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Pre-Budget Report Commentary

Key points

- Massive and much larger-than-expected fiscal give-away

Tax and spending measures announced by the Chancellor in the *Pre-Budget Report* amount in total to a large fiscal loosening. The cost to the Treasury of the various measures is of the magnitude £5b.-£6b. or over 1/2% of GDP. Taken in combination with give-aways in the March Budget and increased government expenditure resulting from the July Spending Review, the overall impact of measures announced this year is a massive fiscal give-away of approaching £15b.

- No widespread fuel cuts

Fuel protesters' hopes for across-the-board cuts in fuel duty were dashed. But the total cost of all the "transport measures" is equal to 4p-a-litre off excise duties, deliberately exeeding the Conservatives' promise of a 3p-a-litre reduction.

- Treasury implausibly assumes slower growth next year

This large fiscal boost comes at a time when the economy is already buoyant. GDP has been growing at an above-trend rate for much of the past year, driven largely by strong private demand. Rapid real money growth and the impetus from the fiscal packages announced this year should ensure that growth continues at an above-trend rate into 2001. The 2.25%-2.75% rate assumed by the Treasury looks too low.

- Policy dilemma for the Bank of England

The boost to growth poses a problem for the MPC. Interest rates need to be raised to dampen domestic demand, but the exchange rate remains stubbornly over-valued. The economy could overheat in late 2001.

Lombard Street Research **8th November, 2000**

(This publication has been prepared by Brendan Baker, Professor Tim Congdon, Martin McMahon and Stewart Robertson)

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Lombard Street Research

Pre-Budget Report Commentary

November 2000

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Overview: Mr. Brown embraces boom-bust

Biggest fiscal expansion since the early 1970s

Predictably, Mr. Gordon Brown talked about the "prudence" of his financial policies in the *Pre-Budget Report*. In fact, 2001 will see the biggest tax-cut-and-extra-spending binge since the early 1970s. The *Pre-Budget Report* was unequivocally bearish for gilts and fixed interest.

The Treasury estimates the cost of the *Pre-Budget Report* measures as £2.6b. in 2001/02 and almost £4b. in 2002/03. But this makes no allowance for the so-called "transport measures", which have a more uncertain cost provisionally calculated as about £1 3/4b. If this is added, the "give-away" amounts to almost £4 1/2b. in 2001/02 and £6b. in 2002/03. That would be an important loosening of fiscal policy by itself. But the *Pre-Budget Report*, which of course anticipates the March 2001 Budget, must be seen in conjunction with the March 2000 Budget and July's Spending Review.

The March 2000 Budget contained a tax give-away of £1.2b. in 2000/01 and £2.6b. in 2001/2, implying a favourable effect on spending power in 2001/02 of £1.4b. The impact of the Spending Review is more difficult to quantify. Social security spending has proved less than expected in the last year or two, because of the cyclical benefits from falling unemployment. The SR announced higher spending on health and education to offset this, with official documents implying that the effect was neutral. But this was not so. The increases in spending on health and education undoubtedly reduced the cyclically-adjusted budget deficit. In that sense they were fiscally stimulative. It is reasonable to suggest that the true tax-cut-and-extra-spending package next year will amount to over £10b. and could be as much as £15b. That would be the biggest demand injection from fiscal policy since the Heath-Barber "dash for growth" in the early 1970s.

It is true that the public finances are still in good shape, but they ought to be given the fortunate help from the mobile phone auction and the drop in social security spending. Monetary policy may be able to neutralize some of the inflationary effect of the fiscal boost, but only because interest rates will have to be higher than would otherwise have been necessary. The Treasury's view that growth will moderate next year is implausible, given the scale of both the fiscal demand injection and the rapid growth of real money now being recorded. Mr. Brown's three important statements in 2001 are - when taken together - bad news for fixed interest markets.

