JSA Consultancy Services

ECONOMIC UPDATE OCTOBER 2022

It is early days for the Truss Government. But we need to understand what she and the new Chancellor mean when they say they wish to change UK Treasury orthodoxy.

This is my attempt to explain.

Regrettably the EU looms large in this. In 1992 the Maastricht Treaty agreed some broad parameters for the fiscal policy of EU member states. This was both to create a level playing field and as a prerequisite for a single currency to work effectively.

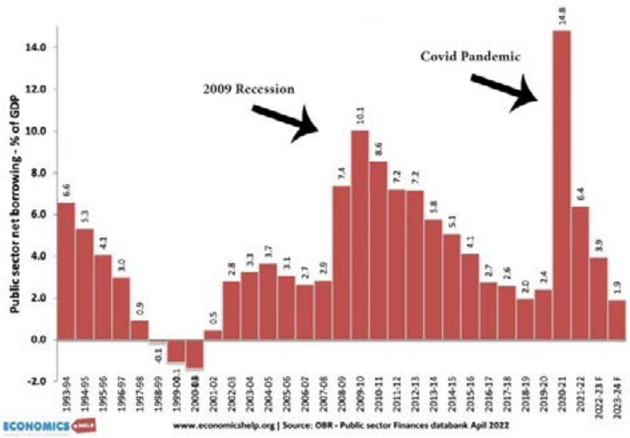
It was agreed that, barring exceptional circumstances such as war or a pandemic, Governments should borrow no more than 3% of GDP and aim not to exceed a National Debt target of 60%.

As the graph shows this target was met on average until the 2008 crash.

It required taxation receipts to rise broadly in line with Government spending.

The next chart shows national debt as a percentage of GDP.

UK ANNUAL NET BORROWING % OF GDP



Regardless of political persuasion, UK Governments met the targets until the exceptional events of 2008.

Treasury orthodoxy was followed in the last Sunak budget which showed current deficits below 3% and a steady reduction in National Debt.

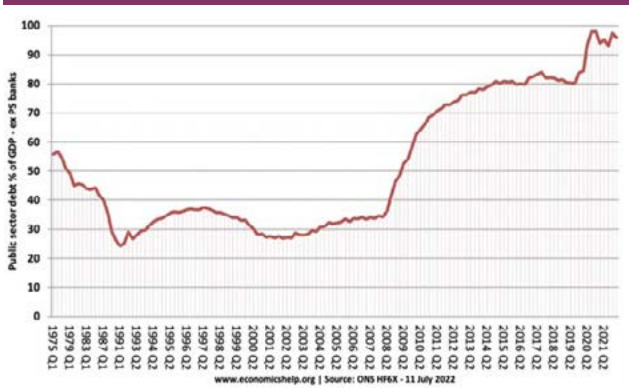
The Truss administration believe that this will keep actual economic growth below potential growth. They say potential has been growing at the long run average of 2.5%.

The plan is to use around £70bn of tax receipts to cut corporation tax and NIC which would otherwise have been used to reduce some of the debt.. .

But the energy crisis has deepened and so an additional plan is to subsidise business and consumers with around £100Bn over the next two years.

I assume the Permanent Secretary to the Treasury was sacked because he challenged Kwasi's intentions. He would have pointed out that longer term interest rates would rise and the pound weaken. He would have challenged the argument that low tax = higher investment and productivity growth.

