



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%

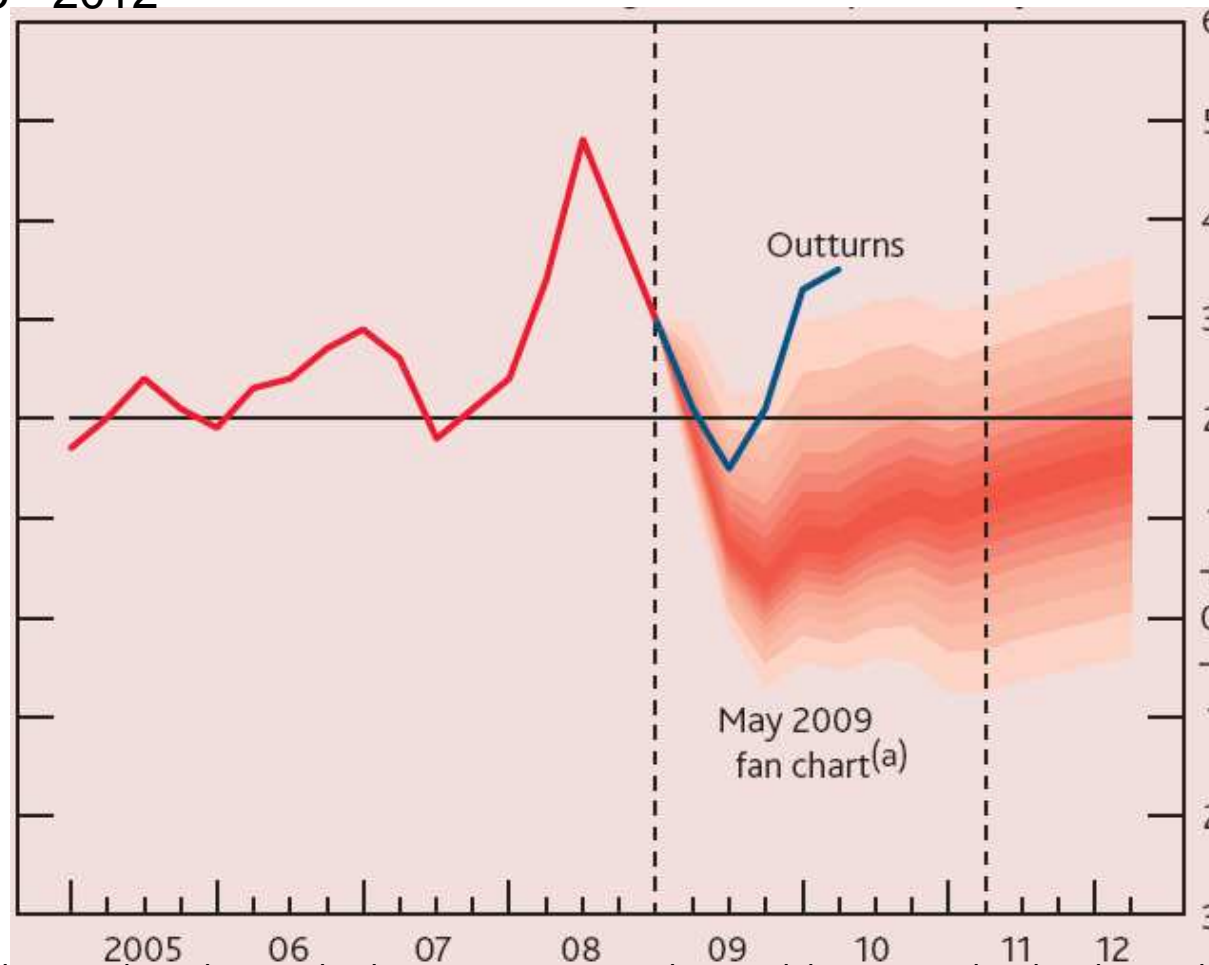
Core Purpose 2: Financial Stability

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



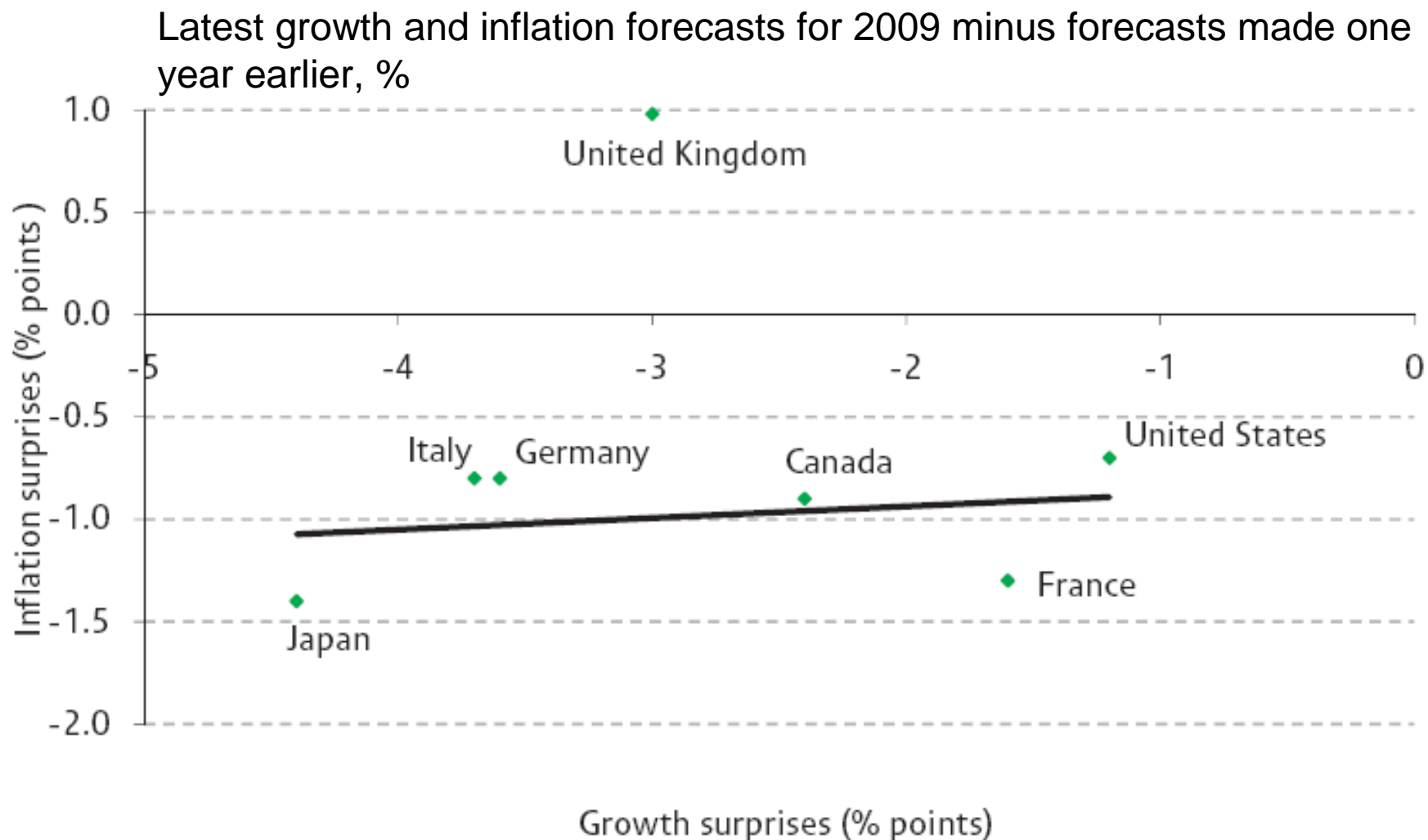
CPI inflation projection*, percentage increases in prices on a year earlier, 2005 - 2012



*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.

