JSA Consultancy Services

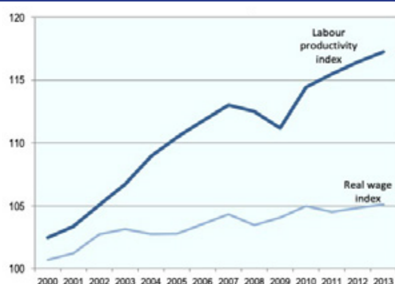
ECONOMIC UPDATE FEBRUARY 2022

Looking back over the past two Covid years, I'm struck by the pace of innovation, the resilience of individuals, the sheer volume of new money, and how quickly change happens on a burning platform.

From this year onwards, we should expect to enjoy a period of real growth above historic trend as the productivity gains come through the system. The dominant risk is a wage price spiral due to excess money.

Significant increases in wages are a good thing if justified by productivity gains. When there is a plentiful supply of labour, productivity gains are captured by the owners of a business. When labour supply is constrained, gains are rightly paid to those who created them.

Evolution of average wages and labour productivity in selected advanced G20 economies, 1999-2013



This chart is old but little has changed since 2000. It confirms my previous point, which is that since 2000, productivity gains have benefited the owners in the G20 more than the workers. However, since 2000, the demographic profile of most rich countries has changed. In 2000, the birth rate dropped significantly which is why today, in the UK, we have 1.8m fewer 15-25 year olds. And thanks to real estate price inflation, many over-55s are retiring early financed by downsizing. The UK labour market is the tightest for 50 years,, with unemployment at 4.1%.

Over the next few years, we should see the share of wages rising and profits falling in the major economies. This is an overall picture. Of course, well run individual firms should be able to grow returns for both owners and employees.

The media is full of commentary that higher taxes on business reduces investment, dampens entrepreneurship, and reduces GDP growth. The evidence doesn't support this. Firstly, the majority of start-ups do not happen because the entrepreneur wants to be rich. Secondly, if the rate of taxation reduces disposable income then the majority of people will increase their efforts to boost their after tax income. Thirdly, in most rich countries, investment spending is tax-deductable so taxable profits are quite small.

Tax on profits is 6.8% of UK Government revenue.

Back to the main point. Demographics will cause a shift in the share of national added value going to wages. This of course will ensure booming consumer demand (as most taxes and Government revenues are on income.)

This shift will be a further stimulus for automation and AI.

INFLATION AND HOW GOVERNMENTS SEEK TO CONTROL IT

Inflation is always a monetary phenomenon. It is too much money chasing limited resources, whether these be food, buildings, people, classic cars, super-yachts, oil, gas, or tickets to see the Rolling Stones!

Inflation will persist if there is sufficient growth in the supply of money to finance excess demand. Increases in interest rates are designed to reduce the supply of money. However, in pre-Covid times, money was created by commercial banks owned by shareholders. When interest rates rise, banks do their very best to

mitigate the impact on their business. They will increase their marketing effort, offer special deals, in short do anything to keep their sales (i.e. the money supply) growing.

An interest rate increase is only effective when bank customers decide they cannot afford to borrow regardless of the marketing effort. The question then becomes .....what rate of interest will cause this effect?

We don't know. But history tells us that using interest rates to control money supply growth is like pulling on a brick with an elastic band. There comes a point when suddenly the system stops dead in its tracks. My instinct is any base rate above 3% would cause a recession. The best guess currently is for base rates to be 1.5% by the end of 2022.

Interest rates are raised to reduce the demand for credit, bank loans and mortgages. The rate of growth in money consistent with a real growth rate of 2.5% and inflation at 1.5% is 4% a year. In the past two years excessive money growth is primarily due to the Government borrowing from its own bank. This stopped in December 2021. From now on monetary expansion will depend on commercial banks' willingness to lend and their customers to borrow. UK banks have significant lending capacity currently and are keen to lend. Now QE has ended, money supply growth will revert to normal i.e. 4-5% a year and inflation should return to around 2%. The question is when? Currently the consensus is by the end of this year, but I am less optimistic because of the wall of money which still exists in the global economy.

The charts show just how large it is for 60% of the global economy. This money will only leave the system if central banks begin selling their Government Bonds to the market and destroy the electronic money when it is transferred to them from the purchaser. Because this action is likely to push up long run interest rates, they will not undertake it.

Back to the wall of money. The cause of current global inflation rate is 20% due to supply shortages and 80% due to excess money. When A buys something from B, money changes hands but doesn't disappear. Inflation will only come down when the purchasing power of existing money is reduced by rising prices in all sectors.

The Global GDP is $100 trillion, the amount of excess money is $17 trillion. If there was a one year inflation rate at 17% then yes inflation is a blip. But if the rate hovers around 6% then we are looking at 3 years of inflation at this level. And this, for me, is the most likely outcome.

