



Investment Bulletin

In the final instalment of our series of articles on the global growth slowdown, this month we discuss the use of the **Fiscal Credibility Rule** as one potential macroeconomic policy, proposed by some commentators.

The story so far – Debt and the Base Rate

The UK's Debt-to-GDP (D2G) ratio has increased since 2010 and, like many other member states, exceeds the European Union's recommended level of 60%, remaining above 80% since 2014. This is one of five criteria that the EU ask member states to meet in order to maintain stability in the Eurozone. Practically, controlling the D2G ratio helps provide stability to prices and the wider economy and reduces the potential risks to the fiscal position from increasing borrowing costs. However it is also important for countries to control D2G to provide global investors with confidence.

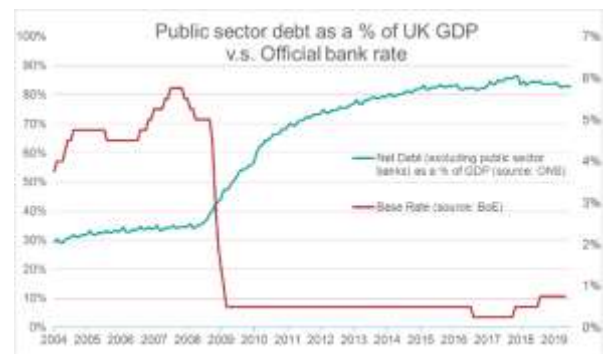
One of the key tenets of current monetary policy across the US, the EU and the UK is to set interest rates with the aim of maintaining price stability. In the UK the inflation target is currently set by the government at 2% pa. To help meet this target the Bank of England (BoE) independently sets the Bank Rate, which affects the rates of interest other banks apply to savings and borrowings which, in turn, influences spending and borrowing within the UK economy. This policy can only work when the Bank Rate is at a level where changing it is impactful and in recent years the Bank Rate has fallen towards what is seen as its 'lower bound' ie reductions are thought to have minimal further positive effect. Whilst QE has been used to provide further stimulus beyond that achievable solely through the Bank Rate, this is considered unsustainable in the long term.

The Fiscal Credibility Rule

With less room for stimulus in both fiscal and monetary policy (due to the simultaneous rise in D2G and the fall in the Bank Rate shown in the graph), the "Fiscal Credibility Rule" (FCR) has been proposed as one potential alternative policy by some macroeconomists. The rule centers around public borrowing and spending to create sustainable economic growth.

In 'normal' times the rule states that each year the government of the day should finance all 'current spending' from the public purse, with an exception for infrastructure, which is considered to be self-financing in the long term due to its economic benefits. The rule *can* be suspended in 'exceptional times', decided independently by the BoE. However, the government would still have to demonstrate each year that it is on track to reducing its D2G ratio within the next 5 years, the period of time over which spending changes fully take hold, using non-austere policies (such as bringing the rate of borrowing below that of GDP growth).

In a period of lower bound Bank Rates, many economists believe that fiscal policy (eg government spending and tax policy) needs to be used to minimise recessionary risks and maintain price stability. Fiscal policy can stimulate inflationary pressure, bringing an economy back to the position where Bank Rate increases can be applied to control the new inflationary pressure.





Market Update for end June

Once again the Bank of England (BoE) voted unanimously to keep interest rates at 0.75% and to maintain the level of quantitative easing. This goes against the global trend with several central banks reducing interest rates this month in a difficult and uncertain economic climate. The maintenance of the interest rate is despite a deterioration in the BoE's expected growth rate. Previously economic growth was forecast at 0.2% for the second quarter but has been revised down to 0%. The prolonged Brexit uncertainty and difficult global economic environment, in large part due to continuing tensions between the US and trading partners, are blamed for the slow down.

Inflation for the month was lower than expected, coming in at 2.4% as opposed to the predicted 2.6%. The ONS reports that higher upward pressure on the inflation rate from transport was offset by less pressure from food and drink, clothing and footwear and computer games. Core inflation declined from 2.1% to 1.9% versus a previous expectation that it would rise to 2.2%.

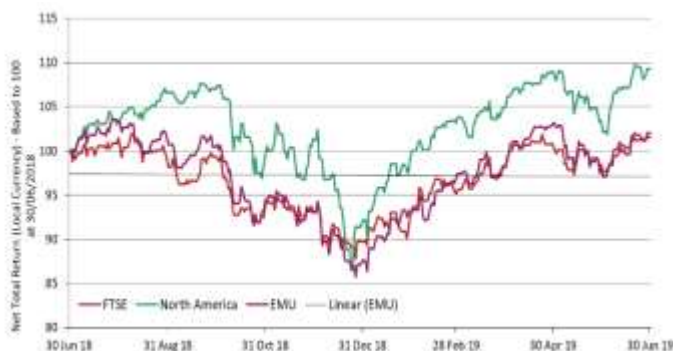
Real yields and nominal yields on short and long term bonds remained stable over the month.



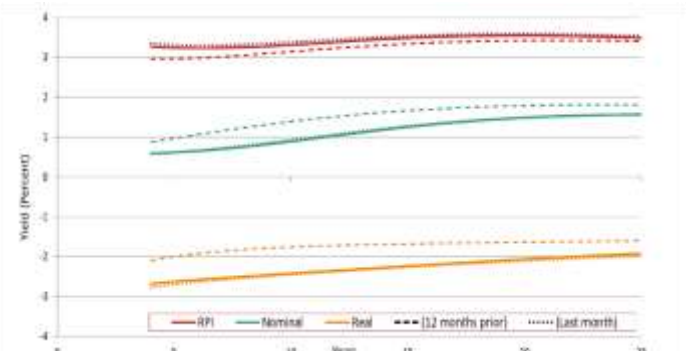
Credit spreads of higher rated bonds fell over the month.



All equity markets rose over the month.



Real and nominal yields remain in line with last month.



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