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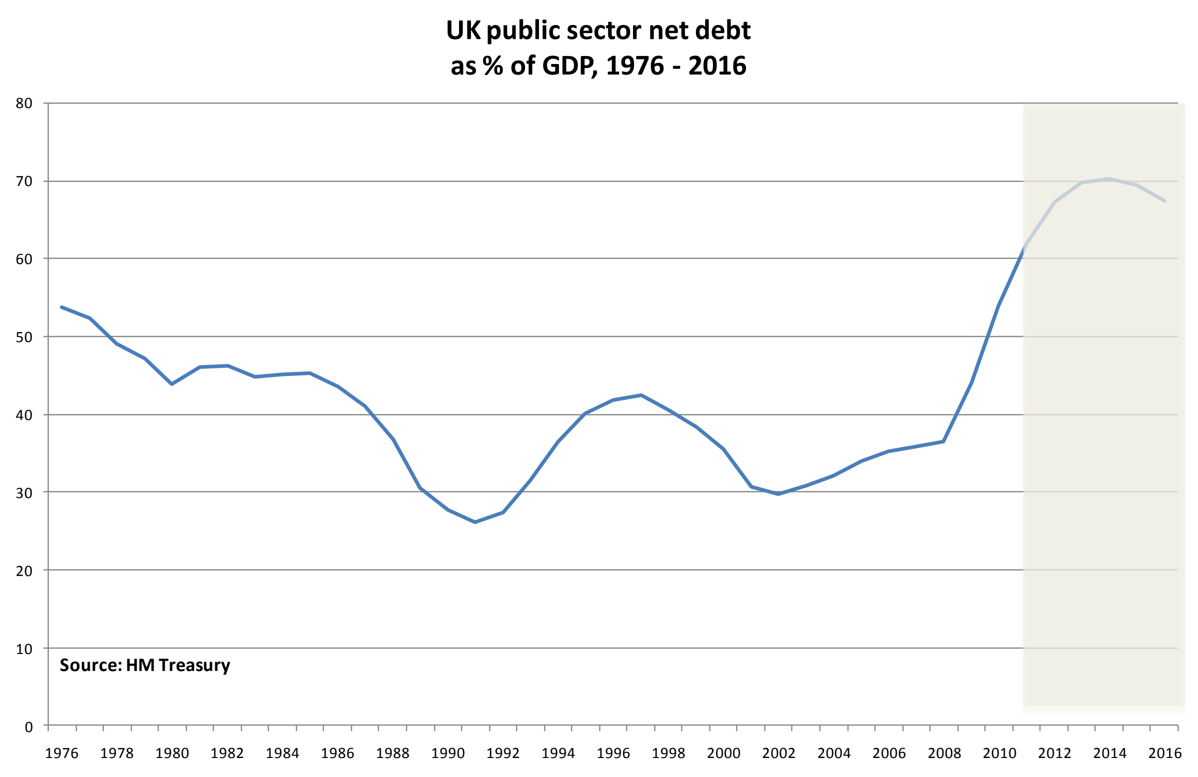
Global Commentary **October 2010**

