

HAMPSHIRE COUNTY COUNCIL**Decision Report**

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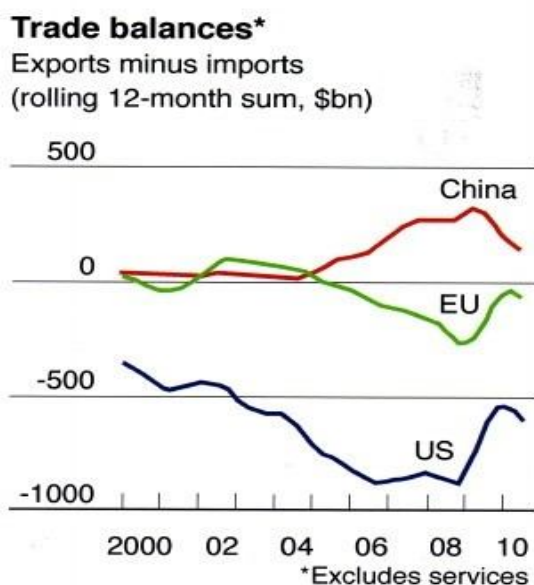
1. Purpose of report

- 1.1. The following are the thoughts of the Independent Adviser on what can be discerned of the economic and financial scene as at 22 October 2010.
- 1.2. Since June there have been an unusual number of unusual events and developments, and the outlook is, if anything, even more obscure than it was then, both nationally and internationally.
- 1.3. In order to deal more easily with the relevant issues, I have decided to treat them in an order which may not seem immediately logical, but which, I hope, may seem sensible.
- 1.4. The following sections are therefore:
 - The Chinese/US Standoff
 - Currency Clashes and Trade Wars
 - The Growing Correlation in Investments
 - The Banking System
 - The US Economy
 - The UK Economy: After the Cuts
 - The Hutton Report
- 1.5. Given the length and complexity of these items, I propose to comment on the outlook for equity and bond markets, and for alternative assets, in brief notes to be circulated ahead of the Panel Meeting on November 19. The present Report is being written to a deadline a fortnight ahead of the first meeting. This will allow a considered and timely assessment of the scene to be made, and later reactions to recent events to be taken into account.

2. The Chinese-US standoff

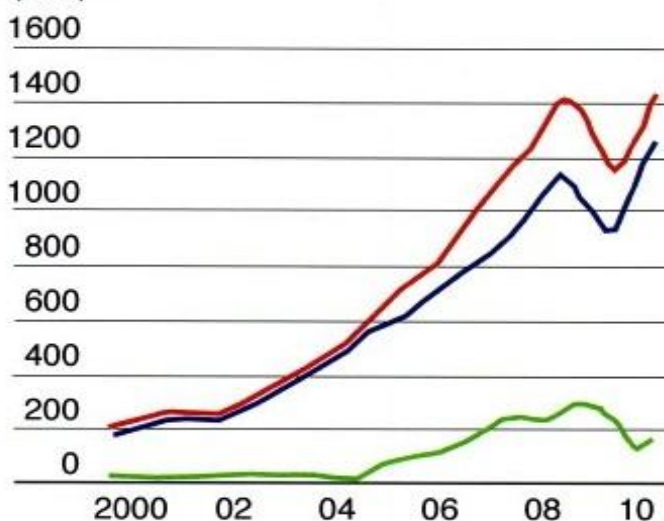
- 2.1. There are three rather unusual features affecting Chinese trade with the rest of the world, and the US in particular.

- 2.2. First, and contrary to some suspicions, China is not forcing its manufactured goods down American throats. Indeed, many US companies either have their own manufacturing plant in China, or form outsourcing contracts with local firms. Indeed, if WalMart were a country it would be China's seventh most important customer.
- 2.3. Secondly, much Chinese economic activity consists of re-exporting not just raw materials that have been processed, but also sub-assemblies and other parts and machinery that are subsequently re-exported incorporated in finished goods. It follows that any reduction in sales abroad – unless matched by higher domestic consumption – would have a knock-on effect in cutting back imports, and thus reducing the market for foreign suppliers.
- 2.4. Thirdly, while China is regularly criticised for keeping its currency down on the foreign exchanges and putting excessive emphasis on maintaining the share of exports in its national output, it is by no means the only offender – and possibly not even the worst.
- 2.5. Germany, which enjoys similar price advantages when the Euro is weak, actually channels more of its output into exports than China: 5.2 per cent of GDP last year, against 4.9 per cent for China. Given that its population is only a sixteenth of China's, its export surplus stands at over ten times as high per head of population.
- 2.6. Given the size and long-lasting nature of its export surplus, it is not surprising that China has accumulated the largest reserves of foreign currency and other assets (predominantly in dollars) of any country. But what is surprising is that this hoard, now standing at about \$2.8 **trillion** dollars (and expected to reach \$3 trillion by the end of next year) is dwarfed by the \$3.9 trillion held by other emerging countries. Again, on the basis of per capita figures, the Chinese \$2,000 is barely more than the average for the whole of the developing world.



China

Sum over previous 12 months
(\$bn)

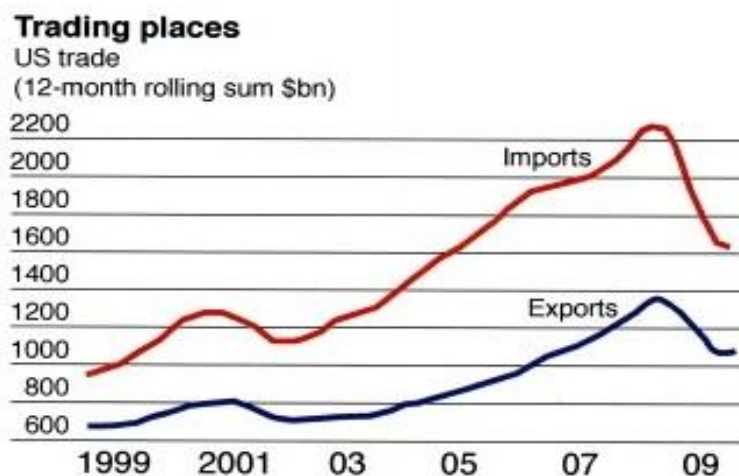


- 2.7. The following Table and chart give a snapshot from the other side of the Pacific and illustrates the broad trend in the American trade balance at 5-yearly intervals from 1999.

US trade with main partners 1999-2009 (\$ billions)

	1999		2004		2009	
	\$bn	%	\$bn	%	\$bn	%
EU	-47	(13.6%)	-126	(27.2%)	-71	(12.5%)
Mexico	-23	(13.8%)	-38	(17.1%)	-48	(16.7%)
Canada	-78	(35.7%)	-45	(12.3%)	-21	(6.9%)
China	-58	(65.9%)	-82	(37.4%)	-235	(69.1%)
Rest of World	-93	(13.2%)	-247	(32.6%)	-183	(14.6%)

Note: Figures in brackets are percentages of combined exports and imports.



China and the US appear determined to cut somebody's nose off – even if it is their own. That would be to update the traditional story of the frog and the scorpion. The frog wanted to cross the river because he thought that the supply of insects was better the other side. The scorpion asked for a lift, promising that he would not sting the frog on the way. But, half way across, he did. Before they both died, the frog had time to ask why the scorpion had done that. 'It is just my nature' came the reply.

