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Housing boom continues

No slowdown in consumption at present interest rates

Treasury expects consumer slowdown

One intriguing feature of the Budget has been overlooked. In the *Financial Statement and Budget Report* the Treasury forecast that consumption, which grew by 3 3/4% in 2001, will go up by 3% to 3 1/2% in 2002 and by 2 1/4% to 2 3/4% in 2003. In other words, the official analysis is that the consumption boom will fade in the next few quarters at interest rates much the same as those now prevailing. As paragraph B39 of the *FSBR* explains, "household consumption growth is expected to begin to moderate in the second half of this year and to grow more in line with developments in income and wealth thereafter, as households limit further accumulation of debt".

Wealth as a whole - not debt in isolation - crucial to consumption prospects

This view - that the high level of personal debt will have to be offset by reduced borrowing, more saving and slower consumption growth - has been a familiar refrain in all the consumer booms of the last 30 years. It has justified official complacency about interest rate levels, despite plainly unsustainable trends in both domestic demand and key asset prices such as those of houses and commercial property. It has generally been wrong, as excess demand leads to rising inflation. The central mistake is simple, a confusion of cause and effect. The economists who say that excess debt will lead to spontaneous consumer retrenchment believe that the houshold sector balance sheet responds to its income and spending behaviour; they do not understand that - in fact - households' income and spending behaviour is better seen as responding to the balance sheet. They think that - because debt is "high" and the savings ratio low - the savings ratio will have to revert to some normal, long-run average value, and that this will check consumption. The truth is quite different. In virtually all years the change in household wealth due to the revaluation (or devaluation) of assets held at the start of the year is a high multiple of the change in wealth due to new savings flows. The revaluation effect is much more important than the flow of new savings in determining balance sheet strength.

With house prices increasing by 1% a month, rising wealth will support consumer boom

More specifically, the savings ratio may be low (as it is at present in the UK) and yet household wealth gains are massive because of, for example, high house price inflation. As the housing capital gains swamp the effect of low savings on wealth, consumer spending keeps on booming. Some numbers may help to put the position in context. In early 2001 the housing stock was worth about £2,000b. In the year to March 2002 the Nationwide house price index advanced by 13.8% and the Halifax house price index by 16.0%. So - broadly speaking - the British people have secured a wealth gain of about £300b. from house price inflation over the last year. This compares with disposable income last year of under £700b. and "savings" (in the sense of the net amounts set aside from income in "the savings ratio") of about £35b. Bluntly, while house prices are rising by 1% a month, the Treasury (and indeed the Bank of England) are fantasizing if they think the consumer boom will weaken of its own accord. Base rates of 4% are too low.

Professor Tim Congdon **30th April, 2002**

Summary of paper on

How healthy are the UK's public finances?

Purpose of the paper

The UK's public debt situation compares favourably with the other large industrialised nations. But public finances are now deteriorating, albeit from an extremely healthy starting point. The recent Budget represents another noticeable fiscal loosening which will raise public borrowing significantly in coming years. The Government should satisfy its own self-imposed fiscal rules fairly comfortably, but the rules themselves are not sufficient to ensure prudent Government budgeting.

Main points

* **Public finances in the UK at the start of the 21st century were in excellent shape. But deficits have now returned and are set to get larger over the next few years.**

* **By international standards the UK has managed its public finances well over the last 25 years. It has the lowest ratio of public debt to GDP among the major industrial nations and, uniquely in the G7 group, has reduced the ratio over that period.**

* **Although the PSNCR was higher as a proportion of GDP in the mid-1970s than in the early 1990s, underlying public finances were arguably worse in the latter period. Deficits were kept down in the late 1970s, 1980s and 1990s by:**

  a) public corporations - often with large investment and borrowing programmes - being transferred to the private sector through privatisation,

  b) privatisation receipts reducing the PSNCR,

  c) bumper tax revenues from North Sea oil profits, and

  d) huge cuts in public sector capital spending.

* **No similar influences will help reduce public borrowing in the immediate future. Indeed, with the Government embarking on a massive programme of public sector investment (quite consistent with their golden rule), public finances could deteriorate alarmingly.**

This paper was written by Stewart Robertson.

How healthy are the UK's public finances?

Public borrowing could rise significantly over the next few years

A return to "tax and spend"?

Despite the announcement of an increase in national insurance contributions in April next year, the 2002 Budget represented a significant fiscal loosening. Large rises planned in public spending imply a return to ongoing budget deficits over the foreseeable future according to the Treasury's official projections. While the projected deficits are of manageable proportions and the Government's two fiscal rules are easily satisfied, the present fiscal stance is worrying. New Labour may be attempting to deny that they have reverted to the "tax and spend" policies that characterised earlier socialist administrations, but an argument could be made that a major step has been taken in that direction. When combined with Chancellor Brown's continued tinkering with the tax and benefit system, a further case could be brought that the UK economy is being pushed towards the European model that is often characterised as over-taxed and over-regulated.

Favourable inheritance, but New Labour maintained fiscal discipline initially

In one way Gordon Brown was an extremely fortunate Chancellor. The fiscal inheritance that he received in 1997 could hardly have been better. Public borrowing was falling, tax revenues were growing strongly and public spending was under strict control. To be fair to the new Labour Government, fiscal discipline was maintained in the late 1990s as they stuck with the public spending plans of the outgoing Conservative government. The stable macroeconomic backdrop in their first three years of power also helped to convince the British public and financial markets that a Labour government could be a model of financial rectitude. In this context, granting the Bank of England operational independence for monetary policy in May 1997 was a masterstroke. Mr. Brown quickly gained a reputation as a prudent Chancellor.

2002 Budget represented a significant loosening of fiscal policy

But things may now be changing. 2001/02 saw the first public sector deficit for four years. Significantly larger ones are forecast over the next several years as the Government embarks on an ambitious spending spree in order to transform public services, mainly the NHS. Although it is to be hoped that lessons have been learnt from the UK's economic experiences in the 1970s and 1980s, the historical record does show that - from time to time - public finances can lurch out of control alarmingly. The UK recorded a small public sector surplus in 1990/91. The recession meant that the Government forecast a return to deficits for three years, but public borrowing was projected to peak at £12b. (or 2% of GDP) in 1992/93. In the event the peak was over £45b. (over 7% of GDP) in 1993/94. A sharp economic downturn in the UK is unlikely in the near future, but cannot be ruled out further ahead. Should a slowdown occur, the UK's public finances would be vulnerable. Public spending - especially current expenditure - can be difficult to cut back, both practically and politically.

Public debt is low relative to GDP in the UK

The remainder of this paper is set out as follows. Pages 5 to 12 consider the historical record of public finances in the UK since the 1960s and also outline an international comparison of public debt levels relative to GDP. On this basis the UK stands out as having the lowest ratio of debt to GDP among the major industrial nations. More notably, the UK is the only country of the G7 nations to have *reduced* public debt as a proportion of GDP between 1978 and 2000. The plight of Japan is noted in particular. Public debt has soared to over 120% of GDP and is set to climb much higher as the country continues to run massive budget deficits. By international comparison the UK has done well. But in some ways the appearance of satisfactory control over the long run is misleading. A series of charts on pages 8 to 11 show some alternative measures of the public sector's financial position over time and describe its evolution. The windfall from North Sea tax revenues boosted receipts throughout the 1980s, flattering the Government's accounts, while privatisation proceeds also helped enormously. Arguably even more important were the huge reductions in public sector investment in the late 1970s.

Public finances helped by special influences in 70s and 80s...

...that will not be repeated in coming years

The key point is that, from 2002 on, there will be no ongoing boost to tax revenues like the North Sea bonus. The £22.5b. of receipts from the sale of spectrum licenses had an enormous effect on public finances in 2000 and goes some way to explaining the favourable starting point. But it was a one-off influence. The wave of privatisation is over, while the present Government has staked its reputation on a massive increases in public spending, especially investment. The trend is changing.