Professor Tim Congdon **8th November, 2000**

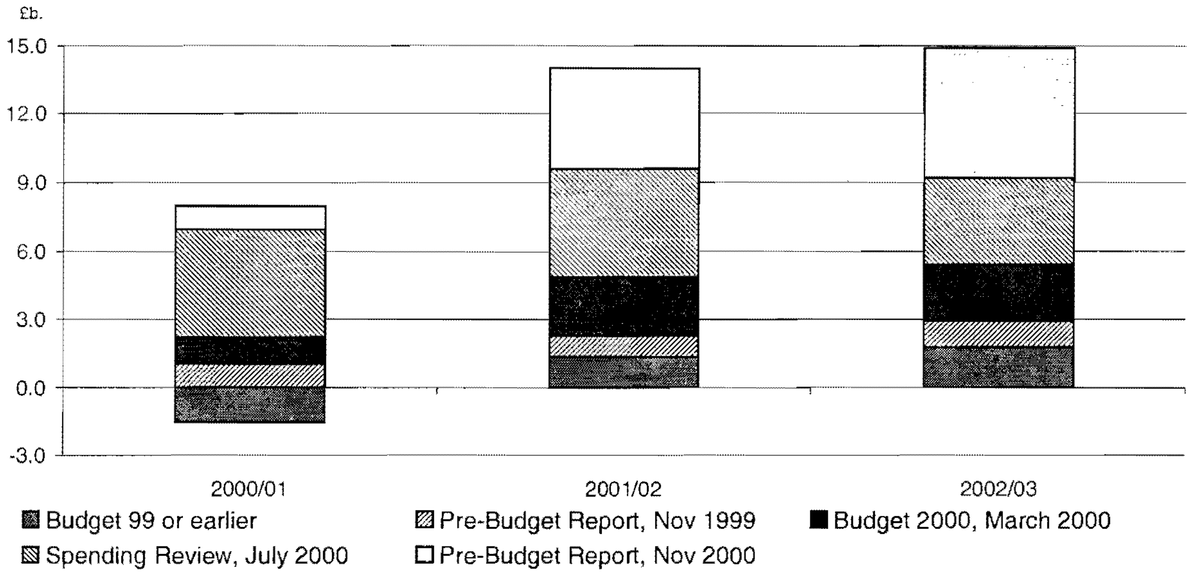
The measures

Massive fiscal easing, with goodies for pensioners and road hauliers, and the greatest impact at election time in 2001

A massive loosening in fiscal policy is under way. After keeping to tight spending plans in its early years, New Labour has switched to a significantly stimulatory fiscal policy. The turnaround will lead to £10b. - £15b. boosts to demand in 2001/02 and 2002/03 respectively, equivalent to 1% - 1 1/2% of GDP a year.

SUBSTANTIAL FISCAL EASING IN PLACE

Bars show tightening/loosening of fiscal position in £b.



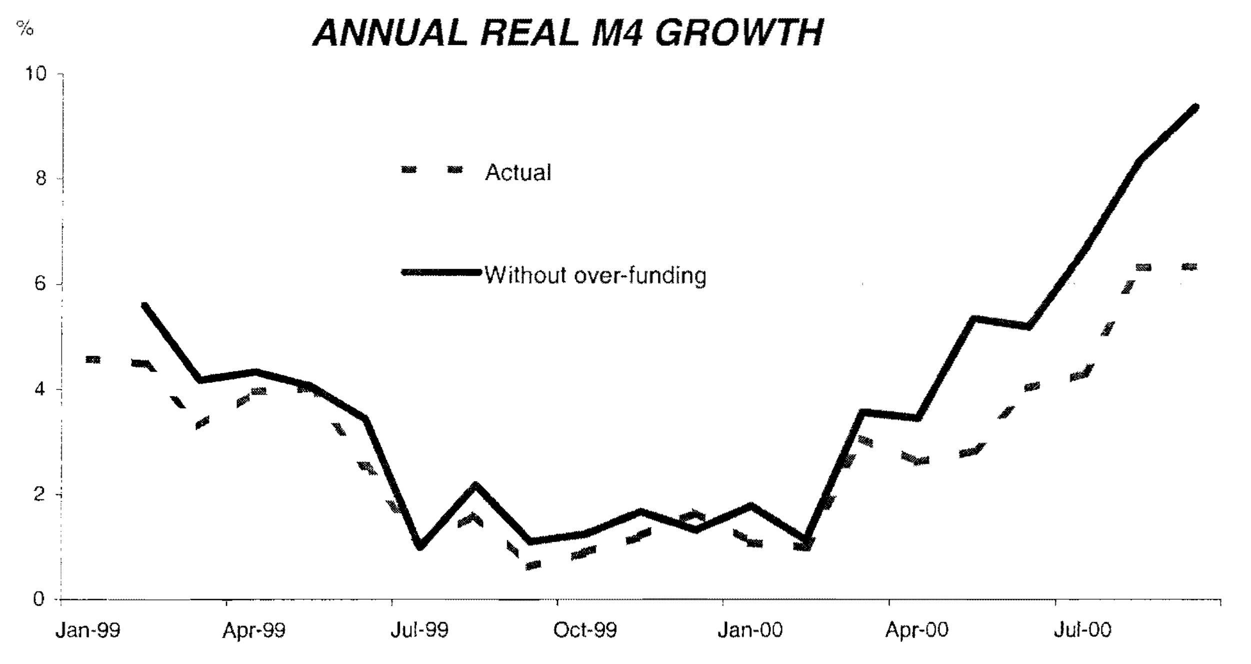
£b. in fixed 2000/01 prices. Sources: HM Treasury and Lombard Street Research

