

# Economic Update 2012

## Where are we now in Europe?

Europe continues its fudge and bodge, it continues to ignore the core problem which is that Monetary Union just cannot work under the current framework.

## The Core Problem

Under a system of freely floating exchange rates - the dollar and sterling are free floating, the RNB is not - the market prices in a combination of factors on a continuous basis. These are - the level of domestic interest rates; the inflation rate; the Government's budget position; the balance of payments ( in particular the current balance - the net of visible and invisible flows) and the way in which this is being offset through the capital account (in particular by Government borrowing from outside the economy).

If the market decides that, in combination, the country is in an unsustainable position, it sells the currency. This is devaluation. This, with time lags, results in an adjustment via more profitable exports, more expensive imports, higher interest rates, and for a time, lower growth. It takes about three years for the rebalancing to work. But it does work. We in the UK have been doing this on and off for the last 45 years.

The Eurozone problem is that this adjustment mechanism doesn't exist between Euro member countries. In any currency union, the balances of the public sector, the private sector and the external sector must sum to zero.

From the beginning of the Euro, the following countries ran surpluses on their external account (i.e. with other countries):

Netherlands; Germany; Belgium; Austria; Finland; and, only just, France.

They were selling more than they were buying.

The following countries ran deficits on their external account.

Italy; Greece; Ireland; Spain; Portugal; Estonia;

They were buying more than they were selling.

The balance of payments for any country must balance each month. This is a feature of double entry book keeping. The surplus countries exported capital (money) to the deficit countries. These flows were organised by the private sector with bank lending, through M&A, and by the middle classes buying property abroad. The flows were large and deemed low risk because there was no exchange rate risk.

When the credit crisis hit in October 2008, these private sector flows ceased. Individuals in the deficit countries stopped spending and began to reduce their debt as their wealth collapsed. As individuals and companies moved from deficit to surplus, their Governments moved deeper into deficit (it happened in the UK too!). So debt moved from the private to the public sector.

The private sector in the surplus countries is no longer willing to finance the debt of the deficit countries. Instead financing is from a combination of the European Central Bank ( ECB), the IMF, and the European Support Fund (ESF)

Germany is one third of the Eurozone. It therefore is the dominant underwriter of the the ECB. Germany is adamant that the ECB should not buy sovereign debt, apart from to supply short term liquidity.

The latest EU agreement is that the size of Government deficits will be limited, and policed by Brussels. The limit is - current borrowing to be no more than 3% of GDP, unless there are exceptional circumstances! This does not address the current problem.

Deficit countries within the Eurozone must reduce their external deficit, i.e. they must sell more and buy less from outside. Because they are so uncompetitive, their only way forward is a deep recession, i.e. buying less because their wages are falling. Germany doesn't seem to realise that its exports to the deficit countries will collapse. So ITS surplus will fall due to lost sales.

## What can be done?

The ECB should be allowed to buy sovereign debt. This will give the markets confidence and ensure private sector flows return. It will reduce the cost of funding for the Club Med countries. It will not be inflationary. It will also prevent a meltdown of the European Banking system and give UK Banks a boost (because the credit default swaps payments will not be triggered)

The alternative is chaos and a horrendous feedback loop which would run as follows: Italy would only be able to borrow at 8-10%, Standard and Poors would then downgrade their debt because tax income is insufficient to cover payments at such a level. It would apply to the IMF for credit. The IMF would impose very tough conditions. Even more of the Italian economy would go unofficial, further depressing tax receipts. The same for Spain.

## Will the ECB act?

Yes, but not before Europe as a whole is in recession. The change will come at the end of this year when Germany has experienced zero growth due to a sharp reduction in exports to the Eurozone.

## What does it mean for UK business?

The exchange rate risk is increasing, particularly Sterling-Euro. Ideally businesses match income and expenditure by currency type, thus neutralising the impact of currency movements. For many this is impossible. They have only two options; buy forward (expensive) or make sure the margin is sufficient to cover the swing in rates. The average for 2012 I guess to be 1.18. But it could go as high as 1.26 and down to 1.08. There are many who would suggest 1.30 plus, but this is highly unlikely because the finances of the UK are fragile and we have a difficult year ahead.

S&P are downgrading sovereign debt in the Eurozone primarily because, unlike in the USA and the UK, there is no lender of last resort i.e. a central bank willing to purchase significant amounts of Government debt from private sector investors. This action creates liquidity and confidence, so that at auction, Government can get the credit they need at a price which is manageable. The French seem to think that their recent downgrade is due to some Anglo-American plot, rather than the simple fact that quantitative easing is an essential

monetary tool which the ECB is forbidden to use, and therefore financing the French deficit is more difficult.

