Perspectives by Ruth Lea

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The markets are calm now: but a hung parliament would surely increase economic uncertainty

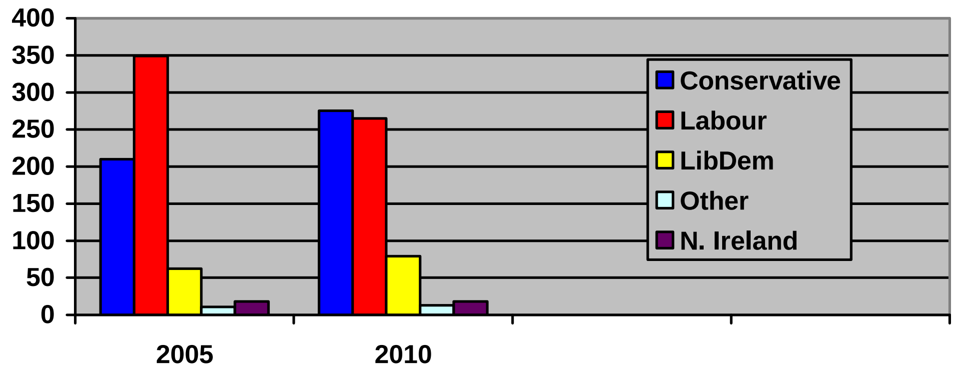
Introduction: hung parliaments

With less than a fortnight to go before the General Election on 6 May, the polls point to a hung parliament, where no one party has an overall majority. It is of course by no means certain and we are not suggesting a hung parliament is a foregone conclusion. Polls have been spectacularly wrong before, for example in 1970 and 1992, and the polls suggest that party support is especially volatile. This Perspective does not assume a hung parliament, we make no predictions, but merely seeks to discuss some of the issues if there is one.

Peter Kellner, President of YouGov, currently expects that the Conservatives will gain 36% of the vote, Labour 29% and the LibDems 26%. These figures are better for the Conservatives and Labour than the current polling and worse for the LibDems on the basis that the "Clegg bounce" will further dissipate.[1]

Feeding these figures into UK Polling Report's swing calculator, then the Conservatives would win 275 seats, the Labour party 265 and the LibDems 79.[2] The outcome would be a hung parliament with the Conservatives 51 short of an overall majority (326 seats). The outcome compared with the notional 2005 election results, i.e. after allowing for the boundary changes, is shown in the chart below.[3]

2005 (notional seats) and 2010 (projected seats) elections



In a hung parliament the incumbent PM remains in power until he resigns. He may, moreover, try to stay in office even if his party fails to win the largest number of seats. He may attempt to form a coalition. Or he may form a minority government, possibly attempting to form a looser arrangement with another party (or parties) in which the partners will support his government if there is a "no confidence" vote in parliament. Such a no confidence vote could be raised by the opposition, aiming to bring down his government. If he loses the vote, his government would fall, forcing an election

In February 1974 Conservative PM Edward Heath won fewer seats than the Labour opposition leader Harold Wilson. He stayed on for four days before conceding defeat, after failing to do a deal with the Liberal leader Jeremy Thorpe. Labour leader Harold Wilson formed a minority Labour government. He subsequently called a second election in October 1974 which resulted in a very slim overall majority (3) for the Labour party.

The uncertainties surrounding a hung parliament
At the very least a hung parliament will increase the uncertainties surrounding a government's ability to take decisions, and its stability and longevity:

- If the party attempting to form a government chooses to run a minority government, doubts will experienced as to if/when it could be brought down by a vote of no confidence and another election called.
- If coalition is the chosen option, there will inevitably be a period of horse-trading and compromise that will take days, if not weeks, to conclude. Common policies will have to agreed, concessions given and highly sensitive posts allocated in a way that will suit the participating partners. Even then destabilising disagreements could simmer, if not erupt, throughout the period of coalition – raising the prospect of another election. The fact that the UK does not have a recent history of successful coalitions adds to the doubts and uncertainties relating to this option.

Some commentators point out coalitions in other countries can work perfectly well. They can be stable and they can make decisions. Scotland and Germany are frequently quoted as potential exemplars. But the Scottish Government's remit is a comparatively limited one. Its role is principally to manage expenditure in the country; it does not have to make difficult decisions concerning fiscal policy. The Scottish example is therefore a particularly poor one.

Germany is a different, more significant, matter. But a brief inspection of Germany's recent coalition history does not make happy reading. After the last election (September 2009) it took the CDU and FDP three weeks of hard bargaining to establish a government – even though it occurred in a country where coalition politics is the norm and the partners had agreed to work together in advance. Since then, the coalition has been marked by tensions and disagreements. It is worth noting that, though there are many challenges facing the German government, they are not faced with a UK-style fiscal crisis.

The fiscal challenge facing a new government
It is widely accepted that one of the greatest challenges, if not the greatest challenge, facing an incoming British government will be tough fiscal retrenchment. We have already discussed the magnitude and dangers of the perilous fiscal position in several Perspectives.[4] Moreover, the fact that total Public Sector Net Borrowing for FY2009 came in at £163bn (11.6% of GDP) rather than the Budget's forecast of £167bn (11.8% of GDP) makes not a jot of difference. The deficit is the worst since the Second World War. It is dangerously high and the worst of any major developed economy.

