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Budget Commentary

Key points

- Although fiscal restraint weakens ...

Buoyant public sector finances have persuaded the Chancellor to relax the fiscal restraint shown in his earlier budgets. The larger-than-expected net borrowing surplus recorded over the past year has prompted plans for net fiscal give-aways of £3.6b. in 2001-2002, and again in 2002-2003. Beneficiaries will include such vote-winning groups as motorists and pensioners.

- ... public finances remain strong for now

Undoubtedly public finances are in a healthy state at the moment. Robust growth has boosted revenues, while expenditure has been more muted. Strong growth in 2001 should ensure that this remains the case for some time yet. However, when growth slows in 2002, public finances could deteriorate quite sharply. The Treasury's estimate of 2 1/4%-2 3/4% GDP growth in 2002-2003 looks too high.

- Cuts in fuel duty could take RPIX below 1.5%

Excise duties on petrol have been reduced, while those on alcohol have been frozen. Taxes on tobacco will rise only in line with inflation. In combination, these measure could reduce RPIX inflation by up to 0.1%, in contrast to last year when they boosted it by around 0.3%. As a consequence, underlying inflation is now more likely to fall temporarily below the 1.5% threshold in the coming months.

- End of the MFR should undermine gilts, but is good news for other assets, such as property

Abolition of the frustrating, if well intentioned, MFR is good news for a number of asset classes. Defined-benefit pension funds are likely to show greater interest in areas that were over-looked because of MFR constraints. Property is likely to be one such beneficiary of the change.

- Mr. Brown indifferent to high money growth

The *Debt & Reserves Management Report* indicates that the Government will reduce its cash balance over the next three years. This could *increase* M4 growth when national output is already above its trend level.

Lombard Street Research **7th March, 2001**

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

Lombard Street Research

Budget Commentary

March 2001

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An electorally correct performance from Mr. Brown

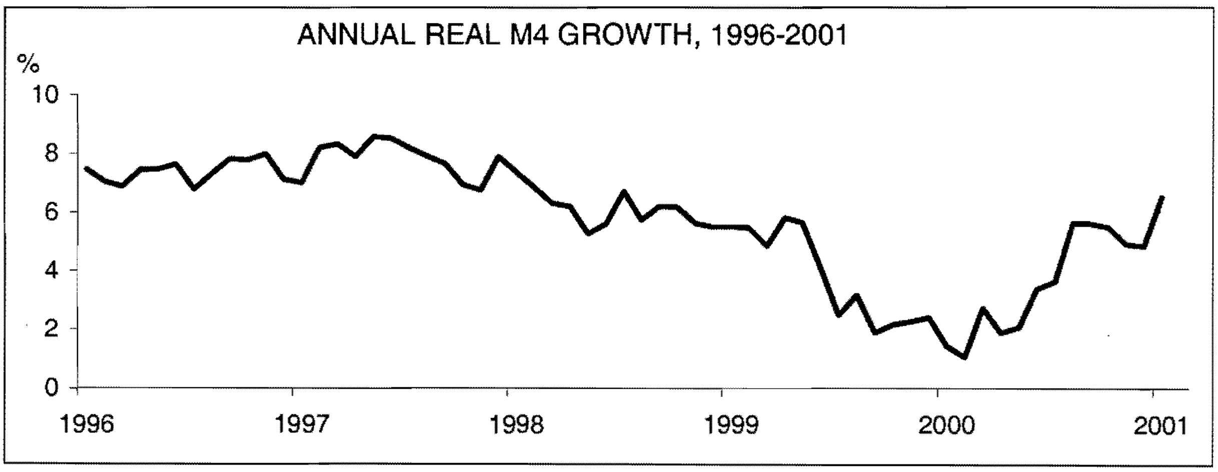
But cynical boomlet and unnecessary mini-bust lie ahead

Mr. Brown has managed to convince financial markets, the media and the general public that he is a careful guardian of the nation's finances. In fact, the 2001 Budget was a cynical pre-election exercise, using money from the tax increases of 1997 – 2000 to finance large tax cuts and spending increases in 2001 and 2002. 2001 will see a boomlet, with GDP up by over 3%. 2002 and 2003 will be more difficult.