Public deficits have risen sharply in recent months

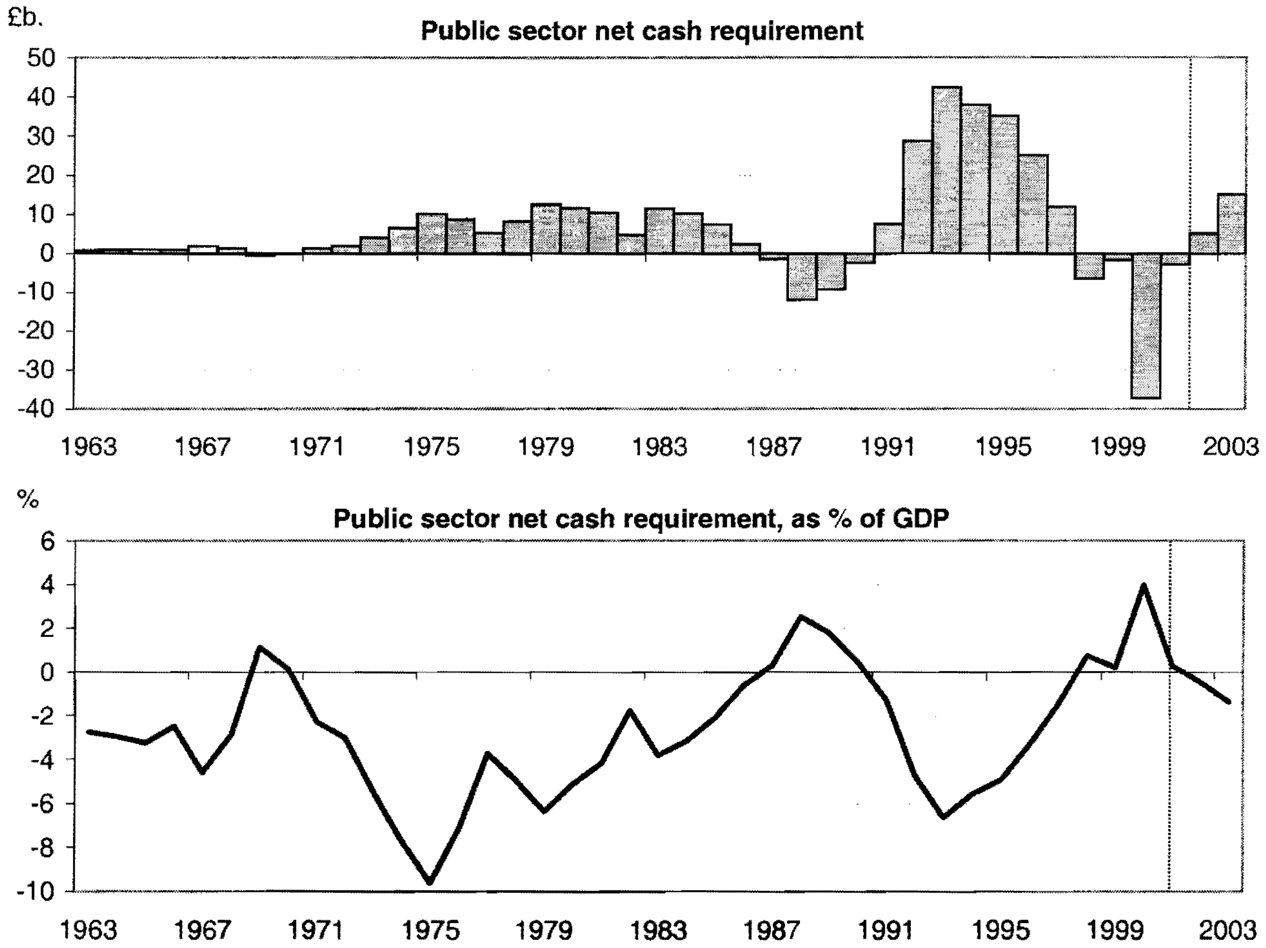
Pages 13 to 16 briefly examine the current public sector financial position and consider some implications of the Government's latest plans. Public finances were already deteriorating before the expansionary measures announced in the 2002 Budget. In the second half of the 2001/02 financial year the public sector net cash requirement was £11.9b. higher than in the corresponding period of 2000/01. (Note that neither of these six-month periods was affected by the 3G windfall.) In the year to March central Government cash receipts were growing at an underlying annual rate of just 1.4%. Meanwhile, net departmental outlays were expanding by between 8% and 9% a year. These two comparisons - monthly PSNCR numbers and trends in receipts and spending growth - both imply a rise in public borrowing of well over £20b. if they were sustained for a year. At present, there is no sign of either trend reversing. The Government's projection of about an additional £10b. of borrowing in 2002/03 (and a minimal further deterioration thereafter) may well prove optimistic.

Labour's fiscal rules are consistent with much higher borrowing

The UK's current public finance position is reasonably healthy, especially when compared with the situation in the other main industrial nations. But public borrowing is already on the rise and is set to increase quite sharply over the next year or so. The Government's fiscal rules are sensible enough, but they are not sufficient by themselves to guarantee prudent budgeting. Far from it in fact. In particular, the golden rule is quite consistent with large rises in public borrowing.

The public sector net cash requirement since 1963

An apparently creditable record, with occasional surpluses



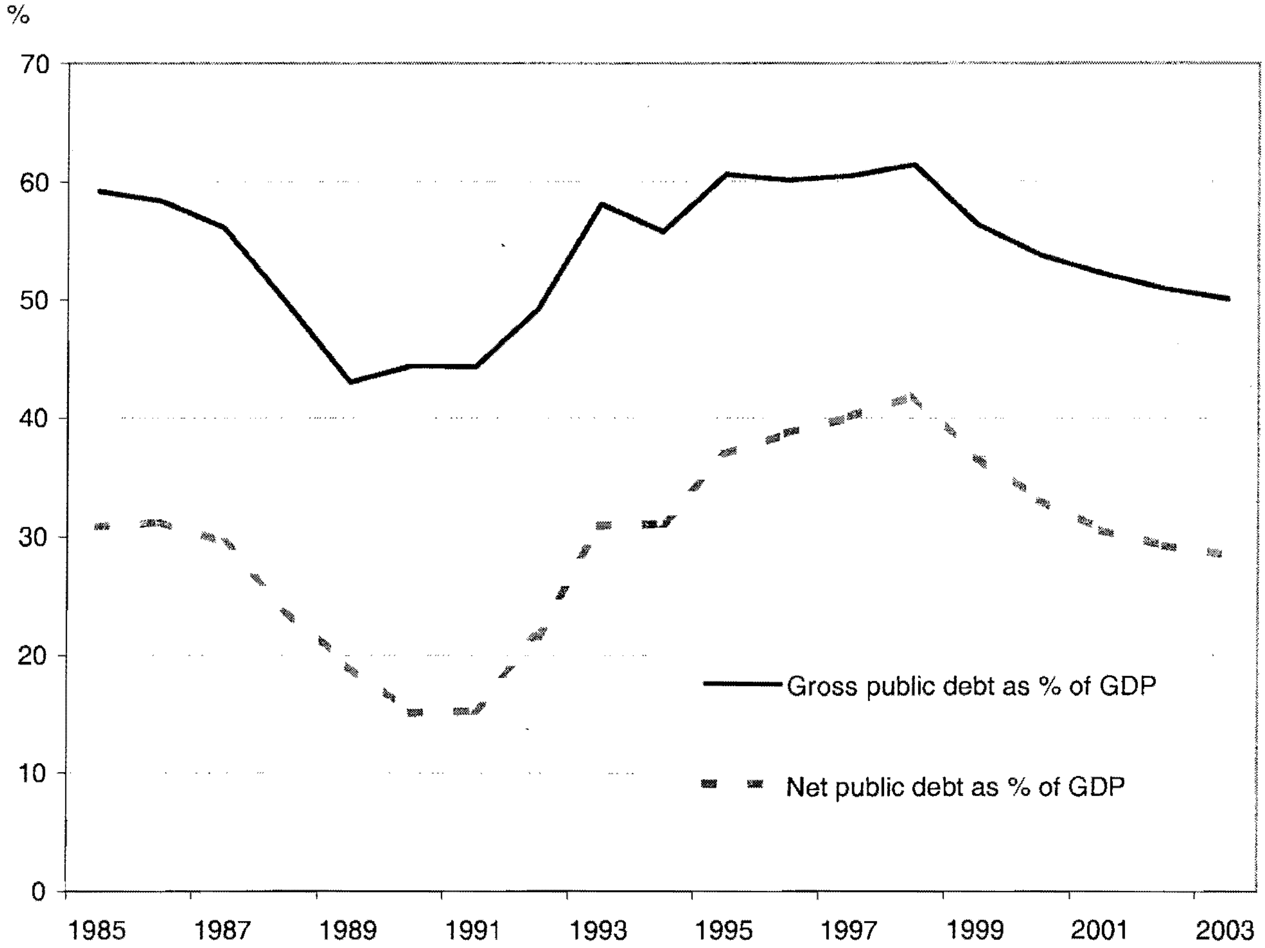
Source: National Statistics, Budget 2002.

