

# Economic Update August 2010

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By Roger Martin-Fagg

## The sweet spot before the Storm

You are either about to go off on your holidays or have just returned. If you are on holiday and reading this, you are not refreshing your mind as much as you should be, read no further!!!!

The big news is that the UK economy grew much faster than expected in the second quarter of 2010. The European banks mostly passed the stress test on their balance sheets. And the value of US retail sales was up nearly 5% yoy in June, but only 3.5% in July yoy. There is much talk of interest rates going up, the recovery being much stronger than the miseries such as I forecast and that we can sit back as the whole system quickly returns to normal.

So I want to review the evidence and in the light of it and a bit of economic theory suggest that although I am a fan of optimism and half full thinking, we must remain cautious and ready for the double dip which will happen in the USA in the last quarter of this year and the UK in the second quarter of next year ( and Euroland as well)

## The UK data

The preliminary estimate for GDP comes out about a month after the end of the preceding quarter. It is an estimate based on limited data which covers only 40% of economic activity. The data is obtained by asking 40,000 UK businesses (less than 1% of UK businesses) to supply details of turnover in the first two months of the quarter, and 20,000 in the last month. This data is in current prices. To get volume changes, it has to be adjusted for changes in prices. The deflator which is used is calculated from price changes in 200,000 individual products offered by 30,000 businesses.

Each sector in the economy is weighted according to its historic contribution to the value of total output. Some examples

Extracting and making things: 23.5%

Moving and storing stuff, hotels, communication, eating out, other services and the Government: 75.8%

Hotels, restaurants and distribution is weighted: 14.4% ( included in the 75.8%)

Manufacturing: 12.8%.

Construction: 6%

Agriculture is now only 0.7%

In the latest data, the biggest improvement came from construction, but this is the first time a new survey has been tried. It is likely to be revised, as indeed all the preliminary estimates will be. However the revisions are usually quite small, and amount to less than 0.15% of real GDP.

We must also bear in mind that the outlook for the economy is primarily driven by the actions of those who employ less than 250 people

In 2009 there were

4.5 million Enterprises employing up to 9 people and turning over £651Bn

172,000 employing 10-49 people and turning over £420Bn

27,000 employing 50-249 people and turning over £406Bn

6,000 employing more than 250 and turning over £1.4 trillion

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The Companies Act 2006 requires stricter audit, accounting and reporting for businesses with t/o above 6.5m, and the compliance requirement is significant for enterprises above £30 million t/o and 250 employees. Enterprises employing fewer than 50 people create more t/o than those employing 50-250.

In the UK 99.9% of enterprises employ less than 250 people, they employ 60% of the private sector workforce, at 13.7 million, and turnover 1.5 Trillion. A third is located in London and the SE. They are more important for growth and innovation than big companies. They pay a great deal more tax than big companies. They are the bedrock of our economy.

Source: the department for business innovation and skills; Oct 2009

So in forecasting the next year or so, it really does depend on the energy, risk taking, innovation and confidence of SME'S. The new government is trying to encourage them with the 18% flat rate of corporation tax and by reducing its structural deficit by 90Bn (which means a smaller share of Government in the system)

A bit of theory

In the 1920's Irving Fisher produced probably the most important identity in macroeconomics. It has been adapted to produce the Quantity of Money theory which then became popularised by the Chicago School.

It is as follows:

$MV$  is the same thing as  $PT$

Where  $M$  is the money supply,  $V$  is how many times a unit of money gets spent,  $P$  is the average price of goods and services and  $T$  is the number of transactions.

No one can disagree with this and be credible. The big debate appears when we start making assumptions and turn the identity into an equation.

Assumption number one

$V$  is constant or if not changes in it can be predicted. Then changes in  $M$  will drive  $PT$  (this is the theory behind Quantitative Easing.)

Assumption number two

If there is lots of spare capacity in the economy then companies will not raise prices. Then  $P$  becomes a constant (or can fall) and changes in  $M$  drive  $T$

Assumption number three

If there is little or no spare capacity,  $T$  becomes a constant and changes in  $M$  drive increases in  $P$  (inflation)

Assumption number four

The Government can determine  $M$

I will not rehearse the arguments but state my own position and back it up with evidence.