There are just enough signs of hesitation on both sides to give hope that the two countries will find their way across the river, and continue their rivalry by less drastic means if they reach the other bank.

3. Currency clashes and trade troubles

- 3.1. The seeds of the present controversies go back at least 20 years. When the West European countries, and the US, were developing their economies in the 19th century, the pattern was for them to import raw materials and food from areas where they were produced, and sell them back manufactured goods in exchange.
- 3.2. When China emerged on the international trade scene as a major player, the process was very different. This 'backward' country became the largest importer of all kinds of primary materials, and developed as an increasingly important supplier of manufactures to the richer countries of the world. Inevitably, this led to a serious and growing imbalance in trade, with the resulting surpluses being invested by China in foreign exchange reserves – largely in the form of US Treasury bonds.
- 3.3. In effect, China became America's banker, lending it back the money to pay for its rapidly growing import bill.
- 3.4. By keeping interest rates low America avoided the normal consequences of a large trade deficit and was able to sustain consumption and employment at artificially high levels. Conversely, by the increasing scale of its

purchases of commodities, China forced its own costs up and profit margins in its industries were eroded.

- 3.5. Both sides had an incentive not to intervene, but continuing pressures in the absence of any countervailing policies were bound to stretch the elastic too far.
- 3.6. Each now holds the other in a mutually powerful grip. America wants China (and also much of the rest of the world) to inflate and insists that the Chinese currency is overpriced and must be weakened. (That would not necessarily help the American trade balance, as much of its imports from China would then likely to be resourced from other Asian countries). However, a revaluation of the renminbi against the dollar would lead to a corresponding cut in the value of China's foreign exchange holdings and, simultaneously, allow the US to inflate away part of its own national debt burden.
- 3.7. This risk has led to many other countries adopting policies that directly or indirectly lower the international value of their own currencies in an attempt to protect their export markets.
- 3.8. Since, without the opening up of interplanetary or intergalactic trade, it is impossible for all countries to run an export surplus at the same time, the end of this beggar most of your neighbours approach can lead only to a collapse of trade and rising unemployment across the globe. If everybody takes their holidays at home, there must be a fall in overall economic activity.
- 3.9. Other developing countries are fearful that the large and increasing inflows of capital from the developed nations will put them under the same kind of inflationary pressure that caused by Asian crisis a decade ago. That adds another dimension to the problem. The inevitable strengthening of interest rates as capital flows in (which can easily create a feedback effect with inflows accelerating) will tend to put a brake on economic growth in these countries.
- 3.10. The situation can be summarised:
- 3.11. **China** is finding that increasing investment is needed for each extra unit of output. Rising material costs are also affecting profits. A switch of emphasis from investment in infrastructure to private consumption is needed, but cannot be achieved swiftly. It also involves consumption growing faster than GDP, followed by higher wages and higher interest rates, together with a higher foreign exchange rate. The combination of the accompanying increase in imports and decline in investment could, unless handled very sensibly, bring about a substantial fall in investment. Although it may seem paradoxical, Chinese progress is now dependent on a decline in the growth rate of its GDP. But the rise in imports that would follow would help to prevent any slowing down of China's economy from affecting global demand.
- 3.12. **The US** will find itself faced with a need to reduce its deficit as China's surplus declines and those being run by Germany and Japan as the main source of employment will also have to be reduced. If world trade is to be balanced in the near future, it will almost certainly have to be at a lower level. This leaves the US to choose between an element of deflation as any growth in its exports must be less than the needed reduction in imports, or

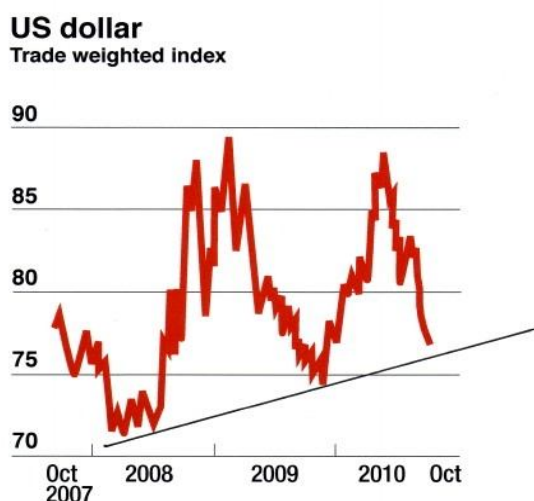
forcing inflation on the rest of the world – which it is able to do by increasing its money supply. (Protectionism also rears its disreputable head).

- 3.13. This has been described as America's trump card, although it will also have undesirable side-effects, such as further encouraging the rush of capital into other countries, mainly those still in the development stage.
- 3.14. There is little doubt that the US government will prefer to export inflation rather than import deflation. Although the Chinese would take the opposite view, they will be unable to force the issue. The power of the printing press will decide the matter – with probably adverse consequences.
- 3.15. The best hope is that the necessary adjustments to the world's currency and trade problems may yet be made gradually, over a period of years, and by agreement. They are simply too large to yield to any dramatic arrangements cobbled together at an emergency week-end summit meeting at a leading hotel. There is an indication in the recent statements from both Chinese and American authorities that there is caution behind their strongly worded defence of their respective positions, and that a compromise is possibly being hammered out behind the scenes.

4. Correlation galore

- 4.1. This year has seen investors piling into virtually every asset class simultaneously. There are two broad explanations. First, there has been an almost unprecedented degree of liquidity throughout the system, and an unusual need to hedge bets while awaiting national and international economies to resolve their paths between growth and contraction, and inflation and deflation.
- 4.2. Equities, bonds, gold and other commodities normally move in contrasting patterns. Gold and equities are the traditional hedge against inflation while bonds provide protection against deflation. Commodities tend to move in line with the trend in economic activity.
- 4.3. Yet prices for all categories have been rising. It has been pointed out that such conjunctions are rare: something similar has happened only four times in the past 40 years – and these all ended badly for investors in one or more asset classes. Which will be the fall guy this time round?
- 4.4. The key may be the course of the dollar in the coming weeks. Should the Fed implement a further bout of quantitative easing, this will trigger a continuing fall in the dollar. As the chart below shows, its value is now testing previous lows going back to late 2008. A dip below the support line may well show that there is no resting point for another 5 – 10 points further down. That would trigger a continuing rise in US bonds as an upsurge in purchases by the Fed would provide the QE mechanism. Bond yields would therefore be forced down below their already insignificant levels. Gold would then rise, reflecting the further loss of value by the dollar, and increased apprehension of inflation setting in.¹

¹ Indeed, price movements in the few days since the chart was prepared suggest that the support line has probably already been broken



- 4.5. Gold is being seen as a two-way bet – rising as and when the general price level goes up, and holding its value when deflation threatens. This trend has been boosted by the return of many central banks to buying gold, rather than currencies, to add to their reserves.
- 4.6. The most striking anomaly in all this is the fact that since mid-2006 core inflation in the US has fallen from 2.9 per cent to a mere 0.9 per cent while the gold price has soared from \$550 to well over \$1,300 an ounce. (Cautionary note for British gold bugs: although the price has risen by 20 per cent since April, the decline in the dollar has left a buyer in sterling only 7 per cent better off – and with no income from the investment).
- 4.7. The virtuous circle hoped for from QE2 is for bonds to rise because of the consequent demand for them; gold to rise as the dollar falls, and equities to continue upwards as some cash finds its way to them and hopes increase of a boost to profits (if only in line with higher inflation).
- 4.8. Problems arise from the probability that much of the extra liquidity will leak into investment in foreign rather than US bonds (after all, many emerging countries are running down rather than increasing their own debt, while offering better returns).
- 4.9. The presumption must be that the US is concerned to see the dollar lower: if expectations of renewed QE2 are disappointed, the other bubbles are likely to burst.
- 4.10. The danger in all this is that those buying gold as a hedge against inflation and also seeking protection against deflation in the bond markets cannot be right in both beds at the same time. If they expect to be able to switch horses at the same moment, they will only be caught up in a panic rush for the exit.

