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ECONOMIC UPDATE

ROGER MARTIN-FAGG'S OCT 2022

Okay, hello again. And welcome to this video summary of Roger Martin-Faggs Economic Report, his October report has just dropped this week. And it's the first of October tomorrow. And interestingly, it's a few weeks earlier than the October report and arriving last year. And I can only think that's because of recent events, and that Roger has decided to get his commentary out quickly, because it's a very fast moving situation. And in fact, even since he published it, I think he must have been writing it on Tuesday or Wednesday of this week. Already, there has been more news, which he wasn't able to comment on, in his report, including a rather sizable quantitative easing, input from the Bank of England this week, which we'll we'll come to in a moment.

In summary, it's fair to say as well, I don't think Roger is too happy about what's going on. I had a quick email exchange with him trying to book him as a speaker to come to shows we can talk to us and several of you watching know that we've done that a few times before, and he's a very engaging speaker. So if anybody does want to be in the audience for that, probably just worth making a note in your diaries, that's November the 16th is at the moment, the date that we've got pencilled in for bringing him to Shrewsbury. So get in touch with us if interested in that. But in that exchange of emails, it's fair to say that he was slightly less than complimentary about some of the decisions that our current chancellor and Prime Minister are making. So we'll cover a bit of that in the in the summary now, the broad structure of his report. This month, he starts off with a bit of historical context, as all of his reports do, and he refers to some of the recent interest rate and inflation changes. He then talks quite a lot about house prices, he's quite interested in how that's going to impact homeowners over the next few years, we'll do a roundup of our major markets, USA, EU and China and then a summary of the budget provisions that were announced a week ago last week.

So if we just start off with how he tries to give us some context, he goes right back to the 1992. Maastricht Treaty, which set in place a few regulations, rules guidelines, which all EU member countries agreed to abide by, in terms of their both their borrowing and their debt. And the idea was that the borrowing would stay at no more than 3% of GDP per year that the total debt wouldn't go above 60% of GDP. And he shows some graphs, which demonstrate that up until 2008, and the financial crash that was broadly observed, despite changes of colour of government, broadly speaking, that was the case. But that was all changed, thrown in the air, when we had the recession, depression in 2008. And borrowing that year spiked at just over 10% of GDP and our total debt, then increased gradually through the 80% barrier and, and trending upwards. Since then, it's gone up again in the COVID crisis through the pandemic, and when closer to 100% of our GDP as a total debt, for reasons that we're all aware of, because of the stimulus and support that the government provided in that period. But broadly speaking, it was in line but the view of the Truss Administration seems to be that that rather orthodox economic view of the world isn't making the most of our growth potential. And she says that the growth potential long run average is still about two and a half percent, but we're not realising it. So it just prompted me to look back at some of the growth figures that we've had over the last 10 years or so. And if you go back to sort of 2014, or there abouts, then we had growth at about 3% dropped down to two and a half to 3% in the following few years and then it did get closer to 2% and below, in the late teens. So 2017, was just about 2.1%. And then it dropped to 1.7% for both 2018 and 19. Now, of course, we can't really do much with the figures after that, because they went crazy. 2020 was minus 10% 2021 was plus seven. And this year, it looks like we're going to land somewhere between 3.1 and 3.6, which is really just rebalancing the losses from 2020. But even so that the point is that the Truss Administration seems to believe that that orthodox view of increasing taxes to keep your debt under control and balancing spending increases is holding us back, and that we needed some sort of stimulus.

