

TONY BLAIR: WHAT CAN BE ACCOMPLISHED IN A THIRD MANDATE?

¶ Tony Blair has finally managed to enter history as the first Labour candidate to win three successive legislative elections. ¶ Although the war in Iraq strained his candidacy and cost Labour numerous seats, it was surely the government's economic record that set the party ahead of the Tory opposition. As early as 1997, the Chancellor of the Exchequer set up a macroeconomic policy framework that has fostered stability, reduced inflation and contributed in the end to the strong performances of the UK economy. On the job front, Labour did not call into question the "liberal revolution", but took measures to help the jobless get back to work.

¶ Yet, despite this favourable track record, much remains to be done. During his third mandate, Tony Blair must finish his plan to modernise public services, although budget constraints will not make this an easy task. His government is bound to step up policies to close the UK's productivity gap. And finally, he will have to continue reforming the welfare state, notably the pressing issue of pension reform.

1997-2004: strong, stable and sustainable growth

"Britain is today experiencing the longest period of sustained economic growth since records began in the year seventeen hundred and one"
Gordon Brown, Budget Speech, March 2005.

As Chancellor Gordon Brown has repeated ceaselessly, the UK is in the midst of the longest period of prosperity in the past three centuries: twelve and a half years of uninterrupted economic growth or 51 quarters of expansion (including Q1 2005) since GDP last declined in Q2 1992. The UK economy can boast several other accomplishments as well:

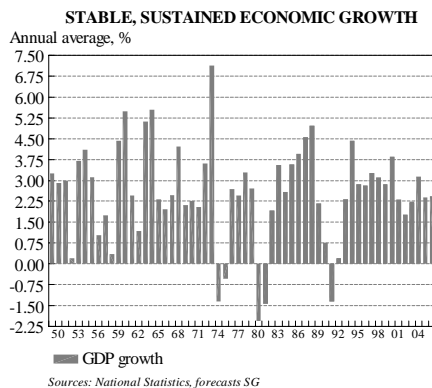
¶ Full employment: the jobless rate has fallen below 5%, according to ILO standards, or fewer than 1.5 million unemployed, compared to over 3 million during the worst years of the Thatcher and Major governments.

¶ Inflation has finally been brought under control.

¶ The standard of living in the UK (PPP-adjusted GDP per capita) now surpasses the average for continental Europe, and in particular, the levels of its two historical rivals, France and Germany.

¶ Finally, the growth potential of the UK has risen significantly compared to the early 1980s.

Throughout the legislative campaign, Labour constantly put forward this somewhat idyllic picture of the UK economy, which undoubtedly spared them from returning to the ranks of the opposition on 5 May.



Prime Ministers since 1945

Clement Richard Attlee, 1945-51, Labour
 Anthony Eden, 1955-57, Conservative
 Harold Macmillan, 1957-63, Conservative
 Sir Alec Douglas-Home, 1963-64, Conservative
 Harold Wilson, 1964-70 and 1974-76, Labour
 Edward Heath, 1970-74, Conservative
 James Callaghan, 1976-79, Labour
 Margaret Thatcher, 1979-90, Conservative
 John Major, 1990-97, Conservative
 Tony Blair, 1997- ??, Labour

How did Labour manage to achieve such a successful record? What policies did they use to obtain these results?

First, in the ten years prior to the mid 1990's, the Labour Party was completely reinvented with the ideological transformation of Old Labour into New Labour, and its economic policies did not reject the fundamentals of the liberal revolution of the Thatcher years¹. To be perfectly fair, however, the exceptional growth record that Chancellor Brown is constantly highlighting as proof of Labour's sound economic management, actually began before Labour returned to power. This is also true for the decline in structural unemployment and the corollary increase in the UK's long-term growth potential.

Yet Labour's success cannot be attributed solely to the acceptance of the Thatcher legacy. The high level of stable, sustainable growth is also due to the success of its economic policies, which we attribute to three factors:

- Implementation of a stable, robust and transparent macroeconomic framework (budget and monetary policy),
- Full-employment: after assuming the Thatcher legacy of a liberalised job market, the government actively pursued targeted employment policies, and increased incentives to get the jobless back to work.
- The acceleration of productivity gains (cyclical or structural?).

¹ Under Neil Kinnock's leadership (1983-92), the Labour Party promised not to undo Margaret Thatcher's anti-union offensive and renounced the idea of renationalising companies privatised by the Tories. In 1992, John Smith replaced Neil Kinnock as the party leader, and along with Gordon Brown, his Shadow Chancellor, worked to make Labour more electable by promoting a rigorous budget policy, a new approach to the welfare state, and by courting the business community in what became known as the "prawn cocktail offensive". In the end, it was Tony Blair who completed this long ideological transformation. Following John Smith's sudden death in 1994, Tony Blair was named head of the Labour Party and immediately set to work to break with Labour's past and accept market economics. At the May 1995 congress, the party was renamed New Labour and abrogated clause four of its 1918 constitution, which stated that Labour's goal was "common ownership of the means of production, distribution and exchange".

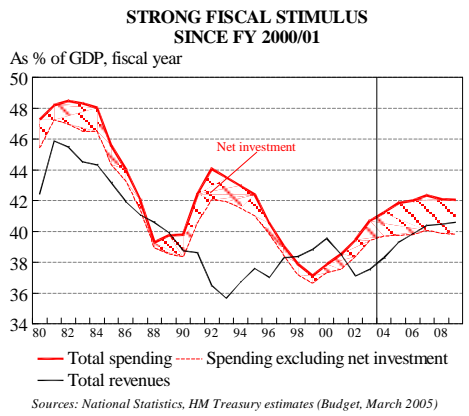
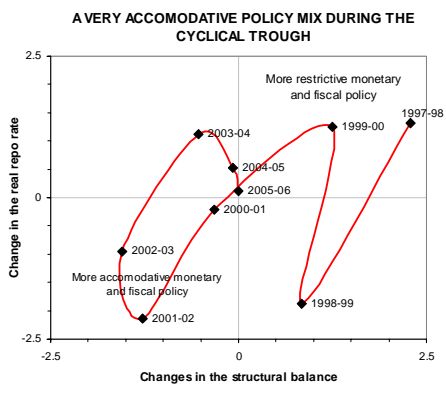
1. A stable, robust and transparent macroeconomic framework

As the Shadow Chancellor of the Exchequer between 1992 and 1997, Gordon Brown took up the challenge of designing a stable and robust macroeconomic framework that would revitalise Labour's image, which had become associated with public spending, taxes, devaluation and instability. Indeed, Sterling was devalued in 1949 and 1967, and in 1976, the UK was the first industrialised country to turn to the International Monetary Fund for a loan. His goal was to make the Labour Party electable again in the eyes of UK citizens (see pages 8-11 for a detailed description of this macroeconomic framework).

