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MACRO MORNING BRIEFING

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Britain's Yearning for Public Investment

Public investment growth constrained by fiscal reality

- UK's public investment weakness contributing to productivity loss
- Labour government will adhere to fiscal rules and prioritize debt reduction
- Fear of "mini budget" shock driving fiscal prudence

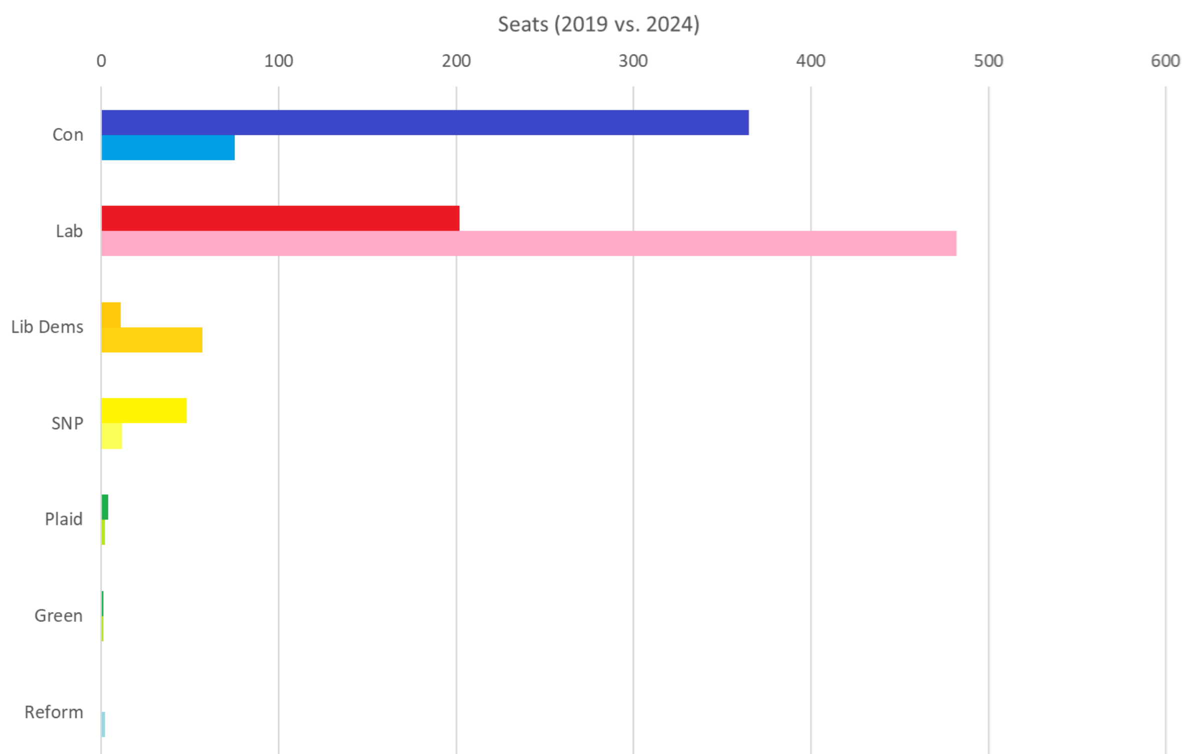
Stagflation headwinds unlikely to ease for now

Electoral surprises upended markets in June. In many markets we observed a surge in trading volumes throughout the month as a result of idiosyncratic risk, which was subsequently amplified by quarter-end effects. As is the case with economic data, it is when the outcomes are unexpected or generate unforeseen or unintended consequences that portfolios begin to rotate aggressively. Tomorrow's general election in the United Kingdom, however, should not be one of these events: six weeks of campaigning has not generated material changes in polling, while the stated manifestos of the leading parties have been almost unambitious to the extreme.

The fact that very few market observers expect any surprises in the final seat count means that even a moderate deviation from consensus estimates would trigger some rethinking on future policy. There are two "risks" in this respect, pertaining to whether Labour's performance is much stronger or weaker than expected. Most of the latest MRP (multi-level regression and post-stratification) polls (Exhibit 1 shows the recent Survation poll) point to the Conservative Party falling to double digits in seats, whereas Labour is expected to win at least 450. Any seat count for Labour close to 500 would be seen as a landslide, whereas if the incumbent Conservative Party were to reach triple digits this would be considered an outperformance. In our view, the risks are skewed toward the latter result as the recent call by the Conservative Party to deny Labour a "supermajority" may, in practice, limit the extent to which their traditional voters choose the new Reform Party, which is still seen as a protest

party but without the ability to win a significant number of seats. Unlike the reaction to votes around the world, such an outcome would likely be seen as more favorable to UK assets. The result would be viewed as a signal that the electorate is not seeking radical change: better governance and outcomes in public services would be a good start.

