

back to the seventies?

why a decisive election outcome is imperative – we need ‘action this day’

we must tackle the deficit – a hung parliament will result in dangerous indecision

The British electorate needs to be decisive on 6th May, since it is imperative that government signals positive intent to the markets by taking immediate and resolute action over excessive public spending and a spiralling national debt. In the midst of stormy economic seas, the very last thing that the British ship of state needs is squabbling on the bridge and demoralisation in the engine-room.

“Never make forecasts”, Sam Goldwyn famously said, “especially about the future”. His advice is particularly apt just days before what is surely the most unpredictable British general election for more than 30 years.

But one assumption can, we think, be made with considerable confidence. It is that no party is likely to emerge from the election with anything better than a wafer-thin majority. A “hung parliament” – in which no party has an overall majority – has long seemed the likeliest outcome. A too-close-to-call race is fascinating stuff for political pundits and *aficionados* of the Eurovision-style tensions of election night. But – at a time when Britain is running an unprecedented budget deficit, and sovereign debt is in the firing line throughout the developed world – what are the likely implications of indecision for the economy and investors?

Potentially bleak, we believe, in that an effective and determined government has seldom been more essential than it is in 2010. By far the best scenario for Britain would be the return of a strong government prepared to cut public spending by £20bn annually, thereby putting the nation’s finances on the road back to sustainability and, far more important in the near term, signalling to the markets that living beyond the country’s means has been an aberration, and is not going to become the norm.

Indecision, on the other hand, would be the worst possible outcome. **A failure to take resolute action within a maximum of three months could point towards a full-blown currency and rates crisis.**

Back to the future?

What might an indecisive result mean? Well, precedent here is limited, but it is not non-existent. The last time that a British election produced a hung parliament was in February 1974, when flared trousers, flowered shirts and platform soles were *de rigueur*, and Suzi Quatro had just ousted Mud from the top of the pop charts. If the cultural differences between now and 1974 are vast, the similarities, both economic and political, are almost uncannily exact. More importantly, the sequel to that near-dead-heat was extremely uncomfortable, contributing as it did to the fiscal deterioration which culminated in the IMF bail-out of 1976.

The economic similarity is that, like that of 1974, this year’s election takes place in a very troubled macroeconomic climate, and the political parallel is that, while the incumbent government was unpopular, the opposition had failed to mobilise enough support for a decisive victory. But it is the subsequent course of events, rather than the immediate similarities, which should cause investors most concern.

The February 1974 election resulted in political instability, such that a second election had to be called in October. The policy paralysis and the lack of effective decision-making of that eight-month period segued into a rapid deterioration in the public finances, such that, within two years, the 1976 sterling crisis forced the UK to go cap-in-hand to the IMF for a last-ditch bail-out. It couldn’t happen again – **or could it?**

Well, yes, it could. Though many other issues have grabbed popular attention, the 2010 vote is as near as it gets to a single-issue general election, even if no leading politician has been sufficiently bold (or perhaps foolhardy) to tackle that issue head-on. The issue is, of course, a budget deficit which, at almost 12% of GDP, is unprecedented (and which, by contrast, makes the 7% deficits of the mid-70s look like storms in a pretty small tea-cup).

Let's state the issues with absolute clarity. Between 2000 and 2008, Britain enjoyed an economic boom that we now know was almost entirely illusory, and resulted from a property price bubble which, given the derisory level of domestic savings during the same period, was necessarily built almost entirely upon wholesale borrowings from abroad. Far from recognising the essentially illusory nature of this economic spurt, government proclaimed an end to "boom and bust", and lived up to (indeed, far beyond) Britain's apparent means by increasing public expenditures by more than 50% in real terms. When, inevitably, the bubble burst, the fiscal tide went out, leaving the public finances high and dry.

Last year, government spent 48% of GDP but received only 36% in taxes and other revenues. At almost 12% of GDP, the British deficit is comparable to that of Greece, and worse than either Spain or Italy. Indeed, **the observer might at times be hard pressed to understand quite how the UK has, so far at least, got away with such profligacy without seeing its currency and its bond prices come under much greater pressure.**

Time-limited defences

As we explained in a recent report¹, sterling has been supported by 'three props', each of which is time-limited. The first of these 'props' has been quantitative easing (QE), whereby government has created £200bn of new money. According to the government, QE has not amounted to the monetising of debt, and the symmetry between QE and the government's CGNCR² cash-raising requirement (of £201bn) is simply a coincidence. Right.