When Labour took power in May 1997, the first political decision was to boost the credibility of inflation targeting by granting the Bank of England operational independence over monetary policy. This general monetary policy framework was officially adopted with the passage of the Bank of England Act in April 1998. The Code for Fiscal Stability was published in March of the same year and laid down the framework for budget policy, which is implemented through two fiscal rules: the golden rule and sustainable investment rule (see box on page 11).

Although this macroeconomic framework was initially designed to shore up Labour's credibility for sound management, it is also clear that even today, this policy is still contributing to the UK's excellent economic performance. Inflation has been brought under control, and expectations are now firmly anchored to the BoE inflation target (see graph page 8). Over the past seven years, economic growth has been stronger and more stable than in previous periods. In other words, the country's growth potential increased at the same time as the volatility of the output gap dropped off sharply. Of course, this trend was also observed in other parts of the world and cannot be attributed solely to improvements in implementing macroeconomic policy. Other factors also came into play, including trade integration, financial market deregulation and the introduction of microeconomic policies designed to stimulate competition.² Yet the stability of growth, as indicated by the low volatility of the output gap, was much stronger in the UK than in any other country.³ This is undoubtedly due to the fact that the UK's stable, robust and transparent macroeconomic framework went hand in hand with the other factors listed above.

Under these conditions, the UK authorities have been able to set up a particularly well-adapted and effective policy mix in recent years. During the cyclical trough after the worldwide recession of 2001, monetary policy and budgetary constraints were loosened considerably (see graphs below).



In 2001, the Bank of England (BoE) lowered its repo rate by a total of 200bp. Faced with uncertainties over the war in Iraq, BoE further loosened its grip by 50bp in 2003, bringing the repo rate to 3.5%, the lowest level in nearly 50 years. Thereafter, to counter the risks of an overheated economy, the BoE began tightening monetary policy, raising its base rate by 125bp between November 2003 and August 2004.

Labour's budget policy also proved to be conveniently countercyclical. When Labour took power in 1997, it upheld its campaign promise to stick to the Conservative Party's spending plan during the first two years in office. Labour pursued the public finance stabilization launched by the Tories, while it was in the midst of a top-of-cycle period (with average growth of over 3% in 1997-2000). Under the Conservatives, the public deficit had been slashed from 8% of GDP following the 1992-93 recession to about 3.5% in 1996-97, right before Labour took office. The Labour government then went on to transform this deficit into a surplus of 1.6-1.7% of GDP in fiscal years 1999-2000 and 2000-01.

After upholding its pledge to respect the Conservative Party's spending plan for two years, the Labour government began to work on another campaign promise: the modernisation of public services. Starting in fiscal 1999-2000, the government increased spending significantly for its three top priorities: education, health care and transportation. Yet it did not adopt a resolutely expansionist budget policy until 2000-01, and even more so in Tony Blair's second mandate. This proved to be a godsend as the cycle entered a downturn with the 2001 world recession. The considerable sums invested in public services were suddenly acting as a Keynesian-type stimulus. Investment spending (net of capital depreciation) rose to 1.5% of GDP in fiscal 2004-05, compared to only 0.5% in 1999-2000. Moreover, the government plans to continue its investment policy for its three priorities (education, health care and transportation), with investment spending accounting for 2.25% of GDP in 2007-08. Current expenditure has also risen sharply due to public sector payroll increases, since modernisation has been accompanied by extensive hiring (see section 2 on employment). Spending has risen by over 3 points of GDP, to 39.8% in 2004-05 from 36.6% in 1999-2000, but the government does not plan to increase its share of national wealth any further.

² See Barrel R. and Gottschalk S.: "The volatility of the output gap in the G7", *National Institute Economic Review*, no. 188, April 2004.
³ See Barrel R., Kirby S., Metz R. and Weale M.: "The Labour government's economic record and economic prospects", *National Institute Economic Review*, no. 192, April 2005.



RULES DETERMINING THE POLICY MIX IN THE UK

Monetary policy: a success story for inflation targeting

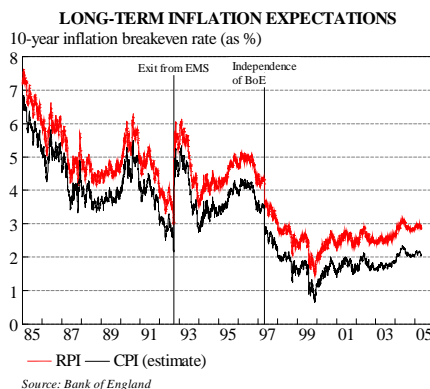
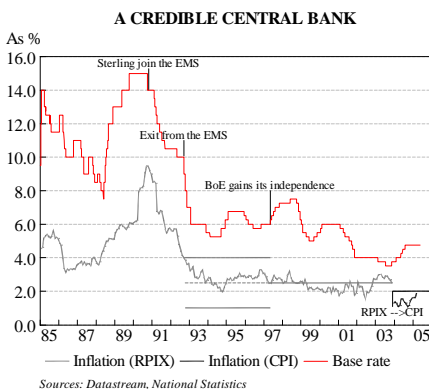
Ø *The UK has pursued a strategy of inflation targeting since 1992,...*

Following speculative attacks, sterling left the EMS on Black Wednesday, 16 September 1992, and as a result, the government scrapped its nominal exchange rate-based monetary policy objective. In its place, a new strategy of inflation targeting was introduced. On 8 October 1992, Normal Lamont, the Chancellor of the Exchequer, set an inflation target range based on the RPIX, a retail price index excluding mortgage interest payments, of between 1% and 4%. The goal was to guide inflation down towards the bottom end of the range (i.e. 2.5% or below) before the next general election. To restore the credibility of monetary policy, the Conservative government asked the Bank of England (BoE) to publish a quarterly assessment of the inflation outlook over a two-year horizon, and the first edition of the Inflation Report was published in February 1993. The Governor of the Bank of England and the Chancellor of the Exchequer met every month to review monetary policy. However, operational responsibility remained with the Chancellor who ultimately set interest rates. Following the Conservatives' defeat in the May 1993 Newbury by-election, Normal Lamont resigned and was replaced as Chancellor by Kenneth Clarke. In April 1994, he decided to increase the transparency of monetary policy by publishing the minutes of the meetings between the Chancellor and the BoE's Governor. Shortly afterwards, during the Mansion House Speech to the City on 14 June 1995, Ken Clarke reasserted the inflation target and extended it by stating that even after the general election, the goal would be to keep inflation at no higher than 2.5% and that monetary policy would be geared to achieving this target to ensure that inflation remained in a 1-4% range. By authorising publication of the minutes and setting a clear inflation target (2.5% or less), Ken Clarke put himself in an awkward position. Between May 1995 and April 1997, he regularly opposed the interest rate moves proposed by the Governor of the BoE to achieve the two-year inflation target ("*Ken and Eddie show*").

