Pointmaker

MASKING THE SYMPTOMS

WHY QE AND HUGE DEFICITS ARE NOT THE CURE

EWEN STEWART

SUMMARY

- The quantity of UK sovereign bonds issued has increased by two and a half times in just five years, by £832 billion – the equivalent of £33,000 for every UK household.
- At the same time, monetary policy has been extremely loose: UK base rates at 0.5% are at their lowest in 300 years. QE has also been larger, relative to GDP, in the UK than in either the US or the Eurozone.
- These policies, while extreme, have had unimpressive results. Since 2008, UK growth has been the weakest of any G20 nation (bar Italy).
- The Bank of England and the Treasury promised that QE would be temporary, stimulatory, and non-inflationary. These promises have been broken.
- QE has punished the innocent parties of this recession to the benefit of the indebted. QE has imposed a stealth tax on savers, who are losing an estimated £65 billion a year in interest foregone. Pensioners and the young have also lost out.
- The sovereign bond market is no longer a free market in the normal sense of the phrase. Low gilt yields should not be taken as a 'vote of confidence in the UK economy' (as the Chancellor claims).
- If public spending had grown in line with nominal GDP since 2001/02, it would have been £150bn lower than it was in 2011/12. There would be no deficit. Despite claims of austerity, total spending is rising, not falling.
- The Coalition's initial deficit reduction plan was predicated on a return to robust growth. This was wrong then; and is wrong today. Without radical reform, the deficit is likely to remain between £100bn and £150bn a year.
- Loose monetary policy, coupled with huge deficits, distorts asset decisions, delays economic rebalancing and harms long-term productivity. It also masks the underlying problem of too much debt, a bloated public sector and a crowded out private sector.
- There is a real danger that markets could lose confidence in the UK economy, with devastating consequences for bond yields, house prices and prosperity.
- But the right policy prescriptions would raise the productive potential of the economy. Restoring monetary rigour, controlling government spending and implementing health-inducing supply-side reforms could cure the British economy.

“A BIG VOTE OF CONFIDENCE”?

There is an apparent paradox. The more government bonds that are issued, the cheaper the cost of government borrowing. This defies the simple rules of supply and demand. A glut of apples would usually lead to their price falling. A shortage of skilled engineers and the wages of skilled engineers rise. So when it comes to UK sovereign bonds, surely a glut must mean yields, which are inversely related to the price, increase?

Chart 1 clearly demonstrates that a substantial increase in supply has not led to a fall in the price seen through a rise in the yield. Indeed, despite the recent tick up, yields at all maturities are very close to all-time lows. Perhaps this is indicative of, as the Chancellor puts it, “a big vote of confidence in the UK, and a vote of confidence in the Coalition Government’s economic policies”.

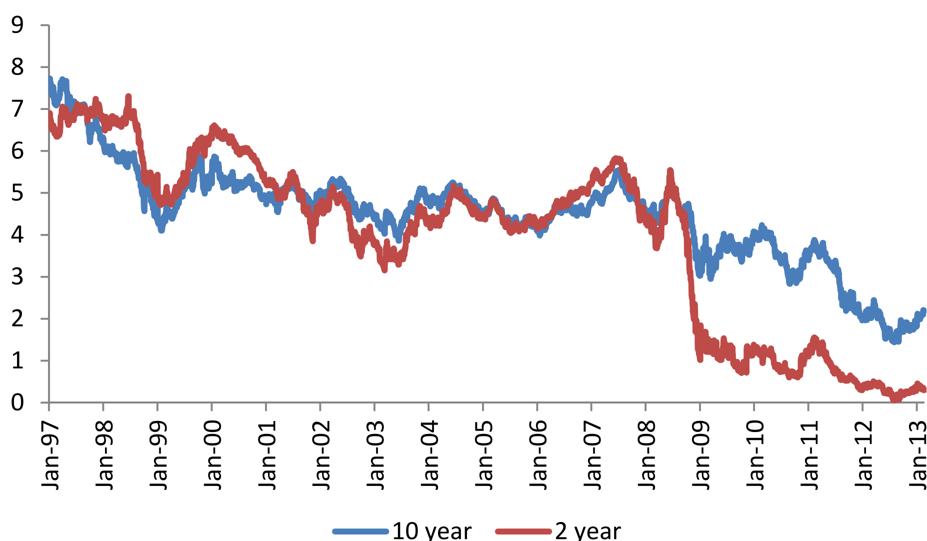
Clearly the magnitude of supply is only one factor in determining bond prices. Others include: attitude to risk, perceived and real inflationary pressures, regulation, monetary policy, global perceptions of the UK economy (absolutely and relatively to other markets), and the prospects for the Government’s fiscal position.

So why have bond investors apparently looked so favourably on UK Gilts, at a time of such significant new issuance? And is it sustainable? And will Moody's arguably belated decision to downgrade UK Sovereign paper from AAA to Aa1 herald the start a loss of confidence in UK bonds? The answer to these questions are critical because, as any mortgage holder, or saver, will be aware, significant shifts in the interest rates can have a dramatic influence on asset values and disposable income. We have got used to ‘cheap money’. But post-war history shows us this is the exception, not the rule.

This paper examines:

- recent trends in bond issuance and asks who the net buyers are;
- what has been the primary cause of low bond yields;
- the possible reasons behind support for UK sovereign bonds;

CHART 1: UK 10 Year and 2 Year Benchmark Gilt Yields (%)



Source: DMO

- the outlook for GDP growth, which is so critical to the scale of future bond issuance due to its relationship with tax receipts, as well as the perception that the UK is some sort of 'save haven';
- the inflationary pressures (which have remained elevated despite very weak aggregate demand) and the likely direction of those pressures in future;
- the distortions caused by QE and the winners and losers of the policy.

It then asks:

- is current monetary policy sustainable?
- or is this a bubble which is actually damaging the long-term health of the economy?

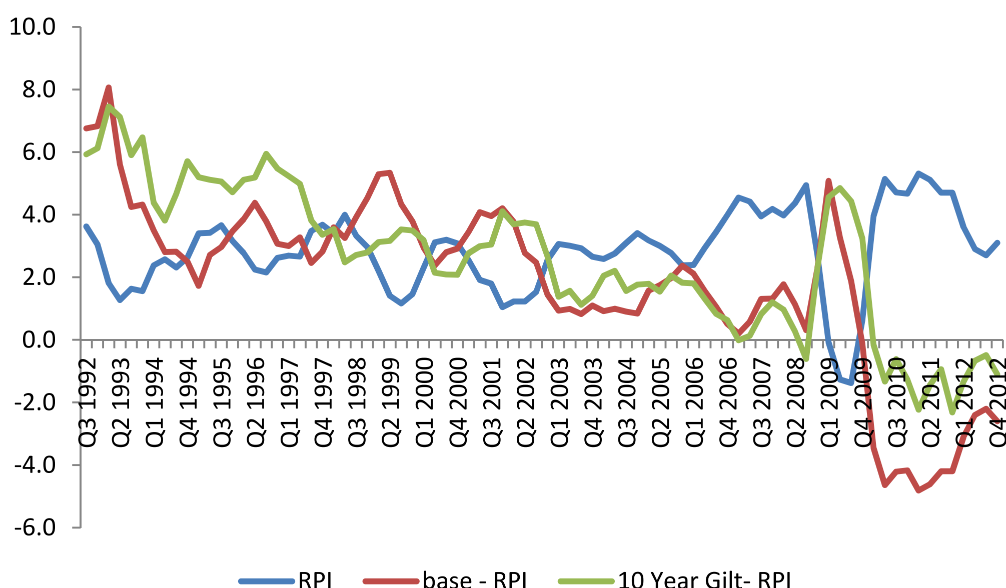
The danger is that on unchanged policies, UK growth prospects will remain weak, the deficit will remain high, and the distortions of a continuation of cheap money policies will damage the long-term health of the economy. But all is not lost: with the right policies, the UK economy can be put back on a long-term stable footing.

MONEY IS FREE

The so called 'Great Moderation' (roughly the period from the mid-1980s to 2007) saw a long period of benign inflation. Yet, despite the most significant decline in GDP since the 1930s, stubborn inflation has coincided with the recent glut of gilts. Between January 2008 and December 2012 the purchasing power of sterling, as measured by RPI, lost 17.2% of its value. Despite this, the yield on the 10 year benchmark gilt today is 2.18%. Unless one is particularly optimistic on the direction of future inflation, the real return on bonds is almost certainly baked in at firmly negative levels. Thus not only do we have a 'glut of bonds' (and not just in the UK, but globally too) but we have a resurgence (fairly modestly so far it must be admitted) of the arch enemy of bond returns: inflation.

Chart 2 highlights RPI, the real return on the 10 year gilt and cash at base rates. The average real return on UK 10 year gilts over RPI between January 1992 and January 2008 was 2.53%.

