

# avoiding waterloo

## the budget in a strategic context

- **In presenting his emergency budget, George Osborne made a useful start in tackling the immediate and longer-term threats facing Britain.**
- **The near-term risk, which the UK shares with many other countries, is that public debt could turn lethally exponential.**
- **Longer term, the economic emphasis needs to be rebalanced decisively away from the state and towards private sector value-creation.**

**After any budget – and especially given the scale of the challenges facing the new administration – investors are deluged with research outlining the investment implications of the new measures.**

**Our aim, by contrast, is to stimulate debate by looking at the budget within its strategic context, a context in which two Tullett Prebon themes – “dangerous exponentials” and “generational theft” – play pivotal rôles.**

On 26<sup>th</sup> February 1815, Napoleon Bonaparte – French military genius or Corsican bandit, according to taste – escaped from exile on the island of Elba. On 18<sup>th</sup> June, he was defeated at Waterloo, bringing to an end his celebrated Hundred Days<sup>1</sup>. Since then, this period has come to be regarded as the duration of the ‘honeymoon’ which leaders of governments can expect after their election to office.

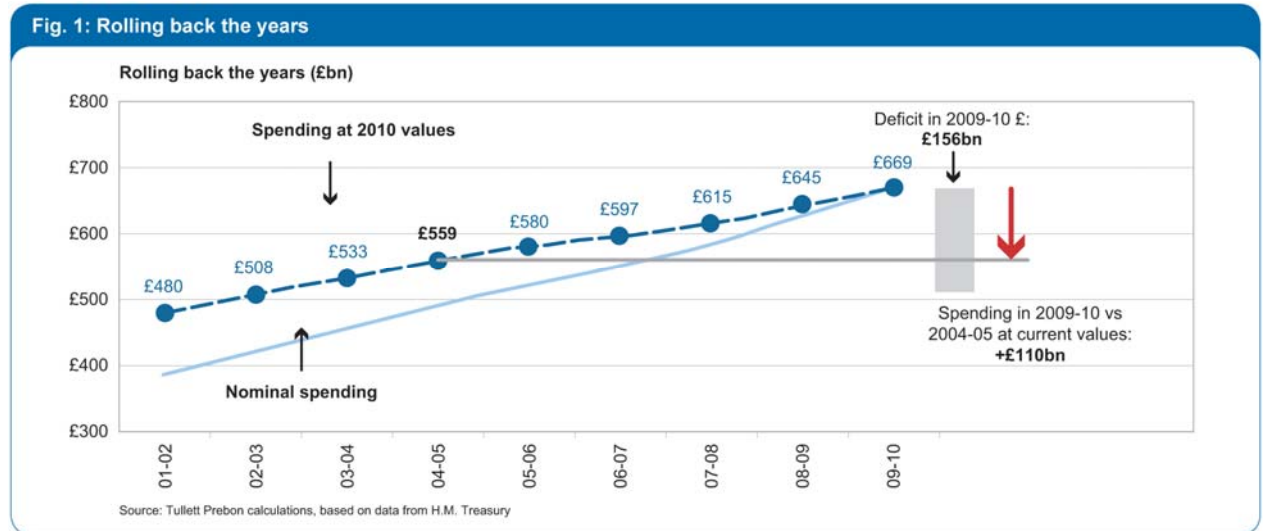
In framing his first budget, George Osborne had to take two legitimately-political issues into account. Of these, the first is an imperative need to impose painful fiscal changes quickly, in order both to maximise the opportunities presented by the 100-day honeymoon and to establish, in the minds of the public and of the markets, the firm new direction to be taken by Britain after more than a decade of fiscal profligacy.

Longer term, however, Mr Osborne also needed to bear in mind that the sheer scale of the fiscal and economic challenges dictates that reforming the UK will not be a single-parliament task. Put simply, by accelerating the economic pain, the hope is that the coalition can also accelerate the political payback. In essence, David Cameron’s administration needs to emulate Napoleon by escaping from a tight situation whilst planning ahead to avoid also emulating his subsequent overthrow.

**Mr Osborne’s emergency budget**, presented within a general atmosphere of near-crisis, is a positive step towards these objectives. The well-trailed increase in the rate of VAT – an increase which, incidentally, each of the major parties pointedly refused to rule out ahead of the election – provides the necessary revenue lift without the adverse economic side-effects of the increase in National Insurance (NI) proposed by the previous administration.

