OUR VIEW

Economic recovery?

Much recent media coverage has concentrated on the UK's apparent economic recovery. Some of the key economic indicators seem to support this view. Inflation appears to be under control (for the moment at least), unemployment is falling, earnings may at long last be increasing in real terms and the International Monetary Fund has recently predicted 2.9% growth in the UK economy this year.

The Coalition government believes these trends and forecasts indicate that their strategies have worked and that there is a return to "business as usual".

Unfortunately, "business as usual" in the UK economy is not necessarily a good thing. The recovery is being primarily driven by a toxic mix of excessive state and private consumption which is possible, for the time being, because of easy money and cheap credit. This is exactly what got us into trouble in the first place.

Key economic indicators which would indicate a sustainable recovery with a properly rebalanced economy would include an increased level of business investment, improved productivity, a reduction in the balance of payments deficit and an increase in the savings ratio. Unfortunately, none of these indicators show any cause for optimism.

The government and the Bank of England are deliberately pursuing policies (quantitative easing and ultra low interest rates) which will bring about in the short term the opposite of what is desirable in the longer term. So, the unprecedented amount of cheap money sloshing about props up spending and disincentivises saving.

The Coalition inherited a dreadful economic legacy from the loathsome Gordon Brown, the incompetent muppet who repeatedly assured us he had "abolished Tory boom and bust". Brown fostered a wholly unsustainable private sector credit bubble and (mis)appropriated large chunks of the proceeds through taxation which he then used to vastly increase government spending.

Of course, the bubble burst when the economy collapsed and the public finances went into freefall. Against this backdrop, the Coalition are no doubt delighted to have engineered a situation which many shortsighted commentators conclude is a recovery of sorts.

However, Britain's economic recovery looks like an illusion based on consumption-led growth, cheap money and rising property prices.

Debt, debt and more debt

The UK as a whole is plunging ever deeper into debt. The Coalition government has taken tentative steps to reduce the deficit (the amount by which government spending exceeds income annually) but in the current year, government spending is expected to exceed income by £108 billion. So, each week the government "overspends" by an eye watering £2 billion (£2,000,000,000).

The Office for Budget Responsibility projects that the government will only finally bring its spending under control in the 2018/19 year, when a surplus is projected for the first time in 18 years.

In reality, George Osborne or any other Chancellor, has little or no chance of balancing the books anytime soon. This is because of a combination of the relentless growth of the "Social Protection" budget (payments for welfare, pensions and tax credits) and the politically "untouchable" expenditure on the NHS, Education, Debt Interest and International Aid.

Gordon Brown succeeded in making as many people as possible dependent on the state. By 2010, the state was the main financial provider for around a third of UK households. By 2013, the welfare state paid some kind of benefit to 20.3 million families, of which 8.7 million were pensioners.

A visitor from outer space, on viewing our dilapidated infrastructure and failing health service, would find it hard to believe that public expenditure had not been cut to the bone already. In reality, nearly 50% of our national income is consumed by the public sector. Inefficiencies, structural flaws and misplaced priorities mean the value for money obtained for the taxpayer is often dreadfully low.

In the current year, the government expects to spend **£720 billion**. Expenditure on "protected" areas is projected as follows:

Social protection **£220 billion**
Health **£137 billion**
Education **£97 billion**
Debt interest **£51 billion**
International Aid **£11 billion**

This means that the expenditure which politicians (of all the main parties) feel might be "touchable" totals just **£204 billion**. Clearly, the necessary savings required to achieve a balanced budget cannot be achieved by targeting just 28% of overall government spending.

Why does the debt matter?

As a nation, we continue to live way beyond our means and our low calibre politicians are failing to face up to this problem or admit it to the public. By the time we reach 2018/19, the national debt is projected to total £1.6 trillion (£1,600,000,000,000).This figure does not take account of the unfunded public and state pension liabilities estimated at an astonishing £5 trillion.

We are effectively stealing wealth and prosperity from future generations to pay for the UK's lavish and unsustainable lifestyle today.

Many people feel that this has no direct impact or relevance to them personally. However, this is wrong. Increased debt interest payments will inevitably reduce the amount of government spending allocated to "useful/desirable" areas and taxes will have to rise which will stifle economic growth.

The inexorable growth in government spending over the last 30 years has been possible as the UK has been able to borrow money at relatively low interest rates. The government currently borrows money at an interest rate of about 2%.This is exceptionally low, compared to the historical average of 5%. It is also worth remembering that as recently as 1982, the UK government had to pay interest at 15%.

By the time our national debt reaches £1.6 trillion, a 3% increase in the cost of state borrowing will mean an extra £48 billion of public spending every year on interest charges alone. That will require either £48 billion of spending cuts or £48 billion of extra tax revenue. That is why controlling the debt and deficit matters.