Mr. Brown cannot be blamed for cutting taxes in today's Budget. He had a large budget surplus to play with and, even after the latest give-away, further surpluses are in prospect. The ratio of public debt to GDP is expected to keep on falling, to the lowest levels since before the First World War. However, as pointed in Lombard Street Research's comment on the *Pre-Budget Report*, Mr. Brown's latest announcement needs to be seen in the context of three previous exercises – the 2000 Budget, the July 2000 *Spending Review* and the *Pre-Budget Report*. The overall fiscal relaxation – when all four packages are combined – is one of the largest in British history. It is one reason for forecasting a buoyant economy in 2001, despite all the media nervousness about the supposed American "recession". Another reason – also emphasized in Lombard Street Research's publications – is that monetary growth is high and may even be rising.

There is little sign in the official Treasury documents that the Government cares at all about the upturn in annual money growth to an almost double digit rate. (It is very debatable whether the Bank of England cares either, but at least the subject can be discussed.) The December 2000 issue of Lombard Street Research's *Monthly Economic Review* argued that – if rapid growth of bank credit to the private sector persisted – the Government might have to continue to build up its own cash balance in order to prevent faster growth in private sector bank deposits (i.e., in M4). But the Treasury's *Debt and Reserves Management Report 2001/02* says, "It is anticipated that [the]net cash position will be run down over the next three years, consistent with the policy commitment given by Ministers at the time of the PBR". In other words, it is *not* official policy to adjust debt management decisions in order to keep broad money growth to a reasonably low figure. Again, the mssage is "expect a strong economy in 2001, with rising inflation and adjustment problems in 2002 and 2003".

Professor Tim Congdon **7th March, 2001**



Budget arithmetic - an end to restraint?

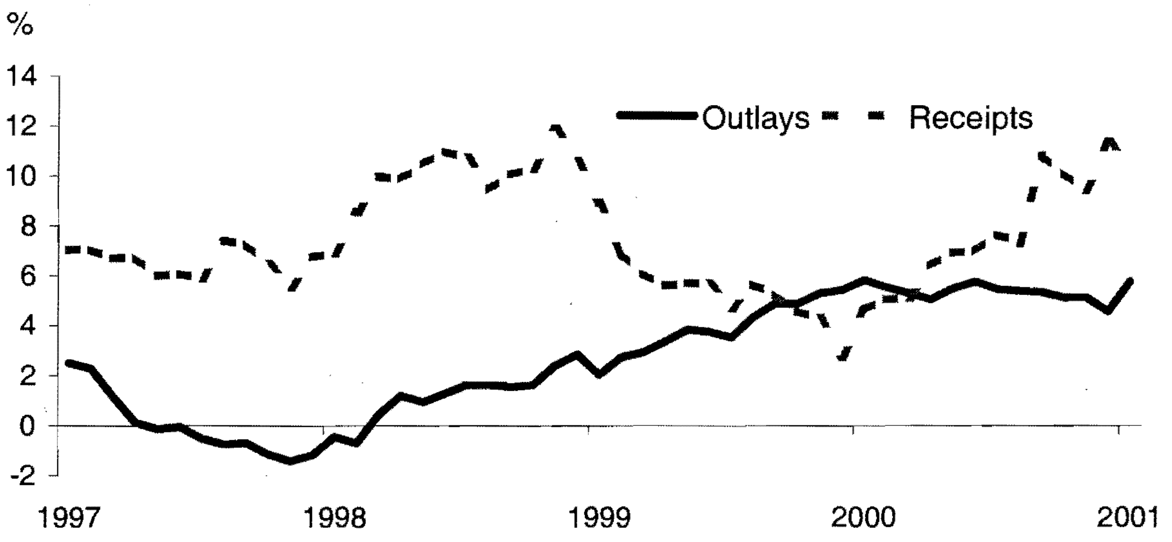
Buoyant public finances provoke predictable pre-election give-aways

Healthy public finances gave the Chancellor the opportunity for today's £3.6b. net fiscal give-away. Earlier spending restraint and a strong economy have ensured that his fiscal rules will be met in the short term. However, the large fiscal easing now under way could cause problems when the economy slows, probably in 2002.

