GERRARD & NATIONAL

Monthly Economic Review

No. 74, August 1995

Contents

Page No.

Gerrard & National Holdings PLC

Gerrard & National Limited   Lombard Street Research Ltd.

33 Lombard Street, London, EC3V 9BQ Tel: 0171-623 9981 Tlx: 883589 Fax: 0171-623 6173

GNI Limited
4th Floor, Atrium Building,
Cannon Bridge,
25 Dowgate Hill,
London EC4R 2GN
Tel: 0171-337 3500
Tlx: 884862
Fax: 0171-337 3501

Plough Court Fund Management Ltd.,
33 Lombard Street,
London EC3V 9BQ
Tel: 0171-621 1185
Fax: 0171-621 1270

Gerrard Vivian Gray Limited
Burne House,
88 High Holborn,
London WC1V 6LS
Tel: 0171-831 8883
Tlx: 887080
Fax: 0171-831 9938
Stx: 74377

LM (Moneybrokers) Limited
4th Floor,
25 Cannon Bridge,
25 Dowgate Hill,
London, EC4R 2GN
Tel: 0171-337 6500
Tlx: 8811553
Fax: 0171-621 1652

New worries in monetary control

Take-over finance and building society de-mutualisation boost money growth

Recent acceleration in money growth largely due to Glaxo/Wellcome deal and ought to unwind,

Money supply growth accelerated in early 1995, with the annualised growth rate of M4 in the six months to June running at 9.1% compared with 4.4% in the six months to December. The acceleration was largely caused by one big deal, Glaxo's acquisition of Wellcome, as Glaxo financed the purchase by borrowing over £6b. from the banks. (The extra loan boosted the banks' assets on one side of their balance sheets and, in the first instance, Glaxo's deposits on the liabilities side. Glaxo then wrote cheques to Wellcome's shareholders, which increased their deposits. These extra deposits were part of the money supply.) The exceptional nature of the upturn in money growth argues against any specific policy response. In coming quarters Glaxo will repay its loan, and both M4 credit and M4 itself will grow more slowly as a result. The case against higher interest rates receives further support from the sluggishness of mortgage credit, which constitutes about half of the stock of M4 credit. The latest *Monetary statistics* from the Bank of England show that in the second quarter (Q2) net lending secured on dwellings was £3,964m., 21% down from a year earlier, and that the value of mortgage loans approved was £13,362m., down from £14,706m. in Q4 1994 and from £14,310m. a year earlier.

but there are more take-overs in the offing

On the whole monetary trends remain satisfactory. As the Glaxo loan is repaid and mortgage credit weakens in late 1995, the growth of credit and money ought to slow down. However, two special influences boosting monetary growth deserve mention. First, more take-overs involving bank finance have been announced in the last few days. A story in the *Financial Times* for 2nd August reported that "Hanson...is widely expected to come to the syndicated loans market to pay for its £2.5bn. agreed offer for Eastern Group" and that "Royal Bank of Scotland is arranging an £800m. facility for Scottish Power to help finance its hostile £1bn. bid for Manweb." With other bids in prospect, take-over lending might boost M4 credit (and M4) by perhaps £3b. - £4b. before the end of the year.

and the de-mutualisation of building societies may also have an effect

Secondly, the de-mutualisation of building societies will have complicated but quite important monetary effects. If a building society converts to a plc merely by issuing shares (i.e., re-labelling the "reserves" as "equity capital"), there is no monetary effect, because the building society keeps its own bank deposit unchanged and the shareholders' deposit total is also unaffected. But, if de-mutualisation is accompanied by a cash distribution, the building society's bank deposit (which is not part of M4, because it nets out for the monetary sector as a whole) is reduced and the shareholders' bank deposits (which are part of M4) increase. So M4 is higher than it would otherwise have been. The precise scale of this effect is not yet clear, but it could be a few billions.

Professor Tim Congdon — 3rd August, 1995

Summary of paper on

"Are the UK's public finances in good shape?"

Purpose of the paper

The debate about tax cuts in the Conservative Party has heightened concern about the UK's public finances over the medium term. The paper examines past trends in the budget deficit (variously defined) and considers whether public debt will remain under control in the late 1990s, particularly in the light of a probable change from Conservative to Labour rule.

Main points

* **By international standards the UK has managed its public finances well in the last 15 years. Uniquely in the G7 group of leading industrial countries, the ratio of public debt to GDP has fallen since 1978. (See p. 6 and p. 7.)**

* **But the PSBR/GDP ratio rose sharply in the early 1990s (see p. 5) and in any case it was kept down in the 1980s only by a number of special influences:**

  i. public corporations, sometimes with large investment and borrowing programmes, were moved from the public to the private sector by privatisation (see p. 8),

  ii. the privatisation receipts reduced the PSBR (see p. 9),

  iii. large cuts in public sector capital expenditure, many of them implemented in 1977 and 1978 under the last Labour Government, cut public borrowing (see p. 10), and

  iv. substantial tax revenues on North Sea oil profits were received in the early and mid-1980s.

* **Different definitions of the budget deficit can be proposed, where - in contrast to the PSBR - the beneficial effects of these changes do not appear. (See pp. 8 - 11.)**

* **Perhaps partly in response to the definitional problems, Mr. Gordon Brown, the Shadow Chancellor, has suggested a "golden rule" whereby the Government would borrow only to finance capital expenditure. But this could lead to high PSBRs. (See p. 12.)**

This paper was written by Professor Tim Congdon and Stewart Robertson.

Are the UK's public finances in good shape?

Appearance of satisfactory control over the long run is deceptive

PSBR has been disappointing in 1995,

Recent information on the public sector borrowing requirement has been disappointing. The Treasury has upped its projection of the PSBR for the 1995/6 year to £24 1/2b., equivalent to about 3 1/2% of GDP. There has to be a risk that in practice the figure will be well above £25b. As 1995/6 will be the first full year to see the extra revenues arising from the huge tax increases announced in the two Budgets of 1993, an outturn in this vicinity would be much too high. A theoretical case can be made that the maximum PSBR/GDP ratio consistent with long-run price stability is only 1%. (See T. G. Congdon 'The analytical foundations of the Medium-Term Financial Strategy', originally published in the May 1984 issue of *Fiscal Studies*, reprinted pp. 65 - 77 of *Reflections on Monetarism*.)

