JSA Consultancy Services

ECONOMIC UPDATE DECEMBER 2020

As I write this, there is a palpable sense of optimism on the airwaves. Families will enjoy Christmas, vaccines will be available for the old and vulnerable in the next three months and, by the end of the summer, the nation will be fully protected (we hope!)

And then there are financial journalists banging on about how taxes must increase significantly to bring down the unsustainable debt incurred by Governments. Additionally, it will be the rich who will be required to cough up.

I will not comment further on the Covid prevention measures but for the rest of this update, I want to brief you on the whole issue of Government debt, how it is managed and why it doesn't have to be paid down.

I will try and keep this as simple as possible, without losing the subtleties.

The capitalist system depends on individuals with energy and vision monetising land and or intellect. This means adding value to land and or intellect. In short, it means arranging for something to happen for which others will willingly pay such as the supply of goods, buildings, and services. We attempt to measure this and call it GDP.

Paying for something requires the exchange of money. The exchange of money creates jobs and more goods and services as it flows between people.

In Britain, the industrial revolution began in around 1750. Lloyds Bank was founded in 1765 by a button maker and a Quaker iron merchant at Dale End in Birmingham. The first cheques were issued 100 years earlier by London gold and silver merchants. Cheques enabled individuals to make payments whilst keeping their wealth locked up in vaults. By 1750, there were small, privately owned, banks beginning to issue cheques in the provinces.

The earliest surviving cheque of an English provincial bank was drawn on Samuel Smith & Co of Nottingham in 1705. The first pre-printed cheque form (apart from the Bank of England's) was issued by Vere, Glyn & Halifax in the 1750s, and in 1811 Commercial Bank of Scotland issued the first cheques pre-printed with the customer's name.

The Bank of England was established in 1694 with the object of lending to the Government. It was clear at the time that France could and would invade Britain. However, in 1693, the British Navy in partnership with the Dutch showed its superiority off the coast of Barfleur. Louis XIV continued to expand his army and it's generally accepted that, in 1695, he would have invaded but for a famine in Europe at the time. The Government needed to spend more than its tax income to build up the country's defences, which is why the Bank was established - to supply credit to the Government.

The Industrial Revolution was enabled by the emerging banking system. In essence, banks discovered that customers would accept a bit of paper (a cheque) as money and would only require a proportion of their money held by the bank in cash. In arithmetical terms, Customer A deposits £100 physical cash, but only requires £20 cash on demand and £80 is left idle. Customer B wants a loan of £400, but needs only £80 on demand in cash; the rest he will spend using a cheque. Thus the bank creates £300 of credit. The cash ratio in this example is 20%.

Issuing a cheque allowed credit to be created out of thin air, which is how the Industrial Revolution was financed; it was built on debt.

When individuals bang on about debt and how bad it is, they forget that, if they have a mortgage, they are living beyond their means. We are the sixth richest country on Earth because debt has financed initiative and creativity. It also financed our exploitation of foreign lands, adding value to natural resources - and regrettably to the trading in humans.

So, to be clear, as and when individuals borrowed from their bank, new money came into existence, and flowed between people and businesses. New money in existence allows the original money borrowed from a bank to be paid back. The bank could then destroy that money it in its balance sheet. However, the bank wishes to grow its own business, so it doesn't destroy it; it finds another borrower. So the total amount of money in the system - and thus the GDP - continues to grow.

Providing the new money creates new goods and services, inflation will remain subdued. There will be individual product and service inflation based on assumed quality and functionality (e.g. Apple and Dyson product pricing) but also price reductions, due to competition and efficiency e.g. a modern TV is 90% cheaper than one made in 1955. Inflation took off after 1973 in most Western economies. This was primarily because of a quadrupling in the price of oil. Individuals wanted to maintain their standard of living, so they pushed for higher wages, but the supply of goods and services did not increase: the result was inflation.

