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Budget Commentary

Key points

– Public spending boom continues

Evidence is mounting that the large rises in public spending are resulting in higher wages and prices and the creation of thousands of non-productive jobs. There are few signs of significant improvements in public services. (See p. 1.) The growth of public spending in 2003-04 will be the highest for 30 years.

– Slide into deeper deficit is bad news for gilts

Net gilt issuance of £26.3b. is planned for 2003-04, the highest level for eight years. With the Chancellor's fiscal rules placing no constraint on gilt supply in the short run, ongoing weakness in the public finances should also feed straight through into greater gilt supply. (See p. 3.)

– M4 growth too high for 2½% inflation in medium term

In the 11 years to end-2002 M4 growth was on average about 2% a year faster than that of nominal GDP, but – if allowance is made for the effect of the gilt repo on M4 – the underlying gap was probably only about 1% a year. 5%-a-year nominal GDP growth is consistent with 2½% inflation, implying that 6%-a-year M4 growth is about right. But at present M4 growth is running at over 7% a year and may be accelerating. (See pp. 4-5.)

– Increased deficit threatens monetary control

The task of monetary control will be complicated by the increased budget deficit. The Debt Management Office in fact envisages substantial financing of a fairly large PSNCR (of over £32b. in 2003-04) at the short (i.e., mostly from the banks).

– Boom in public sector recruitment will hit productivity growth

Mr. Brown's sharp increases in public spending since 2000 have led to substantial employment in the public sector, where market disciplines are weak or non-existent. The implied weakness in productivity growth is inconsistent with the Treasury's optimism on the trend rate of output growth and the current level of the output gap. (See pp. 6-7.)

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(This publication has been prepared by Tim Congdon, Matthew Jackson, Martin McMahon and Stewart Robertson)

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Lombard Street Research

Budget Commentary

April 2003

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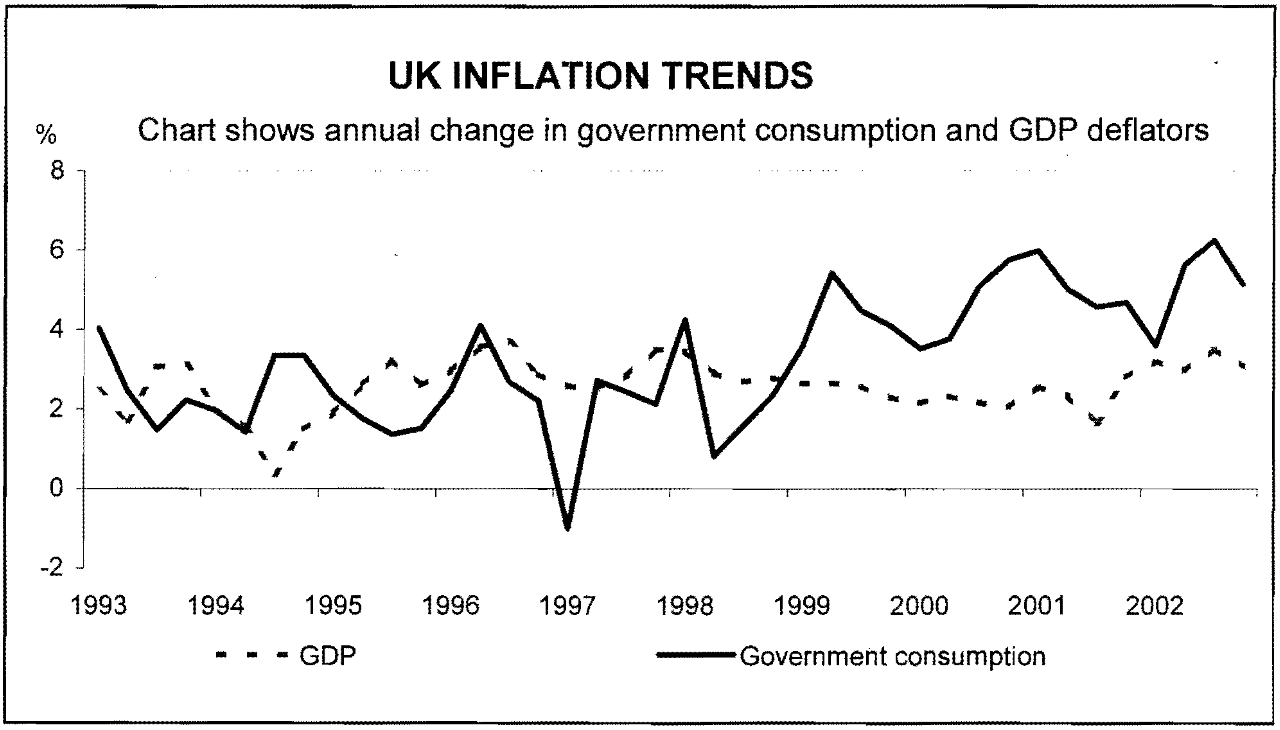
The return of "Tax and Spend"

