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Budget Commentary

Key points

- Public finances remain in good health

A combination of favourable developments have allowed Mr. Gordon Brown to reconcile tax cuts and higher public spending with sound public finances. The factors working in his favour include the favourable fiscal inheritance (a luxury rarely afforded to new Chancellors), the peace dividend and a sharp reduction in debt interest costs. (See pp.1-2).

- The composition of public spending is changing

Lower debt interest payments and defence spending have given Mr. Brown room to expand expenditure in the politically high-profile areas of health and education. (See p.3).

- Macroeconomic forecasts look reasonable

The Treasury's official growth and inflation projections have been criticised for being too optimistic. In particular, his assumption that there will be only a mild slowdown in 1999 has been questioned. But the mood regarding Britain's growth prospects is already shifting. Leading indicators suggest the dip in activity levels will be shallow and short-lived, while inflation should remain under control, as Mr. Brown asserts. (See p.4).

- The PSBR is no longer in the limelight...

The PSBR (public sector borrowing requirement) has been one of the most important policy variables for Government over the last 25 years. But it has now been relegated to a small table in the second appendix of the offical *Budget 99* document and is hardly referred to in the text at all. (See p.5)

- ...and has been replaced by a number of different measures of public borrowing

Fiscal policy today is governed by two rules, the "golden rule" and the "sustainable investment rule". Both are forecast to be achieved with some ease over the next three or four years. The targets which have been set are tough, but the starting point for public finances could hardly be better. In particular, public debt in Britain is much lower as a proportion of GDP than it is throughout Europe. (See pp.6-8).

Lombard Street Research **10th March, 1999**

(This publication has been prepared by Tim Congdon, Brendan Baker, Stewart Robertson and Michael Taylor.)

A subsidiary of Gerrard Group PLC
Registered office: Cannon Bridge, 25 Dowgate Hill, London EC4R. Registered in England No.2357712. VAT Registration No.524 7500 61

Lombard Street Research

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March 1999

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Mr. Brown is a lucky Chancellor

Miracle Budget only partly a reward for prudence

1. How are tax cuts and higher public spending reconciled with sound finances?

Mr. Brown has wrong-footed many commentators. Before the Budget it was widely expected to be fiscally cautious, with little net tax give-away. Instead he has announced a net tax cut of over £1b. for the forthcoming fiscal year and a large give-away of almost £4b. for the 2001/02 fiscal year. Given the commitments already made on extra public spending, fiscal policy has become stimulatory. Yet still the Budget complies with the Government's two rules for sound finance (i.e., the so-called "golden rule" of a balanced current Budget and the "sustainable investment rule"). Indeed, net public debt is projected to decline relative to GDP over the next few years. How has the Chancellor managed to perform this miracle? How has he combined apparent fiscal generosity with strong public finances?

Much of the answer lies in the dynamics of public debt. As is well-known, these are vicious to profligate Chancellors who inherit large budget deficits. The deficit adds to debt, which puts up interest costs, which expands next year's deficit, which hits confidence and raises real interest rates, which aggravates the increase in interest costs...But the story can also work in a benign direction. If a responsible Chancellor inherits a sound fiscal position, the surplus reduces the debt, which cuts next year's prospective deficit (or secures another surplus), which boosts confidence and reduces real interest rates, which further lowers interest costs... To give Mr. Brown his due, he has been cautious in his first two years, keeping public spending within the limits set by the previous Government and achieving a healthy budget surplus. That has been good for his reputation and for the Government's financial image. Moreover, the decision to give the Bank of England operational independence in May 1997 was a brilliant move, which - at a stroke - cut the future cost of servicing the National Debt by many billions of pounds. Nevertheless, he has been lucky. Not only did he become Chancellor when the UK's public finances were very much on the mend, but also he has been helped by two wider trends. These are the global decline in both inflation expectations and real interest rates in the late 1990s, and the end of the Cold War.