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<sup>1</sup> Strictly speaking, 112 days separated these dates, though Napoleon did not actually return to Paris until 19<sup>th</sup> March, 91 days before Waterloo. Napoleon abdicated on 22<sup>nd</sup> June – 95 days after his return to Paris.

**Fig. 1: rolling back the years**

More to the point, Mr Osborne has begun to address the potential for savings implicit in the reckless expansion in public spending over the previous decade. Indeed, and as fig. 1 shows, the sheer scale of that prior spending expansion is such that much of the necessary saving could be found simply by unwinding past increases. In 2009-10, public spending (of £669bn) was higher by £110bn, in real terms, than the sum spent in 2004-05, when Britain's public services were by no means noticeably cash-starved.

### The precedent? A brief history of handbags

The scale of the challenge faced by David Cameron and his team has often been compared to that which confronted Margaret Thatcher in 1979. History records that Mrs Thatcher was re-elected in 1983, but the outcome might have been very different had not two political 'wild cards' wholly changed the equation. Two years into her administration, Mrs Thatcher's poll ratings were dismal, whilst rioting erupted across a string of British cities including London, Liverpool, Bristol and Birmingham in the early summer of 1981. At this point, her re-election was beginning to look somewhat implausible.

But then came the first of the 'wild cards' which were to rescue the Thatcher Experiment - the implosion of the opposition Labour party as the ideological left triumphed over the pragmatic centre. The second wild card was, of course, victory in the South Atlantic, as the Task Force restored British rule in the Falkland Islands.

Mr Cameron surely cannot rely on a repetition of either event (and Britain probably could not re-fight a Falklands-type war anyway<sup>2</sup>). Moreover, the problems that he inherits are far more severe than those which confronted his predecessor. In contrast to the 11% deficit in 2009-10, the deficit in 1979 was 5% of GDP - and falling. And, contrary to myth, the Thatcher administration did *not* cut public spending (see figs. 2 and 3), but merely moderated an erstwhile-unsustainable rate of expansion. The sheer scale of the current problems dictates that fundamental reform will take (at least) a hundred *months*, rather than a hundred days.

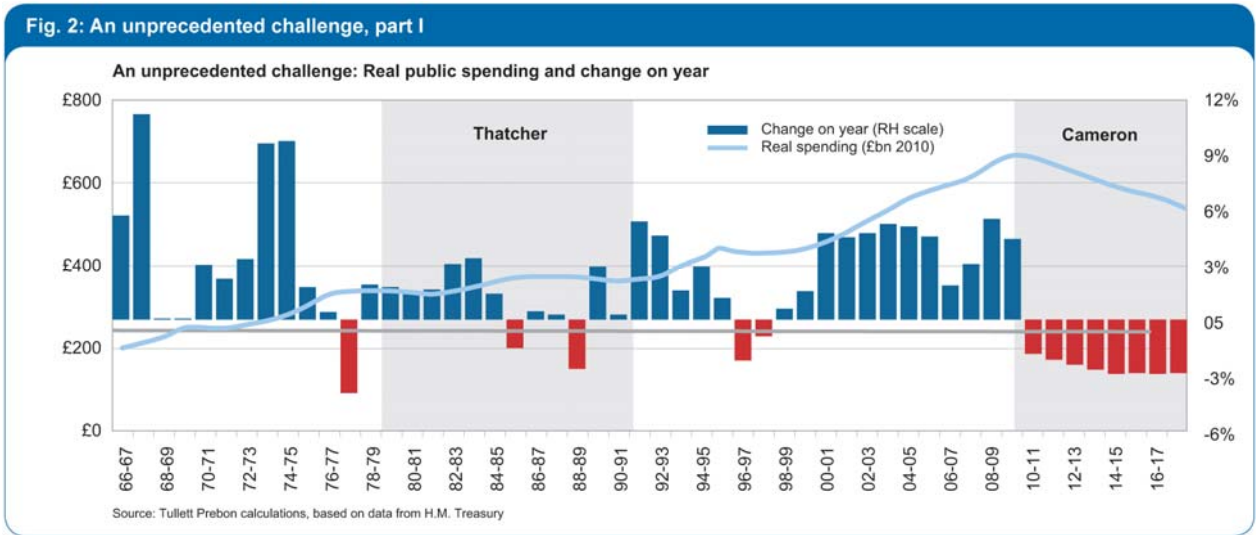
<sup>2</sup> Since 1982, the size of the British merchant fleet has fallen sharply, whilst the availability of the critical escort (destroyer and frigate) component available to the Royal Navy has almost halved. Worst (and surely most ludicrous) of all, the withdrawal of Sea Harrier fighters has stripped the Fleet of its vital air combat component.

