

Embargoed to 00:05 am Tuesday 6 October 2009



making business sense

The economics of George Osborne - assume very low interest rates a weakish pound and falling bond yields

With Conservative policy becoming clearer and the state of the UK economy gradually becoming less uncertain, it is now possible to make an assessment of their economic consequences. Our latest UK forecasts, to be released later this week, are based on our normal convention that we take the spread betters' conclusions for the results of uncertain political developments. In this case we therefore assume a Conservative victory in a May election with a decent working majority. In effect, we see monetary policy being moved into 'fast forward' while the fiscal policy levers are put into 'fast reverse'.

We assume £80 billion of public spending cuts, £20 billion of indirect tax increases and a 'get back to work' package with a gross cost of £3 billion. The good news for the Tories is that it looks as though the policies should work; the Budget deficit is reduced to 2.5% of GDP before the end of the parliamentary term, the economy does not go back into recession, while unemployment stays high and rises slightly – but starts to fall back in 2013.

The policies depend for their success on keeping monetary policy very loose – a combination of quantitative easing and base rates at 0.5% until mid 2011 at least and a fall in the 10 year bond yield to 2.5% in two years. This leads to a continued weak exchange rate – the pound falls to \$1.40 and could temporarily reach parity with the euro unless the markets become aware at an early stage of the euro's structural weaknesses.

Low interest rates and a competitive pound eventually revive net exports – particularly constraining imports of manufactured goods – and business investment, especially in commercial property. GDP growth from 2010-2014 averages just short of 1.5% - not high but not obviously much lower than under any other strategy. Following emergence from the recession in the second half of 2009, growth comes back in 2010 but falls back again in 2011-12 as fiscal retrenchment takes its course. Through 2013-14 growth reaches and surpasses the 2.0% mark for the first time since 2007.

Of course there are risks. The biggest risk is that external factors and a weak pound may mean that underlying inflation is too high for interest rates to be kept low. This is why the Tories' labour market strategy is so important – the 'back to work' policy may cost money (we suspect rather more than the £600 million quoted in the press) but is essential to limit the rise in unemployment and to keep downward pressure on pay inflation, business costs and hence the Consumer Price Index.

But the Conservatives could justifiably argue that the risks of the alternative strategy are much greater – a risk of financial markets being unwilling to finance a debt burden and a major economic crisis.

We think George Osborne's sums add up – but he is reliant on the problems of the world economy easing, on growth outside the UK and on maintaining market confidence.

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