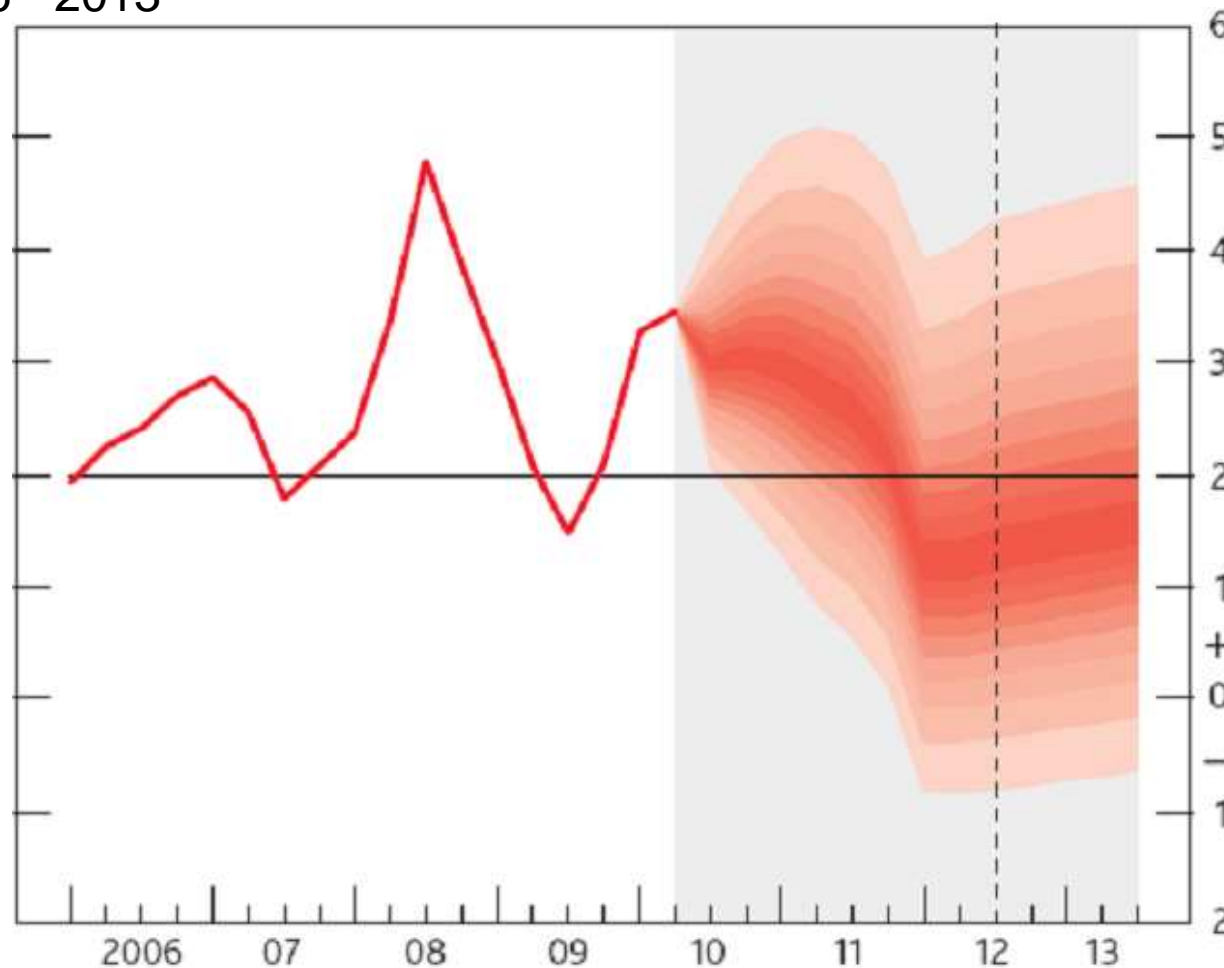
Growth and inflation surprises in 2009



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

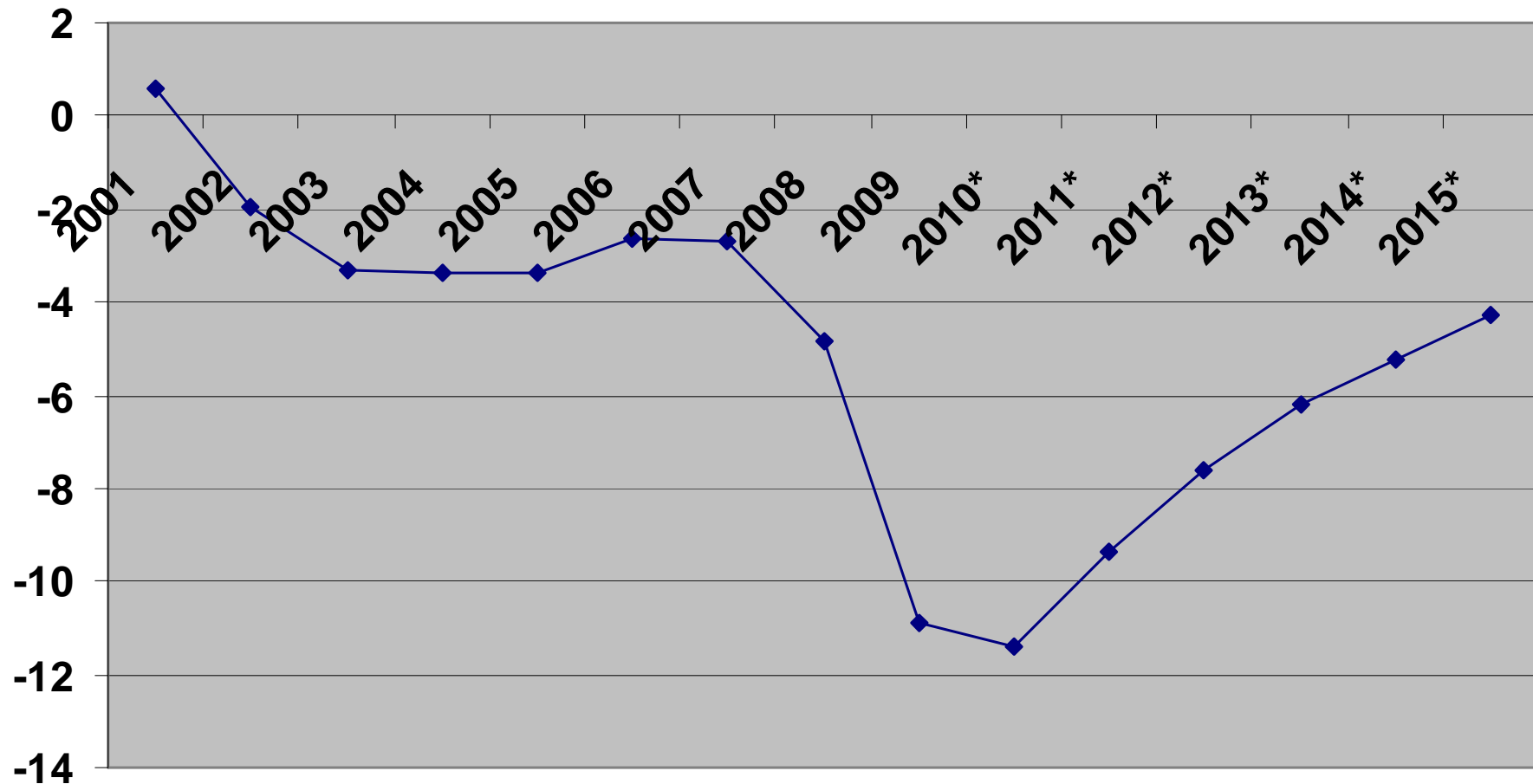