### After the honeymoon – unprecedented challenges

Re-election, then, will be essential if the reform process is to succeed. Thus far, the coalition government has got off to an extremely good start, but the budget represented the new administration's first real confrontation with painful fiscal realities. Of these, the most obvious and pressing is the deficit, but two other issues need to be addressed as well – the longer-term problems posed by off-balance-sheet public sector pension obligations, and the fundamental weaknesses of the British economy.

Let's take pensions first. In its inaugural report<sup>3</sup>, the OBR (Office for Budget Responsibility) put the net present equivalent of future unfunded public sector pension commitments at £770bn, but outside commentators believe that the real figure is much higher than this. Here, the initial objective – as we outlined in a recent report<sup>4</sup> - must be to ensure that the net annual cost to the Treasury does not, as the OBR has predicted, rise rapidly, from £3.1bn last year to £9.4bn by 2014-15. However, this sum – representing the difference between benefits paid and contributions received in a single year – is not the crux of the issue, which is the unfunded commitment being bequeathed by today's generation to those of the future as part of a process that we have described as "generational theft".

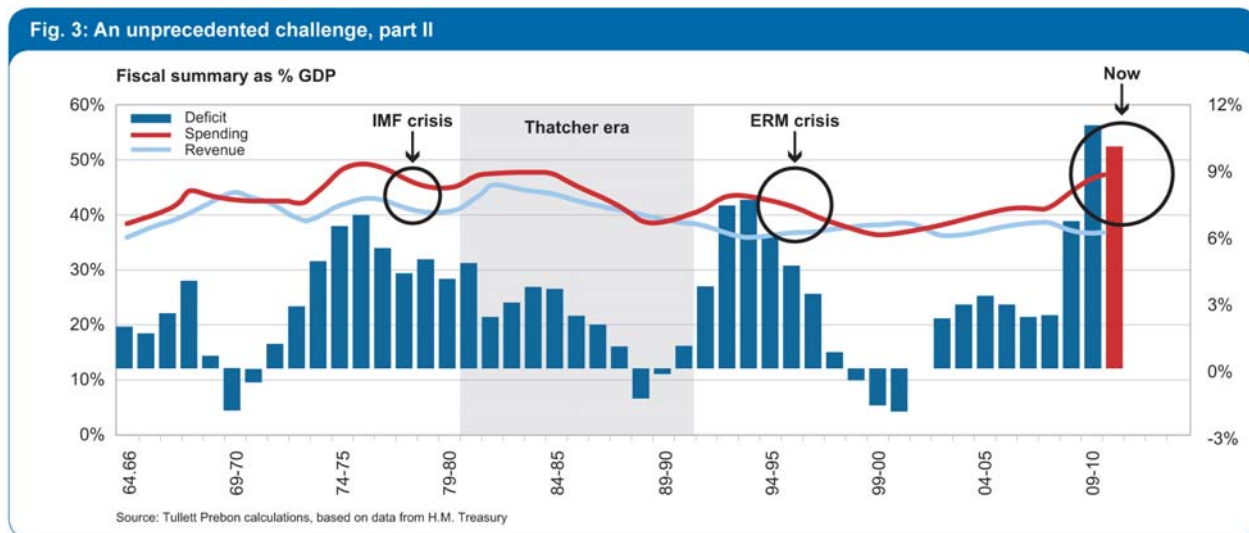
Fig. 2: an unprecedented challenge, part I



<sup>3</sup> Pre-Budget Forecast, June 2010

<sup>4</sup> Tullett Prebon Strategy Insights issue four, Britain at the Crossroads, April 2010

**Fig. 3: an unprecedented challenge, part II**



As we explained recently<sup>5</sup>, **the current generation, by consuming far ahead of income, is accumulating huge burdens on behalf of future generations, a process which is as immoral as it is, ultimately, self-destructive.**

Given that existing public sector pension commitments are contractually binding, there are two approaches which government can take to tackle the scale of future obligations. The first is to impose much higher annual contributions on existing members, and the second is to reduce the scale of the benefits provided to new entrants to the public sector schemes. Government will have to do both.