5. Banks and their problems

- 5.1. Banks appear to be awash with cash, and yet not making the loans to business and other customers which are supposed to be the reason for their existence.
- 5.2. The explanation is that, in spite of their apparent liquidity, they remain under pressure to control and reduce their own borrowings.
- 5.3. UK banks are having to roll over and renew £125 billion a month this year, and their commitments will rise to £800 billion in 2012. Worldwide, major banks have commitments of £3.3 trillion by then.
- 5.4. Britain faces the biggest relative problem: refinancing needs for the main countries are compared in the table below:

	2010	2011	2012	Average
US	100	85	45	75
UK	110	200	130	145
France	115	100	100	105
Germany	150	90	95	110
Italy	95	125	95	100

- 5.5. In addition the profile of British banks' borrowing is very short, with well over 50 per cent of loans being for less than a year. This is in contrast to the structure of UK Government indebtedness, with rollover periods averaging well over three years, and thus providing a much firmer cushion than enjoyed by other countries.
- 5.6. It is also true that the level of demand for loans by business is (a) not particularly strong where all except small firms are concerned; (b) that companies' own cash reserves are quite high; and (c) that much of the funding for expansion is being provided by institutions other than the banks.
- 5.7. At the same time, the banks are enjoying easy profits by raising the spreads on their own lending substantially above financing costs, and exploiting this to make easy profits. Under QE it has been possible to borrow from the government at less than 1 per cent, and lend it the money back at over 3 per cent – while using part of the margin to pay large bonuses for the strong performance.
- 5.8. The fundamental fact is that as a result of the collapse of 2007-08 there is an enormous amount of money sloshing around the system which in many ways is not real money at all. At the same time, it is not, as traditional theory would suggest, fuelling inflation but will still have to be worked off by gradually resuming economic growth over an extended period.
- 5.9. The mechanism for achieving this depends largely on regulation to reduce substantially the degree of leverage that was provided by increasing use of more and more complex derivative instruments, aggravated by poor control over risk levels.
- 5.10. Hence the application of stricter rules for the amount of capital which banks must hold through, primarily, the new international agreement known as Basel III. This will reduce the gearing that can be built into bank lending and requires them to maintain much higher reserve ratios, thus reducing the effectively available money and sterilising part of the surplus.

- 5.11. Even slow inflation will erode much of the overhang, but what is really needed is a slow but steady resumption of genuine growth which will outpace any increases in total interest costs to governments and business.
- 5.12. With great attention being paid to the proportion of GDP being accounted for by sovereign (or government) debt in various countries it is often overlooked that private indebtedness is the main problem in some countries such as Spain, but that in others the sharp rise in sovereign debt is a direct result of official bailing out of failing banks.
- 5.13. As for the new Basel arrangements, they will not be fully in force until 2019, and it is not unduly cynical to point out that in the normal course of events a moderately serious financial crisis of one kind or another (although not on the recent scale) is a probability between now and then.
- 5.14. Without being over-technical, the potential problem is that pressure from leading banks during the prolonged negotiations resulted in the provisions to reduce the risk from 'toxic' leverage not being strengthened as much as appears necessary.
- 5.15. Regulations requiring banks to maintain a minimum level of capital at 8 per cent will in practice refer to what are known as 'risk weighted assets' which will form much less than 8 per cent of total assets.
- 5.16. If the so-called RWAs form, or are made to form, a low proportion of the total, then the potential leverage remains large. And the 8 per cent minimum does not become compulsory until 2016 (although after that it is scheduled to rise to 10.5 per cent by 2019).
- 5.17. Before the crash many major banks operated on the basis of a ratio of capital to trading assets of a mere 1 per cent. Basel III could raise this, but only to 3 per cent. For those stretching, but remaining within, the new rules, high leverage could still outweigh the tying up of several billions of extra equity capital.
- 5.18. The argument continues as to whether the separation of banks into traditional credit providers and those which undertake large-scale investment activity including much business on their own account, continues. Simply separating the two functions and preventing banks from using their normal reserves (i.e. their depositors' money) to finance highly leveraged business seems to be aiming at the wrong target. What is needed is to ensure that banks in future earmark sufficient capital to cover the estimated risk on each transaction – and for there to be a mechanism for checking, by random inspection, that this is being done. Internationally agreed regulation cannot effectively be applied to differing banking structure – particularly where the banks themselves have an international presence.
- 5.19. Meanwhile, the volcano may have been tamed, but the risk of future eruptions has not been extinguished.

6. The US economy

- 6.1. After euphoria earlier this year, optimism for economic recovery in the US has been evaporating, with fears of a double dip, or at least a period of sideways stagnation, replacing it. Expectations are high of an imminent reversed stimulus in the form of quantitative easing (or QE2) through the injection of money by the sale of bonds by the Federal Reserve.

- 6.2. This would result in a further decline in the dollar, although some estimates are for this to be limited to about 2 per cent, with a further accompanying drop in effective interest rates and yet another boost to bond prices.
- 6.3. Other consequences would include a potential improvement in the US foreign trade balance, with exports strengthening and imports becoming more expensive. While open to objections of currency manipulation, this course is at least preferable to direct protectionism through tariffs and raising barriers to imports from countries that the US accuses of being manipulators themselves.
- 6.4. This \$700 billion of support (originally proposed, it is often forgotten, by President Bush, but with its emphasis then altered by the Obama administration) prevented a far more serious collapse of the economy. Analysis by several researchers indicate that, in its absence, the economy would have plunged by 12 per cent by mid-2010 from its 2008 level, instead of which it dropped only 4 per cent by mid-2009 and then rose to 1 per cent above 2008 levels.
- 6.5. Similarly, while unemployment remains stubbornly just below 10 per cent, without Tarp it would now be standing at 16 per cent.
- 6.6. The knock-on effects world-wide would have been disastrous. The real criticism of Tarp is that in many ways it was clumsily applied and that it in fact underestimated the scale of the initial problem.
- 6.7. While a steady drip of renewed QE2 funds, rather than a single large injection, is now probable, the US still faces the challenge of setting a national budget that will contribute to longer-term stability.
- 6.8. Lip-service is paid to the importance of balancing the budget by the Republicans who seem set to have regained control of the House of Representatives by the time this Panel meets. But their rhetoric tells in the opposite direction.
- 6.9. A key plank in their platform is to maintain all the time-limited tax cuts made by the previous administration, and not to raise any new taxes. While intending to ring-fence programmes covering 75 per cent of spending, and proposing cuts of \$0.3 billion over the next ten years, the Republican House leader has indicated a further \$4,000 billion in tax reductions over the same period.
- 6.10. This is in the context of promising a balanced budget. In practice, a continuing deficit on the scale this suggests would be impossible to finance.
- 6.11. Concern about the federal finances also tends to overshadow the serious difficulties facing the budgets of the 50 individual States. These are not legally allowed to go into deficit, and the need to keep within the confines of a balanced budget threatens large cutbacks in expenditure, and thus a negative impact on the economy as a whole.
- 6.12. One particular disaster is emerging from the plight of most of the State pension funds. 16 of these schemes are promising benefits which account for more than 30 per cent of total revenue for all purposes. 14 of the funds will actually see their assets run out by 2030.
- 6.13. This is on the basis of assuming an annual return on their assets of 8 per cent: the discount rate adopted by most of the funds. But, with the usual asset distribution of around 40 per cent in bonds and 60 per cent in