The Government has in fact endorsed a balanced budget as a constraint on fiscal policy. Mr. Clarke, the Chancellor of the Exchequer, has not only emphasized that balance remains the eventual goal, but also warned his Cabinet colleagues that - without tighter control over public expenditure - there is only limited scope for tax cuts. Whether strictly justified by the fiscal arithmetic or not, there will undoubtedly be some tax cuts in the two remaining Budgets before the next general election. Financial markets, notably the gilt-edged market, are therefore becoming concerned that the UK's public finances may deteriorate over the medium term.

and there are worries about a possible Labour government

The probability that the Labour Party will win the general election is a further worry. Mr. Gordon Brown, the Shadow Chancellor, has tried to dampen the markets' fears by proposing a "golden rule" to guide the UK's public finances in future. Its essence is that borrowing would be allowed only if it were to finance capital expenditure. This appears to be responsible, since it is analogous to the behaviour of profitable and solvent companies. It is also consistent with the view that the "public sector's net worth" (i.e., the value of all the public sector's assets, tangible and financial, minus its borrowings) is the correct target for the Government's financial decisions. The underlying thought, which has been much discussed in Labour Party circles since the mid-1980s, is that the level of public debt should not by itself be the focus of policy. Instead the Government's finances are taken to be under control if public sector net worth is stable (either in absolute amount or as a proportion of GDP).

The Conservative record appears good, particularly by international standards

Despite the frustratingly high PSBR so far in 1995/6, the fiscal record of the present Conservative Government has in many ways been admirable. The chart on page 5 shows that there have been four years of public sector debt repayment (i.e., a surplus) since 1979. Between 1984 and 1990 public debt fell sharply relative to GDP. (See p. 6.) In 1978 the UK had the second highest ratio of gross financial liabilities to GDP in the G7; today it has the lowest. (See p. 7.) For all its blunders in public relations, and despite many genuine faults in other areas of economic policy, the Conservative Government seems to have done a good job here. In some ways Mr. Clarke's lukewarm attitude towards tax cuts is heartening, because it commits the Conservatives once more to sound finance.

The argument of this paper is twofold. First, while the present Government has to be commended for being the only one in a significant industrial country to have reduced the ratio of public debt to GDP in the last 15 years, the uniqueness of its success owes much to special and transient influences. Secondly, Mr. Brown's "golden rule", far from being a copybook maxim of sound finance, could lead to extremely high PSBRs in the early years of the next century.

But the Conservatives have been lucky and different definitions of the "budget deficit" give a less flattering verdict than the PSBR

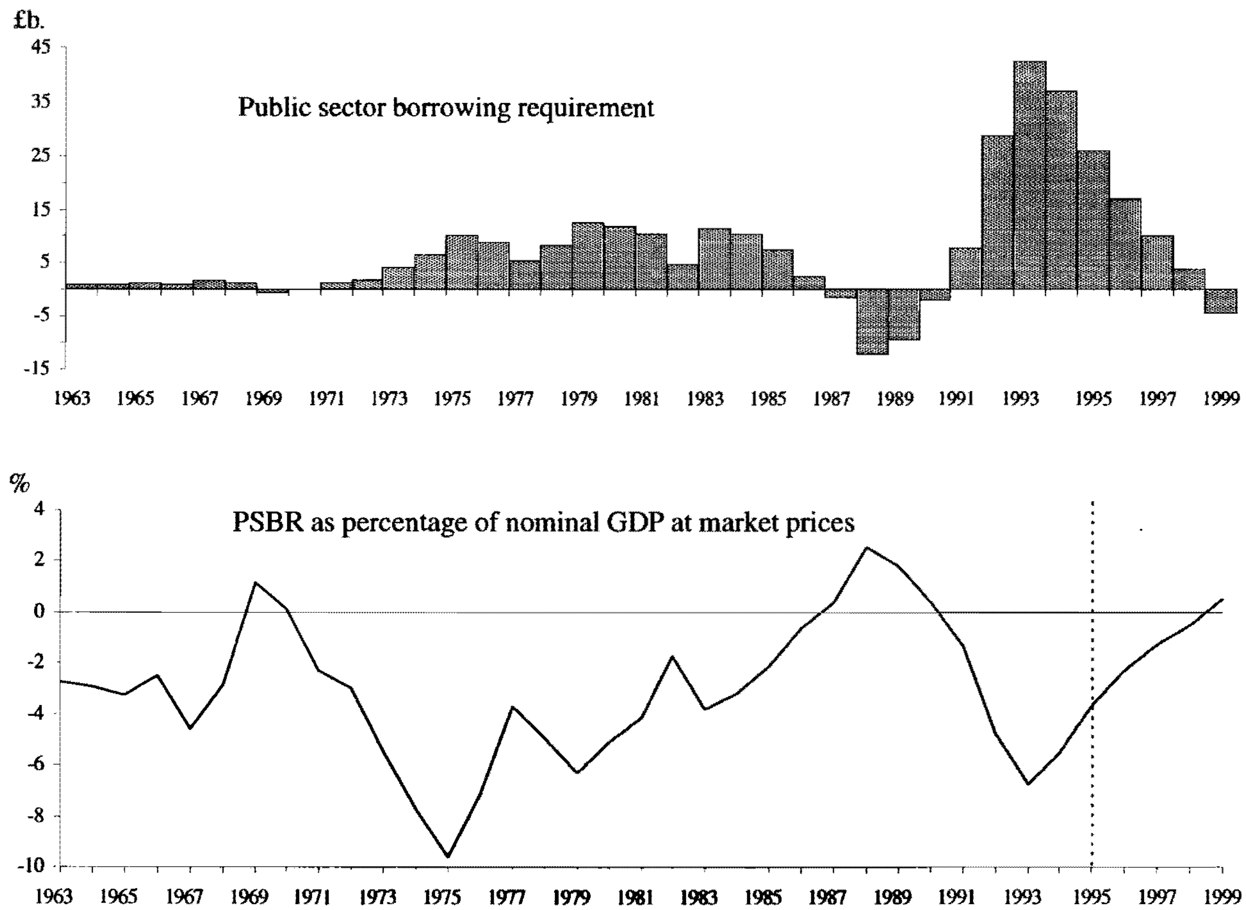
The argument proceeds by means of charts. The four charts on pp. 8 to 11 set out alternative definitions of the Government's financial position, to demonstrate that the PSBR flatters and deceives. Another possible definition (see p. 8) is the general government's borrowing requirement, i.e., borrowing by central and local government, not the public sector as a whole; since 1979 it has fallen less, as a share of GDP, than the PSBR because privatisation has removed many public corporations' borrowing from the PSBR. Another measure (see p. 9) is the general government's financial deficit, i.e., the increase in its net debt; since 1979 this also has made less progress than the GGBR (and the PSBR), because the GGBR has been reduced by privatisation proceeds whereas the GGFD has not been. A further option (see p. 10) is the general government's current account position i.e., excluding all capital expenditure and receipts; since the mid-1970s it has done much worse than the GGFD (and both the GGBR and PSBR), because the late 1970s saw massive cuts in capital expenditure which were not reversed by the Conservatives. Finally, the chart on p. 11 compares the PSBR and the general government current account position. Whereas the PSBR/GDP ratio in 1994 was slightly less than in 1979, the ratio of the general government's current account deficit to GDP was about 4% higher. In short, if the Government's finances had not benefited over the last 15 years from privatisation, a low level of capital expenditure and the happy accident of large North Sea oil revenues between 1981 and 1988, the PSBR/GDP ratio would now be nearly 10% of GDP.