## How deep will the European Recession be?

It is my opinion that it will be deeper than many expect for the following reason: since October last year European banks have been shedding assets at the rate of 35Bn Euros a month. They have sold these assets on. This doesn't reduce the supply of credit or money. But they are doing the easy bit first, as they try desperately to meet the July 2012 deadline for their core capital to be at least 9% of their balance sheet.

From now on they will be reducing their net loan book, and withdrawing credit from central and eastern Europe. In the last two weeks (16 January) they stopped lending to each other. The wholesale money market is key to the proper functioning of the credit system. When the UK market seized up in October 2008, the impact on growth was quick and substantial. The same is happening today in the Eurozone. On 16 January 2012, Eurozone banks had parked 501 billion Euros at the ECB. This is money which should be oiling the wheels of commerce. The chart on the next page illustrates my view.

My guess is the Eurozone will shrink by 1.5% by the end of 2012, and with no change in ECB policy, by 2.0% in 2013. We have to hope that this will cause Germany to rethink its current stance on lender of last resort for the ECB, but once the credit crunch begins, the feedback loop is powerful in a downward spiral.

## The impact on the UK

The EU is the largest importer and exporter on the planet. 50% of UK exports go to the region. Of our top ten markets, eight are in the EU. This trade is worth 3.5 million jobs, and around £2,300 per household. So a 2% contraction in the Eurozone, translates into a 4% nominal drop (assume a 2% inflation rate in Europe) which, in round figures is £100 per household income contraction. This is on top of the increase in income taxes which Gordon Brown announced three years ago would apply in 2012

**Eurozone growth in Bank Lending : the October 'rescue' plan will reduce this to -2% over the next two years. Probability of a recession? 100%**



The red line is my forecast.

## The USA

The USA will grow by about 1.6-2% in 2012, driven by consumption spending, financed by a reduction in the savings ratio and a growth in bank lending. Net exports are showing a modest improvement too. But real disposable income (income after tax adjusted for inflation) is still flat. And the recession in Europe will slow the USA in the second half leading to near zero growth in 2013.

## China

Still unsustainable. Capacity creation and building and construction are together nearly 50 % of total output. The closest comparator is Ireland and Spain 2000-2007. New shopping malls are springing up everywhere and many are practically deserted, with another 700 planned! Consumption continues to fall to a record low of 32% of GDP, even though retail sales are expanding at 17% yoy in money terms. I keep saying that China is headed for a brick wall, and will

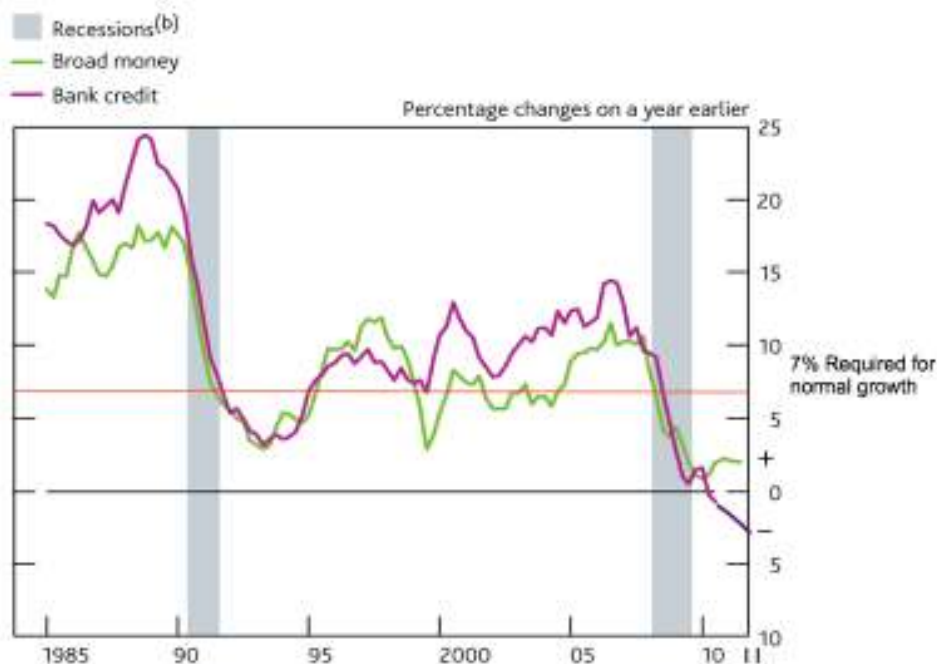
continue to do so until consumption spending reaches normal levels (i.e. at least 55% of GDP). The export sector is beginning to falter as demand in the West softens and low added value assembly can be done more cheaply in Cambodia, South Vietnam and Indonesia.