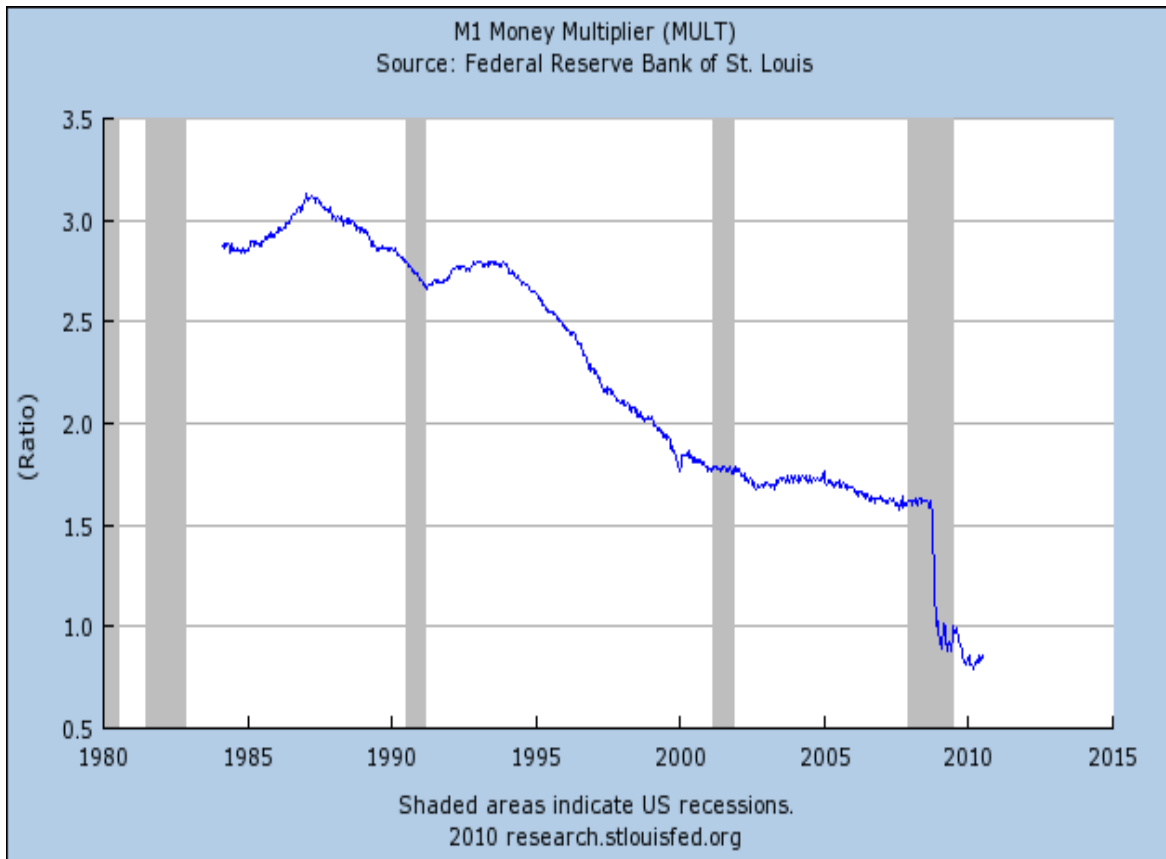
Is  $V$  a constant or at least predictable?

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NO! Look at the evidence from the USA and the UK.

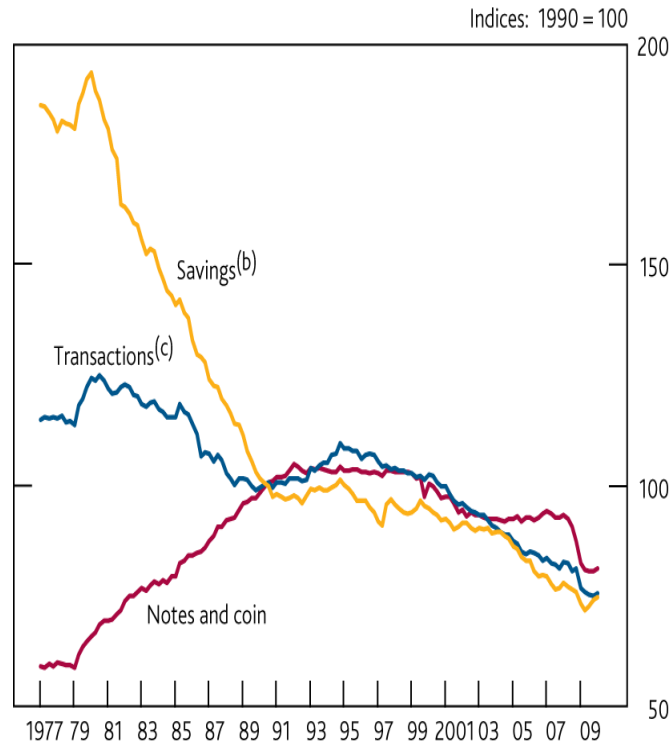
## The Velocity of Money in the USA latest data point June 2010



No one predicted the collapse in V in 2008 onwards. What causes V to collapse? It is the dash for cash by households, companies and Banks. When all three are trying to increase their liquidity, they spend and lend less. The most recent upturn explains why US retail sales have been better than expected since April 2010.

Let's now look at the UK

## The Velocity of Money in the UK: latest data point Dec 2009



Sources: Bank of England and ONS.

(b) Savings is nominal GDP divided by M4 excluding financial institutions  
NB all data rebased to 1990, so pre 1990 not significant.