Mr. Brown's "golden rule" could lead to extremely high PSBRs

In broad terms, it is the general government's current account position that is relevant to its net worth. Here is the link between the Conservatives' record and Mr. Brown's golden rule. Mr. Brown could claim that the slide on the GG current account since 1979 is evidence of a serious deterioration in the public finances. But, if Mr. Brown were to do nothing about the current account position and to increase GG capital expenditure to its level in the mid-1970s (i.e., by about 3% of GDP), the PSBR could climb to 7% or 8% of GDP. Ironically, it was anxiety about the inflationary dangers of a similarly-sized PSBR/GDP ratio, and consequent pressure for fiscal restraint from the International Monetary Fund, that led to large cuts in public sector capital spending in 1977 and 1978. To quote that weary old line, those who cannot learn from history are condemned to repeat it.

The public sector borrowing requirement since 1963

An apparently creditable record, with occasional surpluses



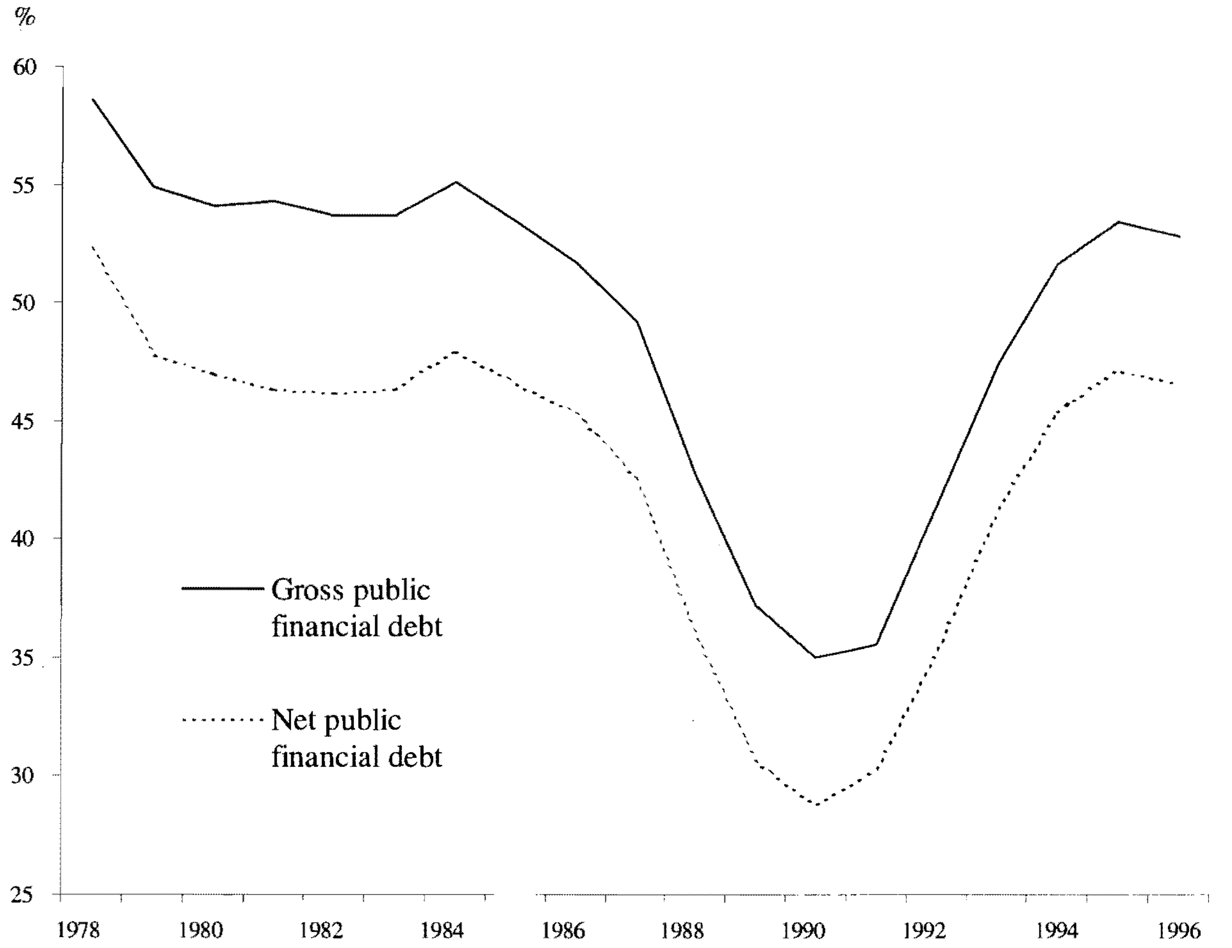
Source: Central Statistical Office, Financial Statistics *and 1995/96* Financial Statement and Budget Report (FSBR)

