

HAMPSHIRE COUNTY COUNCIL**Decision Report**

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1. Preliminary

- 1.1. This report reflects the views of the Independent Adviser as at May 13, 2011 on the current state of the UK economy, and the longer term outlook for investment.

2. Introductory

- 2.1. This report follows a rather different pattern from earlier ones. I concentrate first on the UK economy, and then look at problems within the Eurozone, with particular reference to Greece. I then consider the commodity markets and the question of the banking system and its regulation.
- 2.2. A further main section examines the long-term climate for investment, which I treat globally, but with specific consideration of the relationship between China and the US.
- 2.3. I have therefore not addressed on this occasion the particular circumstances of various asset categories, or of individual markets. (A brief examination of these matters may be included in a report to the next meeting of the Panel).
- 2.4. I address a bee in my personal bonnet in the shape of comments on economic forecasting, and conclude with a selection of charts illustrating a number of points of current interest.
- 2.5. I propose to widen the scope of my reports by mentioning some of the more important matters that have been raised in my attending outside events on behalf of the Pension Fund.
- 2.6. These fall into two categories. First, meetings of the Group of Independent Advisers to Local Authority Pension Funds. This has 49 members, representing between them over 80 per cent of such funds. I will be

referring to discussions between members that raise matters, of procedure, administration and investment policy (among others) which appear to be of interest to the Panel, or on which the Panel's views might usefully be of value to the Group.

- 2.7. Secondly, I will highlight matters which arise from meetings hosted by institutions, fund managers and others, at which papers are presented, new forms of investment and techniques aired or seminars held on specific topics.

3. The UK economy: faltering?

- 3.1. It is clear that the pattern of the UK recovery is clouded. There is the usual dispute as to the reliability of the figures for GDP which occurs when they are disappointing, and suggestions that they will be revised upwards later. (A study of the official statistics over the last 60 quarters shows an average subsequent adjustment of no more than 0.1 per cent – with movements in both directions).
- 3.2. It has been argued that errors in collecting information from the building industry may have depressed the result for the first quarter of 2011, and that it was 'really' 0.8 per cent instead of 0.5 per cent. On the other hand, it now seems that the result for the past quarter of 2010 may have been worse than the published decline of 0.5 per cent – in which case an advance of 0.8 per cent would still leave the result over the last six months as virtually static.
- 3.3. But it must be best to put the microscopes, and arguments about what they show, on one side and take a wider view. This reveals few exciting signs. To take just the building industry itself: it has announced that, over the next five years it expects to build just 700,000 new homes. That is 40 per cent below the level said by the Government to be needed to prevent a worsening of the existing shortage.

Inflation or deflation?

- 3.4. If sustained, the interruption of the upward spiral in commodity prices will have a beneficial impact on UK price inflation by reducing import prices of raw materials and oil, although the effect will not be all that large, and will take some time to show up. This may reduce pressure for an early increase in interest rates, and defer any such rise until possibly 2012.
- 3.5. But it is far from clear that higher rates are the correct weapon with which to tackle higher prices anyway. When these result from what used to be called 'cost push' rather than 'wage pull', increasing prices are in fact deflationary because of their effect on squeezing consumption. (Think of more costly petrol prices in isolation: they present people with a choice between spending more at the pump or less in the shops, or drawing on savings).
- 3.6. But where incomes are going up faster than output, this reveals a lack of capacity to meet demand, and unless people save more, prices must go up.
- 3.7. In today's conditions higher interest rates would have their normal effect of strengthening the pound and making imports cheaper. But ¼% would have

very little impact on the level of imports and would also have a similar but opposite effect on exports.

- 3.8. What is beyond dispute is that, in a rapidly changing world, with the major share of future global growth being taken by the large populations of poorer countries, the amount for developed countries, including Britain, must grow more slowly. Accommodating to that must mean a sharp rebalancing of the economy, towards exports and investment and away from consumption.
- 3.9. Both deflation and inflation offer a route to this destination, if applied in moderation, but it would seem that mild inflation is to be preferred – if it can be kept under control – not least because it offers better prospects of securing real growth, whereas deflation would tend to rely too heavily on keeping domestic demand down, and involves increasing the real burden of already very substantial debt, in both the public and private sectors.

Dealing with debt

- 3.10. Contrary to widespread belief, the Government is not aiming to eliminate the public debt by 2015 – or any other year. Its target is to reduce the element of annual borrowing in its accounts which is described as structural, i.e., the borrowing not due to successive waves of lending money to the banking system. (That accounts for approximately half of the total borrowed since 2007). Over the period to 2015, Government borrowing will continue to grow, although after this year the annual amounts will diminish (a relevant point is that, following the revised (lower) estimates for this year and the next of the growth in GDP, by the O.B.R., which still expects total growth by 2015 to hit its original target, more will need to be borrowed each year from 2011 to 2014).
- 3.11. In addition, although Britain enjoys the advantage of having the longest average maturity of Government debt – and thus the lightest schedule of refinancing (almost 14 years, with Greece (!) in second place at 8 years; the US at 5 and most other major countries at around 6) some resort to the market will be needed.
- 3.12. In total the Government will probably need to raise close to £700 billion. If it pays an average of 4 per cent interest on new loans, the total interest bill would be increased by around £25 billion by 2015. With GDP projected to go up by only about 10 per cent by then, it is clear that about an eighth of growth will be pre-empted by higher debt interest costs.

Growth in exports?

- 3.13. If the cost of imports resumes its rise, a higher level of exports will be needed to balance the books, unless the price of those exports outruns that of imports, particularly as imported materials account for about 20 per cent of our exports of goods.
- 3.14. The prospects are not highly encouraging. Despite a fairly steep fall in the value of sterling against other currencies in the last 2 – 3 years, there have only been glimmers of improvement in the country's export performance, and some of the occasional narrowing of the trade gap has been accounted for by a drop in imports. For example, a resurgence in exports in March

mainly reflected a sharp fall in February being reversed, February having shown the largest deficit ever recorded).