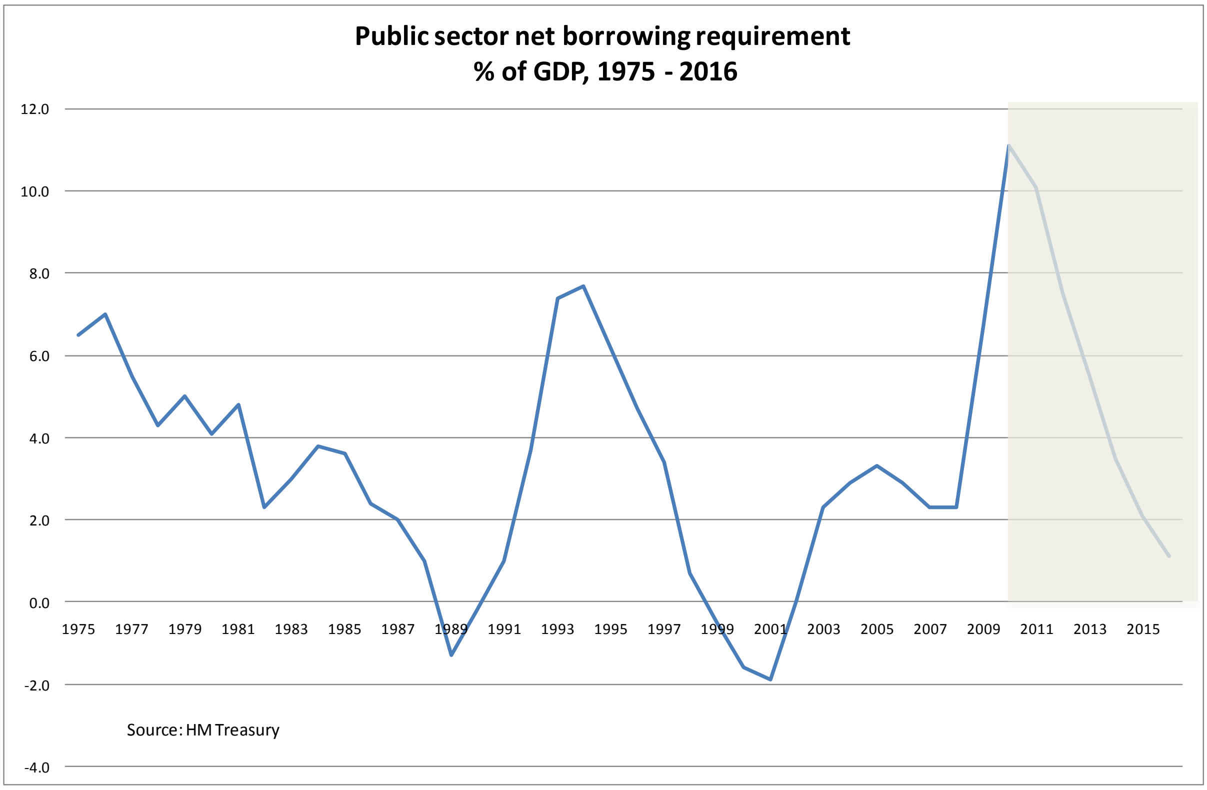
Re-orienting UK public finances: economic prospects after the Coalition's Comprehensive Spending Review

"It's just not fair" complained the child. His parents, both immigrants to the UK, were amused at the Britishness of their child's expression of injustice, and their smiles made the child even angrier.

The coalition government wants to be thought as "fair" and references to "fairness" litter the reports which accompanied George Osborne's Comprehensive Spending Review on 20th October. The review announced a staggering £81billion of reductions in planned public expenditure over the next four years, equivalent to 5.5% of 2010 GDP. Despite the scale of the cutbacks and claims of fairness, grannies who live in mansions will still collect their winter fuel subsidy from the tax payer, but many disabled individuals on low incomes will lose benefit in an attempt to encourage them back to work. But pain has been spread across income bands and across demographic groups. Highest income earners are being hit hardest by the previous government's new 50% income tax rate. However, families on moderate, but above-average incomes from public sector jobs will feel particularly hurt. They may have lost child benefit and now face the prospect of helping children through ever more expensive university education, and will have to pay more in contributions towards less well inflation-proofed pensions at the same time as facing unprecedented job insecurity.

At the general election in May there was agreement among each of the three parties that retrenchment in the public sector was unavoidable, though each was reluctant to share detailed plans with the electorate ahead of polling day. This unusual consensus was a reaction to the size of the budget deficit after the banking crisis of 2007-9 and the government's vigorous efforts in 2008-9 to increase spending and cut tax to stave off the risk of depression. But a further influence was the turmoil in Greece in the months before the UK general election as financial markets punished the Greek government's financial profligacy. UK politicians and senior civil servants can recall the days when the labour government in the mid 1970s was held hostage by financial markets and Denis Healey needed to agree a financial rescue plan with the IMF. "Never, ever again" is an unspoken message from all sides in UK politics.


UK public sector net debt
as % of GDP, 1976 - 2016
80
70
60
50
40
30
20
10
0
Source: HM Treasury
1976 1978 1980 1982 1984 1986 1988 1990 1992 1994 1996 1998 2000 2002 2004 2006 2008 2010 2012 2014 2016