Mr Brown today found himself in the enviable position of presenting a pre-election Budget with the public finances in buoyant health. Public sector net borrowing, the Government's preferred measure of the budget deficit, recorded a surplus of £16.7b. over the financial year to January 2001. The cumulative total for 2000-2001will easily exceed the £10b. estimated by the Treasury in November's *Pre-Budget Report.* Perhaps unsurprisingly, the Chancellor did not resist the temptation to give-back £3.6b. in pre-election sweeteners. Motorists, pensioners and lower-rate income tax payers were amongst the groups benefitting from Mr Brown's generosity. Certainly, the current general health of the public finances is not in doubt. Strong growth over the past year has boosted tax receipts, while falling unemployment and restrained public investment have kept expenditure more muted. This has allowed scope for looser fiscal policy within the framework of the Chancellor's two self-imposed fiscal rules. However, today's measures in conjunction with those already announced, amount to a large fiscal easing. Given that the current buoyancy of public finances is partly cyclical, the risk must be of a deterioration in public finances when the economy slows. Net borrowing and debt levels could easily rise back up again.

CASH RECEIPTS HAVE GROWN FASTER THAN OUTLAYS

Chart shows annual growth of central government receipts and outlays in latest twelve month period compared with the previous twelve months



MFR consigned to the scrapheap

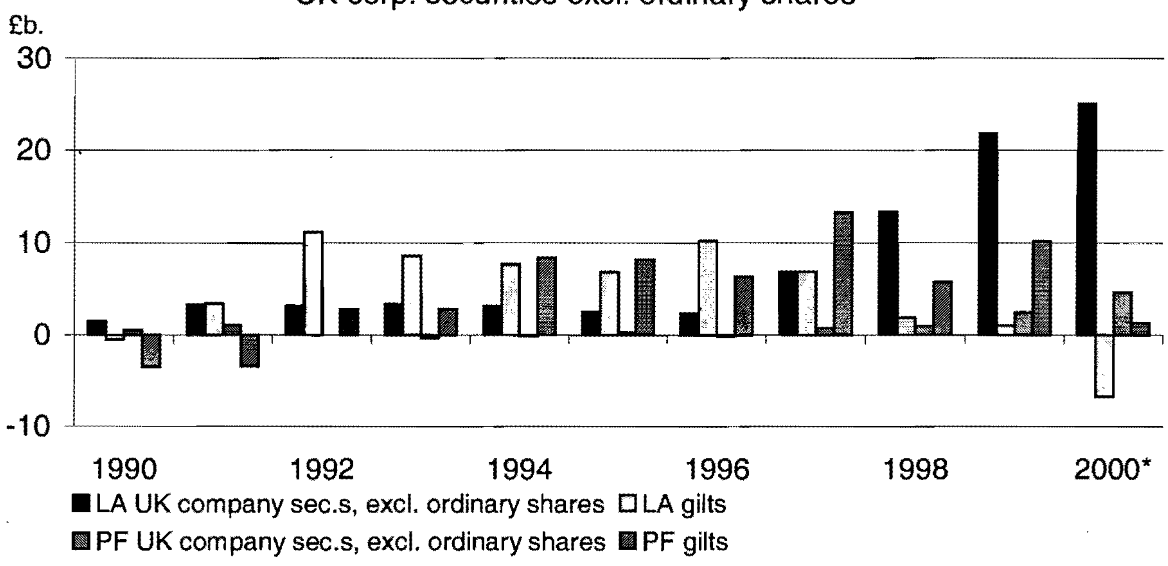
Ending of the Minimum Funding Requirement will be good news for a number of over-looked asset classes

Abolition of the frustrating, if well intentioned, Minimum Funding Requirement is good news for a number of asset classes. Defined-benefit pension funds are likely to show greater interest in areas that were over-looked because of MFR constraints. Property is likely to be one such beneficiary of the change.