- 3.15. Some of the projections for export growth can only be described as verging on fantasy with one official source suggesting annual increases of 8.7 per cent over the next ten years. That would mean them reaching 2.3 times their 2010 level. Allowing, optimistically, for GDP to grow 30 per cent by then, the target could be hit only if exports' share of GDP rose to 27 per cent pre-empting two-thirds of all growth to then in the process.
- 3.16. Another example, on a smaller but more amusing scale, came during the Prime Minister's visit to China. He announced targets of more than doubling trade with that country by 2015, with British exports being nearly quadrupled. But what that would entail is an increase from £29 billion to £63 billion, in two way trade and British exports going from £5.4 billion in 2009 to £19 billion. Apparently very encouraging, but it also means our deficit would increase from £18.9 billion to £24 billion.
- 3.17. The real problem is that too large a share of our exports is still channelled to our traditional markets which are slow-growing, both in population and relative wealth, and such improvements as are occurring are too slow and too dependent on a limited number of sectors of industry.
- 3.18. Services have a more encouraging record, but while some, such as the arts, are becoming major contributors, the share of financial activities may diminish in future.
- 3.19. All in all, not a promising element in any overall solution.

Can investment fill the gap?

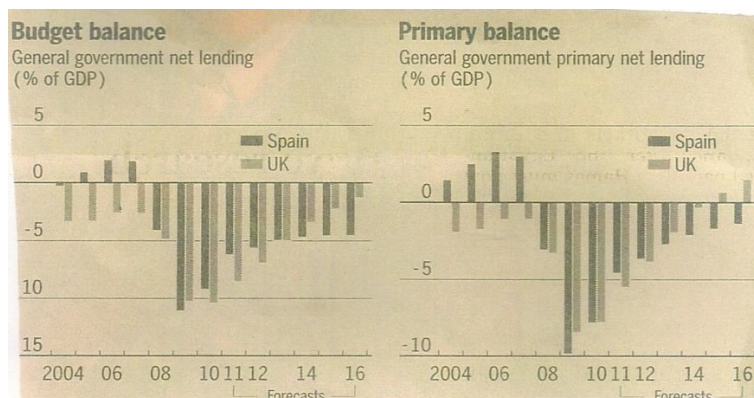
- 3.20. While the public sector has been running an enormous financial deficit, this has, necessarily, to be offset by surpluses elsewhere in the economy – the personal and corporate sectors and the balance of foreign trade and payments.
- 3.21. Sure enough, the corporate sector has been overflowing with cash: a recent estimate put the figure at £50 billion. But capital expenditure has been in the doldrums. With a heavy squeeze being imposed on incomes and spending, companies are dubious about risking any big increases in capacity, and where the money is invested it has tended to go into liquid assets or distributed to shareholders, who in turn have been putting it into more risky, or foreign, opportunities rather than other companies' funds.
- 3.22. As a result, fixed investment has been declining, falling from an average of about 16 per cent of GDP in the period 2000 to 2006 to no more than 13 per cent by the end of 2010.
- 3.23. It is even more disappointing that such investment as is occurring is heavily biased to the UK. In a recent survey by Deloitte's 56 per cent of large companies regarded the most attractive opportunities over the next three years as being in the home market. (Not surprisingly, perhaps, the proportion of smaller companies taking this view is a little higher, at 64 per cent). While 16 per cent of large companies were looking to the US, and 12 per cent to Western Europe, the four BRIC countries, together with the

Pacific rim, where growth prospects are brightest, elicited only 7 per cent of large companies' interest.

- 3.24. Given that half of the companies in the FTSE350 index secure more than a third of their revenues from overseas customers, this is a disappointing result, particularly as it tends to reinforce the gloomy outlook for exports.

4. Europroblems unlimited

- 4.1. Like a smouldering fire which keeps breaking into renewed life, the Euro seems to face a fresh emergency almost every week. Just when you might have thought that Greece's debt had been dealt with for at least two years, secret weekend meetings were duly publicised and rumours of a Greek exit from the MS were spread in order that they could be denied. It may not be long before Ireland reappears as a supplicant, and Portugal has yet to show that the stiff terms it has been offered will not be trimmed back – let alone that they will work. And Spain looms on the horizon.
- 4.2. Part of the difficulty is that all the various sovereign risks that have surfaced are being handled in much the same way, although their cases differ. While the plight of Greece and Portugal is due to loss of control over their public finances, Ireland brought its own house down around its ears by ill-advisedly taking responsibility for the enormous losses of its private banking system, where were larger than the national economy.
- 4.3. The other Euro members, with Germany in the lead, and now followed by Finland, dragged their heels over providing assistance – even though it was a question of loans rather than gifts – and the result was long delay before too little was offered too late.
- 4.4. One suspects that it was only when Mrs. Merkel was reminded of the scale of the hit to German banks' balance sheets if they had to write down the value of their holdings of bonds issued by the potential defaulters that reluctance was overcome by self-interest.
- 4.5. With its banks and the rest of the public sector holding €150 billion of exposure to Greece, Ireland and Portugal, Germany has contributed just over €50 billion to the bail-out. The UK has coughed up €10 billion against €120 billion similarly at risk and France some €45 billion against €80 billion.
- 4.6. The possibly imminent case of Spain is (or would be) closer to that of Ireland in that the state of the public finances is fairly sound – and as the charts below illustrate – quite comparable to those of the UK. The trouble is that the network of private banks known as cajas hold on their books enormous toxic assets in the form of mortgages on homes which are in default or where the value of the property is less than the outstanding loan. With the property market extremely weak the further increase in interest rates being considered by Brussels would be likely to have the disastrous effect of forcing many of these loans to be written down or off: the scale of the rescue operation that Spain would then need is generally agreed to be beyond the capacity of the Eurozone countries, together with the assistance from outsiders such as the US and UK, to cope with.