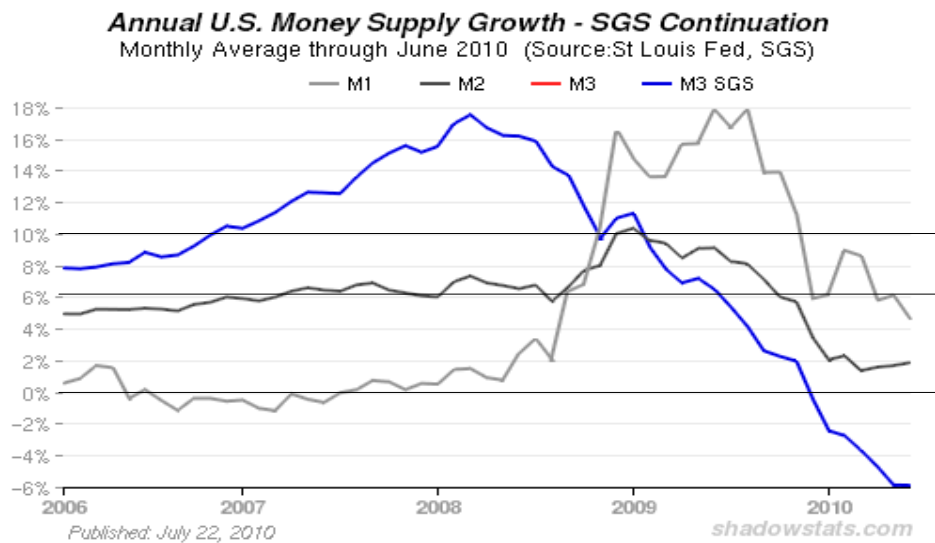
No one predicted the sharp fall in V at the beginning of 09. Do not pay too much attention to notes and coin, they are only 3.7% of the money supply but do show what has happened to small change spending.

So if V falls then it needs to be offset by increases in Money Supply. Which measure of money is subject to endless debate by economists. I prefer the broadest measure which is M3 in the USA and M4 in the UK. It measures the deposits (Liabilities) held by the banks and building societies. It doesn't directly measure credit growth but as every loan creates a deposit and deposits are M4 there is a close relationship. The first chart shows M3 in the USA. It's called SGS continuation because the Fed decided to stop measuring it in 2007; SGS still do from various Fed sources.

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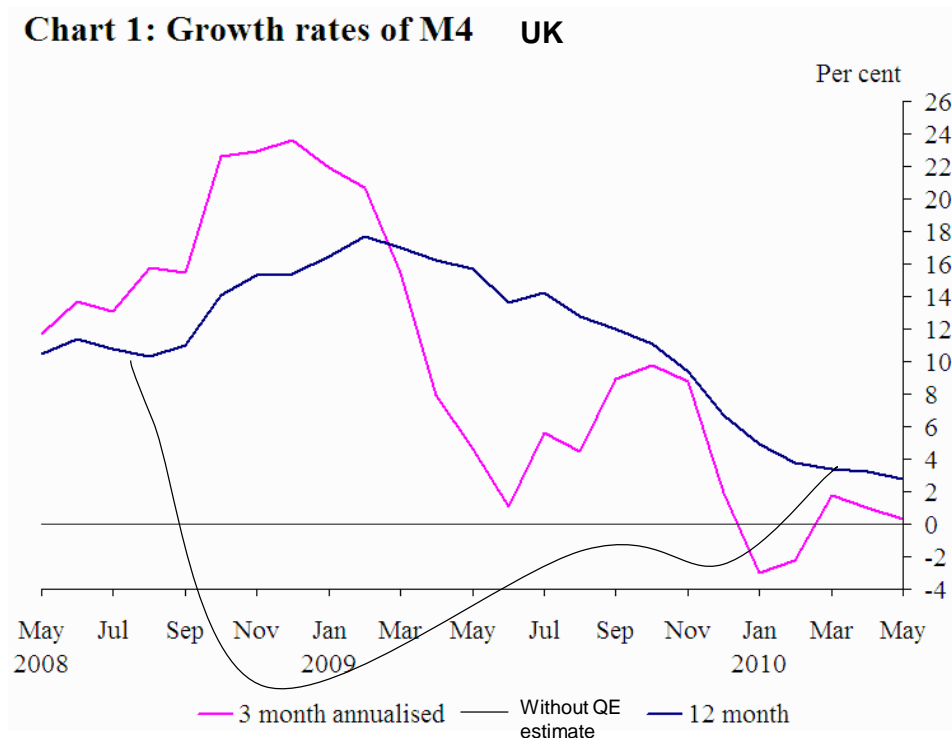
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As you can see M3 (the blue line is negative). So the USA has V which is flat, and M3 which is shrinking by 6% yoy, this must drive PT. Either prices will fall (deflation) or T will fall or some combination of the two. The lag between MV and PT in the USA is 9 months. So we can expect the USA to shrink in the last quarter of this year. And the Federal Reserve to Quantitatively Ease in the autumn.

On the next page is the data for the UK. I have drawn a thin line which is my estimate of M4 without QE. You can see that if the B of E had not created new money, overall the money supply would have shrunk, and a depression guaranteed. Unless M4 grows more strongly over the next six months then I expect they will do some more QE. However, because of the typically 9 month lag between changes in M4 and Nominal GDP (PT), you can see from this data why the UK economy will shrink again in the second quarter of 2011. HSBC reduced its net lending in the UK by 2% in the year ending March 2010, and overall lending to UK Business has fallen by £30Bn in the last year.