PSBR is on a calendar, not financial year basis, for easier comparison with GDP. Numbers after 1995 reflect official intentions in 1995/96 FSBR, *but with adjustments to bring them to calendar year basis.*

The UK's public sector borrowing requirement has tended to fluctuate in line with the economic cycle and to increase over time. But rises in national income have meant that the ratio of the PSBR to GDP has been kept broadly under control. After the last recession the ratio peaked at 6.7%, well below the high of just under 10% recorded in 1975. During the 1980s the PSBR declined steadily as a proportion of GDP, culminating in surpluses (i.e., public sector debt repayment) between 1987 and 1990. Much of the initial improvement was due to buoyant North Sea tax revenues. Subsequently, the unsustainable activity levels associated with the Lawson boom maintained the improvement. Recent poor monthly PSBR numbers suggest that the Government's aim of moving back into surplus by 1999 is not altogether credible.

Public debt as % of GDP, 1978-96

Public debt under reasonable control over the medium term



Source: OECD Economic Outlook

Chart shows general government gross and net financial liabilities as a percentage of nominal GDP at market prices. The data comes from OECD publications and uses OECD projections for 1995 and 1996.

Total government debt outstanding as a proportion of GDP fell sharply in the mid- and late-1980s due to budget surpluses and rapid economic growth. But the onset of recession and accompanying rises in public spending led to a reversal in this trend. Most of the spending increases were financed by the issue of new debt. The ratio of gross debt to GDP had fallen from over 50% to around 35% by 1990, but was back above 50% again in 1994. This deterioration made necessary the tax increases in the last Lamont and first Clarke Budget in 1993 which aimed to restore the public finances to a more healthy state. Despite the large tax rises, it is only now that any significant improvement is becoming visible. Even so, the amount of debt outstanding is still considerably greater than five years ago.