Exhibit #1: Latest MRP Poll Estimates

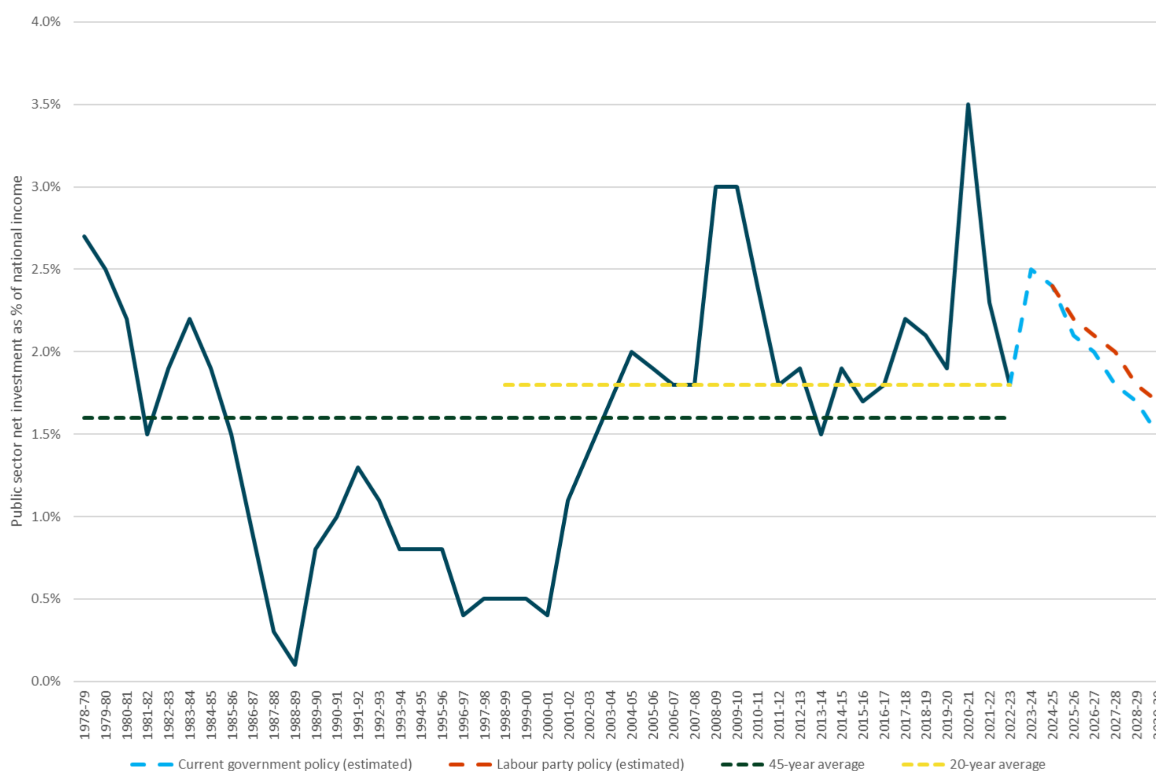


Source: Survation, BNY

Even with a relatively large majority, we believe that the incoming Labour government will need to immediately manage expectations regarding public services. Lack of public-sector net investment across all sectors, from infrastructure to healthcare, has been seen as one of the main reasons behind the UK's extremely poor productivity, which in turn has led to perhaps one of the most stagflation-prone economies in the G7. As Exhibit 2, using data from the Institute for Fiscal Studies (IFS) shows, excluding the extraordinary circumstances seen during the pandemic, public-sector net investment as a share of national income has been relatively steady at around the 25-year average of 2%. Rather than the headline level, some advocates of a more activist administration favor a repeat of the surge in public-sector investment throughout the Blair administrations, which saw public-sector net investment increase from near zero to 3% right before the financial crisis. However, the UK's fiscal position has deteriorated markedly and the starting point for public finances is completely different: the UK's debt-to-GDP ratio was less than 40% in 1997 after Tony Blair won his first election, whereas Sir Keir Starmer may inherit a ratio close to 100%. Furthermore, the IFS notes that "both the Conservative and Labour parties are (at the time of writing) committed to a fiscal rule that requires government debt to be falling as a share of national income between the fourth and fifth years of the forecast…and the debt target will likely constrain the

