ECONOMIC UPDATE SEPTEMBER 2024

THE UK

The economic consequences of a Labour Government
We have a new Government. Now they have looked into the detail, they find they have inherited a mess. When Labour came into office in 1997, the party inherited a public sector in need of repair, but a strong economy. When Labour left office in 2010, it passed on to the Conservatives an economy in bad shape, following the financial crisis, but with public services in good order. Now Labour is back, the economy is in poor shape, due to significant reductions in productivity, higher investment by the private sector since the Brexit vote, and the public sector in a bad state too. A double whammy.

What have Starmer and Rachel Reeves *actually* done so far?
They have decided to spend £9.5Bn on public sector wage awards that meet, in full, the recommendations of the UK's independent pay review bodies. They have funded it in part by scrapping some capital projects, and by means-testing the winter fuel allowance. The outcry from pensioners illustrates the perennial problem for Government - any grant, subsidy or tax relief is difficult to cancel because it will adversely affect some groups in society.

In the Budget there will be some large, and new, spending commitments. Given everything Starmer has said about prisons, you would assume they will be high up the list, funded partly by tax rises and partly by spending cuts. The re-nationalisation of the railways is about to begin. It should be noted that half the delays on the network are due to infrastructure issues, which has always been the responsibility of the state.

The winter fuel allowance is a New Labour-era benefit, from a time when pensioners were the demographically most likely to be in poverty, in both real and absolute terms. Thanks in large part to the triple lock, and other measures to fight pensioner poverty, introduced by the Conservatives, Liberal Democrats and Labour party last time it was in office, pensioners are now the group least likely to be in poverty. As the triple lock is to remain, the state pension will soon be at the level of the more generous provisions in other rich countries.

Labour is proposing to enhance workers' rights. This will be a challenge for employers, but it will bring the UK into line with other rich market economies (apart from the USA).

Under the Conservatives, Britain did not correct the imbalance of power between labour and capital. The need for change was widely accepted by all, except the Government. In 2019, the Organisation for Economic Co-operation and Development (OECD), argued that collective bargaining needed to be mobilised. A recent report for the Trades Union Congress showed the degree of job protection enjoyed by UK workers dropped from the OECD average, following the advent of Thatcherism. It only partially recovered under New Labour, and the gap widened again after 2010 as other OECD countries modernised their labour laws, while the UK cut protections in key areas such as protection from dismissal.

As workers' rights were being whittled away, shareholders were increasingly benefiting from company profits. The Common Wealth think tank pointed out that, in the 1970s, when unions had more power, private non-financial corporations paid out 20p in dividend payments for every £1 of gross fixed capital formation. In the second half of the 2010s, this figure was 95p. Payouts to shareholders rose two-and-a-half times faster than total employee compensation between 1988 and 2019. This money could have been used to increase productivity, but instead, UK business investment has been consistently lower than the average for leading industrial nations.

The core reason why there is a 20Bn black hole in the public accounts is that the Conservatives stopped carrying out comprehensive spending reviews in 2021. Given that Covid dominated all activities, it's not surprising, but it means that policy decisions were not joined up and properly costed.

What measures can Reeves take to mitigate the back hole?
There has been virtually no media coverage of what follows. I suspect it's too arcane for the majority. I will attempt to explain as simply as possible, and finish with a policy option for Reeves.

The bill for the Bank of England's losses from its quantitative-easing (QE) programme since interest rates began to rise, is projected to reach around £200Bn (7.4% of GDP).

The government's approach to these losses, and their messy interaction with Britain's fiscal rules, could determine whether Britons face tens of billions of pounds more in tax rises at the end of October.