CHART 2: RPI and Real Returns on Cash at Base Rate and UK 10 Year Benchmark Gilts, %



Source: ONS and DMO

This return is a reward for 'the time value of money.' i.e. for not consuming today. With the 10 year benchmark gilts currently yielding 2.18% to maturity, this implies an expected rate of inflation that is negative, if the pre-credit crunch real returns were to hold. However, the Bank of England has recently indicated that it now believes inflation is likely to remain elevated beyond its 2% target, a view shared by the Treasury's independent Panel of Experts forecasts (its RPI inflationary expectations are currently 2.8% for 2013 and therefore imply a negative real return).

While this independent consensus view has been consistently 'optimistic' on inflationary expectations over the last five years, something does not add up. Why would investors willingly accept a negative real return at a time of elevated macroeconomic uncertainty and public finance data which require a continuing very high level of gilt issuance?

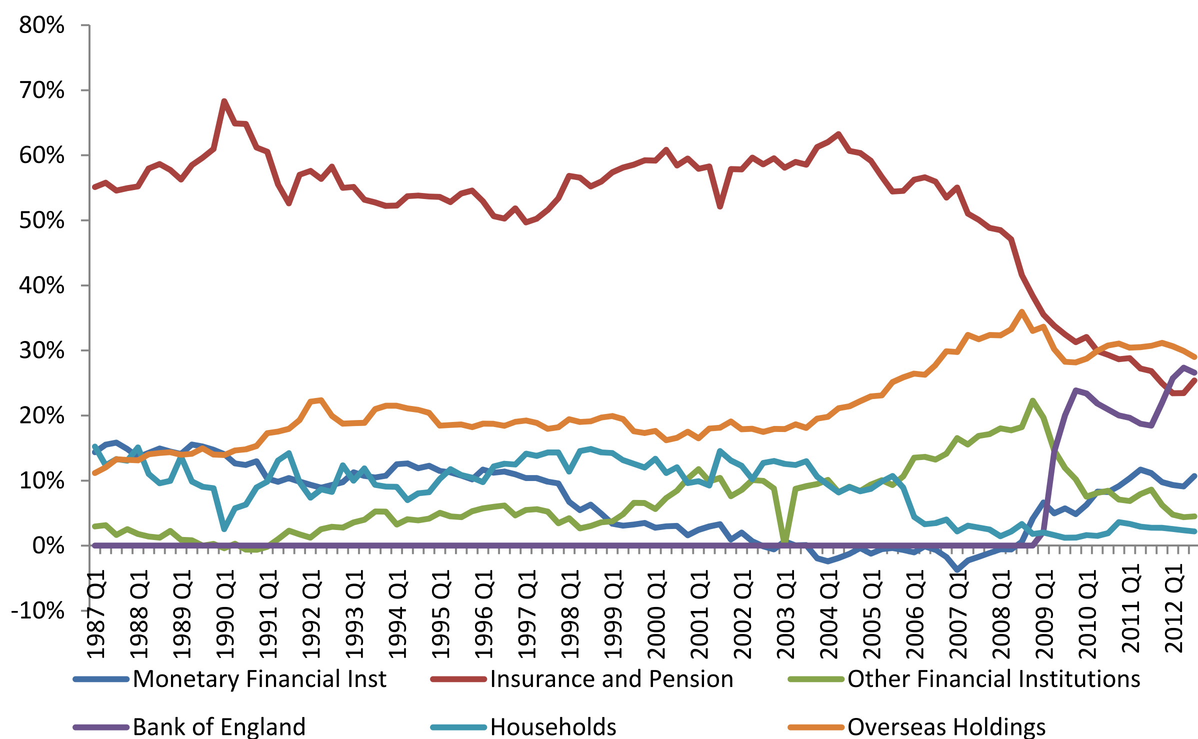
It is extraordinary that investors should support such a situation. The only way a positive real return could be ensured would be a period of deflation. Yet as Central Banks have clearly articulated they will not countenance deflation, this explanation seems unlikely.

AN UNPRECEDENTED GLUT OF GILTS

The early years of the century saw very little net new gilt issuance. It took until Q2 2003 for the UK gilt market to exceed its size at the start of the new millennia. However, steady real increases in public spending saw the outstanding stock increase from £324.7bn in Q2 2003 to £496.7bn by Q1 2008. This was just the beginning.

Just four years later the size of the gilt market has exploded to £1.323 trillion (2012 Q4). This is a staggering increase of £832bn since January 2008. It continues to grow unabated today.

CHART 3: UK Gilt Ownership



Source: DMO

To put this explosion in context: what took 314 years to accumulate from the foundation of the Bank of England in 1694 has increased two and a half fold in just four years.

In other words, Britain won and lost an Empire, engaged in two world wars and experienced the chaos of the 1970s and yet only built up a debt that is 37% of that which has been added in the last four years.

But despite this massive and unprecedented gilt issuance, yields at all maturities are substantially lower today than they were in 2008. In fact, they are at the lowest point since the foundation of the Bank of England. The normal expectations of supply and demand appear to have broken down.

WHO ARE THE BUYERS?

Since the War, the gilt market has been overwhelmingly funded by British institutions such as pension funds and insurance companies. Chart 3 shows that up to the mid-2000s, these institutions owned between 50% and 60% of the total stock. Today, however, they hold just 25.4% and have been relegated to third place in terms of scale of ownership.

Of the £832bn of additional gilt stock issued since January 2008, 46% of the take up is a result of the Bank of England's QE asset purchase programme (see Table 1). Banks have also been major net purchasers (£114bn), as have overseas institutions (£239bn) – with foreign central banks now accounting for £74bn of that total.

UK institutions and households have not been major purchasers and other financial institutions have been substantial net sellers.

In other words, the majority of net purchasers of gilt stock have been agents of the state, be it directly via the Bank of England's QE programme, foreign central banks, or indirectly, domestic banks via regulatory pressures to hold 'risk-free' short-term paper to boost their liquidity. With the exception of support from overseas investors, traditional supporters of gilts (the UK institutions and even individuals) have been largely absent net new purchasers.

Furthermore, market participants almost certainly acted on the fact that such large 'forced' purchases were occurring; and were able to benefit from this expected action. Just as Gordon Brown's pre-announcement that he was going to sell off roughly half of the UK's gold holdings temporarily drove down the price of gold, so too have market participants been able to play the market.

On top of that, while the QE programme is in current abeyance, clear pronouncements from the Fed and hints from the UK Chancellor and Bank's Governor-elect suggest that central banks will not be idle in trying to 'promote growth' via monetary policy. These signals do not go unnoticed by capital markets.

It is therefore difficult not to conclude that the predominant capital flows into gilts were driven by *force majeure*, not fundamental reality.

TABLE 1: UK Gilt Ownership, holdings by category Q1 2008 to Q2 2012, £ millions

	Banks	Insurance & pension funds	Other financial Institutions	Bank of England	Households	Overseas Holdings	Total central gov. liabilities
2008 Q1	-7,651	229,901	85,697	0	24,203	158,859	**496,749**
2012 Q2	106,810	335,814	61,495	386,818	29,136	398,313	**1,319,385**
change	**114,461**	**105,913**	**-24,202**	**386,818**	**4,933**	**239,454**	**822,636**

Source: DMO

The UK gilt market (and indeed US Treasury market) no longer reflects normal supply and demand patterns with decision making based on economic outlooks, inflationary expectations and 'natural demand.' Instead it is increasingly based on the perceived intentions and purchases of state bodies, or organisations highly regulated and influenced by state bodies. The sovereign bond market is far from a free one in the normal sense of the word.

Therefore, so long as participants do not completely lose faith in the UK's ability to finance the debt (as they have questioned in parts of Southern Europe), investors are prepared to back bonds that deliver near certain negative real returns to maturity not because they are good value *per se,* but because the actions of forced buyers currently and in the future are likely to impact positively on valuations in the short-term. It is only when confidence is manifestly lost, as was the case with Greece, that these influences break down.

The problem with this approach is that it can become a never-ending dance. This was alluded to recently by Bank of England Governor, Sir Mervyn King.[1] But what happens when the music stops? Will we face a violent correction in yields, or a nice gradual move back to normality?