Ø *...which was strengthened in 1997 when the Bank of England was given its operational independence*

With sterling's exit in from the EMS in 1992, the Conservatives' claim to run the economy better was left in tatters. Gordon Brown, who had been Shadow Chancellor of the Exchequer since July 1992—even though he had been in favour of EMS membership—seized the opportunity to rid the Labour Party of its reputation of being the party of devaluation and instability. In 1993, he emphasised the need to reform the Bank of England. He expounded upon this proposal in 1995 in "A New Economic Future for Britain", a document that served as a basis for his party's 1997 election manifesto, which stated that the Labour Party would reform the Bank of England to guarantee that monetary policy decision-making would be more efficient, transparent and free of any short-term manipulation for electoral purposes, as well as confirming a commitment to inflation targeting. Led by Tony Blair, New Labour took power on 1 May 1997. Upon his appointment as Chancellor of the Exchequer, Gordon Brown gave the Bank of England its independence on 6 May. Not full independence, however, since the government continued to set the inflation targets. On 12 June 1997, the Chancellor set the BoE an explicit RPIX-based inflation target of 2.5%. The BoE is independent insofar as it has complete freedom in how it achieves the inflation target it has been set. For instance, it sets the repo rate.

On 10 December 2003, as announced in June when the update on the possibility of the UK joining the euro⁴ was published, the Chancellor set the inflation target at 2% based on the harmonised index of consumer prices (HICP), which was renamed the CPI.



N.B. 10-year inflation expectations are calculated as the difference between the nominal yield of 10-year government bonds indexed to the RPI price index. The RPI is the measure of inflation used for index-linked bonds, but is not used for inflation targeting in the UK. The RPI is not the same as either the RPIX or the CPI. Some of the differences are attributable to the scope of the index (e.g. the RPI includes mortgage interest payments). In addition, the RPI is actually higher than the CPI, which is built on the basis of a geometric rather than an arithmetic mean for the purpose of aggregating prices within each spending category (effect estimated at 0.5 percentage points). To assess 10-year inflation expectations based on the CPI, they are adjusted by the standard deviation between the CPI and RPI since 1989 (i.e. 0.8 points).

The success of the general monetary policy framework introduced in 1997 and definitively enshrined in the legislation by the Bank of England Act of 1998 is predicated on:

##the greater credibility achieved by giving operational independence to the Bank of England. The experience of sterling's spell of EMS membership followed up by a policy of inflation targeting from 1992 produced a genuine deflationary impact. Even so, inflation expectations remained relatively high, especially between 1995 and 1997 when, as stated above, the Chancellor of the Exchequer regularly opposed the BoE's Governor interest rate recommendations. Long-term interest rates thus built in a risk premium reflecting the political factors to which monetary policy remained beholden. When the BoE was given operational independence, monetary policy was freed up from electoral considerations, and this risk premium diminished. Upon the announcement of the bank's independence on 6 May 1997, the market's inflation expectations immediately sank by 0.5 percentage points. Over time, a credibility bonus built up and helped to bring expectations further down:

⁴ The Chancellor had set five tests for euro membership (see Monthly Report March 2002). After a review, he announced on 9 June 2003 that the sustainable convergence and flexibility tests were not yet met. To help satisfy these conditions, reforms were announced, including a new inflation target based on the HICP.

the choice of a symmetrical point inflation target. Compared with a range, a point target avoids the central bank having to focus unduly on keeping the rate of inflation within the range or even concentrating solely on one end of the range, instead of aiming to hit the median point. In addition, setting a precise numerical value for the inflation target helps to anchor inflation expectations—something that a range does not facilitate, especially where a broad range is set. A point target does not mean, however, that it has to be achieved continuously. Unforeseen shocks, or uncertainty, may drive inflation—i.e. the inflationary outlook—up or down, while it is not always reasonable or even possible to get inflation straight back to the target especially given the time it takes for monetary policy to act. Since the target is symmetrical, a deviation above or below the inflation target is considered and dealt with in the same way (which makes sense if you accept that high inflation is as damaging as deflation).

transparency and accountability in the conduct of monetary policy. The decision to give the Bank of England its operational independence did not sacrifice its transparency or accountability. In fact, these aspects were enhanced. The minutes are now published after two weeks, rather than after six weeks as previously. Probability forecasts of growth and inflation over a two-year horizon are published in the quarterly inflation report. And shortly after publication of the inflation report, the members of the Monetary Policy Committee (MPC) appear before the Treasury Select Committee to explain the logic behind interest rate decisions. In addition, in the event of a deviation of more than one percentage point above or below the inflation target the BoE's Governor is obliged to send an open letter to the Chancellor explaining how and by when the MPC intends to bring inflation back to the target level⁵. This greater transparency and accountability are regarded by the members of the MPC not as a hindrance to their independence but as an opportunity for them to make the principles guiding their monetary policy decisions much clearer and understandable, thereby helping them to enhance the credibility of monetary policy.

While the general monetary policy framework introduced in the UK is impressive, a rapid comparison of the three leading central banks (Fed, BoE, ECB; see the comparison chart on the following page) does not suggest that the UK model is decisively superior. First of all, the targets set for the central banks include in all three cases price stability, growth and employment. For the ECB and the BoE, the priority is placed on price stability (note that the formulation of the BoE's objectives is largely based on the ECB's), which is primarily intended to shelter the central bank from political pressures (the central bank cannot pursue a more accommodative policy in the short term if to do so would be at odds with long-term price stability). But unlike the ECB, the BoE is not free to determine what price stability means because the Chancellor sets the inflation target. What's more, some experts have underlined the importance of opting for a symmetrical target in the UK. With an asymmetric target (e.g. the BoE's pre-1997 target of 2.5% or below and the ECB's target of less than, but close to 2%), there is the risk that in a bid to bolster its credentials the central bank may seek to minimise all chances of breaching the target (i.e. by pursuing an excessively restrictive target) to the detriment of growth and employment. According to Sushil Wadhvani, a former member of the BoE's MPC, a symmetrical target can potentially help to achieve the highest level of growth possible while satisfying the inflation target⁶. This said, the academic literature and the various studies do not conclude decisively that the ECB is less responsive or has helped to stabilise the economy in the short term any less than the other major central banks. Conversely, the BoE undeniably appears to be the most transparent and accountable central bank. The ECB's (relative) lack of transparency, particularly the fact that it does not publish its minutes, is attributable to the principle that the nationality of the MPC members must not influence decision-making. Were the positions adopted by the Governing Council's members during the meeting made public, there would be a risk that the central bank governors would be put under pressure by the governments or by public opinion in their respective country of origin.