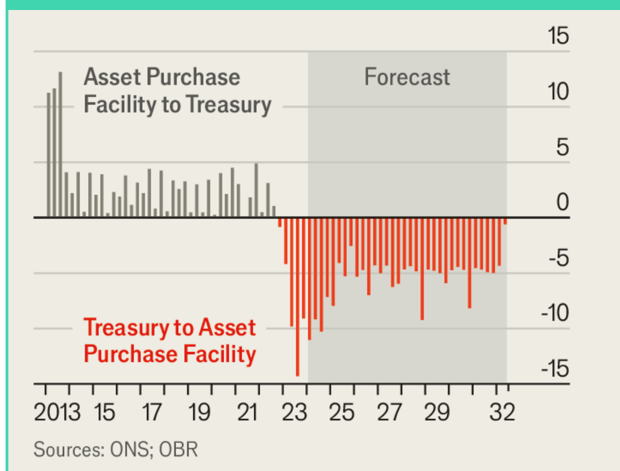
Like most of its peers, Britain has leaned heavily on QE—whereby central banks create money (in the form of bank reserves) and buy gilts, which the Treasury sell to pay for unfunded Government spending. The result is lower bond yields (i.e.higher bond prices) and much more liquidity for banks. This stimulates more borrowing and growth, and leaves central banks with balance-sheets stuffed with bonds. It also causes inflation.

Whether central banks made a profit on those holdings was, until recently, mostly an irrelevant question. The goal of QE was to save the economy, not make a profit. Things worked out well. Swapping reserves for bonds is, in effect, a bet on lower interest rates. In the 2010s, central banks were usually on the right side of that trade. QE helped push yields down (meaning bond prices rose) and an anaemic economy kept them low. The Bank of England made £124Bn this way between 2009 (when QE first began) and 2022. Any profit on gilts goes to the Treasury. £124 Bn is what would be raised if the basic rate of tax was increased by 20%!

More recently, however, the bet turned sour. Globally, bond yields jumped in 2022 and, in September of that year, Truss killed confidence in the UK with her insane budget. Bond prices collapsed, and the Bank of England, and other central banks, began paying out more in interest on reserves than they received on the bonds they held. Thus, they were making a loss. The UK Treasury had to cover this loss of around £35Bn.

The Americans have a different approach. The Federal Reserve treats QE losses as a "deferred asset", which can sit on its balance-sheet indefinitely. That doesn't eliminate the fiscal impact; future QE gains or seigniorage (profit from issuing currency), would go to paying off the deferred asset, rather than to the US Treasury. But it does spread the pain and prevent a big upfront payment. Unfortunately, Britain's accounting rules mean that the Treasury must send cash to the Bank of England as losses crystallise, whether from negative cashflow or from selling bonds at a loss.

Flip! Britain quarterly flows between Bank of England's Asset Purchase Facility and Treasury, £bn



Current plans have the Treasury paying the B of E between £5bn and £15Bn or so a year, until 2032.

WHAT OPTIONS DOES REEVES HAVE?

UK accounting rules collide unpleasantly with Reeves' main fiscal rule: that debt should be falling as a share of GDP in the final year of a five-year forecast horizon. In effect, therefore, the payments knock £25Bn off the government's room to borrow. That's a big number; the last budget, in March, left the government with just £8.9Bn in fiscal headroom. Ms Reeves has since spent more than that on public-sector pay rises. The previous government's plans also included around £30Bn in future public-service cuts, which is implausible.

Ms Reeves has plenty of incentive to soften the fiscal impact of these QE losses. She could tweak the Bank of England's accounting rules to a deferred-asset approach, along the lines of the Fed. This would require legislative changes to allow the central bank to retain seigniorage, which could provide a flow of cash to gradually pay back the loss.

A simpler option would be to amend the definition of debt used in the fiscal rules to exclude the losses from QE or alter the timing of when they enter the debt numbers. In a pre-election interview, Ms Reeves said she would retain the current definition, but recently she has sounded more open to changes. Politically, editing the terms of self-imposed rules may be more straightforward than meddling with the Bank of England's mandate.

Since Labour ruled out most of the less painful ways to raise taxes during the election, temporarily higher borrowing is required, or a mishmash of taxes on capital assets and cuts to investment. The press, other than the DT, will let Ms Reeves off if she fiddles once, but not if she makes a habit of it. An accounting fiddle could give Rachel Reeves more room to avoid excessive tax rises and stop the rot in public services.

As regular readers will know, I have often pointed out that the UK taxes income more heavily than capital This has encouraged the rentier class (a rentier is a person who derives an income from ownership, not production) and many researchers have shown that it is one of the factors behind falling productivity. British banks have around 12% of their loan book supporting production, and 70% supporting property ownership.

Reeves is likely to begin rebalancing taxation in favour of earned income, by taxing capital gains across the board. There will be an outcry from the rentiers, but any opinion that it will reduce economic growth is nonsense. There will also be countless

opinions that it will discourage saving for retirement, or result in a significant capital outflow abroad. It will, but to a very limited extent.