A tight fiscal stance in the early years of New Labour's administration helped to bring the public finances into surplus by 1998/99. But a turnaround in the fiscal stance has taken place since then, perhaps unsurprising given that an election is likely in 2001. Policy is set to be stimulatory in the three years to 2002/03. Exact figures are not available on a consistent basis. But using figures from *Budget 2000*, July's *Spending Review*, the November 2000 *Pre-Budget Report* (*PBR*) and Lombard Street Research estimates, the fiscal stance will be relaxed by £14b. in 2001/2 and £15b. in 2002/3, equivalent to 1 1/2% of GDP a year. In the *PBR* £4.1b. of the £4.4b. loosening is being directed towards pensioners and vehicle users, two of the most high-profile and vociferous lobby groups over the last six months. Gordon Brown makes much use of the word prudent and, up until now, New Labour has surprised on the upside with its handling of the public finances and the economy as a whole. But in the *Spending Review* and *PBR* the Government has switched money saved from lower-than-expected cyclical expenditure (mainly due to declines in unemployment) into non-cyclical departmental spending. Further, asset sales are expected to raise £4b. a year in the next three years. A risk is that a deterioration in the economy in 2002 would lead to weaker-than-expected revenues and to honour spending commitments public borrowing would need to rise.

Fiscal versus monetary policy

The accommodative domestic monetary policy stance will be the dominant influence on the UK economy in 2001 and 2002, but the fiscal giveaway may add to the problems

Monetary policy is arguably a much more important influence on the business cycle than fiscal policy. Nevertheless, there are very important links between them which have been largely neglected by both the Treasury and the Bank of England. Moreover, the large fiscal stimulus comes at exactly the wrong time in the economic cycle.



