



# **Steering the British Economy**

Howard Davies  
Director, LSE

Orientation 2010

Old Theatre, 6 October 2010

# My credentials



- 1976 – 82**      **HM Treasury official**
- 1984 – 85**      **Special Adviser to Nigel Lawson,  
Chancellor of the Exchequer**
- 1992 – 95**      **Director General, CBI**
- 1995 – 97**      **Deputy Governor, Bank of England  
(Monetary Policy Committee 1997)**
- 1997 – 2003**   **Chairman, Financial Services Authority**





# The 1997 Reforms

- Bank of England granted independence to set interest rates, but with the target set by government
- Monetary Policy Committee set up with 9 members, 4 of them 'external'
- Banking supervision moved to the Financial Services Authority

# **The Bank exists to ensure monetary stability and to contribute to financial stability**



## **Core Purpose 1: Monetary Stability**

The Monetary Policy Committee sets monetary policy by deciding the short-term level of interest rates to meet the Government's stated inflation target - currently 2%

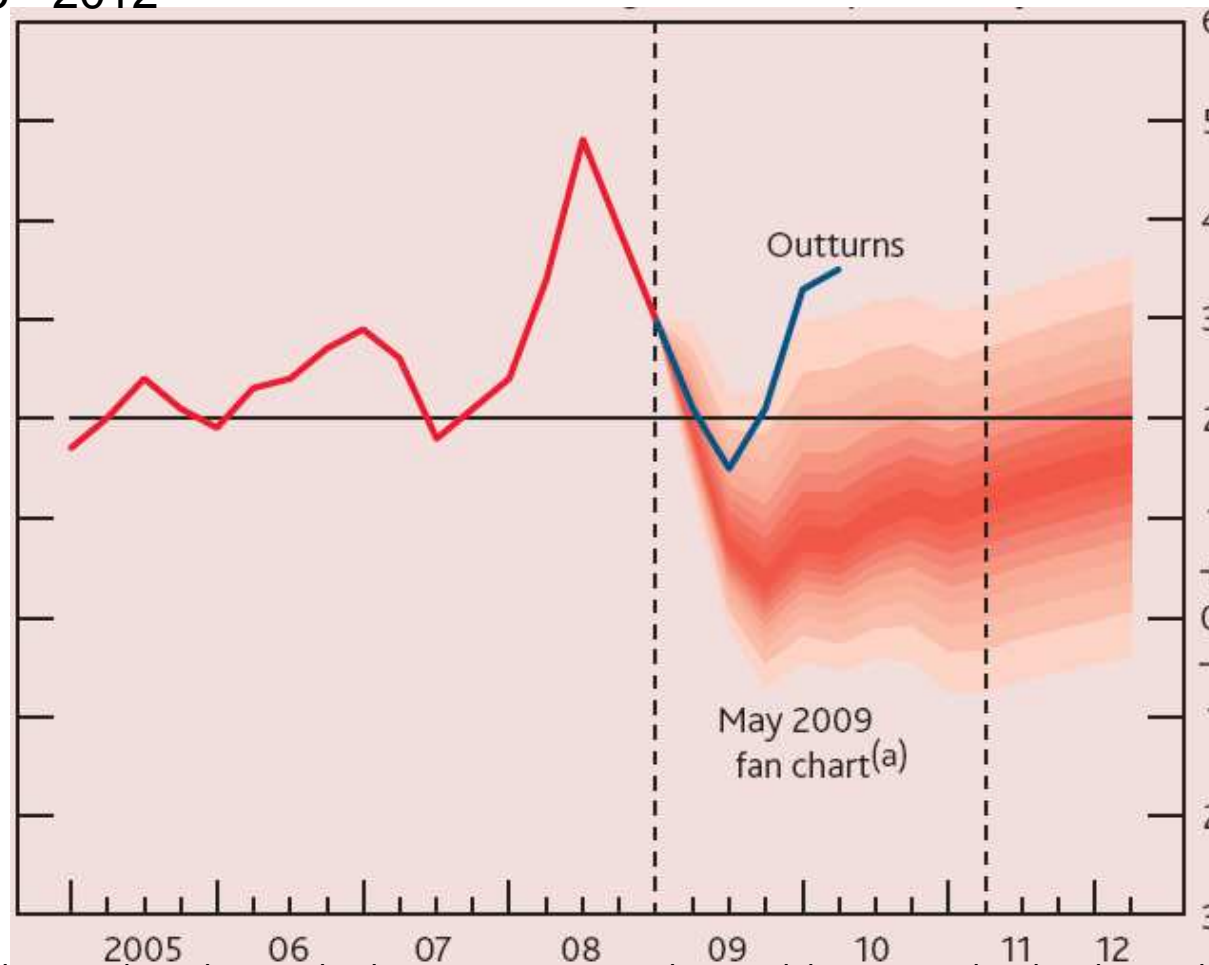
## **Core Purpose 2: Financial Stability**

The Bank has played a key role in maintaining the stability of the UK's financial system for 300 years and it is now a core function of most central banks. The Bank detects threats to the financial system as a whole through its surveillance and market intelligence functions and reduces them by strengthening infrastructure, and by financial and other operations.

# During the crisis, inflation has been above the target range for some time



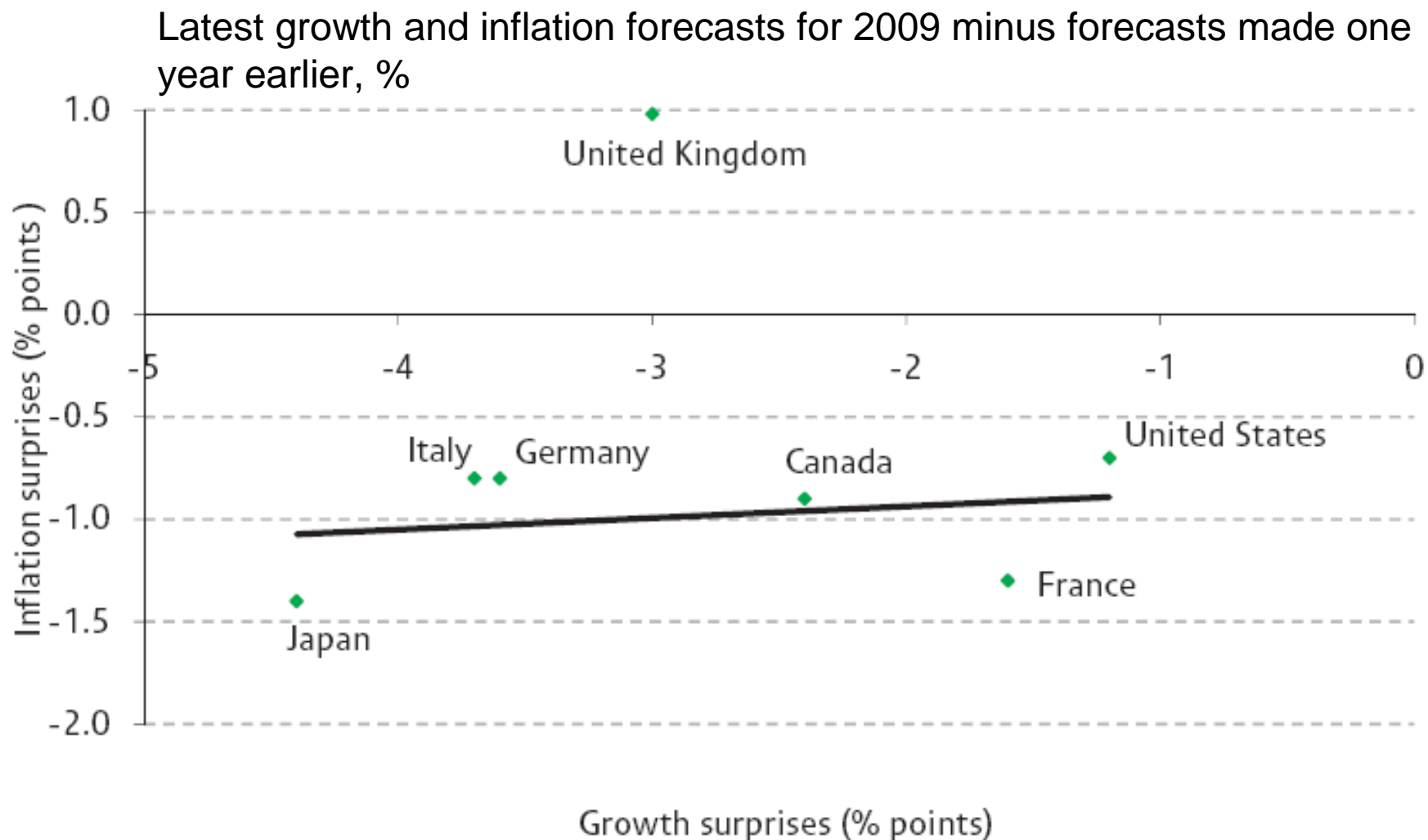
CPI inflation projection\*, percentage increases in prices on a year earlier, 2005 - 2012