Public spending growth in 2003-04 will be the highest for 30 years

The Government was re-elected in 2001 on a platform that promised big rises in public spending. So perhaps we should not be surprised by what is happening. The suspicion is growing that money is being frittered away on higher wages and prices with thousands of unproductive public sector jobs.

Public spending (total managed expenditure) in money terms is projected by the Treasury to rise by 8.3% in 2003-04 according to today's Budget documents. It rose at similar rates in the early 1990s, but inflation then was running at 8% to 10% and the economy was in recession, implying high welfare spending. The increases over the last three years have been discretionary, a direct consequence of the Government's stated intention to attempt to improve public services. Between 1993 and 1998 the government spending deflator (the price index for goods and services that the government buys) rose by 2.2% a year on average, the same sort of rate as inflation more generally. But since 1999 the average has more than doubled to 5% and it may still be rising. Simply "throwing" more money at health and education does not seem to be having the desired effects. Instead evidence is mounting that it is being absorbed by higher wages and the creation of thousands of unproductive public sector jobs. Public sector wage inflation was running at 5.6% in the year to January. The comparable figure for the private sector was just 2.9%. One indication of what is actually happening is provided by today's *Guardian* newspaper. The appointments section stretches to no less than 111 pages of public sector positions. There must be doubts about whether all these jobs are actually useful.



Slide into deficit sharper than anticipated

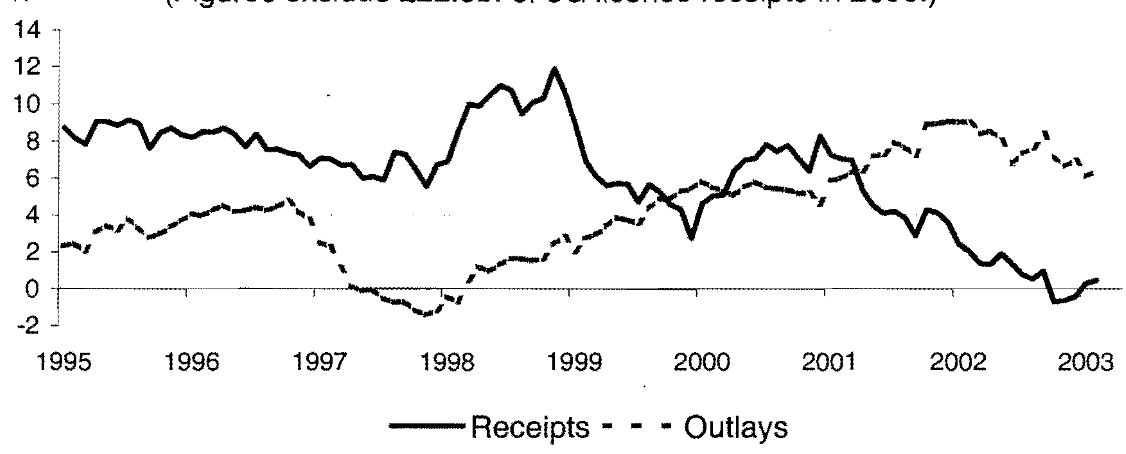
Deteriorating public finances will threaten the 3% SGP deficit limit

Slumping income and corporation tax revenues have combined with bumper public spending to produce a clear adverse shift in public finances. Deficits could reach and even exceed 3% of GDP in 2003/2004.

