JSA Consultancy Services

ECONOMIC UPDATE OCTOBER 2021

My regular readers will remember that I was adamant we should expect significant labour supply issues once lockdowns ended. And this is where we are today. The blame game is in full swing with Brexit the often-quoted culprit, but it's more complicated than that. My objective is to think through the likely pattern of events we can expect over the next 18 months.

But, as always, we must begin with recent history...

THE MONEY TREE

Before Covid hit the World, Western Governments had finally realised that the mediocre, or non-existent productivity growth of major economies since 2008, was partly due to austerity measures, especially the collapse in public sector investment.

The private sector needs an efficient and effective base from which to operate with power, water, sewage disposal, telecoms, space, port facilities, a supply of labour with the necessary basic skills, and an effective diplomatic core to facilitate global trade and influence.

Many countries such as the USA, Germany, India and the UK have significantly under-invested in their domestic infrastructure. The countries which did invest, such as Singapore, China, UAE and Sweden, performed better. In 2019, the UK announced £100Bn of capital spend, each year for five years, to be financed by issuing of gilts purchased by local and international pension funds. If higher growth results, the arithmetic is straightforward: nominal GDP will rise faster than the cost of borrowing providing a net gain. Investment spending boosts nominal GDP. It is Modern Monetary Theory in action. If, for whatever reason, the pension funds are reluctant to buy the gilts at an acceptable yield, the Bank of England steps in and buys.

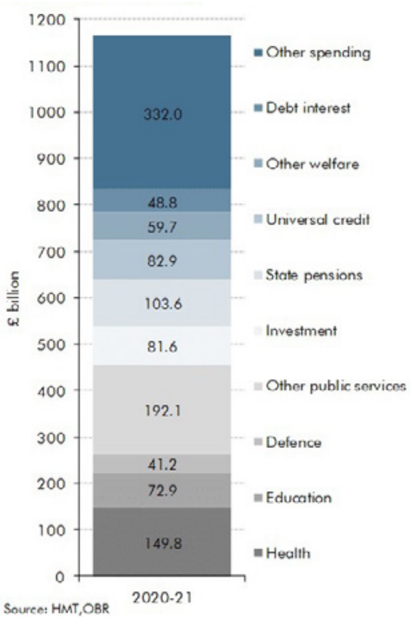
Before Covid, borrowing for capital spending was considered sound, but borrowing to finance social spending such as pensions, was considered irresponsible.

Then Covid hit and, for 18 months, the view changed. Spend whatever it takes to find a vaccine, prevent death, and maintain productive capacity in lockdowns. The result has been a massive increase in global money supply, and a much smaller increase in the volume of goods and services. As markets work to balance supply and demand, the inevitable consequence will be price increases across the board. My view is that the $19 trillion of new money created by central banks has created excess demand. There is no way supply can rise fast enough to match this, so inflation is not a blip, but will remain in the system until purchasing power is eroded and demand slows to match rising supply; this will take another two years.

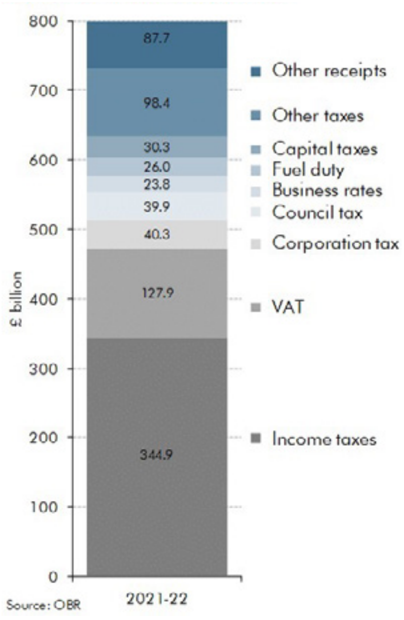
In the UK, the Government has begun to revert to raising tax to fund social spending. National Insurance will rise from next April. This tax redistributes income from the healthy to the sick and elderly. It does not change the amount of money in the system. But if private companies notice their sales are falling below budget and they then take steps to reduce their outgoings, we will have the beginnings of a recession. This is why some are forecasting a sharp slowdown, or even a recession.

They are unduly pessimistic. The excess money in our system is £300Bn. The NIC increase will take £13Bn a year from employers and employees. It will, however, remain in the system unless social spending is reduced by the same amount - i.e. 13Bn - AND the Bank of England sells 13Bn of its bond holding to the market AND then writes £13Bn out of its balance sheet, thus destroying some of the £400Bn it created beginning in April 2020. There are no signs it will do this.