\*CPI inflation projections are based on market interest rate expectations and the assumption that the stock of purchased assets reached £125 billion and remained there throughout the forecast period.

Source: Bank of England Inflation Report, August 2010.

# Growth and inflation surprises in 2009



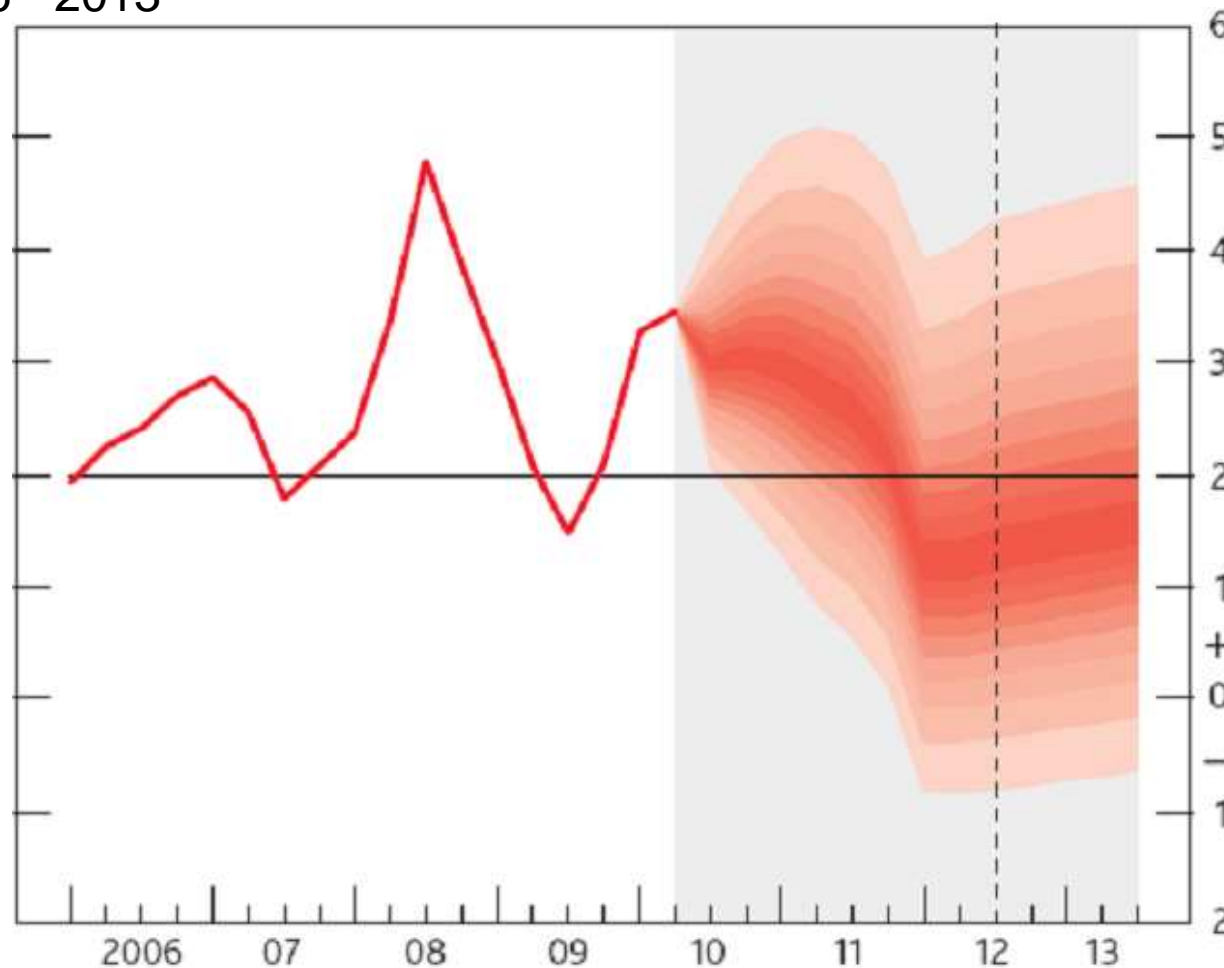
Note: Surprises are defined as latest forecasts for 2009 (taken from *Consensus Forecasts*, published by Consensus Economics Inc.) or actual out-turns, if available, minus forecasts made a year earlier.

Source: The IFS Green Budget, February 2010.



# Inflation is forecast to come back within range next year

CPI inflation projection\*, percentage increases in prices on a year earlier, 2006 - 2013



\*CPI inflation projections are based on market interest rate expectations and £200 billion asset purchases.

Source: Bank of England Inflation Report, August 2010.

# 2010 Reforms



- Banking (and other) supervision to return to the Bank of England
- Financial Policy Committee established
- Office of Budget Responsibility established



# Objectives of OBR



- Independent assessments of the public finances and the economy
  - Direct control over the forecast and all the key judgments that drive the official projections
  - Full access to the necessary data and analysis produced by the Treasury
- Presenting a range of outcomes around its forecasts to demonstrate the degree of uncertainty
  - In each Budget and Pre-Budget Report the OBR will confirm whether the Government's policy is consistent with a better than 50 per cent chance of achieving the forward looking fiscal mandate set by the Chancellor
- Independent assessment of the public sector balance sheet, including analysing the costs of ageing, public service pensions and Private Finance Initiative contracts