As had been widely expected, the Chancellor revised up official public sector borrowing forecasts in *Budget 2003*. Expected borrowing over the next five years has been adjusted up by a cumulative £17b. since the November *Pre-Budget Report*. Slumping revenues and bumper spending growth have combined to leave a large gap in the Chancellor's *Budget 2002* financing arithmetic. Corporation tax receipts were down by nearly 10% in the year to February compared to the previous twelve month period, pushing borrowing in the financial year as a whole above £20b. for the first time since 1996/1997. Moreover, the slide into the red will continue with net borrowing projected to reach £27b. in 2003/2004, or 2.5% of GDP. Admittedly, the Chancellor has a number of ready-made excuses for the ongoing deterioration, namely the war with Iraq and weaker-than-expected global economic performance, partcularly in the Euro-zone. Nevertheless, the new forecasts still look to be optimistic for a number of reasons. First, it is by no means clear that revenues will return to the buoyant levels of the late-1990s even in a cyclical economic upturn. Indeed, the composition of GDP growth is also changing, shifting away from tax revenue rich sources towards an ever growing public sector. Public finances look set to disappoint for some time yet and could easily breach the 3% limit of the Stability and Growth Pact in the year ahead.

GOVERNMENT SPENDING OUTPACING REVENUES

Chart shows annual growth of central government receipts and outlays in latest twelve month period compared with the previous twelve months. (Figures exclude £22.5b. of 3G license receipts in 2000.)

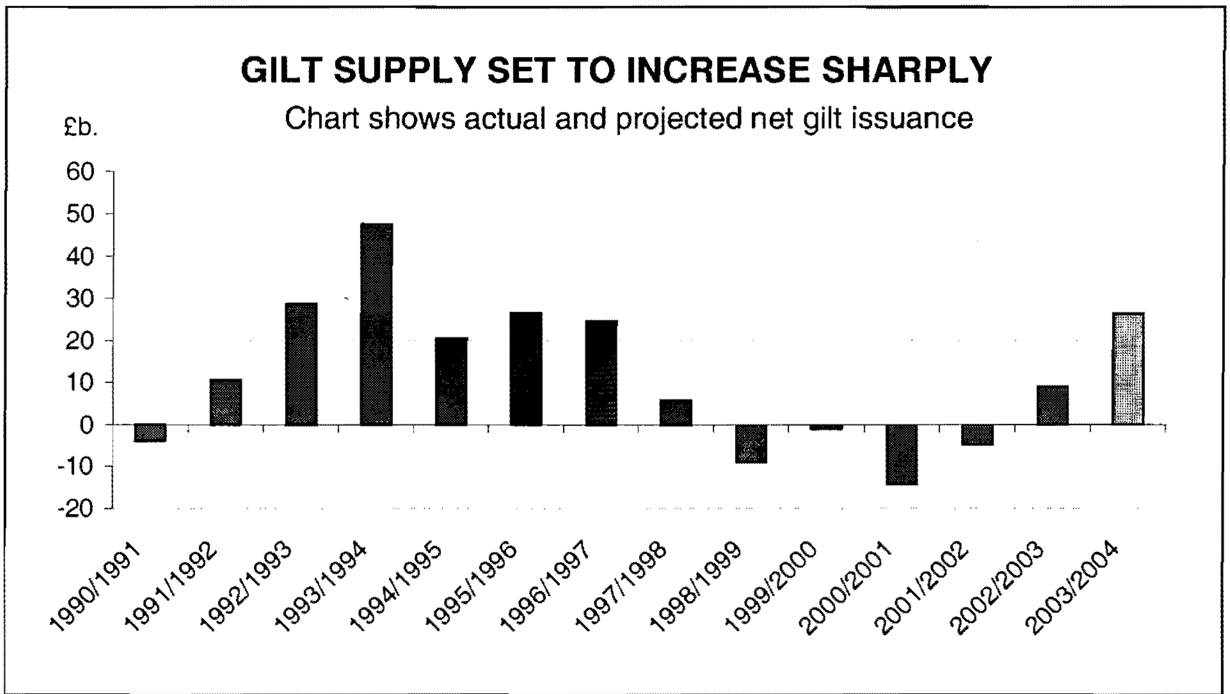


Gilts flood ahead?

Net gilt issuance in 2003/2004 at its highest level for eight years

The Chancellor's two fiscal rules place no short run constraint on gilt supply. Planned net gilt issuance of £26.3b. in 2003/2004 will be at its highest level since 1995/1996. Increased supply will help to drain institutional cash piles.