Now at the same time that this has happened and we'll go through the mini budget in a moment. There's obviously also been the energy crisis and the response from the government. And that's where the exact figures on this yet, but it's estimated at least 100 billion pounds is going to be provided to support for both homeowners and businesses to help cap the energy prices and try and forestall any business closures. So that's added at a time that we're putting this extra fiscal stimulus in. And it's up to you to read in the cause of this but the Permanent Secretary to the Treasury was sacked the week before because he announced his mini budget and one could only presume that that was a matter of differences of opinion. And probably the advice was being given that to go as far and as fast as the government has announced, the well now doing would have impacts on both the exchange rate, and the pound going further down and interest rates going go much higher. So it's, it's interesting speculation as to how they reach these decisions in government. And I should imagine they've been getting lots of advice, but not necessarily following. Following all of that advice, they probably would have pointed out that our current interest bill every year just to service, the current debt is already at 94 billion pounds a year. So with interest rates going up and increasing that debt, that's that's becoming an even greater drain on our public resources. But clearly, the administration believes that going down the route of tax cuts, financed by borrowing will boost growth, and that eventually, there'll be self funding. So Roger comments on this. And he says that there is a version of events where that could be true. And it can work that there is this virtuous circle, where sales and income expand because of the inflation rate, the expansionary effects of those measures. And that therefore then pays for the extra boring that's been incurred through the extra growth. But that relies on the fact that there's spare capacity in the economy. That's that's how that's the space that the economy grows into. And at the moment, there isn't a spare capacity, there is a shortage of labour, which most businesses are acutely aware of. And we've had a really poor productivity run since really 2016. Now he does a couple of things here with the graphs he's included. One of them is to introduce the graph of productivity, which shows a pretty much on trend growth up till about 2016. And then it goes dead flat before falling off a cliff when we hit the pandemic. So about the transition from the Cameron administration to Theresa May, that seems to have stopped the growth period. I'm not blaming Theresa May, but it did also happen at the site at the time of rather significant referendum that many people may hear and general uncertainty around the business environment. So productivity has plateaued and then fallen off. And the other graph that he includes in here is the relevant corporation tax rates around Europe, because one of the measures that Kwarteng has introduced is to unwind the promised increase in corporation tax, which was going to go up to 25% from the current 19.

Now, what's quite interesting in there, and it's not often appreciated by lots of businesses, is that that higher rate would have only really applied to the top 25%. In size of companies in the UK, there would have been some form of taper relief for smaller companies like there was when there used to be a 25% tax rate before. So in fact, it doesn't really help SMEs much by reducing the corporation tax. And 65% of our GDP comes from SMEs. So it's questionable as to whether this measure was really designed to help grow the economy, or whether it's more about bringing more businesses into London, especially if that seemed to be a favourable tax economy tax regime compared to other countries. So he does a little round robin, of the other countries in the EU and their rates. And whilst the there are some outliers, like Ireland, down at two and a half percent, the UK at 19. But the other major economies in Europe are considerably higher with Germany 30%, France, or 28 Italy is a 28 and Spain a 25. So, already we have a competitive advantage, if that's what one would call it on corporation tax rates. And yet, despite us being 11% percentage points lower on corporation tax than say, Germany, our investment is significantly lower. So Germany as an average invest 24% of GDP every year, whereas the UK is only 17%. So even with that advantage already, it hasn't driven investment up. But it possibly would bring in more larger companies to London, which of course will help the lawyers and, and the tax accountants are all based down there. But as I mentioned before, it's not really a major boost for SMEs because it wouldn't have affected them anyway.

So he then summarises recent changes saying okay, the energy pass package was required, it was going to be a disaster without that we need to, we need to have done that. And that has added that 100 billion or so on to the borrowing. And with the tax cuts that have been announced, it will no doubt demand boost demand a little only as far as the capacity allows, which may mean if we have a recession, it's a slightly smaller recession than it would otherwise have been. But it's probably going to be more driven by whether the USA or the rest of the EU goes into recession because they're our main trading partners. So he talks there about quantitative easing. And remember I said earlier that that had happened since he'd published his report. And overall, over the last few years, we've had $17 trillion of quantitative easing, and that's what's driven a lot of the increase in the money supply and therefore, inflation around the world or countries are experiencing that. So he says assuming no further QE, that interest rates are going to have to rise From 3.2%, up to maybe 5%. Now we have now had that QE about 70 billion went into the markets this week, when the Bank of England bought some of its own bonds back, it will no doubt be looking to sell those in time. And it will probably have to maintain that quantitative easing level for a while just to avoid the interest rates going up even further. Now, the impact on that will be seen most, most obviously, in fixed rate mortgages, where they'll probably be going up to rates of something like 5%. Now, he does note that about 80% of UK mortgages are fixed. But about a third of those fixed rate mortgages will be coming up for renewal over the next couple of years. So those increased interest rates will be starting to affect homeowners. So that's, that's how we'll see at the most. It also talks about the exchange rate impact on inflation, and a useful little snippet. One of these sort of rules of thumb that economists have is that a 10% drop in the value of sterling adds about one percentage point to our inflation, because of our imports denominated priced in priced in dollars. And since January, the pound has dropped 14% compared to the dollar, so that's already going to have driven up inflation by one on a bit percentage points. So he's saying that whilst a lot of pundits will say that the lower value pound will help our exporters, he noticed that a lot of UK exports are generally speaking price insensitive. And so therefore, we'll just increase the margins for those exporters. But as a country, it will be more than made up pulling in the opposite direction by the price increases that we see on imports. So he sees inflation remaining high house prices, maybe softening a little bit. And maybe we've prevented a recession. So that's his general roundup of the current orthodoxy would appear from the administration, and how they're treating their fiscal policies.