UK NATIONAL DEBT % OF GDP



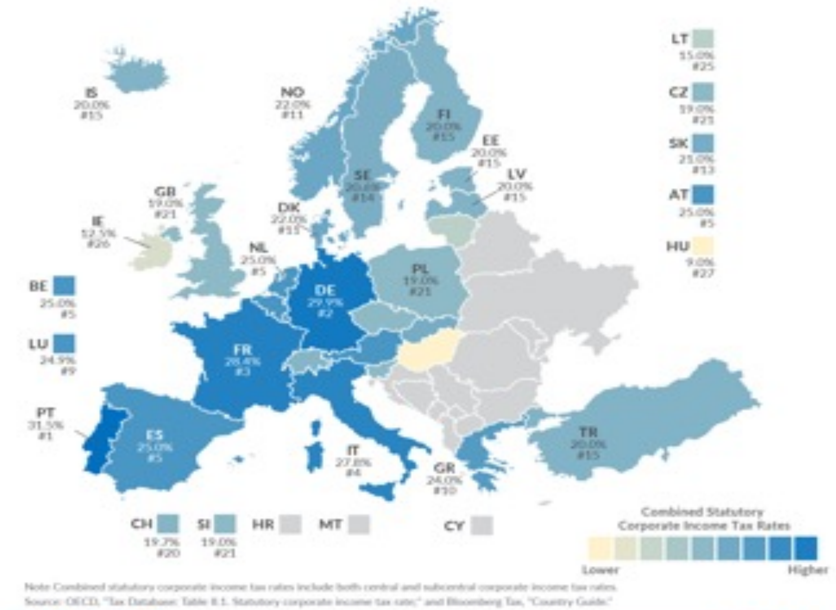
The Treasury would have pointed out that the interest bill on existing debt is currently £94Bn and because a third of the debt is inflation linked, it's continuing to increase.

The impression I have is the new administration believes that tax cuts financed by borrowing will boost growth which will ensure the cuts are self-funding within two years.

If the economy has spare productive capacity, this virtuous circle does work, as sales and incomes expand. BUT currently, the UK has no spare capacity, no available labour supply, and poor productivity due to a collapse in investment since 2016.

The idea that lower corporation tax would boost SME growth and investment spending is wrong.

CORPORATE INCOME TAX RATES IN EUROPE
Combined Statutory Corporate Income Tax Rates in European OECD Countries, 2022



All the entrepreneurs I know see tax as a cost of doing business; they know there is a range of deductions such as R&D spend and plant and equipment. I understand that the limiting factor in their growth is not their tax bill, but the lack of labour.

UK PRODUCTIVITY WILL REMAIN POOR UNTIL INVESTMENT PICKS UP
UNDERINVESTMENT HAS TRASHED OUR PRODUCTIVE CAPACITY!

Reductions in CT will make no difference to investment . In fact Germany has a much higher CT tax rate and spends 24% of GDP on investment, compared to our 17%.

It is my opinion that Kwasi is only attracting multinationals to have their tax domiciles in London. This would be good for London-based lawyers and tax accountants. And it artificially boosts GNP, but has a very small effect on GDP. As the Irish Government will tell us, their GNP is 25% larger than their GDP. It has no impact on jobs or incomes outside Shannon and Dublin.

In the interest of balance, more multinationals in London would indeed boost capital inflows (until dividends are paid), and this will help fund our yawning current account deficit. I would point out to Kwasi, however, that 65% of our GDP is produced by SMEs.

These SMEs, as mentioned above, need labour supply and consistent joined-up Government which they have not enjoyed since 2016.

SO, CONCLUSIONS THUS FAR:
The Energy support package is timely and a necessity. It will prevent a deep recession. Any tax cuts will ensure demand is boosted (a bit). Taken together, any recession next year should be short-lived and mild, unless our major trading partners, the USA and the EU, experience a much deeper downturn – as 25% of our income is derived from trade with them, we would not be immune.

The Bank of England is supposedly independent, despite being owned by the Treasury. They have an inflationary target of 2% and are charged with delivering plus or minus 1% on this target. Their main policy tool is the base rate. Exceptionally, their overdraft facility (QE) can be used by the Government.

Our current inflation rate is primarily caused by Global QE amounting to $17 Tn, plus the weakness of sterling against the dollar and wage growth in excess of productivity, due to labour shortages.

IF the Truss plan is implemented in full, and assuming no QE, the capital market will be asked to buy around £70Bn of new Gilts, plus the £80Bn the Bank wants to sell from their stock of QE. This will give the market indigestion and would require higher yields.

The long run interest rate would need to increase from the current 3.2% to close to 5%.

TEN YEAR GILT YIELD

This would push the price of fixed rate mortgages to 5% plus. 80% of UK mortgages are fixed, a third will be re-financed over the next two years. So clearly it will affect the cash position of some households.

Truss will want to have house prices at least stable in the run up to the election so we should expect more QE (to keep the gilt yield around 3%). But the forex markets will see that as a driver of inflation and mark sterling down.

$1.10 is possible.
(it was $1.04 this am but recovering)

A 10% drop in the value of sterling adds 1% to inflation. Sterling has dropped 14% against the dollar since February.