PSNCR is on a calendar year, not financial year basis, for easier comparison to GDP. Numbers for 2002 and 2003 reflect official intentions as outlined in Budget 2002, but with adjustments to bring them to a calendar year basis.

Over the last 40 years the UK's public sector net cash requirement (PSNCR or the old PSBR) has tended to fluctuate in line with the economic cycle. The small surpluses between 1987 and 1990 were helped initially by strong North Sea tax revenues, but were mainly attributable to the buoyant activity levels associated with the Lawson boom. They proved unsustainable, and borrowing soared in the early 1990s as tax receipts dried up and unemployment rose steeply. As a proportion of GDP the PSNCR peaked at 6.6% in 1993, well below the figure of just under 10% recorded in 1975. Subsequently, the long period of macroeconomic stability helped public finances improve slowly, a trend that was assisted by budgetry restraint under both the last Conservative administration and the first Labour one. Recent surpluses were boosted enormously by the windfall from the 3G mobile phone auction receipts. With the public spending shackles now removed, a return to deficit is projected.

Public debt as a % of GDP, 1985-2003

Public debt remains under reasonable control



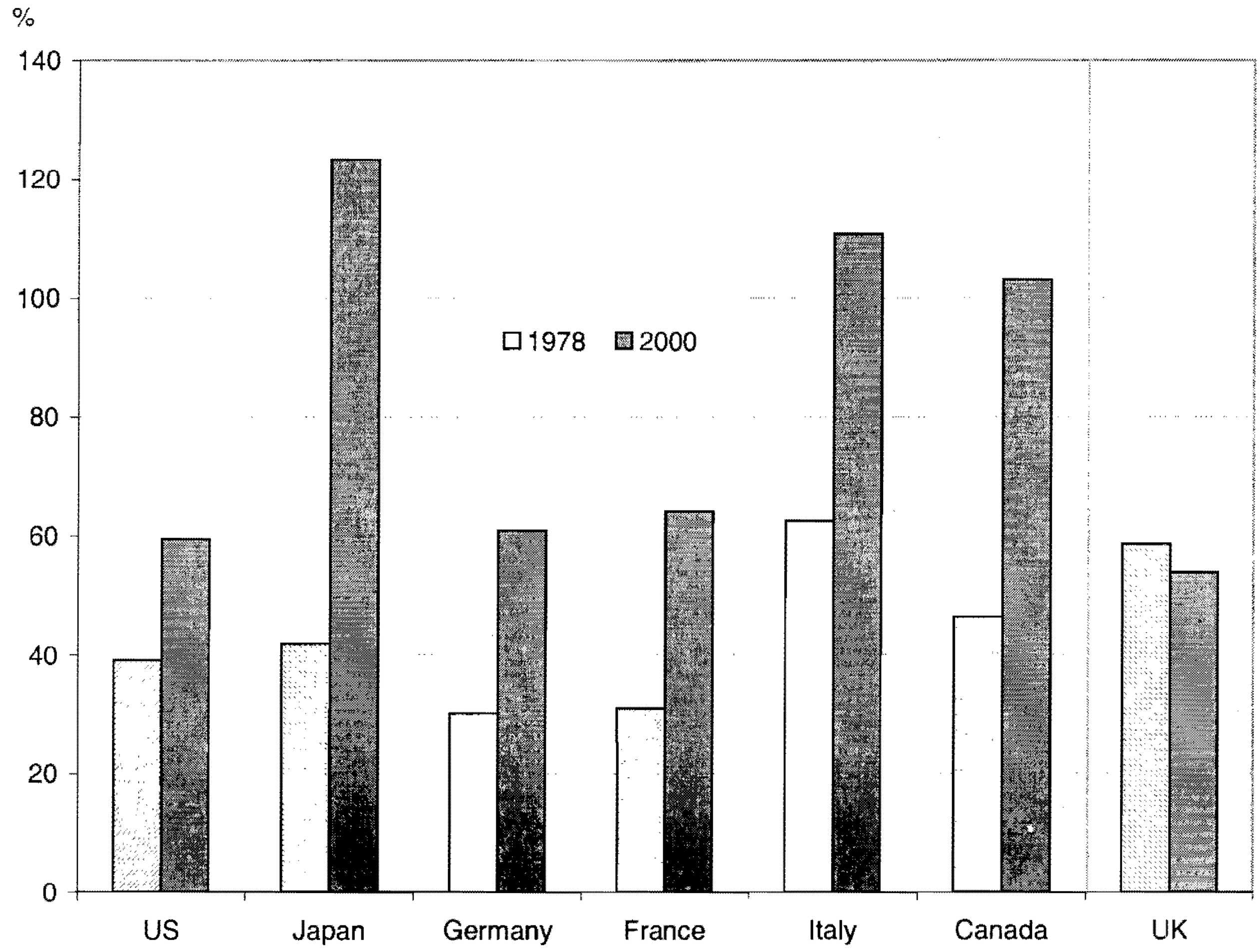
Source: OECD December 2001 Economic Outlook

Chart shows general government gross and net financial liabilities as a % of nominal GDP at market prices. The data comes from the OECD publications and uses OECD projections for 2002 and 2003

Total outstanding government debt as a proportion of GDP fell to post-war lows in the late 1980s on the back of rapid economic growth and four years of Budget surpluses. But the trend reversed in the 1990s as recession led to large increases in public spending, most financed by issue of new debt. Social security expenditure, for example, increased from under £60b. in 1990 to over £100b. in 1995. The ratio of gross debt to GDP rose back above 50% in 1993 and has remained above that level ever since. Tight Budgets under Lamont and Clarke in 1993 and 1994 were a reaction to this trend and fiscal discipline was maintained in the late 1990s by the incoming New Labour Government. Debt-to-GDP peaked in 1998 and has declined gently since. Although the 2002 Budget was the most expansionary for a decade, Gordon Brown was still able to project net debt remaining close to 30% of GDP, well below his self-imposed "prudent" limit of 40%. But such a favourable outcome is by no means certain.

International comparisons of public debt, 1978-2000

Britain has a good record by international standards



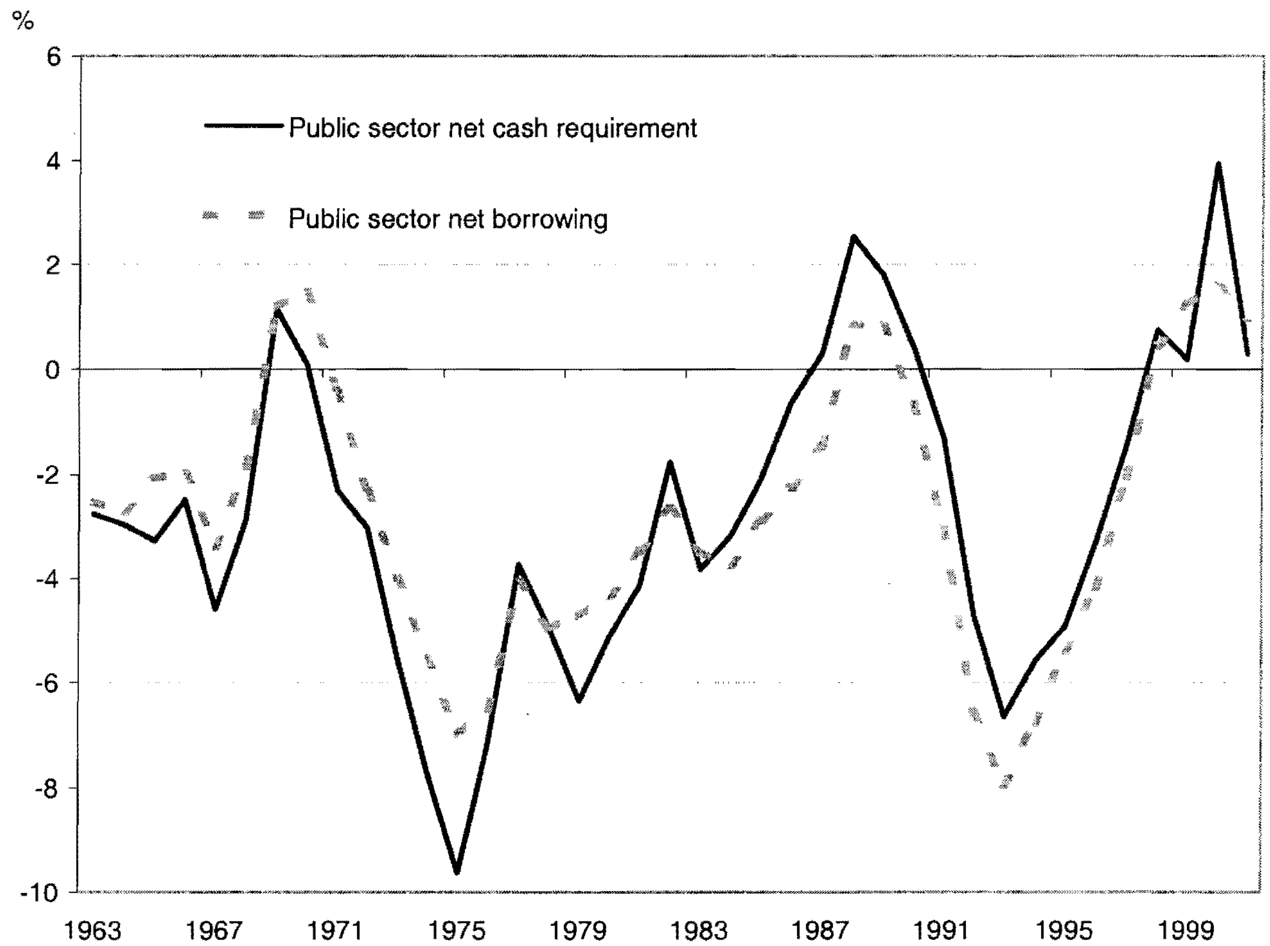
Source: OECD December 2001 Economic Outlook