equities, and the current return of about 2 per cent in bonds, equities need to produce an average return of 12 per cent. This appears beyond improbable – and even if it miraculously materialises, the pot will still be empty by 2030.

- 6.14. This prospective deadweight will be an important drag on US growth.
- 6.15. There is thus a big question-mark over the future level of growth in the US. Even though global expansion may resume at 3 – 4 per cent, the rebalancing of the world economy must inevitably mean a below average rise in the US – and other developed economies.
- 6.16. While Wall Street has been advancing strongly on the back of a rapid rise in reported company profits, these are not necessarily evidence of a continuing trend.
- 6.17. Two elements, restocking and improved productivity during the recession, explain much of the upsurge in profits. Low inflation has also contributed.
- 6.18. But, at the same time, the slow rise in inflation also indicates a possible relapse into near-deflation, which would not benefit future growth in profits.
- 6.19. A consequence of recent trends is that a large part of profit-growth has been an extraordinary rebound in the proportion taken by banks and other financial companies. That cannot be projected into future years. And non-financial corporations, although they have made a recovery, are still showing a profit decline of 6 per cent on 2006 levels.
- 6.20. A more subtle analysis shows that the share of profits in profits plus wages is almost back to its peak level of 2006, while the share of wages alone is virtually unchanged since then.
- 6.21. Should recovery continue, then competitive recruitment of labour will resume; productivity will level off, or even fall, and the profit share of GDP will therefore contract.
- 6.22. Perhaps a further depressing factor is the very fact that the cutbacks are to be spread over four years. Since the war there has never been a period in which government expenditure has been reined back for more than two successive years. There is a real possibility that the prospect of austerity stretching so far into the future will create a kind of recession fatigue.
- 6.23. So, while some are arguing that US equities are undervalued – by 30 per cent on some bullish estimates – the very pace of the recovery may indicate a coming change of direction, particularly if the general appreciation of asset values itself peters out.

7. The UK economy – after the cuts

- 7.1. Plan A, as eventually unveiled, was very much as expected in its overall form, but with some surprises in the detail. The biggest among them was the severe cutback in the allocation of funds to local authorities, with a cumulative withdrawal of more than a quarter over the next four years. On top of that, capital expenditure is to be reduced from £7.4 billion a year to £2.5 billion.
- 7.2. While this takes some pressure off the Government, it simply transfers the job of transmitting pain to councils. Apart from the prospective employment losses – potentially estimated at around 100,000 across the country –

efforts to mitigate the impact on local services will lead to widespread rises in fees and charges which will effectively eat into the real level of private consumption.

- 7.3. Other examples of clamping down include increased fares for public transport with the Chancellor gaining a surreptitious windfall by linking rail fares to 3 per cent over inflation for the next three years, but choosing RPI as his yardstick rather than the more gradual growth of CPI (which he adopted for many benefits, notably public sector pension schemes).
- 7.4. The immediate jolt to GDP thus goes well beyond the subtraction of the headline £81 billion in actual cutbacks that are being imposed. With a large projected jump in interest payments from £30 to £43 billion this year, the programme appears front loaded. The direct reduction in GDP this year looks likely to be £24 billion or so, with slightly below £20 billion in each of the following three years. The cumulative effect is a drop of over 5 per cent in GDP at the end of the period.
- 7.5. The loss of jobs is officially estimated at 490,000. But this is only the beginning of the story. In 2009-10 just over £206 billion of general government expenditure went on procurement and other contracts with the private sector. While some increase in outsourcing will occur, the loss of business from central (and local) government is forecast to double the number of jobs that will disappear among private firms.
- 7.6. The Government's capital programme is to be cut by 28 per cent. When allowance is made for depreciation, this means that net investment will drop by half. While some major projects have been reprieved, the outlook is for private contractors to lose around £13 billion worth of business, or almost 1 per cent of GDP. Even though the company sector is flush with cash, the outlook for mending the roof while the strong winds start blowing seems poor.
- 7.7. The Government's hope, and gamble, is that in the second half of the period, the private sector will expand at a fast enough rate to provide not only the 1 million jobs initially lost, but more than that, so as to leave the overall unemployment rate below current levels even after accommodating the further growth in the prospective labour force.
- 7.8. Further holes in spendable incomes also have to be taken into account. Of the £81 billion, as much as £18 billion takes the form of reductions in various welfare benefits. That is more than another 1 per cent of GDP, and also has the effect of reducing Government revenue that will be lost as the £18 billion will no longer be spent and yield VAT and other taxes.
- 7.9. There is also the impact of the two-year pay freeze on public sector employees earning over £21,000 – and the prospective rise of 3 per cent in their pension contributions to be taken into account.
- 7.10. More widely, for much of the next four years, and for very many people, net income may well fall short of inflation when allowance is made for the knock-on effect of reduction in services and growth in their costs.
- 7.11. All in all, I consider that the money that is to be taken out of the economy, without allowing for any other factors, will reduce GDP by between 7 and 8 per cent by 2014-15.
- 7.12. Growth of 2 per cent a year will therefore be needed to maintain GDP at the current level (which would still mean a fall in income per head as a

population increase of rather of 1 per cent will occur by 2015.) That would still leave national income some 15 per cent lower than if growth at 2.5 per cent a year had taken place steadily from 2008 – 2015.

Employment

- 7.13. If you think you know how employment and unemployment are moving, you haven't confused yourself by looking at the official figures.

Last month, the Office for National Statistics said that the numbers on job-seekers' allowance had increased by 5,300 (to 1.4m) in September. At the same time unemployment (including those unable to claim benefit) fell from 2.47m to 2.45m in the three months to August. However, the numbers in employment rose by 178,000 to 26.16m over the same three months. Vacancies dropped 30,000 to 459,000. There was a fall in unemployment of 39,000 among 16 and 17-year olds, but a rise of 35,000 (to 742,000) in the 18-24 age group.

For what all that is worth, the typical newspaper headline was downbeat: 'Jobs recovery shows fresh weakness' said the Financial Times.