The fiscal position deteriorated sharply in the crisis



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



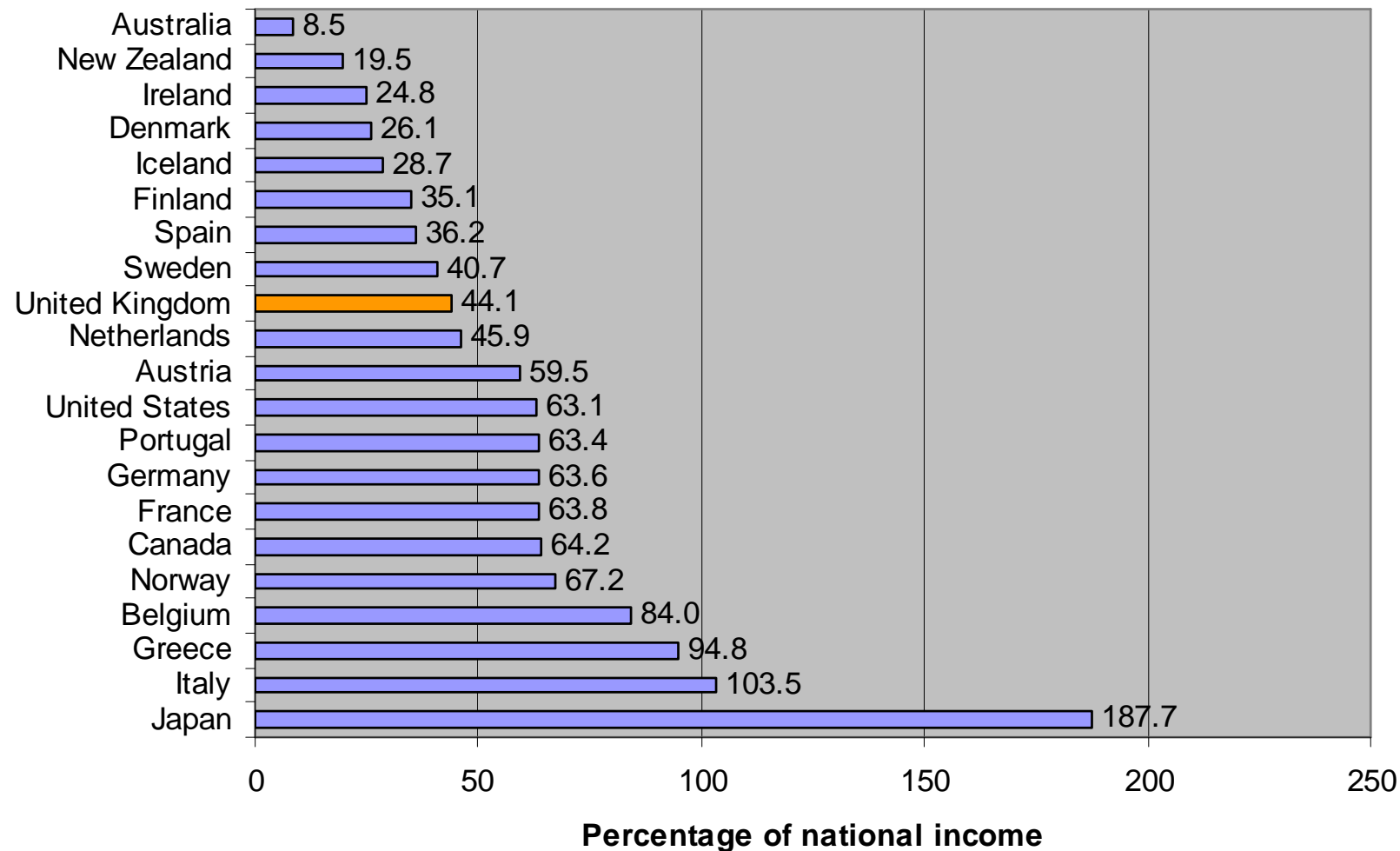
*Forecast.