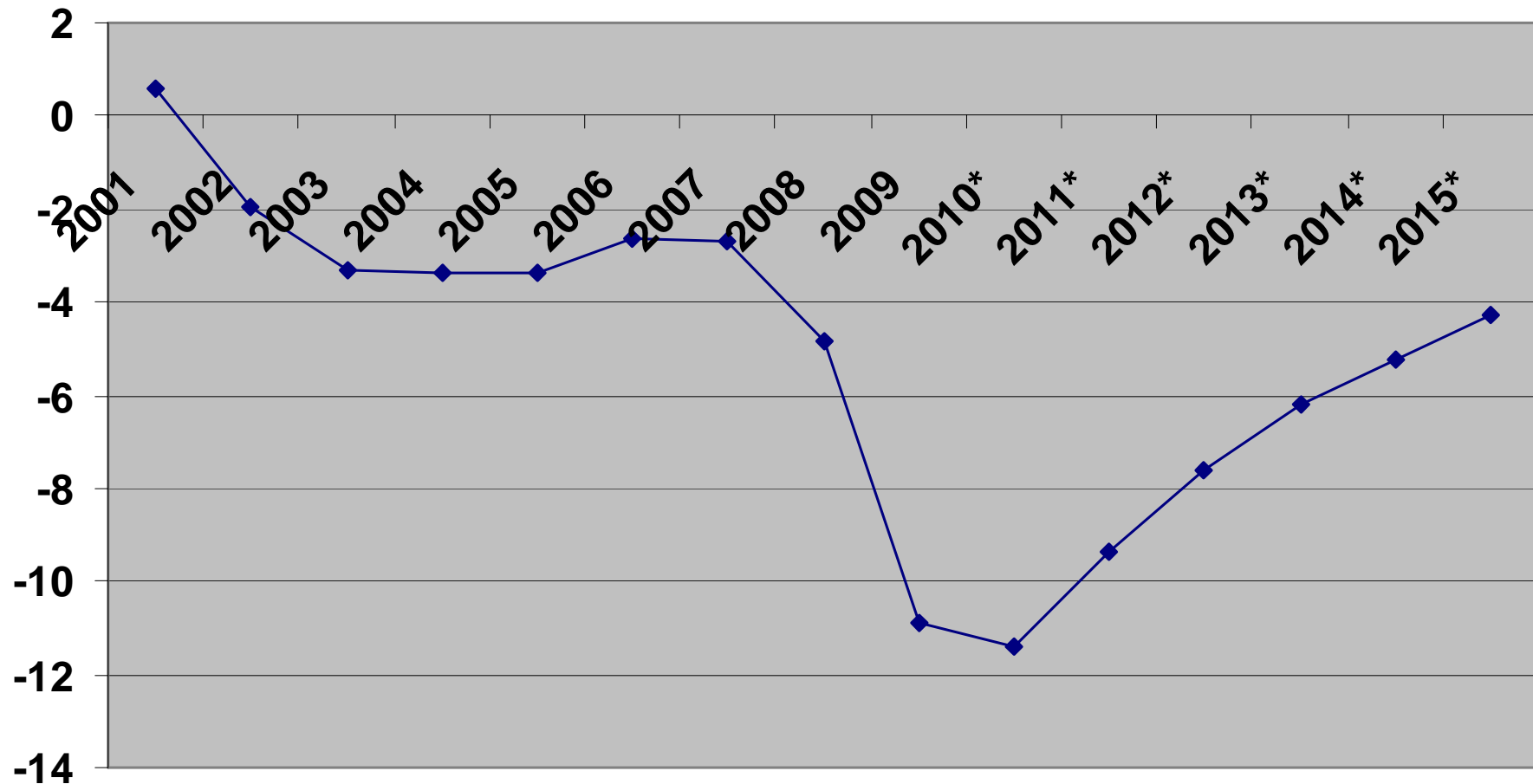




# The fiscal position deteriorated sharply in the crisis



General government net lending/borrowing, % of GDP, 2001 -15



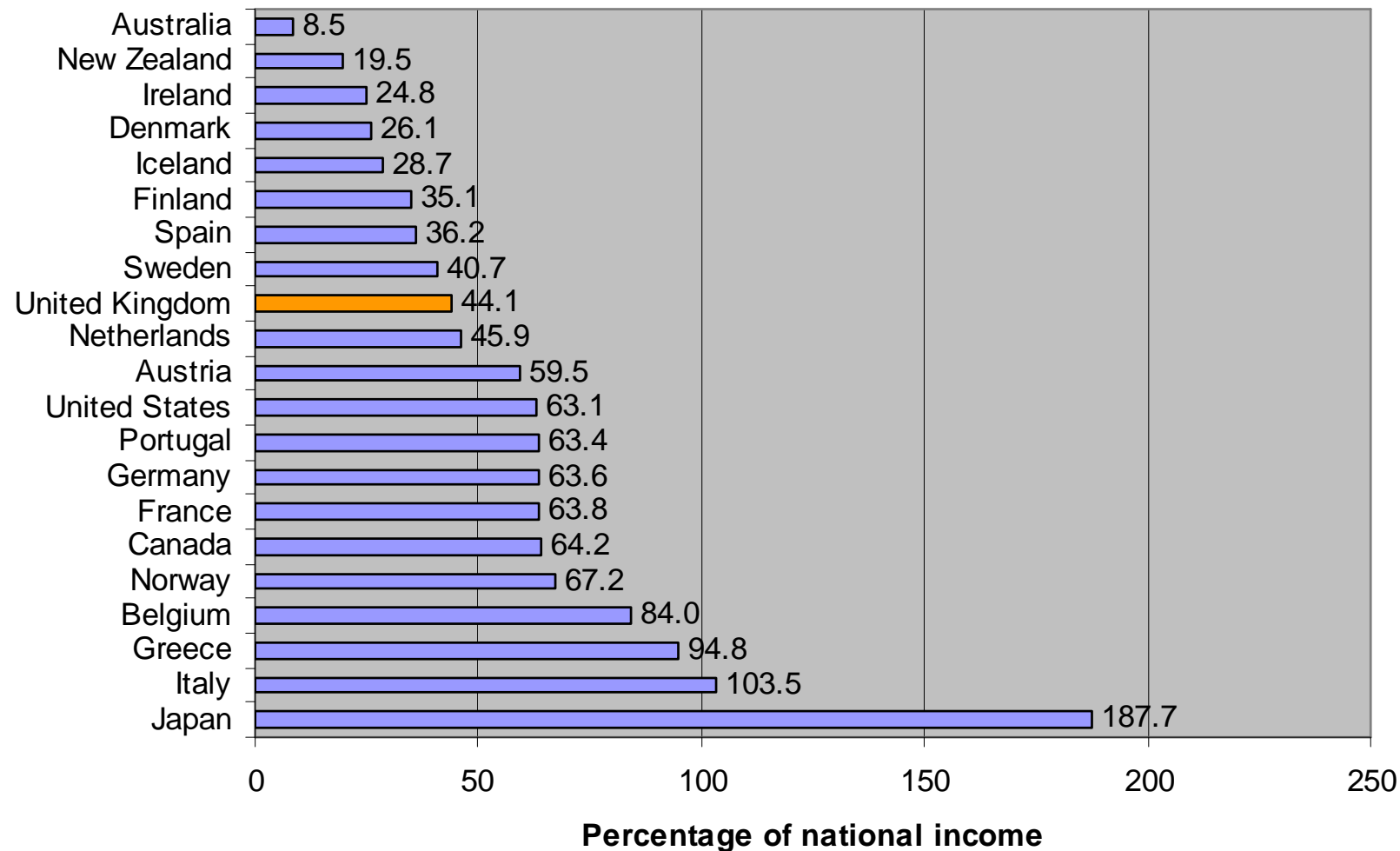
\*Forecast.

Source: IMF WEO, April 2010.