ability of the post-election Chancellor to cut taxes and/or increase spending.” Domestic reforms and efficiencies aside, better-than-expected growth outcomes could provide some additional fiscal flexibility. However, this will be highly contingent upon the lack of external shocks. We doubt this will be the new Chancellor’s (likely Rachel Reeves) central scenario given the state of global affairs.

Exhibit #2: Limited Divergence in Public Investment Plans

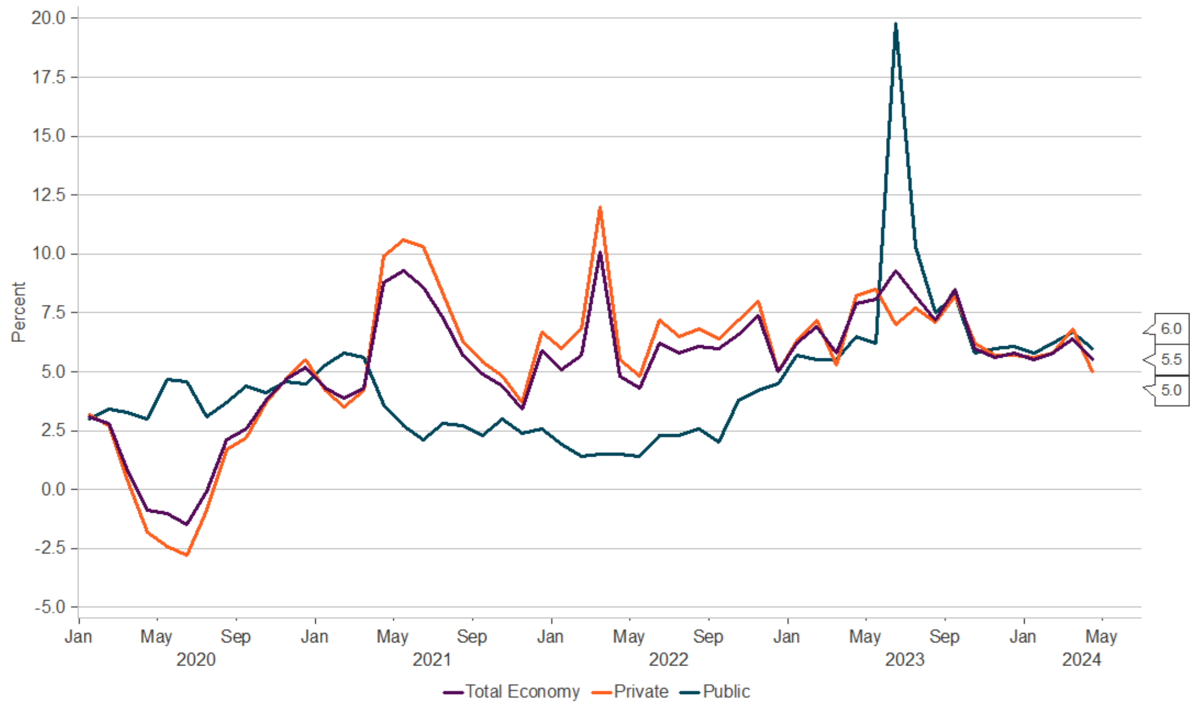


Source: Institute for Fiscal Studies, BNY

One of the concerns in some corners is that a Labour landslide could be interpreted as a mandate for a sharp rise in public spending, irrespective of the fiscal narrative, and much of this spending would be on personnel and wages. The current stance of the Labour Party’s leadership and candidates renders an ideologically based fiscal expansion unlikely, and we have highlighted that their spending commitments in the manifesto are less than a tenth the level proposed by Starmer’s predecessor. Strong public-sector pay growth is an acknowledged marginal inflation driver across Europe (ECB President Lagarde flagged this in her Sintra speech last year), and we can see that in the UK public-sector total wage growth has also outpaced the private sector for much of the last year, though the positions were reversed in 2021 and 2022. We do not see much chance of this changing: the UK’s health sector is facing a labor supply shortage due to sharply rising economic inactivity rates. The new government will be constrained on immigration for political reasons, so the risk of incremental stimulus on labor costs is very high, with very little guarantee of immediate productivity gains. For these reasons, Labour’s fiscal caution is understandable, but the political pressures may grow quickly if public services continue to deteriorate – winter 2024,

when pressure on services rises, will be one of the first tests of public expectations meeting reality.