Australia, Denmark and Luxembourg all charge CGT at the same level as income tax. They all have higher rates of GDP growth than the UK. In fairness, the Australian top rate is 45% but this is halved if the assets are held for more than 12 months. Denmark is at 42%, Norway 38% and Finland 30%. Currently UK rates are between 10% and 24%.

Reeves is likely to move it to 30%. This is similar to Germany, Ireland and France. It is estimated that this will raise, circa, £15Bn. Another approach is to abolish all the reliefs which, according to the LSE, enables someone with an income of a million from assets, to pay the same percentage tax as a newly trained paramedic. This is clearly bonkers.

LABOUR'S HOUSEBUILDING TARGET

Tottenham Hale in North London has a tube station. 15 mins into central London. Next to it is a car wash. A large site which would be ideal for houses. But it's designated green belt. Impossible to build on.

Across the U.K. our five biggest cities have 116,000 acres of similar land, close to train stations with a fast service to city centres (source - The Economist). Yet they cannot be built on. The new Government intends to change this by using legislation to create the grey belt.

It will allow the building of 2.5 million new homes at average densities, with no loss of farmland or parkland. This important fact is not well known. Assuming there is sufficient labour, it means that the Government's housing target can be met. The constraint is the supply of house-building tradesmen. Over the next five years, 250,000 will retire.

The surge in house prices is primarily driven by free money (i.e. interest rates below the inflation rate) and the change in attitude from a house as a home, to a house as an excellent capital asset which can be leveraged by borrowing. Landlords sprung up everywhere when money was free. It was better to borrow to buy properties than to invest in other assets. Or even to build a non-property business from scratch. Airbnb has also diverted housing stock away from ordinary people. The key point is housing prices have primarily been driven by cheap money, rather than constrained supply.

Any help for first time buyers translates into high prices within three months. It is always self-defeating.

THE PROSPECTS FOR GROWTH OVER THE NEXT FIVE YEARS

The first point is to explode the myth that higher taxes kill growth. Let me explain.

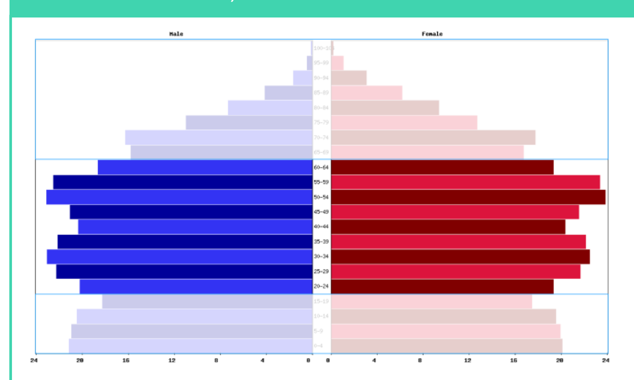
Taxation raises money for the Government to spend, mostly on social care, health, defence and education. Money moves from the taxpayers' pockets, into the pockets of those employed by the state, or receiving benefits. Taxation is merely a transfer of spending power from one section of the population to another. It does not change the amount of money in the system; in fact, it tends to redistribute money from those who save, to those on lower incomes who spend everything they earn. Thus, paradoxically, it increases final demand.

So what limits growth?
The capacity to increase supply, in response to higher demand. If capacity exists, real GDP will grow. If it doesn't, nominal GDP grows as firms increase prices to effectively allocate scarce resources. Look at hotel prices in the cities which will host the Oasis revival.

The UK has limited capacity. The best estimate is that the UK can grow in real terms by 1.8% per annum. Any attempt to grow faster than this will just drive up average prices i.e. inflation. Our capacity is limited due to significant underinvestment by both the public sector, and by large shareholder-value-driven companies, since 2010. In order of importance: the financial crash, followed by Brexit, and finally inconsistent national leadership since 2019. N.B. I have not mentioned Covid because it's a factor shared by all countries.

Britain has a flexible labour market. This means, compared to, say, France which has almost identical GDP, British business can more easily hire and fire. This has, in the past, meant that a growing business will rely on new workers, rather than buy new equipment. A lump of machinery is a fixed cost, regardless of volume. Labour is a variable cost. This flexibility needs a pool of employable workers, especially when sales are ahead of expectations. This pool no longer exists. There are 880,000 job vacancies and 1.4 million unemployed. Unfortunately, the unemployed are not all employable.