Public sector spending



Sources of public sector receipts



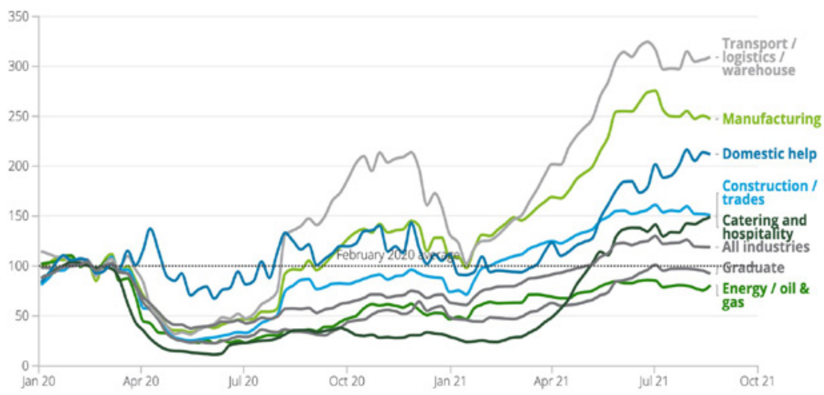
In summary, tax increases used to increase Government spending do not reduce the total amount of money in the system; they redistribute it. This year, the Government will pay out £103.6 Bn to pensioners.

DEMOGRAPHICS

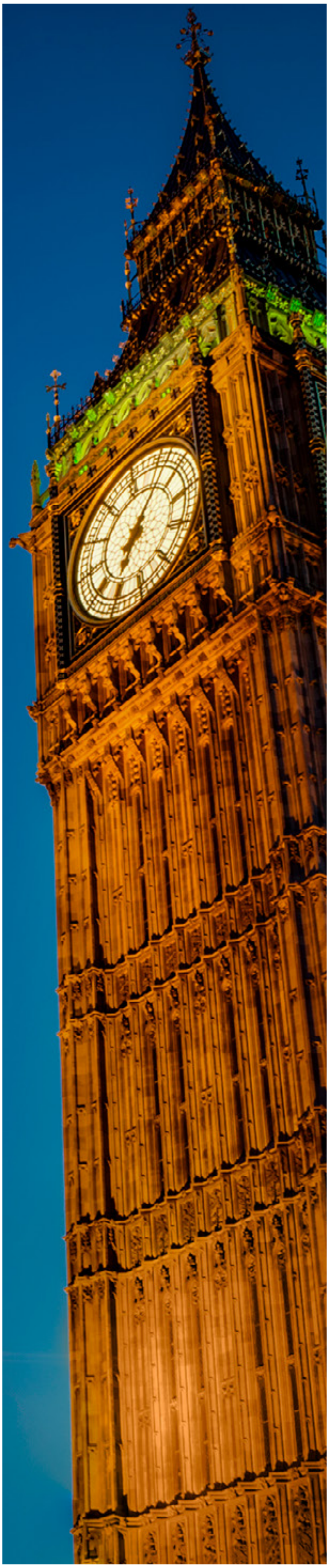
We now know the UK Government believes that allowing EU workers into the UK since 2005 has depressed wages to the extent that nearly 3 million people in work are also claiming Universal Credit. Although unstated, they are hoping that wages will rise sufficiently to remove the remaining 3 million from the benefits register. They also believe that persistent labour shortages will drive innovation when the wage bill becomes prohibitive.

A look at the type of jobs where there are high levels of vacancies raises some question marks. We are some way off from self-driving trucks and vans (although Ocado is expecting to have driverless electric delivery vans within 2 years). There are robot hoovers and lawn movers but most gardening jobs from my experience will probably still require humans. In warehousing, there is significant innovation, and fully automated warehouses are nearly with us. In manufacturing there is a lot of scope, and many manufacturers are innovating. The construction industry is still fairly traditional, and our housing stock is old. There is plenty of automation in prefabricated building, but I suspect re-pointing a 1880 chimney will always require a human. In hospitality, there are opportunities, particularly for self-service. If wages rise sufficiently, a meal out with human table service may well become a luxury.