Aside from the aspects of transparency and democratic accountability—the importance of which with regard to the effectiveness of monetary policy should not be underestimated—it seems hard to conclude that superior execution of monetary policy is the key factor accounting for the growth differential between the UK and the euro zone. Conversely, the BoE has an advantage in terms of how the impact of monetary policy propagates to the wider economy. The predominance of variable-rate mortgages means that it propagates much more rapidly in the UK. To a great extent, it takes place via households through the property market and attendant wealth effects (loans secured on dwellings), as well as via financial assets, which carry much greater clout on the balance sheet of households than in continental Europe—especially owing to the development of pension funds—thereby helping to increase the impact of monetary policy. As for the ECB, it faces a much more variable situation, with, to simplify things, both countries such as Spain where variable-rate mortgage loans predominate and thus where changes in monetary policy propagate rapidly and other countries such as Germany, where changes in monetary policy are propagated more by businesses and where long-term fixed-rate financing is pre-eminent, thereby making monetary policy less effective as a tool⁷. Lastly, monetary policy and fiscal policy are much easier to coordinate in the UK than in the euro zone.

⁵ The Bank of England has emphasised on numerous occasions that the open letter mechanism does not in any event constitute the setting of a tolerance range (the target remains a point target) and that having to send an open letter does not mean the failure of the MPC, but provides an opportunity for the latter to explain why the deviation occurred.

⁶ Some reflections on the MPC, Speech delivered to the National Association for Business Economics in Washington DC by Sushil B. Wadhvani on Monday 21 May 2001.

⁷ Measures intended to promote the deregulation and convergence of financial systems in the European Union should be envisaged in this respect as ways of making monetary policy more effective. On 3 May 2005, the Commission published the new Green book on financial services policy (2005-2010) in which the idea of pursuing tighter integration between the EU's financial markets is proposed. The final programme for financial services policy is due to be presented in November 2005.

COMPARATIVE ANALYSIS OF THE THREE MAJOR CENTRAL BANKS

	FEDERAL RESERVE (Fed) Independence of instruments and objectives	BANK OF ENGLAND (BoE) Independence of instruments, dependence on the objectives set	EUROPEAN SYSTEM OF CENTRAL BANKS (ESBC) Independence of instruments, de facto independence with regard to the objectives set
OBJECTIVES	<p>"The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."</p> <p>Federal Reserve Act, section 2A</p>	<p>"In relation to monetary policy, the objectives of the Bank of England shall be – (a) to maintain price stability, and (b) subject to that, to support the economic policy of Her Majesty's Government, including its objectives for growth and employment."</p> <p>Bank of England Act, Chapter 11, Part II, Section 11</p>	<p>"The primary objective of the European System of Central Banks shall be to maintain price stability. Without prejudice to this objective, the European System of Central Banks shall support the general economic policies in the Union in order to contribute to the achievement of its objectives".*</p> <p>Article III-185 the EU Constitution, drawing on Article 105 of the Treaty establishing the European Community.</p> <p>* Article I-3 of the EU Constitution: "The Union shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress (...)" and previously Article 2 of the Treaty establishing the European Community "The Union's objectives are: To promote economic and social progress and to achieve balanced and sustainable development and a high level of employment through the creation of an area without internal borders (...)".</p>
STRATEGY ¹	<p>No formal strategy (defined in the regulations). Implicit anti-inflationary strategy (core PCE deflator of between 1½% and 2%)</p>	<p>Strategy of Inflation targeting The Chancellor of the Exchequer is responsible for defining price stability: "The Treasury may by notice in writing to the Bank specify for the purposes of Section 11 – (a) what price stability is to be taken to consist of, or (b) what the economic policy of Her Majesty's Government is to be taken to be." Bank of England Act, article 12 The BoE aims to meet the target set by the government (currently 2% based on the HICP). It publishes explicit inflation forecasts over a two-year horizon and guidance on how it intends to achieve the Section 11 objectives.</p>	<p>No formal strategy (defined in the regulations) The ECB defined its strategy on 13 October 1998, then clarified and restated it on 8 May 2003, including: ≠ a quantitative definition of price stability, and; ≠ an analysis of the risks to price stability based on two pillars (cross-checking). Price stability is defined as a year-on-year increase in the harmonised consumer price index (HICP) of less than 2% in the euro zone. Price stability must be maintained in the medium term. The Governing Council has announced in connection with the pursuit of price stability that it aims to keep inflation rates below, but close to 2% in the medium term. The ECB's approach for organising, assessing and cross-checking information relevant for estimating risks to price stability is based on two pillars - an economic analysis and a monetary analysis – which form a basis for the overall assessment that the Governing Council form of the risks to price stability and to its monetary policy.</p>
INSTRUMENTS	<p>≠ Open market operations: - Repo transactions: daily intervention between 11.30 and 11.45. The Fed buys securities from financial institutions, which it undertakes to sell back to them on an agreed date. Maturity of 1 day to 3 months. Objective: to guide the fed funds rate towards the target set by the Federal open market committee (FOMC). ≠ One permanent facility: - Primary discount rate: in the event of liquidity problems, banking institutions can borrow for a short period at the discount rate (fed funds rate + 100 basis points). ≠ Obligatory reserves</p>	<p>≠ open market operations: - repo transactions: daily intervention (9.45, 14.30 GMT). The BoE buys eligible assets from participating institutions, which it undertakes to sell back to them on an agreed date for a maturity of around two weeks at the repo rate. - Overnight repo facility. If there is still a liquidity shortage at 15.30, the repo rate is lifted by 25 basis points. At the same time, there is a one-day deposit facility at the repo rate -25 basis points. - Overnight repo facility: If following the daily repo operations there is still an imbalance in the daily operations of the institutions, the BoE may carry out an end-of-day repo session (16.20). Repo rate + 25 basis points. <i>N.B. a reform is underway, which aims to reduce the volatility of the overnight market rate so that it is as close as possible to the repo rate.</i> ≠ A low level of obligatory reserves (0.15%) that do not earn any interest do not come into play in the conduct of monetary policy.</p>	<p>≠ open market operations: - principal refinancing operations: temporary sale transactions (repos, guaranteed loans) based on weekly tenders and for a maturity of one week. The refinancing rate is the minimum tender rate; - fine-tuning operations: carried out from time to time to manage the liquidity situation in the market and to steer interest rates; - longer-term financing operations: carried out on a monthly basis with a maturity of 3 months; - structural operations. ≠ Permanent facilities - deposit facility, the floor rate for the market overnight rate; - marginal loan facility at the overnight market rate, guarantees necessary (securities repos). ≠ Obligatory reserves</p>
TRANSPARENCY ²	<p>The Federal Open Market Committee (FOMC) sets the target for federal funds rate 8 times per year. Announcement of decision: immediate. Publication of voting: immediately. Publication of minutes: no later than the Tuesday following the Committee meeting. Beige Book (8 times per annum, 2 weeks before each FOMC meeting). The Federal Reserve Present presents a semi-annual report to Congress on monetary policy.</p>	<p>The Monetary Policy Committee (MPC) of the Bank of England meets each month (first Wednesday and Thursday of each month) to set repo rates. Announcement of decision: immediate. Publication of voting: with the minutes. Publication of the minutes: two weeks after the meeting. Inflation report (publication of explicit forecasts for a two-year horizon used by the MPC members). Quarterly bulletin. If inflation deviates from the stated target by more than one percentage point, the Governor is bound to write a letter to the Chancellor explaining why. The annual report submitted to the Chancellor is debated by Parliament. In extreme cases, the Treasury has the power to give instructions to the BoE for a limited period, if it is a matter of national interest.</p>	<p>The Governing Council of the European Central Bank meets twice each month. Decisions to change the refinancing rate are taken during the first monthly meeting. Announcement of decision: immediate. Publication of voting: no. A simple majority decision is required, with the Chairman holding a casting vote. But most of the time, the Governing Council does not hold a vote and operates by consensus. Publication of minutes: no. A press conference takes place after each meeting concerning monetary policy (the first one each month): statement by the Governor followed by a question-and-answer session with journalists. Monthly bulletin; Consolidated financial situation of the ESCB each week; Annual report. The President of the ECB has to present the annual report to the European Council and Parliament, which may hold a general debate on it in plenary session.</p>

