

Economic Update

December 2017

Making sense of our current economic landscape with
Vistage Economist **Roger Martin-Fagg**





As I write this the reality of the referendum decision is beginning to take shape. And it is regrettably as was forecast by us, the much maligned 'experts'!

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Economic Update December 2017

As I write this the reality of the referendum decision is beginning to take shape. And it is regrettably as was forecast by us, the much maligned 'experts'!

The headline is that for the next five years the UK's trend growth rate is downgraded from 2.3% to 1.5%. This is significant.

The trend growth rate is best described as the steady state speed limit. The economy can run above it for a period of time during a boom but the longer it runs above trend (a booming economy), the longer it then has to run below it (a recession or slow growth).

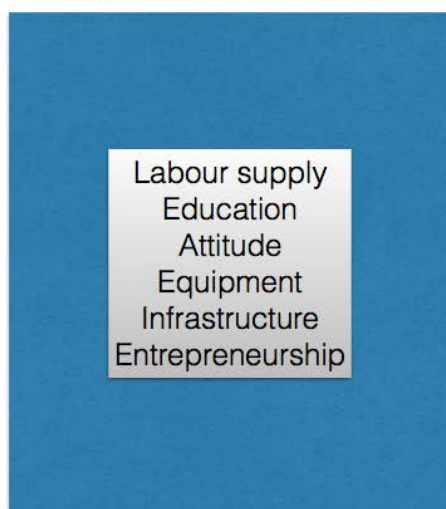
The forecast begins by estimating the size of the 'output gap' between the economy's current level of activity (as estimated by the ONS) and the 'potential' level consistent with stable inflation in the long term. A negative output gap is associated with lower rates of capital and labour utilisation, implying some spare capacity in the economy. A positive output gap is associated with higher rates of resource utilisation and, if sufficiently positive, evidence of 'overheating', such as upward pressure on wage growth and inflation.

Economists cannot measure the supply potential of the economy directly, so we use various techniques to estimate it indirectly, including statistical filters, cyclical indicators and production functions. The techniques used to construct these estimates are refined from forecast to forecast, so the precise variables and parameters may vary over time.

The OBR uses 9 different methods.

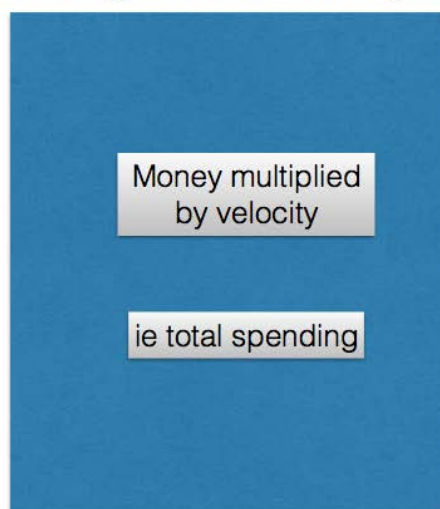
Assume a 2% inflation rate

this grows at 2.3%pa



SUPPLY SIDE

this grows at 4.3%pa



DEMAND SIDE

In the diagram the economy is growing at its full employment growth rate of 2.3%. This is what the Bank of England tries to achieve by altering interest rates and rules on mortgage lending. Assuming no change

in taxation, the Government would get an increase in income of 4.3% per annum each year at this growth rate.

Real wages grow at 2.3% per annum. If this is maintained then the real standard of living doubles every 31 years, which is what the UK achieved between 1950 and 2008.

The output gap is the difference between the demand side and the supply side. If the demand side grows faster than the supply side then inflation takes off. This is called the positive output gap. If the supply side grows faster than the demand side then unemployed resources exist. This is called the negative output gap.

The current estimate is that the supply side is now growing at only 1.5% per annum.

This is not a sudden realisation, it is based on data for the past seven years.

Yes it could be wrong, but there are good reasons to support the view that it is broadly correct.

Why has it happened?

- The demographic profile of the UK (covered at length in previous updates)
- The substantial underinvestment by Government in infrastructure (the capital budget has been reduced from 12% of GDP in 2011 to 4% today, partly in order to meet the triple lock commitment on pensions)
- The substantial underinvestment by large companies whose boards have preferred to buy back shares rather than invest to yield higher productivity.
- The tendency in companies to use low cost labour instead of high cost technology.
- The British preference (amplified by the banking system) of borrowing to buy real estate rather than creating new businesses or upgrading existing businesses.

And of course the Brexit vote which has created huge uncertainty and is consuming all the manpower of the civil service.

