# New Minerva Report


## New Labour Is Old

"Pre-election spending plan" was the headline in the *Financial Times* on 19th July, the day after Gordon Brown announced an increase of £43bn in government spending. The responses of the UK stockmarket and gilt market were minimal. The main reason for this was that the actual figures had been pre-announced in the Budget, and the announcement in July just puts flesh on the bones. Are the markets' responses the right ones? On the other hand, are they being complacent?

One reason that markets are not worried about the spending spree is that we have just experienced three years of austerity, which have taken public managed spending as a percentage of GDP to 37.7%, its lowest level since 1963-64. The new plans will raise it to 40.5% of GDP in 2003-04, which is still lower than the 41.2% in 1996-97.

The other main reason for the markets' sanguine responses is that we now have an independent Bank of England. Their response to the Budget was that it would not be necessary to raise interest rates to curb any potential increase in inflation, caused by the extra spending.

So far, we haven't seen any figures produced by the City's economists which question the rosy scenario being painted by the Chancellor. Since they have had the broad money figures since March, you would have expected someone to at least have posed the question "can we really afford it?"

In our minds, there is no question that the Labour Party's spending plans have increased the risk to the UK economy. We also believe that the Labour Party will regret the spending further down the line. Bear in mind that Tony Blair must face an election within the next 21 months. It is widely accepted that any increase in spending takes at least 18 months to kick into the sentiment of the electorate. This means that there is a good possibility that, by the time of the next election, Mr Blair will still be up against it. If he wins, he is likely to have a much reduced majority. After all this money has been spent, what will the Labour party do next?

Ignoring the worries about how well will this money be spent, there are two main worries that we have about this expenditure. Firstly, we are concerned that all the figures assume that UK GDP will grow by 2.25% per annum. The Treasury and the Bank of England think that 2.5% is closer to the sustainable trend, and therefore Gordon Brown's assumptions remain prudent. However, the economy has been in good health for a number of years, and the odds of a slowdown in the next couple of years must be high. The latest figures show GDP growing at 3.1% annually. If that continues, the Bank of England may be forced to increase interest rates. There is already a fiscal drag on the economy caused by the "stealth" taxes Gordon Brown has put in place. These include the abolition of ACT, and therefore the inability of pension funds to reclaim tax, and the high duties on fuel. In the same way as spending takes 18 months to kick in, the increased costs caused by the likes of higher petrol prices take time to have an effect on behaviour.

Apart from internal pressures on the economy, there are also pressures fromoverseas. The biggest threat on this front is the US economy(see below). If that slows sharply, we will be affected. The point is that if the economy does not manage to maintain the growth expected, Gordon will have to find other ways of raising the money. This is because the expected tax-take will fall with a slower economy. He will either have to raise taxes, or he will have to borrow the money. Both of these will impact the markets. It would create a negative "double whammy". This is because Gordon Brown has assumed that Annually Managed Expenditure (AME) will rise by just 0.7% a year to 2003-2004. AME is made up of interest on debt and social security benefits. If the economy slows, and the Chancellor needs to borrow more, both these will rise further than expected.

The second concern we have about the Comprehensive Spending Review is inflation. When you have an economy running at close to capacity, with the lowest level of employment for decades, it is not the best of times for a government to stimulate it with a £43bn spending plan. The official line is that the money is to go through to the "front line services", these being nurses, teachers and policeman. That entails enticing them out of their current jobs, and that means increasing wages. It will be very interesting to see how the public sector unions as a whole, will react to all this new money flowing in their direction. Many of these workers have seen their wages fall in comparison to their counterparts in the private sector. It is very difficult not to experience the feeling of déjà vu. The Third Way looks like just a term to cover up the 'old' Labour Way. The Chancellor tells us that he has eradicated the "Boom and Bust" of the UK economy. Why is he pursuing a "Famine & Feast" government spending plan?




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