¹ Money supply, Inflation targeting, Exchange rates, Interest rates, Nominal income, Financial balance, Monetary basis, ² Transparency, democratic accountability, credibility.

Budget policy: the UK opts out of the stability pact and sets its own rules

To shed its reputation as the party of devaluation and instability, Labour affirmed its attachment to inflation targeting and proposed to reform the BoE. Similarly, to dispel the party's image of big spending and tax hikes, New Labour made three major promises in its 1997 party manifesto: 1) it would not raise the base rate or upper rate of income taxes during the legislative session, 2) the Conservative Party's spending plans would be maintained during the first two years of government, and 3) strict guidelines would be introduced to manage public borrowing.

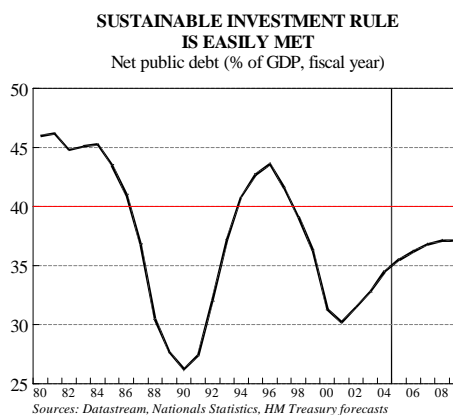
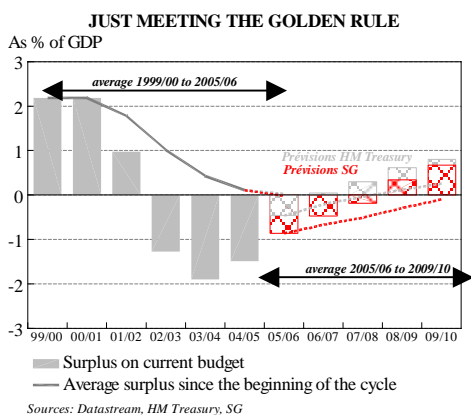
Although the UK authorities must strive to abide by the rules of the stability pact,⁸ once in power, Labour fulfilled its campaign promises and laid down its own rules to guarantee the medium-term equilibrium of public finances.

In pair with the Bank of England Act, which defines the handling of monetary policy, the Code for Fiscal Stability adopted in 1998 provides the principles for managing monetary policy based on two fiscal rules: the golden rule and the sustainable investment rule.

Ø The golden rule

The golden rule stipulates that on average over a complete economic cycle, the current budget must be in balance or surplus (i.e. revenues minus expenditure, excluding net investment). The underlying principle is that, over the entire economic cycle, the Government will borrow only to invest and not to fund current spending. Public investment, like the modernisation of infrastructure, is favoured because it is likely to increase the country's long-term growth potential. This principle is particularly well adapted to the UK economy, where infrastructure has been hit by chronic under-investment, notably during the Thatcher years. The golden rule is relatively attractive compared to the stability pact because it makes it easier to pursue a countercyclical budget policy during an economic slowdown (although this is less true since the stability pact was revised). This fiscal rule has two shortcomings, however, that risk undermining its credibility: 1) the boundary line between public investment and current spending is never very clear-cut, and 2) the Treasury determines the length of the economic cycle. This gives the Treasury some leeway, which can certainly be seen in a positive light, since it adds a little flexibility to the application of the rule. Yet it also opens the door to criticism since the definition of the cycle could prove to be largely political in the end.

For the Chancellor, the current cycle began in fiscal 1999-2000 and will end in 2005-06. Moreover, the Treasury estimates that the average budget surplus between 1999-2000 and 2005-06 will reach 0.1% of GDP. The government is thus convinced that it will comply with the golden rule during the current cycle, and that it has a safety net of £6bn. We, too, believe that the golden rule will be met this time round, although only barely, since we are looking for a higher deficit in 2005-06. For the next cycle (2005-06 to 2009-10), the Treasury is forecasting a current surplus of as much as 0.25% of GDP. Based on our scenario, which starts from a weaker position and uses less optimistic growth forecasts, we fear the government will find it much harder to respect the golden rule during the next economic cycle.