UK HOUSE PRICES 1970-1974

Money supply grew by 76% over 4 years!

			% Increase
Q1 1970	231.5	4,378	5.6
Q2 1970	235.5	4,452	6.0
Q3 1970	238.4	4,508	6.6
Q4 1970	242.4	4,582	6.3
Q1 1971	250.7	4,741	8.3
Q2 1971	259.6	4,908	10.3
Q3 1971	277.3	5,244	16.3
Q4 1971	292.6	5,533	20.7
Q1 1972	317.7	6,008	26.7
Q2 1972	346.8	6,557	33.6
Q3 1972	391.1	7,395	41.0
Q4 1972	416.7	7,880	42.4
Q1 1973	444.0	8,396	39.8
Q2 1973	467.1	8,832	34.7
Q3 1973	485.7	9,183	24.2
Q4 1973	516.6	9,767	24.0
Q1 1974	525.1	9,928	18.2
Q2 1974	530.3	10,027	13.5
Q3 1974	536.7	10,148	10.5
Q4 1974	539.9	10,208	4.5
Q4 1974	539.9	10,208	4.5

Where did the money to pay the higher wages come from? The banks created it by selling many more and much larger value mortgages. Companies also borrowed heavily to buy real estate.

The insurance industry began offering endowment mortgages. The Government gave tax relief on interest payments and there was zero capital gains tax on disposal. Money supply growth expanded wealth - the value of a house and commercial property.

Western Governments claim that the fall in inflation rates since the early 1990's is due to their careful and responsible management of their respective economies. I believe that, in fact, it has been the entry of China and India into the global supply chain which is primarily responsible. If imported clothing, footwear, vehicles and consumer durables are falling in price, overall CPI, and, in tandem, the demand for wage increase are moderated.

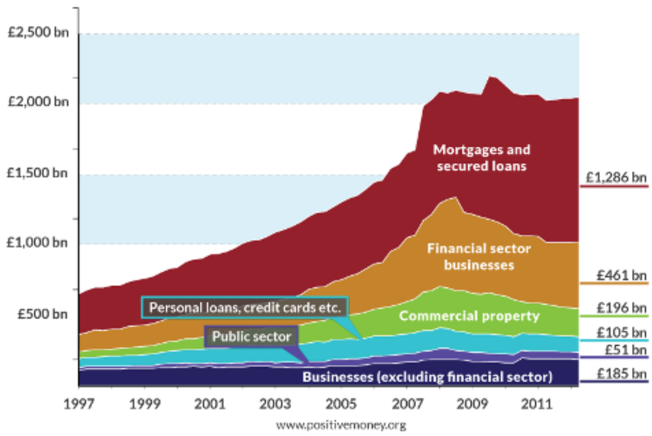
From 2000 the free movement of young eastern Europeans offset the poor demographics of the UK such that labour shortages were met with increased supply, and not escalating wages.

By 2000, Basle 2 allowed banks effectively to determine their own risk profiles and, yet again, they caused the mortgage market to expand rapidly with the new money driving up house prices.

If you look at the chart below you see that lending for growing business is negligible, whereas lending for property is dominant. Note too that many of the financial sector businesses will also be supplying mortgages!

HOW HAVE UK BANKS USED THE MONEY THEY CREATED?

Sectorial lending figures from the Bank of England



In 2008, we experienced the near-collapse of the Western Banking System - the inevitable consequence of allowing bonus driven banks to determine their own risk profiles and consequently, over-leverage their balance sheets.

Banks began to call in loans to commercial property companies and financial sector businesses. They were rescued by the Bank of England who purchased bonds from the private sector with new money which ended up in the accounts of pension funds, insurance companies and the banks' own accounts.

None of this money went to the man in the street. Of £375Bn newly created QE money, only £23 Bn resulted in new spend. But the already rich became even richer.