Chart is based on OECD data of gross financial liabilities of general government as a % of nominal GDP at market prices.

The UK's public debt situation compares extremely favourably with that in the other major industrialised nations. As recently as 1978 Britain had the second highest debt-to-GDP ratio of the G7 nations. But by 2000 it had the lowest. Uniquely among the G7 countries, the UK has reduced public debt as a proportion of GDP over this period. The improvement was helped in the 1980s by the windfall from North Sea tax revenues and from the wave of privatisation which both boosted the public coffers and offloaded debt liabilities of previously public corporations onto the private sector. But the admirable performance cannot be attributed entirely to beneficial one-off influences. The UK's public debt record is undeniably good and is a sharp contrast to that elsewhere. Debt has doubled as a proprtion of GDP in Germany and France, while the situation in Japan is little short of catastrophic.

How healthy are the UK's public finances?

1. Public sector net borrowing compared with the net cash requirement



Source: National Statistics

Chart compares public sector net cash requirement (PSNCR) with public sector net borrowing (PSNB), both expressed as a % of nominal GDP at market prices. A minus sign indicates a deficit.

When the New Labour Government was elected in May 1997 they were keen to portray themselves as very different from previous socialist administrations. In particular, they wanted to separate themselves from the "tax and spend" image of Labour Governments in the 1960s and 1970s. The responsibility for monetary policy was largely ceded to the Bank of England by granting operational independence immediately. As far as fiscal policy was concerned, two rules were adopted by Chancellor Brown. The "golden rule" states that, over the economic cycle, the Government will borrow only to fund capital spending. The "sustainable investment rule" states that public debt would be kept below 40% of GDP. To this end, the Government switched the focus from the PSNCR to PSNB, the latter concept representing the flow that adds to or subtracts from public sector net debt. The two are closely related, but there have been periods when they have diverged.

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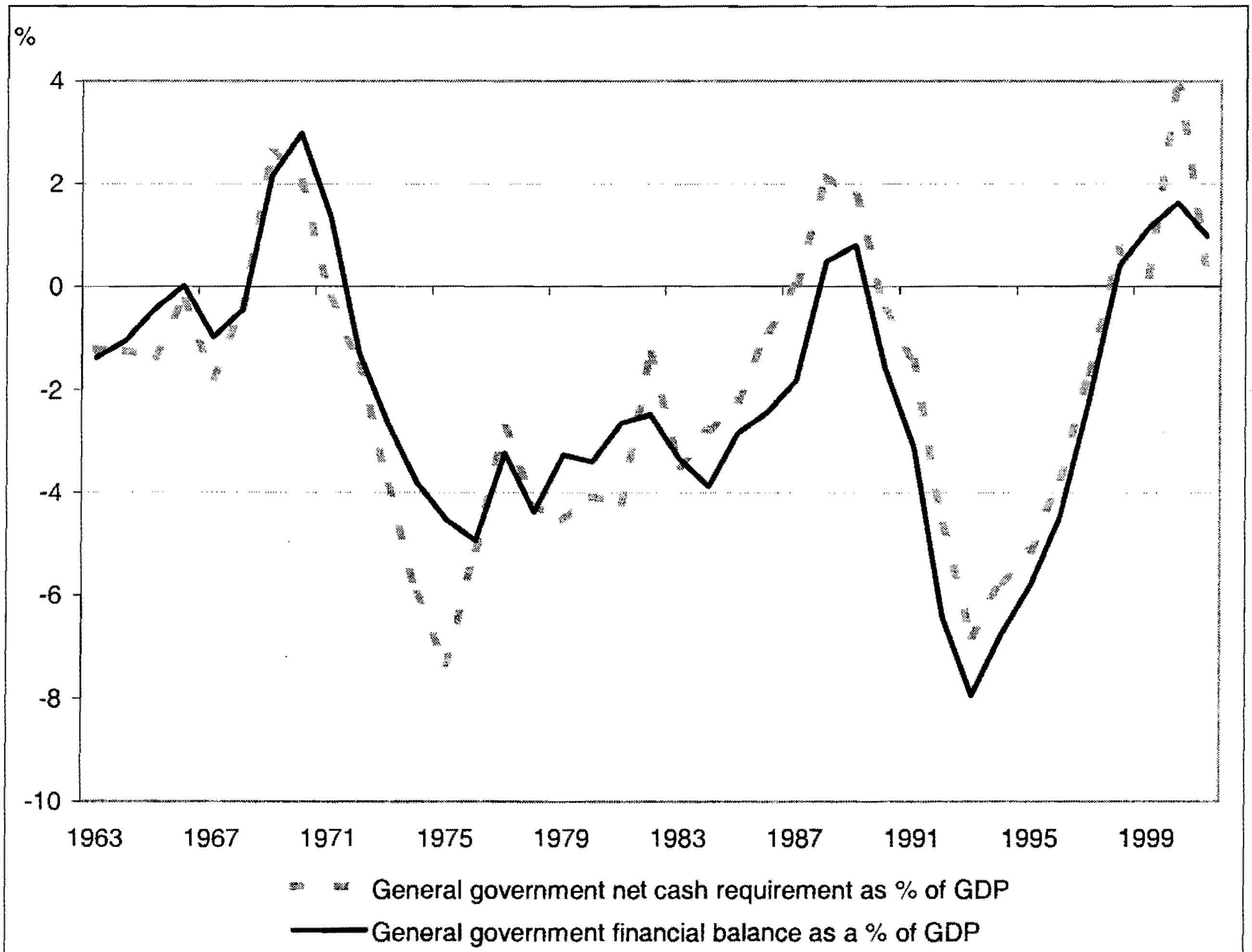
2. General government's cash requirement compared with its financial deficit