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

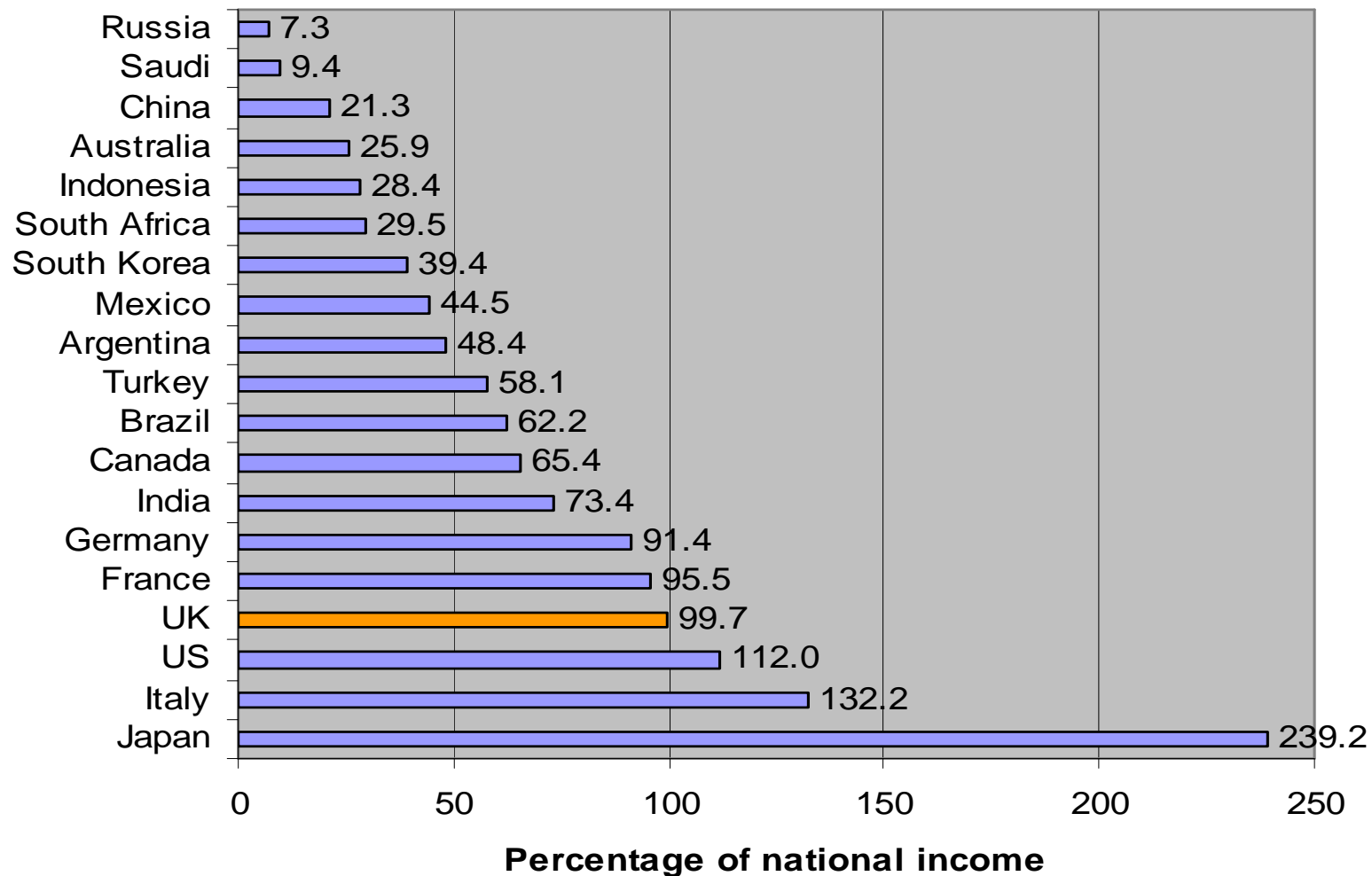


Source: Institute for Fiscal Studies, Britain's fiscal squeeze: the choices ahead.

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



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

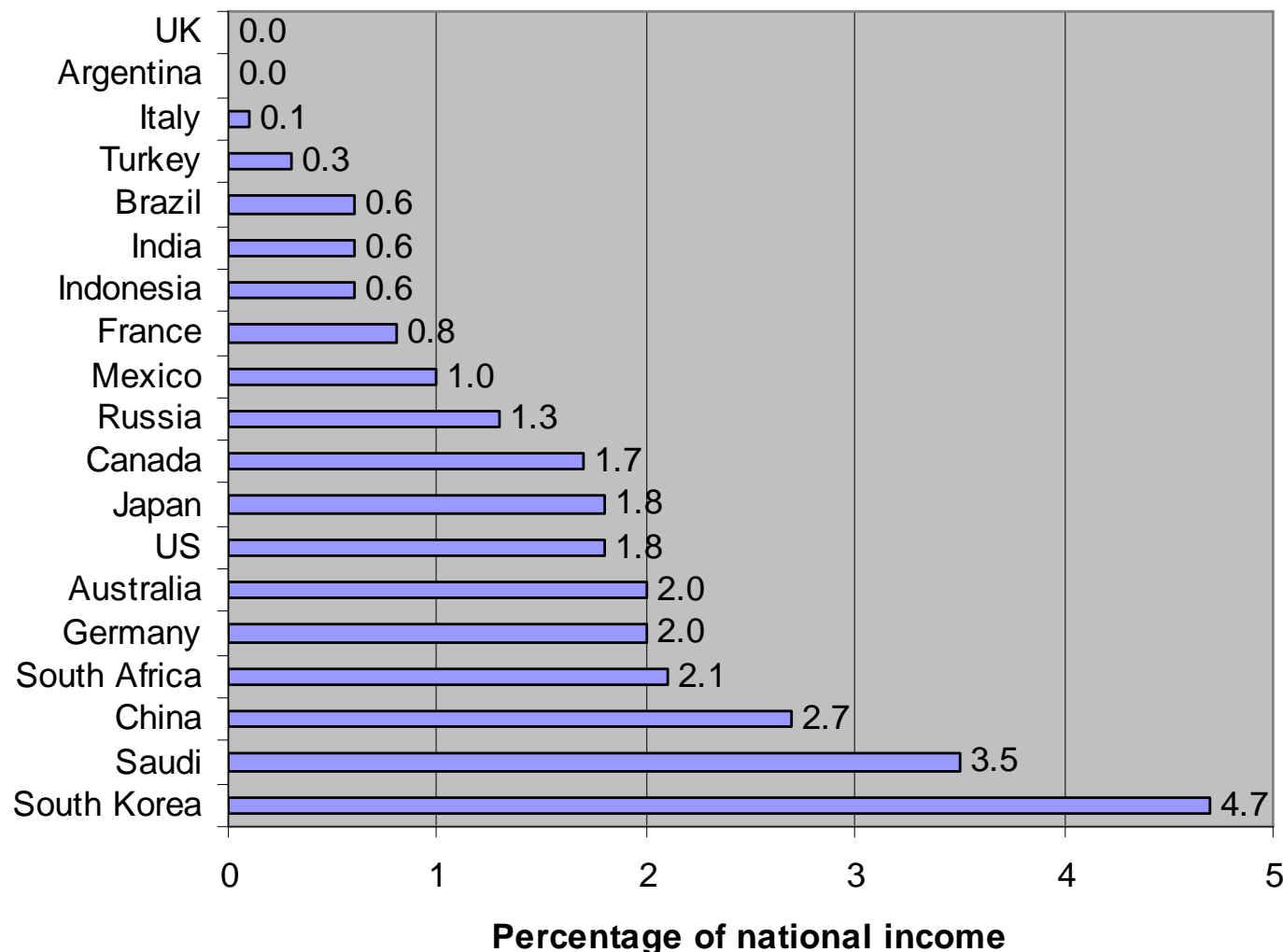


Source: Institute for Fiscal Studies, Britain's fiscal squeeze: the choices ahead.

