Steering the British Economy

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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.

Growth and inflation surprises in 2009

Latest growth and inflation forecasts for 2009 minus forecasts made one year earlier, %

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.

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.

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

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

Source: FT.
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 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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