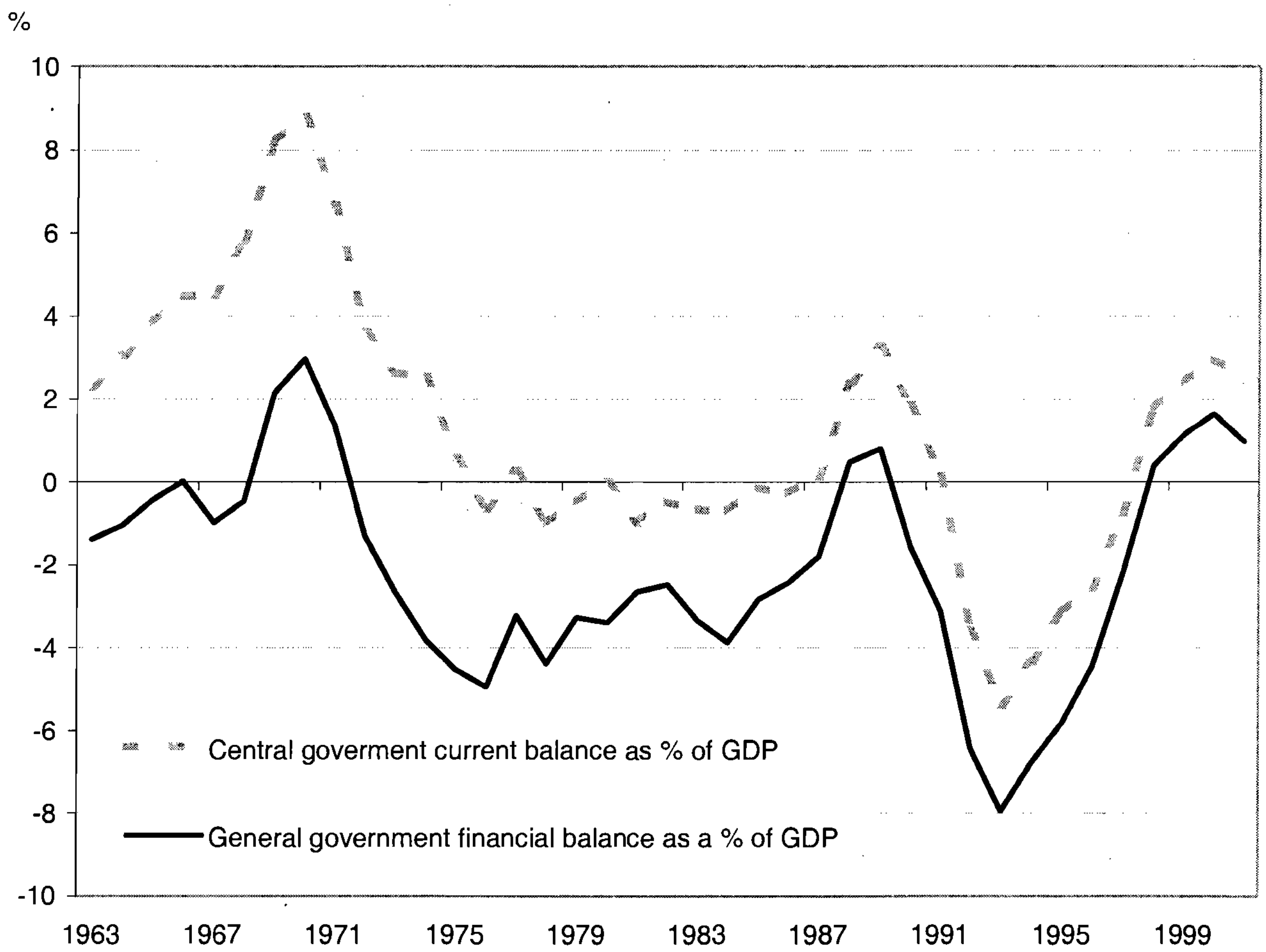
Source: National Statistics

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

The general government's financial balance represents their net acquisition of financial assets. The large number of privatisations - totalling almost £68b. between 1984 and 1997 - brought in substantial receipts for the Government. But ownership of the asset is lost so that net financial assets are unchanged as a result of such transactions. The GGNCR was lower than it would otherwise have been because of privatisation proceeds as the need for borrowing was reduced. The GGNCR peaked at 6.8% of GDP in 1993, a little less than the figure of 7.3% reached in 1975. But the financial deficit amounted to 8% of GDP in the early 1990s, well above the 4.9% peak in the mid-1970s. The current starting point for public finances is extremely healthy, but a return to deficits is projected. Moreover, privatisation proceeds are unlikely to help in the immediate future. Between 1998 and 2001 they totalled just £1.4b. and there seems little prospect of significant revenues over the next few years.

How healthy are the UK's public finances?

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

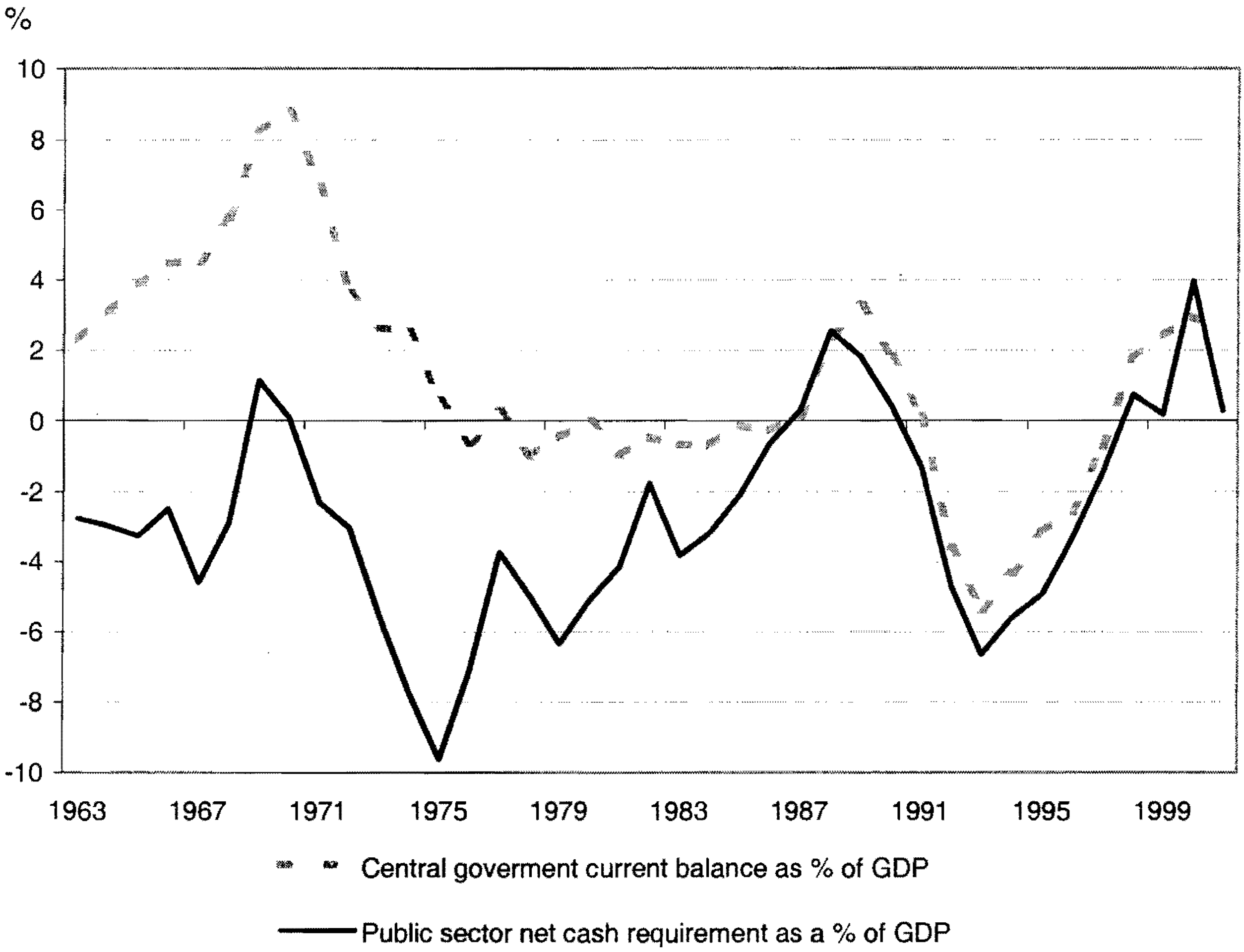


Source: National Statistics

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

The comparison of the general government's finanial balance with its overall current account position highlights the impact of public sector capital expenditure on the public finances. In the 1960s and first half of the 1970s the general government recorded healthy supluses on their current budget. The golden rule may be new, but the concept of prudent public finances dates back to Gladstone. Until the 1960s the guideline was to balance the Budget "above the line". What this meant was that both current spending and "recurrent" capital spending should be financed from receipts, but that other capital spending could be financed by borrowing. The 1960s and early 1970s was a period characterised by large expenditure on schools, housing, roads and other infrastructure, and was accompanied by some borrowing. The Government's financial deficit halved as a % of GDP between 1976 and 1981 as huge cuts were made in public sector capital spending. But their current balance remained unchanged.