International comparisons of public debt, 1978-96

Britain seems to have a good record

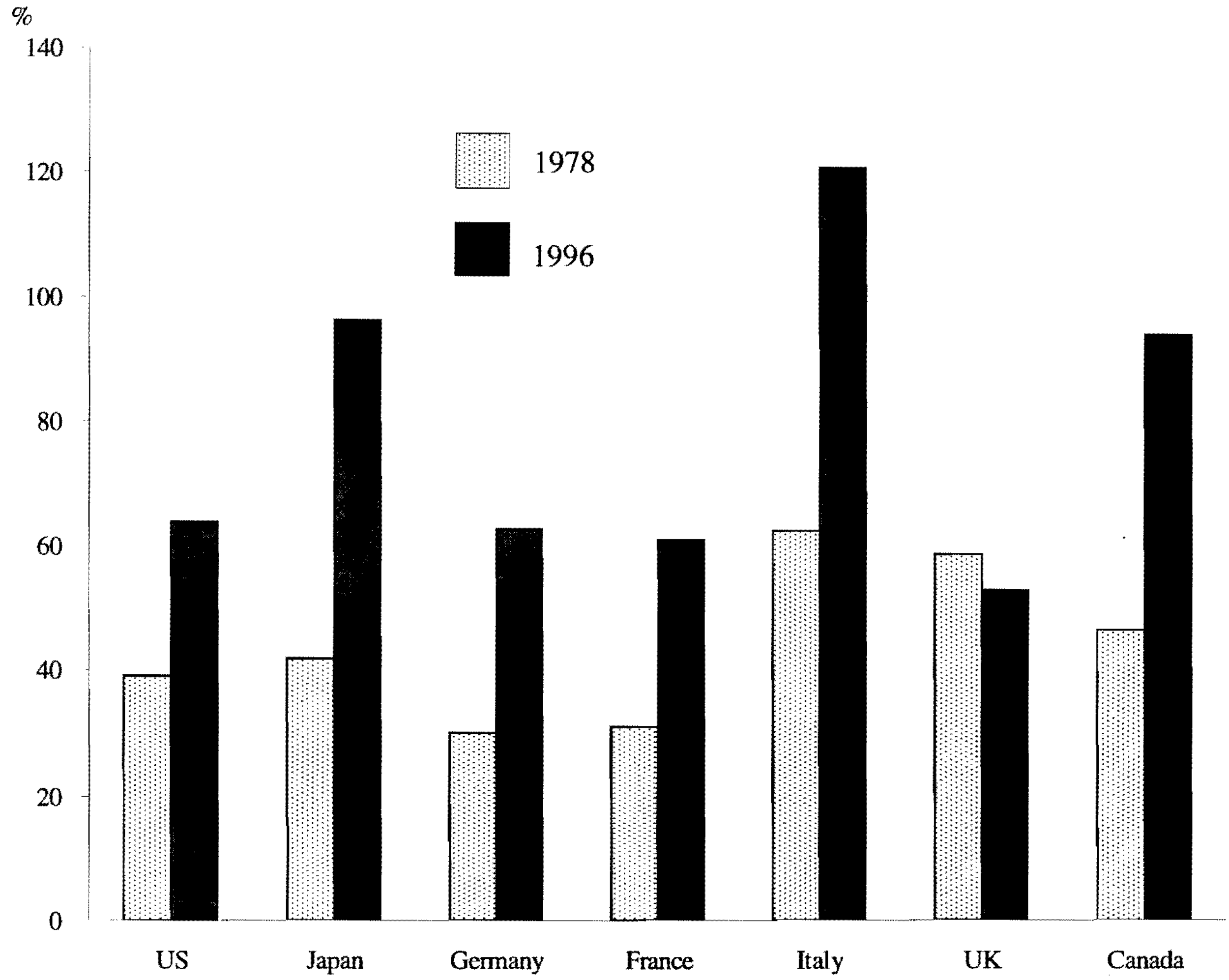
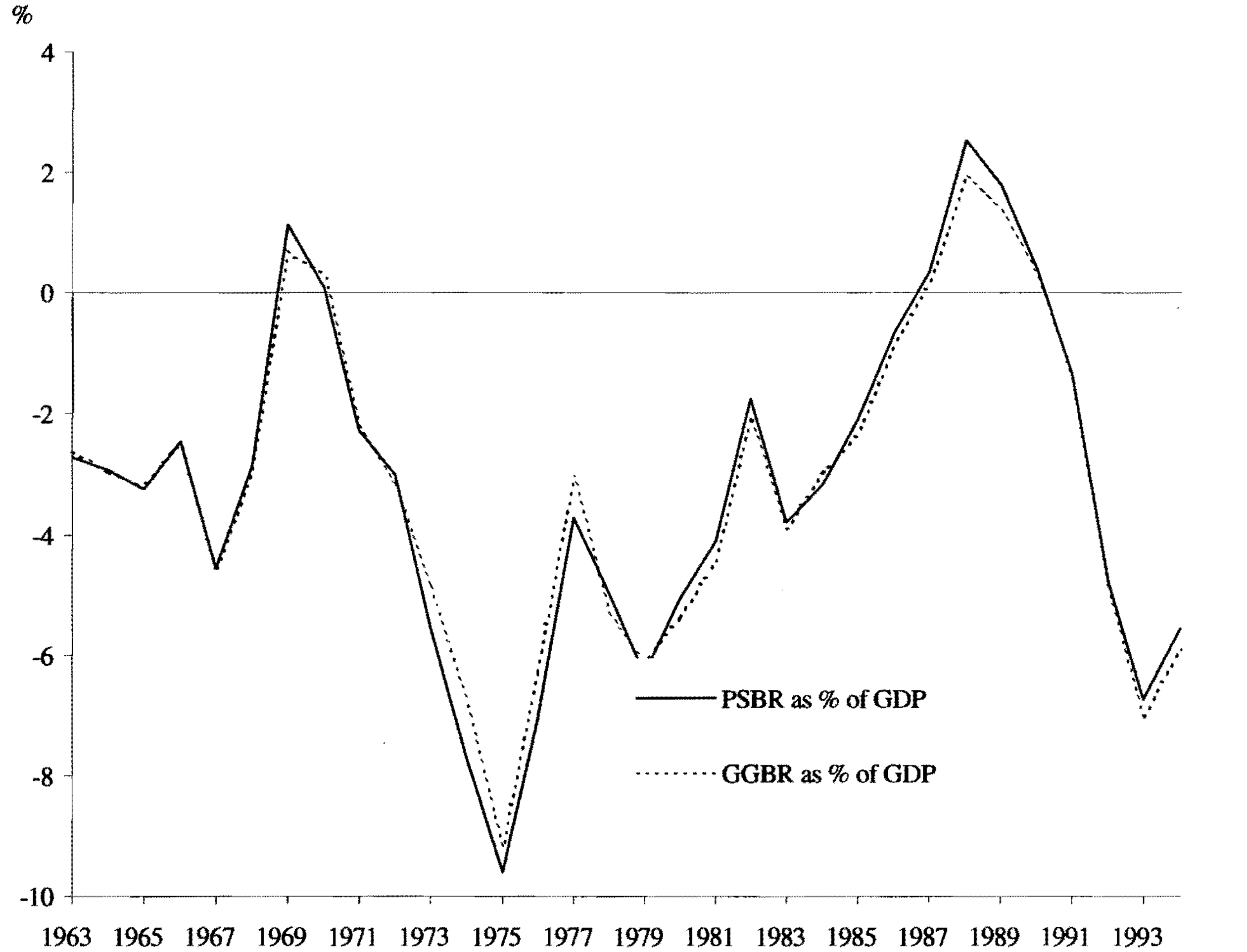


Chart is based on OECD data of gross financial liabilities of general government as a % of nominal GDP at market prices contained in the June 1995 OECD Economic Outlook. *The data for 1996 is based on OECD projections.*

The UK's public debt situation appears to compare extremely favourably with that of other industrialised nations. In 1978 Britain had the second highest debt to GDP ratio among the G7 countries. By the early 1990s it had the lowest, a position that is expected to be maintained over the next few years according to OECD projections. The UK is also the only country among the seven to have reduced public debt as a proportion of GDP over the period. But the comparison flatters the UK's actual performance because we have benefitted from two unique events. First, North Sea tax revenues provided a considerable boost to government revenues. Secondly, the privatisation boom during the 1980s both added to public receipts and removed the debt liabilities of some of the old public corporations.