By way of comparison, broad money in India is growing at 17% yoy, and they have just raised interest rates to 4.75%, Brazil has raised interest rates to 10% and China to 5.5%. All because of too rapid monetary growth, the exact opposite of what is happening in the West.

## The European Banking System

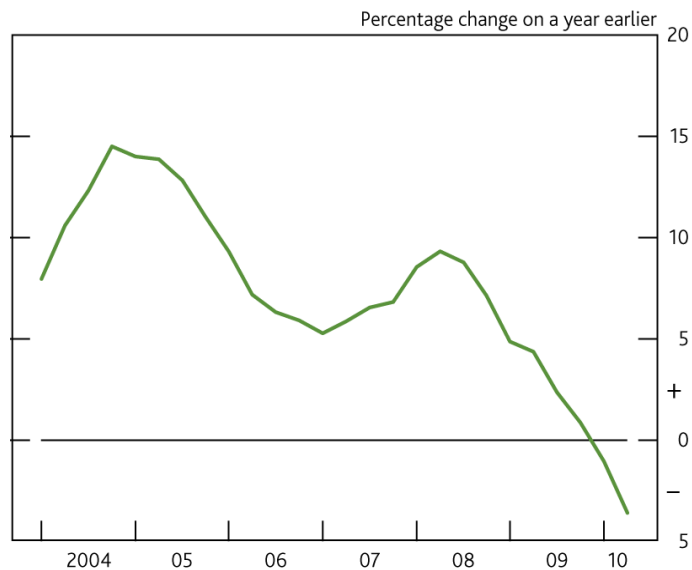
The stress test was so gentle nearly everyone passed. It was like asking engineers will this bridge survive a strong gust of wind. It should have asked will this bridge withstand a gale which might occur only once in a lifetime.

The test did not cover sovereign debt default, the regulators must assume that no European country will default, which is surprising when most observers think Greece will do so. The test was undertaken to show that a bank meets the regulatory capital requirement but on this basis Northern Rock would have passed. And yet it failed because depositors wanted their money back. The tests have only reassured shareholders that there will be no further call for capital, not depositors that their money is safe. So yet again it's assumed that any bank deemed too big to fail will receive unlimited support from the ECB. If I were an Investment banker I would be laughing all the way to the Estate Agents knowing that nothing has changed, I can behave and earn as before. A big fudge.

Vince cable has rightly pointed out that if British banks limited their bonus and dividend payments to the level established 2009, then they could retain another 10Bn and create £50Bn of new mortgages and SME finance based on it.

The banks are not lending to SME's

**Chart 1.16** Loans to small businesses<sup>(a)</sup>



Sources: British Bankers' Association and Bank calculations.

(a) Term lending and overdraft borrowing provided by seven major UK lenders to UK commercial businesses with an annual bank account turnover of up to £1 million.

## Basel Three

The banks are getting off lightly here. Broad agreement has been reached and the banks have until 2018 to meet the requirements which start to be applied in 2013.

Broad agreement has been reached on:

the definition of capital (watered down to suit the French and Germans)

the leverage ratio (it would seem that this is broadly unchanged)

the treatment of counter-party credit risk

and a Global liquidity standard

Nothing has been done to address the issue that Global banks are too interconnected and too big to fail. The obvious solution which is to separate retail and investment banking has not been taken up. The parasitic investment banking divisions will continue to enjoy implicit taxpayer guarantees on the deposits they readily speculate. This outcome is a testimony to the lobbying power of banks, and it would seem that excessive leverage is not going to be a thing of the past.

Over the next three years more detail will emerge, but the future landscape for banking looks much the same as it has been for the past 10 years.

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## **The US Economy**

The data for the second quarter GDP which showed annualised growth of 2.4 % is the advanced estimate. Over the past 23 years the average error ie the difference between the advance estimate and the solid GDP data, has been 1.3% in either direction. So the USA could be growing at 3.7% or 1.1%. My guess is its closer to 1.3%.

If we ignore percentages and look at absolutes then the quarterly output in real terms has hovered around \$13,000Bn for the past 4 years. The biggest economy in the world has gone nowhere for 4 years. If some Americans have increased their real income over this period, it will be at the expense of others. In fact the data shows that Middle America is getting poorer as the top ten % get increasingly richer.

The annual incomes of the bottom 90% of US families have been essentially flat since 1973. They have only risen by 10% in real terms over the past 37 years. Over the same period the top 1% has enjoyed a 300% increase. In 1973 CEO's were paid 26 times median income, now it is 300 times.

In the most recent boom beginning in 2002 and ending in December 2007 the US median household income dropped by \$2000.

Up until 1973 real incomes grew at 2% a year, doubling with every generation.

For many years deregulation of banking and cheap credit masked the problem, but easy money has now turned into heavy debt. Baby boomers are postponing retirement, College graduates moving back home. Four million homes have been repossessed in the past 4 years. Half the personal bankruptcies are caused by serious illness or accident. The impact of globalisation has been profound. The Detroit car worker of 30 years ago, who enjoyed the good life is now in Southern China.

All this is important to our forecasts for the USA. Without real wage growth for Middle Americans, and without an increase in credit, I cannot see how the largest consumer market in the world can enjoy a sustained expansion.

## **Chinese Wages**

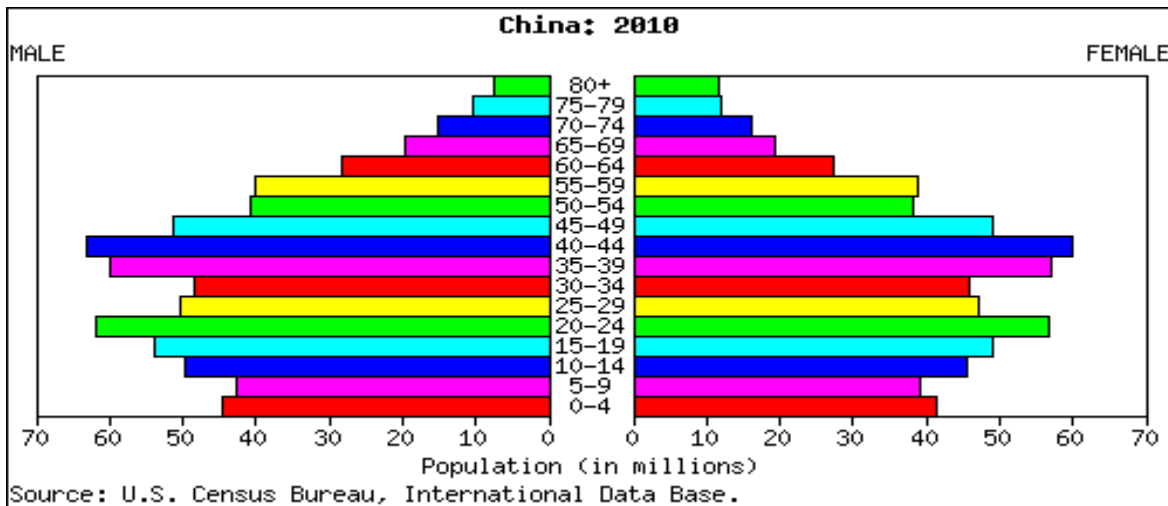
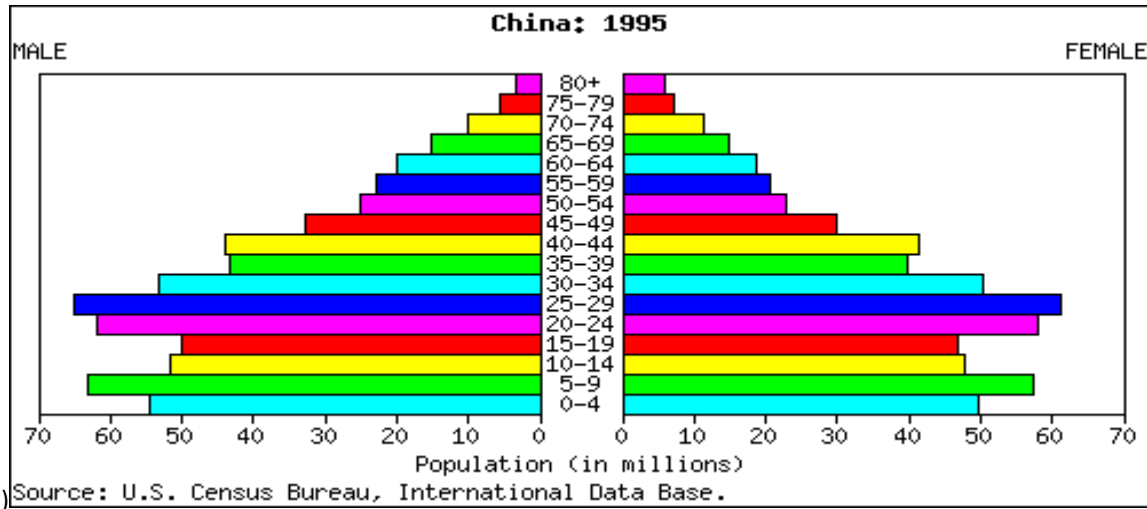
The impact of the one child per family is now being felt. The number of 20-39 year olds has shrunk by 10% over the past 10 years. In the Pearl River basin wages are rising at between 10 and 30% a year, prices at around 5%. This is a significant increase in real incomes. And yet per capita disposable income is still only \$2000 a year for 300m households.

In 1983 wages were 57% of GDP, they are now 37% of GDP. The average for OECD countries is 66%.

China's Demographics

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In China real wages are rising strongly but the average worker is still saving a third of what he earns just in case of illness and for retirement. China may become a consumer led economy, but not yet. Consumption spending is only 37% of total spending. Ideally the Chinese would allow their currency to appreciate and allow the locals to buy American!! Or at least European.

Most of the growth in China in the past two years has come from infrastructure spending. The massive expansion of credit (to offset the loss in export earnings) has created a property boom which puts the UK in the shade, most residential prices have risen 40% in a year. However the Chinese have just announced significant tightening in credit conditions, so expect property prices to fall as fast as they rose.

A viable economy cannot be built on concrete and steel alone, China's problem is the misallocation of resources, with an overdependence on investment and external demand. Investment growth will soon hit a ceiling imposed by social,

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environmental and natural resources. China's first priority must be to improve the quality of their growth, ahead of quantity. Will they allow the RMB to appreciate substantially to assist this, I very much doubt it. It's a wait and see on this one.

## Europe

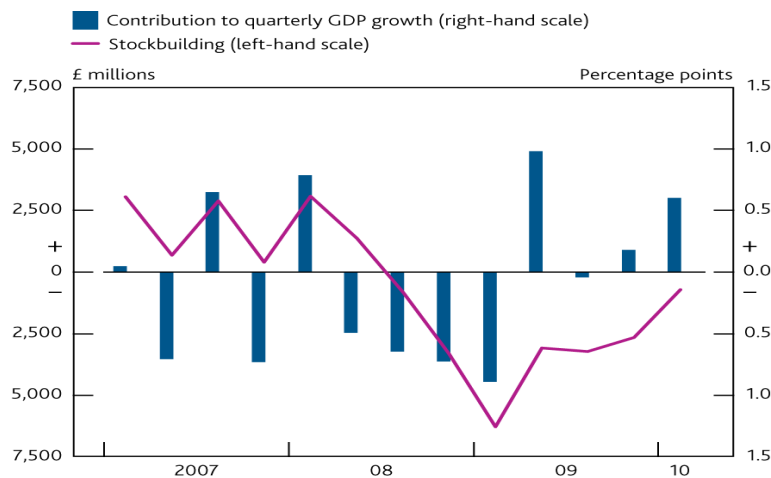
Consumer credit is contracting in Europe with the exception of Greece (here its growing by a staggering 29%) and Germany (+4.6%). Corporate credit is contracting by 2.6% except Greece (+15%) and mortgage lending is up 4%, with Greece leading the way at +23%, Ireland at the bottom of the class with -6%.

Overall M3 money is shrinking by 1.3%. Europe is the UK's largest market, it will experience double dip too next year. And Greece will surely default in 2011, prompting a further contraction in EU Banks' balance sheets. Retail sales for the 27 EU countries were up just 0.5% yoy, they contracted in Germany, France, Spain and Ireland.

*Why there will be a double dip in plain words.*

A normal recovery gathers momentum when retailers build stock, which causes a surge in manufacturing. This creates a surge in demand for working capital, for many SME's this is met by increasing the overdraft. The banking system rushes to lend, the new money becomes overtime payments, which are spent down the high street, thus reducing stock levels which prompts a second wave of increasing sales and output. And so on. The chart shows stockbuilding for the UK.

**Chart 2.10** Stockbuilding<sup>(a)</sup>



(a) Chained-volume measures. Excluding the alignment adjustment.

In previous recessions the real incomes of those in a job rose strongly (1980-83 by 7%, 1990-93 by 4%). This time it's only 0.7%. And still the banking system is deleveraging ie reducing the amount of credit available. Add this up and it is easy to see why the expansion will peter out due to a lack of finance. Many SME's are having their overdraft facility reduced when the opposite is required for a sustained recovery.

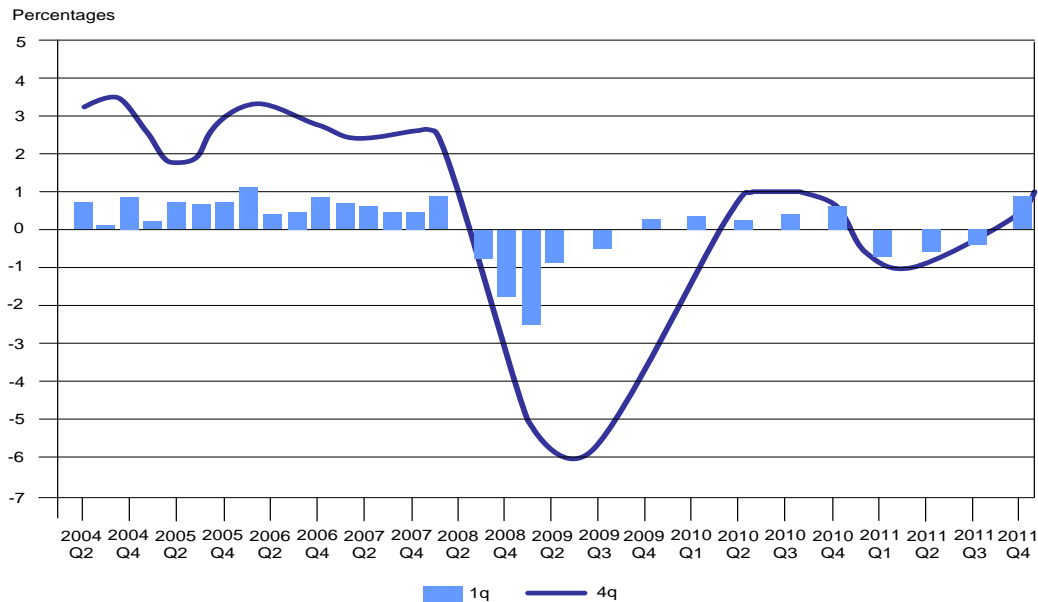
We now have the data on the impact of Quantitative easing. Of the £200bn new money created, only 1.5bn went on the purchase of commercial paper, the rest was spent on Gilts. And the banks choose reduce their lending and increase their holding of Government debt. In short the impact of QE has been to keep long run interest rates below 4%, not increase the amount of money going to SME's and for Mortgages.

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Christmas will be better than expected as households bring forward purchases to avoid the higher rate of VAT. And as a consequence first quarter next year will be very poor for retail, there will be unplanned stock building and a collapse in orders in February 2011 and Quarterly GDP. As per the chart below.

UK Real GDP The RMF View

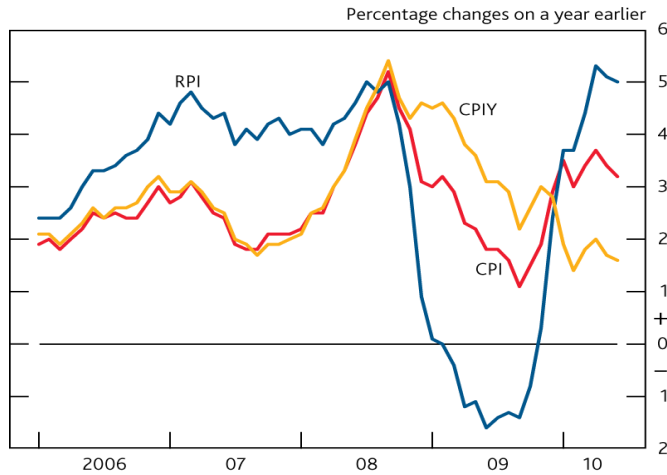


## The outlook for interest rates and inflation

The B of E will keep its rate at 0.5% for at least another year. But LIBOR will steadily increase to 1.5%, unless there is another round of Quantitative easing in the Autumn, in which case it will remain around 0.8%.

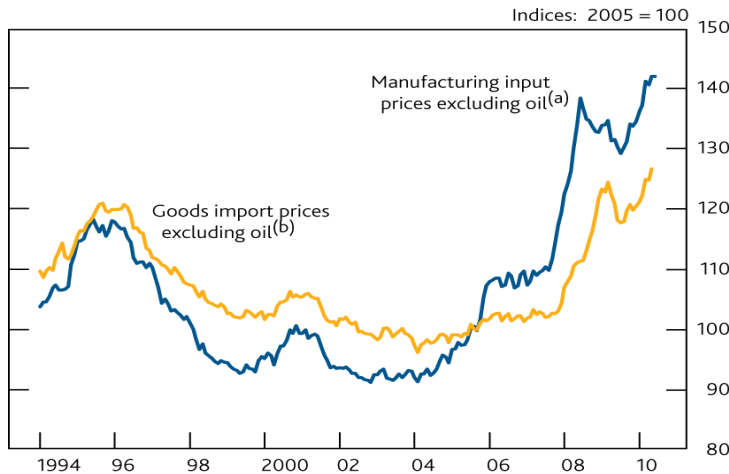
On the next page there is a chart of the three indicators of inflation. RPI has shot up because of the significant increase in the cost of mortgages (and rents) for households. CPI which excludes most housing costs will remain around three percent for the next year, but will not rise significantly above this because the money supply is not growing sufficiently to make such price increases stick. We can certainly expect food price inflation due to the weather in Canada, Russia and the Ukraine. But importers of goods from China will have great difficulty in passing on the full price increase. The second chart on the next page shows just how much these prices have risen in recent times. And much has clearly absorbed by business (mostly by the labour force either by real wage cuts and or job losses)

**Chart 4.1** Measures of consumer prices<sup>(a)</sup>



(a) Data are non seasonally adjusted.