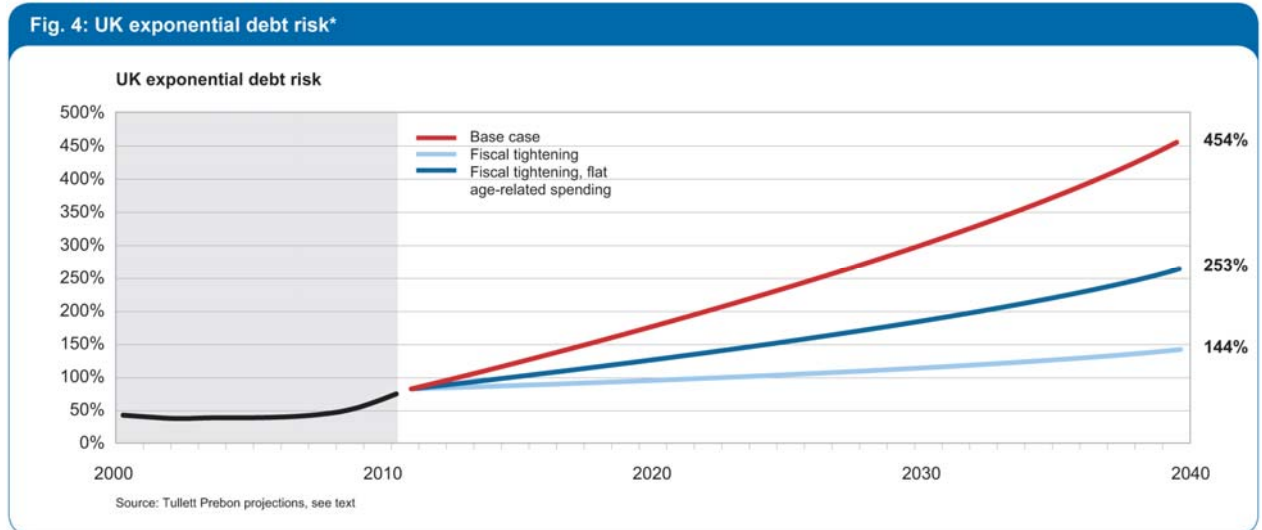
For new members, this means that benefits will be much less generous than those enjoyed by their forebears, yet their contributions will be a lot higher. This may seem unfair and, in one sense at least, *it is*. But this unfairness represents an outlier for the unwinding process implicit in generational theft. For a generation whose motto has been “consume now, pay for it later”, **‘later’ is now arriving.**

### Dialogues of the deaf

Since the financial crisis struck in the autumn of 2008, debate over macroeconomic strategy has been polarised between two competing orthodoxies. The first of these is the neo-Keynesian view that governments should counter the threat of recession through fiscal stimulus, whilst the other has been that this process is unsustainable because of the sheer scale of the sovereign debt that is being accumulated. Over time, in Britain as elsewhere, the ascendancy has shifted from the former to the latter, and fiscal tightening has now become the predominant informer of policy, in Britain as in most of Europe. Neo-Keynesians – amongst them, the Labour opposition in Britain – contend that fiscal tightening will not only damage the economy but will also *worsen* deficits (because government revenues will be impaired by reduced economic activity).

From a demand-side perspective, the neo-Keynesian argument has a great deal of merit *within its own limitations* (though the credibility of Labour on this issue is undermined by the party’s own past failure to observe the other side of Keynes’ equation, which is that government should accumulate surpluses in times of prosperity, thereby damping down unsustainable expansion whilst creating ammunition for future interventions).

<sup>5</sup> Tullett Prebon Strategy notes, issue one, *The Dick Turpin Generation*, 18<sup>th</sup> March 2010

**Fig. 4: UK exponential debt risk\***

\* Chart shows Treaty debt as % of GDP. Source: Tullett Prebon analysis, see text

Given that GDP<sup>6</sup> can be described<sup>7</sup> as the sum of private and government consumption, investment and net exports, logic supports the Keynesian stance, though only so far as it goes. If government consumption falls, overall output will diminish unless the decline is offset by expansion in one or more of the other categories. Since, for practical purposes, neither investment nor net exports is capable of expanding at a magnitude sufficient to offset fiscal retrenchment, GDP will decline unless that retrenchment is at least matched by increases in private consumption. This, critics of retrenchment argue, is improbable, so fiscal tightening will return the British economy to recession (defined as two or more consecutive quarters of falling real GDP).