The underlying deterioration in the UK's public finances

1. The public sector as a whole compared with general government

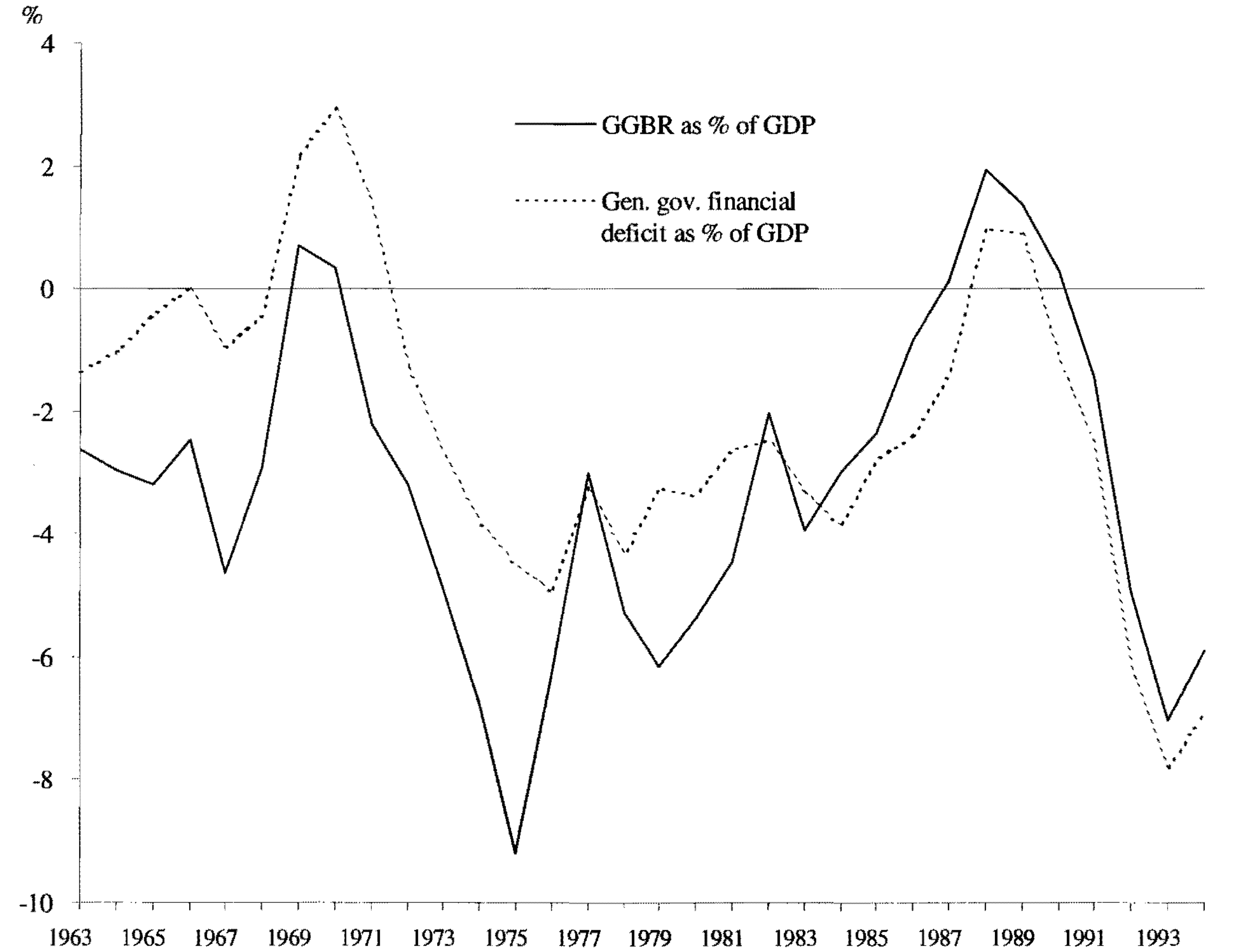


Source: Central Statistical Office

Chart compares PSBR with the general government borrowing requirement (GGBR), both expressed as a % of nominal GDP at market prices. A minus sign indicates a deficit.

The PSBR is made up of borrowing by central government, local authorities and public corporations. The GGBR is derived by excluding borrowing by public corporations. As a proportion of GDP, the GGBR has fallen less than the PSBR since 1979 because of privatisations. Privatisation has removed borrowing by nationalised industries from the PSBR, but has had no effect on the GGBR which has therefore shown less of an improvement. In contrast to the 1970s when the PSBR was almost always more than the GGBR, the situation is now reversed. Last year the PSBR amounted to £37.1b., but the GGBR was £39.3b. as remaining public corporations repaid debt. This trend also lies behind the Government's recently announced plan to target central government borrowing in the future rather than the PSBR as a whole.