If a hung parliament resulted in a coalition government the key issue would be whether it would prove to be sufficiently stable and cohesive to make the necessary hard decisions on the fiscal position. (If there were a minority government the key issue would be about its stability and whether it would be sufficiently supported by other parties in parliament to govern.) Some commentators take the view that because all three major parties have talked about deficit "cuts" there would be a fair chance that any coalition partners would agree on the big strategic fiscal issues and all would be well. Indeed the credit rating agency Moody's have recently suggested that a coalition government could prove more effective than a single-party government because it would imply a broader measure of popular support.[5]

The markets are calm – for now
Moody's may be right. And indeed the markets, in both sterling and gilts, seem to be taking the prospect of a hung parliament remarkably calmly, despite the old adage "markets hate uncertainty". And uncertainty has to be a factor if there is a hung parliament. This sanguinity seems to reflect the view that the risks of a hung parliament (such as they are according to some) have been "priced in". Moreover there would be a "relief rally" if the Conservatives could form a majority Government on the grounds that a Conservative government would adopt the toughest approach to the deficit of the three major parties. Given the Conservatives policy on starting cuts this year, this is a reasonable assessment.

But the notion that the uncertainties have been "priced in" should be challenged. Even though all three parties are talking of "cuts", there are significant differences between them that could well cause tensions and prevent the necessary reduction measures being taken if there were a coalition.

There are basically two coalition options on offer: Labour-LibDem and Conservative-LibDem with the likelihood of a Labour-LibDem coalition being significantly greater than a Conservative-LibDem coalition, other things being equal. If however the Conservatives were to gain substantially more seats than Labour, a Conservative-LibDem coalition would probably be more likely.

The Conservatives have a policy of £6bn savings for this year whilst Labour and the LibDems agree that any spending cuts in FY2010 would be premature and risk wrecking the recovery.[6] The LibDems do not support the Conservatives plans for mitigating next year's increases in national insurance rate either. But the LibDems differ from Labour in, for example, saving money by scrapping Trident and ID cards. These issues would cause friction even if they proved not to be deal breakers. Labour too is apparently keener than the LibDems on ring-fencing expenditure on hospitals, schools and the police. We are not suggesting that coalitions could not work, but merely pointing out that the necessary hard decisions on the public finances would almost certainly be more difficult than in a single party government.

The proof of the pudding will be in the eating of course. If a coalition government could decisively develop and implement "credible" fiscal reduction plans which could satisfy the credit ratings agencies that the UK's AAA rating is justified (the UK really is effectively on probation until after the election) and convince the markets that UK sovereign debt and other sterling assets are worth holding, then all could be well.

If, on the other hand, disagreement and delay prevent "credible" plans being implemented and the credit ratings agencies downgrade the UK, the markets, both sterling and gilts, could turn negative very rapidly.[7] (The financial markets' herd-instincts should never be under-estimated.) If this were to happen, a precipitate fall in sterling could leave the Bank of England little choice but to raise the Bank Rate. Indeed even if the fall were significant but not dramatic the Bank could still raise rates because of inflationary concerns.[8] Falls in gilt prices would raise borrowing costs throughout the economy as well as increasing the Government's debt interest payments. The stakes of having credible and detailed fiscal consolidation plans cannot be exaggerated.

Cuts should start this year

We said above that one of the sticking points between Labour, the LibDems and the Conservatives is the timing of the start of the fiscal tightening. More specifically, Labour and the LibDems are claiming that the Conservatives plans to save £6bn this financial year would derail the recovery. But this seems exaggerated at best and perverse at worst.

The economic recovery seems to be established. Following the 0.4% quarterly rise in GDP for 2009Q4, the ONS reported last week that GDP had increased 0.2% in 2010Q1. This was interpreted in some quarters as a hesitation in the recovery – a possible precursor of a "double dip". But the first quarter figure was affected by the "big freeze" as well as the reinstatement of VAT at 17.5% and the winding down of the car scrappage scheme. Data for January were undeniably weak, but February and March data were better and business surveys look cautiously positive.

A cut of £6bn for FY2010 would probably be back-end loaded. Arguably £2-3bn could fall in 2011 and a mere £3-4bn (0.2-0.3% of GDP) in calendar year 2010. This cut , in itself, would not derail the recovery - even if there were no positive implications for interest rates and the pound of this signal to the markets that the Conservatives "meant business" in cutting the deficit. But such a signal, if followed up by credible comprehensive fiscal retrenchment plans, would benefit interest rates across the yield curve which, in turn, would benefit the economy. (Gilt prices would probably rise and the Bank would be less inclined to raise the Bank Rate.) The net contractionary impact on the economy would then be less than the 0.2-0.3% quoted above. In these circumstances the risk that the Conservatives £6bn cuts would derail the recovery would be vanishingly small.[9] And it would be a modest step towards the necessary discipline in the public finances.

References

1. Peter Kellner, “Why it’s an uphill battle for the Conservatives”, *Sunday Times*, 25 April 2010.
2. The website is www.ukpollingreport.co.uk/blog/swing-calculator.
3. See Ruth Lea, “The statistical background to the forthcoming General Election”, Arbuthnot Banking Group, 12 April 2010 for discussion of the boundary changes.
4. See Ruth Lea, “A ‘do little’ Budget: pain yet to come”, Arbuthnot Banking Group, 29 March 2010.
5. Daniel Pimlott, “Moody’s sanguine on hung parliament”, *FT*, 23 April 2010.
6. IFS press release, “Conservatives plan to cut public spending to cut National Insurance”, 29 March 2010
7. The run on sterling on 16 September 1992 was dramatic and resulted in sterling’s expulsion from the ERM.
8. The CPI rate rose to a greater-than-expected 3.4% (annual) in March.
9. David Smith, “Recovery mountain is not as steep as it looks”, *Sunday Times*, 25 April 2010 reported that “Economists who predict the UK numbers expect growth of 1% or so this year, even if the Tories manage to find their first-year cuts…”

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