UK POLICY IS EXTREME

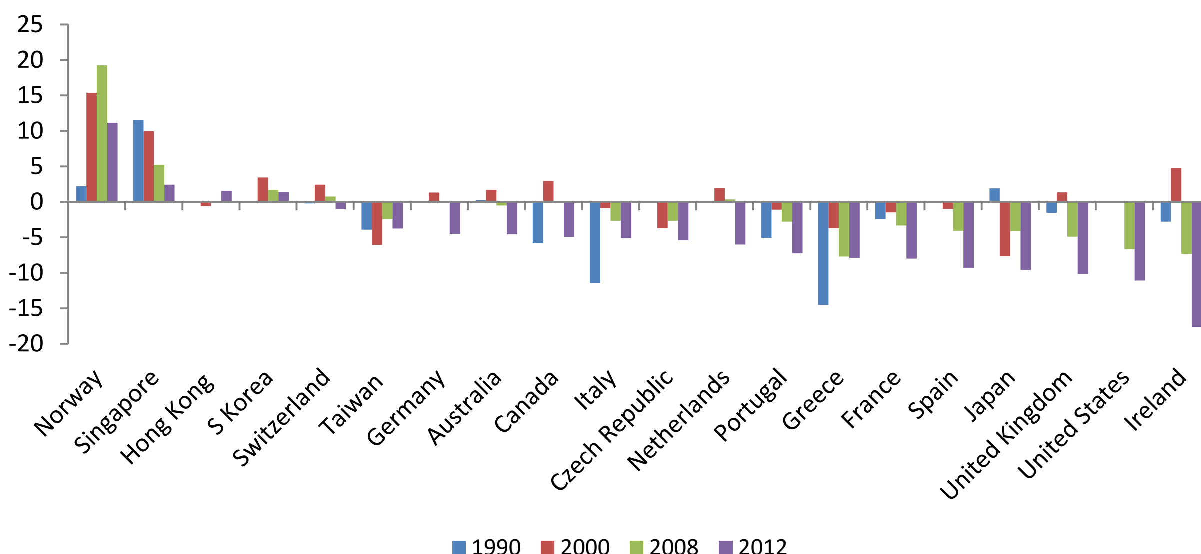
The scale of Asset Purchases in the UK needs to be put in the context of other major bond markets. QE has been a much more freely used tool in Britain than in other major currency areas.

- In the Eurozone, asset purchases are equivalent to 4% of GDP;
- In the US, they are equivalent to 14% of GDP;
- In the UK, they are equivalent to 26% of GDP.

Not only has the UK operated an asset purchase policy to a more extreme extent than the other major economic blocs, but its interest rate policy is also right 'up there.' The base rate, held at 0.5% since 2009, is at its lowest rate in the 314 year history of the Bank.

[1] Sir Mervyn King, The CBI Northern Ireland Mid-Winter Dinner Speech, 22 January 2013.

CHART 4: Global fiscal Deficits (% of GDP)



Source: IMF

To complete the trilogy of extremity, the fiscal deficit remains closest to the highest ever achieved in peacetime and bares very poor comparison with a range of other advanced nations. This deficit is significantly more elevated than large parts of Southern Europe, for example. Chart 4, using IMF data, highlights the UK's relative position.

PERHAPS THE UK IS A SAFE HAVEN?

So the UK has not been shy in applying very strong medicine. But has it worked?

Unfortunately, the UK's GDP growth performance has significantly lagged that of other major western nations. Chart 5 highlights UK GDP performance since the onset of the credit crunch. Italy is the only country to have seen inferior growth. Indeed, UK GDP remains below that achieved in Q2 2008 and is some 16% below what the Treasury forecasts of 2008 said it would be.

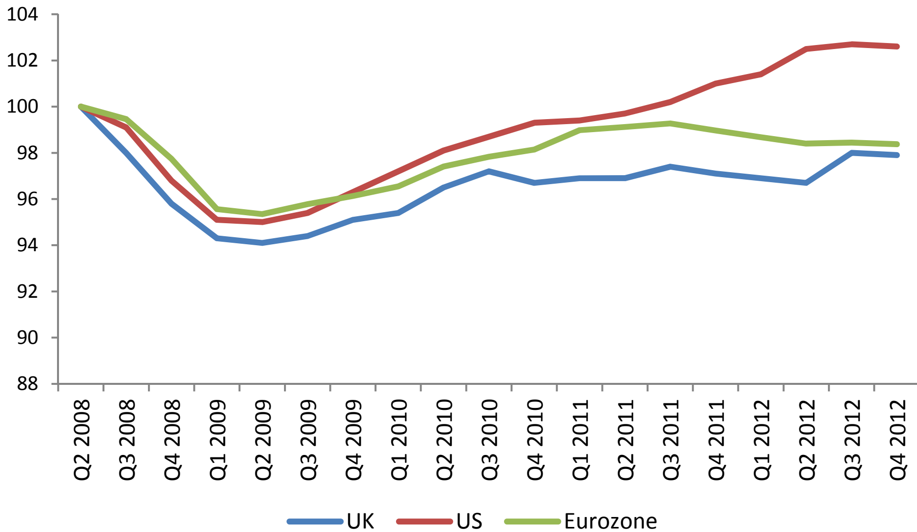
So if the UK is indeed regarded as a 'safe haven', it must be either because investors perceive that policy is broadly on the right track and that things will get better, or that the situation is so bad that 'risk free' investment is superior to 'risk' investment.

Despite significantly more positive demographics than much of continental Europe, a currency which has depreciated on a trade weighted basis by around 15% since 2008 and an unprecedented fiscal and monetary response, growth remains elusive. This suggests the issues are largely structural and, on unchanged policies, any expectation of a resumption of pre-2008 'trend growth' is highly improbable. Therefore the fiscal deficit is likely to remain significantly more embedded than either the OBR or the Treasury currently recognise. If this is the case, it would be wrong to regard the UK as a safe haven.

THE GREAT DELUSION?

Looking back, the 'Great Moderation' could perhaps be more accurately described as the 'Great Delusion.' Many of the drivers of growth were in fact one-off factors and, in aggregate, were damaging to long-term growth potential. These include:

CHART 5: GDP Performance from eve of 'Credit Crunch'



Source: Datastream

- the increasing indebtedness in the domestic economy fuelling a property and asset bubble (not a productivity gain);
- an unprecedented increase in public spending; and,
- a reliance on financial services growth that for reasons of prudence (de-leverage), political will and regulation are unlikely to revert to significant growth any time soon.

But if UK GDP growth in the 2000s was a mirage, then attempts to keep the economy white hot are futile. For the economy must eventually settle at its productive capability. To maintain the pretence that our previous economic performance was sustainable, through yet more leverage and monetary creation, cannot improve the underlying productive position of the UK. All it does is shifts the bill.

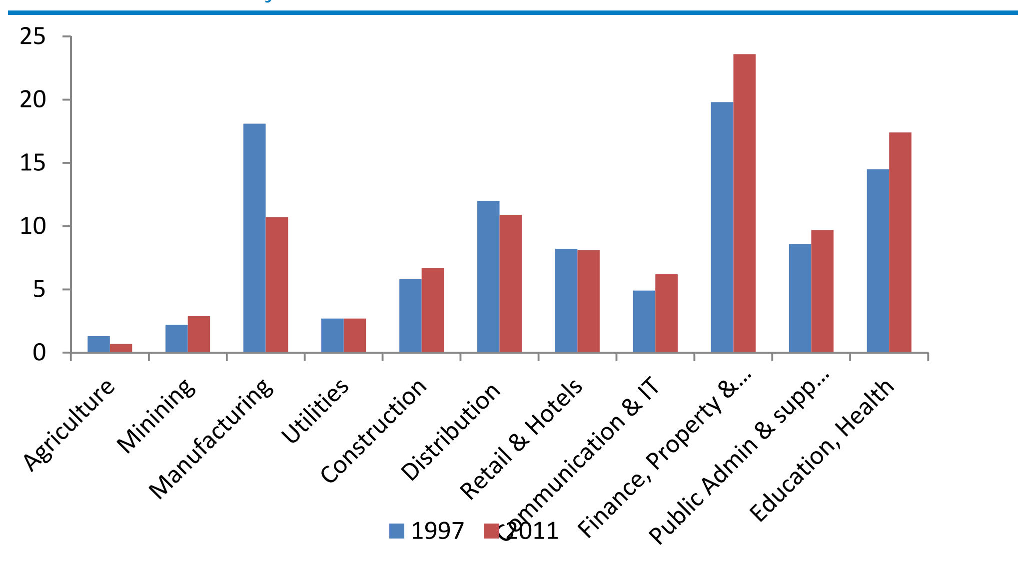
WHERE CAN GROWTH COME FROM?

The sectorial weights of the UK economy have shifted significantly over the last 30 years, away from manufacturing towards financial services and the public sector. This trend accelerated in the early years of the millennium, as Chart 6 shows. While the decline in manufacturing may be unwelcome, it is not out of line with other major economies, notably France and Italy (although not Germany, or to a lesser extent, the US).

However, the growth in the public and financial services sectors is unlikely to recur for many years. In that context it is not entirely clear where the growth is going to come from, particularly given it is improbable and undesirable that the slack will be picked up from a consumer re-leverage (especially given the scale of the UK trade deficit).