The pundits will scribble that a weak pound will boost exports. But it doesn't, because the majority of UK exports are price insensitive. However it does increase exporters' profit margins. And of course, it makes food and imported materials more expensive.

We can conclude that the Truss policy will result in inflation remaining elevated, house prices softer, but it may also prevent a recession.

UK HOUSE PRICES

Regular readers will know I have a poor view of media coverage of the housing market.

I think it is time to look at fundamentals again.

MYTH NO 1

Houses are so expensive only a few lucky people can afford them.

In fact the average house today is no more expensive than it was 2004 when adjusted for inflation. Look at the chart on the last page.

MYTH NO 2

In the long run, house prices in real terms grow faster than GDP.

They don't, they grow in line with GDP.

If the real price of the average house grows faster than GDP for a few years, it will be followed by a period where it grows less than real GDP.

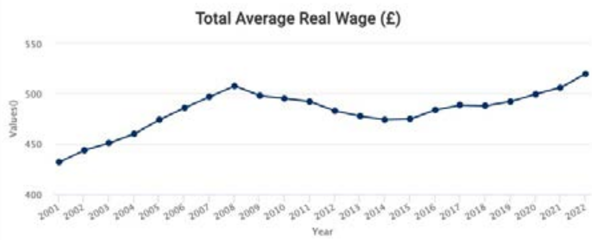
The big boom of 2002-2010 has been followed by negative real growth. The area under the trend line has not yet compensated for the area above the curve. Thus, over the next few years, the real price of a house will remain static, or even fall. This means house prices will rise, but only in line or a bit less than inflation.

MYTH NO 3

The next few years could see a repeat of 2008.

Real house prices crash when the banking system stops creating mortgages, as in 1990-96 and 2008-2012.

In both cases this happened because changes in regulation rendered banks insolvent. House price booms are caused by banks creating excess money.

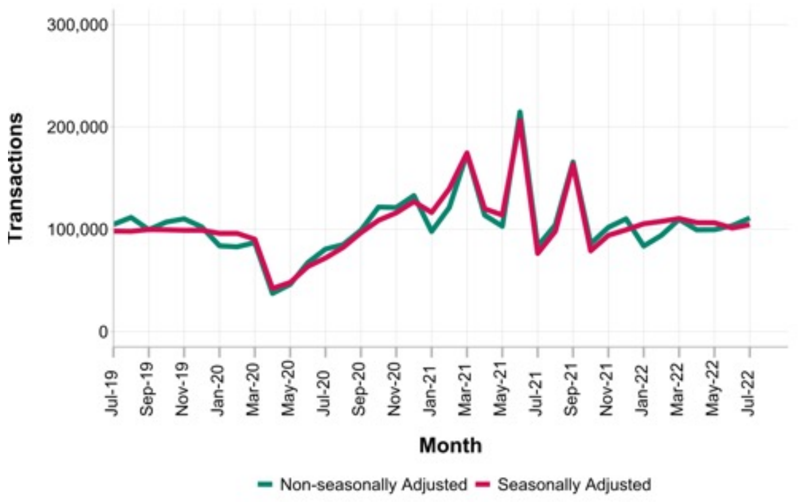


Now look at real wages.

In real terms, the average person has 5% more spending power than in 2004, and yet the real price of the average house is unchanged.

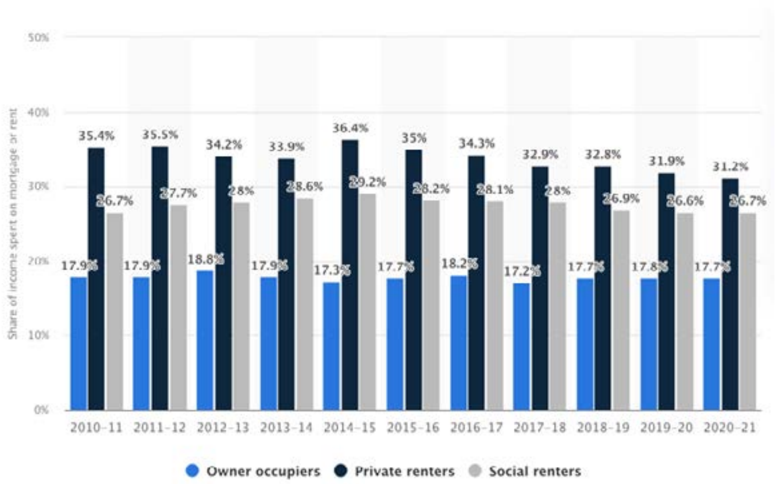
In August, the rules on mortgage lending were loosened. Banks have lots of lending capacity; they will lend. We are at over-full employment, even if a million people lose their jobs we will still be at the official definition of full employment.

