NEW MINERVA REPORT

Gordon's Lost Surplus

Be careful what you wish for' is a warning we should all heed. Gordon Brown should also take note. His Budget on 22nd March was more of a claim for the job of Prime Minister than a useful economic adjustment. Despite his self congratulations, Mr Brown once again failed to redress the problems he has been creating. Just four years ago, in his 2002 Budget, he was forecasting a Current Budget Surplus of 9bn for the tax year 2006-07. He is now forecasting a deficit of £7bn. Only last year he was projecting that it would be a surplus of £1bn. If you look back over Mr Brown's forecasts, he has consistently had to revise down his budget balance forecasts. It is difficult to believe that only last May the UK faced a General Election, and retained this Labour government. Potentially we have another four years before we have the chance to go to the polls again. For the year 2009-10 Mr Brown is forecasting a Current Budget Surplus of £10bn. Would anyone like to project what that will be revised to by then?

Mr Brown has some big problems ahead. The first big problem is that the one big success that he has created, an independent Bank of England, is effectively working in the opposite direction to Mr Brown's needs. For Mr Brown's forecasts to have any semblance of reality, he needs his growth forecast of 2.75% to 3.25% to be achieved. However, the Bank of England get jittery every time there is a possibility of a resurgence in the housing market. The Bank of England almost guarantees that the consumer will not be allowed to come to Mr Brown's rescue by borrowing ever more money to spend. This means that it will be necessary for the corporate sector to take up the running.

That's Mr Brown's next problem! As in 'Old Labour' governments, he has failed to realise the impact that taxation has on the economy. The more you tax an economy, the lower the productive capacity becomes. This becomes a vicious circle. A perfect example of this can be seen in the pensions debacle. In his 1997 Budget, Mr Brown abolished tax credits on dividends received by pension funds. This has effectively transferred £5.5bn from pension funds to Treasury coffers every year since. That's £49.5bn taken so far, and that ignores the principle of compounding interest. Ignoring all the issues we have discussed about how the pension fund deficits should be funded, the point is that this hole is likely to be plugged by the companies whose pension funds have the deficit. Therefore, effectively, £49.5bn 'tax' will be taken from being invested into the real economy by those companies.

Within the Budget were a number of further stealth taxes and tax planning nightmares. VCT tax relief was reduced to 30% from 40%, and the size of companies into which they can invest reduced from £15mn to £7mn. This will mean a significant fall in the number of VCT offerings in the next tax year.

Gilt Issuance

In the coming tax year the Debt Management Office (DMO) is planning to sell a record £63bn worth of gilts. To be fair, £29.9bn of this is due to redemptions of gilts over the year. In his Budget, Gordon Brown, bowing to pressure from pension companies, issued more longer dated gilts. It is ironic that going back a few years, an announcement about this size of gilt issuance would have sent shivers down gilt investors' collective spines. Now they are still moaning that this is not enough. Some are suggesting that the government should overfund itself, in other words, borrow more than it needs. For Mr Brown this must be sorely tempting. Interest rates are at historic lows, which would make it very easy to argue for this from a 'prudent' point of view. However, there are some long term concerns. Since 2002, the nominal value of the gilt market has risen from £279bn to £405bn. That's a 45% increase. The second worry is that, historically, the best way to reduce the impact of borrowing is to allow inflation to pick up and effectively whittle the borrowing away. When nearly 30% of the new issuance will be in the format of index linked gilts, that option becomes expensive.

Recent figures released by the Bank of England show that foreign ownership of gilts has risen from £78.37bn to £112.98bn, or 27% of total gilts in issue. Also it is thought that there has been an increase in the gilts purchased by investors like Hedge funds. It is likely that demand at the long end has not been driven just by pension funds, but by hedge funds and speculators that are forcing the price up, knowing pension funds will have to buy. This increases the risk that there will be a correction in at the long end of the gilt market. Increased supply, coupled with hot investors holding stock, does not make for a sound market. Volatility will increase, especially if some of the gilt auctions don't get fully subscribed. So, in the same way that Gordon Brown ought to be careful what he wishes for in wanting to become the next Prime Minister, so pension fund investors may want to change their wish for more supply of gilts at the longer end of the spectrum.

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