Producers and Drains, 2023



Look at the above chart. It's the demographic profile of the UK. Look at the 60-64 year olds; over the next five years, most will leave the labour force.

Look at the 15-19 year olds; over the next five years they will join the labour force, apart from those who stay in tertiary education. The labour pool is shrinking at a time when Government wants to boost real growth back to 2.5%.

If we look ten years out, the pool of labour is even smaller. It is just possible that the application of AI will make the difference. We must hope so.

The demographics also show the challenge for Government. There is no way the tax burden can be reduced with the growing burden of social care. Nearly half the NHS budget is spent on the over 65 age group. An 85 year-old male costs the NHS 7 times as much as a 38 year-old.

Look again at the chart. The faded age bands are essentially big consumers, but zero producers.

The rest are the income and tax receipts generators. Over time they will be asked to do more. However, the over 65 group live off relatively lightly-taxed assets, and are able to contribute more. Thus, the new Government is likely to make tax changes to address this demographic reality, but it is being called out as socialist dogma, and an attack on the middle classes.

Demands on public spending are U shaped. The first 20 years cost a lot, and the final decades even more.

The other issue is the impact of aging on growth. As we get older, we become more resistant to change and more stubborn. The 'old days' were always better. Innovation is driven by youth who are prepared to take more risk.

Musk was 12 when he created and sold a computer game, Steve Jobs 21 when he started Apple. Gates was 20 when he set up Microsoft. The UK's poor productivity is due to low innovation and insufficient investment.

Which brings us to the thorny issue of immigration.

For the moment let us ignore religion, colour, and attitude – i.e. tribalism. Let's be rational (something generally absent in political discourse). It makes economic sense to encourage young healthy workers to be part of our labour supply. It's what made America great. It's what made the UK the leading nation in 1870. There is no such thing as a 'pure Brit'. We are all mongrels.

The ageing West, and the UK must now decide; limited or no immigration, or faster growth.

Of course, all people are irrational 80% of the time. Populist leaders are very good at offering simplistic solutions such as 'less immigration means more jobs for the locals'. Gen A and Gen Z do not recognise religion or colour, and are unlikely to be persuaded by this kind of argument.

■ THE RETURN OF THE BIG STATE?

We have had 14 years of government which dogmatically believed that private enterprise will meet the needs of society. And that the state has crowded out the private sector. Which is, in their view, why growth has been so low. That is nonsense.

Private enterprise is not interested in the public interest. It's focus is always on shareholders, customers and its workforce. In that order.
The UK privatised utilities have underinvested in water quality, because, from a shareholder point of view, it is value-enhancing to pollute rivers with sewage, and pay the fines, rather than sign off the capex to prevent it.

Entrepreneurs are lauded as risk takers, and the source of tax revenues, but they do it for themselves. Government is the only risk taker of last resort. When the entrepreneurial financial sector pushed loans at those who should not have taken them, to boost bonuses and dividends - and it went wrong, the state stepped in as lender of last resort.

Society has needs which it is in nobody's interest to satisfy. So much in the public sector realm has a payback period which is much, much, longer than the private sector can tolerate. And the return, in money, can never repay the expense. There is no private sector-run railway on the planet which survives without subsidy. Someone will tell me that the Japanese railway system is not subsidized; it is; the Government allowed the railway to purchase vast quantities of land around each station. The rents from this are the subsidy.

By definition, government is required to be lender of last resort, and to do things, in the interests of society, which have such a poor financial return, or too long into the future, that the private sector has no interest.

The Reeves' country renewal plan, which expects the private sector to place £3 for every £1 of taxpayer money, will test the time/return mindset to its limits.

PFI began its life in 1992. John Major saw it as a way of meeting EU Government debt limits, as the embryonic single currency was being developed.

Then Gordon Brown saw it as a way of getting public works delivered by the private sector, without adding to government borrowing.

However, the returns required by the private sector have created very, very, expensive schools and hospitals. And yet, government holds all the risk. Simply put, government can borrow money at lower cost than the private sector, thus the financial return can be lower, and the risk is always with the state. Also, society-based projects have cost/benefits trade-offs, which the private sector would not tolerate.