2. General government's borrowing compared with its financial deficit



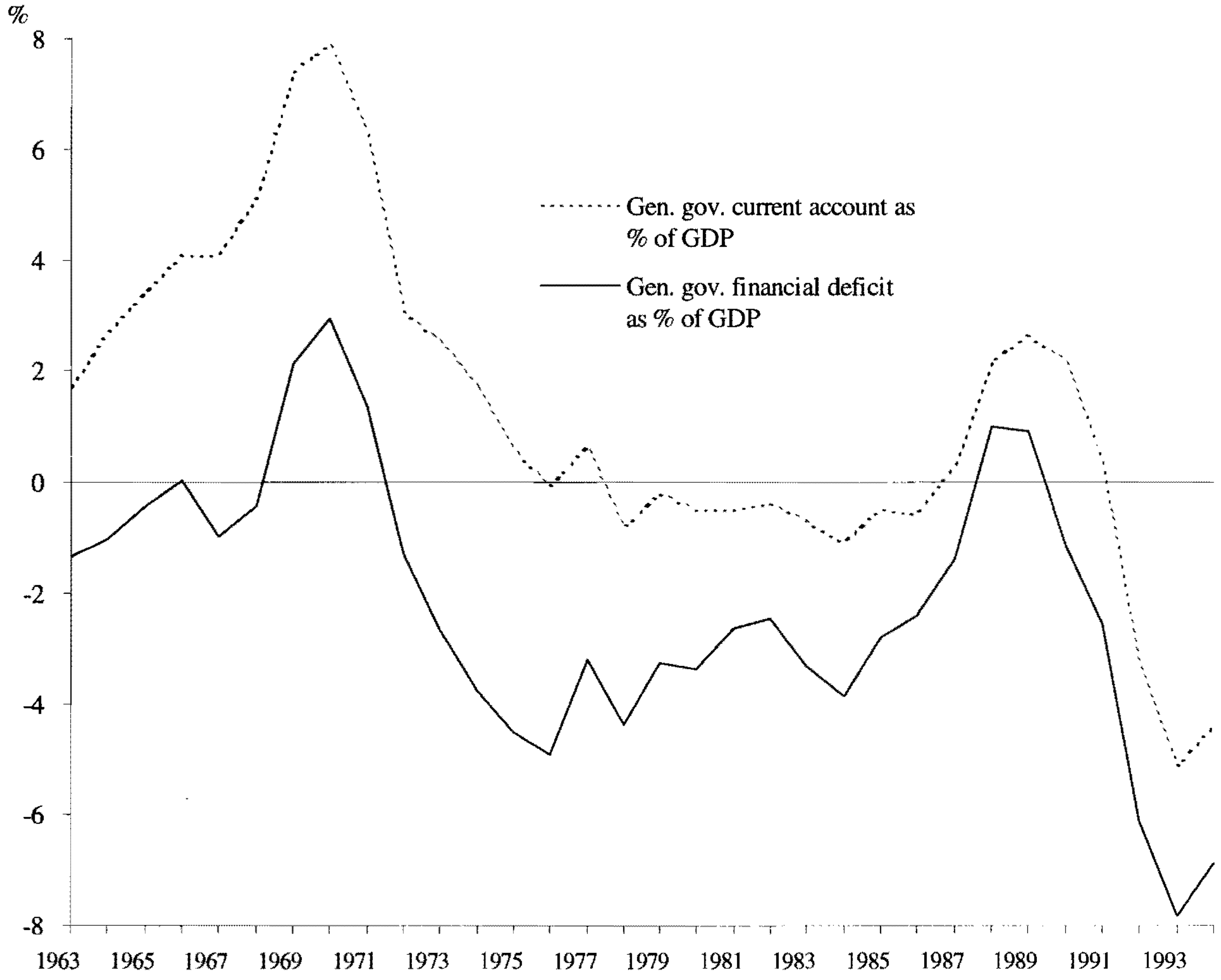
Source: Central Statistical Office

Chart compares general government borrowing requirement (GGBR) with its financial deficit, both expressed as a % of nominal GDP at market prices. A minus sign indicates a deficit.

The beneficial effect of privatisation proceeds on the UK's public finances is more apparent if the GGBR is compared with the general government's financial deficit, i.e., their net acquisition of financial assets. Privatisation brings in receipts, but ownership of an asset is lost. The Government's net financial assets are unchanged. The GGBR improved much more markedly than the financial deficit during the 1980s because privatisation proceeds reduced the need for borrowing. As the chart clearly shows, the financial deficit of general government as a proportion of GDP is significantly higher now than it was at any time during the 1970s. Further reductions in public borrowing over the next five years will not be assisted to the same extent as in the past by proceeds from the sale of public assets, especially if there is a Labour government.

The underlying deterioration in the UK's public finances

3. General government's financial deficit compared with its current account

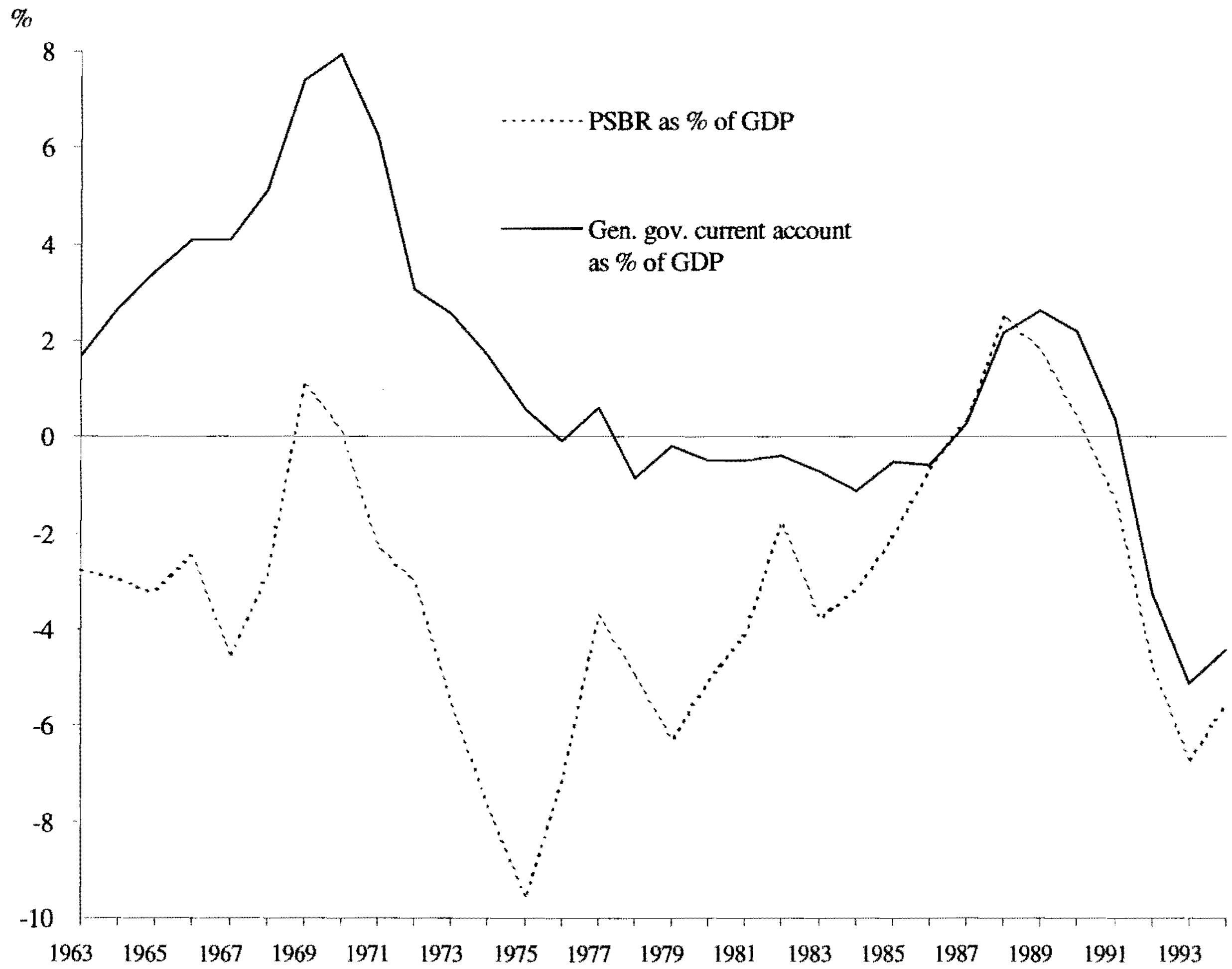


Source: Central Statistical Office

Chart compares general government financial deficit with general government current account, both expressed as a % of nominal GDP at market prices. A minus sign indicates a deficit.