This year there will be no discretionary fiscal stimulus



Discretionary fiscal stimulus measures in 2010 (relative to 2007)

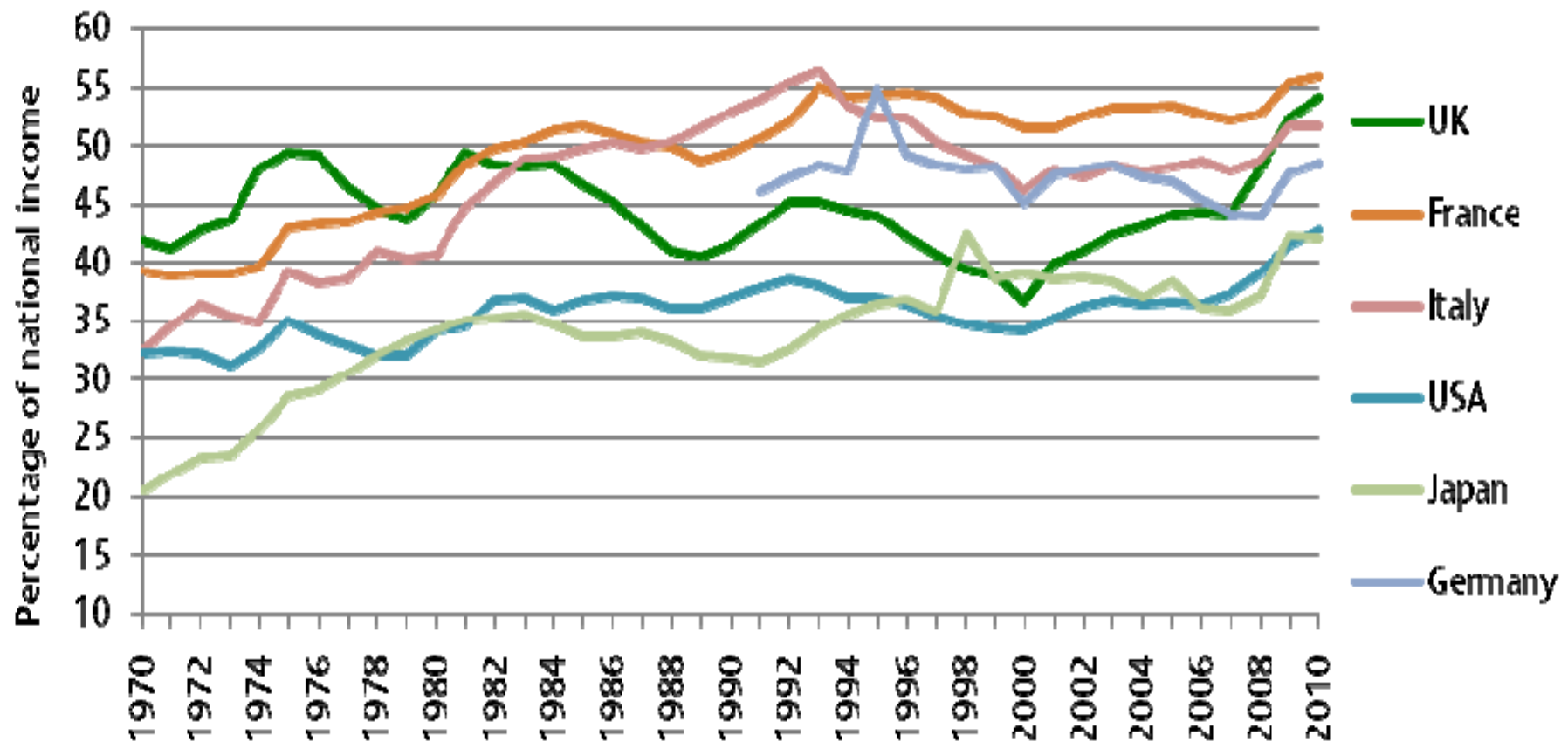


Source: Institute for Fiscal Studies, Britain's fiscal squeeze: the choices ahead.

Losing control



Total public spending in selected countries, 1970-2009

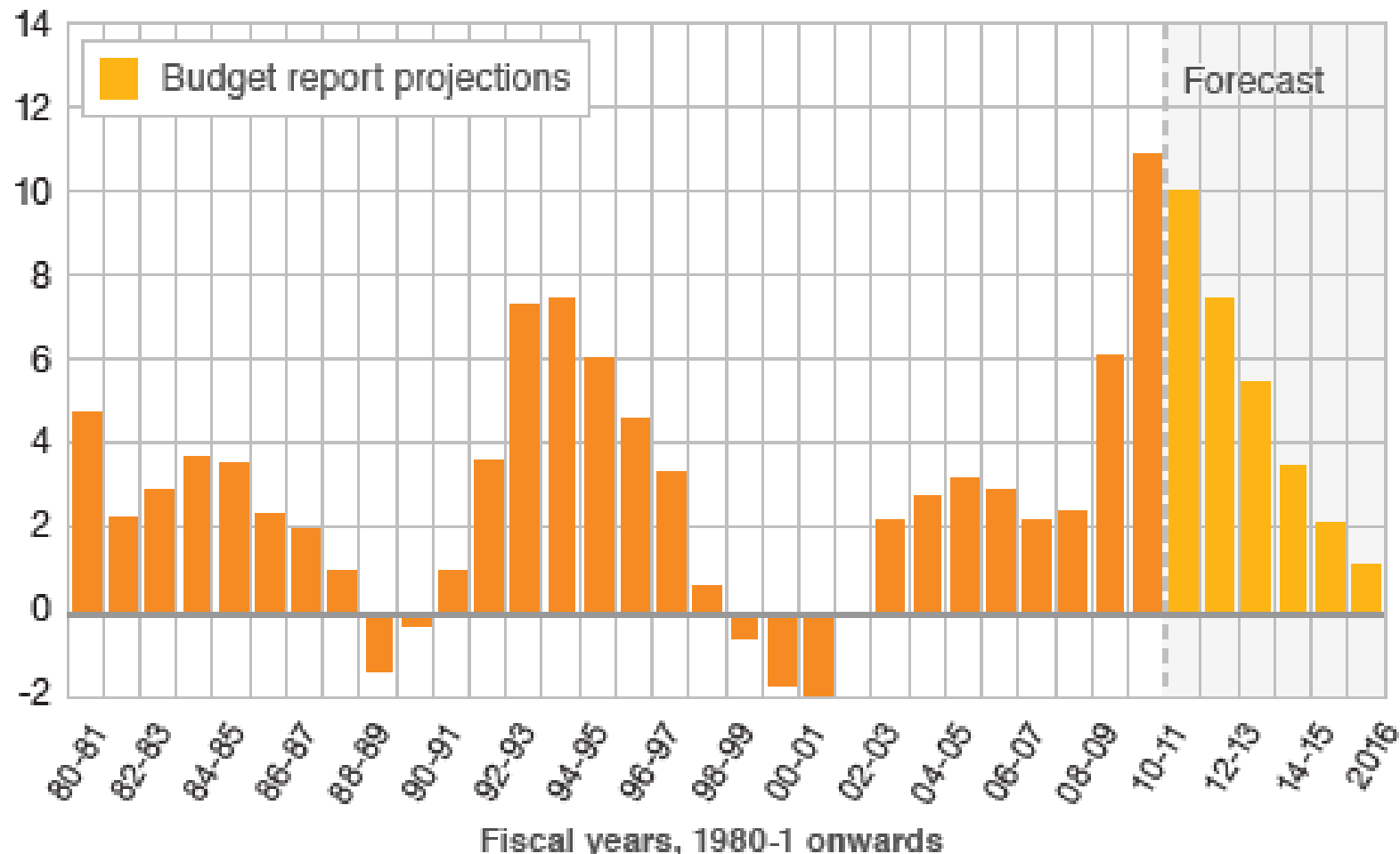


Source: Institute for Fiscal Studies, A Survey of Public Spending in the UK, IFS Briefing Note BN43.