The housing market

The Royal Institution of Chartered Surveyors (RICS) has recently predicted a nationwide house price boom with prices forecast to rise by 5.9% a year for the next five years.

This boom is being driven by low interest rates, a shortage of supply, government sponsored schemes, net immigration, relatively low unemployment and foreign interest in London properties.

In our newsletter last year we were very critical of George Osborne's Help to Buy scheme, which is essentially an attempt to buy political support by stoking up the housing market using taxpayers' money. One commentator recently described this policy as "akin to giving a recovering alcoholic a bottle of whisky as a reward for staying off the booze for a while".

The government will no doubt be delighted by the surge in house prices as they hope it will engender a feelgood factor amongst homeowners. They will conveniently forget that there has never been a house price boom in the UK that has not ended badly.

Commentators who look solely at "affordability" will tell you there is no problem. If you track so-called mortgage affordability measured as a percentage of a buyer's income taken up with mortgage payments, this is below the long term average. So, one conclusion could be that houses are more than averagely affordable.

This is wholly the wrong way to assess the situation however, because interest rates are so far out of their normal range. We all know interest rates will rise, but huge numbers of households are blissfully ignorant of how vulnerable their own finances might be if interest rates rise to more normal levels. How many households could survive the base rate rising to 5%, or even 10%?

A more sensible way to assess house prices is to look at the ratio of average house prices to average earnings. This ratio indicates that house prices are already too high, with the current ratio at 5.4:1 standing well above its long-term average of 4.1:1

Does any rational person really think that a further five years of price increases at nearly 6% per annum is in anyway desirable or sensible?

The UK population never seems to learn that a house price boom will result in some people becoming better off but with no gain for the population as a whole, i.e. a zero-sum game.

The “money for nothing” mentality makes the majority misguidedly believe that as a society we become richer. However, with no new assets being produced this clearly can’t be true.

In reality only a pronounced and longlasting building boom, which would cause average prices to fall would result in increased wealth for the country as a whole. There is no evidence whatsoever that any political party will adopt the necessary policies to facilitate this, so strap yourself in for the next instalment of the UK property rollercoaster.

Red tape

Ronald Reagan famously claimed the nine most terrifying words in the English language were:

“I’m from the government and I’m here to help”.

On taking power in 2010, the Coalition promised they would tackle the excessive amount of unnecessary and complex regulations which stifle businesses in the UK. These regulations often have the greatest impact on small businesses imposing burdens and costs which divert business owners from wealth creation.

In reality however, new obligations keep mounting and the introduction of pension auto enrolment will add a further 3% to labour costs. There will be no genuine reduction in red tape until the whole UK tax system is reformed and our relationship with Europe is radically altered. Don’t hold your breath!

Europe

We have highlighted in numerous newsletters the problems with the European project. The huge costs, lack of democracy, corruption, self-interest, illogicality of the Euro, dire economic performance and crippling unemployment in the Euro zone are all matters that are relatively well known.

The Euro should either be dismantled in an orderly way or the leading members (in reality Germany) should take measures to make the Euro growth and employment friendly. Time is running out for a lost generation of educated young people unable to find work through no fault of their own. Unemployment is running at 12.1% in the Eurozone, with 19 million people out of work.

But the sheer absurdity of the European project was recently highlighted with news that Germany could face EU sanctions because their current account surplus (the amount by which exports exceed imports) is too high. So, Germany is being denigrated for export success at a time when most Germans believe they are the cash cow for the EU, convinced they are bailing out southern Europe and holding the Euro together. Astonishing.

State and public sector pensions

The Coalition has taken tentative steps to lessen the huge unfunded future liabilities relating to state and public sector pensions. The small adjustments to state pension age and the requirement for many public sector employees to contribute more and work longer will be wholly insufficient to plug this black hole in the nation's finances.

State and public sector pensions in the UK are effectively an official Ponzi scheme. Charles Ponzi was a conman who used money from new investors to pay existing investors fantastic returns, over and above the genuine profits of the scheme.

This is effectively how UK pensions work. The schemes are virtually all unfunded. So there is no pot of money that has been saved and the pensions are funded by current taxpayers. As demographic changes take hold, with a fall in the proportion of working age people, this intractable problem will be revealed. The government should of course abolish public sector final salary schemes and replace them with money purchase schemes, but a radical solution like this would present huge political challenges.

Conclusion

Governments in most Western democracies are struggling to offer rational economic policies as they run huge structural deficits in order to give voters what they want now at the expense of long-term investment.

As the 2015 election approaches, all the political parties will grandly announce policies which they think will be populist. In reality however, there is now a dangerous mix of dependency on government coupled with contempt for it. In 1950, 20% of Britons were members of political parties. Today a mere 1% are.

Given the fact that the politicians of all our main parties share an increasingly unrealistic consensus on tax and spending, it's not surprising that the public are so disillusioned with politics.