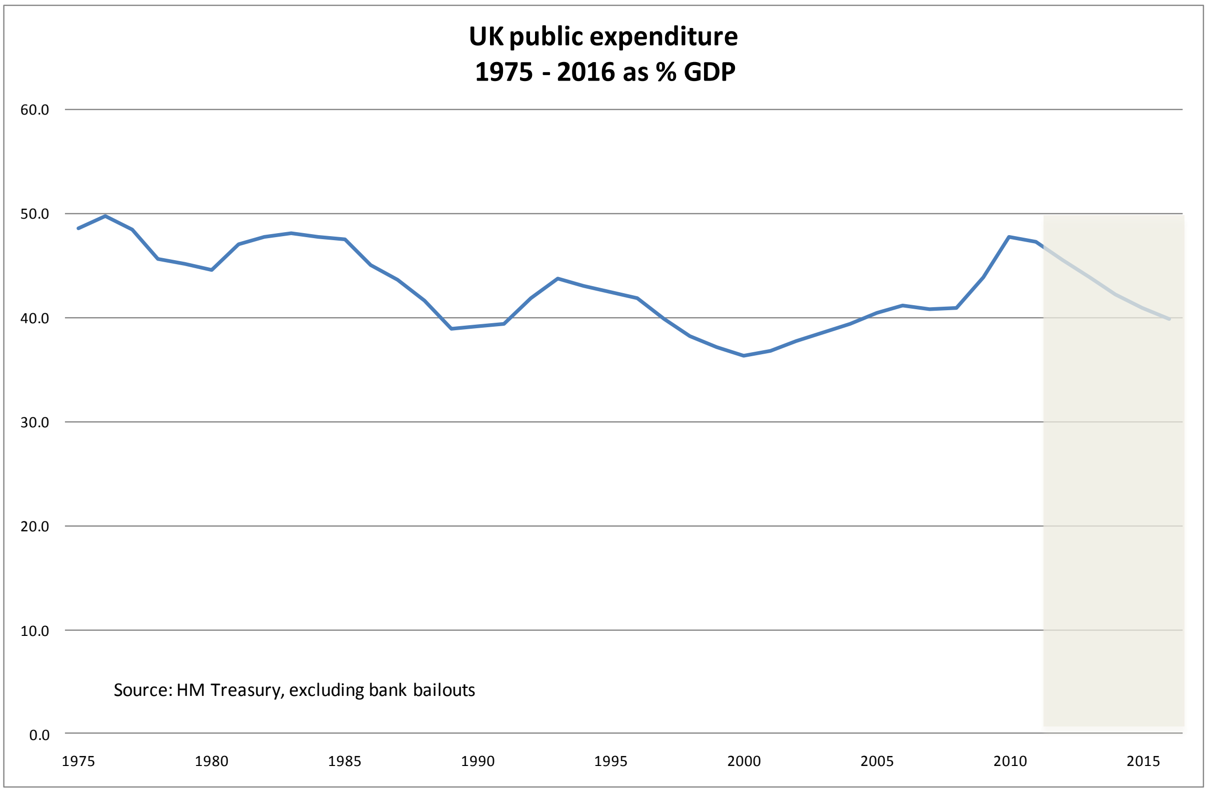

Public sector net borrowing requirement
% of GDP, 1975 - 2016
12.0
10.0
8.0
6.0
4.0
2.0
0.0
-2.0
-4.0
1975 1977 1979 1981 1983 1985 1987 1989 1991 1993 1995 1997 1999 2001 2003 2005 2007 2009 2011 2013 2015
Source: HM Treasury

"Countries don't go out of business", the former chairman of Citibank Walter Wriston said in the late 1970s. As if to mock the idea that governments are good credit risks, the following decade saw the Latin American debt crisis which nearly brought Citibank to its knees; followed in the late 1990s by south east Asian financial implosions; and the new century has already experienced the greatest public and private sector debt crisis of the past 50 years. The calamity of Icelandic and Greek public sector finances, and the tribulations of Irish, Spanish and Portuguese government debt markets following the financial crisis of 2008-9 tell us, if we ever needed reminding, that countries can and do fail. They also tell us that the costs imposed on countries by excessive debt burdens can be as painful, costly and as impoverishing as those imposed on individuals or companies by bankruptcy.

And then in January, Bill Gross, the highly regarded leader of PIMCO, one of the world's largest managers of bond portfolios, described the gilt market as "resting on a bed of nitro-glycerine" and said that it was "a must-avoid market". In investment terms, this has so far been a very poor investment judgement. But it was a poor investment call because of the consensus that emerged earlier this year among UK politicians that reducing the size of the budget deficit was an over-riding priority for the next five years. If this was not the case, and if tough decisions on spending and tax had been postponed, then UK interest rates and sterling would be vulnerable and the eventual cost of putting the budget back toward balance would have been much greater.

Our reactions to the coalition government's Comprehensive Spending Review have to be seen in this context. Taken in isolation, the picture is of a significant withdrawal of spending power from the economy to restore balance to government finances. The spending review itself talks of a reduction in public sector employment of almost 500,000 jobs. By itself, this will weaken economic growth. But such a withdrawal of spending power, sooner or later, was inevitable. There are two key questions: has the coalition got its timing right and has it made use of the crisis to force through change that will set the economy on a more prosperous and balanced route than otherwise.