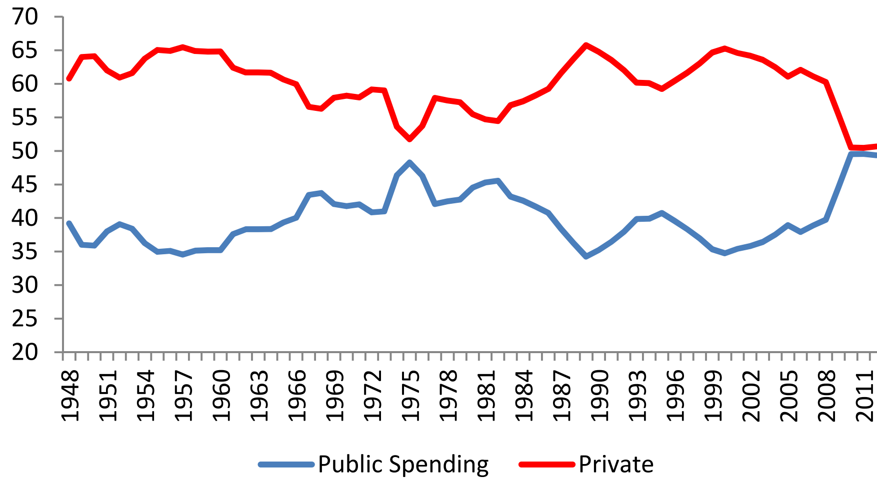
In addition, the degree to which the public sector grew in the 2000s has sometimes been under-appreciated: public spending was £363bn or 36% of GDP in 2000/1. By 2011-12 spending was £703bn or 49% of GDP. This increase in spending as a share of GDP is substantially steeper than the rate of increase in the mid-1970s (see Chart 7). While the rhetoric is different today, the result, in terms of the growth of the state, has been every bit the same. There is a wealth of academic evidence that demonstrates that countries with a relatively large private sector are more prosperous than those dominated by the state. The UK's current dependence on the state does not bode well for either productivity or growth in the future.

CHART 6: GVA UK Economy 1999 on 2010



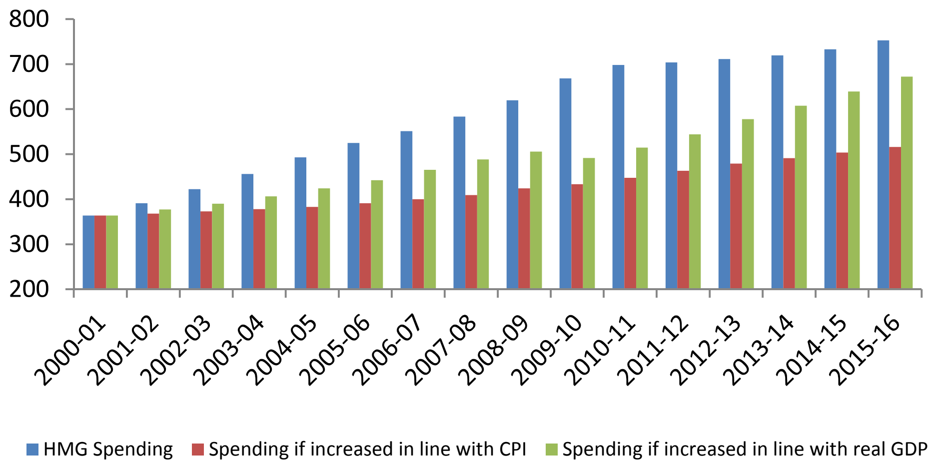
Source: Blue Book

CHART 7: Post War Growth of the Welfare State (% of GDP)



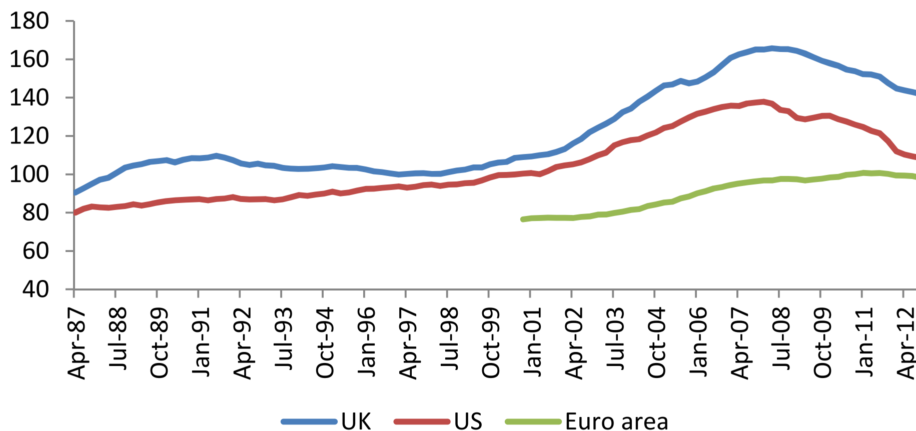
Source HM Treasury

CHART 8: HMG Spending from 2000/1 – actual and indexed to CPI and Real GDP (£bn)



Source: HM Treasury, Walbrook economics

CHART 9: Household Debt as a % of Income



Source: Bank of England

The rapid growth in public spending in the 2000s is also likely to act as a drag on future growth: public spending was £363bn or 36% of GDP in 2000/01. By 2011/12 spending had reached £703bn or 49% of GDP. For there is a wealth of academic evidence that demonstrates that countries with a relatively large private sector are more prosperous than those dominated by the State.[2]

To put the New Labour spending spree into perspective: if the public sector had grown in line with CPI to 2011-12, total spending would have been £463bn in that year. If it had grown in line with real GDP, spending would have reached £544bn. In reality, the uplift above that level was in excess of £150bn, or around 10% of GDP (see Chart 8).

The scale of this spending increase in the Blair/Brown years was unprecedented in peace time. It puts Osborne's austerity programme in sharp relief. Real spending cuts of 1.5% are planned to 2014-15, taking real spending back to 2008-9 levels hardly startling when put in historic context. To date, in aggregate, there have been no real spending cuts at all.

This remains important in understanding the UK's predicament If the current expenditure levels persist, unmatched by GDP growth, there is a price to pay in either punitive levels of taxation or inflation (or both). These will rob the innocents of this recession – savers, pensioners and the young.

CONSUMERS HAVE A PRICE TO PAY

Governments were not the only ones to go on a binge. Consumers also read the signals from the Fed, central governments and the Bank of England. Households reacted rationally to the cheap money policies of central banks by borrowing more.

Chart 9 demonstrates this clearly by looking at household debt as a proportion of income in the UK, US and the Euro area from 1987. While UK households have started to deleverage again their debt levels remain highly elevated by historic standards. Despite lending targets and saver suppression, via low rates, it seems improbable, least of all desirable, that consumers can re-leverage. As a result, increased consumer spending will not be a driver of economic growth.

The net new consumer credit figures (see Chart 10) back up consumer's attitude to deleverage. Another driver of the Blair/Brown delusion is spent.

THE SHRINKING PRIVATE SECTOR

A further problem is the increasing regional polarisation of UK GDP and public spending. As can be seen in Chart 11, Gross Value Added (GVA) in London is in excess of £35,000 per head while the next most prosperous region, the South East, enjoys a GVA of around £21,000. No other major European country has such a regional wealth concentration.

The gap between prosperous London and the South East and the rest has generally been widening over the last 20 years and this is despite very significant real increases in public spending in the regions throughout the 2000s.

Chart 12 compares identifiable regional public spending per head. Chart 13 shows how in 7 of the 12 British regions, public spending now exceeds 50% GVA and in a number of cases (notably Northern Ireland, Wales and the North East) exceeds 60%.

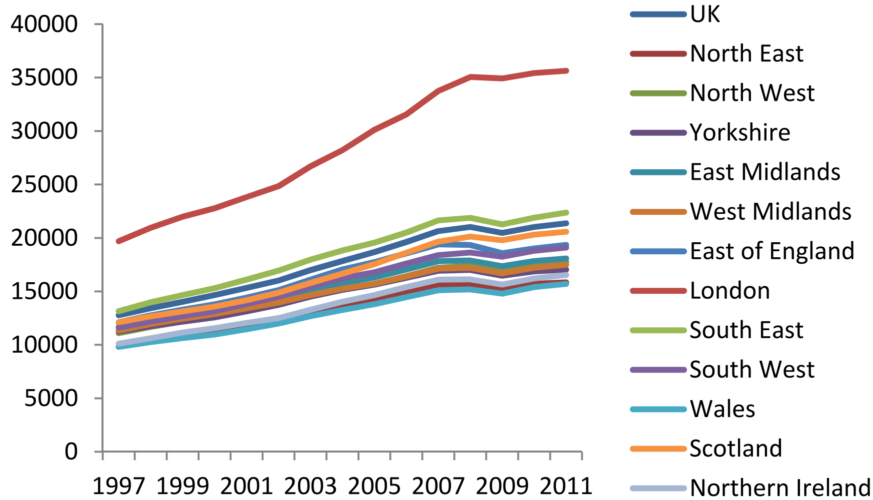
Further monetary policy has almost certainly benefited the South over the North. The new

[2] See for example, A Afonso and D Furceri, 'Government size, composition, volatility, and economic growth' *European Journal of Political Economy,* Vol. 26 (4), 2008; and A Bergh and M Henrekson, "Government Size and Growth: A Survey and Interpretation of the Evidence'" *Journal of Economic Surveys*, 2011.