- 7.14. This at least confirms that the country enters the era of stringency in a better position than at the end of last year.
- 7.15. It has been pointed out that in the last big shake-up in the early '90s, the private sector absorbed some 860,000 jobs from public employment. To repeat this trick on a scale one quarter greater is a rather different matter: 'Black Wednesday' had provided a big boost through the 25 per cent devaluation of sterling as the UK left the European exchange rate mechanism; the banking system was in good working order, and not merely was the global economy booming, but British exports were more concentrated on expanding markets than they are today. In addition a high proportion of economic growth was channelled into the boom in financial services.
- 7.16. While three sectors have been granted increases above inflation, only aid to the developing world (accounting for 0.6 per cent of GDP) really has anything to shout about.
- 7.17. Costs of the NHS and education always, and unavoidably, run ahead of RPI (and even more so CPI) without taking into account the increasing pressure from greater numbers requiring treatment or teaching.
- 7.18. Realistically, they also face a reduction in resources, particularly as there would seem to be little or no funding available for the planned increase in 'school participation' from 16 to 18 before the end of this Parliament.
- 7.19. Another problem is the strong possibility that much of the theoretical saving from reduced public sector employment may not be realised immediately in terms of hard cash. Redundancy payments and benefits to the newly unemployed do not appear to have been factored in, and may largely offset the targeted savings even though taxation of these sums will fill part of the gap.
- 7.20. Uncertainty also clouds prospects for house-building. Low interest rates are doing little to sustain the market, with buyers finding it difficult to finance down payments. In the last year completions of new dwellings hit a low for

half a century, of 128,000 – barely half the target figure laid down by the previous Government.

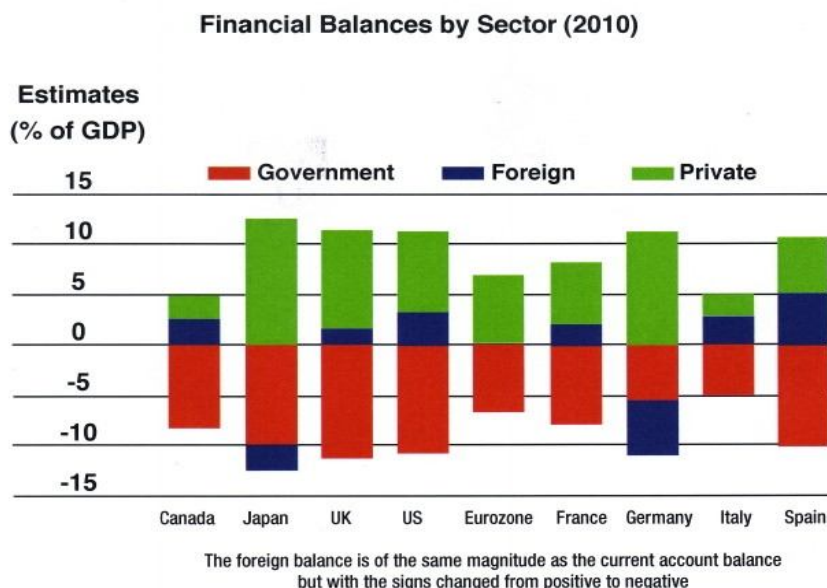
- 7.21. Proposals to build 150,000 social housing units over the next four years look about as realistic as the construction of that number of Castles in Spain – particularly as prospects of local authorities re-emerging as developers must now have bitten the dust.
- 7.22. None of this offers much hope for a sharp rebound.

Footing the bill

- 7.23. The money to fill the gaps, and pay the interest on it, has still to be found. Borrowing is estimated to be raised as follows:

	£bn
2010-11	149
2011-12	116
2012-13	89
2013-14	60
2014-15	37
2015-16	20

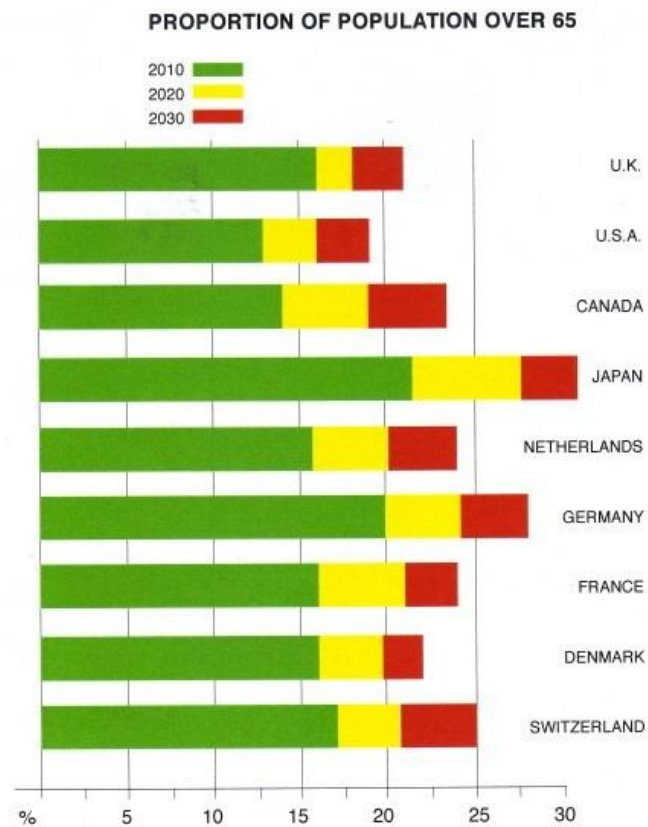
- 7.24. By the end of that period, total outstanding Government debt will stand at over £1,300 billion (around 80 per cent of GDP) and interest payments will have risen from £30 to £63 billion annually.
- 7.25. Debt will still have to be run down from that peak. (It may be mildly reassuring to realise that, since 1700, the national debt has exceeded 100 per cent of national income for over half the time.)
- 7.26. More seriously, recent trends in the gilt-edged market, with 2-year yields actually falling below 2 per cent in the immediate aftermath of the Spending Review, offers a faint prospect of a lower cost of financing for at least part of the next five years.
- 7.27. This is largely because the near omnipotent markets have been reassured by the tone of the Review, and are not worried by the detail as long as they believe that the Chancellor will maintain his ultra-hawkish stance.
- 7.28. There are, however, some lurking risks. In order to retain that confidence, the Chancellor may turn a blind eye to growth falling below the threshold necessary to make steady inroads into the indebtedness: it looks all too likely that the Plan B which many commentators have clamoured for may simply be to double up on Plan A. Secondly, if interest rates remain low, lenders could well decide to invest in the national debt of emerging countries, with their enormous foreign currency reserves and rapid economic growth. Such a preference could force British interest rates much higher, upsetting even a slowly recovering apple-cart.
- 7.29. A simple but often-overlooked truth must also be remembered. Government debt must always be equal to the balance between the sum of the balances of the private sector and the surplus or deficit of a country's foreign trade. The chart below illustrates the position of the UK and other developed countries.