i. Savings on interest costs

The net public debt is about £350b. Since May 1997 conventional gilt yields have fallen from over 7% to about 4 1/2%, while the yield on index-linked gilts has plunged to under 2%. If these yields now stabilize, the saving on interest costs would be approaching £10b. a year. Of course, the immediate benefit is much less. As only a portion of the National Debt matures each year, the reduction in interest costs is gained over many years. However, in conjunction with the surplus in the current fiscal year (which of course reduces the size of the debt and so debt interest), the interest savings on maturing debt become worthwhile. In essence, debt interest in nominal terms is expected to be much the same in 2001 as it was in 1996.

ii. The squeeze on defence spending

The Cold War came to and end almost a decade ago. Of course, the consequent savings on defence spending are not new. (In fact, the Major Government also squeezed defence spending.) But defence spending in money terms is to grow only slightly from 1996 to 2001. The combination of virtually stable spending on two big items (i.e., debt interest and defence) and nominal GDP growth of 5% a year is immensely helpful to the public finances. In 1995 defence and debt interest together amounted to £48.5b., compared with nominal GDP at market prices of £712.5b. If GDP rises in nominal terms by 30% (i.e., by 5 1/2% a year) between 1995 and 2000, their stability in nominal terms would cut their share in GDP by over 1 1/2%. That may not sound dramatic, but it is vital in understanding how Mr. Brown can increase spending on health and education much faster than GDP, and still keep the budget deficit under control.

2. Should Mr. Brown have given a fiscal stimulus?

The change in cyclically-adjusted public sector net borrowing (i.e., the old "public sector financial deficit") is usually regarded as the cleanest measure of the effect of fiscal policy on aggregate demand. The Treasury's Budget 99 document puts it at plus 0.4% of GDP. This is fiscal stimulus, although not not on a large scale. It helps to explain Mr. Brown's optimism that the economy will not enter a recession this year and will return to trend growth next year. Mr. Brown said nothing about the public sector net cash requirement (i.e., the old "public sector borrowing requirement" or PSBR) in his Budget speech and it is buried in Table B26 of Budget 99. It is projected to change from a surplus of £5.2b. in 1998/9 to a deficit of £4.5b. in 1999/2000. This swing amounts to roughly 1% of GDP. There is no doubt that the gilt market dislikes any moves towards fiscal stimulus, and it may well be suspicious of Mr. Brown's neglect and demotion of the PSBR/PSNCR. However, the relaxation of the fiscal stance is far from dramatic. (Mr. Brown is not remotely interested in the relationship between the PSBR/PSNCR and money supply growth, but Lombard Street Research will continue to track it.)

3. Overall assessment

In his first two years Mr. Brown kept the budget deficit (however defined) under good control. As the fiscal situation was improving strongly in 1997, and favourable background influences were at work, he built up an extremely strong position from which to launch spending increases and tax cuts in the second half of the Government's term. Some fascinating and difficult strategic issues are now emerging. For example, will the Government's continued friendliness to the euro lead to more interest rate convergence between sterling and the euro, and so to a credit boom in 2000 and 2001? But one message is clear. The Labour Government will enter the next general election campaign with a favourable macroeconomic background. Spending on health and education will have risen rapidly in the previous three years, the standard rate of income tax will have been cut to 22p. in the pound (if not lower), and yet Mr. Brown will be able to boast about moderate inflation and sound public finances. (Poor Mr. Hague!)

Professor Tim Congdon **9th March, 1999**

More detail on defence spending and interest costs

The composition of public spending has changed significantly

The *Financial Statement and Budget Report* (the FSBR or Red Book, as it used to be known) has gone. It has been replaced by New Labour's "*Budget 99*" document which is rather more flashy, but contains a great deal of useful information. The FSBR, which used to be the seminal reference work for anyone wishing to get to the bottom of fiscal policy, has evolved into a glossy with chapter titles such as "Increasing Employment Opportunity" and "Building a Fairer Society".