CHART 10: Total Consumer Credit, year on year growth

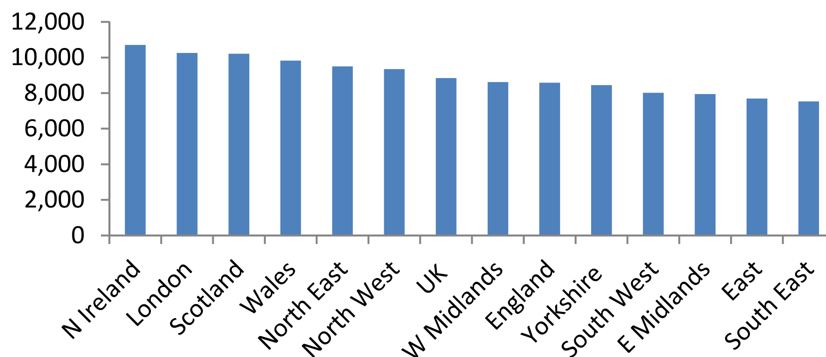
Source: ONS

CHART 11: Regional GVA per head, £, 1997-2010



Source: ONS

CHART 12: Identifiable Public spending per head, £, 2011-12



Source: HM Treasury

money (QE) has disproportionately fed through to London, via its banking and real estate sectors with a much smaller regional benefit. Thus many British regions are hindered not only by excessive state spending and its productive crowding out, but also, in relative terms, by monetary policy.

This begs the question: if public spending growth needs to be restrained, can these regions generate meaningful growth when their private sectors are so small? Further, regional public salaries are often substantially higher than in the private sector (particularly if pension benefits are included), primarily as a result of national pay bargaining. It is hard for the private sector to get a look in in many parts of the country. It is thus very doubtful the private sector can quickly regenerate, in a number of regions, given its current scale and dependence on the State.

Chart 13 shows the relationship between regional GVA and the percentage of public spending. There is a clear correlation: the lower the public spending, the higher the GVA. In other words, higher public sector spending does not seem to lead to greater relative prosperity. Indeed the opposite is true. State spending, while often well-intentioned, is linked to relative regional decline. The clear lesson is more public spending is at best a short-term palliative that in the longer term does meaningful harm to local prosperity.

DEFICIT REDUCTION – MORE WORDS THAN ACTION SO FAR

The Coalition rightly put deficit reduction at the heart of their programme for government. Unfortunately, progress has been modest so far both in terms of deficit reduction and in terms of reducing aggregate spending.

Chart 14 shows the accumulated annual deficits from 2008/9. Excluding the somewhat dubious £28bn surplus reported from the transfer of the Royal Mail Pension Plan and the proposed future transfers of surplus cash from the Bank of England Asset Purchase Facility Fund, the current underlying deficit remains at a near all-time record.

Further, despite a series of significant tax rises, (notably VAT, higher rate tax allowances, Stamp Duty etc.) tax receipts have flat-lined as growth continues to disappoint. More unbelievably, despite the rhetoric, public spending growth has started to pick up again. Indeed, over the last three months, spending growth has been 5.9% (for the latest available figures in December 2012). This is despite significant cuts in certain areas like defence, law and order and basic infrastructure.

The bottom line is that, if growth continues to be elusive, the annual deficit will prove to be embedded in the £100bn to £150bn range into the foreseeable future, despite the cuts we have seen and the tightened tax burden. Chart 15 overleaf compares what would happen to expenditure and tax receipts under those circumstances with the forecasts of the OBR.

THE PERILS OF RING FENCING

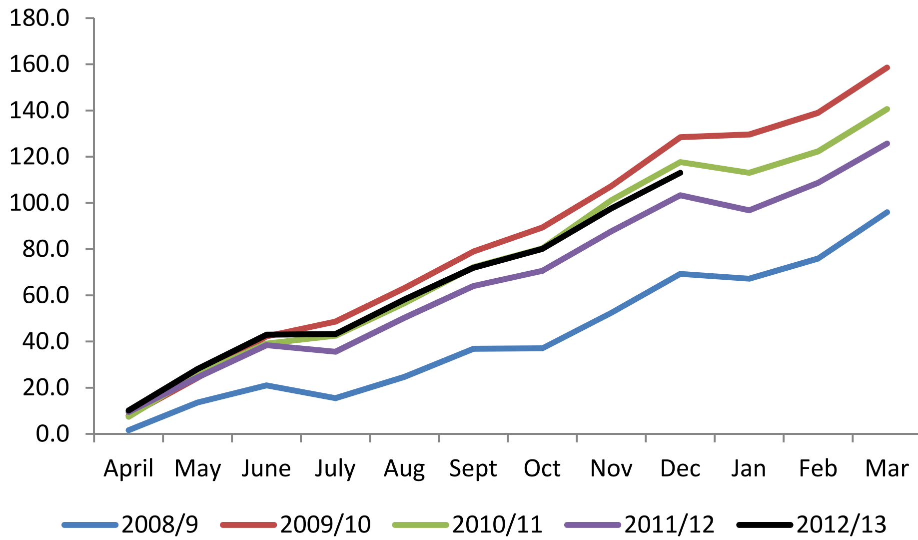
After the protection of health, schools, international aid and, of course, debt interest payments, the Coalition has planned some significant cuts in certain areas.

But almost 60% of all spending is accounted for by the ring-fenced areas. On top of that, the increase in population (because of longevity, an increased birth rate and immigration) makes constraining spending problematic. Limiting percentage increases in a range of welfare benefits to 1% will not be remotely sufficient for long-term spending control given these demographic and spending pledge dynamics. In the medium term, the scope and eligibility of benefits need to be restricted.

CHART 13: Regional GVA and State Spending to GVA, 2011

Source: ONS

CHART 14: Cumulative Government Borrowing, £bn, 2008-9 to current



Source: ONS

Similarly, the health budget has grown by 4% a year in real terms since the war. Restraining similar future growth will not only be politically difficult but likely to prove unrealistic without fundamental reform – for which there appears little appetite. In other words, there are built in structural growth drivers to ever-increasing spending. In this context, scrapping a frigate, here or there, is irrelevant. The only alternative to a constant treadmill of money printing and increasingly arbitrary and painful tax rises is a fundamental reform of public spending.

SOME HOPE FROM UK CORPORATES

While HMG and consumers are mired in debt, there is one great hope – British business. Although credit does remain an issue for smaller companies, large quoted companies have acted very quickly to pay down debt and, as measured by net debt to EBITDA (a measure of corporate profitability before interest payments and depreciation), UK companies overall are in their strongest position for many years.

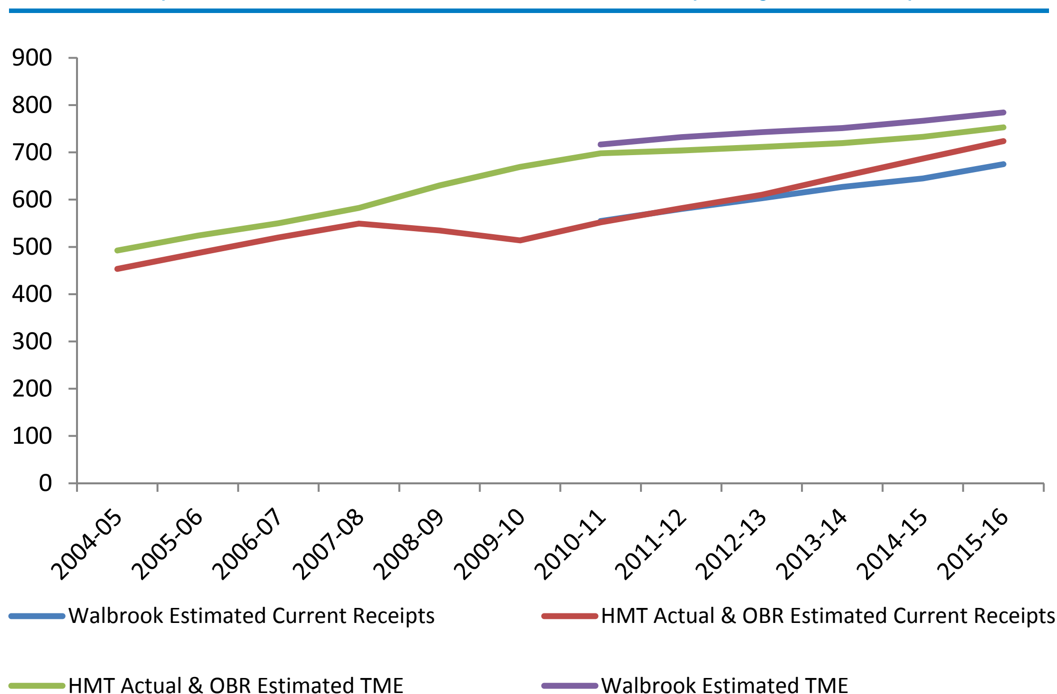
Having gone into recession carrying a high degree of indebtedness, corporates have acted quickly to improve their balance sheets. They have shown a flexibility and dynamism that has eluded most Western governments. If government can create a stable environment entailing supply-side reforms and a stable fiscal framework, then business is in a good place to provide a light at the end of the tunnel.

RISK AVERSION

Some have argued that bonds may have done well because investors are so risk adverse that these 'risk free' bits of sovereign paper, yielding a negative real return, are a better store of value than 'risky' assets like equities and property. This is a seductive argument.