The point is this. It is not inefficient for Government to use debt and taxpayer money to provide resources in societies' interest. Researchers have shown that privatisation of utilities has had benefits, but mostly for investors.

If we assume that the system's purpose is to provide good quality, public services, in an efficient way, then it's been a failure.

But the purpose of the system is what it actually does, which is to funnel billions of public money into the hands of overseas investors. In this sense, it has worked exceptionally well.

This year, 28 of the country's private energy suppliers failed, when the wholesale market got a little rocky. The energy regulator, Ofgem, has said that all 17 of the remaining suppliers are failing vulnerable customers. The cost of bailing out the failed energy supplier Bulb, has now reached £6.5bn, with little transparency as to how or why.

No doubt Thames Water shareholders will expect to be compensated when the state has to act as lender of last resort, even though their company put them before everybody else, and the company is a failure.

We should expect the National Grid to apply for state funding to cover the cost of the £65Bn renewal of the grid as we move to a green electricity environment. And yet it's a shareholder-driven business.

We know already that HS2 will never make a profit. It is regrettable that recent governments, with their private sector mindset, have now created a project which will not solve the West Coast capacity problem.

We can conclude that what is defined as the big state, is actually government working for society as a whole. And in recent years, this has not happened.

As the majority of my readers run private companies, I am expecting some push back. I expect the main theme will be 'But the public sector is always less efficient than the private sector'. I think this is on balance true, but there is a reason. Simply put, a private company has a narrow band of stakeholders. A state enterprise has society as a whole as stakeholder, all with its conflicting interests. This creates a complexity which, when combined with the electoral cycle and ministerial revolving doors, inevitably creates inefficiencies and waste. A great example is the MOD. The private sector suppliers are delighted when, half-way through a major armament renewal, there is a change in spec. Variations from original contract are shareholder-value-enhancing. No major public works have ever been completed on time and on budget anywhere, except possibly in China and Singapore.

If we, as a nation, deem it in society's interest to house people of limited means, then the state should build social housing, but not for resale.

THE OUTLOOK FOR THE UK

As forecast, money supply is growing again. Mortgage lending is up. The composite PMI is running above 52 which is the number consistent with stable growth. Households have growing cash balances. Overseas investors like what they see. The UK is more stable than France or Germany, and the USA is a political risk.

A week ago, the Treasury offered £9Bn of gilts, it was oversubscribed 10x. A record. And a third of the demand was from overseas. At last, the UK is showing some of the pragmatism and consistency which investors value. After years of steady decline, the UK stock market is up 7%.

I expect to see investment spending on an upward path when data is released early next year.

Real disposable income is growing at the trend rate of 2%. Retail sales volumes are growing year on year.

It's now highly likely that by December the UK will have grown 1.5% in real terms. Inflation is 2.2%. I expect this to be the low point with increases close to 3% by the end of the year, primarily because of food prices, due to poor global weather this year. UK House prices grew at 4.3% in August; the upward cycle as forecast has begun. There will be some tax increases next month. These will be on capital gains, not earned income. The impact will be felt mainly by the top 20% of households. Their combined spending power is around £450 Bn, but the other 80% have nearly £900Bn.

Paradoxically it may increase supply of workers, as those in their fifties discover they need to work for a few more years to ensure a retirement income.

The money markets like stability. The ten-year gilt yield is now down to 3.8%. This means lower fixed rate mortgages and further stimulus to house prices.

CHINA

China is the second largest economy in the World, after the USA, with 18% and 25% respectively of global GDP. In recent years, the Xi regime has steadily reduced the accuracy of data, or banned it altogether, if it suggests things are not going well. National security has been put ahead of economic growth. Market information is manipulated, giving misleading price signals. The workforce is shrinking. It is likely that Xi only receives data which affirms all his policies are working.

Social media is managed by the state. Individual liberty is in retreat. Government is pouring capital spend into EV, semi-conductor production, and green energy.

The published data shows China has resumed pre-Covid GDP growth. This is highly unlikely, given the reduction in infrastructure investment plus the oversupply of housing. It is estimated that 30m people have paid for apartments which were never built.

An economics professor at Peking Uni did some work on youth unemployment data in 2023, suggesting the youth unemployment rate was 46%. Within a month, the authorities ceased producing the data.