Online adverts by job type



Sources: ONS, Adzuna

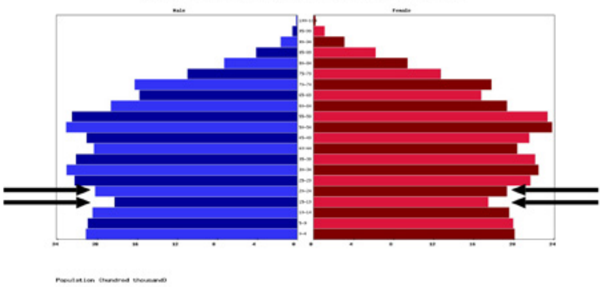


BUT LOOK AT THE CHART BELOW:

We are short of 1.2 million 15–19-year-olds, and 600,000 20–24-year-olds. This partly explains £100K starting salaries for newly qualified solicitors with big six firms in London. Those who state the labour shortage has little to do with Brexit are deluded. Professor Portes, the renowned Professor of Economics and Public Policy, estimates 1.3 million EU workers, many of them in their early twenties, have left the country since Brexit. It is clear why businesses are short of suitable workers.

There will be significant wage inflation as companies poach from each other. The 3 million in work but claiming UC will earn more. Will the remaining 3 million claimants join the work force? This is doubtful. Of these 3 million, 1.7 million are presumed to be actively looking for work. Arithmetically this matches the demographic shortfall but in practice, it will be a question of skills, attitude and location. So a good match is unlikely. This is why we say 5% unemployment equates to full employment.

Notice the shortage of 15-24 year olds



The chart also shows us why the demand for family homes has been strong, but will fall away from 2028. And the demand for I bedroom flats from 2025 will weaken.

It's clear that wages will rise faster than normal in the private sector. The Government limits rises in the public sector and will, quite rightly, be excoriated for this. There will be an exodus from public to private sector by the more talented. Apparently if it's a hard winter, the roads will not be gritted because there has been exodus of HGV drivers to the private sector.

Wage growth in excess of productivity will lock in inflation. Productivity gains will prove elusive, particularly in social care and activities where person-to-person interaction cannot be substituted. It's worth noting that by 2028, there will be a million more 85 year olds.

THE MONEY SUPPLY

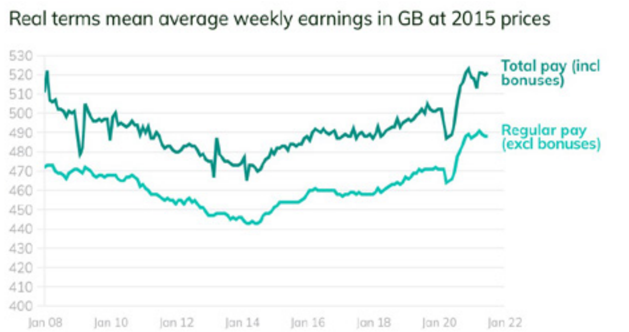
Please take a look at the chart below. When there is no QE by the Bank of England, the black and red lines move almost in tandem. This is because the black line - commercial bank lending - creates new money out of thin air which then appears in the red line. The red line can only be above the black line if either foreigners decide to buy Sterling and hold it in a London account (possibly because they are laundering) and/or the Bank of England is creating money.

Typically, UK money supply grows by £100Bn a year. Changes in the rates of interest are designed to control its rate of growth. In the last 18 months, it has grown by £400Bn, the £300Bn excess growth has come from the Bank of England operating QE. There is £300Bn sloshing around our system. It can only leave our system if either it is spent overseas, if commercial banks call in loans, or if the Bank of England unwinds its bond holding. If the last, then the long-run rate of interest will rise from the current 1% to closer to 3%, and the mortgage rate will soon follow.

There is enough money in our system to finance a 5% inflation rate. Indeed, currently earnings are growing close to 5% but productivity by 1%. Last year output per worker fell 10% but wages didn't. We have an inflationary gap. This gap could be filled by big increases in output – unlikely - or price inflation which is what the UK and the rest of the World are experiencing. In short, inflation is the process by which excess money is absorbed.

Paying people wages for no output is inherently inflationary. Furlough has been hugely successful in maintaining capacity but there has been no increase in capacity.

Wages finally back at pre-recession peak



Source: Office for National Statistics, EARN01: Average weekly earnings • Data represents mean average weekly earnings for employees in Great Britain only. Earnings are adjusted by the CPIH measure of inflation.

THE PRODUCTIVITY ISSUE

The UK has a record of poor productivity when compared to our neighbours. Total productivity is the same as France but output per hour of work is about 15% lower. There are many arguments as to why this is the case. The favoured one is that much higher minimum wages in France drive higher levels of automation.