Accepting the recommendations of Mr. Paul Myners' review of institutional investment, the Chancellor is putting to rest the Minimum Funding Requirement (MFR). While not explicitly required, the MFR in effect encouraged defined-benefit pension funds to increase gilt holdings. This coincided with healthy public finances which resulted in reduced gilt sales. Medium-coupon long-dated gilt yields fell from 7 3/4% to 4 1/2% between January 1987 and February 2001. Meanwhile, non-MFR constrained investors were able to enjoy a yield uplift by switching into the increasing supply of corporate bonds. In Budget 2001 the Government has identified private equity and venture capital as areas they would see receive more support from institutional investors. Ending of the MFR constraint will also encourage defined-benefit funds to invest in a much wider range of instruments. Property may be a particular beneficiary of the change since direct ownership results in income (i.e., rent) being received gross. Real estate ownership was shunned by funds when the MFR was in place. Between 1995 and 1999 pension fund investment in property ran at £200m. a year, a sixth of that by life offices.

LIFE OFFICES' SWITCH INTO CORPORATE BONDS

Chart shows annual net investment by life offices and pension funds in gilts and UK corp. securities excl. ordinary shares



* 2000 = first three quarters at annual rate. Company securities excluding ordinary shares includes debentures and preference shares, but is mainly fixed-income instruments. *Sources: Financial Statistics and LSR*

What will Mr. Brown do with his cash balance

Debt management policy in 2000 led to massive "over-funding" and kept down money growth, but the Budget indicates a switch to a more neutral *and less appropriate* policy

Despite a vast Budget surplus the Government has continued to sell long-dated gilts, mostly to non-banks (and particularly to such institutions as pension funds and insurance companies). The result has been to reduce the quantity of money in the economy, as the private sector pays its taxes (reducing its bank deposits) and the institutions buy gilts (again, reducing their bank deposits). In 2000 this policy was sensible in its macroeconomic effects. The *Debt & Reserves Management Report* published in conjunction with the Budget indicates that this policy will change. The implication may be faster money growth and more stimulus to the economy, just as signs of stronger demand growth are emerging.

2000 was a fascinating year for UK monetary policy. The change in M4 – which had been only £32.0b. (or 4.1%) in 1999 – climbed to £64.2b. (or 7.9%). The upturn in money growth was striking, but the truly remarkable feature was the pattern of the so-called "credit counterparts". (The quantity of money – measured by M4 on the broad definitions – is dominated by banks' deposit liabilities. They expand when banks increase their assets by extending new credit, i.e., by adding to "the credit counterparts to M4".)

Few bank lending to the private sector was £110.6b., sharply up from £78.0b. in 1999 and an all-time record. Fortunately, this was offset by a negative "public sector contribution to M4 growth" of £20.0b. and an increase of £30.5b. in non-deposit liabilities. The scale of both the negative public sector contribution and the reduction in money growth due to non-deposit liabilities was unprecedented. If the two counterparts had taken more normal values of, say, nil for the public sector contribution and minus £15b. for non-deposit liabilities, M4 growth would have been higher by £35.9b. – and M4 growth would have been 12.3% instead of 7.9%. The prospective behaviour of the economy and inflation would then have been quite different.