The second prop has been the political situation itself. Realising that tough decisions were unlikely to be taken with a general election looming, international markets have treated sterling with considerable tolerance, assuming that decisive action would follow immediately after the election. Third, it has been widely assumed that the major deterioration of sterling over the last two years would promote an export-led recovery.

Now, **each of these props has reached its sell-by date.** Repeating the QE expedient would carry levels of market and inflationary risk that can surely be regarded as unacceptable. With Britain's anaemic recovery far weaker than those of other developed economies, even a stale bull could put little if any faith in the devaluation stimulus argument. Most pertinently here, the 'political hiatus' defence obviously won't work after 6th June.

In short, **swift and decisive action is needed if Britain is to avoid paying the full price for past fiscal irresponsibility.** And the prospect of a hung parliament – or, for that matter, of a wafer-thin, barely-workable majority for one party, which would be almost as bad – makes such swift and decisive action frighteningly unlikely.

Fighting the wrong war

While the imperative national need is for deficit reduction, a hung parliament would be far more likely to produce party posturing and policy prevarication.

For one thing, a distinctly possible implication of the 1974 precedent is that a hung parliament will be unworkable, such that a second general election might follow the first within months. If politicians even suspect that this may be the case, they will remain on an election footing, which means that no one will risk courting electoral unpopularity by taking tough decisions.

Some commentators have scouted the hung parliament dangers, and have persuaded themselves that a 'balanced parliament' could be a good thing. This, we think, is about on a par with Pollyanna placing her

¹ See Tullett Prebon Strategy Insights, Issue Four, *Britain at the Crossroads – The Case for Fundamental Change*

² Central Government Net Cash Requirement

faith in 'the glad game'³. While most European systems of governance do indeed produce coalitions of varying degrees of effectiveness, the British political system is essentially confrontational, and is not suited to consensus politics.

Fig. 1: External debt, selected countries, end-2009*

| | External debt (\$bn) | External debt as % of GDP | External debt per capita (\$) |
|-----------|-------------------------|------------------------------|----------------------------------|
| UK | \$9,088 | 423% | \$148,708 |
| France | \$5,021 | 238% | \$78,382 |
| Germany | \$5,208 | 185% | \$63,258 |
| Spain | \$2,410 | 176% | \$59,469 |
| Greece | \$553 | 162% | \$51,486 |
| Portugal | \$507 | 218% | \$47,348 |
| US | \$13,450 | 94% | \$43,781 |
| Italy | \$2,328 | 132% | \$40,051 |
| Canada | \$834 | 65% | \$24,899 |
| Japan | \$2,132 | 52% | \$16,777 |

*Source: CIA World Factbook

Moreover, the UK electoral system is dangerously unbalanced – if each of the main parties was to garner 30% of the vote, for example, Labour would win 315 seats, compared with 206 for the Conservatives and just 100 for the Liberal Democrats⁴. (The sheer absurdity of this arithmetic should be borne in mind by anyone who thinks that the UK does not need electoral reform).

Any investor who believes that the UK can afford a lengthy period of indecision ought to bear the following in mind. First, Britain's reported national debt (of £761bn, or 54% of GDP) understates the true scale of government obligations which, including public sector pensions and PFI⁵ commitments, we calculate at £2.1 trillion (150%).

Second, the oft-cited benchmark of national debt is not the key issue anyway. Debts owed within a country do not pose an unmanageable problem, and **the real scale of the fiscal challenge should be calibrated by looking at debts owed to overseas investors.**

At the end of 2009, Britain's external debt was \$9.1 trillion. At 423% of GDP, this overseas indebtedness is far worse than that of France (238%) or Germany (185%), let alone Greece (162%) or Italy (132%). External debt equates to \$149,000 per British citizen which, again, is far higher than the equivalent numbers for Spain (\$59,000), Greece (\$51,000) or Portugal (\$47,000) (see fig. 1).

Therefore, it seems abundantly clear that decisive action is required immediately after the election, irrespective of the outcome. Many possible political permutations have been suggested by commentators but, where the investor is concerned, the overwhelming issue is neither labels nor personalities. The requirement is – in the words of Winston Churchill – for 'action this day'.

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³ *Pollyanna*, written by Eleanor Porter, was published in 1913. The "glad game" meant that, if Pollyanna pretended that everything was fine, a happy ending was assured. It is not a good investment philosophy.

⁴ For seat calculations, see BBC website, http://news.bbc.co.uk/1/hi/uk_politics/election_2010/8609989.stm

⁵ Private Finance Initiative

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