Britain: Brown’s fiscal stimulus no longer an option for G20 summit

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The G20 summit started to go badly wrong for British Prime Minister Gordon Brown last week when the governor of the Bank of England, Mervyn King, took the unprecedented step of overruling official government policy.

There could be no more fiscal stimulus, King told the Parliamentary Treasury Select Committee. He said that, given the size of government deficits, "I think it would be sensible to be cautious about going further in using discretionary measures to expand the size of those deficits.... The level of the fiscal position in the UK is not one that would say, ‘Well, why don't we just engage in another significant round of fiscal expansion?'"

Brown was effectively put on notice by King that Britain could not afford to build up any more government debts without facing the danger of a collapse of the pound.

To date, the Treasury has pledged £40 billion to recapitalise Britain's banks and offered guarantees for £585 billion of toxic assets. Because of the government's efforts to bail out the banking system its deficit is predicted to reach £165 billion in 2010, over 10 percent of Britain's gross domestic product (GDP). This is the highest level since World War II and proportionately by far the highest of all the Group of 20 countries.

Borrowing will remain between £140 billion and £170 billion in the two following years, leading to a total increase of debt in three years that is more than the total debt of £356.4 billion inherited by the Labour government when it came to power in 1997. The impact on the markets of the UK's deepening debt was seen the day after King spoke to the committee. Long-term government bonds, or "gilts," were put up for sale and failed to find enough buyers, the first time this has happened in 13 years.

The *Financial Times* commented that "the risk is the UK will slip back to its 1970s and early 1980s pariah status in government bond markets, leaving the next government struggling to fund huge levels of borrowing."

Britain's budget deficit tripled in the first 11 months of the current fiscal year to a record £75.2 billion. Meanwhile, output fell by 1.6 percent in the last quarter of 2008, worse than the 1.5 percent expected and the worst quarterly fall in GDP since 1980. Howard Archer of IHS Global Insight commented that the latest data showed the UK economy's decline continuing in 2009, with the economy contracting "by around 4 percent."

Fears that a continuously falling pound could lead to inflation were exacerbated by the latest consumer price index (CPI)—largely reflecting the prices working class people are paying for food—showing an increase of 3.2 percent.

Politically, King's intervention is unprecedented in its implications. Britain's top banker has very publicly told the government what it can and cannot do.

He spoke as Brown was touring the world touting the policy initiative he had agreed to in talks with President Barack Obama and US Treasury Secretary Timothy Geithner, advocating that the G20 countries help inject £1.4 trillion into the world's finances. These calls have been strongly opposed by Germany and other European countries, as well as China. They are also opposed by the British Conservatives, who have demanded the imposition of cuts and austerity measures even deeper than those Brown has so far contemplated.

The *Independent* noted that Brown was being pushed "by Mr. King into the same camp as Germany and France, both of which have already enacted quite big fiscal packages but insisted they won't go any further. As if on cue, the European Union yesterday attempted to re-inject some fiscal discipline into the system by insisting France and Germany cut their budget deficits to below 3 percent of GDP by 2012, and Britain by 2013."

Conservative Shadow Chancellor George Osborne enthused that King had "pulled the rug on the entire fiscal approach pursued by this government." Brown had been humiliated as he was touring Latin American lecturing on "fiscal probity while the governor of the Bank of England cuts up his credit card back home."

The *Financial Times* commented that, "Mr. King's warning puts him in a position where he could be accused of constraining the options of elected politicians and puts the Treasury on notice that the Bank might feel the need to take offsetting action if a second stimulus package was proposed."

Daily Mail City Editor Alex Brummer wrote, "King has trespassed into very dangerous territory. He has placed himself at the heart of the battle over how best to deal with the worldwide economic slump. By challenging Mr. Brown on budgetary policy the governor has exposed the sharp differences over the conduct of economic policy at the centre of government. This potentially calamitous public row can only add to the nervousness of financial markets about the ability of Labour to navigate through the worst crisis in generations."

Clearly chastised, Brown has signaled that he has abandoned any plans for a big new fiscal stimulus package for the UK, saying that measures in Britain's annual budget next month will be "cautious" and "targeted." He added, "What Mervyn King was saying is what I have always said, that you have to be cautious about everything you do."

The impact of King's warning was also underlined by the government's decision not to bail out the Dunfirmline Building Society, Scotland's largest, which provides mortgages to 35,000 people and has 250,000 savers. It did so after the Bank of England and the Financial Services Authority concluded that Dunfirmline was unviable and would not be able to pay back any money loaned. Even so, while Nationwide has agreed to take over the profitable parts of the company, the taxpayer has been landed with a bill for around £1 billion for risky debt and non-functional parts of the society.

This is the third building society in Britain to go under, the first being Northern Rock, whose collapse heralded the start of the credit crunch in Britain. Northern Rock had to be taken over by the government. The second was Bradford and Bingley, whose toxic debts were taken over by the government, while Santander, the Spanish bank, took over its savings accounts and branches.

A leak of a draft of the G20's final communique by the *Financial Times* Sunday contained no specific plans for a fiscal stimulus package. In an effort to play down the clear evidence of a rift between the US and Europe, President Obama told the *Financial Times* yesterday that too much emphasis has been put on the US insisting on stimulus, as opposed to European calls for regulation of the global financial infrastructure.

"We need stimulus and we need regulation," Obama said. "With respect to the stimulus, there is going to be an accord that G20 countries will do what is necessary to promote trade and growth.... The most important task for all of us is to deliver a strong message of unity in the face of crisis."

Such platitudes will convince no one. In an interview with the London *Times*, financier George Soros made it known that whereas he believes that the G20 meeting is the last chance to avert global disaster, "The odds would favour that it fails, because there are such differences of opinion. It's difficult enough to get it right in your own country, let alone with 20 governments coming together, but if it's a failure, I think then the global financial and trading system falls apart."