Ø Sustainable investment rule

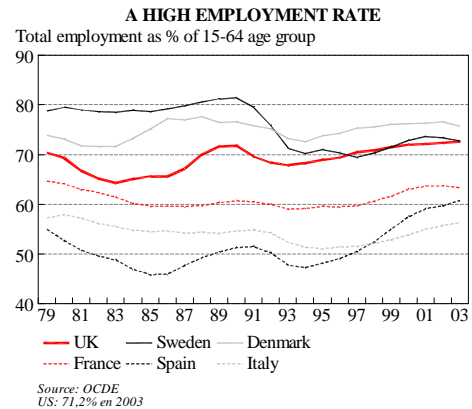
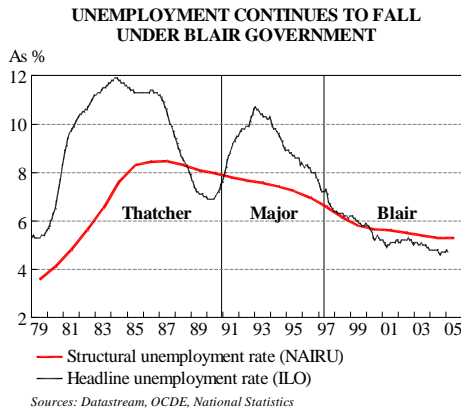
The golden rule fosters conservative management of public finances since the current budget must be balanced over the length of the cycle. Yet since public investment does not have to be sacrificed to short-term pressures that might strain spending, the public sector could potentially run up a constant deficit. Obviously, this is unsustainable in the long term, since it would constantly add to the public debt. It is for this reason that a second fiscal rule was created to manage public finances in the UK: the sustainable investment rule.

This rule requires that public sector net debt (net of liquid assets) must be held, over the economic cycle, at a stable and prudent level. The government currently esteems that it will easily meet the sustainable investment rule and that net debt will hold below 40% of GDP in each year of the cycle. Despite the sluggishness of world economic growth between 2001 and 2003, and major public spending efforts, the Treasury esteems that net debt will level off at 37% of GDP for the forecast horizon (fiscal year 2009-10, see graph).

⁸ EU regulation 1467/97, which aims to clarify the implementation of procedures concerning excess deficits, stipulates that since the UK is not in the euro zone, it does not have to avoid excess deficits, although it goes on to say that the UK should strive to avoid them (from this respect, the UK was the subject of a 2004 EU report after it reported a deficit of over 3%). The UK cannot be sanctioned, however, as part of excess deficit procedures.

2. Employment: targeted policies in the most fragile categories and strong incentives to rejoin the work force

When Tony Blair came to power in 1997, the headline unemployment rate was about 7.5% while structural unemployment (or NAIRU – the nonaccelerating inflation rate of unemployment) was a little over 6.5% according to OECD figures. This was already a much more comfortable situation than in the mid-1980s, when unemployment reached about 11.5% and NAIRU was not far from 8.5%. Clearly, the job market had already improved substantially before Labour returned to power.



The decline in structural unemployment since the mid-1980s is largely attributed to the impact of the Conservative Party's sweeping liberalisation movement. We tend to agree. Below, we have summarised the three points developed by Nickell and Quintini⁹ to explain the reduction in the equilibrium rate of unemployment:

- Changes in wage-setting procedures: Nickell and Quintini first outline the classic theory of unemployment, in which wage talks, in countries where they occur in an uncoordinated and confrontational manner, tend to generate inflationary pressures, and, for a given level of labour demand from companies, they tend to drive up the equilibrium rate of unemployment. Consequently, they argue that job market reforms and cutbacks in union rights implemented in the 1980s¹⁰ reduced the clout and negotiating power of unions, which in turn significantly reduced the level of classic unemployment.
- Changes in the benefit system: According to Nickell and Quintini, four aspects of unemployment insurance have an impact on the equilibrium rate of unemployment: the level of jobless benefits, their duration, the system's coverage and the severity of eligibility requirements. Trends that favour a decline in the equilibrium unemployment rate have been observed for all four points: the decline in the replacement rate since the beginning of the 1980s, cutbacks in the duration of benefits and system coverage, and stricter eligibility requirements.¹¹
- Changes in the tax wedge on employee earnings: changes in labour taxation have also reduced the equilibrium rate of unemployment since the early 1980s, albeit to a lesser extent, since the tax wedge fell slightly during this period. The impact on the equilibrium rate of unemployment is estimated at a little over one half of a percentage point.

In the end, by the time Labour came to power, the job market was already completely deregulated with more flexible forms of employment (short-term contracts, part-time work). The share of part-time work rose from about 20% in the mid 1980s to 25% in the mid 1990s. New Labour did not call into question the Thatcher legacy. Even today, the UK has one of the least regulated job markets. According to the OECD index of job market regulation, the UK has the least regulated market of the OECD countries (1.1 on a scale of 1 to 6), after the United States (0.7). In comparison, France and Germany score 2.9 and 2.5, respectively.

Under this environment, New Labour developed its job policy around three vectors:

- Active employment policies targeting the least favoured categories;
- Greater back-to-work incentives designed to make work pay;
- Extensive public sector hiring.

Active employment policies targeting the least favoured categories

Despite more stable and sustained growth, the liberalisation of the job market left certain categories of workers out of the job market. To remedy this situation, New Labour launched a series of targeted activation/insertion measures in 1998, called the New Deal. The first programs were the New Deal For Young People (NDYP), which targets 18 to 24 year olds; New Deal 25+ for the long-term unemployed aged 25 and over; and the New Deal for Lone Parents (NDLP), which is designed to help single-parent households.

⁹ Nickell S. and Quintini G.: "The recent performance of the UK Labour Market", *Bank of England, August 2001*.

¹⁰ Five major laws were passed, including the Employment Acts of 1982, 1988, 1990 and the Trade Union Act of 1984. These laws limited the right to strike as well as solidarity strikes, liberalised hiring and firing regulations and decentralised the formation of wages after the elimination of the Wage Councils, which had set minimum wages and working conditions for various professional categories.

¹¹ This movement began in 1980 with the Social Security Act, which called for the gradual elimination of the proportionality of unemployment and healthcare benefits to wages, and the return to a flat-rate system. In 1996, the Job Seekers Allowance reduced unemployment insurance to six months from one year, and tightened eligibility requirements (which are dependent on active job searches and the verification of resources after six months). For international comparisons, the OECD calculates a benefit replacement rate (average of unemployment benefit entitlement relative to average gross wages), which fell from 27% at the end of the 1960s to 17% today (vs. 44% in France).