The only benefits the average person obtained were the improved safety of their bank deposits and a fall in the cost of mortgages. Governments introduced austerity measures to ensure that spending was in line with lower tax revenues, other than the spend on state pensions which was triple locked. Effectively, capital investment was diverted to pensioners. And the infrastructure of the nation began to deteriorate. By 2019 it was quite clear that productivity growth since 2008 had stalled.

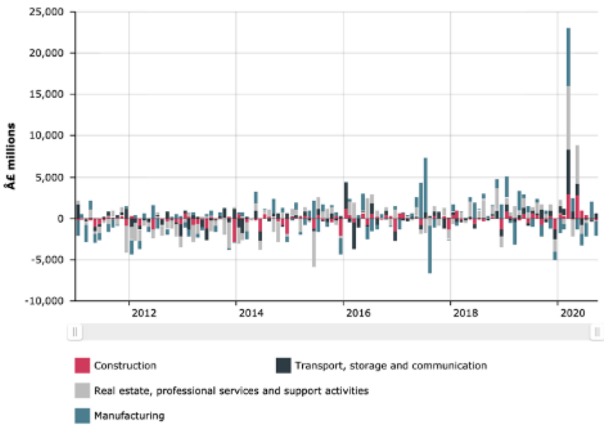
The new Conservative Government in March 2020 announced it would spend £130Bn each year on infrastructure to level up North and South and make Britain great again. This money to be financed by borrowing through the issue of gilts at virtually zero cost to the Government because the Bank of England agreed to provide the necessary funds and purchase the bonds at the highest price. The Bank is running gilts auctions every week now, instead of once per month. It bids high enough to keep the cost of borrowing under 1%.

DIRECT LENDING TO BUSINESS

They also announced wide ranging measures to limit the impact of Covid on business and households. In particular, furlough schemes where Government pays 80% of wages up to £2500 per month. This, too, is financed by the Bank of England. The scheme has been extended to next March.

The total cost so far of all Government measures is 380Bn, with another £150Bn to be supplied by the Bank through 2021.

DIRECT LENDING TO BANKS



TO KEEP IT SIMPLE...

QE 1 2009-2015
Designed to rescue commercial banks and keep interest rates low

QE 2 March 2020-April 2021
Designed to ensure households have an income, businesses unable to trade have cash - even though there is no work, and to keep interest rates low, and to allow Government to run a deficit of £380Bn. In short - to avoid austerity.

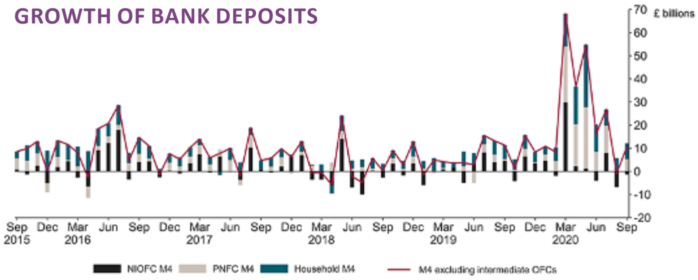
QE 2 is quite different from QE1 in that most of the money is going directly into households' pockets. It's the equivalent of helicopter money.

QE1 depended on trickle down to drive GDP growth; **QE2** is a direct driver of GDP growth.

If we look at the growth of bank deposits, the direct impact can be readily observed. Circa £140Bn more than usual has appeared in accounts since March. When it is spent, GDP surges.

The growth in money supply is normally £8bn a month. I expect to see that double over the next four months and, thereafter, there to be a surge in flows between accounts when households are able to spend as normal.

GROWTH OF BANK DEPOSITS



Dear reader, you may be trying reconcile the numbers you see above with the figure of £300Bn – a thankless task. The Government claims it has spent £15Bn on PPE. That works out at £30,000 per front line health worker! Add in care staff, and the hours worked. The figure drops to £75 per person, per day. A gown which should cost 50p, cost £6.00.