## Exponential hazard

The problem with this neo-Keynesian view, its critics argue, is that it does not explain how, in the real world, governments are either to obtain the new debt or to service it. A recent study<sup>8</sup> by the BIS (Bank for International Settlements) showed that the sovereign debts of most OECD countries are beginning to adopt exponential trajectories, with Britain amongst the worst affected.

We have discussed the exponential debt problem in a previous report<sup>9</sup> but, in brief, the BIS assessed three possible case studies – unchanged policies, fiscal tightening equivalent to one percent of GDP for each of five years, and, additionally, freezing age-related expenditure (which is otherwise poised to increase relentlessly as a result of the ageing of the population). On each assumption, sovereign debt rises to levels which are essentially self-destructive. Our own replication of the BIS calculation, as it applies to the UK, is shown in fig. 4.

<sup>6</sup> Gross Domestic Product

<sup>7</sup> Under the expenditure method for calculating GDP

<sup>8</sup> *The future of public debt: prospects and implications*, BIS Working Papers No. 300, March 2010

<sup>9</sup> *Tullett Prebon Strategy notes*, issue six, *Out of Control*, 12<sup>th</sup> May 2010

As well as finding the BIS argument compelling, we are naturally drawn towards this interpretation by our underlying belief that **the global financial problem is, essentially, one of dangerously unsustainable exponentials<sup>10</sup> operating across a gamut of financial (and non-financial) indicators, including inflation, money supply and debt (both public and private).**

At this point, two of our core theses – ‘dangerous exponentials’ and ‘generational theft’ – intersect, meaning that **the current generation, by consuming at levels far ahead of income, is not only imposing unrealistic burdens on future generations but is setting up exponential debt trajectories which must, at some point, self-destruct.**

So opponents’ first answer to neo-Keynesian warnings of a “double dip” recession is to ask from where the new debt implicit in continued fiscal stimulus is supposed to be obtained, and how, in the future, it is to be serviced.

### **What recovery?**

Moreover, and in reply to opposition warnings that fiscal retrenchment will “damage the recovery”, critics might well be inclined to pose this question – “*what* recovery?” Recent growth in the UK economy, which has been tepid at best, looks a very meagre return on a policy mix which has included huge fiscal stimulus (aggregate deficits of 18% of GDP over two fiscal years), £200bn of ‘new’ money created through quantitative easing (QE), and near-zero policy rates.

In the light of this lack of economic response, one could almost be tempted to believe that each of the traditional control levers – fiscal, monetary and interest rate policy – has, for some mysterious reason, ceased to function. The reality, however, is not that tried-and-trusted policy options have stopped working as theory says that they should but, rather, that **we face fundamental economic problems on a scale which is beyond the control of these established expedients.**

A structural assessment of the British economy strongly supports this view. Leaving children and the elderly out of the equation – that is, focusing purely on the working-age population – those working in the private sector (of 24.6 million) are supporting 6.1 million public sector employees, 5.0 million working-age people dependent on benefits, and over 2 million students. Moreover, a substantial (though probably unquantifiable) number of private sector employees actually depend on government spending, much of it through privatisation and out-sourcing.

One has to wonder if these ratios are remotely sustainable in an increasingly competitive global economy. The number dependent on out-of-work benefits includes 1.6 million unemployed, but also includes 2.6 million unfit for work, a number which seems wildly implausible in a developed-world economy with top-quartile healthcare provision.

Part of the problem, we believe, lies in a historic (and essentially bipartisan) response to industrial change. Many of the great industries of the past – such as coal mining, steel production, ship-building and textiles – have either shrunk dramatically or disappeared entirely, leaving behind them large communities whose traditional means of economic support has ceased to exist. Rather than stimulating replacement private enterprise in these areas, government has all too often resorted to subsidy, either directly or by the indirect expedient of locating government activities in these places.

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<sup>10</sup> See Tullett Prebon *Strategy Insights* issue five, *Dangerous Exponentials*, June 2010

This has at least three downsides. First, it creates an excessive and dispiriting culture of dependency. Whereas, in the past, son<sup>11</sup> would follow father and grandfather into an industry such as ship-building or mining, Britain now has a substantial hereditary benefits class. The second potential form of downside is that the burden which such a structure imposes on the private sector seriously undermines competitiveness. Third, our exponential analysis suggests that the point may eventually be reached at which the economy simply cannot afford to continue with dependency on this scale. That this point is now being reached is indicated both by the exponential debt trajectories discussed earlier in this report and by some of the necessarily unpalatable decisions that Mr Osborne has had to implement in his budget.