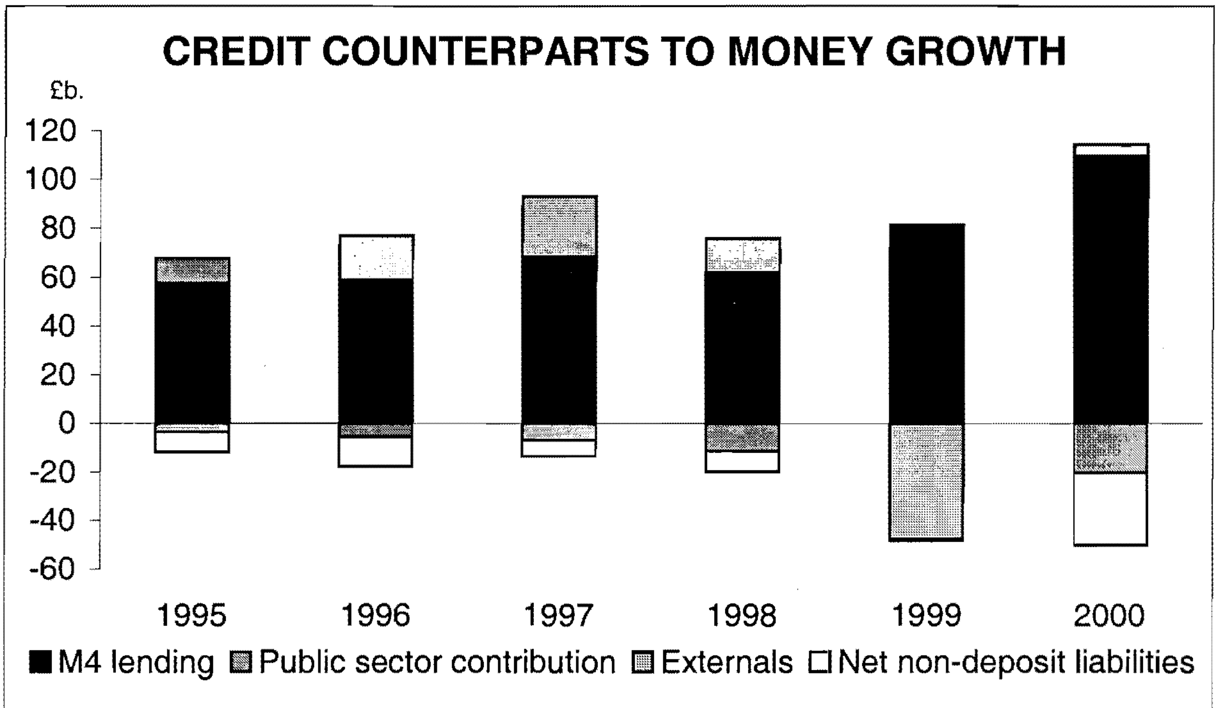
(*A few words of technical explanation.* A. In the past a negative public sector contribution to money growth was sometimes known as "over-funding". So over-funding in 2000 was by far the highest ever. If the Government were still persevering with the (silly) "full funding rule" introduced in 1985 money supply growth last year would therefore have been much higher. B. The more that non-deposit liabilities increase, the smaller the rise in the deposit liabilities which represent most of the quantity of money. C. The remaining credit counterparts added £3.1b. to M4, giving £64.2b. in total.)

The public sector's financial transactions cut M4 by £5.4b. in 1996 and £6.8b. in 1997, and by as much as £9.6b. in 1998, but none of these years came anywhere near the £20.0b. negative impact in 2000. In more detail, the Government's finances benefited last year from the surprisingly high proceeds from the auction of third-generation mobile phone licenses (of over £22b.) as well as a healthy underlying surplus. Moreover, the Government continued to sell long-dated gilts. Insofar as their purchasers were non-banks, the quantity of money was reduced.

According to the official publication *Financial Statistics*, gross sales of long-dated gilts totalled £4.6b. in 2000, while redemptions came to £18.0b.and buy-ins of short-dated gilts to £3.5b. As long-dated gilts are generally held by the long-term savings institutions, the Government was able to build up a large cash balance. At the end of January 2001 the public sector's holdings of cash, deposits and money market instruments with UK "monetary financial institutions" (i.e., banks, basically) stood at £40,434m., compared with £19,991m. a year earlier. The £40b. figure is equivalent to almost 4% of MFIs' total sterling liabilities.