There is an alternative point of view. If the supply side is growing more slowly why are wages not taking off? Surely low wage growth implies lots of spare capacity? The Labour party have this opinion, hence their promise of a large debt-fuelled stimulus which they believe will be self-financing over time.

So, the question is: are low wages due to low productivity or is low productivity caused by low wages?

Economic theory suggests that pay and productivity are closely linked, as if companies pay workers more than they produce then profits will suffer, but if they pay less then workers will go elsewhere (but not if they live in depressed parts of the country). The efficiency theory suggests that higher wages can encourage workers to be more productive, at the same time as saving money by reducing labour turnover rates. And many argue that a wage explosion would force labour saving investment.

Both of these theories have some insights to offer, but the link between pay and productivity will not be exact in the real world. Employers always consider non-pay elements of total labour costs. In the UK, some of these extra costs (e.g. employer contributions to eliminate pension fund deficits) have been relatively large in recent years, making it hard to keep labour costs in line with productivity without reducing employment or freezing wage awards.

In addition, employees have faced rising consumer prices since 2007 due to a generally weak pound, rising global commodity prices and an increase in VAT. These events do not change the net revenue stream employers receive for their output, so they may be reluctant to compensate workers for them through higher pay. This means that while UK productivity growth has been unusually weak since the

recession, real wage growth for consumers has been even weaker and real profit growth has been stronger.

The benefit of low real wage growth has been to allow companies to create a large number of jobs since mid-2009, keeping UK unemployment well below what it was in past recessions, or indeed what it has been in many other major economies in recent years.

The downside is that it has squeezed working age households. This reduces the rate of growth in aggregate demand. Pensioner households have enjoyed real income growth in every year since 2011. In 2016 the average income of a working household was £41,900, and a pensioner household was £29,000. The gap between them has steadily narrowed in recent years.

And now both the Bank of England and the Office for Budget Responsibility are assuming that for at least the next 5 years the supply side of the economy will only grow at 1.5%.

At 1.5% it will take 48 years to double real incomes. We are used to these doubling every 31 years.

Therefore, the implications of 1.5% are considerable.

If we assume inflation at 2% (which is the target), then nominal GDP can be allowed to grow at 3.5%. This means money supply growth must be reduced from the current levels of 5-7% per annum, to around 4%. This means higher interest rates, lower growth in mortgage finance, and lower rates of growth in the value of real estate and wealth.

It also means smaller tax receipts for Government.

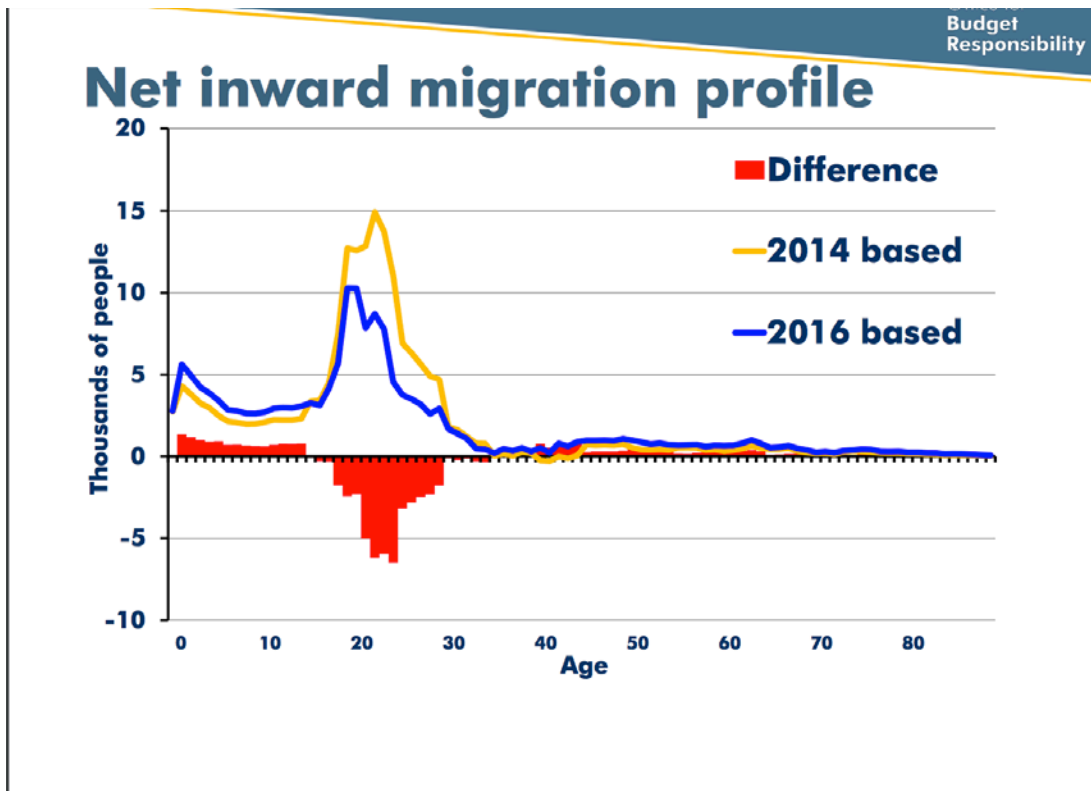
It means either more Government borrowing, or increases in taxation or a pruning of Government spend, starting with the pensioners. After all they did unwittingly vote for lower growth. They should share in the pain their grandchildren are experiencing.