The paucity of the British economic “recovery” – both in absolute terms and in relation to the sheer scale of monetary stimulus supplied by government – should also focus attention not just on recent performance but on the nature of the supposed 2000-07 boom to which Gordon Brown was referring when he made his remark about not returning to “boom and bust”.

We have commented before<sup>12</sup> on the sheer imbecility of believing that the economic cycle could in some mysterious way be abolished, but we also believe that the nature of economic growth during that period does not stand up to scrutiny. In essence, we believe that the **supposed growth of the 2000-07 period – a level of ‘growth’ which in part informed the previous government’s reckless expansion in public spending – was very largely illusory**, for two main reasons.

First, we contend that, throughout that period, the measures of inflation used in the calculation of real growth were extremely fanciful. In 2007, for example, when the consumer price index (CPI) and the GDP deflator were, respectively, just 1.8% and 3.0%, research conducted for supermarket giant ASDA showed that inflation, as it affected the average consumer, was actually 5.2%, a far more believable number given the trends in food, fuel and utility costs at that time<sup>13</sup>.

Second, such growth as remains after adjustment to realistic inflation calculations was borrowed anyway. Huge increases in property prices - driven in large part by an explosion in mortgage borrowing which was prompted, in turn, by low interest rates and by weak regulation – fed consumer spending (not least through equity release, which peaked at £50bn annually). A significant proportion of the apparent growth of the 2000-07 period was provided by a boom in a gamut of property-related activities ranging from builders to lawyers via builders’ merchants, tradesmen, domestic appliance suppliers and estate agents. By definition, a boom based on a debt-driven housing bubble is not sustainable, and hence is largely illusory. It certainly provides no foundation for massive expansions in public spending, let alone for complacency about the abolition of the business cycle. Moreover, the near-disappearance of the domestic savings ratio meant that the bulk of the debt on which this illusory boom was founded was sourced from overseas.

## Avoiding Waterloo

The gist of our stance on the UK economy, then, is that **government must first tackle the exponential threat which is at its most pressing where deficits and debt are concerned**. This imperative has been recognised in Mr Osborne’s first budget.

There are, of course, further measures which we would have liked to have seen in the budget, including (a) a reversal of the long-established fiscal bias towards debt rather than equity capital (which could be accomplished by limiting corporate interest tax relief), and (b) a reversal of the iniquitous 1997 tax raid on pension funds. But there are limits to what can realistically be achieved in an emergency budget. Though in some ways necessarily unpalatable, this budget represents a very considerable step forwards.

<sup>11</sup> Under the traditional industrial system, it was almost always sons rather than daughters.

<sup>12</sup> *Tullett Prebon Strategy Insights* issue four, *Britain at the Crossroads*, April 2010

<sup>13</sup> For more information, see *Tullett Prebon Strategy Insights* issue four, *Britain at the Crossroads*, April 2010

The aim of the new government can be likened to endeavouring to emulate Napoleon – but only so far, and no further. An escape is clearly necessary, not of course from Elba but, rather, from the potentially-lethal implications of relentless exponential increases in indebtedness. But the coalition needs also to avoid Napoleon's fate - Waterloo in his case, but an electoral reversal in this instance.

To do this, government needs, in addition to breaking the debt trajectory, to rebalance the economy towards value creation through private sector expansion.

Fortuitously, the re-incentivisation of the private sector is not by any means entirely a matter of finance. It can be furthered by attacking the disincentives at the benefits-work interface (where raising tax allowances, and limiting benefits, are useful steps forward), but above all by reducing bureaucratic and regulatory disincentives to enterprise. Here, the recent appointment of David Young to examine Britain's sometimes surreal approach to health and safety is surely a positive start. In past research<sup>14</sup>, we have highlighted the generally regressive tendencies of the previous government where individual liberties are concerned<sup>15</sup>.

Ultimately, an agenda of furthering individual freedom of choice – valuable not just in itself but also as a means of encouraging entrepreneurial expansion – may prove just as important as the re-imposition of fiscal responsibility in avoiding an electoral Waterloo.



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<sup>14</sup> *Tullett Prebon Strategy Insights* issue four, *Britain at the Crossroads*, April 2010

<sup>15</sup> For more information, see Eamonn Butler, *The Rotten State of Britain*, especially chapters 5 and 6

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