Looking ahead, a key issue is the Government's attitude towards this deposit. The British Government has *never* before had a large deposit with the commercial banking system. Traditionally, it has tried to restrict its bank deposit to a very low level in order to minimise the interest costs on the national debt. (The deposit – in the past maintained at the Bank of England – received no interest; the Government's debt did pay interest. So it made sense to use any spare cash to pay back debt.) As noted in today's *Debt & Reserves Management Report* from the Treasury, the minimisation of debt interest costs is supposed to be still the main consideration in debt management policy.

A vital implication is that the Government does not really care (or does not care at all) about the monetary consequences of its decisions on gilt and Treasury bill issuance. This is confirmed by a sentence in the *Debt & Reserves Management Report*. "It is anticipated that [the] net cash position will be run down over the next three financial years." In other words, official policy is *not* to retain or even to build up the Government's cash balance, although that may be necessary to avoid excessive broad money growth over coming quarters. 2001 and 2002 will see a less negative public sector contribution to money growth than 2000. If bank credit to the private sector remains strong, or receives further stimulus from lower interest rates, broad money growth could exceed double-digit annualized rates. The British economy may not be in the midst of a boom-bust cycle. It is nevertheless quite a long way into a cycle of boomlet and mini-bust.

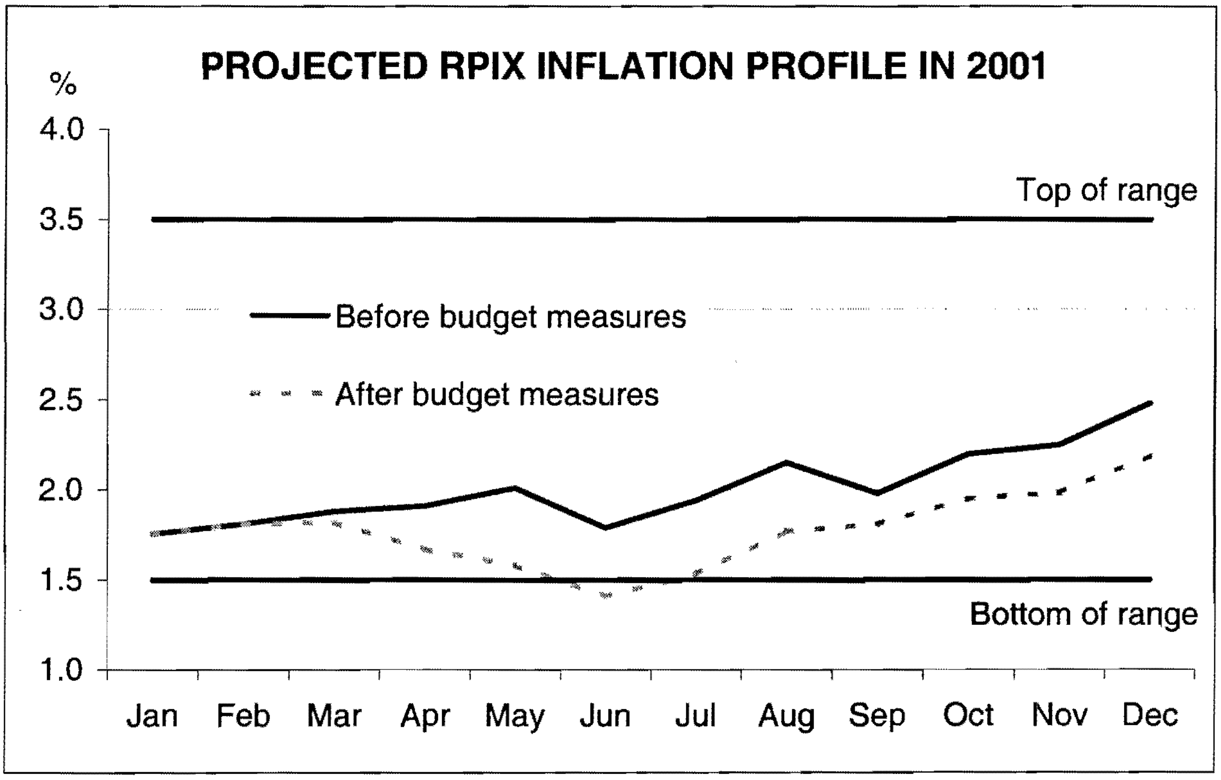


Budget measures could drive inflation down to 1.5%

Cuts in fuel duties, a freeze on alcohol duties and lower increases in tobacco taxes will push RPIX inflation down in the coming months

Much of the slowdown in monetary growth over the last year may have been attributable to the rapid rise in UK residents' sterling deposits held overseas. Such deposits are likely to continue to rise relative to the domestically-held deposits included in national money supply measures.

There has been considerable debate in recent weeks regarding the possibility of RPIX inflation dipping below 1.5% (the bottom of the 1.5% to 3.5% target range) in the first half of 2001. The excise duty measures announced by Mr. Brown in today's budget (on alcohol, tobacco and fuel) make it significantly more likely that underlying inflation will indeed fall beneath 1.5% some time in the next few months. In last year's Budget, the combined influence of excise duty increases added an estimated 0.3% to RPIX inflation. This year, petrol duties