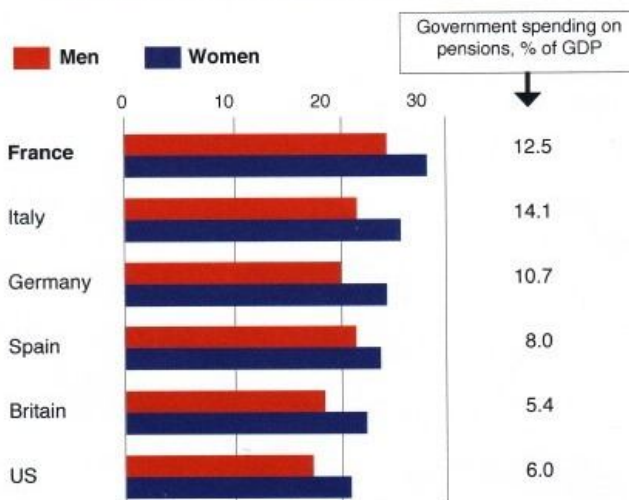
- 7.30. Thus, any reduction in the Government's indebtedness must be precisely offset by a corresponding drop in the surplus run by private sector, combined with a change in the foreign balance.
- 7.31. So, the large sums held by companies will have to decline as a counterpart to cutting Government debt.
- 7.32. This is part of the gradual elimination of what may be regarded as the 'shadow' money created during the over-leveraged expansion of credit before the bubble burst. The paradox of the last few years is that we have created more money than can effectively be used, and this excess needs to be gradually eroded by real economic growth and restrained inflation. That is why Governments and central banks are set against by allowing price increases to fall below 1 – 2 per cent. That could bring the danger of a lapse into deflation and the so-called debt trap which can make a resumption of growth difficult, or virtually impossible, as the Japanese example over the last 20 years has demonstrated.
- 7.33. That fear underlines the talk of a resumption of quantitative easing and feeding more cheap funds into the market by the Bank of England in the hope that they will be used to stimulate investment and growth by the private sector.
- 7.34. QE can certainly help to keep the ship afloat, but it has not so far done anything much to make it more seaworthy. Too much has simply been used to buy higher-yielding Government bonds and sit on them to make easy risk-free profits (much of the purchases having come from abroad anyway). So far this flood of money has forced bond yields lower, but there could be a complete somersault at almost any moment should inflationary fears suddenly take hold.
- 7.35. Given that further easing could have little or no positive effect on a soporific economy, it does not now seem to offer a big enough bang for your pound.

8. Hutton – the background

- 8.1. In recent years the future burden of pensions has been a growing concern, given the ageing of the population and the projected shrinking of the proportion of the population in the future labour force.
- 8.2. It is therefore worth starting by showing that, at least in an international context, these fears are exaggerated.
- 8.3. The first of the accompanying charts shows the current and projected proportions of the population over 65 in the world's leading developed countries. As of this year, the UK has the third lowest percentage, behind only the USA and Canada. By 2020 Canada will have a higher figure than the UK and in 2030 we will even have slightly lowered the size of the gap with the USA.
- 8.4. The second chart shows that the UK has the lowest proportion of GDP spent on the provision of pensions by the government, and also (perhaps a dubious advantage) that its pensioners enjoy fewer years in retirement, with the very marginal exception of the USA.



Estimated years in retirement, by sex, 2007

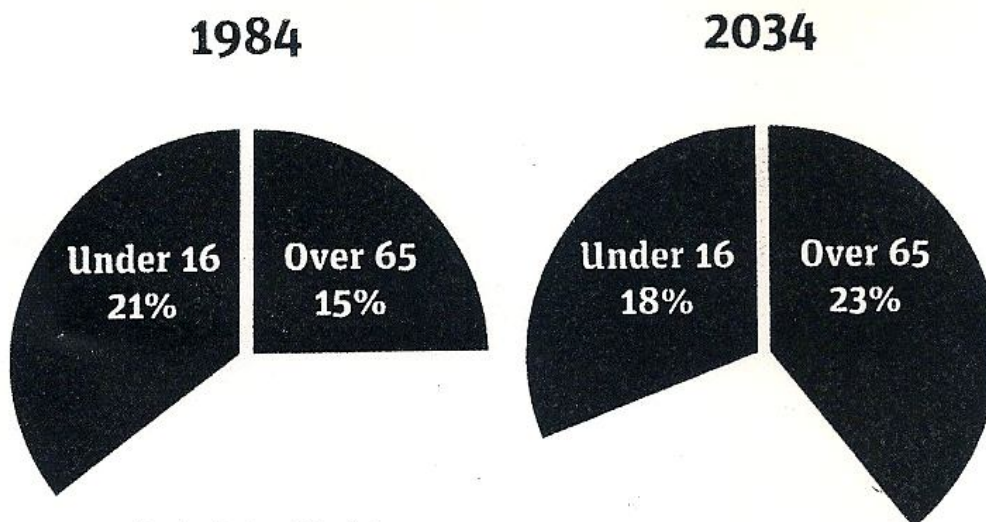


Source: OECD / Economist

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- 8.5. As for the proportion of the active population contributing to the financing of pensions for earlier generations (the so-called dependency ratio), the third chart illustrates this. The missing figure in the two circles for 1984 and 2034 are of course 64% and 59% respectively – the potential workforce.