Looking ahead, it is likely we will see the price of goods and energy stabilise. Productivity gains in manufacturing are quickly reflected in the selling price of goods. But 80% of the added value in rich countries is from services. And productivity gains are elusive in person-to-person transactions. The deteriorating demographic profile of 52 countries on the planet will surely impact wage growth in health care, financial and legal services, consultancy, government services, hospitality, and so on. These are the sectors which will ensure inflation is higher than normal. The wage-price spiral will begin and flourish in the service sector.

Taking all these factors into consideration the forecast for this year, assuming no more lockdowns, is as follows.

Real GDP +3.5% Nominal GDP +9.5%

Wage growth average +6%

Inflation Rate average for the year +6%

Unemployment by year end 4%

Base rate +1.5% end of year

Average house price +6%

Exchange Rate $1.35 Euro 1.20

There will be an investment boom resulting in supply shortages throughout the year. The main driver of inflation by the end of the year will be the service sector.

The overall conclusion is that the inflationary boom will continue as the wall of money flows faster round the global system.

ENERGY PRICES

Energy supplies have been limited by the delay in planned maintenance on oil and gas rigs due to Covid, Nuclear shutdowns, Putin playing politics, the refusal by UK Government to invest in UK gas storage, low wind speeds, and surging demand for LPG (particularly from China). Additionally, OPEC members agreed only to increase supply slowly, to keep prices up.

Traditionally there is an inverse relationship between the price of oil and Global GDP growth, but not this time. The wall of global money enables consumers and businesses to survive much higher energy bills. For example, in 2021 the average UK household spent £1300 on home improvements. They still have circa £120Bn of excess savings. For the majority, higher energy bills does not mean less spending on other things. The 20% of households without savings and on fixed incomes will suffer, unless there is targeted taxpayer support.

The price of energy is an example of how markets respond to excess money and how the purchasing power of excess money is reduced over time. If money supply growth falls back to 4%-5% in the big economies, then the wage-price spiral will only last a couple of years.

THE GLOBAL OUTLOOK

Global trade was up nearly 6% in 2021; this year we can expect 5%. Consumer demand is strong in the main regions and will remain so. China is still suffering from city lockdowns which limit supply.

UK Money Supply Growth Year on Year

A LOOK AT THE UK IN DETAIL

The Bank of England moves interest rates to deliver a growth in the red line of around 4-5% per month. This is enough to finance up to 3% real growth and 2% inflation. There is a time lag between changes in the interest rate and the change in money supply. So the MPC try and guess inflation two years out. If their guess is that inflation will rise, they raise rates, then slowly the growth in bank lending (which is the black line) reduces and in simple terms there is less spending in the economy, making businesses reluctant to raise prices, pay higher wages or increase volume.

It is not possible to reduce inflation without reducing growth. Governments tried to do this using price and wage controls in the seventies. It doesn't work. The recession of 1979-82 was the result of much higher-than-expected interest rates as the Thatcher Government tried to reduce inflation. It eventually succeeded but at a cost of 3 million job losses.

To reiterate, the current growth in money supply is not because commercial banks are creating too much of it, rather it is QE money creation by the B of E. This stopped last month so as I write this the red line should be running at around 2%.If this is the case then there is no reason to raise interest rates unless the committee believes house price inflation is excessive.

The issue for the committee is this: there is every chance there will be a wage-price spiral as employers compete for scarce labour. We are short of three million people.

To stop this, a sharp slow-down or even a recession is required. This can be achieved by getting the red line down to near zero. And an interest rate of at least 3%.

What will the committee do? They will wait and see and hope increasing inflation erodes purchasing power and business optimism thereby reducing the number of vacancies.

Any increase in interest rates this year will not dampen the housing market. Only 20% of mortgages are floating and the majority of the holders have considerable cash reserves. Also the B of E is likely to approve extending the earnings multiple to 5 times earnings . In addition there is a flood of US money, as well as Lloyds Bank, looking for buy-to-let assets.

USA Excess Money

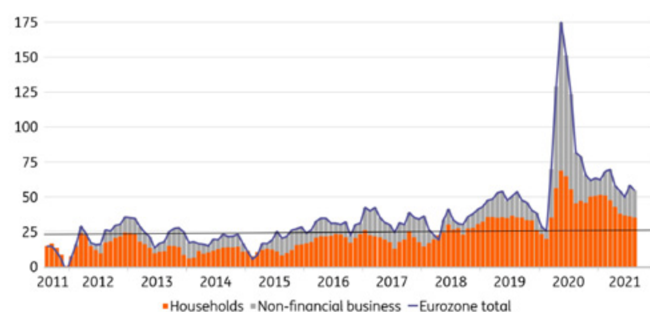
A LOOK AT THE USA

The USA money supply growth rate should drop back to around 5% in March when the Fed stops buying bonds (QE). Meanwhile the bulge in money is financing 7% inflation and creating labour shortages. The Fed say they will raise rates four times this year. I assume they know this will take two years to have any significant effect on inflation.