The ongoing slide into public sector deficit has important implications for the gilt market. While the Chancellor's two fiscal rules remain intact, they place little constraint on borrowing or gilt supply in the next couple of years. The sustainable investment rule, which stipulates that public sector net debt must stay below 40% of GDP, is largely irrelevant to policy at present. Public sector net debt was just 30.4% of GDP in February 2003, implying that the Treasury could issue a further £100b. of gilts this year without jeopardising the rule. The golden rule, meanwhile, is intended to hold *over the economic cycle*. While open to a degree of "interpretation", the huge cumulative surplus of over £50b. recorded between 1999 and 2001, gives Mr. Brown leeway to run deficits in the next couple of years and still cling on to his mantra of prudence. The ongoing weakness of public finance trends should therefore feed more or less directly into higher gilt supply. The DMO has already announced gross gilt sales of £47.4b. or net sales of £26.3b. for 2003/2004, the highest level since 1995/1996. Numbers for 2004/2005 and beyond are not yet available but look set to be of similar magnitudes. Gilt supply will rise both in absolute terms and relative to GDP. The flood of gilts will help to drain institutional cash piles, putting downward pressure on the institutional liquidity ratio and removing one source of support for asset prices.

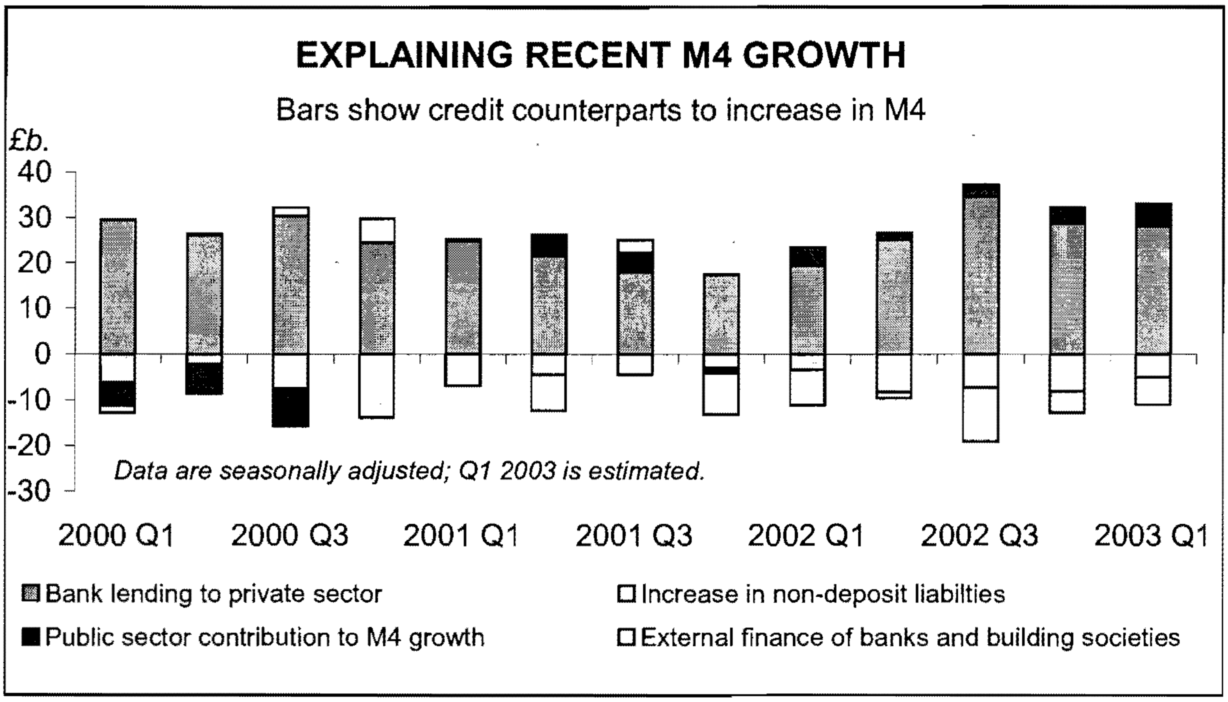


Money growth to stay rather high

Weaker public finances could undermine monetary control

The Budget has confirmed the slide into deficit on the public finances. The public sector net cash requirement in 2003/04 is estimated to be £32.4b., over 3% of gross domestic product. If this deficit is financed partly from the banks (as seems likely), that will raise money supply growth.