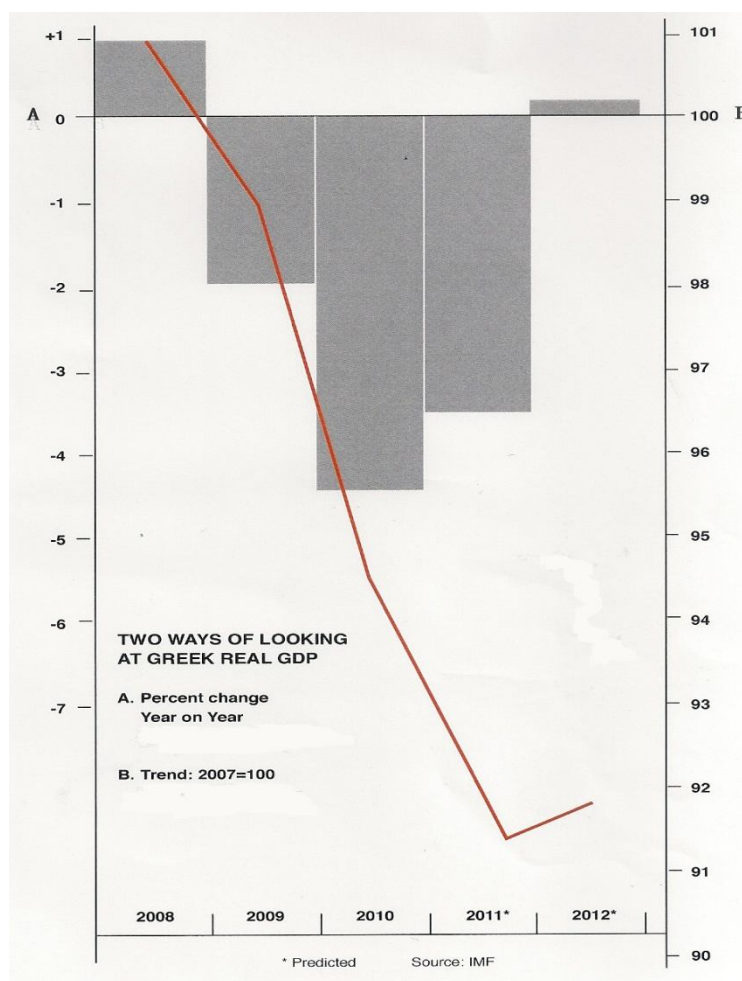
- 4.7. With the logic of the lunatic, the rules for any bail-out for Spain would require contributions from Greece, Ireland and Portugal.
- 4.8. As the crisis has unfolded, the realisation has spread that the ambitions for the Euro to become a fully-fledged reserve currency are doomed – and that they were unlikely to be realised even before the current upheavals. The reason is simple: it is now clear that only a currency issued by a single political authority can successfully perform this role.
- 4.9. The conclusion is clear: even short of attaining reserve currency status, the Euro will only be able to survive in the long run by – at the minimum – making the political decision to run the Euro in a more centralised manner, and in particular, by issuing Euro-wide, rather than individual national bonds. The real difficulty about this is that the long-term looks like being quite short.
- 4.10. Meanwhile, the weakening of the Euro will of course help boost exports from the Eurozone to the rest of the world. The trouble with this is that the benefit will be reaped predominantly by Germany, whose competitive cost advantages have already produced a rise of 7 per cent this year. (And a chronically weak Euro would hold back British exports).
- 4.11. All this is distorting the distribution of the world's currency reserves: indeed, Germany is being labelled the China of Europe, and there are as yet few signs of its economic policies being shifted to promote an increase in domestic consumption.

The Greek Plight

- 4.12. Everybody must by now be aware that the Greek economy is in great trouble. It is perhaps unfortunate that charts attempting to illustrate this all too often give the wrong impression. When depicting changes over time for production, prices and national income it has become usual to present the figures by comparing the latest results with those from the previous estimate. Thus, what appears is just the 'month on month', 'quarter on quarter', or the 'year on year' pattern, rather than a continuous trend line.
- 4.13. This has some curious effects. If, for example, the level of GDP falls in one quarter and again, but by a smaller amount, in the next one, this will be shown on the chart, not merely as an upward shift, but on which automatically shows a recovery into positive territory. A continuous trend

line would show a further decline from the first quarter – albeit at a slower rate.

- 4.14. The chart that follows combines both ways of showing recent and predicted movements in Greece's GDP. The bars give a rather hopeful pattern, with the country apparently moving back into growth in 2012 after two years of steady progress. The trend line is unmistakably pessimistic – and, I would suggest, far more realistic.
- 4.15. Greece suffers from the double disadvantages of having debt greater than its GDP and of facing interest rates on that debt that exceed any realistic estimate of the rate of growth that it can hope to sustain. At the moment, debt stands at 160 per cent of GDP, and may well rise to around 200 per cent if further loans are agreed. But even at the moment servicing its borrowing is likely to cost something like 7 per cent, as an absolute minimum: the markets would certainly not accept anything less than double the rate paid by Germany.
- 4.16. On the other side of the coin, growth in Greek GDP cannot be envisaged as even reaching 4 per cent – which would be greater than projected for Europe's major countries. So, inexorably, indebtedness will grow year by year, and compel the rest of the economy to shrink. That can only end in restructuring or default, and optimistic-looking pictures should not obscure the evidence.