As Mr. Brown was keen to point out, the Budget measures represent a net giveaway of around £1b. in 1999-00, rising to £3.6b. in 2001-02. At this stage of the economic cycle, he claims, the fiscal loosening is an appropriate response. But how has Mr. Brown been able to present such a generous Budget without any significant deterioration in key public finance measures over the coming years? The answer comes in three main parts.

1. The sound fiscal inheritance
The Lamont and Clarke tax increases in 1993 and 1994 laid the foundations for a structural, as opposed to cyclical, improvement in public finances. At the time, they were heavily criticised as being likely to push the British economy back into recession. In practice, easier monetary policy more than offset the fiscal squeeze, and the economy enjoyed a mini-boom. Although public borrowing remained high in 1994-95 and 1995-96, it was falling. The Labour Government has been fortunate indeed to reap the benefits of these measures. In contrast to many in-coming new administrations in the post-war period, there was no fiscal mess to clear up. Much of the hard work was done and the necessary measures were already in place. Even so, sticking to the strict public spending targets set by the Conservatives for two years can only be admired and did much to assert the fiscally-prudent credentials of New Labour.

2. The squeeze on defence spending
The "peace dividend" has also helped public finances significantly and is expected to continue to do so. Defence spending amounted to £20.7b. in 1996-97. The total for 1999-00 is virtually unchanged while the forecast for 2001-02 is only slightly higher at £21.4b. If defence spending were to rise at the same rate as overall (non-defence) public spending over the next five years, the call on the public purse would amount to an additional £5b. or £6b. The fact that it will not has allowed room for significant spending increases elsewhere.

3. Savings on debt interest
Long-term interest rates have fallen from close to 8% in early 1997 to between 4½% and 4¾% today. The interest payable on newly-issued gilts is therefore much lower. The total amount of outstanding debt is perhaps £350b. currently. If all attracted interest at 4½%, annual payments would amount to around £16b. An 8% rate gives a figure of £28b. Of course, the Government's interest obligation does not fall by the full amount since coupon payments are fixed at the time of issuance. But they do benefit as old issues are redeemed and replaced by new ones. While bond rates stay low, the Government's benefit from this windfall will gradually increase. The "bonanza" from the drop in long-term interest rates in terms of reduced interest payments in the future is, effectively, being spent today by Mr. Brown in the many spending initiatives which he announced today. The impact on the Government's finances seems minimal. But bond rates can go up as well as down while it is difficult, both politically and practically, to cut back on spending programmes.

Stewart Robertson

Growth accelerating, inflation steady

No recession as Mr. Brown sticks by his growth forecast

The Treasury have stuck by their forecasts for GDP growth over the next three years. For 1999, GDP is forecast to rise by between 1% and 1½%, followed by an acceleration thereafter. (See table.) The prediction for 1999 is significantly higher than the consensus among independent forecasters, which is currently for around 0.6% GDP growth this year. But Lombard Street Research broadly agree with Mr Brown's forecast for this year and consider the forecast for 2000 possibly too cautious. Consumer confidence has recovered sharply early in 1999 and the housing market is likely to show increasing strength this year, as the recent cuts in interest rates between October and February have boosted housing affordability to its highest for around 40 years. The Budget forecasts a slowdown in household consumption growth, from 2¾% in 1998 to between 2% and 2½% this year, followed by a recovery to 2½% to 3% in 2000. But if interest rates are reduced much further in the first half of this year the consequent stimulus could push consumption growth towards 4% and overall GDP growth to around 3% in 2000.