A comparison of the general government's financial deficit with its overall current account position reflects the impact of capital expenditure (and receipts) on public finances. General government recorded healthy current account surpluses between 1963 and 1975. This period was characterised by extensive expenditure on schools, roads, housing and other infrastructure. High capital spending was accompanied by high public borrowing. The massive cuts in capital expenditure after 1975 (see p. 12) allowed general government borrowing to fall sharply as a proportion of GDP. But the government's current account position did not improve at all until the late 1980s at the end of the Lawson boom. Between 1989 and 1993 general government's net current account position slumped from a surplus of 2.6% of GDP to a deficit of 5.1% of GDP.

4. The PSBR compared with the general government's current account position



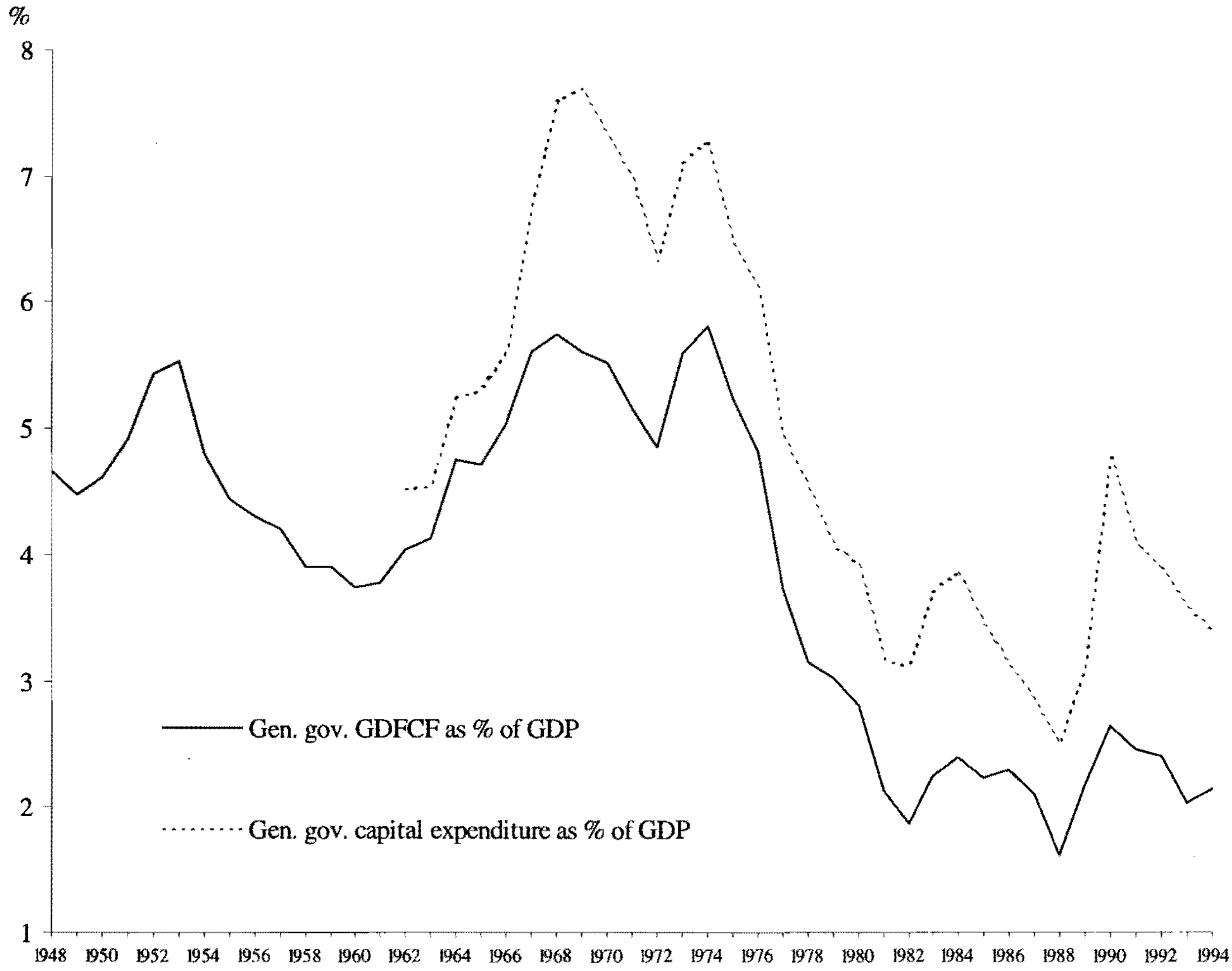
Source: Central Statistical Office

Chart compares general government current account with PSBR, both expressed as a % of nominal GDP at market prices. A minus sign indicates a deficit.

The PSBR as a proportion of GDP peaked at 6.7% in 1993 at the end of the last recession. Political mileage could have been made of the fact that at no time did the ratio approach the figure of almost 10% recorded in 1975 under the last Labour government. But looking only at current receipts and expenditure, a reasonable indication of the government's fiscal stance, the situation at present is significantly worse than that 20 years ago. The ratio of the general government's current account deficit to GDP is now about four percentage points greater than it was in the mid-1970s. Had it not been for the beneficial effects on public borrowing of North Sea tax revenues, privatisation proceeds and huge cuts in capital spending, then the PSBR as a ratio of GDP might now easily match or even exceed the 1975 figure.

Trends in the Government's capital spending

Massive cuts at the end of the last Labour Government have not been reversed



Source: Central Statistical Office

Chart shows the ratio of general government GDFCF and capital expenditure to nominal GDP at factor cost.

One of the IMF's conditions for the large loan granted to the UK in 1976 was strict fiscal restraint by the Labour Government. The axe fell primarily on capital spending which, as a proportion of GDP, fell from 7.3% in 1974 to 4.1% in 1979. The Thatcher administrations continued to monitor capital spending tightly, but had it not been for the sales of council houses and other property, the ratio of general government capital expenditure to GDP would have been 3.9% in 1989, virtually unchanged from ten years earlier. Higher capital spending might be expected under a Labour Government and while any such increases would be consistent with Gordon Brown's "golden rule", they would also imply a further and more noticeable deterioration in the public finances in the second half of the 1990s.