5. Commodities

- 5.1. Was the spectacular collapse in the price of oil and almost all other commodities earlier this month the bursting of yet another asset bubble, or simply a ripple on a still rising tide? It is too early to say is the answer that avoids the risk of premature misjudgement.
- 5.2. However, it does seem that the suddenness of the event (following a short/medium term warning from Goldman Sachs that prices appeared to be at unsustainable levels) decides the argument as to whether speculative actions were at least partially responsible for the almost indiscriminating rise of almost every commodity traded.
- 5.3. After all, there had been no drastic shift in the balance between supply and demand, and a moderate reduction in the pace of growth in much of the global economy over the next year or two has been discounted for some time.
- 5.4. The combination of the vast inflow of money seeking a quick return, combined with large quantities of many commodities being held off the market so as to provide backing for the new-fangled ETFs and other ingenious derivatives, was increasingly likely to trigger heavy sales if investors decided to try and be at the front of any queue for the exits.
- 5.5. The question is how far the unwinding of positions will go. As always in such situations, the reaction is likely to result in an overshoot, but this should be containable unless it results in a consequential wave of defaults on contracts and financial failures. So far there is no hint of this.
- 5.6. It is also worth remembering that the level of commodity prices – which have always tended to fluctuate sharply, if not always together as in the recent lock-step, only broke into new high ground, in real terms, during the last year, having never until then exceeded the peaks of the early 20th century.
- 5.7. While population growth and expanding economies in countries including two thirds of the world's population, seem certain to underpin higher future consumption of food and raw materials, this does not mean that direct involvement in the various commodity futures markets is the advisable route for major long-term investors.
- 5.8. All too many holders of institutional funds (quite apart from those which specifically invest largely in mining or commodity specialists) have an indirect stake through funds tracking the main share indices. Even after the recent retreat in share prices, the oil mining and resources sectors of the FTSE 100 will still account for about 36 per cent of the index – and the resulting indirect holding by tracking funds is probably more than adequate for the average investor.
- 5.9. Of course, this month's flotation of Glencore needs to be taken into account because of its size and widespread coverage of almost every aspect of the commodity trade from production and transport to actual trading. This results in perhaps unrivalled knowledge of the day to day position in all the commodities in which it has a stake – and to this will be added the ability to

make further and larger acquisitions as the proceeds of the flotation are invested.

- 5.10. For a long-term interest in commodities there is perhaps no better channel than Glencore, to the exclusion of short run, in-and-out, dealing.

Gold

- 5.11. There will probably never be agreement as to how gold differs from all other commodities, but it has certainly been rising together with them, and for a much wider range of reasons than are usually advanced. It has been recommended as a hedge against both inflation and deflation, and as a refuge from a threatened collapse of all the leading currencies, which may seem highly unlikely as a simultaneous happening, but seems slightly less implausible in the light of the policies of so many countries in apparently trying to devalue their own money against everybody else's.
- 5.12. But one aspect that is often overlooked is that, as gold is priced in dollars, this needs to be taken into account by those buying in other currencies. Before the recent strengthening of the dollar (which itself paradoxically reflects some expected weakening in the US economy) it had been 8 per cent higher since the beginning of the year – but a buyer in Euros would have lost 2.5 per cent.
- 5.13. It is also notable that the gold prices increase had been outstripped by virtually every other commodity.

6. Banking and regulation

- 6.1. The unwinding of the international financial cataclysm continues at a slow and irregular pace.
- 6.2. The initial support of the Government for British banks involved £955 billion – 60 per cent of the national income. The Federal Reserve provided \$3,300 billion in the US, more than twice as much, in emergency credit alone. Over the crisis period, British banks actually borrowed around \$1,000 billion from the Fed under various programmes, led by Barclays with \$680 billion, but most of that money was in short-term advances which were quickly repaid.
- 6.3. About half of the UK public support has now been repaid, but there is still a herd of elephants in the boardrooms of British banks and other institutions.
- 6.4. While some of the marking-down of the huge pile of toxic assets has been reversed as values have, in some cases, improved, full recovery still lies four or five years ahead for most of them – with some risk of a further series of shocks meanwhile. We still do not really know which banks may in fact be insolvent!
- 6.5. Meanwhile, attempts are being made to ensure that controls are put in place to prevent a new collapse, but the banks are working on new generation of complex derivatives and the setting up of new 'shadow' banking operations. These would segregate some transactions from the scope of new regulations, such as those proposed under the so-called Basle III, and thus effectively allow loopholes to be drilled into the higher

capital levels that are proposed to reduce the leverage levels that the banks will have to apply.

- 6.6. The bonus schemes offered by the banks to their staff continue. These are primarily justified by claiming that unless the banks can offer competitive terms to attract 'the best' staff, their profits, their reputation, and their shareholders, will all suffer. But as the 'best' staff, however identified, can only work in one place at a time, this simply opens the way to a competitive bidding up of pay and bonuses.
- 6.7. The history of bonuses in the financial firms is often not appreciated. Originally the main institutions were partnerships, using and risking the partners' own money. They also ran the whole risk of their enterprises, and it was therefore entirely logical for them to take a salary and distribute their profits as, in effect, a bonus.
- 6.8. Then the established retail banks started to set up joint operations with these merchant or investment banks, most of which were either taken over in the process, or floated their own shares on the market. The profits therefore became the property of the shareholders, and in most cases the original partners did not retain sufficient shares to provide dividends that matched what they had formerly taken out as partnership profits. Hence the bonus.
- 6.9. Of course, the real risks that bankers would be prepared to run as an employee/shareholder tended to be much greater than as an unlimited partner.
- 6.10. The bias that this introduced, together with the much increased leverage levels which the new owners could finance out of their routine retail banking business, encouraged greater risk-taking, and the scarcity of competition enhanced this further.
- 6.11. This has led to the ability of the banks to extract enormous amount of economic 'rent' from their customers and clients and, strangely enough, their shareholders have been among the biggest losers. They appear to have been hypnotised into accepting dividends that are a puny percentage of the profits secured, without protest and without realising that they are being fobbed off with a much smaller slice than in any other industry.
- 6.12. Indeed, before the big crash, pay and bonuses took seven times as much as dividends at one of the major US banks, and the combined shareholders' dividends for the previous eight years were more than wiped out by their losses in the year when the business collapsed – but bonuses were still paid out for that year at the second highest rate for the entire period.
- 6.13. The best answer must be to try and ensure that banking becomes much more competitive and profits more difficult to come by. It is ludicrous that RBS can pay bonuses of £1 billion out of losses of the same amount, and even more so that its controlling shareholder, who just happens to be HM Government, should fall for the excuse that if it opposed this several thousand bankers would simply uproot themselves and transfer to welcoming foreign parts.