The Coalition plan to cut the deficit sharply



Net borrowing as % of GDP, 1980 – 2016

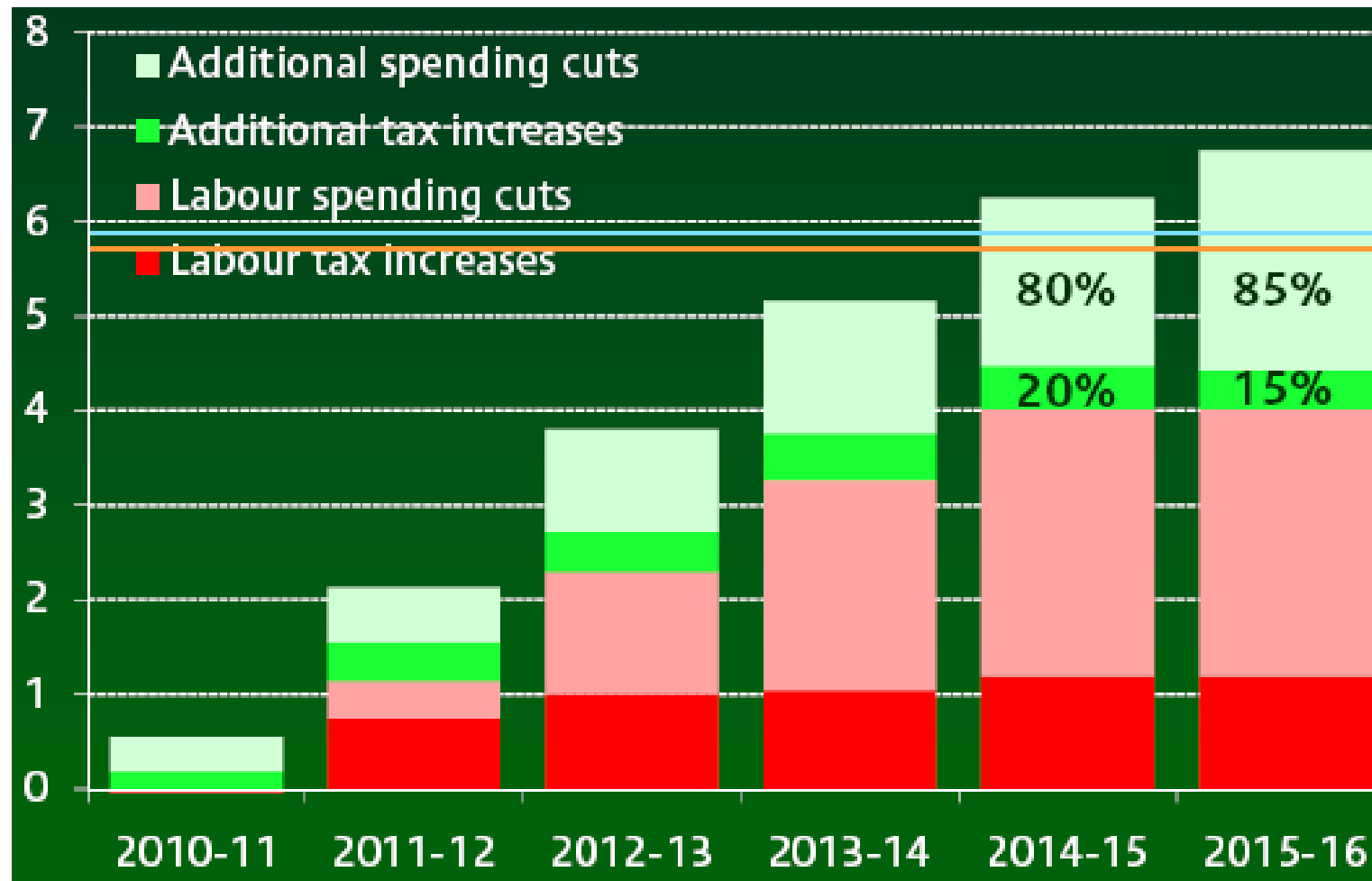


Source: OBR; IFS.