My opinion is that the difference is principally one of culture and that the rise of home working will improve our relative performance. In the UK, on arriving at work, there is an expectation that one chats about the football, the rugby, the appalling traffic etc. usually with the first coffee of the day. This wastes 15 minutes......and then, in an office environment, people leave their desks regularly for a chat with others. I have not witnessed the same behaviour in France or Germany where at 5 pm, offices are empty, Not so in the UK where people stay late to catch up on the work they should have been doing instead of chatting!

However, we must look at other issues. There is a long tail of small businesses best described as lifestyle businesses, where labour resource could be more effectively deployed, but by choice is not. Over the next few years, it is likely many of these will fail, releasing much needed resources for others to employ.

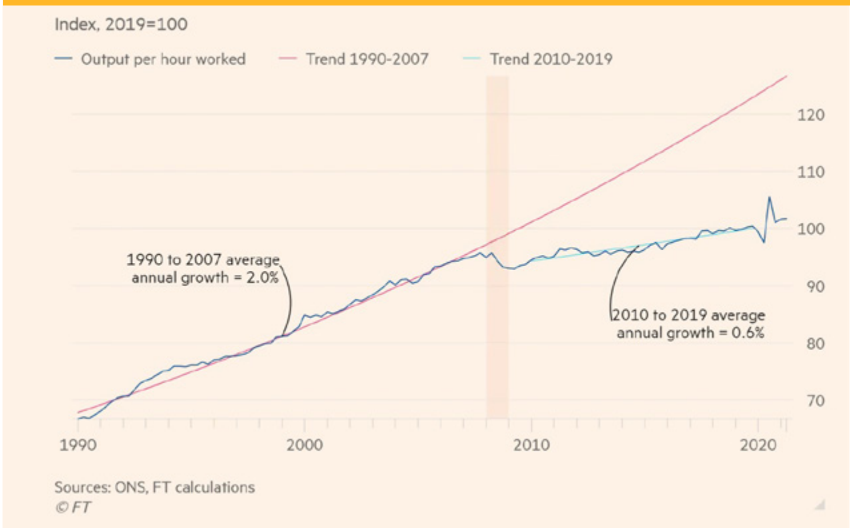
There is also the fact that, from 2008, there has been more uncertainty than previously. Banks were calling in loans and were reluctant to lend; then the Brexit debacle, and now Covid. All three have clearly damaged confidence and the willingness to invest in productive capacity (but not property!) despite record low interest rates.

money, but not reduce the amount of QE.

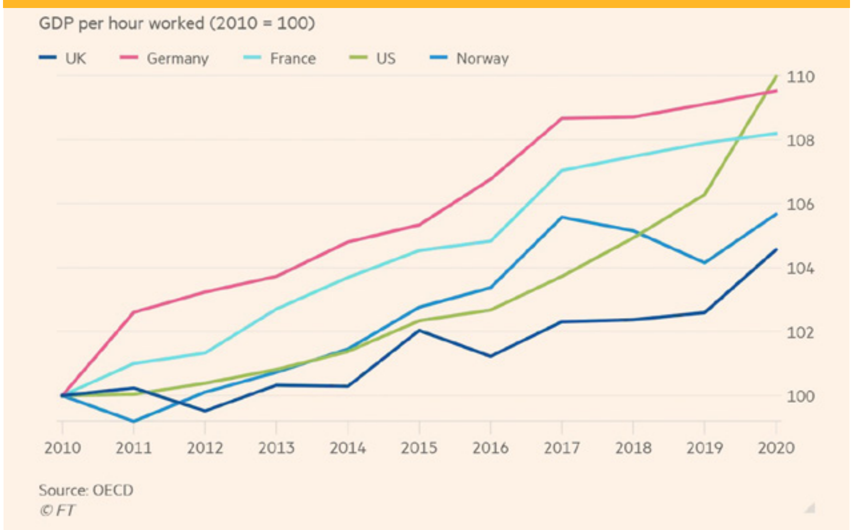
Consequently, a period of inflationary growth is the likely outcome. Stagflation, slumpflation or a recession are all unlikely.

The 80/20 rule will apply to households. The bottom 20% will suffer; their real income will fall due to the loss of the £20 a week UC supplement. And their food bills will be rising by 10%; energy by 30%. The remaining 80% of households - other than those of public sector employees - will enjoy wage awards at least in line with inflation and they will cover their energy and food bills from excess savings (there is £170Bn sitting in households accounts).