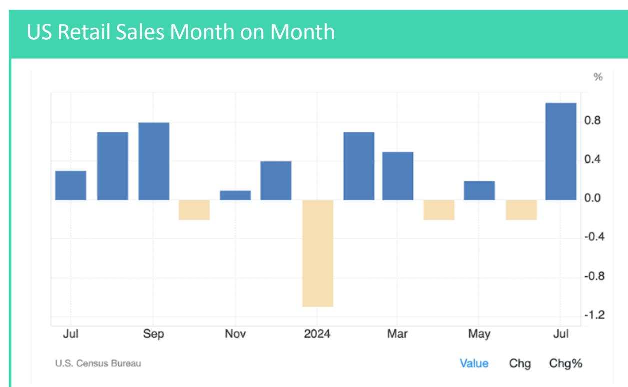
Assuming that money supply data is not manipulated, it indicates a significant slowdown is underway. M2 money which measures current and deposit accounts, has been virtually flat since March. There is always a time-lag, but I expect over the next year to see signs that China is growing circa 2-3%. Retail sales and investment spending are running 2-3%. The export volume data is misleading too, as the chart from the Economist shows.

THE USA

The uncertainty surrounding the presidential election is impacting on investment decisions. Companies are borrowing at record levels to ensure they have sufficient liquidity. $82Bn was raised in the first week of September.

There is evidence that they are letting some staff go which is impacting consumer confidence. US consumers are only saving 2% of their income, so are vulnerable to a loss of earnings.

If consumption drops, GDP follows quickly. Latest data, however, shows continued growth in retail and consumer spending as well as wholesale.



The US stock market wobble self-corrected rapidly, and GDP is growing at 0.7% So overall growth may slow, unless the Fed drops interest rates again, which is a strong possibility. My view is that a recession is highly unlikely.

Political risk has more impact on business decisions than interest rates, as we in the UK know too well. A hung presidential vote would be a depressant for the USA. It will be close.

THE EU

At last, the UK has political stability. The EU is struggling. Germany is the weakest economy. The slowdown in China, and domestic politics has hit manufacturing hard. The German auto industry is likely to shed capacity, with job losses across the board. The auto industry in the EU employs 13 million. An EV vehicle has 80% fewer components compared to an internal combustion-engined one. GDP growth is zero. In my opinion this is impacting on local elections, with the far right making significant gains. The thorny issue is immigration, and Chinese EV imports.

The Netherlands is performing well with GDP up 0.8%, but the largest party in their coalition is the far right. Again, immigration is the issue. France is basking in the success of the Olympics, but a return to reality will be rapid, as the new PM, Barnier, wrestles with a yawning public sector deficit. GDP is growing at 0.7%; the same as the UK. Spain is doing well. The summer tourist spend has boosted business. Its growth rate is best-in-class at 3%.

THE REST OF THE WORLD

Global growth is expected to be running at 3% year-end. This is a return to pre-covid trend. Global inflation will be circa 5.5% this year with increases in food prices, offset by lower energy prices. Next year 4.5% is expected.

The core driver of inflation in the west is service sector wage growth, ahead of productivity. This will continue until the widespread introduction of AI ratchets up output-per-person, per hour of work.

The next five years will see significant development in AI applications. This will be a disruptor. Someone aged 14 today will probably enjoy their first job, which doesn't currently exist. Hybrid working, flexible contracts, much more challenge to hierarchies, and probably less emphasis on "getting on" and more emphasis on travel, experiences and living in the "now". These are the challenges for leaders. Gen Alpha is 25% of the global labour supply. They are different. We must embrace the differences, and use them to add value. This will be the source of future growth.

Generation Alpha is expected to be the most technologically advanced, educated, and globally connected generation yet, with strong emphasis on adaptability, inclusivity, and environmental consciousness.

FORECAST FOR THE UK YEAR END

As forecast, a stable Government is impacting on confidence. The Deloitte survey shows that CFO appetite for risk is the highest for four years; external uncertainty perceptions are the lowest for eight years. Expectations are for higher growth.

Real GDP	1.5%	
Wage growth	4.5%	
Inflation	2.9%	
Interest rate	4.5%	
House prices	4%	
Exchange rate	$1.35	Euro 1.20

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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!