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

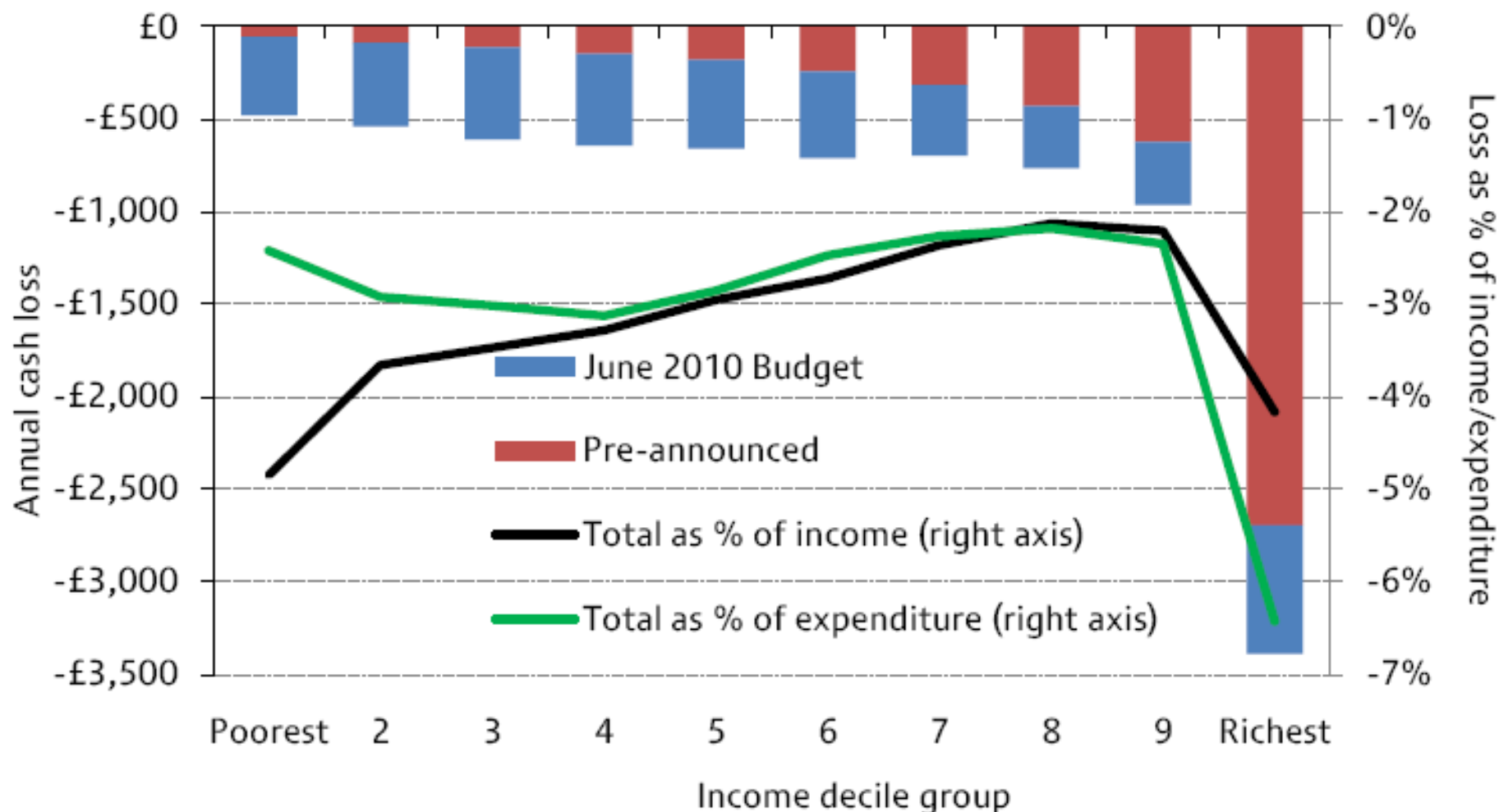


- “The UK economy is on the mend, but ... recovery will proceed at a moderate pace as the economy undergoes a difficult but necessary rebalancing
- CPI inflation should fall back to target by early 2012
- Upside and downside risks are balance
- The government’s strong deficit reduction plan will ensure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

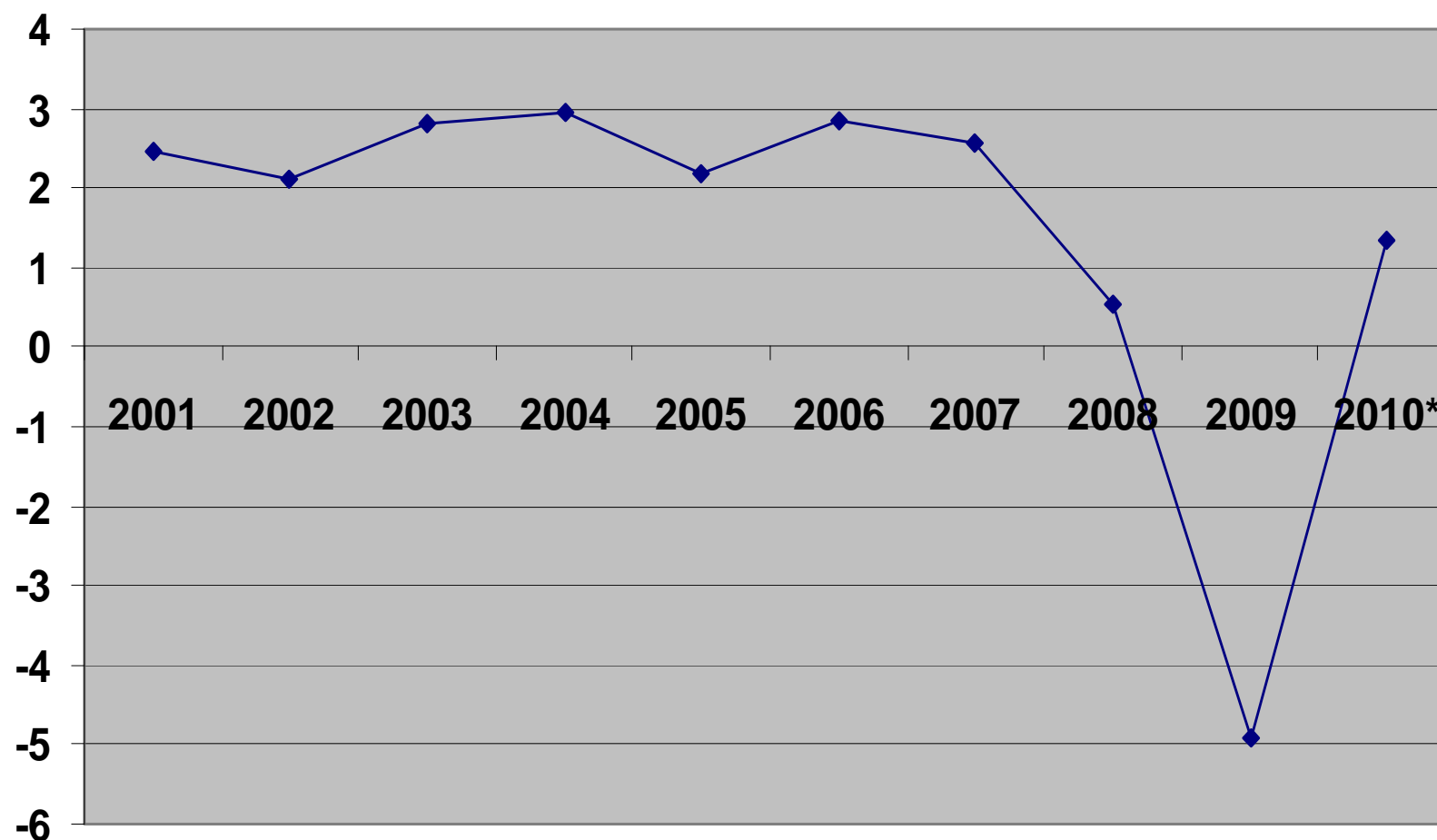
Oct 7-19 Final negotiations: toughest settlements hammered out, including defence, welfare and education