UK productivity has grown much more slowly since the financial crisis



UK productivity has lagged that of its peers over the last decade



THE NEXT 18 MONTHS

I reckon central banks will tolerate above-target inflation for the next 18 months and therefore, although interest rates will rise, they will be kept below the level required. Central banks will cease creating new

They will keep spending. The lowest 20% of earners spend 20% of their income on food and energy. For the rest, the % steadily drops. Half of UK earners spend 10% or less of their income on food and energy.

Government will boast falling deficits as tax receipts rise strongly.

The real growth rate of the major economies will revert to trend when they reach pre-Covid levels of output in the next six months. There will be shortages of certain products, exacerbated by media-driven buying frenzies.

There is the issue of the oil price. It's currently at $80. Under normal circumstances, I would begin to worry that this would soften growth. If it stays around $80 then we needn't worry about growth. Why? The price increases will be passed on, and some of the excess money will be absorbed. Consumers will pay more, but not buy less. If we see more than $100 and the price stays there, then all bets are off.

FURTHER AHEAD

Looking ahead to 2022 I expect the following for the UK - assuming no lockdowns!

- Nominal GDP (i.e. spending) up 8%
- Inflation 5%
- Real growth 3%
- Wage growth 6%
- Interest rate 0.75%
- But long-run rate 1.8%
- Exchange rate 1.18 euro, 1.37 dollar
- Oil price $85

THE REST OF THE WORLD

It's clear to me that most of the price pressure in the World is due to excess demand. The USA illustrates this best. The chart shows the actual spend on consumer durables. Pre-Covid, the spend was $1.5Trn. After the Biden stimulus, it rose to a peak of $2.150Trn. I very much doubt if any durables manufacturer predicted this surge and therefore, of course there is insufficient supply. Latest GDP data indicates the USA growing at 12.3%. Trend growth since 1950 is 3%. The $4Trn of new money is flooding through the USA and driving up global prices. It is estimated that 50% of US money supply flows abroad via imports of goods and services and exports of capital.

THE EU

The EU has recovered more quickly than I, or anyone else, expected. Real GDP will exceed pre-Covid level by the end of this year. This chart shows the change in shop visitor numbers. You will see the UK is the lowest. This is because we use on-line shopping for 30% of our purchases; in the EU it's 15%.

CHINA

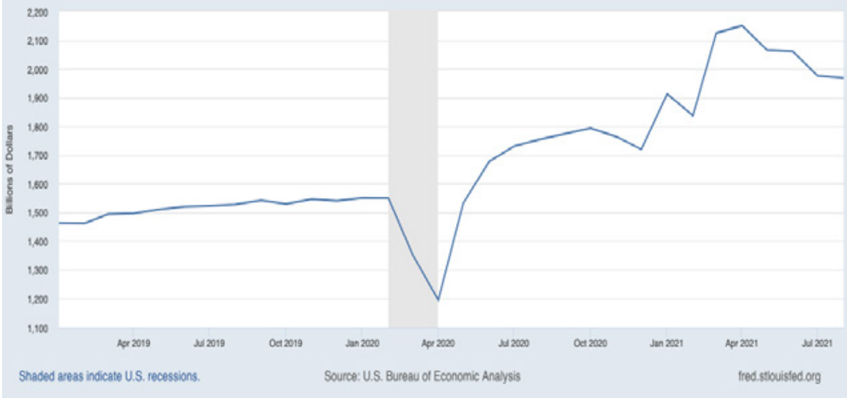
I use energy consumption data to assess China's growth. Its GDP Q2 grew by 9% on this basis. But Q3 and Q4 growth will be significantly less because of electricity rationing. And shortages of a wide range of products will persist.

GLOBAL GROWTH

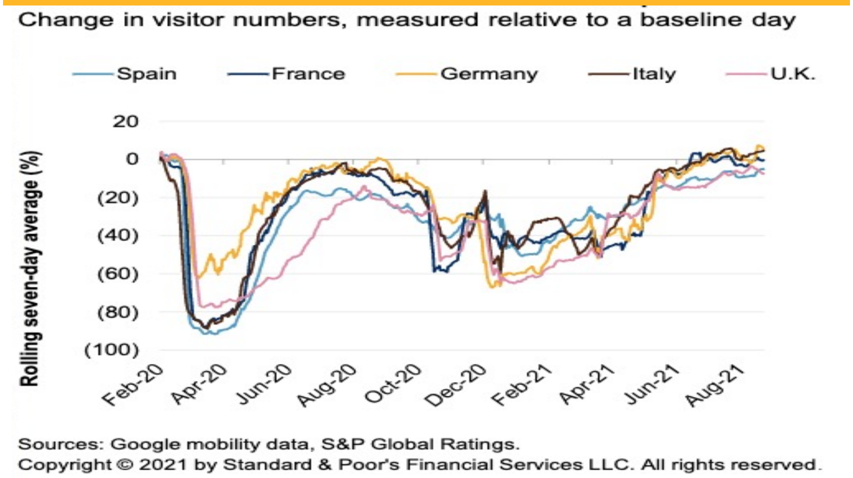
If the forecasts shown in the chart are accurate - or even close - we should expect shortages throughout 2022. And with that will come higher than forecast global inflation rates. I repeat, individual market prices are mopping up the excess money supply present in the global system.