When budget surpluses were recorded in the early years of Mr. Gordon Brown's Chancellorship, most economists had forgotten about the difficult issues of monetary management raised by large deficits. However, the PSNCR (the same thing as the old "public sector borrowing requirement") is now heading towards 3% of GDP. As public expenditure continues to rise relative to GDP, a PSNCR/GDP ratio of 4% or 5% in 2004/05 or 2005/06 (i.e., £40b. or £50b.) cannot be ruled out. The chart below shows the influences on M4 growth on a quarterly basis since 2000. The return of deficits has led to the segment representing "the public sector contribution to M4 growth" being positive again, after several years in the late 1990s when it was negative. Meanwhile bank lending to the private sector continues to grow at about 10% a year. M4 growth is being restrained by the banks' ability to finance their credit extension by borrowing from overseas (represented in the chart by "banks' and building societies' externals"). This form of financing is fickle. In 2004 and 2005 foreign investors may find more attractive outlets for their funds than bond issues from UK clearing banks and building societies. If UK banks were obliged to finance balance sheet expansion from deposits, M4 growth would increase. As in the 1970s, the result would be a weaker pound and higher inflation.

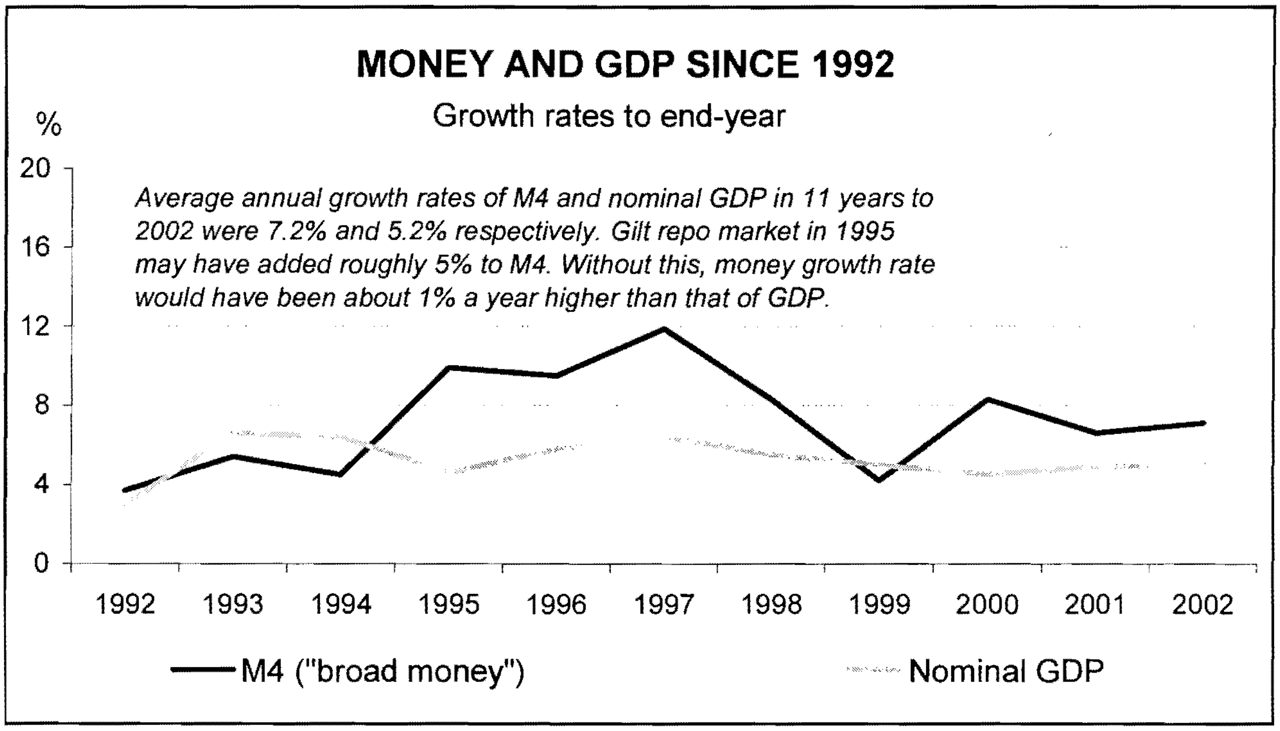


Will inflation stay under control?