In the interest of maintaining a balanced view(!), China Confidential estimates that the wages of the 160 million migrant workers rose by 20% in 2011, rural land transfer prices by 15%, and the incomes of 700m rural workers rose by 11% in real terms. If this continues, the real standard of living will double in under 7 years. (It has doubled since 2005). So maybe those shopping malls will work!

## The UK

It wasn't a great Christmas for retailers. They did enjoy higher volumes (4% up on a snowbound year earlier) - but at the expense of margin. Unlike in the USA, credit in the UK is still limited by the banks as they continue to adjust to Basel three requirements. The Bank of England told the Treasury Select Committee on 17 January that every £1Bn of bonus payments foregone would allow banks to lend an additional £20Bn. If this happened, we would be able to move much more quickly towards the 7% growth in credit which we need for a normally functioning economy. See chart below.

## UK Broad money and bank credit



These are the forecasts I made a year ago, with the outcome in red, and my school report at the end.

## Economic Update January 2011

### Summary

#### The UK

Inflation: between 3-4% in 2011 actual 4-5%

Interest Rate will remain at 0.5% correct

Q2 and Q3: negative; but for the year, real GDP growth will be 0.3% actual will be 0.8%, only Q2 negative not Q3

The coalition will hang together correct

Wage growth: will be 2.5%; but 0% in the public sector 2.3 and 0%

FT100: will continue to rise but was back at 5400 at year end

Bond prices: will fall they did in Europe but not the UK

House prices: will fall - 6% nominal, 10% real actual -1.6% nom, 6.7% real

Commercial property outside London: flat correct

Unemployment: will rise to 2.7 million (up by 200,000) actual 2.62

Sterling: Euro: average for the year e1.18, \$1.60 correct

Retail sector: will suffer more than two years ago, particularly in the next 6 months correct

Company investment spending should rise. it did but not by much

## The rest

Oil price: \$90 first half, \$70 second half, unless war breaks out Arab Spring kept price up at 110

War in the Middle East a growing threat !

USA: will not double-dip in 2011 correct

GDP for the Eurozone excluding Germany: 0.8%, with Germany 1.4% 1.3 and 2.4.

Europe will fudge the sovereign debt issue, default is likely, Greece? (!)

The ECB will keep rates at 1% ; French and German Banks at risk correct

Asia and Brazil: will slow down in response to higher interest rates correct

More currency volatility than usual; the Brazilian real in particular. correct

School report: Martin-Fagg shows some promise as an economist and has achieved a modicum of success this year by being generally more miserable than the majority. We require more improvement in 2012. 7/10

In 1962 my end of term report actually said this “Class position 35 out of 36, Martin-Fagg is not bottom this term because of a new boy who arrived recently”  
Made my Mother laugh (hysterically?)

## Forecasts for 2012

### The UK

UK inflation : RPI 3.2%, CPI 3.5%

UK interest rates: 0.5%

FOOTSIE 100 at year end 5,500

House Prices outside London: nominal increase (2%) real (5%)

Commercial Property: flat

GDP for the year 0.3%, Q1 and Q2 slight contraction, Q3, Q4 some slight growth.

Sectors: Manufacturing will grow more slowly than the last two years: European demand will be patchy, with some shocks. Asian and US demand stronger. Non-food retail will continue to be very difficult with more failures. Financial services flat. Government sector: cuts will begin to bite. Construction: 1% real growth  
Unemployment: 2.8 million at year end  
Private sector wage growth 2%, public sector 0%

## The world

Global growth will be 2.5%, the USA 2%, Brazil 2%, India 7.5%, China 7%  
Europe (1.5%) Russia 3%

Oil: the Saudis need \$100/barrel to break-even on the increased bribes to their population. They will cut output to maintain this price in 2012 and 2013.

Non-food commodities - prices will fall.

Food commodities, harvest-dependent, but steady upwards price pressure from Asian demand.

These forecasts assume Europe stumbles on. If the Greeks default (likely April 2012), will create a Lehman-like effect, then all bets are off. It will be a repeat of 2008-2010.

Happy New Year dear reader!

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