Perhaps a better illustration is the current price of US equities: 30% higher than pre-Covid. Private equity has $2.5 trillion looking for deals; they are currently paying 45% above the market for companies they want to buy. The number of UK buyouts is 60% above the same period in 2019. The loads of money of the late 1980's is back - with a vengeance. It is worth noting that in 1989 the UK inflation was just under 10%!

Personal consumption expenditures: Durable goods



The recovery in Retail and Recreation suggests consumers are now more confident to return to the shops



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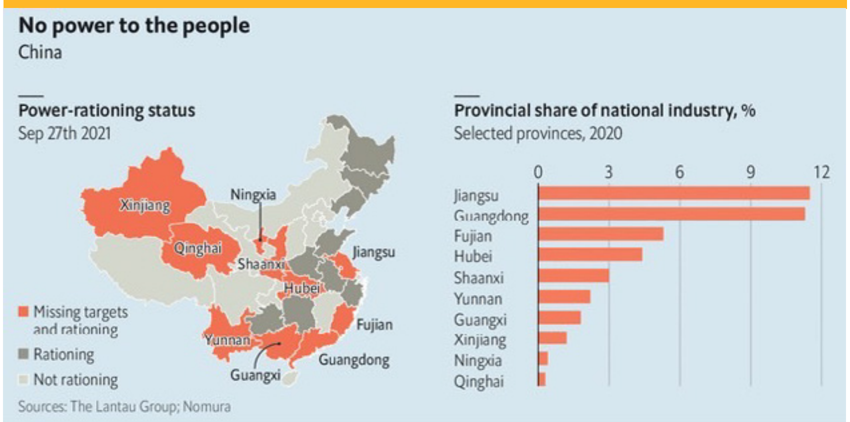
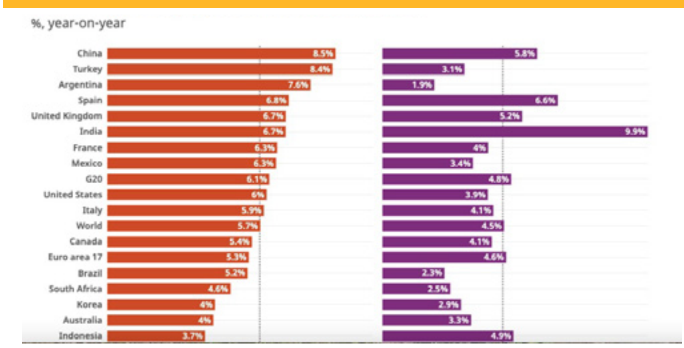


The Economist

Real GDP growth projections for 2021 and 2022



CONCLUSION

UK demography shows us why there are labour supply problems. These will persist. Global supply issues are primarily due to the post-lockdown recovery being much stronger than the mainstream forecasters expected - but as regular readers will know, we fully expected it!.

The current levels of inflation are not a blip, although Government and central banks wish us to believe it is. They will be too slow to reduce the quantity of money they have created. Commercial bank money creation is not excessive; the problem is with central banks. Perversely, increases in base rates will increase the cost of working capital for business, but it will not reduce the level of commercial bank lending.

Scare stories of slumpflation or recession are wide of the mark and best ignored. We will experience inflationary growth. But the Press will be full of business failure horror stories. Remember that business failures always increase with economic recovery, primarily due to over-trading. And the banks know they invariably get their money back, so they play hard ball.

There are many of you who kept your staff on, increased training in the slack periods, innovated, and believed in the upside. You should be beginning to reap the benefits now.

Finally, we now know the Government's strategy: to encourage productivity growth through wage inflation; borrow 100Bn a year for infrastructure; ensure house prices continue to rise, and berate business for not adapting quickly enough. So, if everything goes wrong, it will be the fault of UK business.

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Prepared 22 October 2021

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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!