Governor of Bank of England warns government on debt

Chris Talbot
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Governor of the Bank of England Mervyn King has publicly warned the Brown Labour government that "the truly extraordinary" level of UK public debt must be brought down rapidly.

His warning followed the publication of an Organisation of Economic Co-operation and Development (OECD) report that predicted Britain's debt rising to the highest level of any developed country next year.

UK government debt is already running at £150 billion. The OECD expects it to reach £200 billion by next year. That would be 14 percent of gross domestic product. The OECD predicts that the UK economy will shrink by 4.3 percent this year. This is a sharper decline that previously predicted and worse than official Treasury estimates. It would be the worst fall in output since 1945.

Unemployment, especially among young people, has accelerated to 2.26 million and the OECD expects it to easily top 3 million by next year. Public finances have deteriorated sharply, largely as a result of the bank bailout that cost £1.26 trillion, according to the Bank of England's bi-annual Financial Stability Report. King warned that more money may yet be necessary. UK banks "inevitably remain vulnerable," the report said, and pointed to a £500 billion hole in their finances.

King warned that unless the government rapidly reduces its borrowing requirement, international investors might be unwilling to continue to finance it. The bank found that more than a quarter of City financiers are now seriously concerned about a government default.

King's warnings have been underlined by those of the European Commission, which predicts a UK government deficit of 13.4 percent, or £200 billion, next year. This is a worse outlook for any EU country apart from Ireland.

The picture is uncertain because the extent to which government revenue will fall as a result of the recession cannot be predicted exactly. But Britain is more reliant on property taxes than any other EU country, so the collapse of the housing market, coupled with rising repossessions as homeowners become unemployed, will cut government revenue. The British government had to choose between slashing spending or hiking taxes, the EC said.

According to the *Sunday Telegraph*, credit rating agency Standard and Poor has privately calculated that the UK debt could increase to 200 percent of economic output over the next four decades. Moritz Kraemer, head of S&P's sovereign ratings in Europe, Middle East and Africa, said that the UK was facing a deficit unlike any it had experienced in peacetime. The shortfall demanded tax increases, cuts in health spending or cuts in public sector pensions, he said.

This is essentially what King is calling for as well. But there is the added complication of disputes over new regulatory measures for banks. The government is due to issue a white paper outlining its proposed new measures. King revealed that he had not been consulted about its contents when he spoke to the House of Commons Treasury Committee.

Lord Peter Mandelson, who has taken an increasingly central role in government since he returned from Europe, has insisted that the government intends to make the Financial Services Agency (FSA) responsible for regulation. Responsibility for regulation is currently shared between the Bank of England, the FSA and the Treasury.

Mandelson told the press this week, ahead of the white paper being published, "I don't support a twin peaks system." He made it clear that the government intended to strengthen the FSA at the expense of the bank.

Relations between the government and the bank have deteriorated, as King has aligned himself with the Conservative opposition. Unnamed government sources have accused him of forming "an unholy alliance" with the Tories and leaking information about the bank bailout to them.

The Tories are committed to drastically cutting the FSA, which expanded under Labour and is widely seen as ineffective, and boosting the Bank of England instead. This would increase King's empire at the bank. The financial crisis has already increased the role of this unelected institution in the economy in general and in relation to government spending.

The Tories would be no more willing to oppose the untrammelled expansion of financial activities than Labour. The Tory shadow cabinet contains 13 millionaires, and the party has just taken on a new treasurer, Crispin Odey, to boost City donations. Odey is a leading hedge fund manager, said to have made a fortune out of short-selling banks in last year's crash.

It is traditional for the chancellor to compliment the UK financial services sector for its contribution to the economy at the annual Mansion House speech in the City of London. This year, despite the collapse of the UK banking sector, Alistair Darling said that he intended to keep to that tradition.

The City, he said, was "an immense asset to our country.... I am determined to work with the sector to maintain the UK's position as the world centre for financial services."

Whilst admitting that the banks were on the verge of collapse last autumn and that the government had been forced to step in to bail them out, he claimed that lessons had been learned in the boardrooms of the banks and that they "must have the right people and the right skills and experience to manage themselves more effectively."

In this the British government are in line with their European partners, where despite demagogic attacks by German Chancellor Angela Merkel on the excessive profits of hedge funds, no serious action has been taken to curb the financial sector.

The real question at issue is not to what extent the financial sector should be regulated. There is general agreement among the ruling elite that it should continue to be as lightly regulated as possible. What is at issue is how the cost of the bank bailout can be clawed back from the working class.

The Tories and the governor insist that immediate and savage cuts in public spending are necessary. Tory leader David Cameron is said to be planning a two-day shadow cabinet meeting that will bind future Tory ministers to a package of cuts. Labour adopted a similar strategy prior to coming into power under Tony Blair.

Cameron warned that if the government does not prepare the public for cuts in government spending, there will be "riots on the street." Children's Minister Ed Balls responded by warning that if the Tories came to power there would be "more public unrest."

Balls was launching a white paper for schools that contains what the government hopes will be a series of vote-winning initiatives. He insisted that schools spending would rise under a Labour government because he had made savings elsewhere in his department. Part of the £650 million he had saved, Balls said, would go towards a new social housing programme.

Balls's plans are part of the government's "Building Britain's Future" package that was published this week. The document amounts to a Labour manifesto for the next election. It tries to give the impression that Labour can weather the recession without making significant cuts in public spending.

The Comprehensive Spending Review (CSR) scheduled for the autumn has been postponed until after the election. Mandelson announced the decision on BBC Radio 4's "Today" programme. The government are acutely conscious that setting out the real state of public finances could have a disastrous effect, not only on their own electoral fortunes, but on the markets and the government's ability to borrow.

In reality, Labour is already making significant cuts and will make more. In April, Darling set out plans to make £15 billion in "efficiency savings" on top of the £10 billion in cuts previously announced, while cutting current spending plans by almost half, to just 0.7 percent.

Some City analysts are calling the government's approach to its mounting indebtedness "a scorched earth policy." Even so, the intensity of the struggle between the Bank of England and the government and its very public nature suggest that the prospect of a government default is becoming more likely. If such a default were to occur, any international bailout would inevitably present the bill to the working class, who would suffer savage attacks on their jobs, services and pensions. In reality, both Labour and the Tories are working hand in glove with finance capital to place the cost of the recession on the backs of working people and ensure that the financial aristocracy of the City continue to pocket their millions.