Does it stand up? If investors perceive it really is that bad, not only would the banking system need further recapitalisation but fiscal deficits would be set to increase even further as tax receipts withered.

CHART 15: Comparison of OBR and Walbrook Economics Estimates of Spending and Tax Receipts, £bn



Source: HM Treasury, Walbrook Economics

A longer recession would mean yet more government debt which would ultimately mean more monetary debasement. Gilts are anything but risk-free in this scenario. It is therefore arguable that UK Sovereigns are somewhat riskier than many real assets, be they commodities, property or equities. Is Unilever's paper inherently "riskier" to HMG's?

OTHER REASONS FOR LOW YIELDS

There is some truth in the claim that the UK's problems have not been top of international investors' concerns, particularly as the Coalition has so strongly articulated its deficit reduction credentials.

But as the US continues to show signs of recovery, despite its recent GDP hiccup; and as the Eurozone seems determined to form some form of quasi Federation (for good, or ill), this lack of investor concern might not remain the case. Attitudes of perceived safety can change quickly, as Spain found out.

The support of overseas investors should not be taken for granted. Their money is movable and is clearly dependent on macro-economic and political perceptions. Continuous disappointment over deficit reduction and poor GDP performance may yet test their patience.

A DEFLATIONARY WORLD?

The neoclassical economic view is that long-term interest rates are influenced by current and future expected short-term interest rates and by changing inflationary expectations. Perhaps markets have bought into the view that a long period of subdued growth will result in low inflation or even deflation?

The consensus view, since the start of this crisis, has undoubtedly been that there are few inflationary pressures. Both the OBR and Bank of England have, in common with a majority of commentators, argued that a lack of demand would mute inflationary pressures. This has been one of their primary justifications for monetary policy. It is true that domestic labour settlements have lagged inflation, and that this situation is likely to persist. However, the trade weighted decline of sterling since 2008 has been a contributory factor to the current stubborn inflation. Furthermore, commodity and energy prices have not been subdued. In addition, global monetary easing may have encouraged investors and emerging market participants to buy real, hard assets as a hedge against central bank monetary policy. This would be inflationary. Finally, emerging market wage growth has accelerated in many countries, placing potential longer-term pressures on pricing.

However the consensus view looks highly complacent given the persistent sale of fiscal deficits and the skewing of the time value of money. Mises clearly made this point:[3]

"In discussing the situation as it developed under the expansionist pressure on trade created by years of cheap interest rates policy, one must be fully aware of the fact that the termination of this policy will make visible the havoc it has spread. The incorrigible inflationists will cry out against alleged deflation and will advertise again their patent medicine, inflation, rebaptising it re-deflation. What generates the evils is the expansionist policy. Its termination only makes the evils visible. This termination must at any rate come sooner or later, and the later it comes, the more severe are the damages which the artificial boom has caused. As things are now, after a long period of artificially low interest rates, the question is not how to avoid the hardships of the process of recovery altogether, but how to reduce them to a minimum.

[3] Ludwig von Mises, *Causes of the Economic Crisis*, 1931.

If one does not terminate the expansionist policy in time by a return to balanced budgets, by abstaining from government borrowing from the commercial banks and by letting the market determine the height of interest rates, one chooses the German way of 1923."

Central Banks have been clear about their determination to avoid Japanese style deflation. The Fed is now targeting unemployment and it is possible that the incoming Governor of the Bank of England will get the Coalition's approval to drop formal inflation targeting towards some other measure, perhaps focusing on nominal GDP targeting.

Crucially, the narrow monetary base has expanded very rapidly as a direct result of QE. While bank lending has remained subdued, with this greatly expanded monetary base, any increase in the velocity of circulation of money would result in increasing inflationary pressures. While M4 growth is currently very subdued, after a period of rapid expansion in the Blair/Brown years, this rapid expansion of narrow money, to help fund the deficit, clearly risks embedded inflationary pressures. Central banks argue, that in this instance they would just unwind QE. But would it be that simple?

The problem with this approach is that it assumes central banking omnipotence, which is a hard task at the best of times. It is also unclear where buyers for all these 'QE gilts' would materialise from.

Would such a move not cause an uncontrolled spike in yield curve? At the moment, no credible exit strategy seems contemplated by either the Bank or the Treasury. The cynics might argue that the Bank has abandoned inflation targeting already. Certainly the 2% target has been missed 39 months in a row.

HMG is well aware what impact deflation would have on tax receipts. Given the scale of the fiscal deficit, 'pragmatism' in terms of even more unconventional measures is the likely political temptation. Those believing in deflation will remain disappointed.

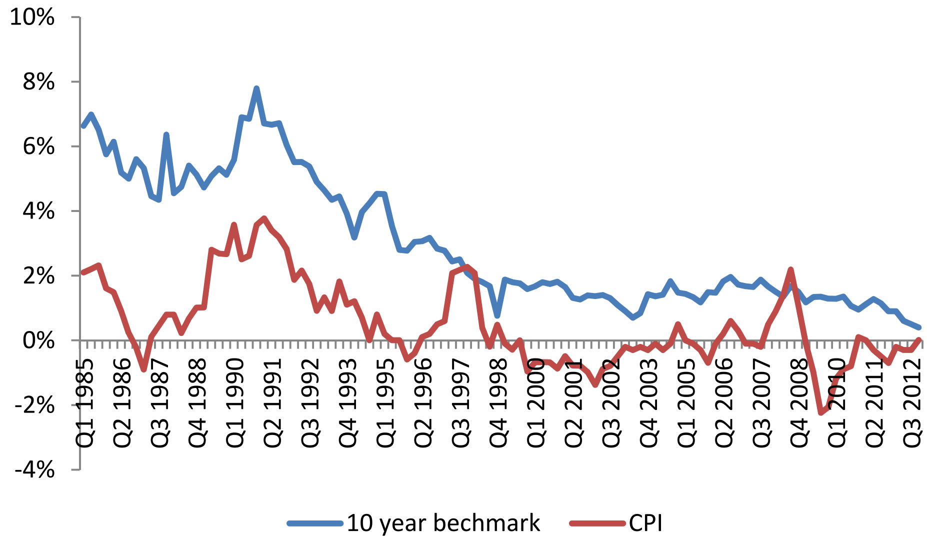
BUT JAPAN GOT AWAY WITH IT?

Many highlight that Japan's gross public debt, at 230% of GDP, currently stands significantly in excess of all EU member states, Greece included. This contrasts with Britain's current gross government debt of 70.7% (using the latest ONS data). Ignoring the fact that the UK definition excludes pension and PFI liabilities and certain other obligations, the UK situation is significantly less onerous than that of Japan.

Further, Japan, while running a significant structural fiscal deficit, has enjoyed very low inflation and, at times, modest deflation coupled with highly disappointing growth. Yet markets have continued to back Japanese bonds despite very low rates of interest (the 10 year benchmark for example currently yields a mere 0.7%). Charts 16 and 17 show Japanese yields, CPI, government debt and the annual fiscal deficit. Some will ask: if Japan can maintain these high debts, why not the UK?

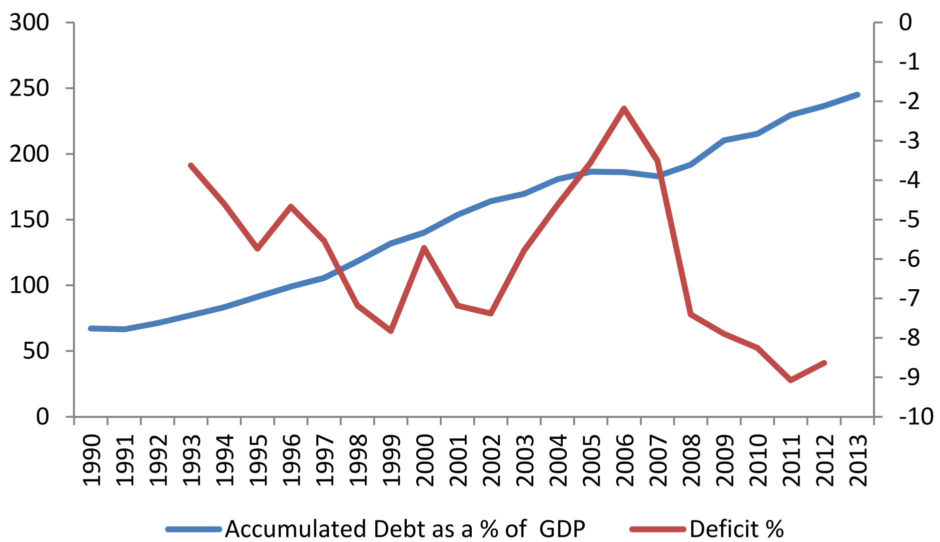
It would be dangerous to assume that because Japan has apparently, for now, 'got away with it', then the same would apply to Britain. But Japanese bonds are held, almost exclusively, domestically. They have with very few global investors. Japan has also enjoyed a very high savings ratio and a consistent trade surplus. While some positive factors are starting to unwind, these dynamics have undoubtedly influenced the local market. In the UK case the opposite is true. Foreign investors remain a significant swing factor and the UK has consistently experienced low savings ratios and a substantial and embedded trade deficit. The UK remains dependent on external good will.