have been cut, with the most important feature being the extension of the excise reduction to all unleaded fuel (as opposed to just ultra-low sulphur fuel) until June. Alcohol duties - which were also increased for wine and beer last year - have been frozen, while tobacco duties were only increased in line with inflation. Last year, they were raised by around 6%. The combined influence of these measures could knock about 0.1% off RPIX inflation, with most of the impact being felt in March and April 2001. The replacement of a 0.3% *increase* with a 0.1% *decrease* will, of course, impact directly on the annual rate of inflation in these months. Since the starting point for RPIX inflation is 1.8% in the year to



January, there seems a good chance that underlying inflation could now fall below 1.5% as early as March 2001. In fact the large rises in meat - and other food - prices in the wake of the foot-and-mouth crisis will be an important offset in March and, probably, in April. However, when meat prices return to normal, there is a fair chance that RPIX inflation will dip temporarily below the 1.5% threshold.

After the summer it is likely that inflation will be on a gently rising trend, a view with which the MPC appears to agree according to the February *Inflation Report.* But if it dips close to or below 1.5% before then, the Bank of England may fall under further pressure to cut UK interest rates again. In that sense, Mr. Brown's latest Budget measures have put unwelcome pressure on the MPC members. But bad economics may make for good politics in an election year.

Elsewhere in the Budget documents, Mr.Brown outlines the Treasury's view of UK growth and inflation prospects over the next few years. RPIX inflation is assumed to reach 2% at the end of this year before rising moderately to 2.5% at the end of 2002. GDP growth is projected to slow from the 3% recorded in 2000 to a more sustainable 2.25% to 2.75% over each of the next three years. Interestingly, the first issue highlighted within the Budget material that outlines the state of the economy concerns the extent of spare capacity at present. A selection of charts presented there supports the view that output in the UK is currently above trend. Moreover, how is this spontaneous slowdown to occur? At present, leading indicators point, if anything, to stronger - not weaker - domestic demand in 2001. Meanwhile, as Mr. Brown was keen to point out, public spending, especially on investment, is now expected to increase sharply. This can only add to capacity constraints. The official forecasts are a little too gloomy on growth and too optimisitic on inflation propsects in the rest of 2001 and into 2002.