# At present, UK government debt is in the middle of the OECD pack



IMF estimates for general government debt among industrial countries, 2007



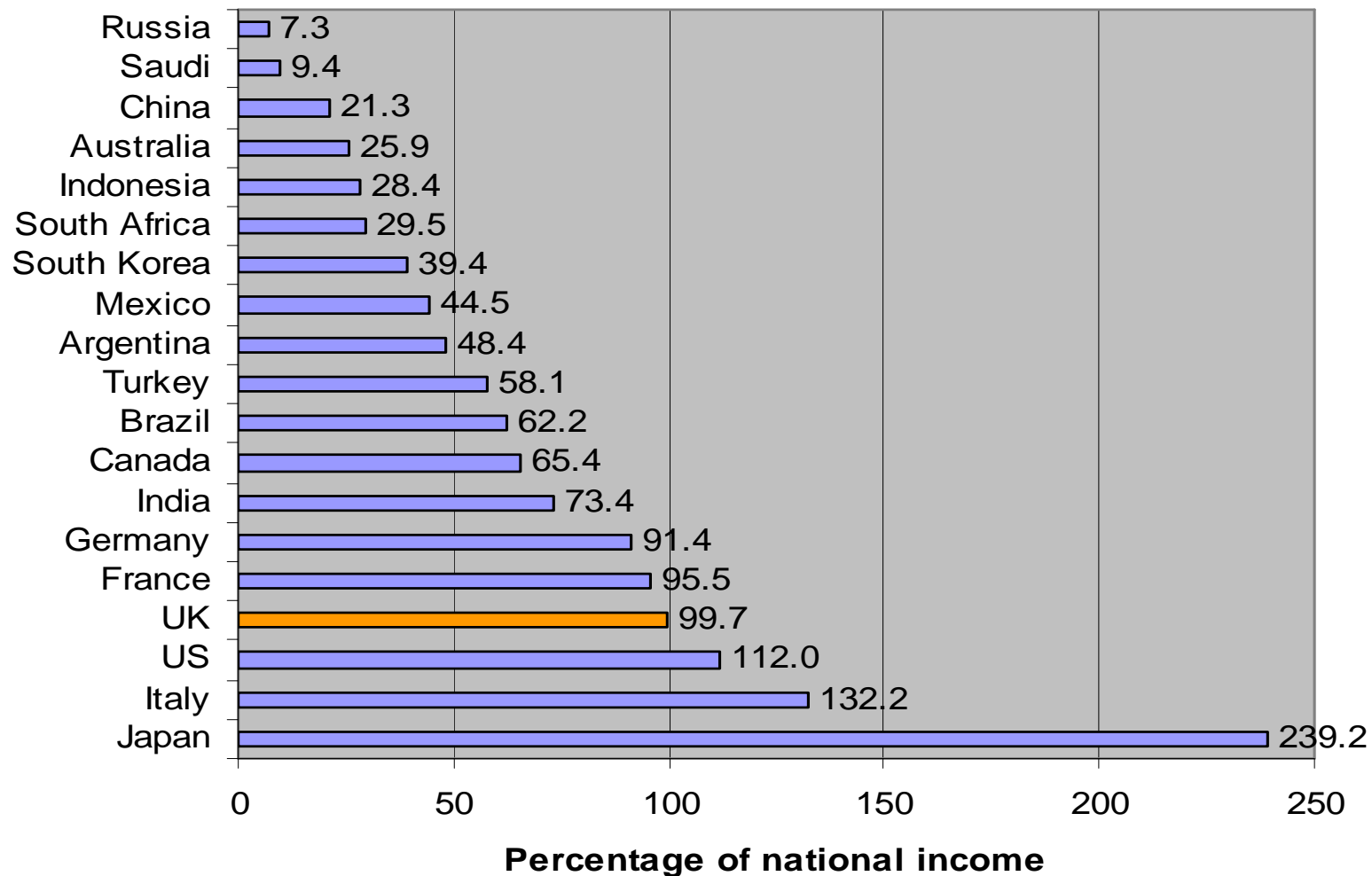
Source: Institute for Fiscal Studies, Britain's fiscal squeeze: the choices ahead.



# But by 2014 we will have broken into the 'Big 4'



IMF forecasts for general government debt among the G20, 2014 (July 2009)

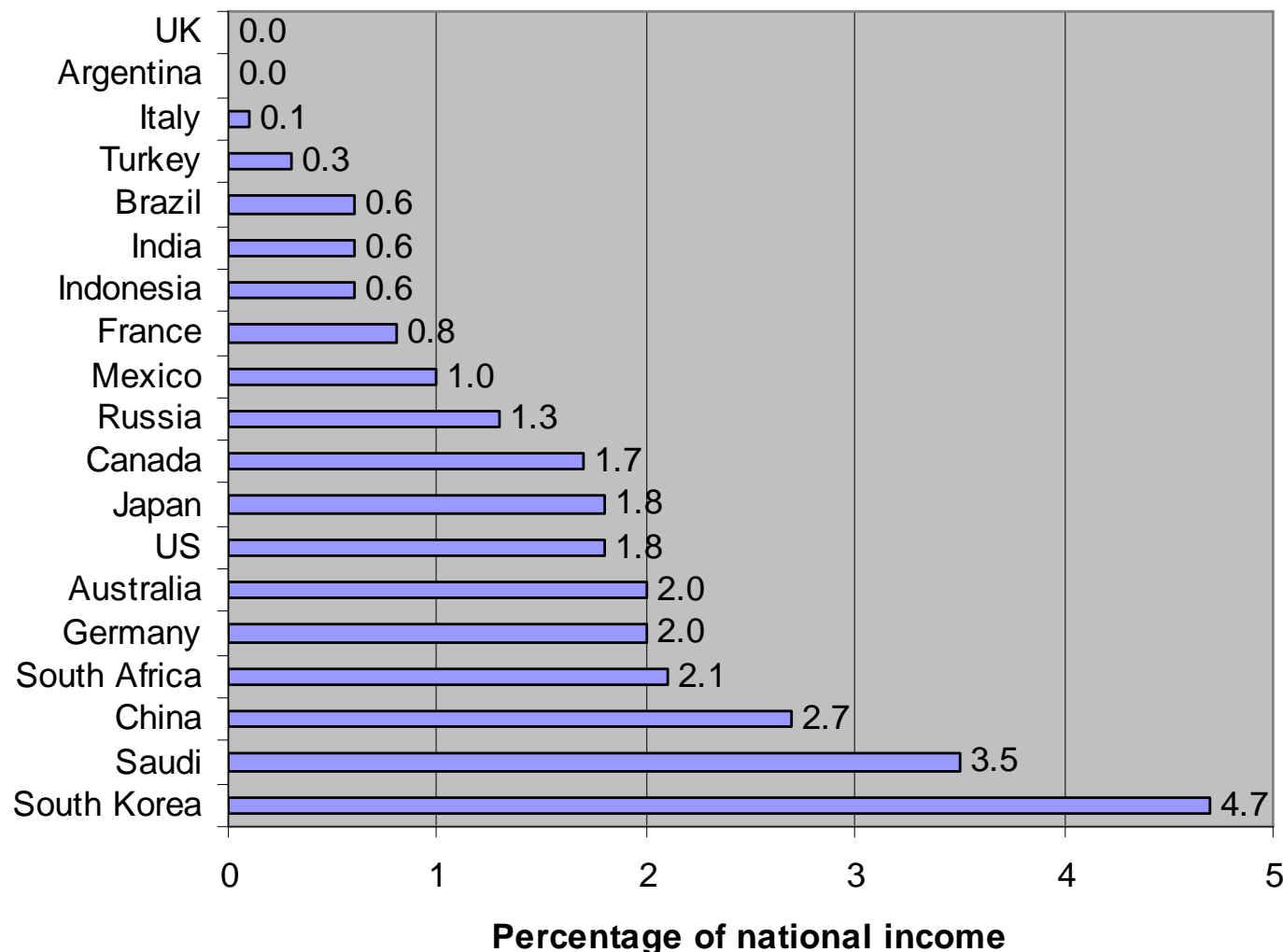


Source: Institute for Fiscal Studies, Britain's fiscal squeeze: the choices ahead.