It means the UK will have diminished influence on the World stage (economic performance drives political influence).

It means there will be a talent exodus to more prosperous and faster growing economies. The UK IT sector currently gets 18% of its workforce from the EU.

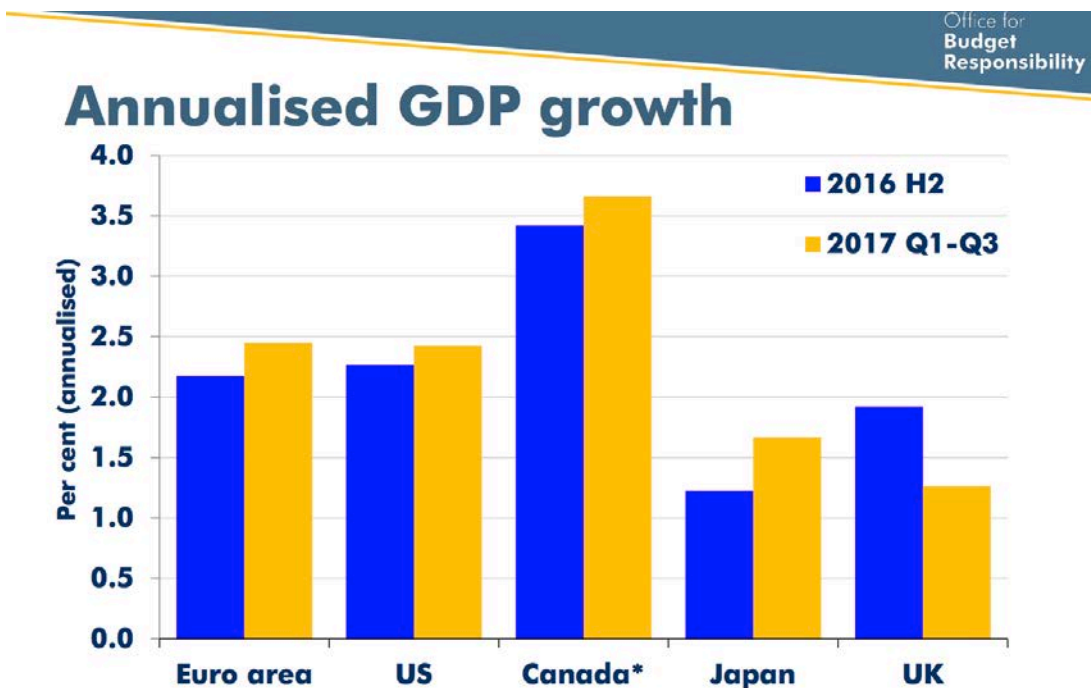
It means there will be a growing social divide between the *anywheres* and the *somewheres*. These are metaphors created by David Goodhart in his book "*The Road to Somewhere*". 'Anywheres' are people who are well-educated, mobile, and global in outlook who feel rooted in new places and networks. They are socially tolerant and do not recognise race or class. The recently announced Royal wedding is a good example: mixed race, divorced, American actress to marry Prince of German extraction!

'Somewheres' are more geographically rooted; they tend to be less well-educated and value security and familiarity. They have a greater group identity and it is thought they have been ignored by the political system until recently. They support Trump, Madame le Pen, many voted Leave and they love Rees-Mogg (if the Daily Telegraph is any indicator). Many live in parts of the UK left behind by the changing patterns of global trade. These 'somewheres' regard society as a home. The 'anywheres' regard society as a shop.