We will see in due course that a good deal of the new money has flowed overseas. So it doesn't appear in domestic accounts. I will bet on a surge in orders for rather large yachts over the next year to be delivered to Mauritius. Of the £380Bn spent so far, I would guess that at least £120Bn has ended up offshore.

Although I am unhappy when journalists liken the country to a single business, consider the following for illustrative purposes in relation to debt levels for a single business.

A gearing ratio lower than 25% is typically considered low-risk by both investors and lenders. A gearing ratio between 25% and 50% is typically considered optimal or normal for well-established companies.

Generally, an interest coverage ratio of at least two is considered the minimum acceptable amount for a company that has solid, consistent revenues. Analysts prefer to see a coverage ratio of three or better.

Assume the country is business.

- Total asset value estimated at £10 trillion.
- Current total debt £2.2 trillion
- Gearing Ratio 22%
- Current interest bill is £55Bn. Revenue £820Bn. Interest coverage is 15
- This business has never missed a payment in 300 years.

So what is the problem?
The problem is our media and general lack of financial literacy.

Does the debt ever have to be paid down?
NO

Can the Bank of England keep purchasing it?
YES to some extent. Currently 46% of its balance sheet is Government debt, so it could purchase another £600Bn of debt if necessary.

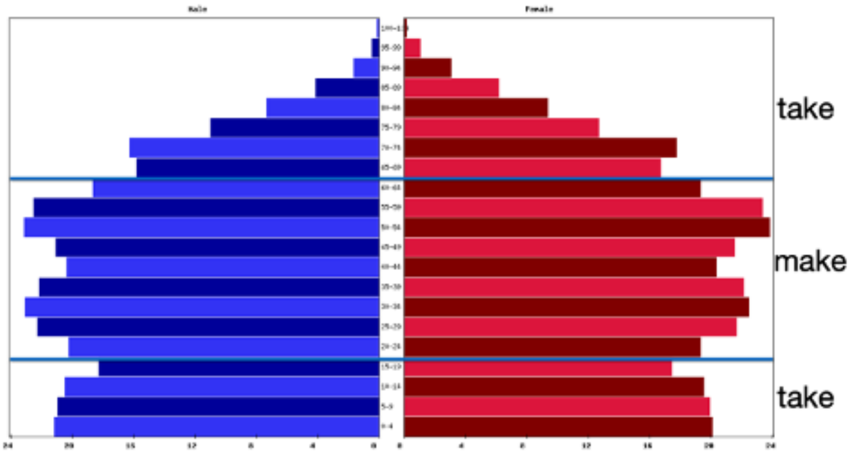
But surely paying all the interest on this debt means taxes have to go up?
NO; the Government owns the Bank of England, so much of the interest is paid to it, and then it pays it back to the Treasury. A closed loop.

But what if interest rates go up?
The interest bill will rise but tax receipts will be rising as well, so interest coverage doesn't change.

But surely if the debt is rising, so does the gearing?
NO; because the value of the assets will be rising, remember debt = new money.

THE NATIONAL CHALLENGE, TOO MANY OLDIES!

Over the next 15 years a lot more takers than makers!



So, the Government should borrow lots more from the Bank of England and not raise taxes? Yes; at least for the time being, until the economy is back on track. But then taxes must increase to finance welfare spending.

THE CORE FINANCING ISSUE IS THIS:

A business should borrow to expand its ability to grow revenues. So a Government should borrow to invest in education, technology and infrastructure; all of this will grow taxable incomes.

A business should not borrow just to pay the wages i.e. current spending. Nor should a Government - except in exceptional times like now.

If Sunak is honest he will state that the cost of looking after the old and frail is rising exponentially, and that this should be financed from current income i.e. tax receipts, not borrowing.

Borrowing should be used to raise the productivity of those who make, so they can afford to fund those that take. Look at the demographic pyramid.

So why hasn't this been done before? Because of belief systems.

Many individuals see this as big Government and call it socialism. They are misled by the media.