# This year there will be no discretionary fiscal stimulus



Discretionary fiscal stimulus measures in 2010 (relative to 2007)

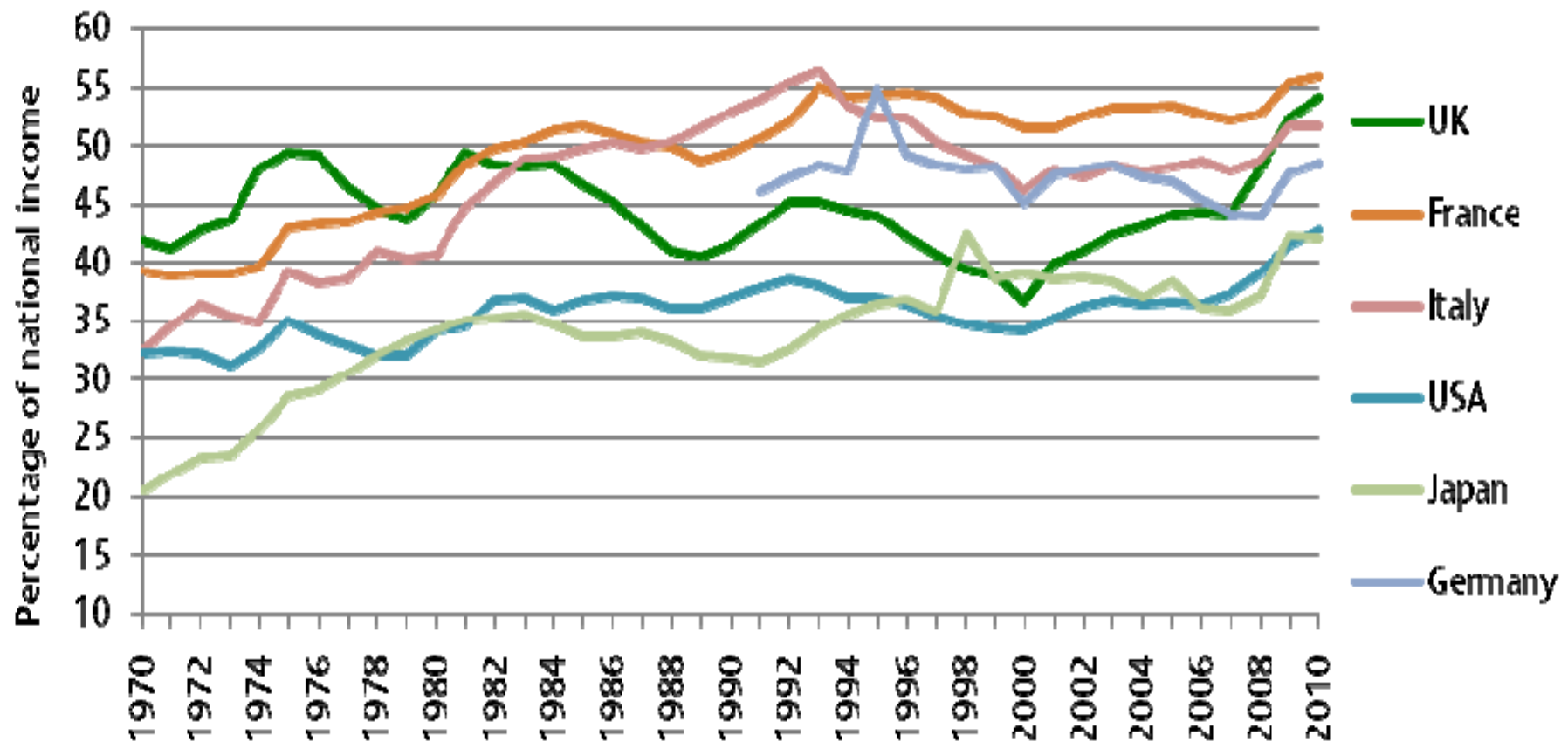


Source: Institute for Fiscal Studies, Britain's fiscal squeeze: the choices ahead.

# Losing control



Total public spending in selected countries, 1970-2009

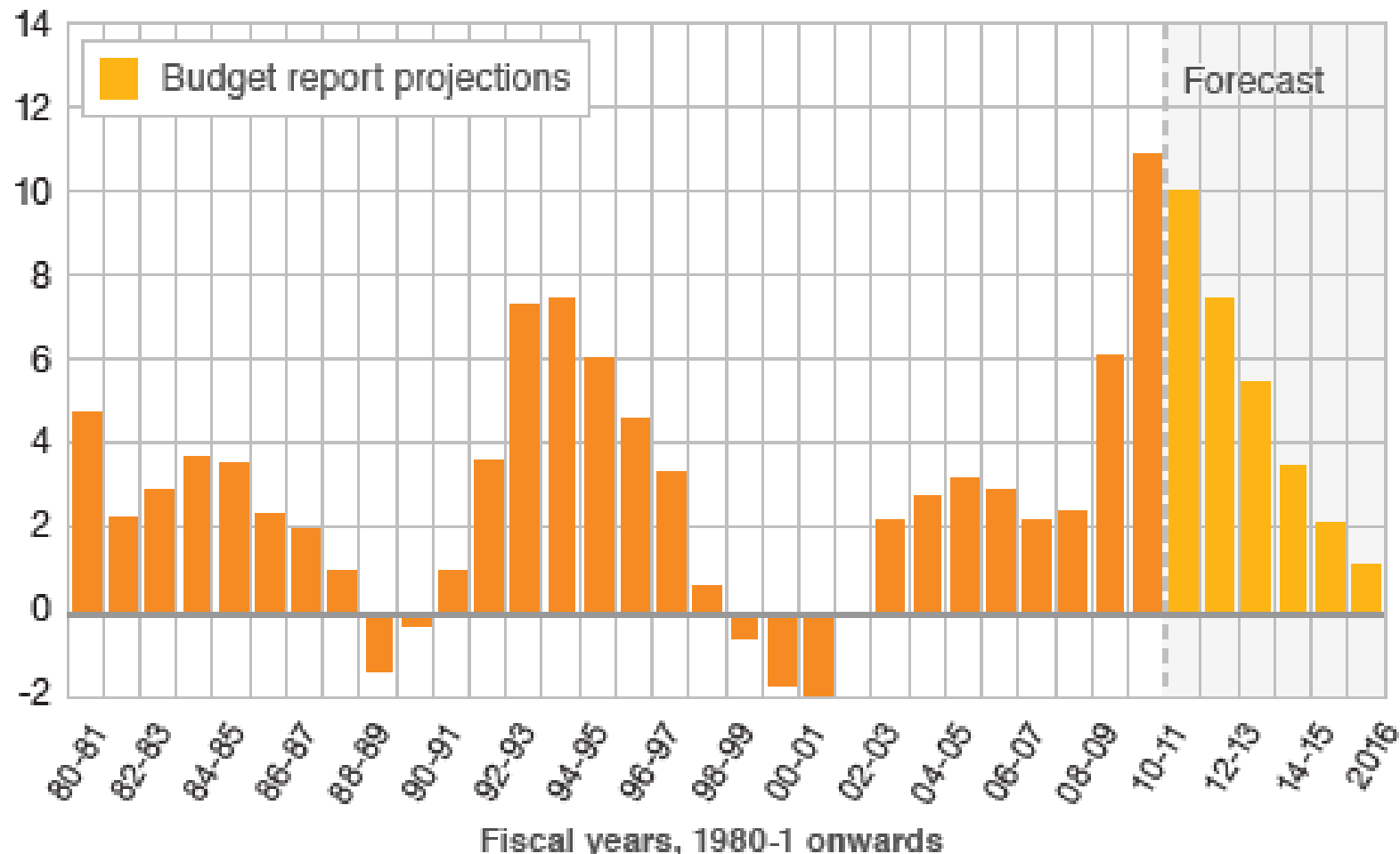


Source: Institute for Fiscal Studies, A Survey of Public Spending in the UK, IFS Briefing Note BN43.