So then he goes on to talk about housing. And he's got quite a big section on this. And he tries to bust a few myths. And the first one being that house prices are getting evermore expensive. And they're only owned by by relatively few. And he shows the long long run trends going back into the 90s and late 80s, of how house prices are varied according to real prices taking into account inflation. And it shows that over the trend, it's it's on the trend line, there's there isn't an overarching over inflating of house prices over the longer term compared to long run GDP rates. But he does note that because that's an average, you have to have as much of the real real prices above the trend line as there are below and at the moment where it skewed, we still had more of the line above the trend and below. So he suggests that that supports this idea of a softening of the house prices lowering of the rate compared to inflation anyway, over the next few years. It also talks about that there is a myth, there's a myth number two, that house prices increase greater than GDP. And he shows in his graphs that that's not been the case. And then in fact, house prices are more impacted by the readiness of the banks to produce mortgages and put money into the system. And that did happen in both of our more recent house price booms. Certainly the 2002 to 2010. One, another moment, that's not the case, because whilst there has been a temporary withdrawal of mortgages this week, while they readjust for the pricing, the banks generally speaking, have an awful lot of money to lend. And so that's not going to be be a constraint on borrowing. He also talks about the fact that we're over full employment. And he makes another one of his interesting comments that makes you wake up a bit that we could have 1 million people lose their jobs in the UK. And still we would meet the official definition of full employment. So that sort of gives a bit of a feel for the robustness of of where he feels the housing market is at the moment. So interest rates are rising. And he's wondering then about whether that's going to reduce demand, but he's making the point that wages are rising faster than interest rates at the moment. So for the majority with mortgages, therefore, the affordability of housing remains pretty much unchanged and pretty much in line with the 30 year average.

So that's just a summary of the housing market. We then do a quick roundup of our three major markets around the world that we trade with USA to start with. And he talks about the fact that the money supply there has dropped from the very high levels, you remember he mentioned in some of his previous reports, is now back to pre COVID rates, and about 6% or there abouts with inflation at 9%. So the dramatic slowdown on those unsustainable rates from before means that that's reducing the risk of a recession in the USA. Unemployment is still full, there's no more capacity in the USA either with unemployment about 3.7%. and house prices have stopped rising. So he says as long as the inflation can get down to about 6% or so in the US then they'll probably avert a recession there. Although the PMI index has come out recently the Purchasing Managers Index has shown an alarming drop. And if that carries on and inflation doesn't go high, then he does say there is a higher risk of a recession in the USA.

In the EU similar figures really inflation running at 9%. And so it's a bit like the USA, if inflation drops to about 5%. In the next six months or so then he feels that the EU will also be able to avoid a recession. He shows the similar PMI index, though with a very steep downward curve like it is in the USA. So the same sort of risks apply. And as I said earlier, that's probably more of an impact on the chance of the UK entering recession, combined with some of our own domestic measures.