Others point out that Government projects always underperform. And yet Government uses the private sector to deliver. An example is test and trace which will cost £22Bn, mostly spent with the private sector.

It has been done before: financing WW2 from which a great deal of innovation emerged.

People are anchored with fixed beliefs, and then choose a media outlet to give those beliefs nutrient.

A current example is the right wing press saying once we are out from under the dead weight of Europe we can be great again. Or the leftwing press saying immigration depresses wages.

Neither point of view is credible, but people believe what they want to believe.

There are many financing issues which are not black or white.

For example: should the Government fund the entire cost of apprenticeship schemes? An SME owner might say 'yes' - because they would rather someone else paid for skills development, especially if the business is young and cash is tight. But it's likely that an SME owner will enjoy high returns with a better skill set so, surely, he or she should pay?

Then should he or she pay in advance or in arrears?

From a taxation point of view, if payment is in arrears, after the value has been created, use CGT to recoup. If in advance, then income tax. But 47% of Brits pay no income tax. OK so use VAT, but that means the poor pay over a bigger portion of their income in tax.

But apprenticeship training is a social good so surely everyone should pay? And shouldn't University education also be free, on the same basis.

The debate is endless.

LANGUAGE MATTERS

I have just listened to Sunaks' Autumn Statement. For the majority, I expect it sounded very disheartening. ‘Worst recession in 300 years’, ‘things will get much worse before they get better’ etc.

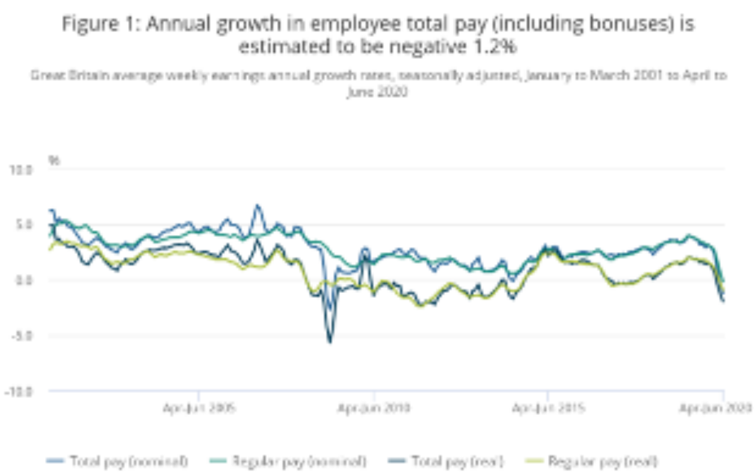
I would have used different language. Here is my rewriting of his speech.

The Covid recession is like no other. Our model has no previous experience of it. But the downturn is the inevitable consequence of the deliberate act of locking down consumers.

Our response is like no other and I want you to know that as soon as restrictions end, it is our firm belief that the recovery will be rapid and our model will be proven to be overly pessimistic.

Your Government is borrowing from its own Bank. This means that there is no additional interest charge to the taxpayer and I will be only raising taxes in future to finance welfare, particularly pensions and healthcare. I have no plans to reduce the deficit currently. I would remind you we paid off the debt incurred to finance WW1 slowly over 100 years. As many of you will know, most businesses rely on borrowed money to expand their capacity, and we are doing the same for our country.

A typical recession lasts two years, during which incomes fall and the recovery is slow because purchasing power has been reduced.



My current policy measures are limiting the degree of income reduction, and I have extended furlough until March next year to ensure here is no repetition of 2008-2010.

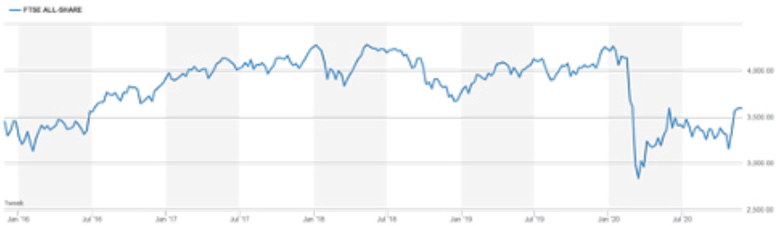
Further evidence shows households have significant cash balances which I believe will be spent when possible.