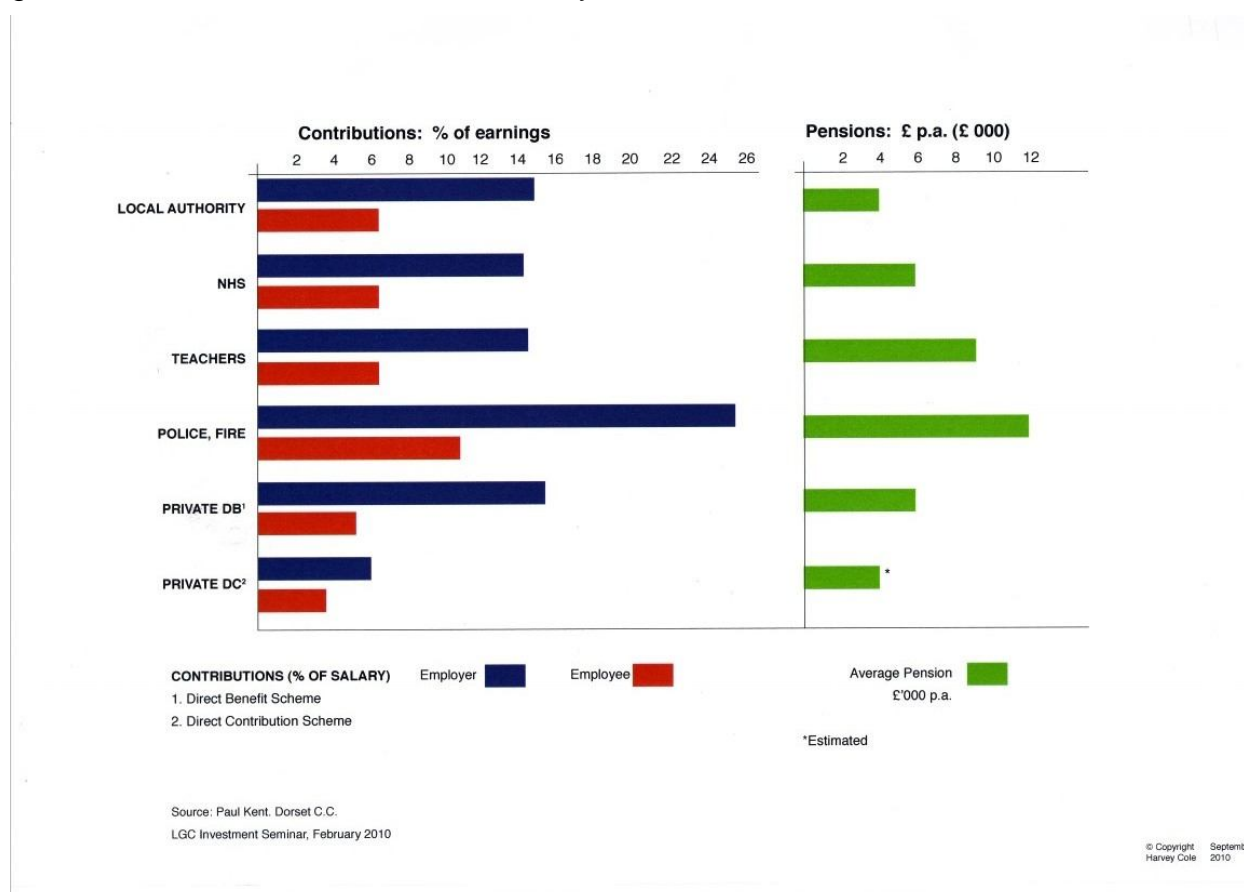
AGEING TRENDS



* Source: Office for National Statistics, 2010

- 8.6. Conventionally, the dependency ratio is calculated by comparing those in the 16-65 age bracket with those over 65. But this is to ignore that children are also dependants.
- 8.7. With the population rising from 56.4 million in 1984 to perhaps 68 million in 2034, the working population (without taking account of any rise in the age of retirement) will go up from 36 million to 40 million while children under 16 will go from just under to just over 11 million.

- 8.8. This will reduce expenditure on education and other children's services. According to the new-born Office for Budget Responsibility, education will absorb 5.8% of GDP in 2039 against a current 6% (and public service pensions a constant 1.8%).
- 8.9. Turning to the pensions, my fourth chart compares the current contributions and pensions paid out in the main schemes in this sector, of which the local government scheme is of course the only one which is funded.



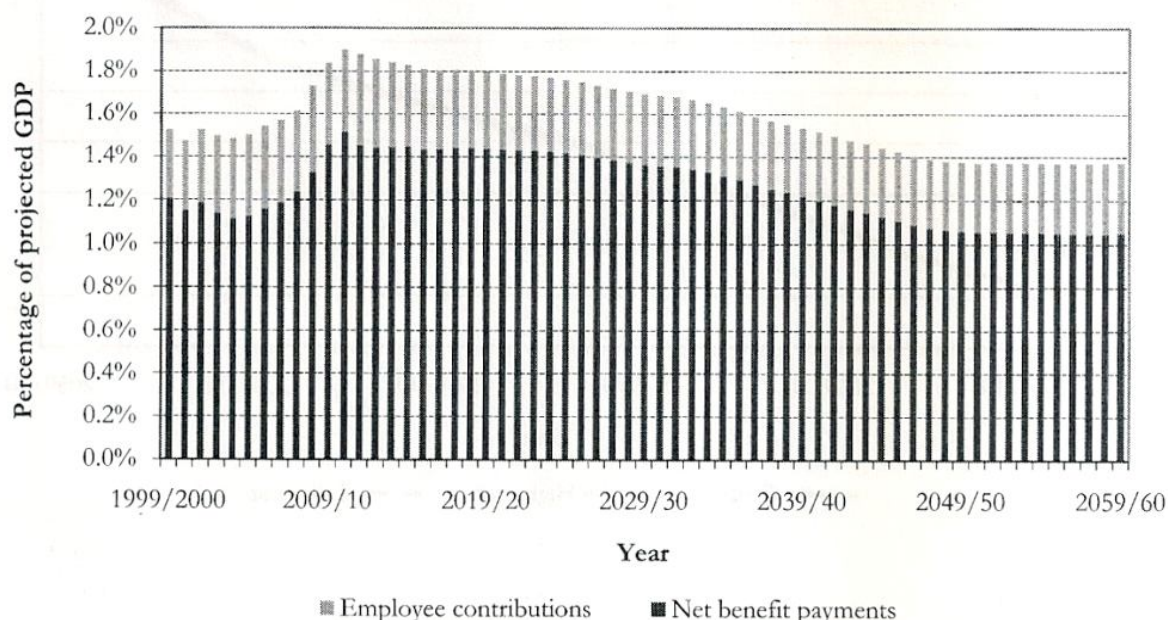
(This table was prepared before Lord Hutton reported, but the figures in it are very similar to those set out in the body of his document.)

- 8.10. More detailed comparisons between the LGPS and the other schemes are made in his report, and it is perhaps worth summarising them here.
- 8.11. LGPS has by far the largest number of members, rising from 859,000 in 2000 to 1,088,000 in 2009, while the four other main pension funds showed a combined growth from 1,731,000 to 2,197,000.
- 8.12. Pensions paid out by LGPS went up from £3.53 billion to £4.41 billion while the other four increased their combined benefits from £12.52 billion to £16.92 billion.
- 8.13. As a result, the average pension from LGPS actually declined from £4,115 to £4,052 in real terms (or 2 per cent) while the other four combined rose from £7,232 to £7,726 (6.8%).
- 8.14. Almost half of LGPS pensions were less than £3,000, while, at the other end of the scale, over half of police pensions exceeded £15,000.
- 8.15. Of just over 310,000 pensions of under £1,000 across all public pension schemes 58 per cent were in the LGPS although that scheme accounts for less than a third of total membership.

The report

- 8.16. With that perspective, I turn to the Report itself.
- 8.17. It is of course an interim document, with a final version to be produced early next year. But Lord Hutton plays himself in with a straight bat worthy of his cricketing namesake, setting himself for a long, but not flamboyant, innings.
- 8.18. He sets the scene with an analysis and explanation of the existing pattern of public sector pensions which is clear, simple and yet indicates the nature and direction of the changes he tends to favour, without any forcing of his opinions on the issue: he very largely lets the facts and figures speak for themselves. This will obviously count for a great deal when the Government has to commit itself to action.
- 8.19. The importance of public sector pensions is demonstrated by a comparison with the benefits paid out by the various schemes within it of £32 billion in 2008-09 with a total of just under £50 billion for all State pensions. (Excluding lump sum payments the amount of state pensions was around £25 billion.)
- 8.20. Alarm and despondency was caused by the highlighting by the press of the projected increase in this last figure to over £79 billion by 2059-60.
- 8.21. But a key chart in his Report shows the proportion of GDP absorbed by payments by the public service schemes actively falling over the 50 years from today.

Chart C.2: Projected benefit payments as a percentage of GDP – central projection



Source IPSPC calculation based on GAD, HM Treasury and OBR data.

- 8.22. To understand the apparent contradiction, it is necessary to appreciate the power of compound growth over half a century. The following table shows the effect of increases at various percentages compounded over periods of up to 50 years, starting from a base of 100.