Below-trend growth this year will create a small negative output gap (i.e., an excess of the potential level of output over its actual level). The official forecast then allows for around trend growth (i.e. 2½%) in 2000, followed by an acceleration in 2001. Above-trend growth can be accommodated without inflationary pressures because of the negative output gap. This explains the official forecast that target inflation (RPIX, the retail prices index excluding mortgage interest payments) will average 2½% in Q4 of each of the next three years. However, if GDP growth is towards the top end of the Government's forecast ranges over the period by 2001 output will have moved above its trend level, putting upward pressure on inflation. Assuming that the MPC still have responsibility for monetary policy in 2001, it may increase interest rates. But sometime in 2001 it is probable that there will be a general election that will return a Labour administration. Thereafter interest rates might converge with the eurozone in preparation for full entry into the Euro.

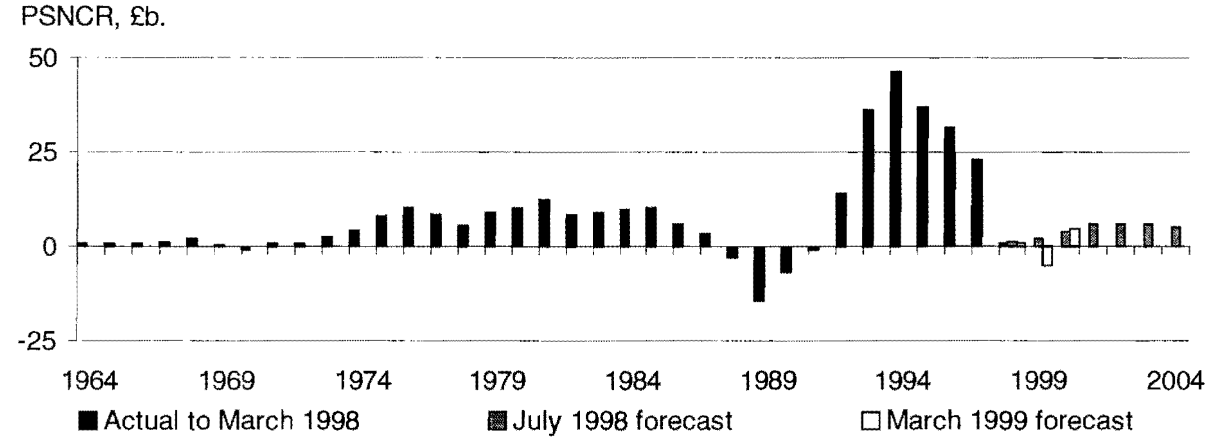
	1999	**2000**	**2001**
GDP Growth %	1 to 1½	2¼ to 2¾	2¾ to 3¼
Inflation RPIX (year to Q4), %	2½	2½	2½