WHAT IS GOING TO HAPPEN TO THE PROPERTY MARKET?
The market has reverted to normal. Transactions have stabilised at 100,000 a month.



There is no fundamental reason why this should change. It's possible that misleading media commentary could cause a reduction. But I doubt it because they have been consistently wrong in the past. And people factor this in when making decisions.

INTEREST RATES ARE RISING SO SURELY THIS WILL REDUCE DEMAND?
It seems to be forgotten that wages are rising faster than interest rates for the majority. Consequently, affordability is unchanged and is in line with the thirty-year average.



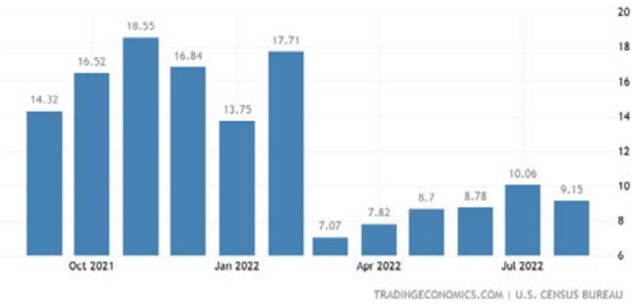
Now let's look at the performance of our biggest customers.

THE USA
USA money supply growth rate has dropped and is now at the pre-Covid rate growth rate of 6%. US inflation is currently 9%.

The USA has dramatically slowed from unsustainable rates of growth. It has run out of capacity with unemployment at 3.7%. The mortgage rate has moved to 6%. This will only affect new borrowers. There are no floating rate mortgages in the USA. House prices have stopped rising.

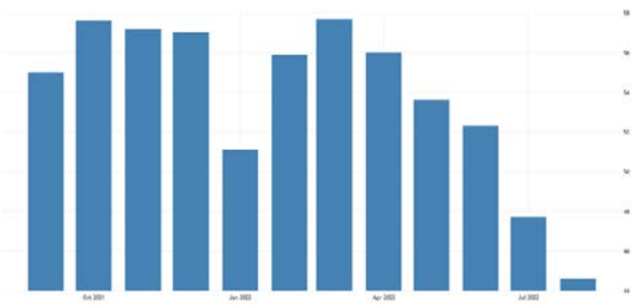
Retail sales, not adjusted for inflation, are growing at 9% so in volume terms, no growth. The chart shows the post lockdown surges which account for shortages of a wide range of goods.

US RETAIL SPENDING % CHANGE YOY



This index shows that the majority of US businesses are reducing their re-order rate. Unless this changes next year the US will be in recession.

COMPOSITE PMI



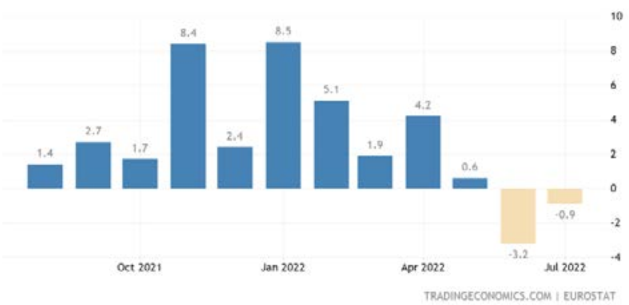
The USA is slowing down rapidly; if inflation falls below 6% they will avoid recession. Wage growth is steady at 5% yoy.

THE EU

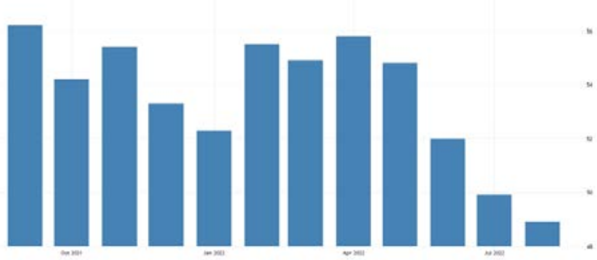
The EU has a voluntary target to reduce energy consumption by 15%. Germany is targeting 20% and has already reduced its consumption by simple means such as reducing the temperature of public buildings, shops closing early, pools no longer heated. BASF has a plant in SW Germany which consumes as much gas as Switzerland. If it is forced to close then Europe (inc. the UK) will run out of Ad-blue, Ibuprofen and insulation for new builds.