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



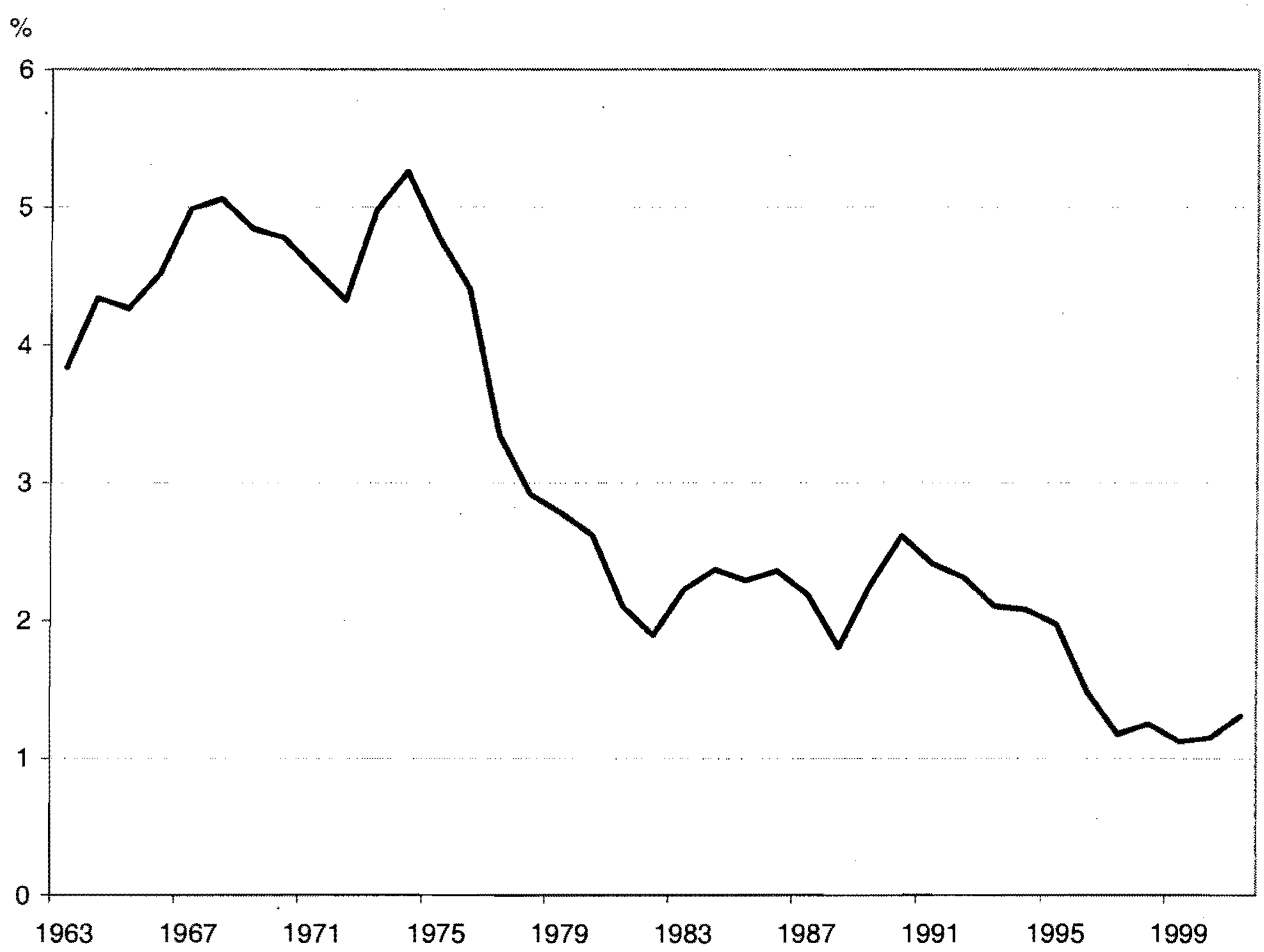
Source: National Statistics

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

At the end of the last recession, the PSNCR peaked at 6.6% of GDP (in 1993), well below the figure of almost 10% in 1975. But the current deficit was much higher. The current balance returned to surplus in 1998, but has not approached the levels (as a proportion of GDP) reached in the late 1960s and early 1970s and is not expected to do so in coming years. The Budget 2002 documents forecast a current balance of around 0.5% of GDP between 2002/03 and 2006/07. Had it not been for the benficial effects on public borrowing of North Sea tax revenues, privatisation proceeds and vast cuts in public spending, the PSNCR in the mid-1990s could have exceeded the 1975 peak. Tight Budgets in the mid- and late-1990s have given the present Government a wonderful starting point for public finances. But public sector capital spending is on the rise and any economic downturn could soon lead to a significant deterioration.

Long-term trends in Government capital spending

Massive cuts in late 70s have never been reversed



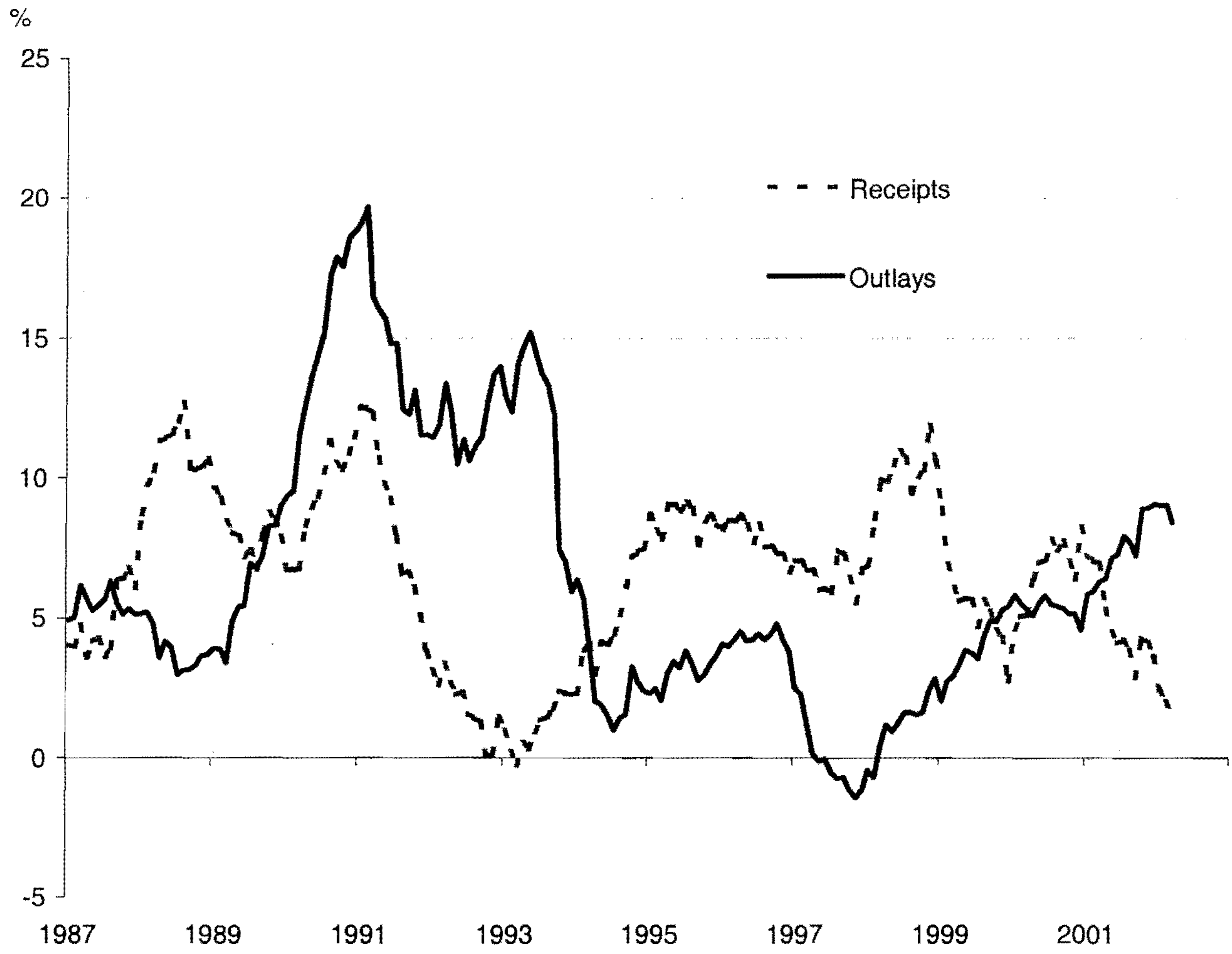
Source: National Statistics

Chart shows general government gross domestic fixed capital formation as a % of nominal GDP at market prices.