To summarise:
This is not a typical recession. The metrics are different. Wealth continues to increase, incomes have been largely maintained for the majority, most firms outside the hospitality, leisure, and travel sector are maintaining their capacity. The big, undifferentiated, chains in the high street were suffering before Covid and I accept there will be further decline, but I would consider this to be creative destruction.

I have injected nearly £400Bn into our economy since March, I expect to inject a further £150Bn next year. This is the biggest monetary stimulus on record. The level of unemployment always lags activity but so far we are at full employment, which is defined as 5% unemployed.

Other countries are doing the same thing in varying amounts but so far, the global stimulus is £17 trillion. This is the equivalent of eight UK economies appearing on earth. I expect a global boom beginning late summer 2021.

The FT all share index will recover steadily following a deal with the EU, and vaccine roll out



Households are saving a third of their income. This has never happened before. There is a lot of potential spending in our system.

HOUSEHOLDS' SAVING RATIO (%)

Current price £m: SA

65% of UK households hold their wealth in property. It continues to rise in value, unlike in 2008-9 when wealth fell by 15%. I expect this to continue. When property prices are rising, people splash the cash.

SINCE NOV 2017 UK HOUSE PRICE GROWTH HAS BEEN CONSISTENTLY BELOW 5%

Finally I will raise taxes when we can afford to pay them. Please ignore the inaccurate reporting of the UK media. But I am proud to be called the best socialist chancellor since Bevan, who you may remember created our NHS, launched at the Park Hospital in Manchester. Great things always begin well north of Watford. It was the Midlands and the North where the Industrial Revolution began, Manchester has always been a liberal city where anyone, regardless of colour race or creed is welcome, if they are prepared to work. This Government will do what it can to ensure our traditional wealth creating regions are reinvigorated as the UK forges its sovereign future.

Yours

RISHI SUNAK

FINALLY...

some forecasts for 2021 assuming a trade deal agreed with the EU in the next 4 weeks.

- Inflation will rise steadily to 4% base rate 0.5%
- Average house price up 5-7%
- Real GDP up 9%, nominal GPP i.e. actual spending up 13%
- Unemployment rising throughout the year due to automation, 6% by year end.
- Exchange Rate : £-$ 1.36 € 1.15
- UK FT All share index up 6%
- Significant increase in business failures in Q2 2021
- Leisure, travel, hospitality and events all fully operational by end Q3
- Global trade exceeds pre-covid level by year end
- Mixed working patterns fully accepted with less daily commuting volumes, repurposed city-centre offices (fewer desks; more meeting and social areas)
- City centre night life vibrant by year end.

RISKS

- No Deal Brexit
- National lockdown for a month in February
- Covid mutates, rendering vaccine ineffective (and all these forecasts will then be wrong!)
- Persistent supply chain shortages due to congestion at UK ports
- Skills shortages in rapid growth sectors e.g. infrastructure renewal, office re-purposing, AI, software design and test, care sector, logistics, and customs.

MONTHLY GDP INDEX

2018 - 1000

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Roger is a graduate of the University of Leicester. He has worked in the New Zealand Treasury, at the Bank of England and, for many years, was Client Director at Henley Management College where he worked with a wide range of businesses. He is a behavioural economist who believes that economic forecasting is an art, not a science and that it is crucial to estimate the nature, size and impact of 'animal spirits' when looking forwards. He believes that Government cannot control the economy; it can only influence the behaviour of economic agents. He was one of the few who forecast the depth of the recent recession based on his anticipation of the behaviour of the banking system. He thinks it is better to be broadly right than precisely wrong when forecasting the future!