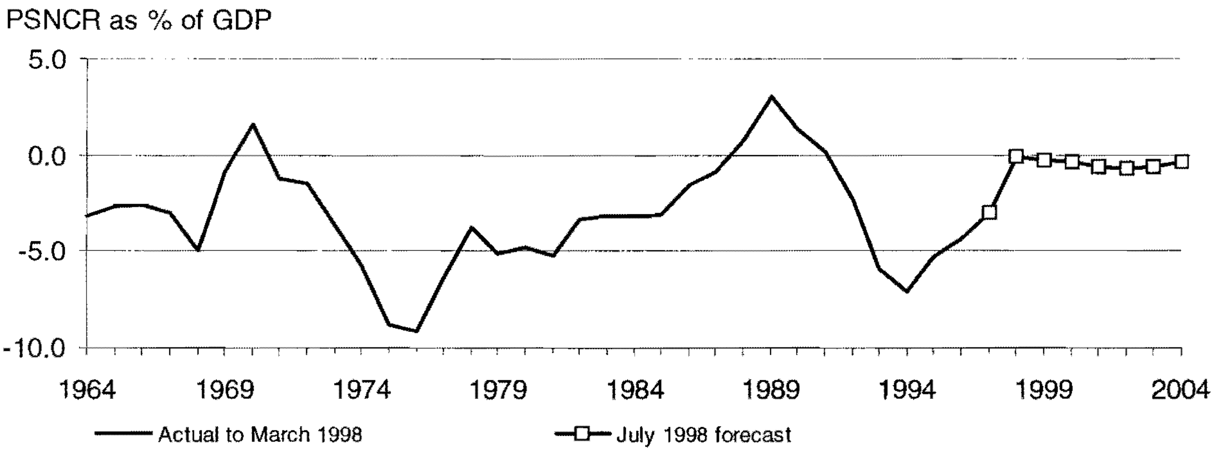
Michael Taylor

Public sector net cash requirement

Less emphasis on the PSNCR, which is in deficit after 1999

Upper chart shows the public sector net cash requirement in £b. The lower chart shows the PSNCR as a %age of GDP at market prices, annual data on financial year basis. Figures are actual to 1998 and Treasury forecasts thereafter.





The PSNCR was formerly known as the public sector borrowing requirement. Sources: Treasury, ONS and Bank of England

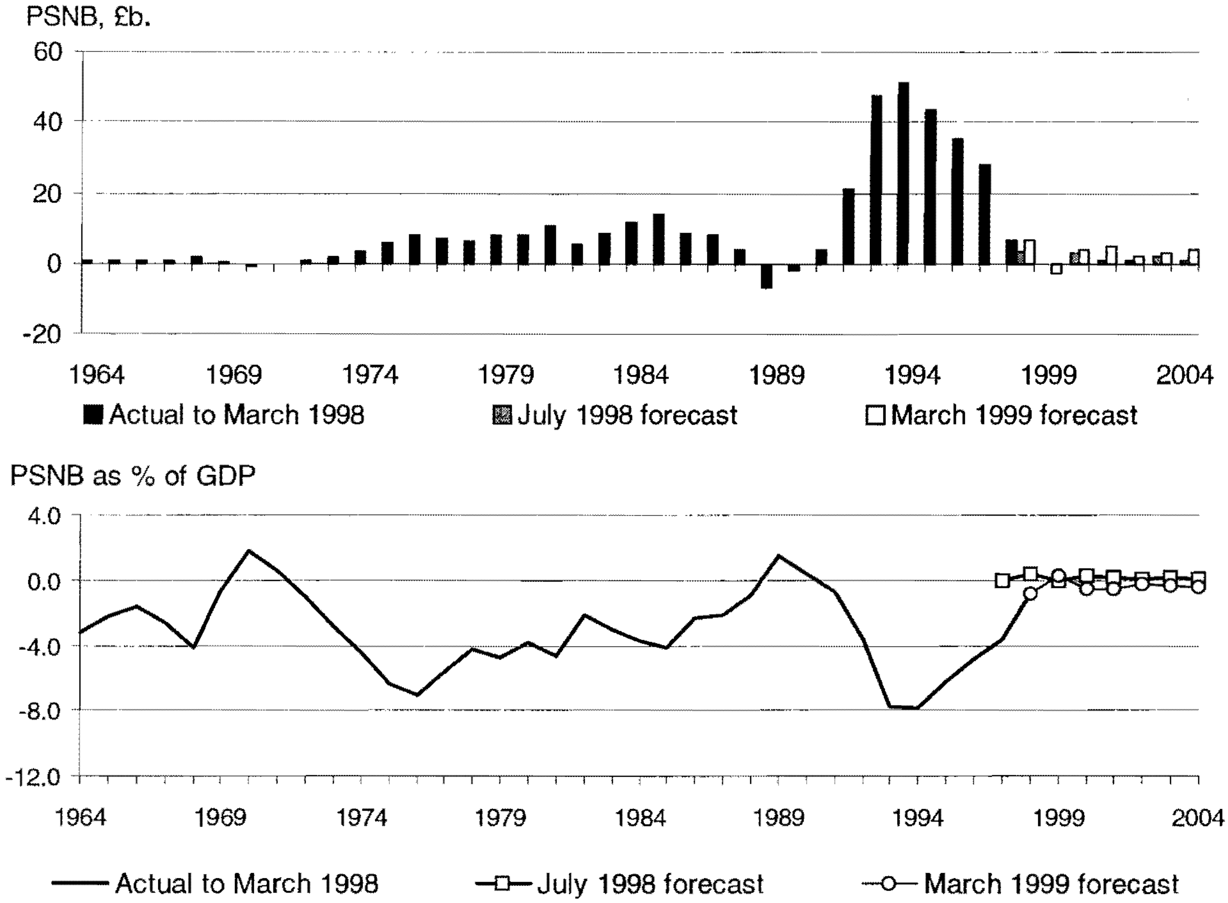
A noticeable change in the presentation of the public finances is the reduced use of the public sector net cash requirement (PSNCR). The PSNCR is derived from public sector net borrowing by adding net transactions in financial assets and an accruals adjustment (principally the capital uplift for index-linked gilts). The figures presented for the PSNCR in the *Budget 99* show a small increase in 1999/2000 relative to the July 1998 estimate. No comparable figures are given for the period 2000/2001 to 2003/2004. However, the July 1998 figures show a small deterioration in the series up to 2001/2002, suggesting a tendency to relax policy in the run-up to the final date for a general election in May 2002. In comparison with much of the post-war period the PSNCR/GDP ratio remains quite healthy at less than +1% compared with a long-term average of +3%.