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



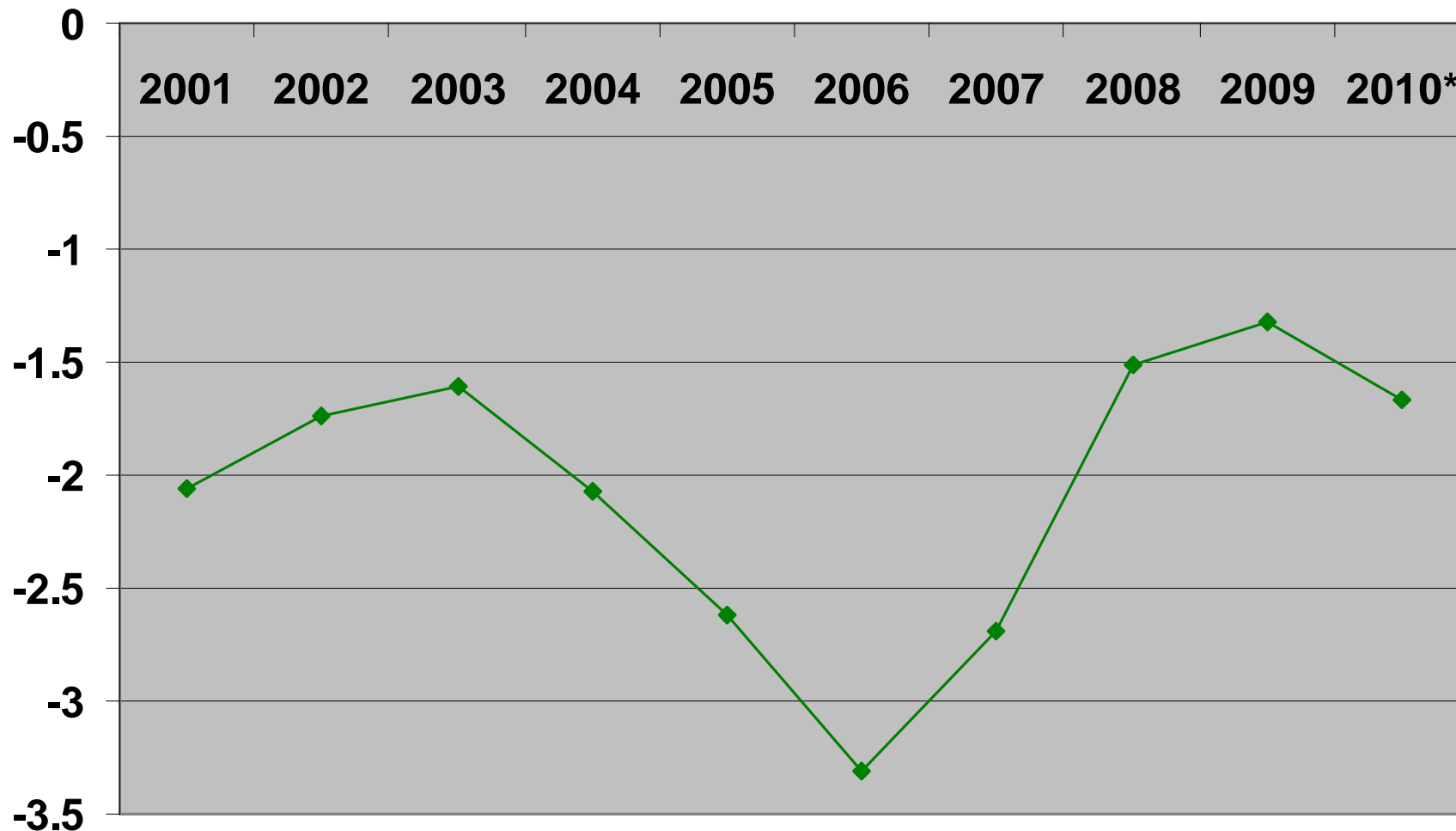
*Forecast.

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

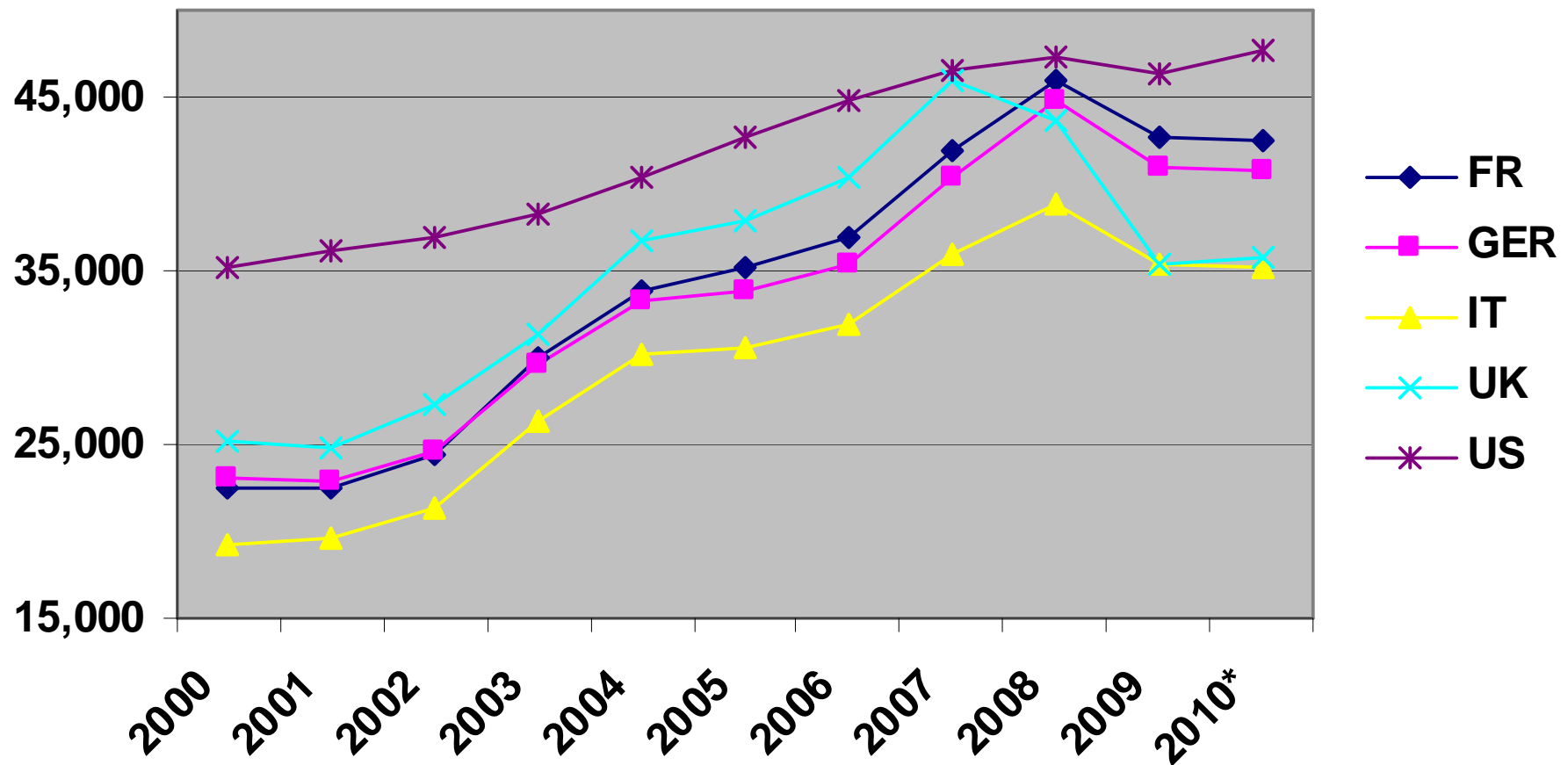


Source: Thomson Reuters, 4 October 2010.

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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