On the other hand, non-shocked countries benefit from the shock in the UK caused by capital inflows from the UK. This capital inflow increased investment, capital stock, consumption, and ultimately an increase in real GDP. Also, in the short run, the non-shocked economies experience deflation.

In closing, the tax cut cannot positively impact the UK because it can cause a loss of confidence in the UK economy. Therefore, the UK government needs to cancel this policy to create a more sustainable budget, thereby restoring investor confidence in the UK economy.

Based on this result, the government in a country needs to be careful if they want to carry out pro-growth policies such as increasing debt or reducing taxes, because if they do not pay attention to fiscal sustainability, then events like what happened in the UK can attack other countries if investor confidence is not maintained.

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