- 6.14. Complex regulations can have only a limited role to play, and the more complicated they are, the more loopholes will be found in them. But much higher levels of risk capital should become mandatory, and if it is complained that this would reduce profit margins, the answer must be that it would also remove the risk of years of easy and inflated profits being wiped out almost overnight.
- 6.15. The one essential rule might therefore be to insist that at all times a bank should be able to show to an official body such as the Financial Services Authority that adequate collateral to support the carefully estimated risk attached to any transaction of more than a set minimum value has been earmarked and the authority could request confirmation of this at any time and without prior notice

7. The investment scene

- 7.1. The long run, apart from being diagnosed by Keynes as fatal to individuals, is also made up of a series of short terms. Most investment activity is focussed on relatively short timescales, but a pension fund needs, at least occasionally, to step back and consider the long term outlook – at least 10-20 years ahead.
- 7.2. This seems to be a particularly suitable moment to do so as there can rarely have been so many, and such large, imbalances in the global economy and financial system in urgent need of resolution.
- 7.3. I had therefore been planning to devote the investment section of my Report on this occasion to discussing the long-term outlook, rather than repeat my usual sector-by-sector analysis. This was strongly reinforced by attending, earlier this week, the 2nd Annual Global Absolute Return Congress. This brought together about 350 invited participants, of whom over two-thirds came from more than 25 countries overseas, and included many eminent academics; government ministers and politicians; central bank governors; directors of major international companies; and senior advisers to some of the world's largest pension funds (from Calpers downwards); banks; insurance companies; hedge funds, and other asset managers. It is no exaggeration to say that if a bomb had blown up London's Landmark hotel between May 8 and 11, a collapse in the world's financial markets high on any Richter scale would have followed.
- 7.4. Over three 10-hour days, a series of specialist papers and intensive discussions in meetings of small groups, produced an enormous amount of information, a wide variety of informed opinions, and an extraordinary sounding board for putting forward, discussing and receiving a wide range of ideas and suggestions.
- 7.5. My overwhelming impression is that over the next few years, attention will be focussed on defusing the tension between China and the US – in the wake of which many other current problems would also be resolved or appreciably diminished. Even more important is the extent to which it appears that discussions between the world's two largest economies are already under way, and becoming more and more constructive.

- 7.6. The starting point is almost certain to be policies that will directly and indirectly influence the future value of the US dollar. Prof. Martin Feldstein, a member of the US President's Economic Recovery Advisory Board, set out four trends which could lead to a long-term **decline** in the dollar. These were:
- steady increases in Chinese consumption and imports, and a reduction in savings,
 - as a mirror-image, increased exports and lower imports into the US, combined with slower growth in consumption and a higher level of savings,
 - lower interest rates (reflecting the above), and lower capital inflows,
 - a smaller role for the dollar, both as a 'haven' in periods of uncertainty, and as reserve currency.
- 7.7. These are not forecasts, but possible trends, which policy might encourage as having, on balance, desirable results.
- 7.8. It appears that President Obama has taken a firm decision that the twin US deficits (budgetary and foreign trade) need to be tackled urgently, and that the preferred route is to give priority to the second of these. Success on this front would help in rebalancing the Federal budget, provided that the positive shift in foreign trade was large enough to produce net growth in the economy.
- 7.9. It is also interesting to learn that the US intends to pursue the same combination of tight fiscal and relaxed monetary policies that are being followed by the UK Government, and that two senior members of PREAB were recently in London to discuss how these are being implemented here. (This was confirmed in a conversation I had with another congress speaker – Vince Cable!)
- 7.10. Feldstein's identification of the four possible trends, clearly offer prospects of a favourable outcome to the current dangerous stand-off between China and the US – which would certainly not emerge from the current short-term consensus which sees a renewed widening of the trade gap between the two countries; an overhang of Chinese reserves still increasing; the possibility of steam leaving the current global recovery, and the dollar still rising as a reflection of difficulties experienced by many other countries. All this in spite of the risk of China liquidating part of its vast holdings of Treasury bills.
- 7.11. Set into a long-term context, many current trends appear in a very different light. To start on the Chinese side of the equation.
- 7.12. There are widespread fears of the Chinese economy overheating, and that this will be transmitted to the rest of the world, leading to a renewed downturn. Rising inflation, and a perceived bubble in the construction industry, are cited as evidence for this.
- 7.13. However, things really do seem to be different in China. For example, inflation has recently been running at between 4.5 and 5.9 per cent, and the

Government has taken some action to restrain it – largely by increasing the level of reserves banks have to hold, and raising the deposits required of some home-buyers and the margins on financial transactions.

- 7.14. But the important aspect of Chinese inflation is that it is being outstripped by gains in productivity. This has a number of beneficial consequences. First, it means that the current wave of wage increases across the economy is translating into higher real consumption. This will produce a rise in imports, thus leading to some drop in the persistent overseas trade balance. Secondly, to the extent that profit margins of existing industry, mainly concentrated in the coastal areas of the country, are eroded, this will result in an expansion of industrial activity and employment into the inland, and poorer regions, thus giving a further boost to these trends and the economy as a whole.
- 7.15. Perhaps most importantly, the rise in production costs is likely to remain well within the levels at which there is any general threat of the economy becoming uncompetitive. To a US customer, a rise of 5 per cent in the local price of the goods he buys comes through as the increase he has to pay in dollars – as long as the exchange rate is fixed. But, for practical purposes, the outcome is just the same as if the renminbi had been revalued upwards by 5 per cent. So, the clamour for a formal revaluation is a category error: it is estimated that over the past four years the effect has been to make the real value of the Chinese currency nearly 20 per cent higher. It is one thing to beware of what you wish for, but quite another not to be aware that you have got it.
- 7.16. Although it is the ‘battle’ between the US and China that attracts most of the attention and the headlines, it is increasingly not America but the developing countries that are likely to figure larger in their share of Chinese exports – and, indeed in trade between themselves, which will become more important in global exports and imports.
- 7.17. The rapidly growing population and potential consumer spending of the so-called ‘emerging’ and ‘frontier’ economies are well placed to become more important customers of China. Over time, this will take at least some of the steam out of US-Chinese confrontations.
- 7.18. Another favourable prospect is that the Chinese should be able to embark on a gradual but steady rundown of their enormous dollar holdings by reinvesting an increasing proportion of these in industrial and commercial developments abroad, mainly in emerging countries, but also in the mature economies. At the moment, in spite of headlines on major schemes involving Chinese companies, China accounts for only about 3 per cent of global foreign direct investment.
- 7.19. The knock-on effect of this will also play a positive part in reducing some of the other imbalances in world trade. As a group, and while they are still relying largely on selling raw materials (and the assembly of manufactured goods) for their export income, the emerging economies are tending to run export surpluses, thus aggravating those by Japan and Germany as well as