Annual public sector capital spending averaged well over 4.5% of GDP between 1962 and 1976. But one of the main conditions for the large loan granted by the IMF (in 1976) was a sharp tightening of fiscal policy. Public spending cuts were concentrated on capital expenditure which dropped to below 2% of GDP by 1982. It fluctuated between 2% and 2.5% from the early 1980s to the mid-1990s. It would have been markedly higher but for the sale of council houses and other property under the Thatcher government. The second half of the 1990s saw another significant decline in public sector capital spending, but it has stabilised at a little over 1% of GDP in the last five years. The trend is now set to change again with the announcement of large increases in public investment spending in the 2002 Budget. (See p. 14.) Any such increases would be consistent with the golden rule, but could still imply a worrying deterioration in public finances over the next three or four years.

More recent public finance trends

The financing gap has widened sharply in recent years



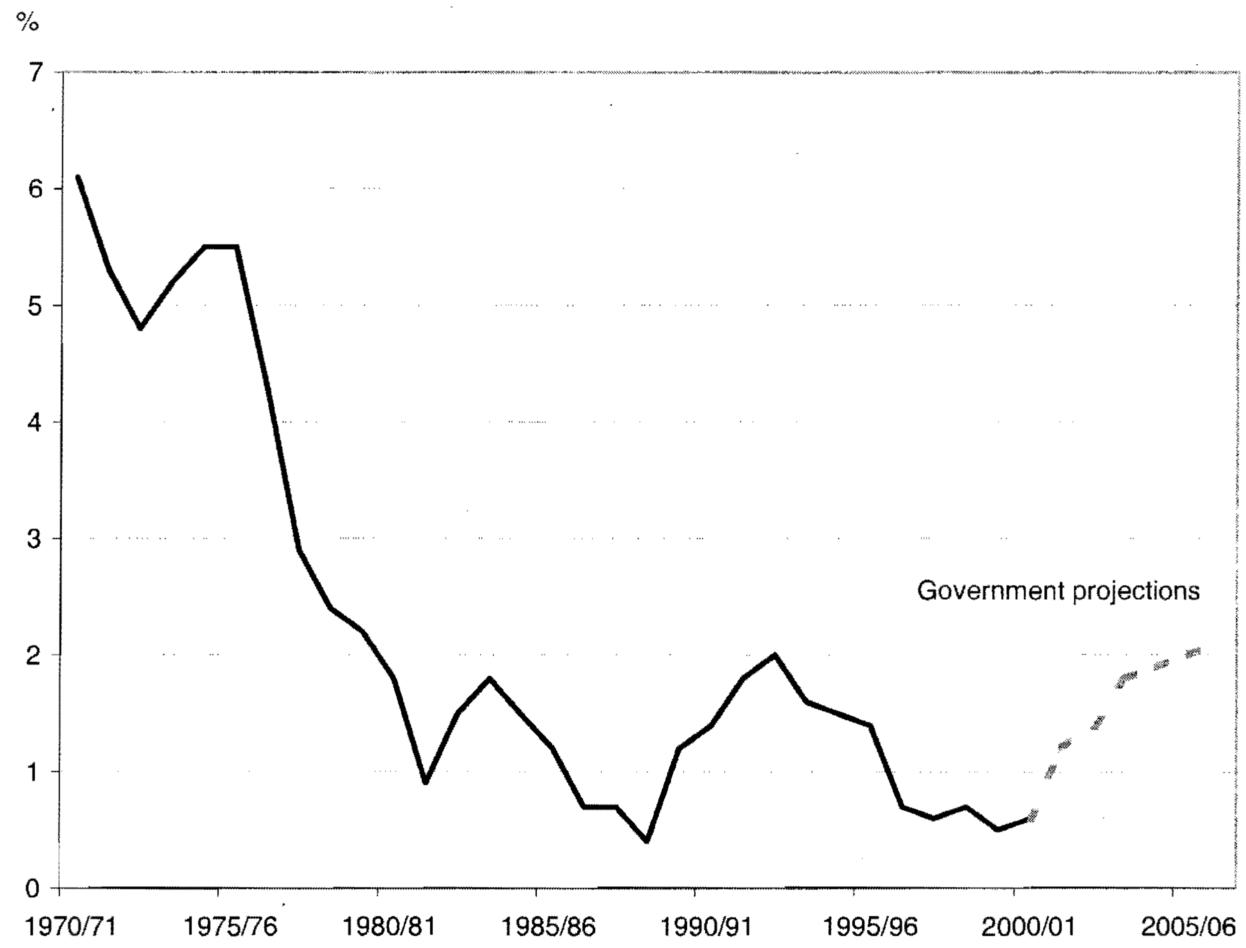
Source: National Statistics, Lombard Street Research calculations

Chart shows the underlying twelve-month growth rates for government cash receipts and for net departmental outlays. Revenues from the 3G auction proceeds are not included.

Tight budgetary discipline in the mid-1990s by the last Conservative administration left the incoming New Labour government with an extremely favourable fiscal inheritance. Public spending growth was running at less than 5%, while the stable macroeconomic backdrop meant that tax revenues were rising much faster. Public borrowing fell rapidly and was replaced by surpluses from 1998 on. The Labour government maintained strict control over public spending for two years, as they had promised before the 1997 election. But the underlying growth rate of public spending has been trending steadily higher over the last four years. At the same time tax receipts growth has slumped. 2001/02 saw the first public deficit since 1997/98 and the PSNCR for the current tax year is projected by the Government to be about £14b. Over the last year public borrowing has been between £1b. and £1.5b. worse each month than a year earlier and this trend has shown no sign of reversing. Were it to continue, the deficit in 2003/04 could exceed £30b.

Public capital spending set to rise

Significant increases in public sector net investment are planned



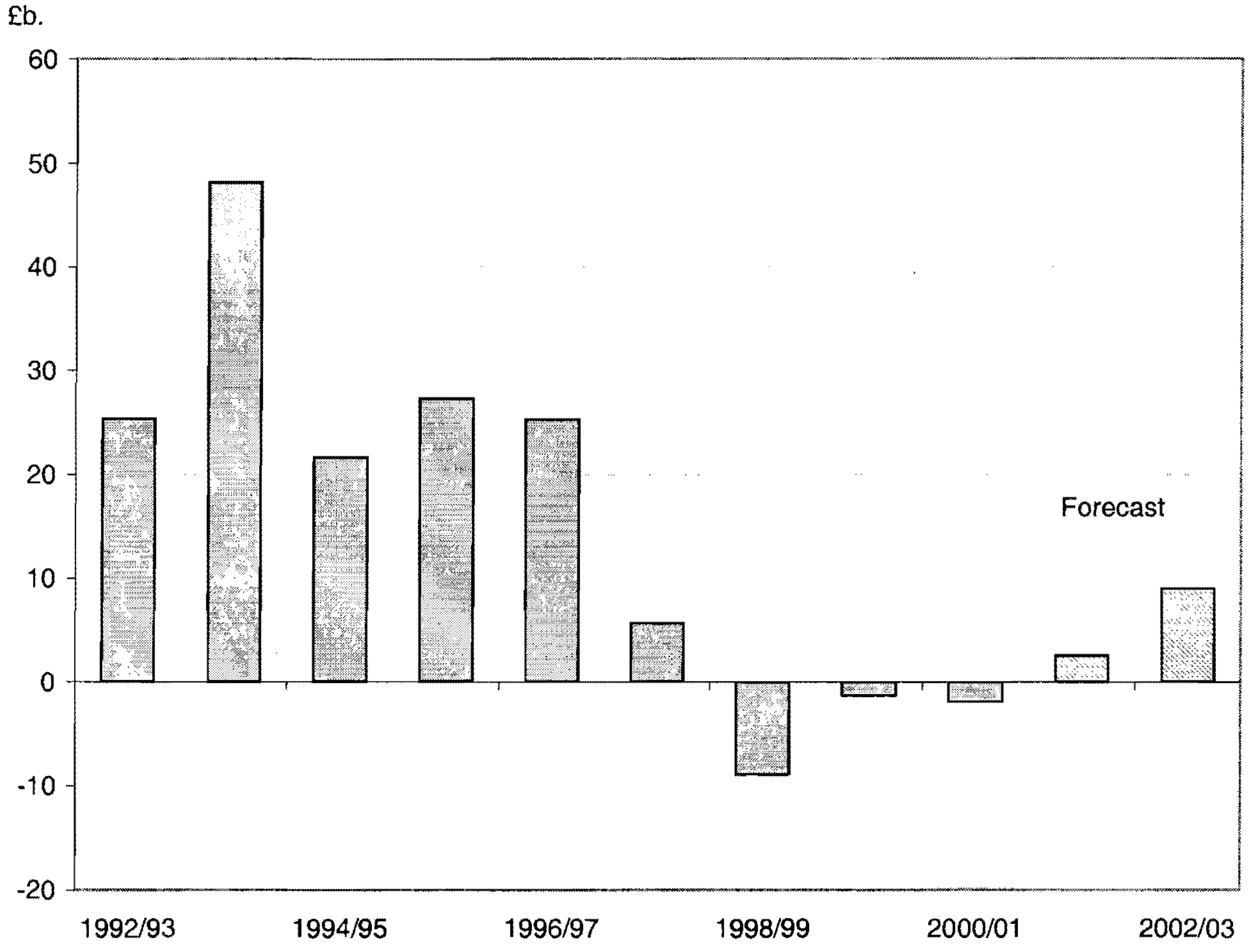
Source: National Statistics, Budget 2002