CHART 16: Japanese CPI and 10 year benchmark Bond Yields



Source IMF

CHART 17: Japanese Accumulated National debt and Annual deficit



Source IMF

THE LOSERS FROM QE

The promise made, when QE was first announced, was that this would be temporary, stimulatory, and non-inflationary.

None of these promises have been kept. Five years later there is no sign of its unwinding – on the contrary. The Fed, the new Japanese Government and now the early pre-inauguration speeches from the UK's Mark Carney indicate that more QE can be expected.

To date it has not resulted in growth – certainly as judged by the UK's GDP performance. And despite the most significant decline in UK GDP since the 1930s, inflation has consistently exceeded the Bank of England's formal target.

The policy has therefore failed to deliver what was promised. But it also has a considerable impact on particular groups.

Savers

The average return of the base rate over RPI between January 1992 and January 2008 was 2.85%. This is a rational reward as it reflects the time value of money. But for the last 48 months, base rates have been stuck at 0.5%. RPI over that period has averaged 3.03%. Hence the average real return is minus 2.53% a year – a swing of 5.38% over the long-term average. British savers have accumulated bank savings of around £1.2tn.[4] However if the long-term real return had remained at the pre-2008 average, the 'lost' interest return has been £65bn a year, or around £2500 for every family in the land.

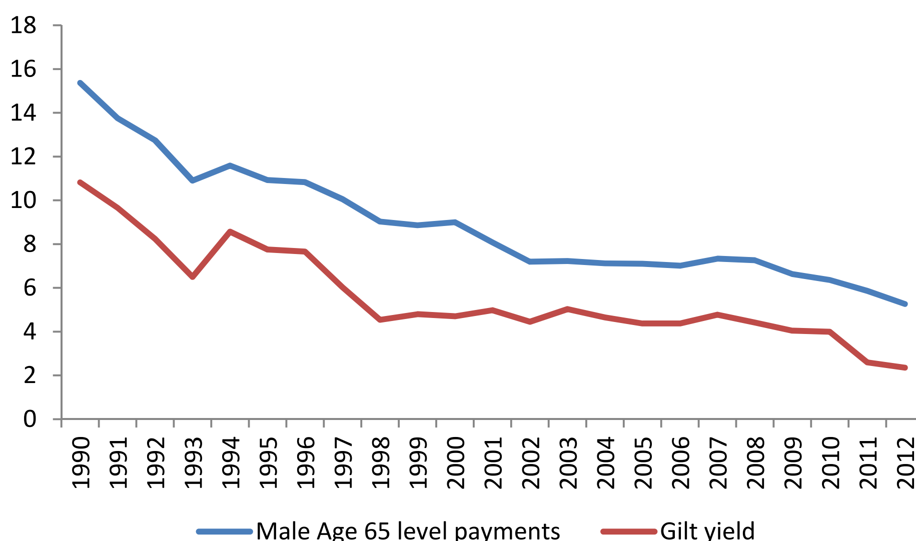
Assuming a 20% tax rate this policy has cost the Exchequer around £13bn a year. Consumption (and growth) have also been constrained as consumers have less to spend. Worse, it discourages future saving, by destroying the saving incentive, which is potentially disastrous for long-term investment and bank health. If the problem was too much debt, it seems paradoxical to penalise the opposite of debt: saving. This policy has thus resulted in an invisible, illogical and substantial tax on savers.

Pensioners and Pension Funds

Pensioners are also clear losers. Annuity rates have collapsed (see Chart 18). In 2000 a company would needed to have set aside

[4] Source: Building Society Association, December 2012.This figure is probably an underestimate, as it is quite a narrow definition of savings excluding, for example, UK residents overseas cash holdings.

CHART 18: Annuity rates and Gilt Yields, %



Source William Burrows

around £115,000 for each £10,000 for a man aged 65 enjoying an RPI linked pension provision. Today that figure is £285,000, with annuity rates for that category around 3.5%

The Pension Protection Fund has estimated that companies saw defined benefit scheme deficits increase by £135bn between 2009-10 and 2011-12, directly as a result of falling annuity rates. Annuity rates are directly related to the gilt yields through the regulatory requirement to hold so-called 'risk-free' security. So companies, instead of directing money towards capital investment, have had to divert earnings into pension schemes which in turn invest in the supposedly risk-free assets of UK Sovereign Bonds. This is a hidden example of crowding out.

Similarly those with personal pensions have seen the purchasing power of their funds slashed as annuity rates for a typical 60 year old have fallen from 8% in 2008 to 5.2% today for a flat line pension for a male aged 65. An indexed linked pension offers substantially less – closer to £3,500 for each £100,000 invested.

The young

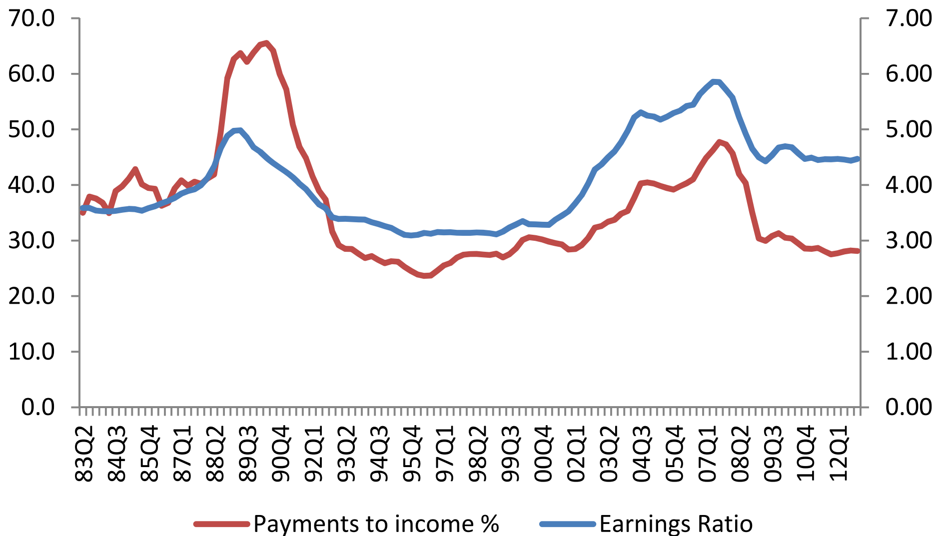
The young are also clear losers. Monetary policy has hit them by artificially boosting real asset prices, residential property being a prime example. It is little surprise the average first time buyer is 33 today compared with 25 in 2000. According to the Halifax House Price survey house prices are 5.5 times the average first time buyer's salary. Rather than letting the market 'clear' to find its natural level, artificially stimulating the market through monetary policy has resulted in a generation of renters.

Then by increasing the stock of Government debt by £823bn, over five years, future generations are paying for today's honey.

AND THE WINNERS ARE...

Property owners and the indebted are the winners. Chart 19, using data from Halifax, shows a paradox. House prices to average earnings remain historically expensive at 4.47 times salary (close to the bust levels of 1989 and well above the long term average of 4.08 times). However, the total cost of interest payments relative to income are now close to a 30 year low.

CHART 19: Halifax House Price Affordability and Prices to earnings Index



Source Halifax

House prices would simply not be trading anywhere near these levels if monetary policy was normalised. And, as long as monetary policy remains loose, a substantial fall in house prices is unlikely.

Further, there have been few repossessions during this recession. This is due partially to monetary policy and partially as a result of a deliberate policy to minimise foreclosure. People have acted rationally and re-leveraged.

Government is another clear winner. If there had been a 'normalised interest rate policy' (i.e. the average rate between 1992 and 2008 had continued) the cost, in terms of interest payments on the additional £832bn of borrowing since January 2008, would have been around £46bn a year today. That is far more than the entire defence budget.

As discussed above, QE asset purchases have indirectly accounted for over 40% of all net new issuance. With 10 year gilts currently yielding 2.18%, the additional funding cost is around £15.5bn somewhat less than the £46bn described above. And on top of that, the Treasury has now said it will start to claim the coupon on their gilts from this created money.

By insulating itself from the realities of a fair return for bond holders, the Government has been, for now, able to avoid taking difficult decisions. Its incentive to reduce public spending to a sustainable level has therefore been greatly reduced.

The case for failure

A free society needs to allow for the possibility of success and failure. If people suspect that every time a problem arises they will be bailed out by monetary policy, it will not take them long to work out they should 'just swing the bat.' This not only creates bubbles and encourages leverage but also severely distorts asset allocation. In the long term no society can prosper without the fear of failure.

For the reasons outlined above, the current monetary policy has therefore had a profound impact on individual's lives. Some have gained, others have lost. While that may be politics, the scale of the consequences of this monetary policy is well outside the norms of policy making.

Even if one excluded these penalties and windfalls from any calculation, the democratic controls are modest to say the least.

While the Chancellor sets the targets for the Bank of England (in this case currently 2% CPI) and has to sign off on QE, Parliamentary scrutiny is limited. A retrospective Treasury Select Committee report hardly represents accountability.