China. Future development will generate increases in production of more manufactures, and generate a jump in trade between these countries.

- 7.20. This process is already established, but has much further to go. This is illustrated by the following striking statistics:
- in 1988 global consumer spending increased by 3.2 per cent. 90 per cent of this was generated by the developed countries. In 2010 the global figure was lower, at 2.9 per cent. But only 20 per cent of that accrued to consumers in developed economies
 - In 1996 global capital expenditure rose by 6 per cent, of which 65 per cent took place in the developed countries. In 2010 the total grew by 10 per cent (on a much larger base) but the developed world's share was down to 20 per cent.

USA

- 7.21. Turning to the US, a different set of trends appear. As the recent question-mark to the AAA rating of its bonds posed by S&P demonstrated, it is only the reserve status of the dollar (with almost every country keeping a significant proportion of their reserves in dollars, and 55 of them actually pegging their currency to the greenback) that prevents the US from facing financial problems on the scale of some minor European economies.
- 7.22. To a perilous extent, the US is in the position of a borrower unable to repay his debt, but who manages to persuade his creditors to increase their loans in exchange for IOU's. The problem becomes that of the lenders, who generally come to realise that trying to turn their IOU's back into cash (or their US Treasury bills back into their own money) would be to cut their own throats or, at least, to give themselves a massive self-administered haircut.
- 7.23. So far, repeated injections of credit to make good the damage being inflicted by vast (and still not fully known) evaporation of value in collapsing credit pyramids and assets leveraged into toxicity, has kept the financial system afloat. The immediate question is how it will weather the impending end to the so-called QE2 programme – much of which seems to have leaked into inflating bubbles of liquidity in foreign markets.
- 7.24. Chaos in Europe (even though some part of it is itself attributable to the looseness of US policy) is only aggravating the problem by strengthening the tendency to move money across the Atlantic, balancing a lessening of perceived risk against lower prospective returns, but discounting the hazard of large losses should the dollar fall.
- 7.25. This policy of holding tight to nurse for fear of finding something worse will probably come to seem less attractive as and when some of the global trends described earlier start to make themselves felt.
- 7.26. Some external changes may help ease the problem. Since the end of the Bretton Woods system, world reserves of foreign currency have multiplied tenfold with the share of the dollar growing substantially. It is possible that some countries will gradually feel less need to maintain their current levels, thus easing the potential overhang.

- 7.27. But there is no escaping the need for action by the US itself. While the country notably earns more on its investment in foreign business and its own subsidiaries' operations abroad, than it pays out, the distribution of those assets is underweight the areas where most growth is to be expected. Thus, Europe, Japan and Canada account for 60 per cent of these assets, with the share of Asia at 16 per cent (with only 3 per cent in China); and South America at a mere 6 per cent.
- 7.28. The question is often asked whether the US may be about to follow the course of the Japanese economy which, since a major setback in the 1980s, has basically only moved sideways, with very little growth in incomes.
- 7.29. In truth, the US is much closer to the Japanese pattern than it realises. Since the mid-70s the real level of pay for the individual worker has barely increased (although there has been some growth in social and welfare benefits). What has kept consumption rising has been a combination of more employment per household and the rapid escalation in the use of credit cards and continual remortgaging of homes.
- 7.30. That has now only too clearly 'maxed out' in the fashionable phrase.
- 7.31. The other trend has been for a sharp redistribution of incomes, in favour of the highest paid. Over half of all the growth in personal incomes in the US since 1980 has gone to the top 1 per cent of earners, and this has been accompanied by substantial reductions in the higher rates of tax.
- 7.32. Comparisons of the US rate of economic growth also need to take into account the steady increase in population, which has been greater than in other developed countries, so that, calculated as it should be on the basis of GDP per head, the performance is correspondingly lower.
- 7.33. All this leaves the US economy in a difficult quandary. It needs to rebalance itself towards: increasing exports and reducing imports; reducing income inequality, but also shifting expenditure from consumption and towards saving more; and adjusting to a lower external value for the dollar and a substantial rundown in the level of public debt.
- 7.34. While the global implications of the US-China deadlock may not be quite so dominant as arguments about it suggest, it is clearly the most important single issue, and any progress in resolving it would contribute to dealing with other problems around the world.
- 7.35. It is therefore encouraging to see, and read with perhaps new eyes, the news this week that in recent intensive negotiations the two countries have agreed on a series of positive measures that appear more significant in the context of the points I have discussed here.
- 7.36. Thus, the US is to relax restrictions on, and opposition to, Chinese firms operating in a wide range of US industries, and acquiring ownership or participation in US-based companies. For their part, the Chinese are considering allowing US insurance companies to operate in what will be the largest car-insurance market in the world, and to introduce liberalised policies dealing with items such as patents and copyrights. For once, the

two countries seem to have gone into discussions aiming to strike bargains that allow both to gain instead of being determined to settle only for their own demands