In 2000, the government launched New Deal 50+, a programme for the 50 and over age group, and in 2001, the New Deal For Disabled People (NDDP).

New Deal statistics (at 31 December 2004)

	Young people	Long-term unemployed	Lone parent	Disabled	50+
Number of participants since inception	1,254,100	769,840	769,360	131,110	
Current number of participants	67,820	51,970	70,570	88,870	
Number of benefit recipients transferring to the job market (% with jobs lasting more than 13 weeks)	550,840 (79.5%)	213,680 (77.9%)	365,440	66,400	131,850*

* 98,000 persons received supplementary revenues between April 2000 and March 2003 (which was merged with the Working Tax Credit in April 2003) 33,850 benefit recipients found jobs between April 2003 and December 2004.

The New Deal becomes mandatory after a person has received unemployment benefits for 6 months for young people, and for over 18 months for the long-term unemployed. The idea is to provide job seekers with personalised assistance via Job Centres (which have been reinforced by the Job Centre Plus 2000-06 programme). This transition period is called Gateway and can last up to four months. If work still has not been found after four months, job seekers will be directed toward training programmes, subsidised jobs or volunteer work. The New Deal for Lone Parents is a voluntary programme for single-parent families who work fewer than 16 hours a week, and whose youngest child is less than 16 years old. Accent is placed on training and information about job-related financial assistance, notably the Working Families Tax Credit (WFTC, see below). These programmes have scored rather well in evaluation studies, notably the programmes for young people and lone parents, especially in terms of getting recipients back to work and cost/benefit analyses.

Greater incentives to rejoin the work force

To increase incentives to rejoin the work force and to make work pay, the Labour government introduced a minimum wage and a tax credit mechanism. Initially, the tax credit was only for working families (*Working Families Tax Credit*, WFTC). According to HM Treasury, WFTC helped boost the revenues of eligible families by an estimated 14.1% in 2000, while the revenues of lone parents rose 44%. At the same time, this system added 81,000 individuals to the labour supply. The employment rate for lone parents rose by 5 percentage points over the span of four years. In April 2003, the government merged several components of the tax system and family benefits to create the Child Tax Credit and Working Tax Credit. Today, nearly 6 million families benefit from a tax credit. The hourly minimum wage was raised to £4.85 from £3.6 in 1999, and will continue to rise to £5.05 in October 2005 and £5.35 in October 2006. The minimum wage, combined with the tax credit system, guarantees minimum weekly revenues for the least favoured households. For a family with one child, for example, the weekly minimum for a full-time worker (35 hours) was £182 in April 1999 and will reach £260 by October 2005.

Extensive public sector hiring

Between 1997 and early 2005, the UK economy created a little over 2.1 million jobs. Excluding the factors mentioned above (job market deregulation, targeted policies for key segments of the population, and incentives to return to the labour force) as well as strong growth during the period, another factor that helped boost employment was extensive public sector hiring. During the first two mandates from April 1997 to May 2005, Labour created an estimated 600,000 public sector jobs. Last March, the statistics bureau published its public sector jobs estimates (based on several sources of information and not just on the Labour Force Survey, which tend to overestimate public sector employment for various reasons). This means that between 1998 and Q1 2004, over 580,000 net job creations were reported in the public sector, including 210,000 in education and 270,000 in public health (National Health Service, NHS).

3. Productivity accelerates

In addition to the macroeconomic framework and job measures, another factor made a small contribution to the relatively strong performance of the UK economy: the slight improvement in productivity.

Breakdown of growth trends

Average annual growth rate, %	Q2 1986-H1 1997	H1 1997 – Q3 2001	Q4 2001 – Q4 2006
GDP	2.55	3.06	2.75
- Hourly productivity	2.04	2.50	2.25
- Labour utilisation	0.51	0.56	0.6
- Working age population	0.24	0.58	0.5
- Employment rate	0.36	0.41	0.2
- Hours worked	-0.11	-0.43	-0.1

Source: Budget 2005, HM Treasury

Since 1997, the Blair government has launched numerous initiatives to close the UK's productivity gap with all other industrialised countries (excluding Japan), which might explain this upturn in productivity. One of the government's first objectives is to increase the qualifications of the labour force, not only through its New Deal programme, but also through special efforts at schools. The government also seeks to encourage competition and to maintain a stable, pro-business regulatory framework. Some of the results of these efforts are outlined below:

- Deregulation of utility networks, mainly telecoms and electricity.



- Creation of the Financial Services Authority (FSA), a unique financial services supervisory board that replaces nine separate bodies, to strengthen the UK's position in financial services (acquired mainly through financial market deregulation in 1986). FSA was set up after the Bank of England became independent, and its supervisory powers were enhanced under the Financial Services and Markets Act of 2000.
- With the Competition Act of 1998, the government set up a modern, dynamic and effective system for implementing competition policy. The Office of Fair Trading (OFT) was created to oversee competition and is responsible for implementing a competition policy that protects the public interest and guarantees market efficiency.
- The government also encouraged small companies (SME) through the creation of the Small Business Service (launched in 1999, operational in 2000), a service of the department of Trade and Industry that strives to reduce administrative barriers and help small businesses comply with regulations.

Several measures were also taken to foster innovation and Research & Development (R&D):

- R&D tax credit: since 2000, SME can deduct 150% of R&D spending (since 2002, large companies may also deduct 125%).
- Tax incentives to encourage SME to invest in telecommunications and IT equipment
- Tax cuts for major corporations that invest in small, high-risk companies.
- The government also encouraged the creation of "clusters", which bring together companies and research units in leading edge technology.

The challenges facing Tony Blair's third mandate

During the traditional Queen's Speech on 17 May, the Prime Minister laid down the priorities of the new legislature.

The government's top economic priorities are:

- Education
- Ongoing reform of the National Health Service
- Ongoing reform of the welfare state in order to reduce poverty
- Helping the disabled return to the work force
- Pension reform.

From a social perspective, Tony Blair plans to lead a firm policy against crime, immigration and terrorism. In terms of international relations, the Prime Minister plans to launch a referendum on the Constitutional Treaty for the European Union, to work to build an increasingly prosperous and secure Europe when the UK takes over the presidency of the EU in July, and to use its presidency of the G8 to secure progress in tackling poverty in Africa and climate change.

The three economic challenges of the Blair government can be summarized as follows: 1) to continue modernising public services, 2) to continue fostering increases in productivity, and 3) to extend reforms of the welfare state.