# The Coalition plan to cut the deficit sharply



Net borrowing as % of GDP, 1980 – 2016

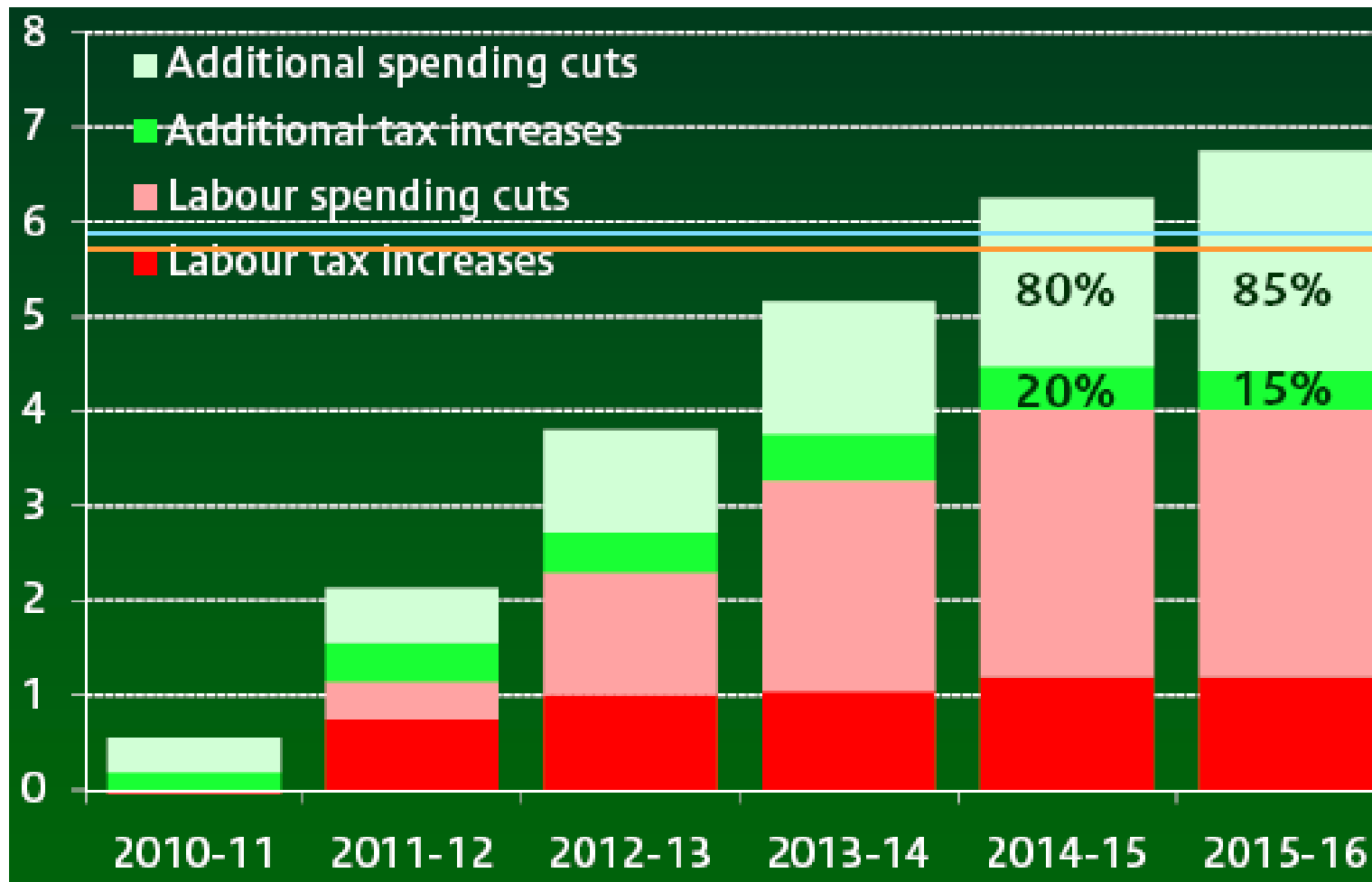


Source: OBR; IFS.

# The additional tightening comes mainly from spending cuts



Fiscal tightening as % of GDP, 2010 – 2016



Source: IFS.

# The double-dippers' case:



- There are already signs of a global slowdown
- Household deleveraging has a long way to go
- Government deficit cuts are being implemented too soon, and in places where they are not necessary
- Monetary policy is powerless as interest rates hit the zero bound

# The counter-arguments:



- Overall, global growth remains over 4%
- Household deleveraging has been rapid (at least in the US)
- Deficit cuts, if focused on public spending, can enhance confidence and not derail recovery
- Central banks still have options: quantitative easing and other related tools

# IMF Mission Statement: September 2010



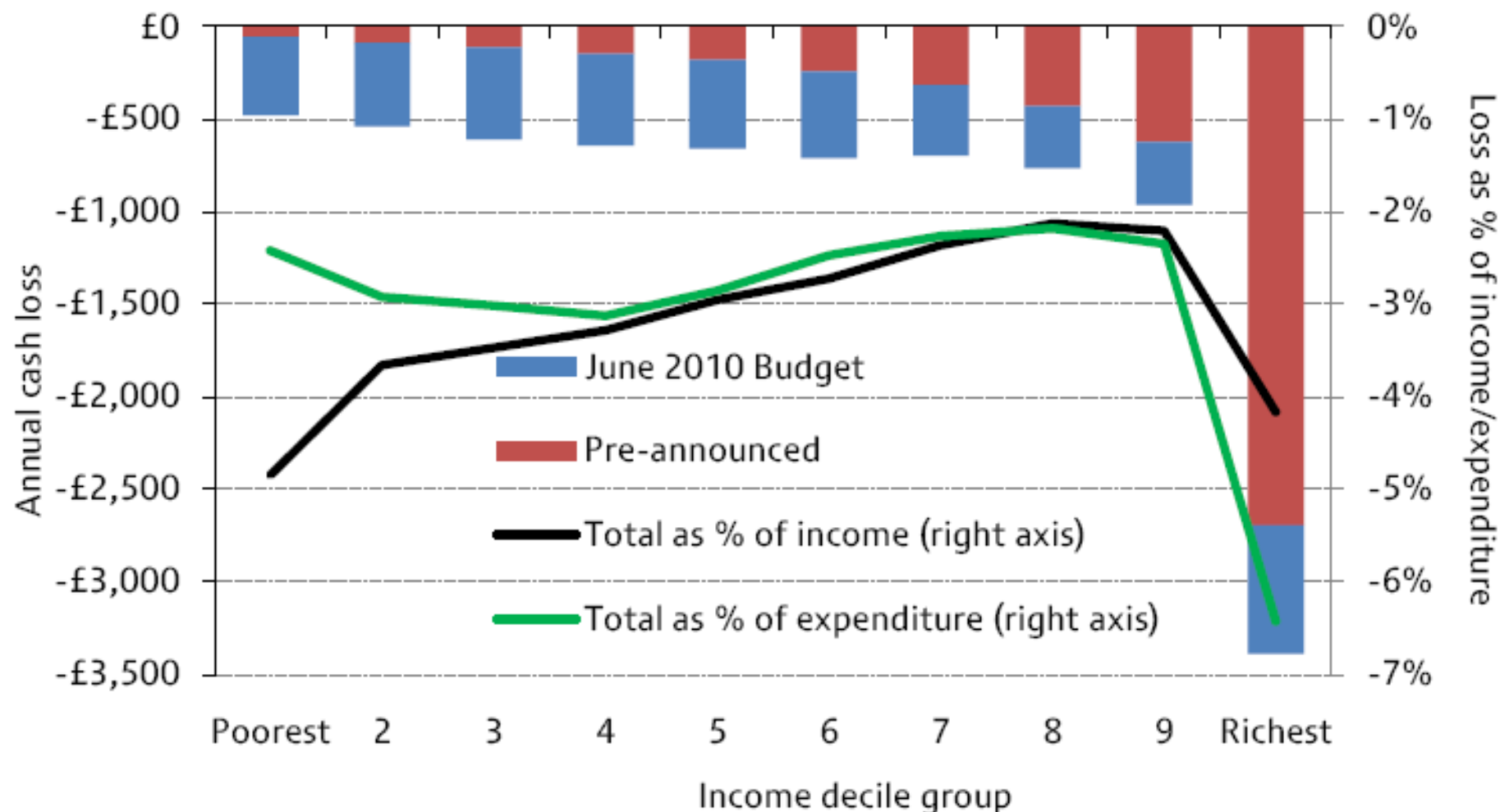
- “The UK economy is on the mend, but ... recovery will proceed at a moderate pace as the economy undergoes a difficult but necessary rebalancing
- CPI inflation should fall back to target by early 2012
- Upside and downside risks are balance
- The government’s strong deficit reduction plan will ensure fiscal sustainability”