The 'somewheres' live in relatively depressed areas such as Minehead, Redcar, Bridlington, some of the South Wales valleys, Rochdale and Blackpool. The 'anywheres' live in prosperous cities like Manchester, Leeds, Newcastle, Dundee, Belfast and of course London.

Net migration data (the above chart) shows we are not attracting as many young productive tax payers and still gaining youngsters who will be net takers from our system. The return to growth in the EU will ensure that the UK becomes relatively less attractive to this cohort.



I do not want to be accused of confirmation bias. So I am going to summarise the work of Patrick Minford, who has produced a forecast which shows sunny uplands for the UK under a no deal scenario.

Minford is a product of the laissez faire school of economics who believe markets work to produce efficient outcomes if they are free from political interference. He gained fame by being a supporter of monetarism in the early 1980's. Mrs T ensured his team at Liverpool enjoyed a huge slug of taxpayers' money so they could develop their rational expectations model, which was much criticised at the time. The rational expectations theory is based on the assumption that people make choices based on their rational outlook, available information and past experiences. It suggests that the current expectations in the economy are equivalent to what people think the future state of the economy will be.

The model developed by Minford at Cardiff forecasts that the UK will gain £135Bn a year following Brexit. This about 4% a year in current prices.

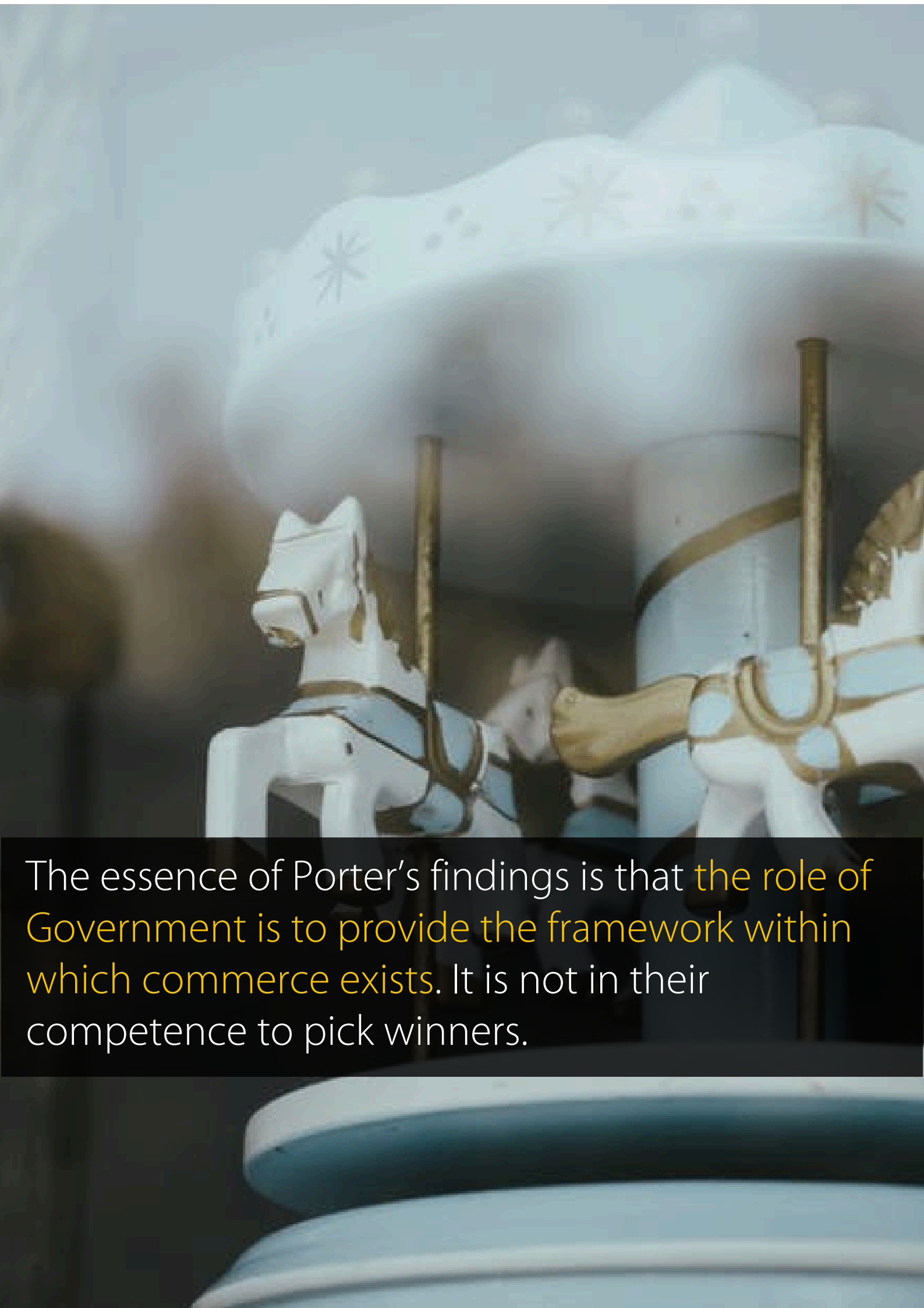
The assumptions are:

- No deal exit.
- All trade barriers are removed by the UK.
- The EU will be forced to reduce its tariffs and regulation over the next ten years from an estimated 20% cost to 10%.
- The EU will not require the UK to match its standards for exports to the EU.
- Lost trade from the EU will be quickly offset by increased trade to the rest of the world.

If we accept Minford's work on rational expectations then the current expectations in the UK show his model to be totally unrealistic! The most important failing is that it denies the proximity effect. The evidence is against him – we sell 46% of our exports to near neighbours. There is no other work on the advantages of Brexit of which I am aware, apart from the commentary produced by the Mail and Telegraph.

Is there any good news?

Thankfully, yes. The Bank of England has just run its financial system stress test. All British banks passed. This means Brexit will not bring down the UK financial system, even if a hard Brexit caused house prices fall by a third.



The essence of Porter's findings is that the role of Government is to provide the framework within which commerce exists. It is not in their competence to pick winners.

The Industrial Strategy

This is a white paper which is a precursor to legislation. The title is a mistake. 80% of our added value is produced by activity not classified as industrial. It should be called the UK Revival Strategy.

255 pages which outline more Government initiatives which will be overlaid on existing initiatives. The result? Confusion.

The overall objective is to increase productivity as measured by added value per person per hour of work.

The report is thorough, evidence based, and has an upbeat tone. Here is an extract:

Through our Industrial Strategy, the country's economic geography will be transformed by a surge of infrastructure investment heralding a new technological era.

We will build a Britain that lives on the digital frontier, with full-fibre broadband, new 5G networks and smart technologies. We will create a new high speed rail network that connects people to jobs and opportunities, regenerate our stations and airports, and progressively upgrade our road network. And we will improve people's lives where they live and work, with high quality housing and clean, affordable energy. Providing the right infrastructure in the right places boosts the earning power of people, communities and our businesses.

The document proposes increased R&D spend, more maths and technical education, and an improved digital infrastructure. It notes that demographics will result in a loss of workers and that 1.8 million engineers and technicians will be required by 2025. (NB it fails to address the current payroll tax on apprenticeships).

There will be a new regulator: the Office for Students will address employer and student needs and create a new national retraining scheme.

There will be money for new postgraduate degrees in AI, and £30m to test online delivery of AI education.

In 1990 Michael Porter published The Competitive Advantage of Nations. It was the result of ten years research on countries around the world paid for by the Reagan Administration who wanted to know what the US should do to grow faster than counter. The result is the Diamond model.

The essence of Porter's findings is that the role of Government is to provide the framework within which commerce exists. It is not in their competence to pick winners.

The more competition between firms the better because monopoly positions allow complacency. The sophistication of the local market (demand conditions) is key to the development of firms who can then compete internationally.