Money supply is now normal at 5.5% growth, inflation is at 9%, so just like the USA and the UK, if inflation drops to 5% within the next six months, recession will be just avoided.

EU RETAIL SALES YOY



COMPOSITE PMI



Just like the USA, companies are reducing their re-order rate.

CHINA

Chinese money supply is growing at 9% which is the pre-Covid rate. The zero tolerance of Covid is causing city shut-downs which kills demand and output simultaneously. The housing market is stagnating with prices falling.

Here are the top ten exports of China by value. We know Apple is shifting orders to Vietnam and other Western companies are trying to reduce their dependency on China. China is a major importer of energy and is not immune from the price hikes.

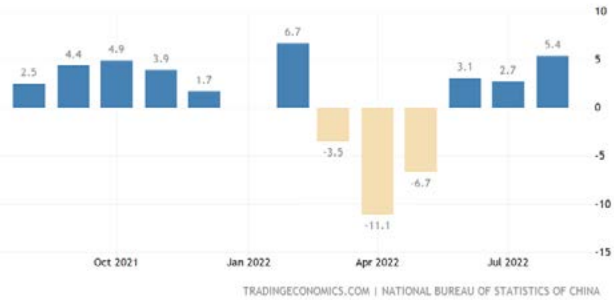
RANK	CHINA'S EXPORT PRODUCT	2021 VALUE (US$)	CHANGE
1	Phone devices including smartphones	$226,655,452,000	+1.5%
2	Computers, optical readers	$182,933,616,000	+7.5%
3	Integrated circuits/microassemblies	$139,816,344,000	+19.4%
4	Lamps, lighting, illuminated signs	$44,666,570,000	+18.7%
5	Solar power diodes/semi-conductors	$43,841,190,000	+22.9%
6	Models, puzzles, miscellaneous toys	$42,015,657,000	+25.5%
7	Automobile parts/accessories	$41,334,907,000	+25.5%
8	TV receivers/monitors/projectors	$36,155,162,000	+13.3%
9	Electrical converters/power units	$35,482,543,000	+18.3%
10	Miscellaneous furniture	$34,615,153,000	+12.5%

Retail in China is holding up well because wages are growing faster than inflation (which is officially under 3%). The yawning problem is a probable property crash. It's estimated that 70% of new build property has been sold to people who already have a house or flat. Xi is likely to prop up the market.

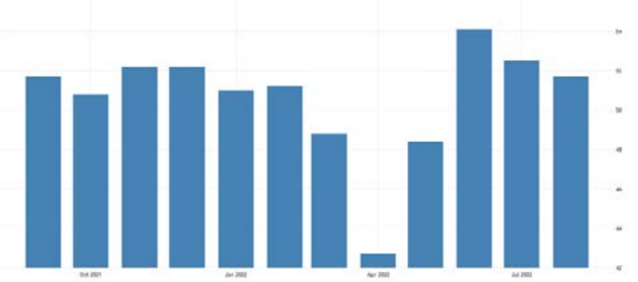
The Composite PMI indicates growing orders by businesses.

So taken together China will avoid a recession next year, but its growth rate will be lower than in recent past at around 4%.

RETAIL SALES IN CHINA



COMPOSITE PMI CHINA



THE UK BUDGET

As always the devil is in the detail, however the new approach is based on liberalisation, lower tax rates, and promoting the City as the place to operate financial services.

The higher rate of corporation tax which has been abolished was only relevant to the top 25% of businesses in the UK. It will attract more multinationals to have their HQs. in London. But makes no difference to the majority of SMEs. The increase in the investment allowance to £1 Mn is a useful change and should benefit some capital-intensive businesses. The 40 new investment zones will cause relocation but no overall increase in business investment.

The reduction in stamp duty will only boost selling prices for first time buyers in the SE and buy-to-let players. It might offset the inevitable rise in mortgage rates.