8. Implications

- 8.1. I would draw a few conclusions from this analysis.
- 8.2. A long-term decline in the dollar appears to be the only realistic route to dealing with the present international crisis.
- 8.3. China and the US represent the lock and the key. It is not yet clear which is which, but this may emerge in the next year or two.
- 8.4. The big question-mark to whether the US economy can secure moderate and sustainable growth from a shift to exports large enough to offset the impact of slow increase in consumption and a rise in the savings rate.
- 8.5. There is a real danger that, if markets become convinced that there is a long-term plan for a planned decline in the dollar over four or five years, the result will be a massive run on the dollar designed to produce the same outcome, but over a weekend. That could dwarf the events of 2008.
- 8.6. The obvious point that arises as far as the Pension Fund is concerned, is what position it should take on investment over more than the short-term in dollar assets

9. Forecasting

- 9.1. Trying to foretell what the future holds is an almost irresistible temptation in most fields of human endeavour – and no more than in economics and investment. This is in spite of the fact that it very often proves impossible to correctly forecast even the past until long after the event.
- 9.2. The trouble often lies with attempts to create models of the future by analysing in very great detail what has happened in the past, and then constructing a model by extrapolating the findings into the future. Models then acquire a life of their own, and when events, and markets, fail to conform to the model's predictions it is reality that is blamed for not meeting the forecast – or bad luck for the modeller in happening to live at a moment when something that 'should' occur once every million years or so chooses to happen today. Ironically, the very investment analysts who tend to rely on such models as a guide to the future ritually add a mantra to their recommendations to the effect that past performance is not to be taken as a guide to the future.
- 9.3. How widespread errors in forecasting tend to be is obvious from a comparison of the accuracy of 39 leading financial, economic and public bodies in predicting the changes during 2010 in five principal indicators of the UK economy.
- 9.4. Between them they guessed 177 outcomes (several omitting one or two of the five items). The success rate was 22 out of 177 or 12.4 per cent. Only three scored two hits, on the generous basis that success meant coming

within 5 per cent of the correct outcome, and 16 did not managed a single bullseye.

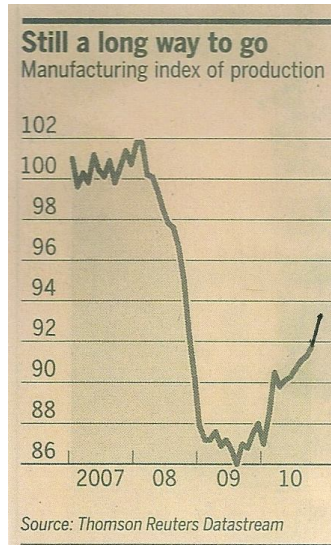
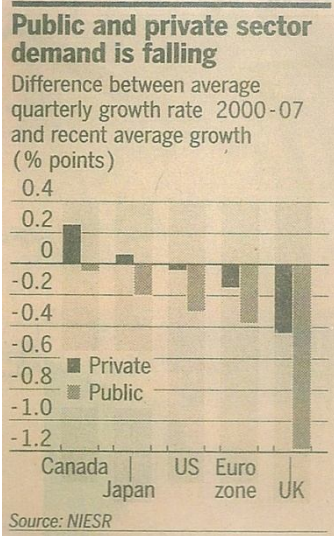
- 9.5. The trouble with most models is that they tend to leave out of account developments which will affect previous trends, or fail to identify small anomalies in the past that may gradually become more important. These unforeseen, or unforeseeable, events can have immense repercussions even though they remain very much less frequent than the models suggest.
- 9.6. The only sensible approach is to set out the current state of affairs with as much precision as possible, then to explain what assumptions and projections look reasonable, and indicate where these would lead. That is an appraisal and should not be given the misleading label of a forecast.

The year's best forecasts: 2010

	GDP growth %	Inflation Q4 %	Current account £bn.	Jobless Q4 m	Bank rate %
Final figures	1.7	3.3	-32	1.46	0.5
1. Societe Generale	1.6	3.3	-15	1.85	1
2. Citigroup	2	3.8	-11.8	1.48	1.33
3. BoA/Merrill Lynch	1.6	2	-20	8.1	1
4. BNP Paribas	2	2	-14	1.5	0.5
5. Daiwa Institute	1.6	1.8	-28	1.4	1
6. JP Morgan	1.6	2.1	-36.3	8.8	1.25
7. Economic Perspectives	2.2	2.8	-16	2.2	2
8. Lombard Street	1.6	1.8	-29.5		1.5
9. Goldman Sachs	1.9	1.8	-19	2.8	
10. CBI	1.2	2.	-28.1	5.8	2
11. Daiwa Securities	1.1	2.1			0.5
12. UBS	1.8	1.6	-14	1.9	1
13. Beacon Economic Forecasting	1.5	1.6	-41.9	1.8	1.5
14. BCC	1	2.1	-23	1.8	1
15. RBS Global Markets	1.1	2	-11	1.7	1
16. CEBR	1.2	1.8	-29	1.71	0.5
17. Deutsche Bank	1.5	1.4	-33.4	1.81	1.5
18. Barclays Capital	2	1.4	-29.5		1.5
19. Commerzbank	1.1	1.7	-26.1	1.74	0.83
20. Oxford Economics	1.2	1.6	-32.9	1.65	0.5
21. Liverpool Macro Research	1.8		-30.7	1.69	
22. Cambridge Econometrics	-0.5	1.8	-29	2.3	0.7
23. Schroders	1.2	2.3	-19	1.7	1.25
24. HSBC	2.2	2.2	-15	1.7	2
25. Credit Suisse	1.8	1.6			2
26. ING Financial markets	1.4	1.8	-20	2	1.5
27. RBC Capital Markets	1	2			1
28. HM Treasury	1.25	1.76	-31		
29. OECD	1.2	1.7	-36	8.81	
30. Standard Chartered	1.2	1.6	-14	1.7	0.5
31. Ernst & Young Item Club	1	1.7	-25	1.8	0.75
32. Experian Business Strategies	1.1	1.6	-24.9	1.75	1.5
33. National Institute	1.3	1.1	-18.5	2.82	1.5
34. EIU	0.7	2.3	-8.3	1.83	0.5
35. Capital Economics	1	1.8	-10	1.9	0.5
36. Morgan Stanley	1.2	1.6			1.25
37. IHS Global Insight	1	1.6	-20	1.82	1
38. European Commission	0.9	1.3	-24	8.8	
39. IMF	0.9	1.3	-28	9.3	
Correct within 5%	8/39	1/38	3/35	3/32	7/33
Total 22/177					