# But the Coalition's cuts will not be progressive



The effect of all tax and benefit reforms to be introduced between now and April 2014 by household income decile group.



Source: IFS. New IFS research challenges: Chancellor's 'progressive Budget' claim. 25 August 2010.

# 'Star chamber' to cut spending

LSE

## Stellar performers

### Members of the public spending committee



**George Osborne**  
chancellor – chair

**William Hague**  
foreign secretary



**Oliver Letwin**  
cabinet office minister



**Danny Alexander**  
Treasury chief secretary – deputy

**Francis Maude**  
cabinet office minister



### Waiting in the wings



**Ken Clarke**  
justice secretary

**Caroline Spelman**  
environment secretary



**Jeremy Hunt**  
culture secretary

**Philip Hammond**  
transport secretary



**Today** Most ministers return to work after summer break, first meeting of spending 'star chamber' this week

**Sept 6-16** MPs return to Westminster for two-week Commons session: 'star chamber' steps up work. George Osborne hopes to start settling some departmental budgets

**Sept 18** Pause in negotiations: Lib Dem conference starts in Liverpool

**Sept 25** Opportunity for more Whitehall spending negotiations while spotlight is turned on Labour leadership election and conference in Manchester

**Oct 3** Informal spending talks with ministers likely during Tory conference in Birmingham

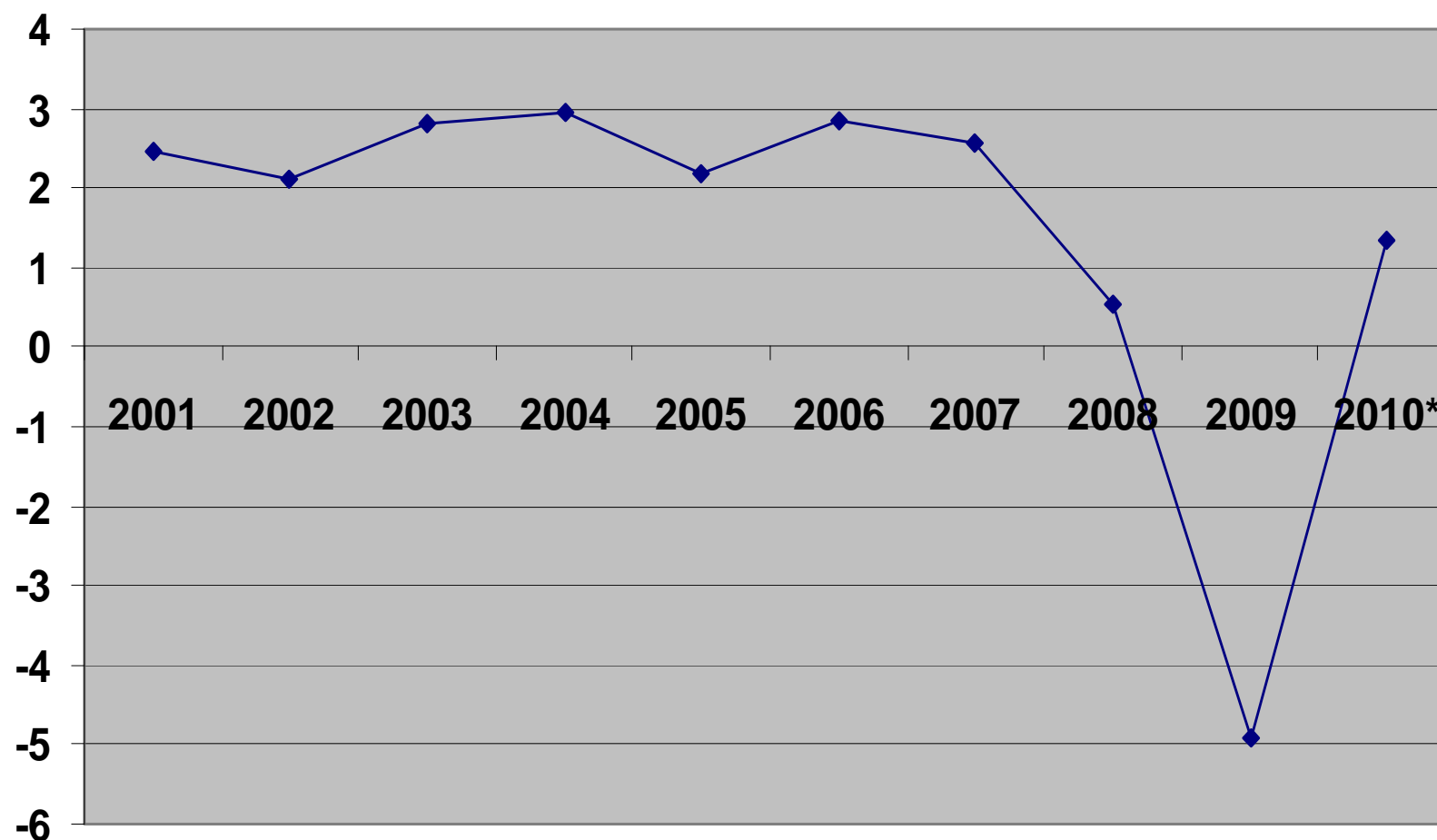
**Oct 7-19** Final negotiations: toughest settlements hammered out, including defence, welfare and education

