



Newsflash – 21 October 2010

Government Spending Cuts

Yesterday, the government announced the biggest cuts in public spending since the 1970s.

The scale and timing of the cuts is clearly going to have a big economic impact. If spending is cut by too much or is cut too quickly, we could be plunged back into recession.

If the cuts don't go far enough, international investors will lose confidence in our economy. The cost of borrowing for the government will rise, and we could lose our AAA credit rating.

According to the markets at least, the initial assessment is the level of cuts are about right. The stockmarket was largely unchanged yesterday and is up this morning. If investors felt UK GDP would fall then shares should have fallen too, since future company earnings would be affected.

In addition, gilt yields actually fell slightly, reducing the cost of borrowing for the government. The initial assessment is that the reduction in spending is enough to satisfy international investors. The credit agency Fitch backed this up by saying that the cuts mean we should retain our AAA status for some time to come.

There is also to be a levy on banks. This will no doubt prove very popular, asking those who caused the economic damage to help pay to repair it. However, the devil is in the detail, and getting this wrong could have an impact on the competitiveness of our banks which still make up a large portion of UK GDP.

In terms of the scale of the cuts, George Osborne was keen to point out that, at an average cut to spending of 19% across government departments, this is less than Labour's planned 20% cuts. It is also far less than the expected 25% fall, so on the face of it this is more positive (or less negative!) for the economy than many anticipated. However, the government are also "saving" £18 billion from the welfare budget (what's the difference between a "saving" and a "cut"?), which will have an impact on consumer spending.

Social Impact

Of course, measuring the impact of the cuts in pure economic terms is too simplistic. There is a social impact too.

The richest in society will pay the most, but according to the Treasury's own figures, the poorest in society will be *affected* the most. Medium and higher earners are more able to get by on a reduced income without cutting their own spending. However, for the poorest in society any cut to income, no matter how small, will have an impact on spending. The poorest in society are also the ones most likely to access public services, which are now being cut

About 490,000 public sector jobs are to go over the next 5 years. That's a lot of people out of work.

However, the evidence from previous recessions shows that the job cuts *might* not have the impact on the economy that you might think. In 1991 the public sector lost 650,000 jobs, and between 1991 and 1997 it lost 850,000. Yet during that time, total employment went up as the private sector created more jobs than were lost.

equilibrium

To put those 490,000 jobs in context, 178,000 jobs were created in the three months to August 2010. The private sector employs around four times as many as the public sector, and private sector employment “only” needs to rise by about 2% to cover public sector losses.

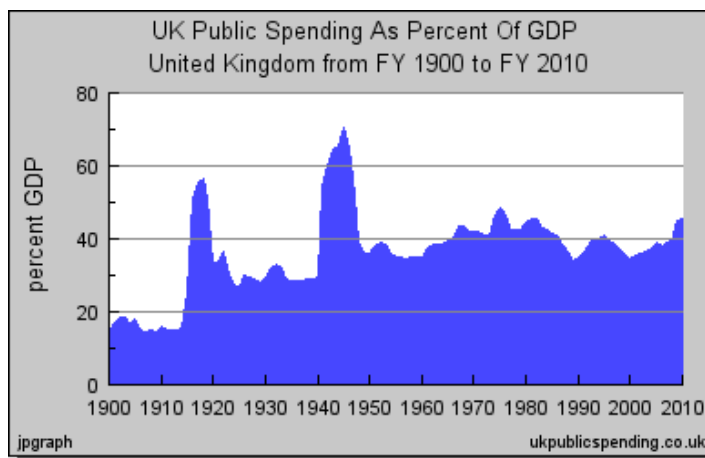
The economy does therefore have the *potential* to create enough jobs. However, this does not mean they will be the right type of jobs, suitable for those who’ve lost their public sector roles. Those who lose their jobs will also be competing for new positions with the people the government plans to get off benefits.

Debt Matters

Remember that the reason we need to reduce government spending so urgently is the amount of debt we have. What is positive from this point of view is that, at present, the interest rate on that debt remains at record lows.

We’ve gone on record in saying that gilt yields will rise at some point. However, for now our interest repayments are relatively affordable. Debt interest is currently around 3.5% of GDP, compared to 2.1% of GDP in 2006/07. That increase is partly down to the fall in GDP during the recession as well as the increase in borrowing.

Government spending is currently around 45% of GDP, so any spending cuts will have an impact on the economy. However, again it is important to put this in context. The chart below shows the level of spending as a % of GDP since 1900:



When Labour came to power in 1997, spending was 38% of GDP. It was 39% in 2008, but then increased to 45% during the financial crisis, as a result of the fall in GDP and the stimulus measures introduced to re-start the economy. The government’s plan is simply to get spending back to where it was prior to the financial crisis, even though it could be painful getting there.

In our view, the announcement does not change our views on any of the asset classes. We still expect slow economic growth but that we will avoid a double dip recession. Inflation should fall as a result of a subdued economy, but the headline numbers will actually increase when the VAT increase comes into effect.

There could be further quantitative easing. This would be positive for equities and fixed interest but would increase the potential for high inflation in the future.