THE EU

The situation in the EU is the same as UK and USA, but with one difference – the ECB are maintaining their stimulus until the end of the year. So we should expect no change in Euro interest rates, and a weaker currency. Wage inflation is likely to be lower in the Southern EU because the average level of unemployment is 8%.

EUROZONE EXCESS MONEY

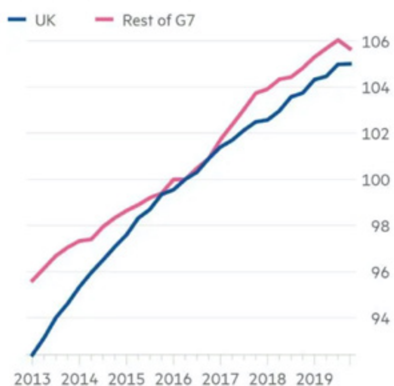


We now have data to show the expected economic consequence of the referendum.

The G7 countries are Canada, France, Germany, Italy, Japan, the UK and the US. The referendum and the subsequent uncertainty caused UK investment to be held back. The good news is survey data indicates a planned surge in investment spending this year. But the timing is problematical with shortages of people and materials. The only thing we are not short of is willing investors.

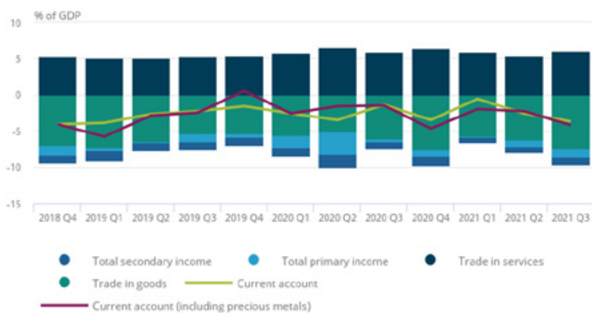
The forecasts for real GDP growth at 5% are I think too optimistic. Total money spending will be up by 10%, but inflation at around 6.5% will take real growth to 3.5%.

UK GROWTH V G7 COUNTRIES



As yet Global Britain is not improving our trading account with the rest of the World. It's early days but the challenge of offsetting our lost sales to the EU from the rest of the World is considerable. We improved our net surplus on services, but the net deficit on goods was bigger. As usual, we are relying on overseas investors who buy UK property and companies to finance our trading deficit.

The UK's current account balance widened in Quarter 3 2021 as the defecit on trade, investment income and secondary income increased

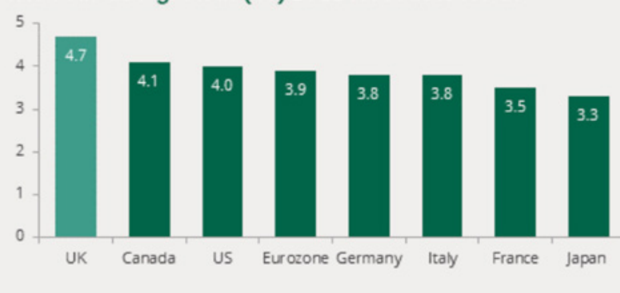


Source: Office for National Statistics – Balance of payments

G7 real GDP % change compared to pre-pandemic level

Q3 2021 compared with Q4 2019

IMF real GDP growth (%) 2022 forecasts for G7



We are repeatedly told that the UK is growing faster than our neighbours. This is untrue.

It is true that the IMF forecast we may grow faster than G7 in 2022.

CONCLUSIONS

Thanks to excess money, the wealth of owners of equities and houses has risen by 10% in the rich countries. This is reducing the supply of labour as it enables early retirement. Additionally, the collapse in the birth rate in 2000 has created a shortage of youngsters.

Excess money in the World is $17 Trillion. This is chasing scarce resources; hence we have a global boom, with inflation.

Small increases in interest rates this year will make little difference to demand. Significant increases in energy prices will be financed by accumulated savings enjoyed by 80% of the population. The other 20% will suffer, some badly.

The real cost of debt will fall as inflation runs ahead of interest rates.

The inflation rate will moderate in 2023 because QE will have ended everywhere, and the purchasing power of existing money will have been eroded. But it will still be at least double the 2% target.

The inflationary boom will continue this year and into next, particularly in the UK due to an expected surge in investment spending by business and Government.\

A wage price spiral is looking more likely as the service sector enters full recovery mode and competes for scarce people.

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30 January 2022

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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!

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