High money growth a worry over the medium term

Disagreement over the size of the output gap (see p. 7) is the main weakness of the "output-gap monetarism" which has governed monetary policy since the early 1990s. Rather high M4 growth (see p. 4) and a weak exchange rate imply significant risks of above-target inflation, perhaps as early as this summer.

Inflation targets – introduced in late 1992 – have been a great success. The dominant theory driving policy decisions has been the principle that the change in inflation is a function of the level of the output gap (called "output-gap monetarism" in the Lombard Street Research *Monthly Economic Review* of September 2002). So – if inflation is on target - policy-makers have to estimate the gap and steer the economy to keep it at zero. The problem lies in making reliable estimates of the gap, with politicians liable to produce over-optimistic assessments. Because the Treasury believes that output is at present 1 ¼% beneath trend, it forecasts above-trend growth in 2004 and 2005, and continued on-target inflation. But, as pointed out on p. 7, if output were currently at trend, above-trend growth would lead to rising inflation. A cross-check comes from money supply trends. Broadly speaking, over the medium term M4 growth of 5% - 7% would be consistent with a slightly lower growth rate of nominal GDP and on-target inflation of 2 ½%. But at present the underlying annual rate of M4 growth is probably nearer to 10% than 5%. As M4 growth has been running about 2% a year faster than that of nominal GDP over the last decade (and perhaps only 1% a year faster when allowance is made for the introduction of gilt repos), M4 growth of 7% or more cannot be reconciled with 2 ½% inflation.

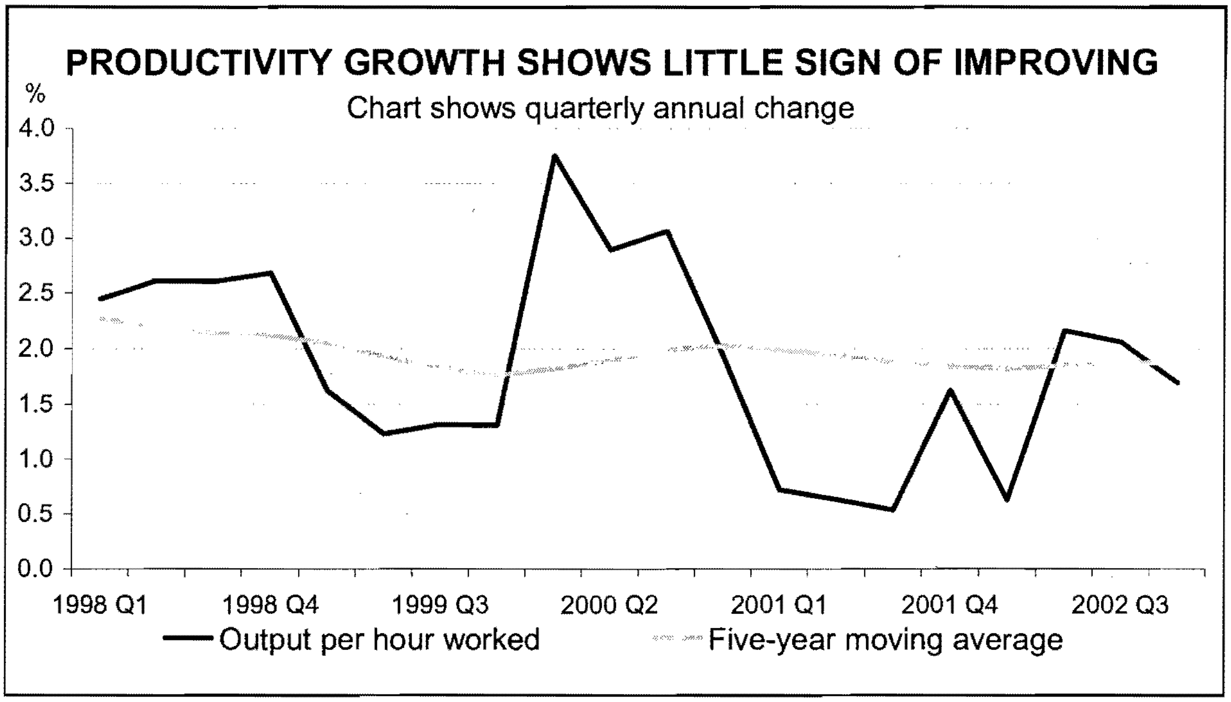


Is the Treasury's trend growth assumption too high?