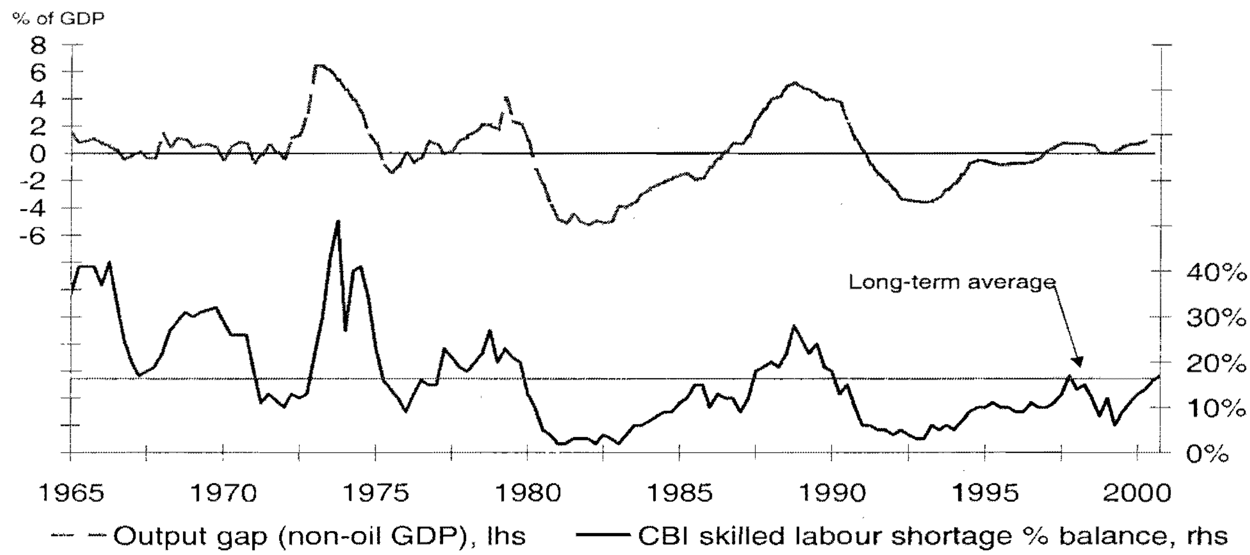
Amid all of the political hype and spin being applied to the contents of Mr. Gordon Brown's Pre-Budget Report, there is a danger that the wider implications regarding the current fiscal stance will be ignored. Newspapers and other media coverage will no doubt focus on the increase in state pension allowances and on the attempts to placate fuel protesters through generous excise duty changes. But the most important consideration is more basic. Today's announcements, together with the measures from the previous Budget last March and the large rises in public spending unveiled in July's Spending Review, represent the largest fiscal boost since the early 1970s. The loosening of fiscal policy comes close to the peak of the economic cycle, right at the time when it is least appropriate. Moreover, monetary growth is rapid at present, while the high exchange rate is helping keep inflation subdued. Indeed, M4 growth would have been even higher, but for the negative offset from "overfunding". Neither the Treasury nor the Bank of England are at all concerned by debt management policy, both seeming to consider it an irrelevance. But if public sector surpluses diminish over the next few years - as even the prudent Mr. Brown suggests is likely - then real money growth could approach 10% a year from now. In the past such rates of growth have always been associated with unsustainable booms that have been followed, with equal inevitability, by rising inflation.

The macroeconomic forecast

Output moving far above its trend level?

GDP grew at an above-trend rate during four of the past five quarters. Output is now generally considered to be at or slightly above its long run trend level. As such, any continuation of above-trend growth will increase the size of the output gap and lead to pressures on capacity. The additional fiscal stimulus will aggravate the build-up of inflationary pressures.

THE OUTPUT GAP AND LABOUR SHORTAGES



Sources: CBI, ONS and LSR

GDP grew by a provisional 0.7% during the third quarter of 2000. This continued its recent above-trend performance, with growth for the year as a whole set to be about 3%. Indeed, output is now probably slightly above its long-run trend level. Lombard Street Research estimates that the UK output gap (i.e., level of output above trend) is currently positive. This implies that any further above-trend growth will increase the positive output gap, adding to existing pressures on capacity, and lead to rising inflation. The labour market is already tight with unemployment at more than a 20-year low, while reports of skills shortages are becoming more common. For example, the CBI reported that the balance of manufacturers facing skilled labour shortages reached its long run average and highest level for three years in October. GDP growth has been driven largely by strong private demand in recent quarters. Annual household expenditure growth averaged about 4.3% in real terms over the past four quarters, while government demand growth was more muted at under 2.5%. However, fiscal loosening already announced this year is boosting demand from the public sector. General government consumption expenditure grew by 2.1% during the second quarter alone. The additional large fiscal stimulus of up to £5b. (about 0.5% of GDP) will merely boost aggregate demand at a time when it needs to slow. GDP growth in 2001 could exceed 3%, well above the Treasury's estimate of 2.25%-2.75%.