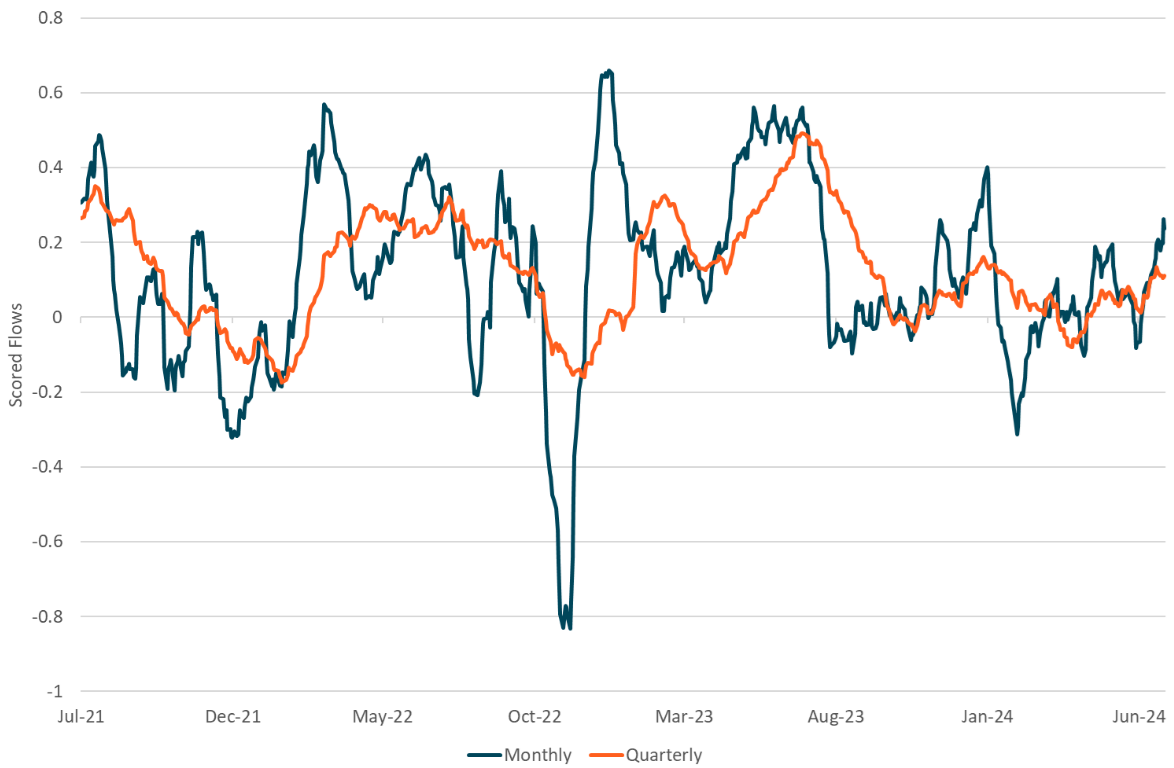
Exhibit #3: Sectoral Wage Growth



Source: Macrobond, BNY

Fiscal rules aside, the market will continue to serve as a safeguard for policy credibility. The "mini budget" experience of 2022 fatally undermined the Conservative Party's reputation for economic competence and has been repeatedly used as an attack line by the Labour Party ever since. As shown below, the market impact of that episode was severe and could have been worse without timely Bank of England intervention. The recent moves in French government bonds are another reminder that fiscal premia are more than possible for G7 economies. Consequently, even if the UK wakes up on Friday morning to a Labour Party landslide, we don't see any immediate justification for a jittery gilt market. However, the fact that gilts have not benefited from recent sovereign gyrations in the Eurozone either indicates a lack of enthusiasm for the asset class as a fiscal haven. Given the scale of the UK's fiscal challenges, no matter the outcome bond markets will likely be impressed if a marginally healthier fiscal path is envisaged by the end of the next Parliamentary term.

Exhibit #4: The Mini Budget Looms Large



Source: BNY

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