Brendan Baker

Public sector net borrowing

Mr. Brown is setting himself high targets

Upper chart shows public sector net borrowing (PSNB) in £b. The lower chart shows PSNB as a %age of GDP at market prices, annual data on financial year basis. Figures are actual to 1998 and Treasury forecasts thereafter.



Sources: Treasury, ONS and Bank of England

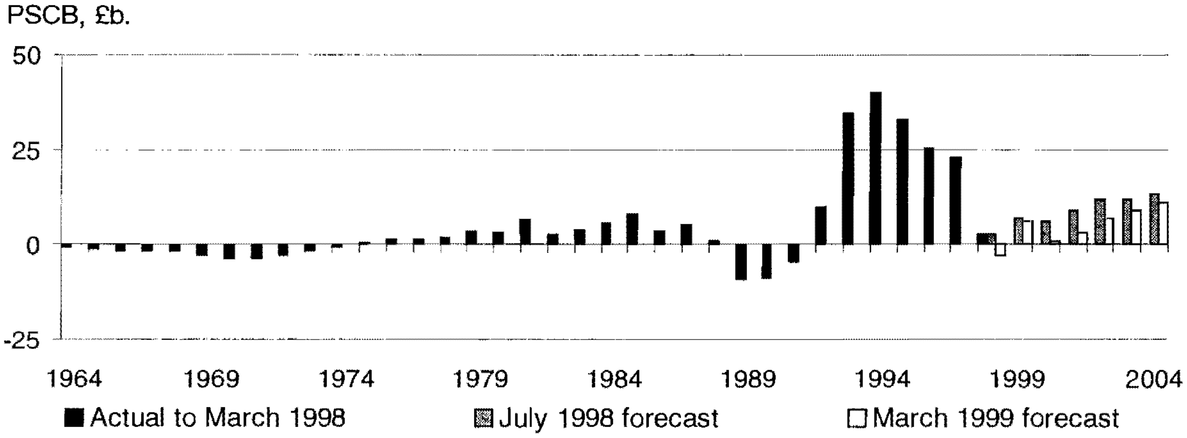
Mr. Brown has committed the Government to keeping public debt under control. According to the "sustainable investment rule", "net public sector debt" is to be kept under 40% of GDP. By the standards of post-war Britain, this is a tough fiscal principle. (In the immediate post-war decades net public debt was over 100% of GDP.) The change in net public sector debt is nowadays known as "public sector net borrowing". The concept used to be known as "the public sector's financial deficit" and was published on a quarterly basis in the specialist publication, Financial Statistics. But the PSNB is to be prepared on a monthly basis, as the Government plainly wants it increasingly to become the focus of fiscal analysis and commentary. It is projected to be 0.3% of GDP in 1999/00 and 0.4% of GDP in 2000/01, after a tiny surplus in the fiscal year now ending. With GDP growing, the result is a projected decline in the ratio of net debt to GDP to 38% by 2000/01.

