

# UK Policy Mix and the Gilt Market

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Next week's budget should see the new government start to accelerate the pace of fiscal adjustment in the UK. The Bank of England is likely to respond by keeping monetary policy very loose for longer. Despite questions about the longevity of the government, this could provide a supportive backdrop for gilts.

When it won the general election in 1997, the incoming Labour Party had a history of poor economic management and the UK's track record on inflation was poor by international standards. In a bold move, aimed primarily at raising credibility with financial markets, the new Chancellor immediately made the Bank of England independent. Since then, UK inflation has averaged just 1.8%, lower than in either the euro area (1.9%) or the US (2.4%).

The importance of institutional reform has not been lost on the new Conservative/Liberal coalition or Chancellor George Osborne. But inflation is no longer the main threat to the UK outlook. With a double-digit budget deficit and markets worried about high levels of sovereign debt, the biggest challenge for the new government is to convince investors that the UK's fiscal position is sustainable.

With this in mind, one of the government's first steps since taking office has been to create an independent Office for Budget Responsibility (OBR). The OBR will provide

its own forecasts for the economy and the public finances. It will also publish an independent verdict on whether it thinks the government will be able to meet its fiscal targets. No longer will the government be able to use optimistic economic forecasts to avoid tough fiscal decisions.

The OBR has already produced its first set of projections. Based on average economic growth of 2.4% over the next five years and unchanged policies, the OBR expects the budget deficit to fall to 3.9% of GDP in 2014 (**Display 1**). Although this is a big improvement on the current position, it is a slower adjustment than in most other countries with very weak fiscal positions. Italy, Spain, Greece and Portugal all aim to have deficits below 3.0% of GDP by 2013. The exception is Ireland, which is targeting a 4.9% deficit in 2013. However, even this is better than the 5.6% projection for the UK in 2013.

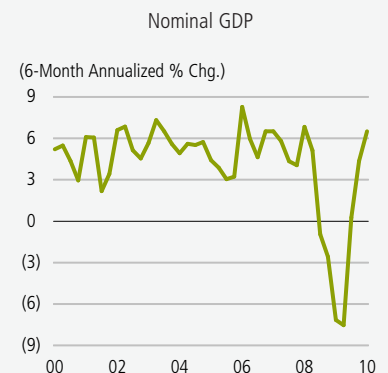
Medium-term fiscal projections are prone to big margins of error. And with nominal GDP now picking up strongly (**Display 2**),

Display 1  
Significant Fiscal Adjustment



Source: Office for Budget Responsibility and AllianceBernstein

Display 2  
Strong Rebound in Nominal Growth



Source: Haver Analytics and AllianceBernstein

it is possible that the public finances will improve more quickly than expected (in this respect, it's worth noting that since December the official estimate for last year's deficit has been revised from 12.6% of GDP to 11.1%). But this does not alter the fact that, in comparison with other countries with similar problems, the adjustment path in the UK is very slow. Moreover, much of the spending restraint included in these projections (5% of GDP over the five-year period) has yet to be formally identified.

While the OBR is a welcome addition to the institutional framework in the UK, it needs to be quickly backed by strong fiscal action from the government—especially in the current environment. Realizing this, the Chancellor is likely to push ahead with additional fiscal measures in next week's emergency budget. The intention is for public spending to bear the brunt of the medium-term adjustment. However, it is unlikely that much detail on the nature of these cuts will be available next week (a comprehensive spending review, providing further details, is due in the autumn). Fortunately, the market should be able to draw some comfort from a (probable) 2.5 percentage point increase in the standard

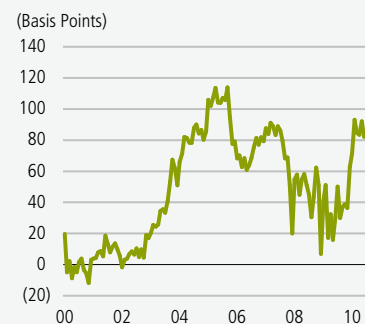
rate of value-added tax.

Many observers argue that an acceleration in the pace of fiscal tightening could put the recovery at risk and should therefore be avoided until the economy is on a far firmer footing. But this argument has been overtaken by events on the euro-area periphery. If the government does not push ahead with more aggressive budget cuts, there is every likelihood that the UK will lose its triple-A sovereign credit rating and that investors will lose faith in the gilt market.

One institution that does not seem to be concerned about additional tightening is the Bank of England. In a recent speech, Governor Mervyn King said that if tighter fiscal policy leads to weaker growth then that would be something that monetary policy could address. We do not believe the Governor was hinting at the possibility of a near-term easing of policy. Rather, we believe he was expressing his support for a tight fiscal / loose monetary policy mix. If the government delivers on fiscal policy, a tightening of UK monetary policy will probably be pushed even further back on the horizon.

### Display 3 Gilts Have Underperformed

UK less German 10-Year Government Bond Yield



Source: Bloomberg, Haver Analytics and AllianceBernstein

Over the last year, the spread between UK and German bond yields has widened sharply (**Display 3**). There are still risks to the UK outlook, such as the potential instability of the coalition. But a combination of tight fiscal and loose monetary policy would be very supportive of gilts. With Germany and other core euro-area markets eventually likely to be adversely affected by their support for the periphery, a period of relative gilt weakness may be drawing to a close. ■

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