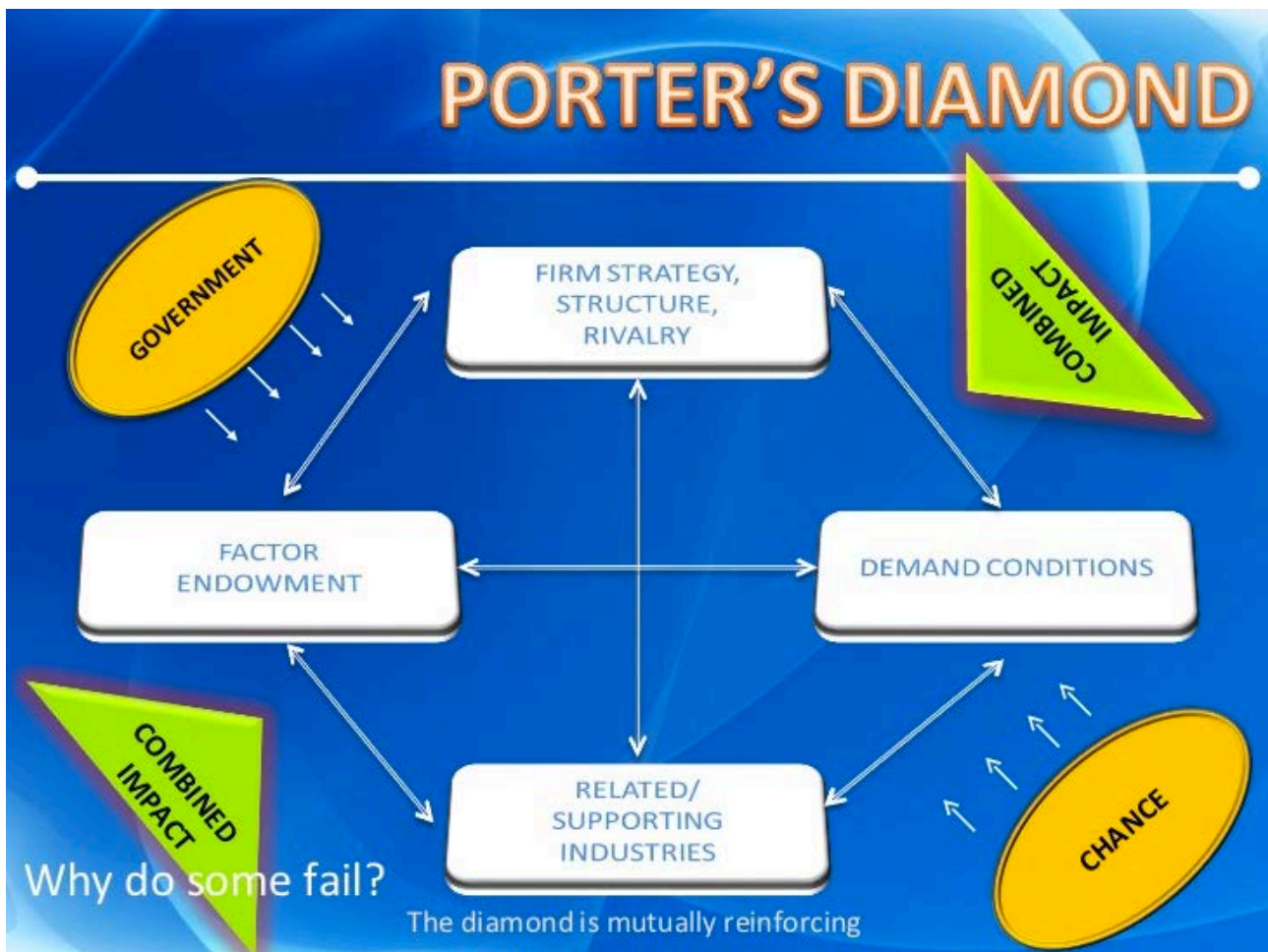
Commercial clusters of related and supporting firms with strong links to universities is important e.g. Cambridge Science Parks and Loughborough University's joint projects with Rolls Royce. There is also MIRA in Nuneaton, where a forward thinking management team are creating a world class R&D technology park for the automotive industry on the site of their test track.

The report identifies 15 activity clusters and shows their spatial distribution across the nation. It is noteworthy that few are industrial. There are movie, advertising, pharma, robotics, performing arts.

Labour supply, infrastructure, quality of management, sources of funding, attitude and culture are all important factor endowments.

Chance and / or luck also play a big role!

The Diamond model shows that all four need to be in place for a competitive diamond which is a mutually reinforcing system. Hopefully the UK Government has recognised this.



The Budget

Hammond is a safe pair of hands, but his targets are not achievable. There is no way 300k houses each year can be built – there is land, but not enough labour. 200k is the capacity ceiling and even if labour was available, the big 5 house builders will limit supply to maintain their 20% margin. There are 500,000 plots all with full planning in the UK. At least half the stamp duty tax break will be added onto the selling price.

He has moved Housing Associations off the state balance sheet which reduces his declared borrowing by an estimated £4.5Bn each year, but be assured the liability still rests with the state. The budget deficit will increase every year for the next five years due to less than expected growth and lower tax receipts, because the Treasury accept that our full employment growth rate cannot be above 1.5%. Latest net migration data shows we are gaining fewer productive migrants in their twenties and gaining more young people who need educating. Net result: higher demand for public services from a tax base which grows more slowly.

Brexit

A paper written 45 years ago by Britain's chief negotiator about our accession to the EU is frank.

He writes that Europe's position is to make the UK "swallow the lot and swallow it now". He states the UK's opening strategy failed because we thought we could change the European Project, then within six months we realised we had to change ourselves.