**Oct 20** Osborne announces outcome of comprehensive spending review

# The peak to trough decline in GDP was around 6 percent



UK GDP growth, percent, 2001 - 2010



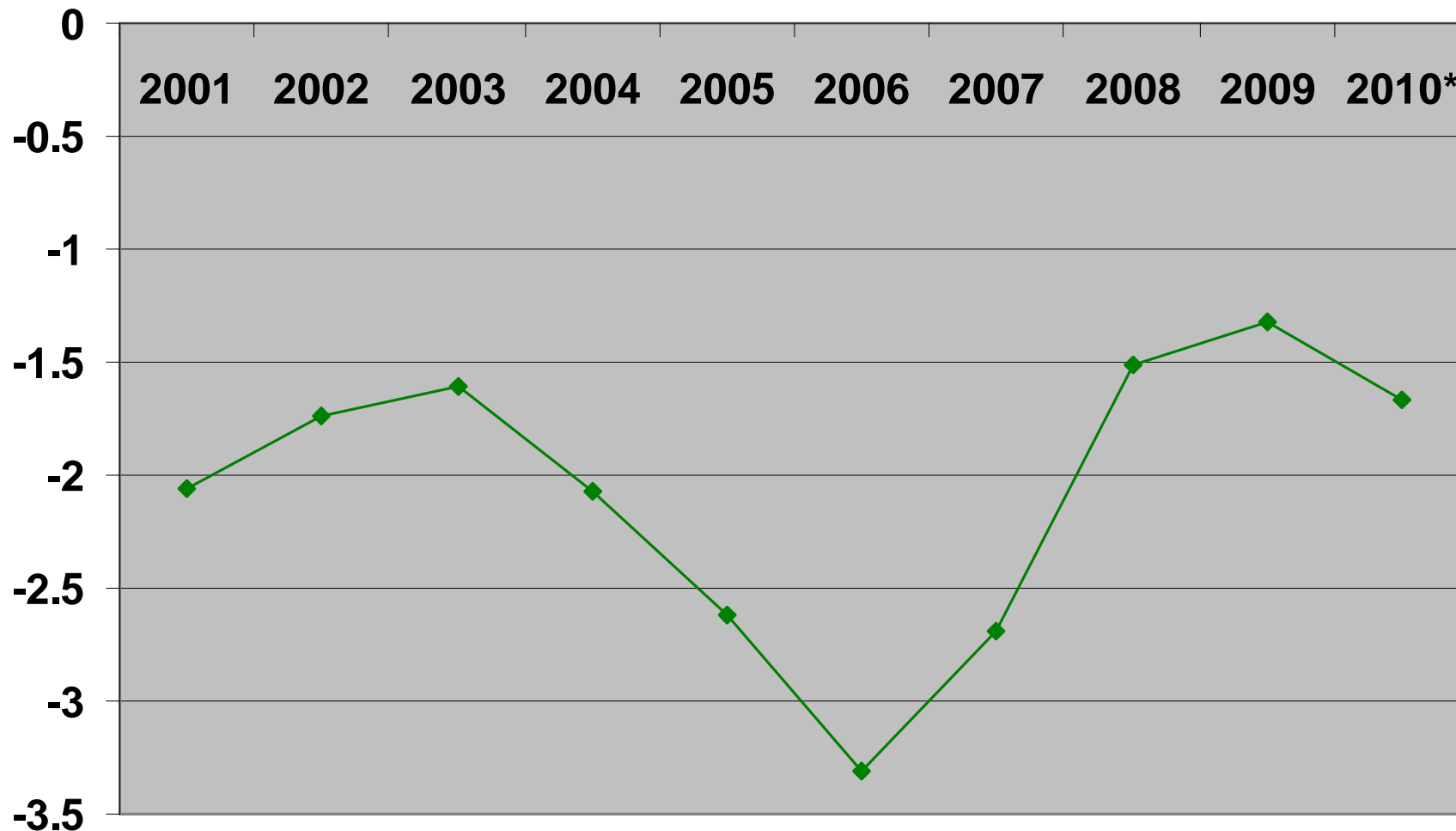
\*Forecast.

Source: IMF WEO, April 2010.

# The current account remains in deficit



UK current account balance, percent of GDP, 2001 - 2010



\*Forecast.

Source: IMF WEO, April 2010.

# In spite of the decline in sterling



Sterling exchange rates, last three years

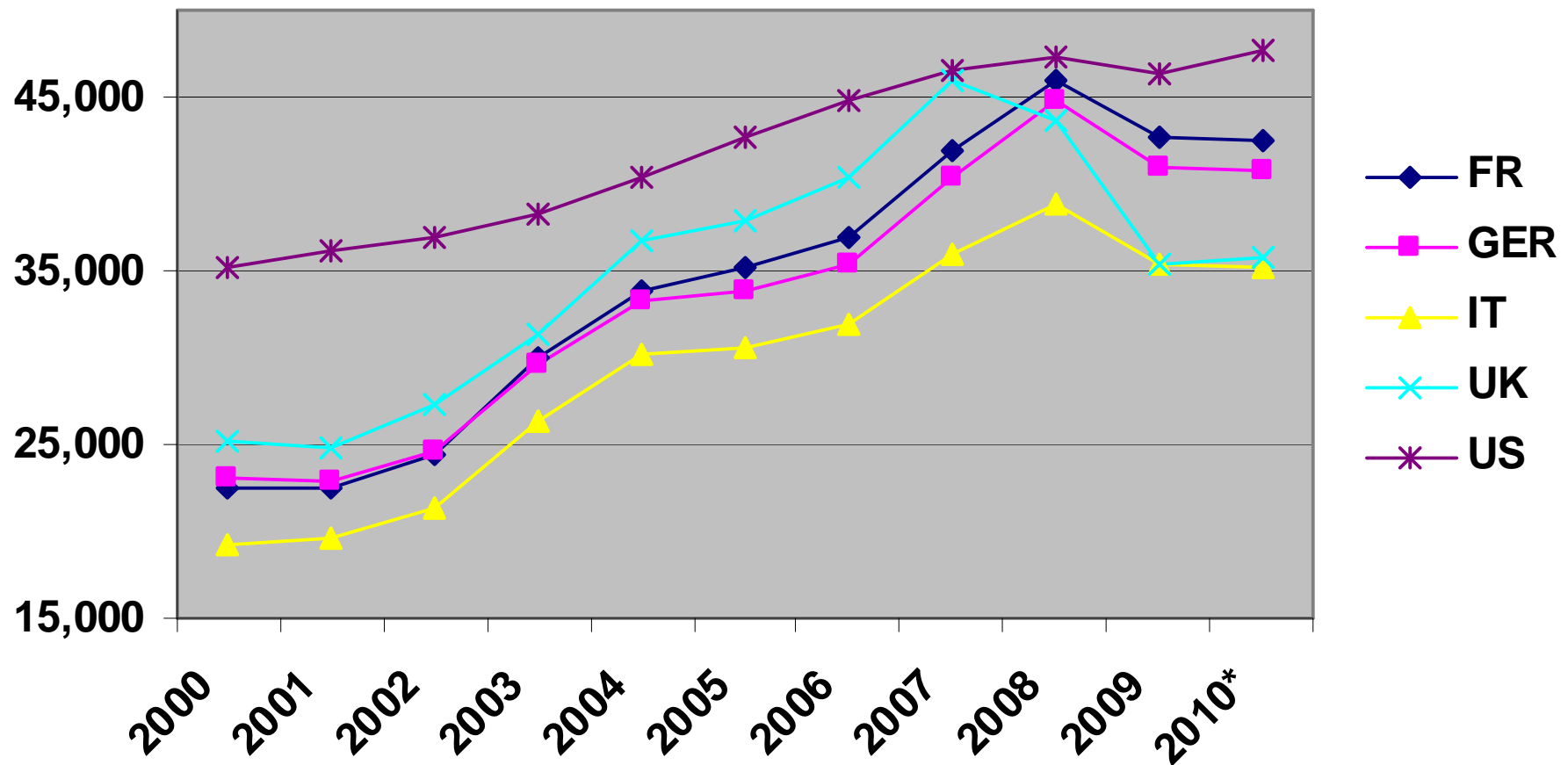


Source: Thomson Reuters, 4 October 2010.

# The UK's relative wealth is in decline



GDP per capita (current prices), USD, 2000 – 2010



\*Forecast.

Source: IMF WEO, April 2010.



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