With hindsight, it is now clear that between 2003 and 2007, the Labour government dissipated the strong fiscal position that had been built up at the end of the 1990s. With the economy after 2002, according to government statistics, motoring at around full capacity, no attempt was made reduce the budget deficit. The government, and many commentators, were persuaded by the reassuring message from the US Federal Reserve and numerous academics, that the global economy was enjoying, thanks to wise policy, the fruits of what was described as "the great moderation" in inflation and in the pattern of business cycles. This now looks like complacency, which encouraged flabbiness rather than fiscal discipline in the public sector and left the UK, and other developed countries, ill-prepared for the storm which broke in 2007-8.



The spending review, and the increase in VAT to 20% from next January, will reduce spending in the economy. Much more difficult to model is how the scaling back of the state and the attempt to improve incentives to work will affect the economy. Milton Friedman enjoyed pointing out that if governments subsidize non-work, fewer people will work and those that do, will want a higher wage to persuade them to give up their leisure time. There is no shortage of anecdotes about individuals on modest incomes in the UK being disincentivised by the tax and benefits system from working extra hours and of how individuals game the system to calculate the optimal amount of time spent working. The spending review is making a bold attempt to reduce subsidies for non-work. The cutbacks in benefits will lead to instances of manifest unfairness but, if it has been generally well designed, it will also encourage an increase in the willing supply of labour.

The easy riposte is that there are precious few jobs available for those who might now be keener to work. Over the longer term, employment and output growth are correlated with changes in the supply of labour. Much will depend on the flexibility of potential employees. If this "supply-side" response starts to work, then the unemployment figures may be better than expected, given the public sector cutbacks; data for hours worked may show surprising signs of increasing; perhaps job vacancy figures will unexpectedly decline, and in particular employment in small companies may pick up. But much of this will reflect changes in behaviour that will not be picked up by the main economic forecasting models, which, by extrapolating past relationships, may err on the side of gloom.

This still leaves the question of timing. A number of critics argue that now is too early in the recovery for fiscal retrenchment. One argument says that cutbacks now risk undermining the stabilisation that has been achieved at great cost so far. A more sophisticated version argument is that the public sector has no realistic alternative to maintaining high borrowing because it has to offset the increased saving in the private sector as households strive to find equilibrium after the borrowing binge of the years up to 2007. Among these, there are those who argue that at this time, the motivation for cutting public expenditure should be to roll back the size of the state and to improve incentives for wealth creation in the private sector. However, to maintain balance, cuts in public expenditure should be accompanied by reductions in taxation, to maintain the government borrowing requirement as the private sector rebuilds its savings.

We may hear of this critique if the economy weakens materially in 2011, because it contains within it a potential - if unlikely - Plan B for the coalition government's financial policy. The resilience of private savings might mean that progress cannot be made in reducing the fiscal deficit without excessively damaging the economy. In this case, a reduction in taxation could allow further progress to be made on scaling back the state, improving incentives to work and generating wealth, while supporting the economy. If the economy does weaken much more than expected, anticipate healthy debate about whether to forge ahead with durable reductions in taxation rather than temporary increases in public expenditure.

Such a relapse is not our central scenario. The government should be able to hold its chosen course, though the outcome will be less dramatic than their forecasts. Private sector savings are already making significant progress in restoring themselves, better labour market incentives should, in due course, have a positive on the economy; corporate cash flows are strong and there may be a surprising amount of postponed capital investment that needs to be undertaken by business, a pattern that has been seen before. Finally, the devaluation of sterling will be a significant help in supporting sectors such as manufacturing and tourism. But each of these sources of growth may be quite weak, and could be outweighed by the impact of continued retrenchment by consumers and the public sector.

Where does this leave investors?

The picture that emerges after the Comprehensive Spending Review is one of a gradual rebalancing of the UK economy. We expect that this will be accompanied by only modest growth, but the threat of slippage into recession is still with us. This rebalancing, if the government stays the course, offers the prospect of a reinvigoration of the economy with the scope eventually for lower tax rates accompanying the slimmer scale of government. Despite the printing presses at the Bank of England working overtime to push out money, inflation is not likely to be a concern for the foreseeable future, though it is a dangerous game that central banks are playing. Nominal and inflation linked interest rates are likely to stay at unusually low levels for a prolonged period, which means that investors need to be very careful when searching for yield.

Well diversified corporate bond portfolios are an obvious supplement to the meagre income that will be on offer from gilts. But the risk of capital losses will never be far away for longer duration bonds. The

property market looks tempting, but it is divided between the increasingly high yielding "junk" secondary and tertiary sectors, which will attract adventurous investors, and the lower investment grade incomes offered by prime properties and tenants. Meanwhile, the prospects for corporate profitability look favourable but are vulnerable to any setback in global as much as the UK economy. But if the economy stays with moderate growth, stock market valuations look reasonable.

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Important Information: