

# Economic Update March 2010

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By Roger Martin-Fagg

In the autumn of 2009 I made the case for a W shaped recovery. I argued that money supply growth in the Western Economies; even with the support of Quantitative Easing is not sufficient to finance money GDP growth at the 3-5% annual rate we need to maintain employment in Western Economies. It seems that others have caught up with this view and as I write Mervyn King the Governor of the Bank of England has been telling Westminster that Europe, our largest export market after a slight upturn is now stalled. Merv thinks another round of QE may be required this year.

In this update I want to explore some of the drivers of spending and how they are performing. In doing so I will again reiterate that we are not in a normal economic cycle but a discontinuity where fundamental changes take place as economic agents search for their survival strategy. All the data except my own forecasts comes from the Bank of England.

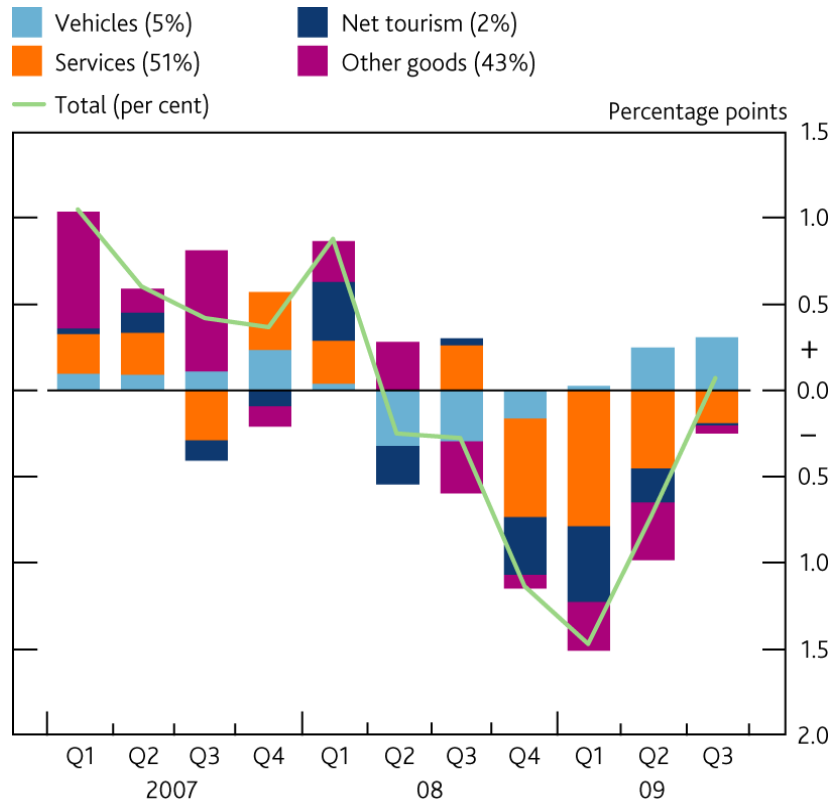
## Consumption Spending

In mature economies consumption spending is the dominant driver of nominal GDP and usually it is relatively stable. In the very short run the weather, the football result, or Wales losing the Rugby can cause big swings for retailers. But over the long run, i.e. over a year, households tend to maintain their consumption spending even when their income varies. In the old days they used accumulated savings to do this, in the last twenty years they have used debt. Once households have reached an income and lifestyle level they are always reluctant to move down from it. Research has shown that we work on a 'permanent income hypotheses. We guess what our income will be in the coming year or two (for most employees this is an accurate guess), then adjust our lifestyle to it. In recent years bonuses have become a part of permanent income for many. In an expansion phase of the cycle incomes rise, householders live up to their new higher incomes, and if they expect further increases in income they will often use debt to bring forward their consumption.

In 2008 UK household debts were the equivalent of 181% of disposable income (i.e. income after direct taxes). In the USA it was 132%. In both countries households expected their cash income to grow each year and used debt to bring forward consumption: in 2003-7 saving in both countries was negative. Today households do not expect their disposable income to rise; in fact the vast majority are expecting it to fall because they know that direct taxes will be rising within two years. So they have reversed their behaviour and are paying down debt as much as they can.

The chart below shows us that in the third quarter of last year in the UK the only growth in consumption was on cars thanks to the 2K scrappage scheme. This means that there is no growth in consumption spending, and unless investment spending or net exports fill the gap, it will be down to Government to maintain the flow.

**Chart 2.2** Contributions to quarterly growth in consumer spending<sup>(a)</sup>



(a) Chained-volume measures. Excluding non-profit institutions serving households.

## Investment spending

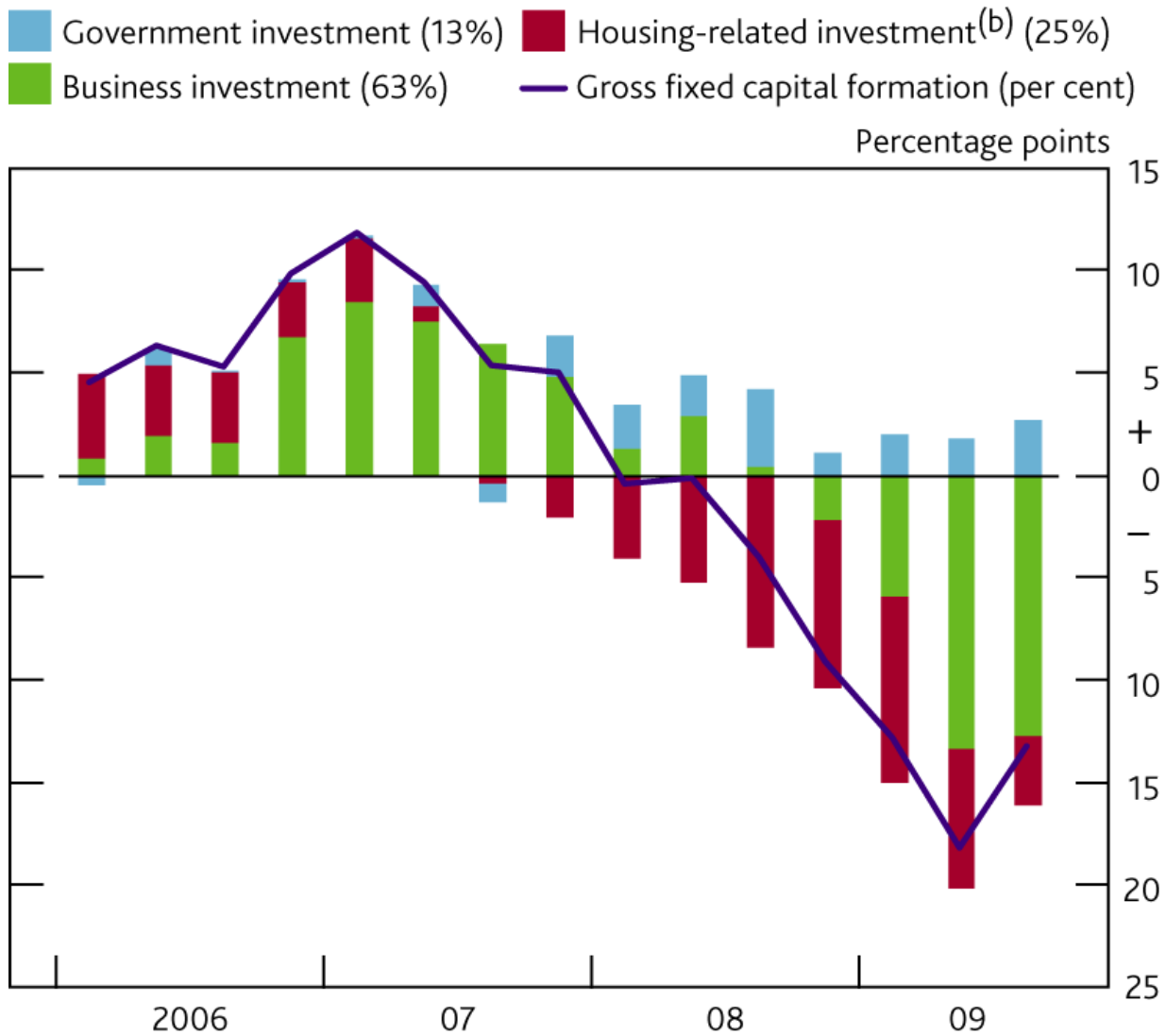
Investment spending is more volatile than consumption spending. It is primarily driven by the mood of Managing Directors as modified by their Finance Director. And their mood is driven by the relationship between planned and actual sales and net cash respectively. If actual sales are ahead of plan and converted into cash (i.e. the customer has paid) then confidence rises. If actual sales are below plan and or debtor days are increasing, confidence falls. Contrary to popular belief, the media does little to reverse this; all it can do is confirm what businesses are experiencing.

Look at the chart, there has been a collective failure of confidence.

Only the Government has maintained investment spending. Please note that if a family buy a house or improve it, it is consumption spending. If they set up a business to do the same it is investment spending and the amount includes estate agents fees and stamp duty. Investment spending as a whole is between 15 and 20 % of nominal GDP.

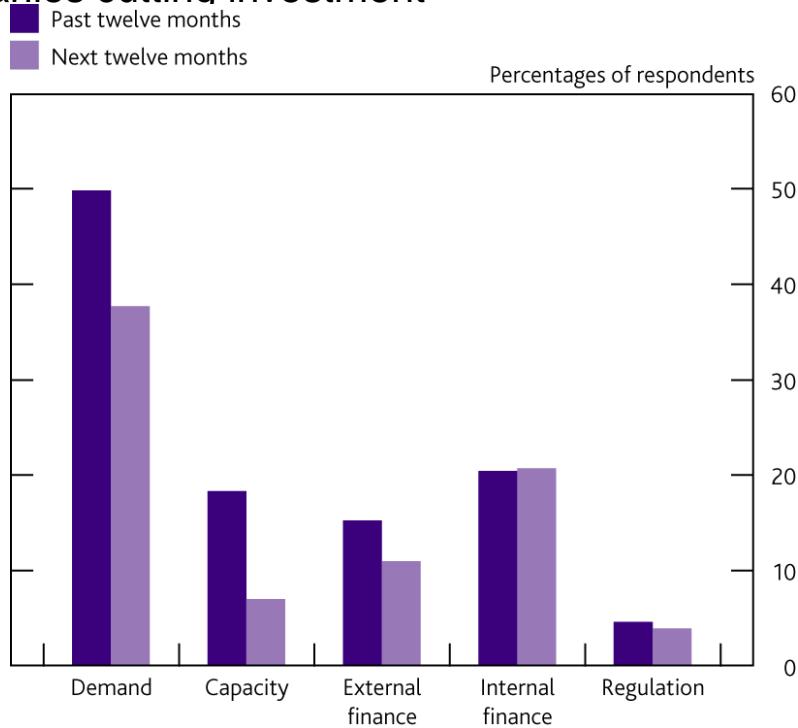
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And the main reason for the cutback is the prospects for demand. Business investment fell again in the 4th quarter, this time by 6%. The chart below is based the qualitative data collected by the Bank of England's agents who are in constant contact with business in their patch. There are 8 regional agents.

**Chart 2.7** Agents' survey: key drivers of investment decisions by companies cutting investment<sup>(a)</sup>



(a) The balances show the proportion of companies, weighted by turnover, citing each factor as an important influence on capital expenditure decisions. Respondents could select more than one option. The survey was carried out between 16 October and 23 November 2009.

## Net Exports

If both the domestic components of spending are flat then net exports is the final source of nominal GDP. From the table below you will see that net trade was a growth contributor for a year until the third quarter of last year. The 25% devaluation of sterling since 2007 has helped produce this figure.

If we add all this together there is only one thing stopping our economy from sinking, it is net Government spending. Look at the table. Even with this, the economy shrank in the third quarter of last year.

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**Table 2.A** Expenditure components of demand<sup>(a)</sup>

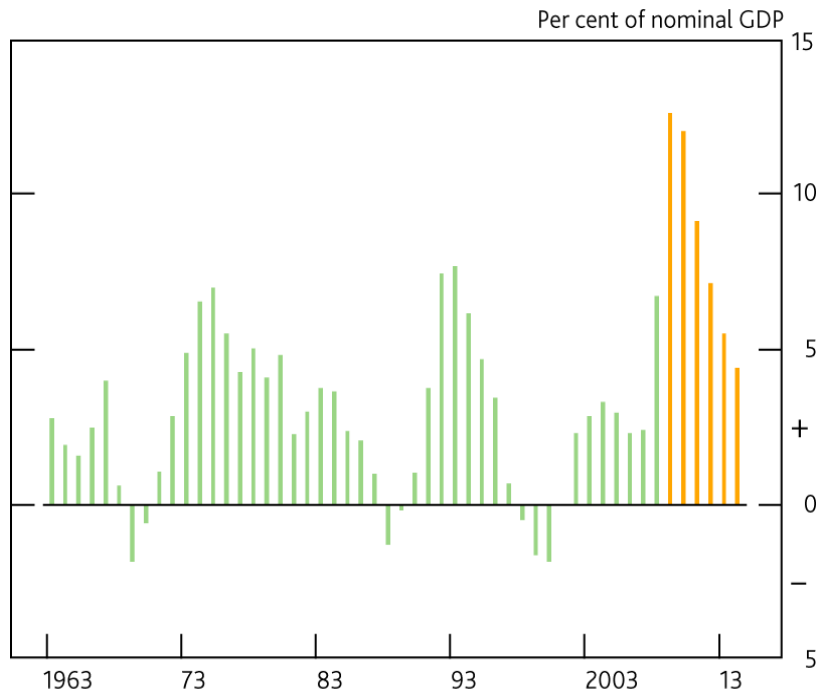
Percentage changes on a quarter earlier	Averages 1997–2007	2009			
		2008 Q4	Q1	Q2	Q3
Household consumption <sup>(b)</sup>	0.8	-1.2	-1.5	-0.8	0.0
Government consumption	0.6	1.1	0.0	0.7	0.3
Investment	1.3	-2.4	-7.5	5.9	2.2
<i>of which, business investment</i>	1.4	-1.6	-8.8	-10.3	-0.6
<i>of which, dwellings investment<sup>(c)</sup></i>	0.7	-5.8	-8.7	-5.1	1.1
<b>Final domestic demand</b>	<b>0.8</b>	<b>-0.9</b>	<b>-2.2</b>	<b>-1.3</b>	<b>0.4</b>
Change in inventories <sup>(d)(e)</sup>	0.0	-0.9	-0.6	0.5	0.3
Alignment adjustment <sup>(e)</sup>	0.0	-0.5	0.4	-0.1	-0.6
<b>Domestic demand</b>	<b>0.9</b>	<b>-2.3</b>	<b>-2.4</b>	<b>-0.9</b>	<b>0.1</b>
'Economic' exports <sup>(f)</sup>	1.1	-4.3	-7.0	-2.2	0.7
'Economic' imports <sup>(f)</sup>	1.5	-5.9	-6.7	-3.3	1.6
Net trade <sup>(e)</sup>	-0.1	0.6	0.1	0.4	-0.2
<b>Real GDP at market prices</b>	<b>0.7</b>	<b>-1.8</b>	<b>-2.5</b>	<b>-0.7</b>	<b>-0.2</b>

(a) Chained-volume measures.  
 (b) Includes non-profit institutions serving households.  
 (c) Whole-economy dwellings investment.  
 (d) Excludes the alignment adjustment.  
 (e) Percentage point contributions to quarterly growth of real GDP.  
 (f) Goods and services, excluding the estimated impact of missing trader intra-community (MTIC) fraud.

NB you will have heard that in the fourth quarter of last year that GDP grew by 0.3% on Q3 instead of the 0.1% originally estimated. This is because the Q3 figure shown above has been reduced. So the actual growth in the fourth quarter is unchanged, but because Q3 has been reduced in absolute terms, the % change has improved. Lies, damned lies and statistics.

But the consequence is a growing public sector deficit.

### Chart 2.10 Public sector net borrowing<sup>(a)</sup>



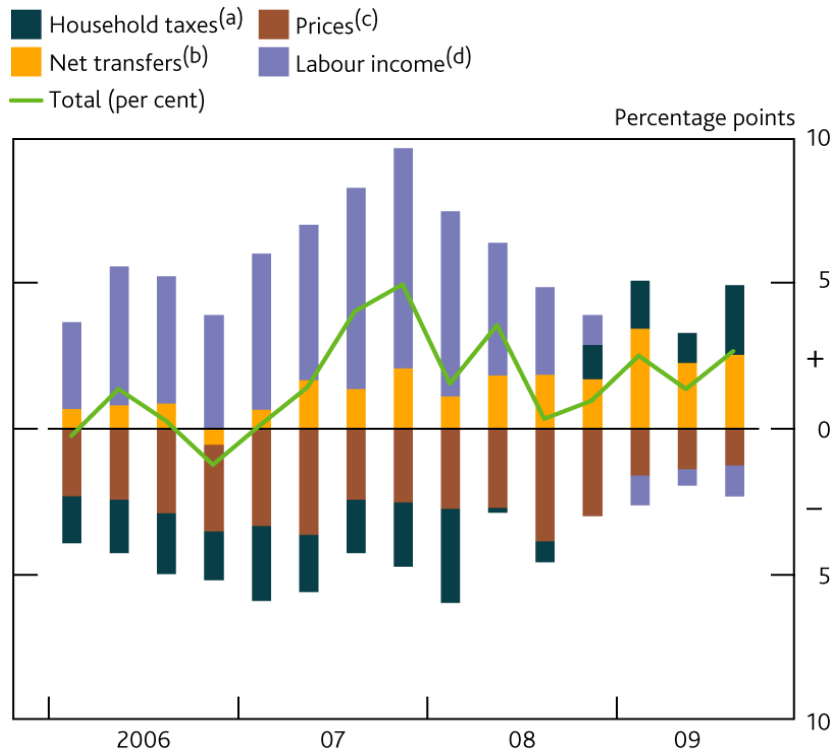
Sources: HM Treasury and ONS.

(a) The chart shows financial year net borrowing data. The orange bars show HM Treasury 2009 *Pre-Budget Report* projections.

It is only the government which is keeping the show on the road. Without the so called automatic stabilisers, average household incomes would be shrinking in the UK. The automatic stabilisers are falling tax revenues and increasing welfare payments. As you can see from the chart on the next page, actual wages are a negative net contributor as are price increases. The chart show the impact of the reduced direct tax take as incomes have fallen. It also shows us that throughout last year disposable incomes were only positive on average because of transfers via welfare payments.

The problem with this chart is that it represents the classic economists' way of viewing things. Real household income has gone up, so the theory suggests, household spending will follow. But households do not calculate things in real terms, they look at nominal cash income after tax, and utility bill payments, it will be this number which makes them feel confident or not! And it is going down for the majority. Be careful to distinguish between Disposable income( income after tax) and Discretionary income ( income after tax and 'fixed cost' living expenses e.g. utility bills, running the car, house insurance and mortgage interest payments.) The chart shows that disposable income in real terms is going up, it does not tell us what is happening to discretionary income and it is this which drives retail spending.

**Chart 2.3 Contributions to four-quarter growth in real post-tax labour income**



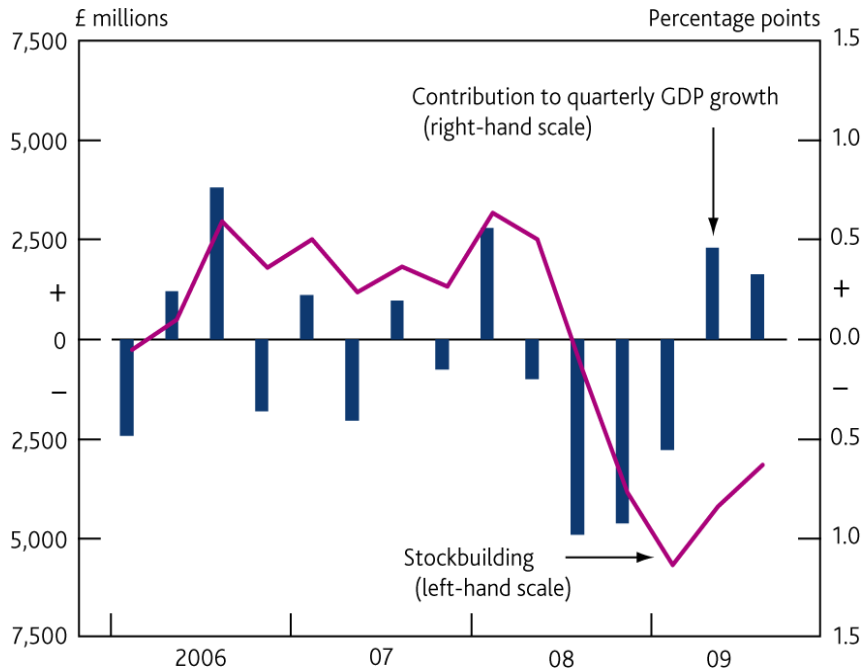
(a) Household taxes include income tax and Council Tax.

(b) General government benefits minus employees' National Insurance

## Stockbuilding

Net stock building has been as big as net Government spending and the supporters of the V shaped expansion use this as the signal for a sustained recovery. It usually is, normal recessions end as stocks are rebuilt, and the flow of incomes and expenditure gathers momentum supported by overtime working and credit expansion. I do not think it will happen this time. Firstly the rate of destocking slowed in the second and third quarter of 2009. And anecdotal evidence suggests that in the fourth quarter stock levels might have actually increased, instead of decreasing at a lower rate. The swing in stocks is worth about 4 Billion of GVA flow. Unfortunately the savings ratio rose by 2% over the same period, which takes out 14 Billion. This was used to pay down debt and the banks took the opportunity to reduce their net advances. Barclays reduced theirs by nearly £4Bn (source annual report)

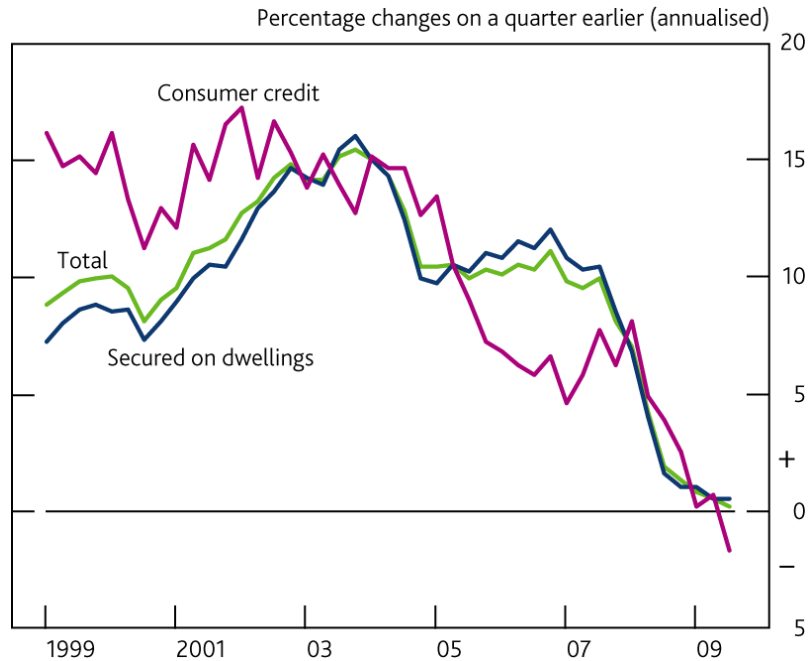
### Chart 2.9 Stockbuilding<sup>(a)</sup>



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

Debt repayment negates any restocking advantage.

**Chart 1.18** Loans to individuals

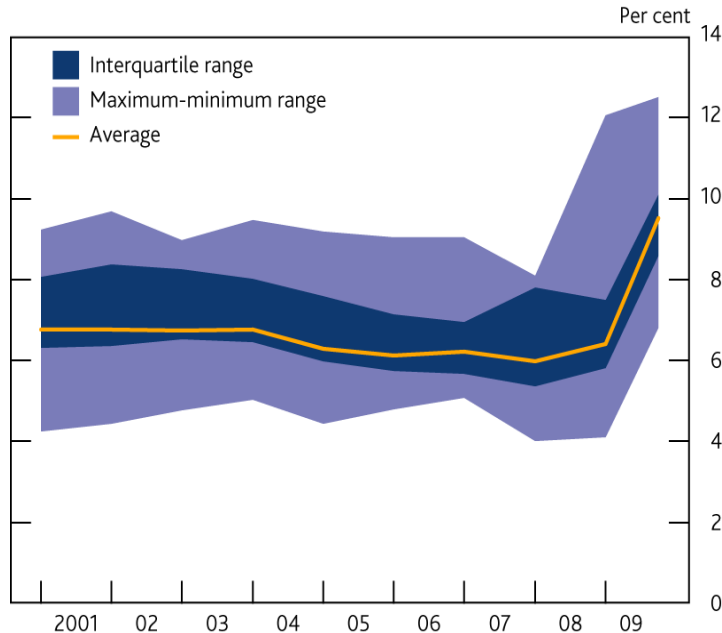


Is there any good news?

The banks are building their core capital which means there will be a recovery , the question is when?

History tells us that there is a lag of up to two years between changes in bank lending and nominal GDP, it can be as short as 6 months ( it all depends on households ). And the banks know that Basel three will be implemented this year. This is a tightening of regulation, the main thrust of it is that all banks will need to hold more core tier one capital to support all lines of business. They will not be allowed to fiddle the definition of core capital, it can only be shareholders funds. This will result in much slower money supply growth, higher borrowing costs and after recovery, no boom in asset prices. Also this years credit depends on last years audited accounts, so we already have a one year lag. 2012 is the earliest we can expect real GDP to be growing at trend which is 0.8% quarter on quarter.

**Chart 1.11** Major UK banks' core Tier 1 capital ratios<sup>(a)</sup>



Sources: Dealogic, published accounts and Bank calculations.

(a) Excludes Northern Rock and Britannia. Core Tier 1 capital is defined as common shareholders' equity and UK B shares adjusted for goodwill, intangibles and regulatory deductions. Data prior to 2009 are taken from annual published accounts. The latest observations are for 2009, and are based on third-quarter interim management statements for Banco Santander, Bank of Ireland, Co-operative Financial Services, HSBC, National Australia Bank and Nationwide; and on estimates on a *pro-forma* basis as at 30 June 2009 for Barclays, Lloyds Banking Group and Royal Bank of Scotland.

When the banks reach 10% it will represent the expected new regulatory minimum (expected with Basel 3). The obvious conclusion is that they will want to move to 12% to give themselves some headroom. To do this they will have to increase their profit margins further by taking more income off their existing customers, limiting higher risk lending, reducing dividend payments and the rate of growth in their liabilities. Remember that the liabilities of the banking system are the money supply M4.

It is this which makes the economic outlook so poor. It is this which will change the economic landscape. Many businesses will need to change their financing model from using other people's money to using their own. It will be a return to equity away from debt. As a consequence all investors need to downgrade their expectations of return on investment from 10%pa to around 5%pa. Real GDP will average 1.2% over the next 5 years, cf to 2.7% from 2000-2007. Of course there will be star performers who do much better than this but they will be characterised by a near monopoly position because of a compelling and distinctive value proposition, in turn driven by innovation, a customer centric culture, and speed of adaptation.

## The Irish Economy

For most countries, GDP and GNP are very similar numbers. GNP is GDP adjusted for net property income from abroad. Ireland is one of the exceptions. Irish GNP is typically 25% larger than GDP. This is because so many international companies have chosen Dublin as their head office location, and report their profits there to take advantage of the low corporate tax regime.

This situation boosts GNP when the global economy is buoyant, but hammers it when the world is in recession. The IMF says that Ireland faces stresses greater than those of any other advanced country. Irish GNP fell by 12% in

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the first quarter of this year: the main causes much smaller profit flows and a large increase in payments to overseas holders of Irish debt. GDP which excludes these flows shrank by 8.5%. For any business operating in Ireland; the GDP figure is more relevant than the GNP. Be careful when listening to Irish politicians they will always choose the largest figure.

Ireland is in serious trouble primarily because of poor lending decisions by their banks to domestic households, and construction companies. It all began when Ireland joined the euro and interest rates halved to 3.5% overnight in 2000. Their Banks also supplied 40% of all commercial property finance in the UK in 2007, since then the average price has dropped 45%, and many of the loans have gone wrong. But for government support, most of the Irish banks would be insolvent. A bank restores its solvency by trying to raise new capital, and cut the size of its balance sheet. To do the latter the bank calls in loans and doesn't replace loans repaid. The consequence is the money supply shrinks. It shrank by 5.5% in May 2009 and continues to shrink, by 2.5% in December 2009

The consequence of less money (less credit) is rising bankruptcies and unemployment. Households who can, cut back on current spending and reduce debt.

The value of retail sales fell 20% in May 2009, even if we strip out car sales we get minus 13.6%.

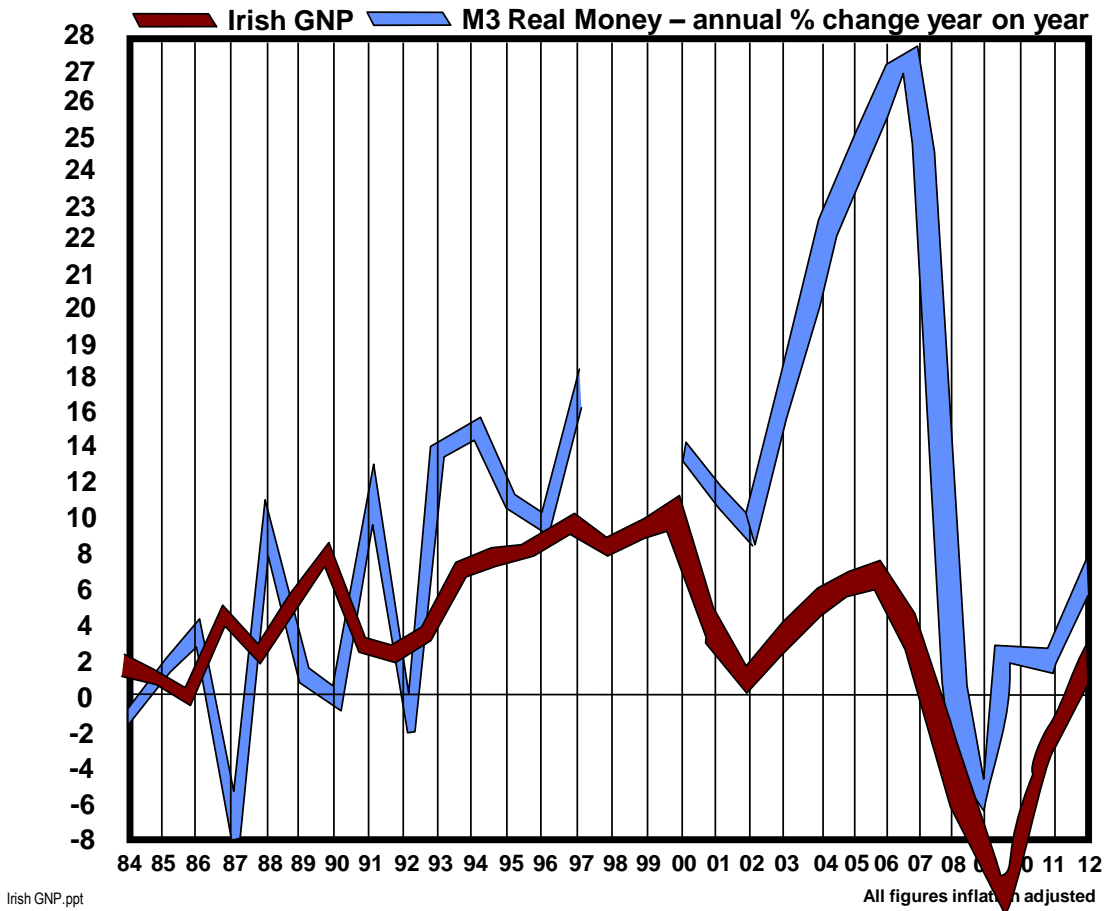
Bars and restaurants were down 11%, clothing down 17%, household equipment down 22%

In 2009 as a whole, retail sales were down 13%, prices fell 5%, and GDP fell 8.5%

It will take at least three years for the Irish Banks to rebuild their core tier 1 capital and start lending again. Any improvement before 2012 will come from printing money by the Irish Central bank, this is unlikely to find its way into high street spend, but it will help their banks rebuild their balance sheets. In addition the Government has proposed setting up a 'bad bank' which will buy land loans from the banks so that they can stabilise their balance sheets.

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As you can see from the money supply chart, the Irish like to party, but the hangover always follows, and this is going to be a long headache. It will affect all sectors. Any business which is growing revenues today will be doing so at the expense of their competitors, and the total cake is shrinking by 8.5%.

But it remains that Ireland has many advantages; it has the youngest and best educated workforce in Europe, it has a business friendly tax and regulatory regime and it is able to attract substantial inward investment particularly from the USA.

The sectors under stress i.e. downsizing and restructuring, starting with the most prominent.

- Building and construction
- Non food retail (except niche players)
- Financial services (except liquidators)
- Middle market restaurants

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The public sector

Sectors reasonably well placed:

Agriculture, food processing and retailing

Outsourced support services i.e. call centres

High added value, niche manufacturing

Low end fast food type restaurants

## Northern Ireland

Northern Ireland is a region of the UK, it has 1.8 million inhabitants who produce GVA of around £16,000 per person ( cf £21K SE England), higher than Wales and NE England but much lower than the £30,000 in south and east Ireland.

The largest employer is the public sector, employing 30% of the workforce ( cf to 22% in England). There is a £9Bn subvention from London to NI, this is 31% of GVA.

Incapacity benefits paid out are 74% above UK average and labour productivity is 16% below UK average.

31% of GVA is a gift from England (Scotland and Wales also receive gifts too). It means the NI economy is more dependent on Government spending than the other UK regions.

The latest expenditure round suggests that NI will lose 4% of its current GVA over the next 3 years, i.e. about £1.1Bn in total. And within its spending categories it will need to transfer £200m from other departments to maintain what is effectively free water and sewage services at point of consumption.

Efficiency savings (laying off public service workers) would not change the total GVA number unless they were immediately employed by the private sector using new bank financing to pay their salaries. Or there was a shortage of skilled workers available to the private sector.

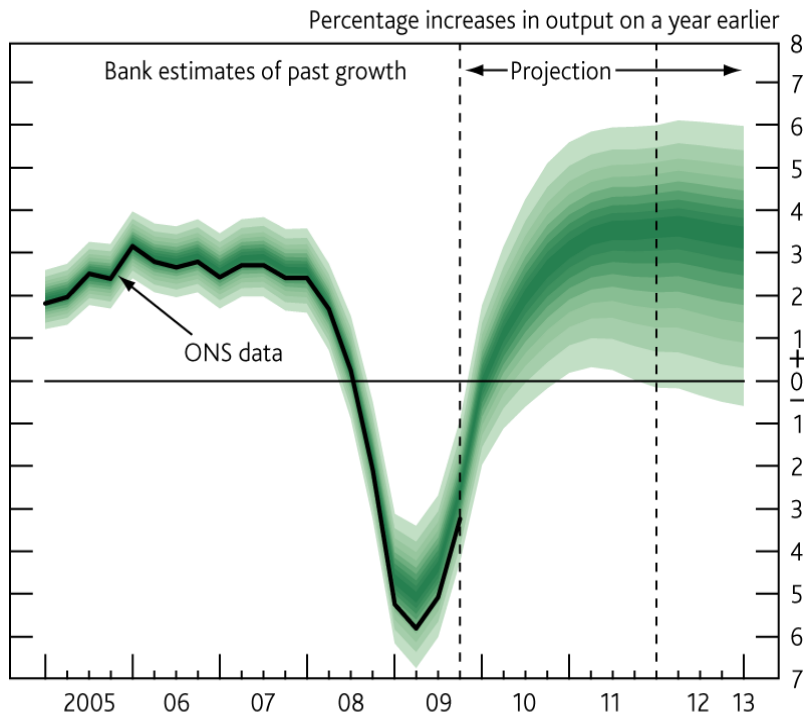
The steady devaluation of the Euro will reduce the net injection of money from the south, currently a big support to retailers close to the border. However NI can supply goods and services to the South, and the exchange rate is still a driver of this.

The outlook for the region is clear; the public sector will be reducing its stimulus, so private sector solutions are required. For Exporters the exchange rate will give advantage

## The Outlook

All the official forecasts are for a V shaped recovery. The chart below shows the Bank of England's forecast.

## Chart 1 GDP projection based on market interest rate expectations and £200 billion asset purchases



The fan chart depicts the probability of various outcomes for GDP growth. It has been conditioned on the assumption that the stock of purchased assets financed by the issuance of central bank reserves remains at £200 billion throughout the forecast period. To the left of the first vertical dashed line, the distribution reflects the likelihood of revisions to the data over the past; to the right, it reflects uncertainty over the evolution of GDP growth in the future. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that the mature estimate of GDP growth would lie within the darkest central band on only 10 of those occasions. The fan chart is constructed so that outcomes are also expected to lie within each pair of the lighter green areas on 10 occasions. In any particular quarter of the forecast period, GDP is therefore expected to lie somewhere within the fan on 90 out of 100 occasions. The bands widen as the time horizon is extended, indicating the increasing uncertainty about outcomes. See the box on page 39 of the November 2007 *Inflation Report* for a fuller description of the fan chart and what it represents. The second dashed line is drawn at the two-year point of the projection.

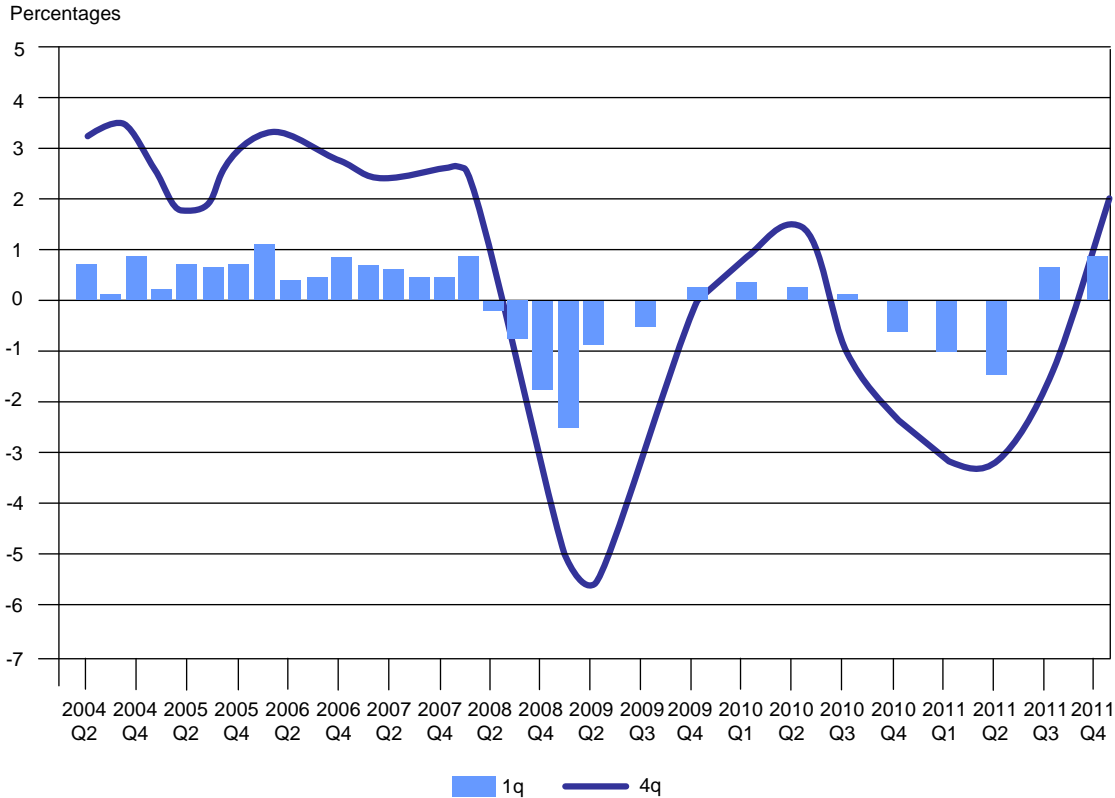
The big error in their forecasting model is the so called monetary equation. This states that the supply of money will always equal the demand for money at any given rate of interest. And normally this is true. Today is not normal, this equation is wrong. There are shortages of money throughout the Western world.

I repeat my forecast below.

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## UK Real GDP



The background to this forecast is as follows.

All business works on planned vs actual. And today's plan is based on yesterday's actual. So if actual is for a number of months below plan, then plans are adjusted downwards and vice versa. The apparent slight upturn of the last six months is actually a reduction in the rate of decline. What has happened is plans have been cut back sharply and actual has exceeded plan as a consequence. It is this which is creating a growing sense of confidence. Businessmen based in Manchester told me that business was picking up, his sales were 6% up in the final quarter of last year, but on further questioning it was revealed that his planned sales of the final quarter were 30% below the previous year.

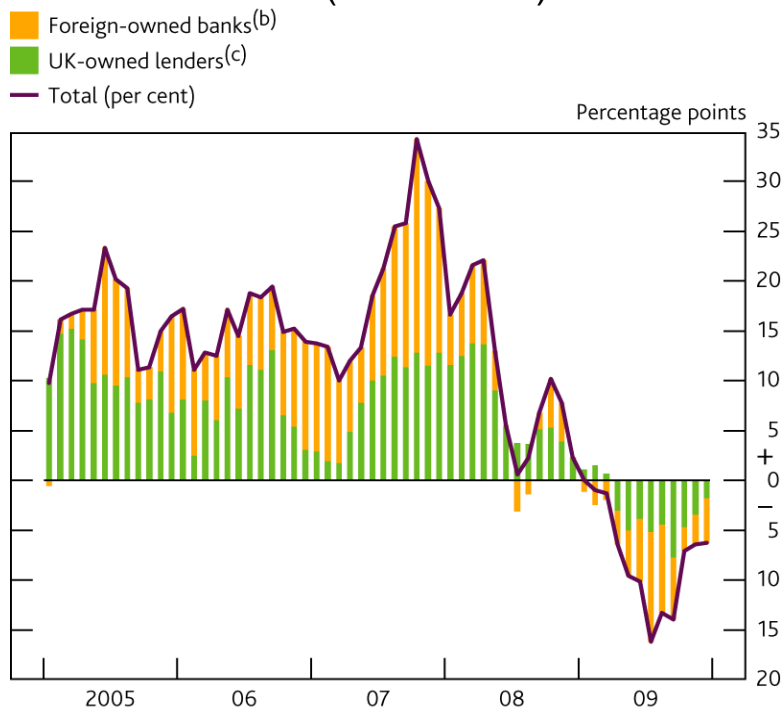
Over this next six months many business will increase their planned sales, and buy in stock in anticipation. I think by the third quarter, actual sales will be below plan and another round of destocking will push the whole system backwards in last quarter of this year and throughout next year.

### On Inflation

I think every economist believes inflation is a monetary phenomenon. The price of labour, land and equities is based on the amount people are willing and able to pay at a given point in time. Ability depends on money. I am

very willing to live on the banks of the river Thames but I do not have the ability to pay the required amount. A bank can increase our ability by extending credit. Banks are not doing this at present therefore on average prices will be stable.

**Chart 1.17** Contributions to growth in loans to UK PNFCs over the past three months (annualised)<sup>(a)</sup>



(a) Includes sterling and foreign currency loans.  
(b) Calculated as a residual.  
(c) Includes Banco Santander.

PNFCs are Private Non-Financial Companies.

This argument does not apply to essentials such as food and water, I will always pay whatever price in order to survive. If we look at the inflation data for February in the UK, we see that DIY, gardening and hardware prices rose by 7.6%. This always happens as retailers know people will spend in readiness for Spring. The same prices tend to fall in the Autumn. Health and Beauty products up 2.7%. Both are seen as essential purchases by the women in my house. Non-food up 1.9%, food up 1.3% and clothing down 0.8%. The overall shop price inflation rate in Feb was 1.7%. This is not same as the CPI of the RPI index.

In December average earnings grew by 1.4% before tax, the split was 1.2% for private sector employees and 2.3% for the public sector. There is insufficient wage growth to allow sustainable price increases. The rise in CPI of 3.5% in January is the one off impact of the VAT rate back at 17.5%.

Inflation will not take off in the UK for years. A year ago we thought that Quantitative Easing might finance generalised inflation, but we now know that the net money supply is only just growing, and QE has ended.

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## The Stockmarket

I have consistently got his wrong over the past year. All the valuation models suggest the footsie is overvalued, particularly if you believe in the double dip. So what is going on? I still think that the QE funds have filled the investment banks with liquidity, the bankers have talked up the Asian growth story, the fund managers as always have herded in, and finally if cash is only earning two percent that is less than the dividend yield at 3.39%, so you need to be in to win. The actual volume of equities traded is well below the norm. Best advice? Use your instinct!

## The EuroZone

Greece is showing us the problem which was forecast before the Euro came into existence. It is that the value of the Euro will be driven by the performance of the largest economy in the system. This is Germany (about 33% of Euroland GDP). In the first three years of its existence the Euro was comparatively weak, as Germany went through major adjustments to reduce its unit labour cost. It succeeded and even with a 20% appreciation of the Euro, Germany can still make a margin on its exports outside the zone.

The PIGS (Portugal, Italy, Greece and Spain) all welcomed the advantage that the much lower interest rates brought with Euro membership. But they did not grow their competitiveness fast enough and because borrowing in Euros was cheap, Governments allowed their deficits to increase throughout the period.

The current value of the Euro makes Europe expensive for the USA and the Brits, and this affects both the volume of exports and the margin on exports. It also makes Euro government debt more expensive to buy. So the price of Government bonds is falling in the market which means more have to be issued to ensure the Government can fund its deficit. This is the Greek problem currently.

The solution is simple. Germany should leave the Euro, restore the D mark. The Euro would promptly weaken 20 %, and the PIGS would gain some considerable benefit. It would be the end of the road to political union but this will never happen anyway.

Meanwhile it is likely the IMF will be called in. I do not think Germany will bail out Greece.

## Sterling

As I write the pound is getting hammered because the markets think there might be a hung Parliament which will delay the timing and the amount of the national debt reduction plan. It follows that if there is big majority for either party the pound should strengthen, and so I stick to my forecast of \$1.65 average for this year, and E1.22

Long run interest rates will rise to 5% by the end of the year, this will put an interest differential in of 2 % between sterling bonds and euro bonds, and it should strengthen sterling.

## Asia

China never grows by less than 8% because that is what the communist party dictates must happen. The big issue is that most of last year's growth was investment not consumption led. The big danger now is too much capacity for too little domestic and global demand. But elsewhere in Asia, growth continues based on strong credit growth. India posted 6.6% last year.

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## The USA

We have had some misleading numbers. 4<sup>th</sup> Quarter GDP grew at an annualised rate of over 5%. But the growth was almost all due to a reduction in the rate of destocking. This is not the way normal recoveries begin, and the USA will have a W like the rest of us. Jan retail was up 0.5% on Dec, but a stonking 5% on the previous 12 months, because 12 months ago they fell 10% on the year before that. You will see a lot of this over the next 12 months. Very small improvements on the previous month will show up as massive increases on a yoy basis. Do not be misled. What the data actually says is the USA has stopped declining.

## The UK Deficit

How big should we let it become? When should Government begin to reduce it?

The basic rule is this. When the national debt is larger than 90% of current GDP (1 years worth) and or the interest payable is more than 10% of current tax revenues, the debt is too large. We will hit this at the beginning of 2012 under current Treasury projections. If there is my W then we will hit in 18 months. Whoever wins the election will have to draw up a credible plan to contain the deficit. It is too much to ask to reduce it, and not sensible given the failure of the UK banking system.

I forecast that by the end of 2011, VAT will be 20%, basic rate will be up 2% and Government spending will be cut by at least 10%. This will get the annual borrowing down from £200bn to £110bn if growth is 1% in 2012, but under 70Bn if its 3%.

By the time I write the next update we will have a new Government. Do not expect too much, it will take a year for any major changes to be implemented. If it's Cameron, then I hope little George will get some first rate advisors around him, because alone he will be not up to much.

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