Years	2%	2.75%	3%	3.75%
5	110	115	116	120
10	122	131	134	146
20	149	172	180	209
40	221	297	325	436
50	244	340	381	524

- 8.23. Assuming that CPI rises at an average of 2.75%, therefore, the price level will be 3.4 times higher than today in 2060.
- 8.24. Earnings (per head) are projected by the Government Actuary's department to increase at 2% p.a. above prices, and GDP to go up almost threefold in real terms.
- 8.25. The effect of CPI in improving funding ratios can be seen from the estimate that those would be increased by 6 percentage points in the first two years and subsequently by a further five, thus theoretically offsetting the adverse effect of current projections of longevity. But this would, of course, be largely at the expense of future accruals of pensions being paid out.

Other considerations

- 8.26. I concentrate on those passages in the Report that are concerned with the Local Government scheme.
- 8.27. Hutton concludes that the arguments for retaining its funded status are to be preferred. He considers points in favour of unfunded schemes, such as eliminating management fees; investment risk and the cost of moving from unfunded to funded status (which of course does not apply to the LGPS). He considers that unfunded schemes should mainly be relied on for public pensions, but also believes that 'unfunding' LGPS is not advisable, and cites a number of practical points, including the associated problems that would arise with admitted bodies.
- 8.28. There is however some suggestion that the number of LGPS schemes might be reduced by some form of amalgamation.
- 8.29. Although average and median pensions being paid are low, Hutton's analysis shows that, across the range of public pensions, payments broadly meet the 'benchmarks' set out by the Turner Commission for adequate payments to replace incomes in employment. These range from 80% for those retiring on incomes of up to £9,500, through 70% up to £17,500 and 60% between £25-50,000.
- 8.30. However, with the LGPS median pension at £3,048 compared with the NHS at £4,087; teachers at £10,275; civil service at £5,023 and police and fire at £15,583 and £13,193 respectively, it is necessary to explore how far this discrepancy can be explained by differences in average pay and/or employer and employee contributions.
- 8.31. Hutton considers the problem of increasing longevity in some detail, and in particular the discrepancy between new and established scheme members in prospective benefits. However, while new joiners suffered appreciable disadvantage in all the other main schemes, there was no differential in the average effective benefits in the LGPS, although while its figure (of some

28%) was slightly higher than the NHS, civil service and teachers, it was well below the armed forces, police and firefighters.

- 8.32. Hutton also identifies an anomaly in that LGPS 'high flyers' tend to receive better value for each pound of their contributions than more modest achievers. This is explained in an example:

A and B both have 40 years service in a scheme providing 1/80th of final salary per year of service. A's starting salary is £10,000 and receives a real terms increase of £5,000 every five years, finishing on £50,000. B's real salary remains at £10,000 throughout. A's pension will be £25,000 and B's £5,000. That is to be expected. But A's pension as a career average is 90 per cent of salary and B's only 50 per cent, so B is paying a higher contribution in relation to the pension.

- 8.33. While this occurs in other public pension schemes, the effects are more pronounced in the LGPS, and Hutton seems to be setting his sights on reducing (if not eliminating) this discrepancy.
- 8.34. Without going into detail in his interim Report, Hutton gives some clear indications as to where he sees need and scope for reforms. In addition, his reasoned analysis increases the probability that these initial suggestions will be firmed up in his final Report, and also that it will be difficult for Ministers to gainsay his recommendations.
- 8.35. Among the hints at what is to come are:
- A firm belief that switching public pensions to a wholly direct contribution basis is neither desirable nor feasible. Although that may have a role to play above a given income level.
 - No dilution of accrued pension rights.
 - An indication that the main thrust in tackling future funding deficits should be borne by employee contributions being increased.
 - Within this some kind of differential adjustment for lower paid employees to provide a continued incentive to save should be considered.
 - Minimising the 'investment risk' to which employees (particularly the lower paid) are exposed in any DC schemes.

The final paragraph of the Report says all the right things:

The recommendations that the Commission will be making to Government are intended to provide a framework for a new pensions deal for the public service. It will aim to be fair to workers, and to suit modern working practices, while delivering a deal that is sustainable for the future.

A NOTE ON CPI LINKAGE

Contrary to popular belief, the reduction in pension benefits from a switch to indexing them to changes in the CPI rather than the RPI will not be large immediately: in the first year each £100 would become £103 instead of £103.7 (assuming CPI at 3% and a differential with RPI of 0.7%).

But from the table set out earlier, it is clear that 10 years on, £100 now would have grown to only £134 instead of £146; at 20 years to £180 rather than £209, and after 40 years to £325 in place of £436. If CPI operated every year of a 50 year career, an entrant today would receive only 70 per cent of the initial pension he would have expected with RPI linkage.

Similarly, the chart in para 8.21 includes the estimated effect in reducing the current level of liabilities to take account of the slower projected increase of CPI as compared to RPI.

Of great importance is the future discount rate to be applied to LGPS funds. Hutton found that funds currently use a rate of between 2 and 4.354 per cent above CPI, while private sector schemes varied between 2 and 2.5 per cent above it.

Hutton inclines the view that, given the strength of their covenants 3.5 per cent would be reasonable for GPG LGPS, and is to look at the implications of a model scheme using this figure.

The length of any 'recovery period' to restore 100 per cent funding where there is a deficit is also crucial. Hutton indicates that a return to full funding over 20 years would, on average, require the rise of 5 per cent in employer contributions and correspondingly more if it were to be met by employees. (Hewitts are of the view that 25 years is possibly too long).

What emerged is that Hutton has not yet considered the effect of moving to CPI on the future discount rate. If the current margin over RPI is simply maintained, there will be a corresponding reduction in the effective rate, so that, 3 per cent over RPI would become only 2.3 per cent over CPI. The effect over 20 years would be to increase the current value of liabilities from £33.6 to £42, thus ending part of the initial improvement in funding levels.

CORPORATE OR LEGAL INFORMATION:**Links to the Corporate Strategy**

Hampshire safer and more secure for all:	yes/no
Corporate Improvement plan link number (if appropriate):	
Maximising well-being:	yes/no
Corporate Improvement plan link number (if appropriate):	
Enhancing our quality of place:	yes/no
Corporate Improvement plan link number (if appropriate):	
OR	
This proposal does not link to the Corporate Strategy but, nevertheless, requires a decision to accept the comments of the Independent Adviser	

Other Significant Links

Links to previous Member decisions:		
<u>Title</u>	<u>Reference</u>	<u>Date</u>
Direct links to specific legislation or Government Directives		
<u>Title</u>	<u>Date</u>	

Section 100 D - Local Government Act 1972 - background documents

The following documents discuss facts or matters on which this report, or an important part of it, is based and have been relied upon to a material extent in the preparation of this report. (NB: the list excludes published works and any documents which disclose exempt or confidential information as defined in the Act.)

DocumentLocation

None

IMPACT ASSESSMENTS:

1. Equalities Impact Assessment:

- 1.1. Equality objectives are not considered to be adversely affected by the proposals in this report.

2. Impact on Crime and Disorder:

- 2.1. The proposals in this report are not considered to have any direct impact on the prevention of crime.

3. Climate Change:

- a) How does what is being proposed impact on our carbon footprint / energy consumption?

No specific impact.

- b) How does what is being proposed consider the need to adapt to climate change, and be resilient to its longer term impacts?

No specific impact.