**Chart 4.10** Imported goods and manufacturing input prices (excluding oil)

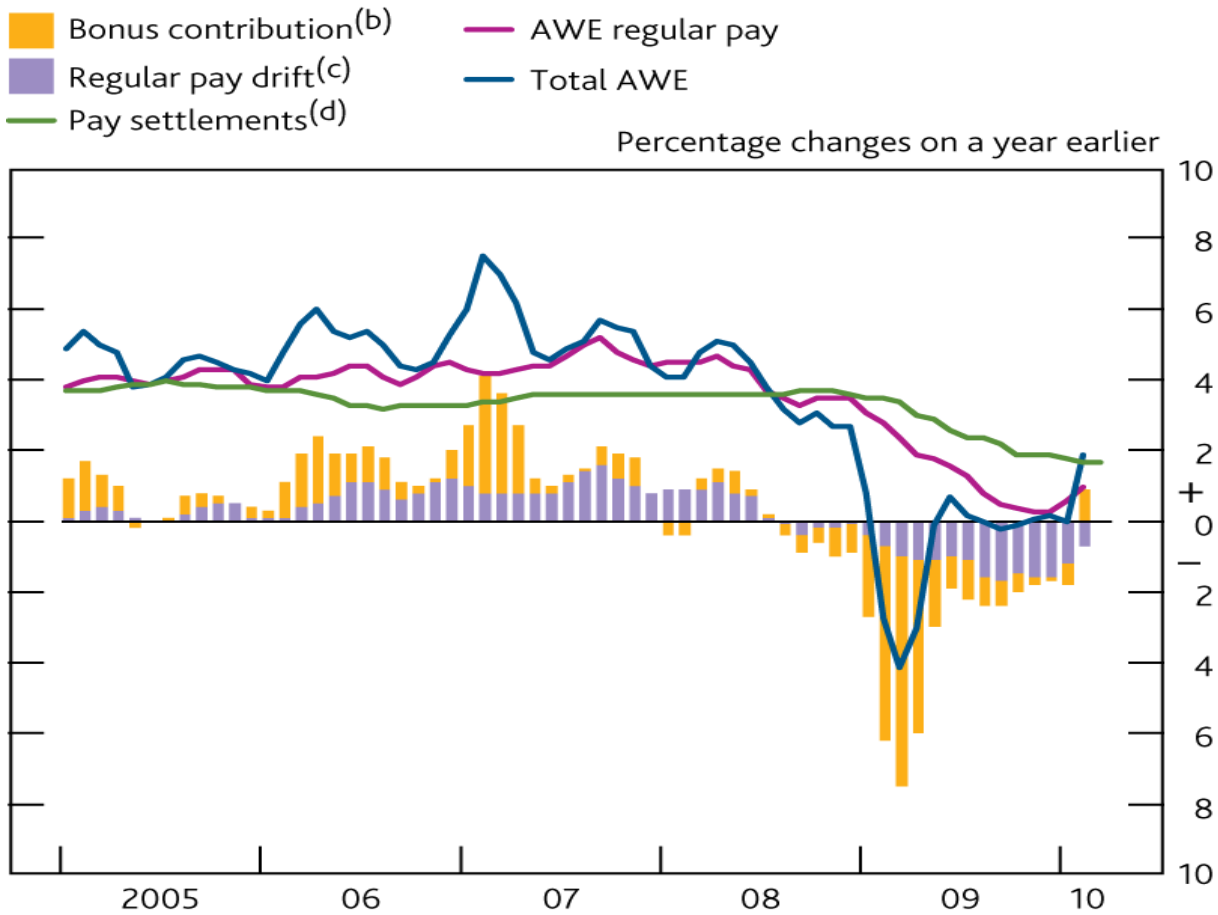


(a) Data are non seasonally adjusted. The latest observation is June 2010.  
(b) Data are non seasonally adjusted and include missing trader intra-community fraud. The latest observation is May 2010.

The chart on this page should be used in conjunction with chart 4.1. (on previous page) It shows us that over the past year real incomes before tax have been falling between one and three percent depending on which inflation measure you use. The FSA announced in June that 47% of UK households have no income left after mortgage payments and basic living costs.

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## Exchange Rates

No real change from the last report, the expected volatility in the dollar is materialising and will still swing within \$1.40-\$1.65 against sterling.

The Euro has gained in the last month but wait till September when Europe gets back to work and the markets reassess its prospects, it will push the pound to 1.25 and next year we could see 1.30, but not more.

## Commodity Prices

Increased volatility bigger swings but overall apart from food products I expect the swings around a downward trend as the double-dip spreads through Western Economies.

## Conclusion

Finally we can return to Irving Fisher.

$MV = PT$  where M is money supply, V is the velocity of money P is the average price level and T is the volume of transactions.

Take the UK and using percentage changes we have now

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$M +2.1\% \quad V +3\% = P +3\% \quad T+2\%$  ( this is the figure the Bank of England expects for 2011)

If companies raise the inflation rate to 5%, then unless M and V change, T will be zero. If the Government cuts to be announced in October hit consumer confidence, V will fall to zero, and T will be -2%, which is close to what I am forecasting for next year.

Take the USA we have

$M -6\% \quad V +3\% = P+1\% \quad T.....$ this will have to be minus 4% to balance the relationship. So a USA double-dip is 80% likely.

Remember the time lag between changes in M and PT is on average 9 months, and nothing in economic analysis is precise!!! But it does give us ball park relationships.

So get ready for another rocky ride, concentrate on getting even better at what you are already good at. Try and think of how you can sell to new segments. Reward your employees for their willingness to be flexible, recognise publicly their contribution, and as soon as you can afford to, pay them more. Do not blame the Economy, grow in spite of it. And be satisfied with a lower return on your investment, if you push to get the returns you made up to 2007, you will probably hollow out your capability to produce sustainable sales and profits growth over the next few years.

Prepared: August 11 2010

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