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INVESTMENT NOTE **18 MARCH 2015**

HERMES: FISCAL CONSOLIDATION IMPORTANT – WHOEVER WINS THE ELECTION

By Neil Williams, Group Chief Economist:

From a gilts market perspective, the Chancellor was probably right to resist ‘fiscally expensive’ give-aways today. Growth may be better, but there’s still some hard work to do – whoever’s the next government - on deficit and debt reduction.

Prolonged growth and lower inflation have admittedly made this a brighter Budget than the Chancellor expected a year ago. With the UK’s ‘sugar rush’ continuing, equities and conventional gilts should welcome the nudging up of growth projections, and the fact that Osborne is not surrendering the fiscal reins.

The gilts supply of ‘only’ £133bn planned for the year ahead is at the lower end of expectations. This should impress, given what he could have done with the proceeds from bank asset sales, and inference in the fiscal arithmetic of possible tax cuts at the end of the next Parliament.

But, the fiscal screw will have to stay tight if the underlying budget deficit is to be whittled down, and returned to the black in 2018/19. The UK’s broadening recovery has helped, but better growth over the term should really have squeezed the headline deficits by far more than they have.

So, let’s not get too carried away.

First, the deficit is still high. Even including special items like the transfer of the Royal Mail Pension Plan and QE profits, the likely 5%-of-GDP deficit for 2014/15 will still be the G7’s widest after Japan.

Second, while the headline deficit falls on better growth, the structural, less growth-sensitive part of the deficit will fall by less, begging further reform and consolidation.

And, only this year is the net-debt-to-GDP ratio expected to have peaked, at 80%. This is disappointing given real GDP is now 5% up on its pre-crisis peak. This 80% ratio is more than twice Japan’s was when Japan limped into a ‘lost decade’ in the mid 1990s.

This means, for financial markets, a blend of more fiscal consolidation – whether skewed toward spending cuts or tax hikes - and ways to protect recovery will still be needed, whoever wins May’s general election.

Meantime, the chance of temporary CPI deflation, an unfixed euro-zone, and real wages – the missing recovery piece – still to creep up, will keep the monetary stance loose. The first BoE rate hike thus looks off the cards till around the next scheduled Budget, in spring 2016.

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