The budget appears to be a populist version of Modern Monetary Theory. This theory argues that it makes sense for Government to borrow, providing the new borrowing is spent on growth-enhancing investment, typically infrastructure and education. The theory shows that providing the subsequent growth is higher than the cost of borrowing, over time, the accumulated debt can be paid down. It's the same principal that any business owner would use to grow using other people's money.

It's been applied in China for thirty years with obvious success, in the main because of a huge supply of low productivity rural workers moving to the Cities and increasing their productivity. Think of the Industrial Revolution in the UK from 1780-1880 when the same thing happened.

The Kwarteng version assumes that lower taxes, less regulation and the push to attract overseas money will deliver growth in the same way.

This is the big gamble. I assume he has noticed there is no ready supply of labour. He also has the problem that an independent central bank charged with keeping inflation at 2% will surely push interest rates up reducing the return on the investment, at least in the short run.

Kwarteng is a big believer in the wisdom of the market, which is the accumulated knowledge of buyers and sellers ensures prices ensure efficient outcomes. It should be noted that Antony Barber in 1972, and Nigel Lawson in 1988 had a similar philosophy. Some of you will remember the outcomes. Currently the market has given the thumbs down. And this will cost us all.

There is no OBR assessment on the measures, it will be published at the end of the year. However I suspect it will forecast real growth next year at around 0.5%, so a recession will be avoided but the UK inflation rate will be around 6-7%. The big issue not covered by the Chancellor is what will happen to long-run interest rates.

The budget deficit will require a minimum £100Bn of new funding and the B of E is planning to sell £80Bn of gilts on top of

this. The market will look for lower prices for Gilts which will push up the long-run rate of interest and new fixed rate mortgages. The chart shows the ten year gilt yield. Real growth would have to be above 3.8% for the current policy to work as intended. Draw your own conclusions!

CONCLUSIONS

The inflation in all major economies (apart from China) is the inevitable consequence of excess money supply growth. Money supply growth is now back to pre-Covid levels. This growth rate is consistent with a 2% inflation rate and a 2-3% real growth rate for most rich countries. The UK may achieve 2% but not until 2024.

We are experiencing the transition from over-heating economies to normal levels. Transitions are never smooth and Putin has exacerbated the process.

I expect inflation to fall to 5% in the major economies by the middle of 2023. But not in the UK. Our rate will be 6 or 7% due to a weak currency and the budget stimulus. I expect the current labour shortage to persist.

The only advice I can give to business owners is focus on what you can control. Manage your debtors and explain that our economy was returning to normal, until the mini-budget which will effectively delay our transition. But that real incomes will continue to fall for another two years.

And, as always, really engage with those who make your business successful, your employees!

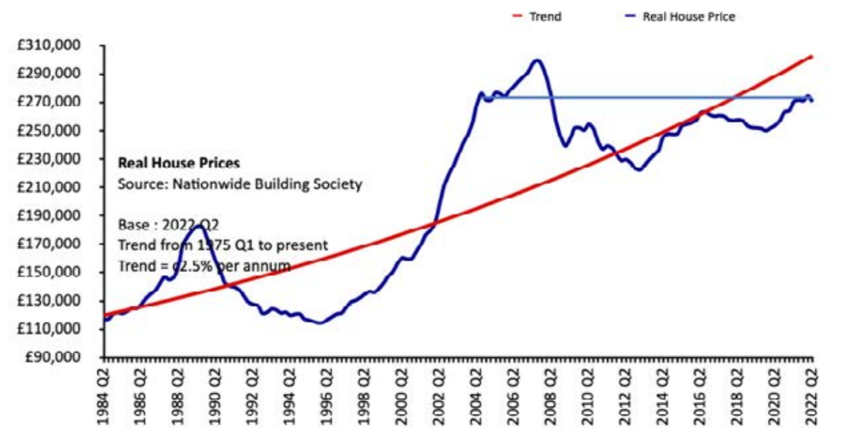
BEST GUESS FOR THE NEXT 12 MONTHS:

Inflation falling to 6-7%, wage growth 4%, real GDP growth 0.5%, £-$ 1.15, euro 1.18
House price growth average 3-5% Unemployment 4% Base rate 4.5%

Prepared September 23 2022

UK REAL HOUSE PRICES

The graph below shows that the media message on house prices is misleading.
The real price of the average house is the same as 2003.



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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!