For a policy that has probably had a greater impact on the electorates' lives than any other, it is imperative that Parliament gains far greater powers of scrutiny.

WHERE DO WE GO FROM HERE?

Central case – continued low growth

The central case envisaged, assuming no change in policy, is that the economy will continue to grow, at best, very modestly. The notion that the UK can get back to pre-2008 trend growth seems improbable.

However, given the structural drivers for ever-increasing government spending described earlier, aggregate increases in public spending will continue, despite cuts in certain departments. Tax revenues will continue to stagnate, despite the increasing complexity of the tax code and the piecemeal tax increases already announced Thus the fiscal deficit is baked in without policy change.

Further, at a time when central bankers are toying with downgrading their inflation targeting remit towards growth measures, the distortions described above will only grow. This will do nothing for real sustainable investment, or productivity growth. On the contrary, the UK's productivity performance will only continue to deteriorate relative to other nations. This does not bode well for long-term British prosperity.

At best this results in the deficit continuing at over £100bn a year into the foreseeable future (and probably closer to £150bn), an increasing taxation ratchet and continuing 'asset purchases' with savers, pensioners and the young continuing to pay a heavy price.

This scenario may not result in a total collapse of confidence, over a short-term view. But the key issues of UK productivity growth and the crowding out of the private sector will not have been addressed. The UK's relative position will have deteriorated further as others, particularly in peripheral Europe, are forced to take action to increase their productivity.

This is not a supportive environment for wealth creation, or indeed the long-term health of the public sector. It is unhelpful politically and given the nature of the debate risks even more radical Keynesian and monetarist solutions to 'get short-term growth going.'

Worst case – toppling off the tightrope

At worst, if current policy continues, Britain risks a crisis of confidence in its financial stability. This could occur if the fiscal position continued to miss substantially already slipping projections, or if a future Government decided to try to 'grow their way' out, by yet further increasing public spending. Real spending increases to date have not worked and will only further damage productivity in the long term. Keynesian pump primes, while running a deficit of well over £100bn, is analogous to trying to run a 100 metres in under 9 seconds without taking drugs.

The Bank of England may just about be able to get away with current monetary policy, given an RPI of 3%. But a sterling shock could not be ignored. Interest rates would then have to rise quickly, in an uncontrolled fashion, and the fiscal deficit would become unsustainable. Britain remains dependent on international goodwill.

Such an outcome would result in unparalleled tensions as welfare promises simply could not be met without confiscatory and ultimately futile taxation policies. The UK would be treading a fine line.

The longer the Coalition's actions fail to match their words, the more vulnerable sterling becomes. The British confidence trick is wearing thin.

CAN ANYTHING BE DONE?

The UK's economic position is bleak. It has been damaged by easy credit, an extraordinary and unabated growth in public spending, and an economy which is currently biased to areas unlikely to deliver substantial growth in the medium term. Throw into the pot a necessary deleveraging, ever-increasing regulation and a self-inflicted structural decline in our principal trading market, and the prospects are unattractive.

There is an alternative. A new Governor of the Bank of England comes to town in July. He and the Chancellor will be faced with a number of distinct options. They can continue the current policy of a soft control of spending coupled with further monetary measures which could include either more QE, or even more direct measures to encourage lending. Difficult spending choices could be postponed, and the crowding out of the productive element of the economy prolonged.

This would avoid short-term pain – but at the cost of increasing and lasting damage to the economy. The status quo has almost certainly led to asset misallocation, into bonds and maintained Government spending, or through elevated property valuations (beyond their fundamental valuation on a normalised monetary policy) and away from productive investment. To continue on this path would lead to the slow but firm strangulation and nationalisation of Britain.

The precondition: tell the truth

In order to achieve lasting and stable recovery politicians need to be honest with the electorate about the scale of the challenge. Let the people decide – jam today and the pawn brokers tomorrow; or perhaps dry toast today and lashings of honey tomorrow.

If that choice is to be made, then politicians should be clear about the true state of the economic crisis. For the vast majority of the population is under the impression that all is well: recent opinion polls suggest that between 6% and 10% of the UK population realise that public debt will rise drastically over the course of this Parliament, while as many as 47% think that the debt will have been wiped clean by the end of this Parliament.[5] This extreme disconnect between perception and reality must be addressed, not least so that public support for the hard measures that are needed can be secured.

Clearly, articulating a policy of austerity when the reality is that public spending has continued to grow in real terms is politically dangerous. It is an easy 'Aunt Sally' for the Coalition's foes, when growth does not materialise. It risks a solution that would be even worse than the current Coalition strategy: a Keynesian 'growth strategy' building up even more debt.

Ten steps to economic health

Ultimately Britain will succeed or fail on the back of its productive capability. The only long-term solution is to rebuild that capability and to raise the medium-term growth rate of the economy. It will take time but it must focus on generating private sector growth through radical supply-side reforms and a normalisation of the public expenditure to more sustainable levels.

The following ten ideas, which are by no means exhaustive, are set out as critical building blocks in providing lasting foundations for economic recovery.

First, the new Governor should rule out any further QE on the grounds it is distorting asset prices, diverts capital from productive areas and damages savers. While unwinding the £375bn of QE to date is unrealistic, in the short term, a clear target should be set to articulate a plan to sell back these asset purchases. This target date for full withdrawal may need to be 10 or 15 years hence.

Second, the Bank of England should announce a medium-term plan to start the process of interest rate normalisation with a very modest target of a 2% base rate by mid-2014. Given current banking spreads, this should have a very limited impact on the cost of borrowing.

Third, the authorities should split investment banking operations from commercial banking operations. While such a move is not fool proof, it would help restore the link between saving and commercial lending rather than transferring capital flows to riskier investment banking. Over time this could help free up capital for commercial lending which remains the poor banking relation.

5 Just 6% of the public realise debt is ballooning in this Parliament – Ryan Bourne, CPS.

Fourth, the Government should set a target to reduce public spending relative to GDP to 2000/01 levels (i.e. midway through Blair's first term) to 36% of GDP, from the current 49%, within 10 years. This needs to be achieved by real spending cuts, significant supply-side measures to raise the underlying growth rate of the economy and gradual, fair and clearly articulated tax reductions. There is plenty of evidence that reducing the extent of Government consumption and transfer spending would raise the UK's underlying growth rate.

Fifth, the Government needs to seriously control spending, which means examining the scope of the state. All departments need to share this consolidation, but the focus needs to be on sustained and meaningful welfare cuts and a control of health budgets. Many avenues could be explored, but making child care, private education and health tax deductible would not only stimulate those sectors but would help reduce the overall cost of provision to the state.

Sixth, the tax code needs simplification and consistency. This needs to be done in a steady and transparent way so players are aware of its direction and priorities. The current situation of second guessing where Government will raid next does not encourage investment. One only needs to ask the North Sea Petroleum industry, or the Solar Power Industry, about the impact of arbitrary taxes. The aim must be to reduce the overall tax burden while broadening bases and lowering marginal rates. There are also some taxes which could already be above their revenue maximising rates. For example, cutting rates of property stamp duty would almost certainly yield positive returns for the state via increased transaction activity feeding through, for example, to increased VAT receipts on renovation and fees on professional services.

Seventh, power and energy remains one of the foremost costs families and industry face. Power choices should be chosen predominantly on their cost effectiveness not on the basis of some arbitrary climate target. High energy costs remain regressive in their impacts both in terms of cost and employment and, from an economic perspective, remain a substantial source of capital misallocation.

Eighth, within the confines of rigid spending targets, infrastructure in the form of road, rail and airports need to be prioritised to help increase overall national productivity.

Ninth, micro-businesses, the main source of employment growth, should be exempted from significant amounts of regulation. While it is understood there is inevitably an arbitrary debate as what constitutes a micro-business, small business is the UK's most dynamic sector in terms of employment growth. The benefits in terms of employment would almost certainly outweigh any costs while employees could choose whether or not to accept the terms on offer.

Finally, corporate balance sheets are strong. Government can only blame itself for their reluctance to invest. By creating a more equitable and flatter (lower) corporate tax structure, reducing regulation and putting in place the long-term drivers for productivity growth, business will invest and we will be back to the virtuous cycle that we enjoyed in the past.

The choice is hard. Put off the tough decision-making, with more and more desperate measures which attempt to promote growth at the price of strangling long-term asset allocation and productivity? Or take the hard choice and create the right long-term environment for investment and sustained growth?

THE AUTHOR

Ewen Stewart is the founding partner of the consultancy Walbrook Economics which specialises in applying economic and political outcomes to investment strategies. Prior to setting up Walbrook, Ewen had a wide range of City experience, in a career spanning over 25 years, working for the investment banks Dresdner Kleinwort, ABN AMRO and latterly Investec, as their macro equity strategist, specialising in UK and European equity markets. His published work specialised in examining fiscal deficits and public spending trends and their market implications. He is Chairman of the FTA Management Committee and on the Advisory Board of the Cobden Centre. Ewen can be contacted at ewenstewart@WalbrookEconomics.co.uk

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