The main topic was transition and the financial demand. The UK had a weak negotiating position, with France trying to "squeeze every advantage out of the British desire for early progress". Meanwhile Germany had been "rather less generous than we had hoped".

The main stumbling block which existed in 1961 (when France vetoed our application to join), in 1973 when we did join, and which remains today now we are trying to leave is the *acquis communautaire*.

This is the accumulation of directives, regulations and implementing legislation which provides the common law for the operation of the single market. This has been and always will be non-negotiable. In 1973 the EU was inflexible on this but it did give the UK favourable terms to enable us to adapt i.e. a transition period. It has done it again!

The deal on December 8 2017 is we will accept the full *acquis* and the institutions which enforce it (although we will be replicating many of these). It is dressed up as "full alignment". The oversight of the ECJ will be effective until around 2027 because UK courts will have to pay "due regard" to ECJ case law.

It means that until 2021 at least we will be accepting free movement, the oversight of the ECJ and paying a £14Bn subscription. In return we lose the voting rights which come with membership. And beyond 2021 we will continue to pay amounts up to around 45Bn in instalments.

What does this mean?

We effectively remain a member of the EU, but with no say on the development and implementation of EU directives, regulations and laws. In effect we are not leaving the customs union or the single market. Beyond 2021 we will stop paying our £14Bn subscription.

In essence the desire of the Tory Government to stay in power will cost the tax payer at least £50Bn over time and reduce the UK's influence in the global economy.

Providing there is no political backlash by March 2018, the Cabinet should provide a vision document to give a broad indication of the desired future state for the UK. When we get this we can begin to make some (positive) forecasts for the UK, but not yet.

One forecast we can make is that a big stumbling block over the next few years will be fish. It is the one natural resource which humans still feel the need to hunt and as we know from the cod wars etc., it is extremely difficult to obtain agreement because it goes to the core of a firmly embedded human right.

As of December 8 2017 I do not expect a recession, just a gradual glide to a capacity constrained growth rate of 1.5% per annum.



The Outlook for 2018

The Cabinet have decided that a transitional deal is preferable to a Corbyn Government. And many would probably agree. The transitional deal requires the ECJ to continue as the adjudicator for trade disputes. But after two years we would no longer be involved with the deals currently being negotiated by the EU with the rest of the world. The EU is not yet talking to the following: NZ, Australia, Bolivia, Venezuela, Angola and Myanmar. The world is mostly already covered with existing or pending agreements. We will lose all of this unless it is agreed that full alignment means we can be part of the deal (but have no say in its conditions).

A country does not have to have a trade agreement for business to trade. There is no EU trade agreement with China. Germany sells 95Bn euros worth of stuff, we sell 12bn. The EU is no impediment to the Germans. So what stops us, apart from mindset?

We are still in the EU, which is growing at more than 2.5% in real terms. The USA will grow at 3%, and Asia Pacific at 5%. The World as a whole will grow by nearly 4% in real terms. Our export volumes and value should grow strongly (assuming we have the capacity to supply). This will be welcome as domestic demand is likely to be subdued. A year ago I assumed wage growth would respond to tight labour supply. It has not. So at best in 2018 household real incomes will show no growth at all, unless they are pensioners, who will get a 1% real increase in April 2018.

Hopefully beyond March 2018 investment spending should expand further. House prices will grow between 1% and 3% depending on location. The Royal wedding might produce a small uplift in consumption.

It is reasonable to assume we are two years from a peak in the business cycle. Peaks are only followed by troughs if the peak occurs well above potential output. Thanks to Brexit we are slowing before the peak, and given full alignment we will not experience a recession. However the interplay of politics and the media could change the outcome.

What are the signs of an impending downturn?

A sustained reduction in the growth of broad money M4. By this I mean the growth rate falling from 4-5% per annum to 1-3%.

A sustained fall in the velocity of money. This is indicated by retail sales value and volume performing below expectations for at least three successive months. And if you are running a business, the best indicator is your customers delaying payment with spurious excuses – for example, the person who deals with this is on maternity leave, wrong PO number, or first invoice never received please resubmit. Delayed payments create significant feedback loops which depress confidence and flow through the system.

The Bank of England MPC voting split on whether to raise or hold interest rates with the minutes describing the data as giving mixed signals.

The R word appearing ever more frequently in the media.

Big companies issuing a spate of profits warnings and sudden resignations with the FD moving up into the CEO role. If you experience some or most of the above you will amplify the slowdown by conserving cash. Basic point: what is right for the individual business is often wrong for the system as a whole.