And then in China, obviously a bit of a change at the moment, they've had their zero tolerance policy on COVID, which has caused city wide shutdowns. They're also exposed like everybody else to the high energy prices. But also we know that there are several Western economies trying to move production out of China into countries like Vietnam, in the case of Apple, because they're just realising that the political mood on China is changing. But money supply in China is running about 9%. And as you may remember, from some of Rogers previous reports, money supply is the sum of inflation and growth, with growth likely to be around 4%. That implies inflation, about 5% in China. So he predicts that China will probably avoid a recession, it's still in reasonably comfortable, positive territory, for growth. So it's really the USA and the EU, that are going to impact us more.

So then his final part of his report is on the UK budget. And it's all about the detail, it does accuse Kwarteng of promoting the city as a as a place to attract new foreign business to come in a higher rate of corporation tax, like you said, would only have applied anyway to the top 25% of companies. So the abolition of that increase doesn't affect everybody else, there was an investment allowance increased to a million pounds, which could be useful, especially for capital intensive industry. And the 14 new investment zones that he announced, like many other commentators have suggested that that's just going to move business around the UK, rather than increasing overall business. Although whether that meets a levelling up agenda has yet to be seen, the reduction in the stamp duty is going to be more than wiped out by the increase in interest rates and therefore mortgage rates. So that's probably not going to really boost buying or house building. But he says it's just a populist, populist budget really very similar to the modern monetary theory that we've seen before. And the theory of that being that it's okay to borrow if you're investing in infrastructure and education, so on, in this case, sees he's going beyond that. And he's borrowing to try and stimulate growth, which is a big gamble. And he mentions the two previous times that this has been tried. And if if you're not students of economics or familiar with a time when you live through it, then I would suggest you go on to Wikipedia and just look up what happened back in 71/72, with what was then called the Barbour Boom. Interesting to note that even though Anthony Barbour got the blame for it, it was really all Ted Heath's invention. And he decided to stoke the economy by lowering interest rates, which was still under government control and lowering taxes. And he also linked wages to inflation. Now, because of bad timing, then the oil crisis came along SMT to thanks to the Yom Kippur War, o f course, and wages started going up at 25%, driven by a four fold increase in oil prices. So we ended up with a pretty horrible recession, winter of discontent and everything else. So that was back in the early 70s. And for those of you that don't remember that far back, you may well remember the late 80s, when Nigel Lawson did something similar, and in the Thatcher government. And similarly, reduced taxes would use a higher rate of tax down to 40%, which is very reminiscent to what we've just heard last week. The lower rate then was coming down from 29 to 25. But growth was then stoked. So by 1987, we had growth at four and a half percent with low interest rates, inflation went crazy. And then we ended up with a big recession in 91/92, which is when people of my age were just entering the workplace. So it's, it's interesting to see that the twice that it's happened before, in living memory didn't work out well. So it doesn't bode too well for this attempt at trying to recreate that sort of monetarist theory.

So just in conclusion, he wraps up with some of his forecasts, he thinks that inflation will fall to about 5% in UK and therefore we will probably avoid a recession or if is, if there is one, it will be a mild one subject to those provisos he gave about what the USA and the EU are going to do with theirs. He thinks the growth rate is probably going to stumble and not achieve anything like the sort of 3% plus that we're gonna get this year. And we've talked already about it maybe being in recession already subject to the lag of, of the measures hitting through and he comes up with some predictions like he always does. So we’ve already talked about inflation getting to maybe 6, 7% growth could be including the second half of this year through to the next year at 4%, but then slowing up by the time we take off inflation that’s going to be closer to zero, the Euro around about one 15, the Dollar about one 18. And house price growth, around about 3 to 5%, with unemployment remaining at 4%, still for full unemployment and a base rate rising to four and a half percent. So that’s the summary of the world economic world. Anyway, according to Roger Martin-Fagg, I encourage you to download the full PDF if you want to read through that or keep a copy for future reference. And note, as I said earlier, that we’re inviting him Shrewsbury to come and answer questions with us, present this and no doubt, a few updates of what’s going to happen between now and then. And we’ve got him coming to Shrewsbury on November the 16th. So look forward to seeing you then. Thank you very much.