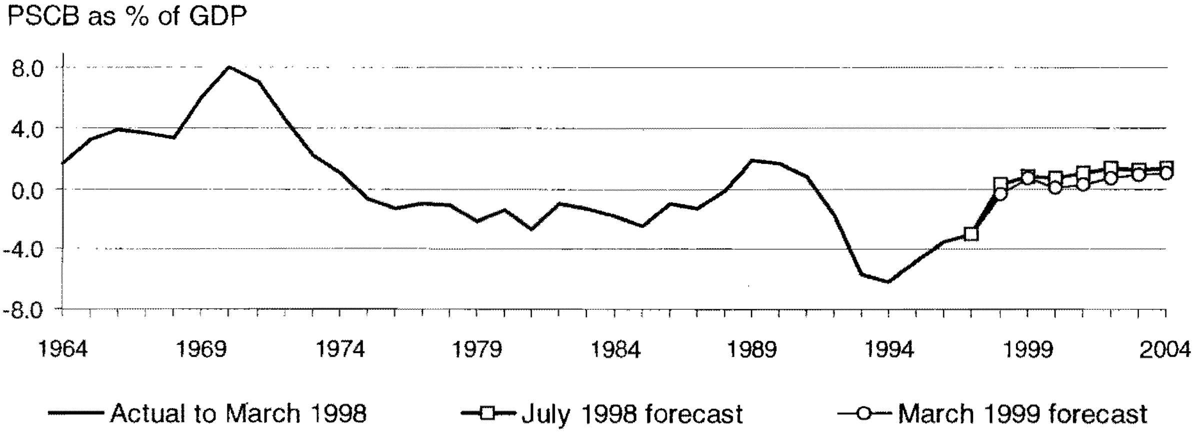
Professor Tim Congdon

Public sector current account balance

Fiscal loosening in this Budget shows through in public finances

Upper chart shows public sector current account balance (PSCB) in £b. The lower chart shows the PSCB as a %age of GDP at market prices, annual data on financial year basis. Figures are actual to 1998 and Treasury forecasts thereafter.





Sources: Treasury, ONS and Bank of England

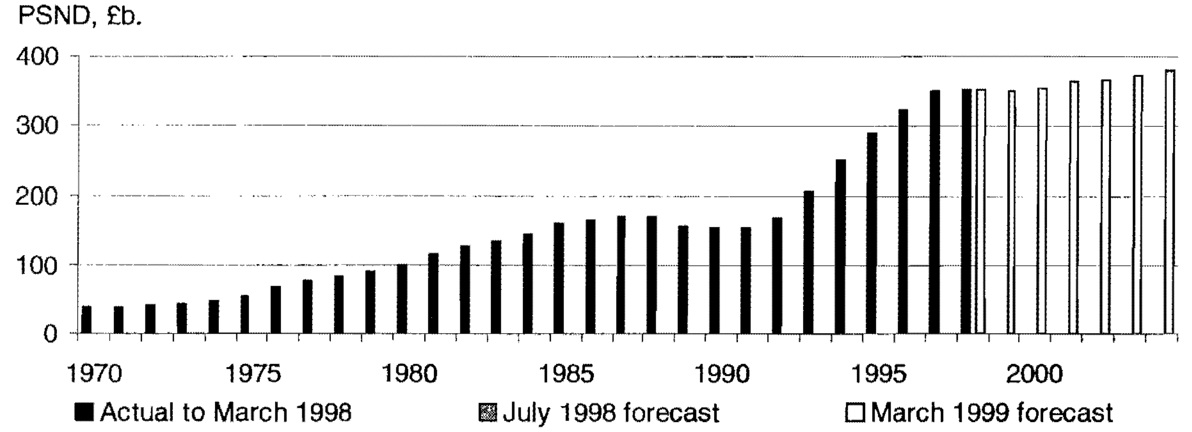
In July 1998 the Treasury estimated that the public sector surplus on the current account (including windfall tax receipts and associated spending) would be £7b. in 1999/2000. Now it puts the figure at only £1b. As a percentage of GDP the change is from 0.7% in July to 0.1% now. The new figure is in line with the series' long-term average of 0.1%. The risk is that over time the Government may not be able to control current expenditure as it has in its early years. For example, higher-than-expected pay settlements in the public sector could put pressure on spending limits. It is difficult to see a deterioration on the scale of the early 1990s occuring again. But Mr. Brown appears to have dipped into his inheritance from the previous administration to fund his fiscal loosening.