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Forecast for 2018

Real GDP +1.5%, nominal GDP +4%

Inflation +2.5%

Unemployment 4.8%

Retail sales volume +2% value +4%

Average earnings growth +2%

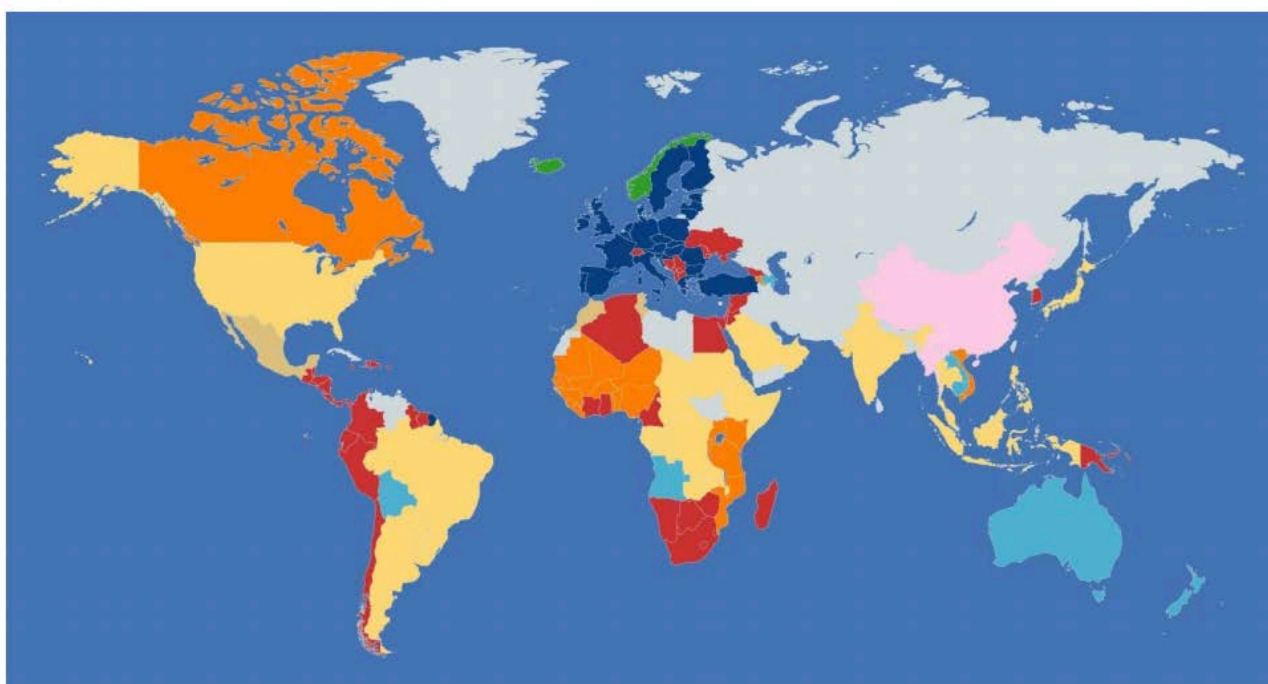
House prices +1-3%

Base rate +0.75% by year end

Exchange rate: \$1.32 and Euro 1.12 but swings according to state of Brexit talks.

The USA will enjoy a surge in investment driven growth encouraged by the new tax regime, expect 3.5% real GDP and more increases in interest rates.

Figure 3. The state of EU trade partnerships and negotiations (March 2017).



- Customs Unions (EU, Andorra, Monaco, San Marino, Turkey).
- European Economic Area (Norway, Iceland, Liechtenstein).
- Preferential trade agreement in place .
- Preferential agreement in the process of modernisation.
- Preferential agreement awaiting adoption or ratification.
- Preferential trade agreement being negotiated.
- Potential for free trade partnership.
- Stand-alone investment agreement being negotiated.

Adapted from European Commission, DG Trade (2017). 'The state of EU Trade 2017.' Available from: http://trade.ec.europa.eu/doclib/docs/2012/june/tradoc_149622.pdf. Accessed 28 March 2017.

Finally the Prime Minister, her team and the EU delivered some Christmas cheer for us remainers!

The next update will have my school report which will show how I performed in 2017, expect it around the end of February 2019. May I wish you and all those you love a really happy Christmas and a New Year full of promise and success.

Roger Martin-Fagg



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Andy Lothian
CEO Insights, Dundee

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