Productivity growth of 2¼% is optimistic

Trend growth of 2¾% between 2001 and 2006 looks optimistic. It is based to a large extent on an assumed improvement in productivity growth. While this is an official aim, official data suggest that such claims are questionable. Public finance projections based even on a cautious trend growth rate could be too favourable.

Last year's seemingly innocuous assumption by the Treasury that UK trend growth had risen to 2¾% a year drew justifiably critical comment. The Treasury attributed the increase to better prospects for productivity growth and a large inflow of immigration, boosting the working age population. The latter was revised down in November's Pre-Budget Report following the 2001 Census, but an increase in the former kept the trend rate unchanged. Output per hour worked is now expected to increase by 2¼% a year between 2001 and 2006, up from 2%. Recent trends in labour productivity suggest that the projection is questionable. Productivity growth has remained broadly flat at 2% on an average basis for much of the last four years, defying the Government's ambitions. Moreover, productivity growth is probably not going to improve while resources are transferred from the private sector - where they are subject to market disciplines - to the public sector. Justifying the increase in the productivity growth assumption, and therefore the trend growth rate, is tricky. It is not inconceivable that trend growth could ease over the forecast horizon. In the interests of caution, the Treasury base their public finance projections on trend output growth ¼% lower than the neutral view. Given the arguments made above, this may itself be too optimistic.



The output gap: Treasury versus the Bank

Output gap equivalent to -1¼% of GDP, according to the Treasury

The Treasury and Bank both agree that there is currently a negative output gap. However, the Treasury believes that it is substantial, while the Bank thinks it is negligible. As a result, the Bank are unlikely to let growth be as buoyant as Treasury assumptions over the medium term. Public finances could be worse accordingly.

The Budget's medium-term macro-economic projections paint a rosy picture. According to the Treasury, growth is set to be 3% or above in 2004 and 2005. Strong output growth will help reverse the slide in the budget deficit, while inflation will remain anchored around 2½%. Such an outcome is possible, provided the output gap - the difference between the trend and actual level of output - is negative at present. According to the Treasury, the current output gap is equivalent to minus 1¼% of GDP, widening to around minus 1½% by mid-2003. (The Treasury assumes a potential growth rate of 2¾% from Q4 2001. See p. 6.) This appears to be out of line with the Bank of England's view. The Bank does not publish specific estimates of the output gap, but inferences can be made from staff comments. During February's Treasury Select Committee meeting, Charles Bean, the Bank's Chief Economist, stated "[they - i.e., the MPC] see the economy as being close but slightly below potential." In the MPC's view the output gap is small and negative. While the MPC would probably welcome growth of 2%-2½% this year, they are unlikely to let growth be above 3% in both 2004 and 2005. This would lead to a positive output gap and, as a result, domestic inflationary pressures. Growth will be held back (via higher interest rates) to keep the economy operating at its trend level.

THE OUTPUT GAP, HM TREASURY ESTIMATION

Chart shows actual less trend output as percent of trend

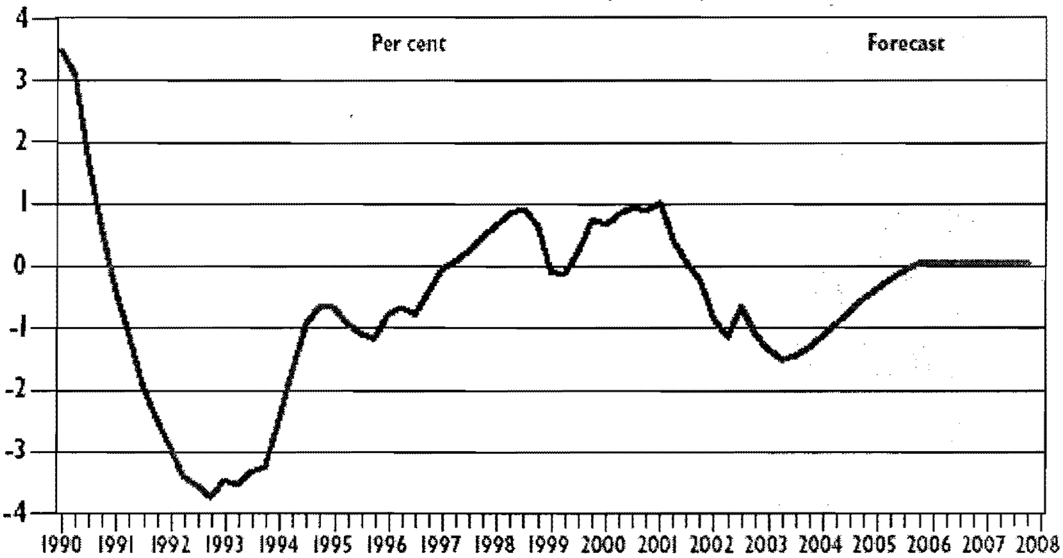


Chart taken directly from *Budget 2003* (Chart B4., p. 226.)