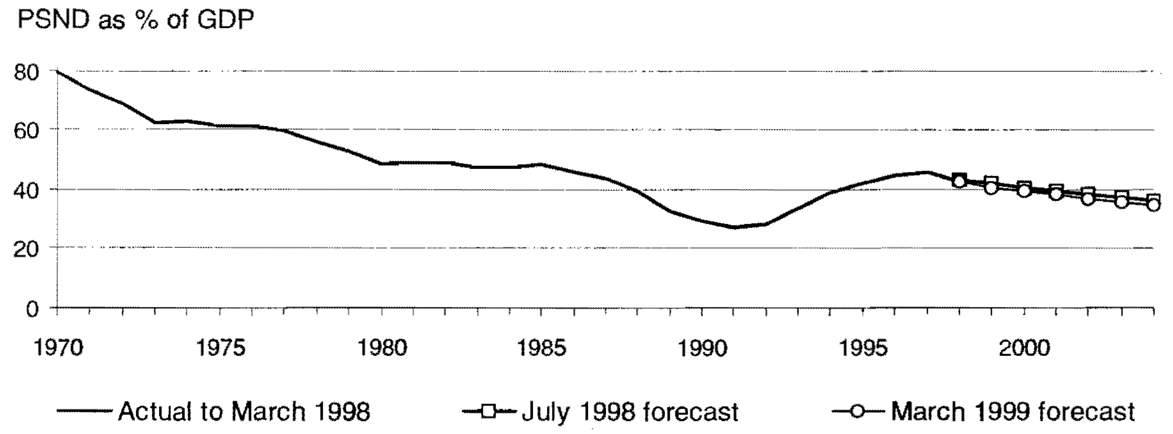
Brendan Baker

Public sector net debt

Higher GDP growth estimates flatter debt-to-GDP ratio

Upper chart shows the public sector net debt (PSND) in £b. at financial year-end. The lower chart shows the PSND as a %age of GDP at market prices, annual data on financial year basis. Figures are actual to 1998 and Treasury forecasts thereafter.





Sources: Treasury, ONS and Bank of England

Net debt to GDP is projected to decline from 43% to 35% between year-end 1998 and year-end 2004 by the Treasury. This definition is not strictly in line with the Maastricht definition, which refers to gross debt, but the terms are similar. The UK appears to be comfortably within the 60% limit on the ratio of gross debt to GDP. Indeed, given the average among euro-zone members of 60% and more, further lowering by the UK seems to be over-doing it. The Treasury has lowered its estimates for the debt-to-GDP ratio in each of the year-ends between 1999 and 2004 from its July 1998 projections. This is principally due to stronger GDP growth forecasts. In nominal terms, net national debt is shown as consistently rising over the forecast period. The Government could have used the relatively healthy position of the public finances to buy back some of the National Debt and lower the tax burden of future generations.

Brendan Baker