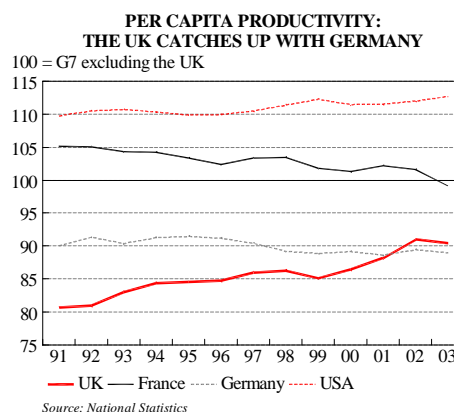
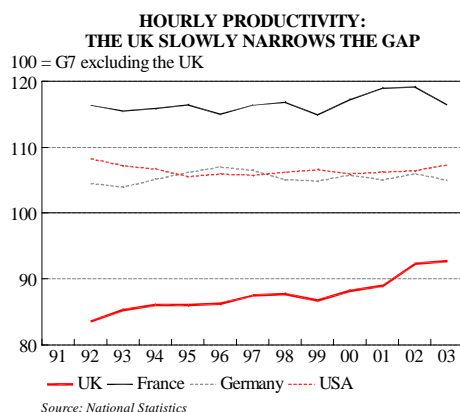
1. Ongoing plan to modernise public services

The first challenge of the Blair government will be to carry through its plan to modernise public services. As we pointed out earlier, since fiscal 1999-2000, the Labour government has invested heavily in its plan to modernise public services. Notable progress has been made. In health care, for example, the waiting period for emergency room services and scheduled operations has been reduced considerably, new hospitals have been built (49 since 1997, with 33 more under construction) and equipment has been upgraded (scanners, X-rays, etc.). Similarly, education spending rose from 4.7% of GDP in 1997 to 5.5% this year (or £1,000 more per student). This has significantly increased the skills of students at the end of primary school (age 11). It is in transportation that the most remains to be done, even though investment has doubled since 1997. During the election campaign, Labour pledged its commitment to make improvements in the rail network, to invest heavily in increasing highway capacity (M1, M6 and M25) and to continue supporting renovation work on the London subway system. Greater public spending will also be accompanied by measures to control the efficiency of these expenditures to avoid waste. The Public Sector Agreement (PSA) sets performance targets for public services and seeks to make public spending as effective as possible to give taxpayers value for money. After his re-election, Tony Blair reaffirmed his plans to accelerate reforms and set new targets, such as reducing the waiting period between referral and treatment to less than 18 weeks, and to improve the skills of 14-19 year olds. At the same time, he recognised the need to continue managing public funds effectively (Voters clearly want more money to be invested in public services, but it is also clear they want more value for their money).

Yet, these hefty spending programmes could well run into budget constraints. It will be much harder to comply with the golden rule during the next cycle (2005-06 to 2009-10), and even though the government still has some manoeuvring room in terms of the sustainable investment rule, it surely will not be easy to finance all of the announced projects. The budget deficit has exceeded 3% of GDP since 2003, and a wider deficit would raise the issue of tax hikes. During the campaign, Labour promised not to raise income taxes, which does not rule out the possibility of increasing national insurance contributions (employer and employee contributions rose 1 point in fiscal 2003-04).

2. Meeting the productivity challenge

Tony Blair must also surmount the challenge of productivity. Despite a slight narrowing of the productivity gap as we mentioned above, the UK's economic performance is still one of the least competitive of all the industrialised countries (excluding Japan). Each budget must now have a special chapter on meeting the productivity challenge, outlining government measures in this area. Public sector modernisation is also part of this chapter.



In its latest study on the UK, the OECD pointed out that the country "is not in a very good position compared to its main competitors in terms of the acquisition of fundamental knowledge and professional skills, which has surely been a major obstacle for improving productivity." Efforts to boost skills and qualifications through education and training go hand in hand with the government's emphasis on increasing productivity. Similarly, the modernisation of transportation infrastructure is also expected to improve long-term growth prospects.

For the UK authorities, the productivity challenge is also a matter for companies (competition, innovation, R&D). Two announcements were made during the Queen's speech: first, the consumer credit law will be updated to provide greater protection for consumers and to create a fairer, more competitive credit market, and second, company law will be reformed to encourage greater levels of investment and enterprise. In its election manifesto, Labour also announced its target of raising R&D spending (in both the public and private sectors) to 2.5% of GDP by 2014, from 1.9% today.

3. Further reforms of the welfare state

The government will continue to reform the welfare state on three fronts: 1) the fight against poverty, 2) helping the disabled return to the work force, and 3) the unavoidable issue of pension reform.

Of course, thanks to policies already implemented by Labour, there has been a decline in the number of poor children (the poverty rate dropped from 25% in 1996-97 to 21% in 2002-03). On the whole, however, monetary poverty has remained flat in the UK over the past decade (under 60% of median revenues). In 2002-03, 17% of the UK population lived in a poor household. Although this is much less than the peak of 21% in 1992, following the recession and the sharp upturn in poverty that accompanied the Tories' liberal revolution, it is still a far cry from the 10-13% figures seen in the late 1970s and early 1980s.

The government has already announced measures to help working families by extending maternity benefits and improving the provision of child care.

On the job front, as we have already seen, the UK has achieved full employment, and effective policies have been implemented to help young people and lone parents return to work. Yet, there are still nearly 2.7 million working-age persons who receive disability benefits (7.5% of the working aged population). So far, however, the programmes targeting this group (New Deal for Disabled People, stricter eligibility requirements to receive disability benefits) have only managed to stabilise this figure at best. In the Queen's speech, it was also announced that services would be set up to provide assistance and help the disabled return to work (including regular medical visits, and for some beneficiaries, the level of assistance would be tied to active job seeking efforts). In its manifesto, Labour also calls for a new disability benefits system to be set up by 2008.

Finally, pension reform will undoubtedly be the most delicate issue. To carry through this reform, Tony Blair has called back one of his most loyal supporters, former Home Secretary David Blunkett. The British are not saving enough for retirement. The basic state pension is extremely low and corporate pension funds were slaughtered by the equity market crisis of 2000-03. Last year, the government set up a retirement commission to evaluate the impact of an aging population. The commission's second report will be released next fall. So far, the government has not ruled out any solutions to resolve the crisis. Business leaders argue that the retirement age should be raised to 70, from 65 today. Unions that have already met with Mr. Blunkett have asked him to require both employers and employees to set aside savings for retirement, and for the government to double its £400m Pension Protection Fund (PPF) to offset the losses of pension holders whose companies go bankrupt (like MG-Rover).

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