* Two correct

Some statistical comparisons:

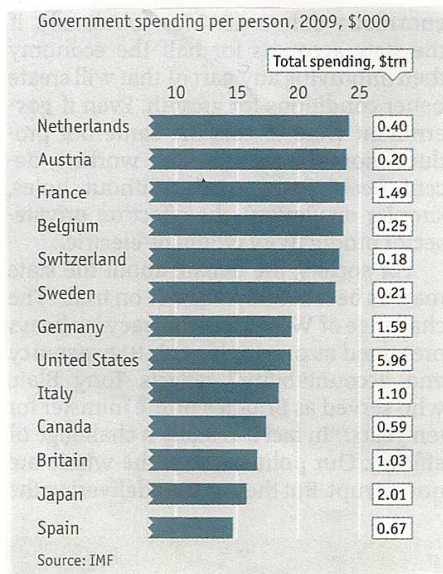


Among leading economies, the UK took the largest knock during the downturn from 2008 – and is making the slowest recovery.

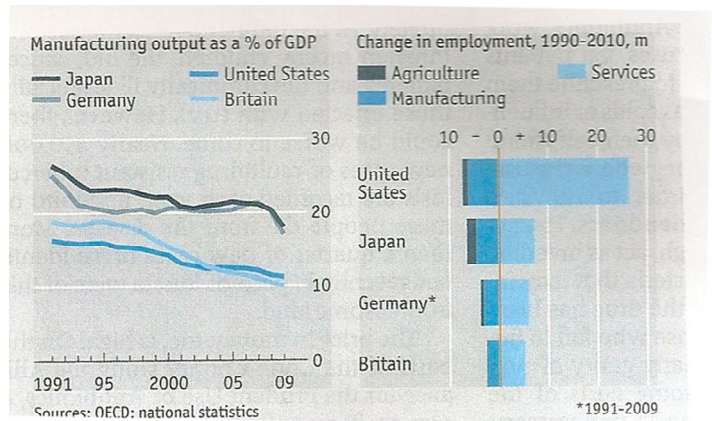
While recent figures have been greeted as showing the sharpest rates of increase in the manufacturing sector for 20 years, it is also true that the first quarter of 2011 shows output still over 9 per cent below its peak of early 2008.



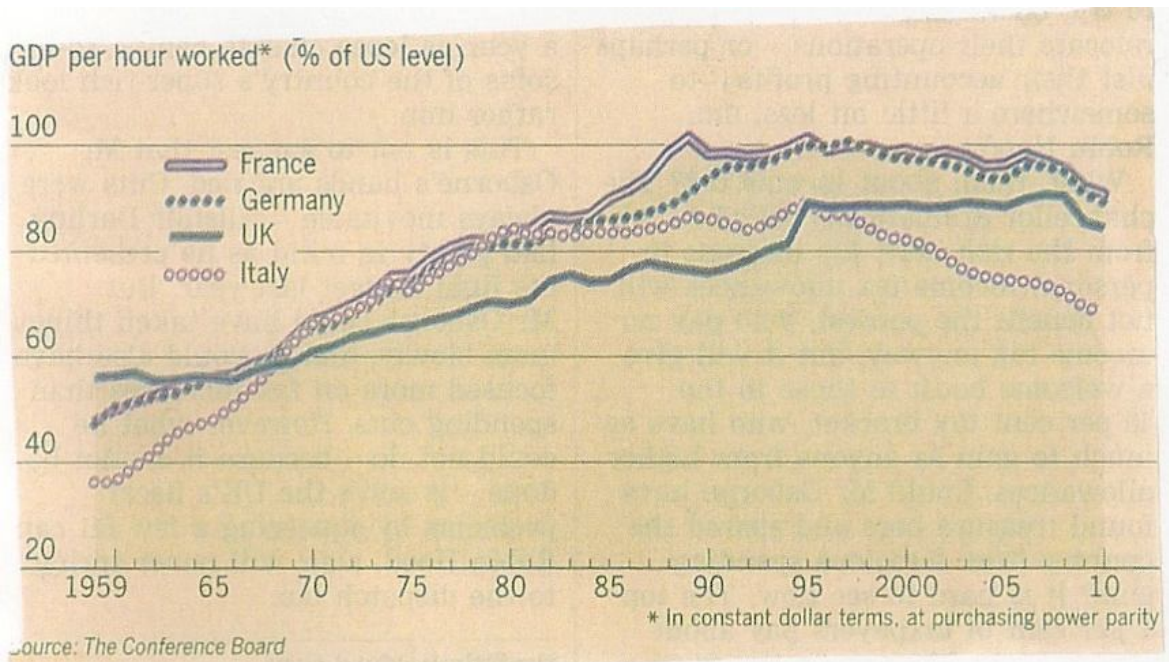
A sharp change of trend is reflected in the shift in the UK's 'league' position in GDP levels, from running a good second – and ahead of the US – up to 2003. The rate of growth collapsed between then and 2010, and was declining even before the 'crash'.



This chart shows, contrary to what one might expect, that Britain has almost the lowest Government expenditure per head of the 13 countries listed.



Manufacturing has been taking a lower share of GDP in all industrialised countries in recent years, although Germany has been levelling off. Productivity tends to rise faster in manufacturing than in other sectors, and a shrinking labour force has proved compatible (and even necessary) for increased output.



The rapid movement in productivity of the UK, France and Germany relative to the US (particularly the UK) may come as another surprise. Note: the chart is in terms of output **per hour**. The longer hours, and shorter holidays in the US give a different pattern for **total** productivity. But it is also the case that different treatment in defining capital or current expenditure has the effects of exaggerating the US relative performance.

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.)

<u>Document</u>	<u>Location</u>
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.