Chart shows public sector net investment as a % of nominal GDP at market prices. The figures for 2002/03 to 2006/07 inclusive are official Government projections

The Government had already planned large increases in public sector capital spending. In the 2002 Budget, these plans were extended. Public sector net investment is now projected to more than treble as a proportion of GDP between 2000/01 and 2006/07 from £5.7b. to £27b. At around 2% of GDP, such spending is still low relative to the 1970s, but the change from the previous decade is marked. Public sector capital spending did rise sharply between 1988/89 and 1992/93, but this could at least be partly justified as an appropriate fiscal response to the deep recession. Much higher public investment in health, education and infrastructure in the UK may or may not be merited. That is a political issue. But there are hugely important economic consequences regarding how it is financed. Present plans would allow for public borrowing of between £20b. and £30b. a year from 2003 on, yet still satisfy the Government's fiscal rules.

Gilt issuance to increase noticeably

The dearth of gilts supply is over



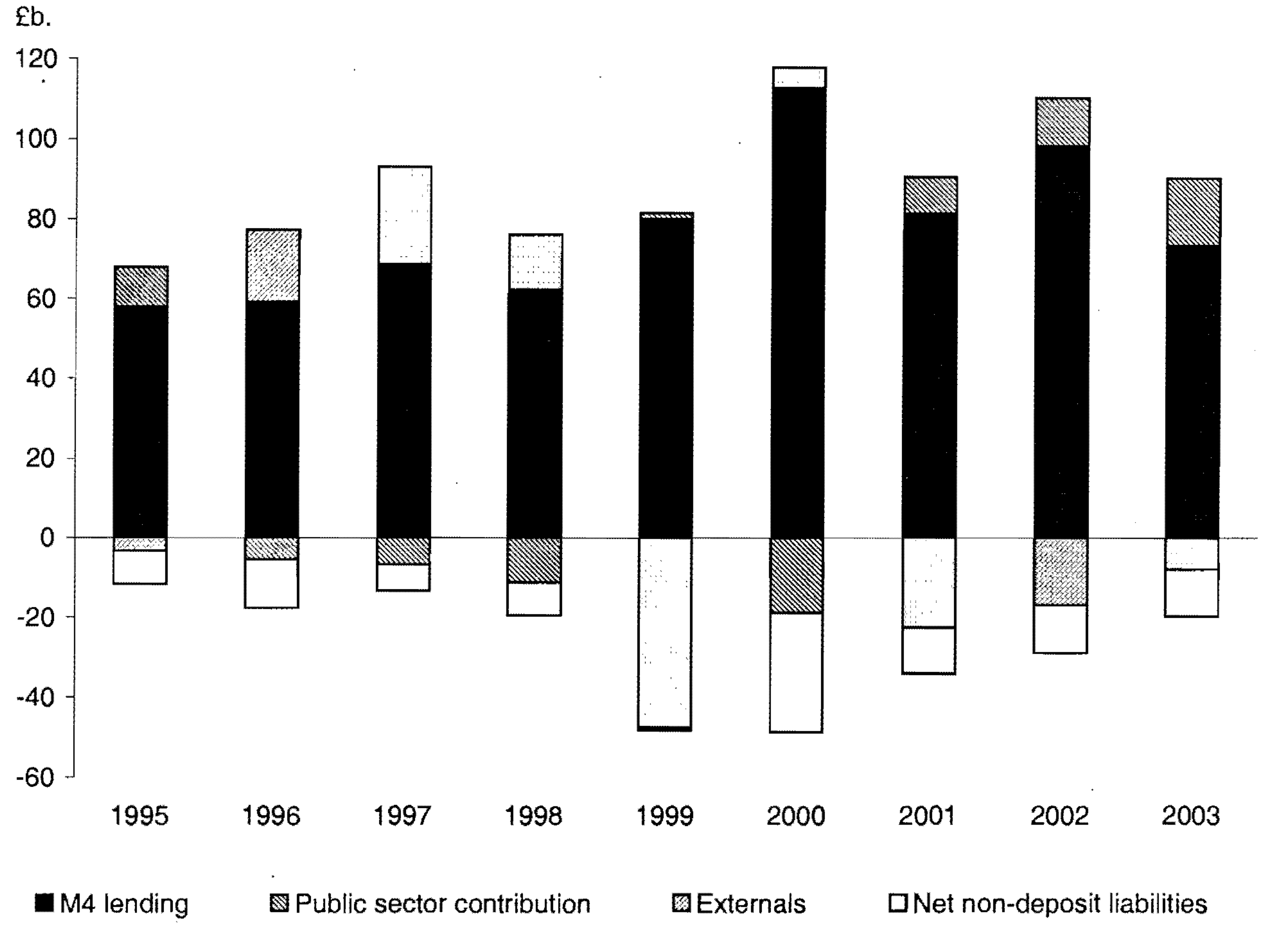
Source: National Statistics, Debt Management Office, Budget 2002

Chart shows total net gilt issuance between 1992/93 and 2000/01. The figures for 2001/02 and 2002/03 are projections made by the Debt Management Office.

Healthy public finances in the late 1990s and early part of the present century meant that there was no need for large-scale gilt issues. The squeeze on supply combined with strong demand from UK pension funds who had effectively become forced buyers because of the Minimum Funding Requirement (MFR). Long-dated conventional gilt yields dropped from over 8% in late 1996 to 4¼% in early 1999. Net issuance returned to positive territory in 2001/02 and will be the highest for six years in the current financial year. The Treasury no longer bothers to forecast the PSNCR, but their projections for PSNB imply continued significant net issuance over the next five years. With the MFR soon to be abolished and gilts supply set to rise steadily, there has to be a risk that gilt yields will continue to drift higher in 2002 and beyond. Once the possibility of higher inflation is considered as well, then gilts do not look an attractive asset class at present. The long bull run is probably over.

Monetary consequences of fiscal policy

Budget deficits likely to boost M4 growth



Source: Bank of England, Lombard Street Research estimates

Chart shows the credit counterparts to monetary growth. Bank s' liabilities are largely deposits, i.e., money. If liabilities increase, then so too must assets. The chart illustrates changes to the assets side of the balance sheet

The link between debt management policy and the money supply is now completely ignored by the Treasury, yet it remains important. The monetary consequences of fiscal policy should not be ignored. Budget deficits will tend to boost the money supply, except to the extent that they are financed by sales of gilts to the non-bank private sector (which would remove the liquidity that is injected by the deficit). Budget surpluses meant that the public sector contribution to monetary growth was negative between 1996 and 2000. But it was positive last year and is set to be even more so in 2002 and 2003. The return to public sector deficits could add between 2% and 3% a year to M4 growth over the next two years (and perhaps beyond). Bank and building society lending is currently rising at annual rates of 7% to 8% at least, and is unlikely to slow unless interest rates rise significantly. The overall message must be that monetary growth is likely to remain strong, stimulating activity levels and leading to a bout of inflationary overheating in 2003.