Could the inflation target be changed?

Chancellor hints that the HICP inflation measure may be used in the future

Few new measures of any great significance were announced in the Budget. But the Chancellor did highlight the possibility of changing the inflation target from the RPIX measure to the widely-used HICP index.

Budget 2003 was broadly neutral in fiscal stance. Indeed, in terms of new measures announced, it was arguably one of the most boring Budgets delivered for a long time. The total net effect of measures announced by the Chancellor is expected to amount to a fiscal easing of £0.5b. Indeed, in value terms the largest single policy was the introduction of the Child Trust Fund, projected to cost £350m. in 2003/2004 and £230m. the year after. Of course, a neutral Budget had been widely expected given the previously announced measures that are due to kick in this year, dominated by National Insurance Contribution increases. Measures announced prior to *Budget 2003* are due to deliver £4.2b. to Treasury coffers this year. Perhaps the most interesting announcement in the speech itself was the specific reference made by the Chancellor to the possibility of switching the inflation target from RPIX to the HICP measure. Mr. Brown stated that there was "a case in principle for adopting" the HICP index and that "the Treasury will continue to examine the detailed implications of such a change". The use of the HICP index, which is already used as the main inflation index around the eurozone, may rest uneasily with the Chancellor's alleged euro-scepiticism. But it may have a short-term benefit in that RPIX inflation is noticeably higher than HICP inflation. A change in the benchmark could save embarrassment for the Government if the RPIX target is breached.

DIFFERENT MEASURES OF UK INFLATION

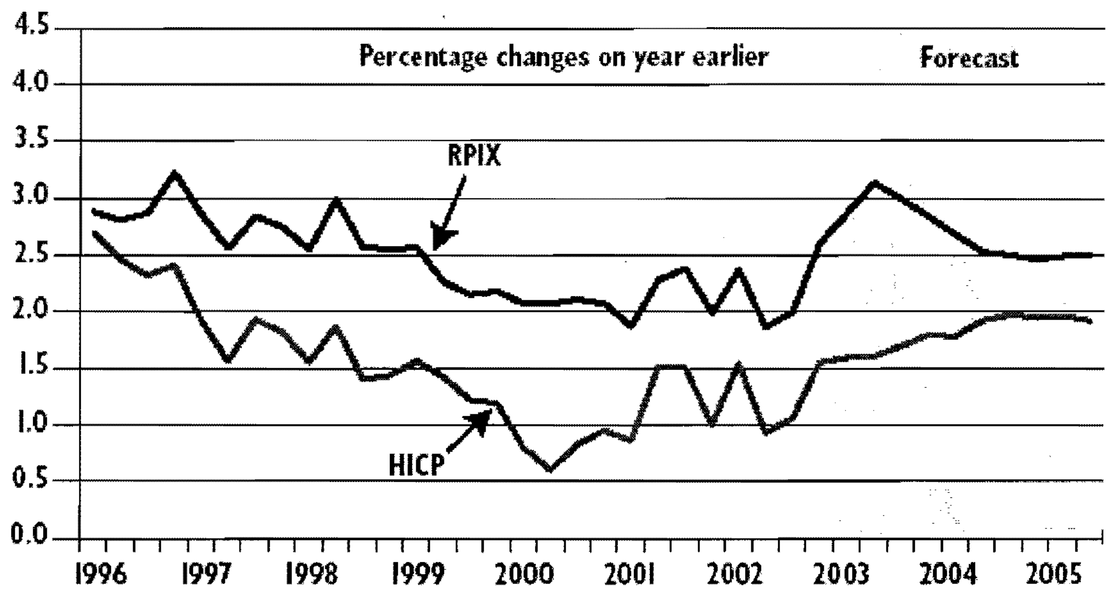


Chart taken directly from *Budget 2003* (Box B7., p. 233.)