Projections for 2001-02

	Outcome	Treasury		LSR	
	2000	2001	2002	2001	2002
GDP	3.0	2.5	2.5	3.2	2.0
Domestic demand	3.7	3.3	3.0	3.7	1.9
Exports	7.4	5.6	5.0	7.0	3.5
Imports	8.9	7.3	6.5	8.0	3.0
Current account (% of GDP)	-1.4	-2.3	-2.5	-1.4	-1.2
RPIX inflation (Q4)	2.1	2.0	2.5	2.0	3.1

Demand set to bubble over

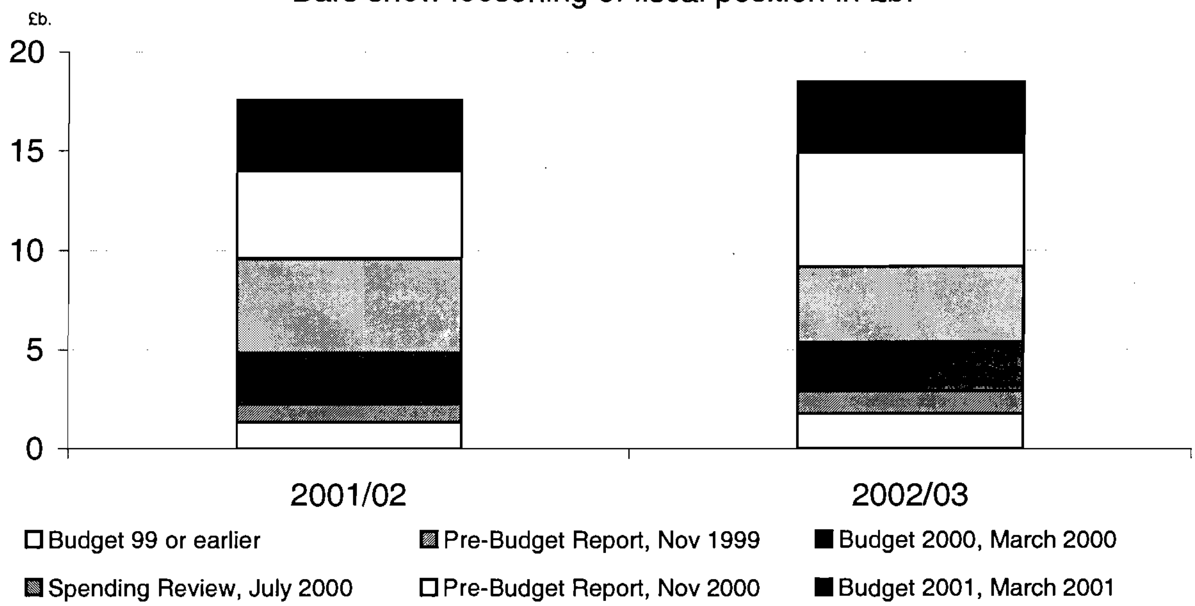
Brown today added significantly to the already substantial stimulus in place for 2001/2 and 2002/3

Chancellor Gordon Brown today increased by £4b. a year the £15b. fiscal easing already announced for both 2001/2 and 2002/3. But skilled labour shortages are already emerging in the economy and domestic demand is continuing to rise by at least trend rates. A risk is that the economy is set for a period of mild over-heating.

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 over the last 18 months. Policy is set to be very stimulatory over the coming two years. Exact figures are not available on a consistent basis. But using those in earlier Treasury documents, Budget 2001 and Lombard Street Research estimates, the fiscal stance will be relaxed by £18b. in 2001/2 and £19b. in 2002/3, equivalent to 1 3/4% of GDP a year. Brown makes much use of the word prudent and, up until recently, he has surprised on the upside with his handling of the public finances and the economy. In Budget 2001 the Chancellor emphasised the need to maintain stable growth, but his measures threaten to exacerbate supply bottlenecks emerging in the economy. For example, when the Pre-Budget Report measures were announced a response from the Construction Confederation was, "We wanted an apple or an orange, and got a fruit bowl." The risk is that the extra stimulus over the coming two years comes as the shrinking labour pool is being accompanied by rising earnings growth.

SUBSTANTIAL FISCAL EASING IN PLACE

Bars show loosening of fiscal position in £b.



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