

HAMPSHIRE COUNTY COUNCIL

Decision Report

Decision Maker:	Pension Fund Panel
Date:	18 November 2011
Title:	The Economic and Financial Scene
Reference:	3462
Report From:	The Independent Adviser

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1. Executive Summary

- 1.1. The following notes reflect the views of the Independent Adviser on the economic and financial scene as at November 2011.

2. Background

- 2.1. The deadline for this report falls almost a fortnight before it is to be presented to the Panel. It had been my intention to set out preliminary views on the meetings of the Eurozone member countries, and of the other members of the EU late in October, but the subsequent announcement by the Greek Prime Minister of his intention to call a referendum of the Greek electorate on the measures agreed in Brussels means that, once again, an unexpected development will have to be considered at a high-level meeting already arranged – this time the G20 Summit – in Cannes on 3 and 4 November.
- 2.2. I shall therefore comment only briefly on the situation immediately after the announcement made by Mr. Papandreou, and then look at a number of other related issues in the light of his action.
- 2.3. A further update may well be given, either orally or in writing, when the Panel meets on 18 November.

3. The Greek thunderbolt

- 3.1. There was no surprise that the initial reaction to the surprise announcement of a Greek referendum should be to plunge markets into confusion and rapid retreat. However, I tend to make a very cautiously hopeful approach.
- 3.2. This is mainly because it was already clear that Greece would have to absorb a series of heavy blows to its economy and financial position if the

details of the EU plans of last week were filled in and adopted, but also if the country abandoned the Euro.

- 3.3. Those proposals resembled a shining array of attractive bottles with nicely coloured contents. But doubts were already being expressed as to whether they contained sufficient of the necessary remedial fluids, and even as to whether the formula to which the prescription had been made up would prove effective.
- 3.4. The alarms over the withdrawn referendum may however prove to have one advantage. There will be strong pressure on the Euro 17 to ensure that fully worked-out alternative plans are in place to meet both possible outcomes to a referendum, and also the situation where one does not happen at all.
- 3.5. The initial positive response of markets to the Brussels announcements appears to have been based, at least in part, on an acknowledgement that, for once, the negotiators had made determined efforts to get to grips with the real issues even though much work still remained to be done. In effect, instead of their usual habit of responding too slowly, and inadequately, to each successive twist of the crisis, Ministers were at least running fast enough to not be seen to be losing further ground.
- 3.6. The determination not to fail, and to ensure that enough is now effectively done to get events under control seems to have been strengthened, and the chances of reasonable solutions emerging may well have been improved.
- 3.7. If the Eurozone were in fact operating as a single economy, the US and UK would be seen as the main targets for concern. The pattern of key indicators shows:

(% of GDP)	Budget Deficit		Current Account
	2010	2012	2011
Eurozone	-6.0	-3.0	+0.1
UK	-10.3	-7.1	-2.7
US	-10.6	-9.1	-3.1

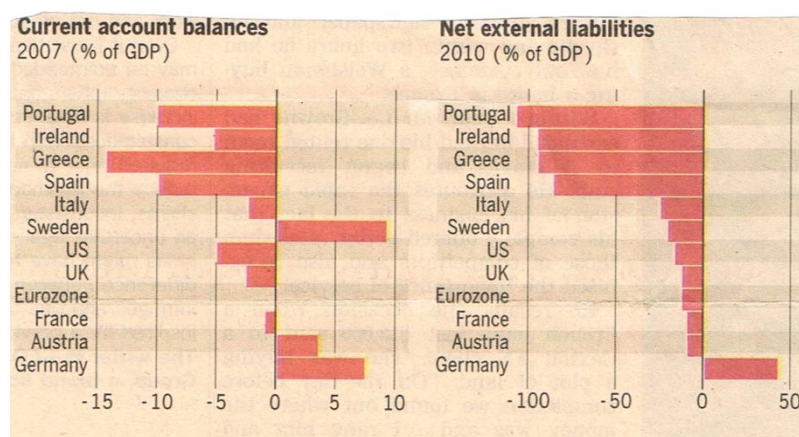
- 3.8. Underlying this is the fact that deficits of individual Eurozone countries reflect surpluses in others, but cannot be simply offset against each other – in the absence of a single political authority or at least its equivalent in financial terms. It is as if English counties or the American states had the same currency but their own individual budgets and tax systems.
- 3.9. Cornwall, for example, or Arkansas, would have weak budgetary and public debt positions, and a large trading deficit with its neighbours as compared, say, to Surrey or Texas. In a world where merchantilism still exercises more influence than is good for anybody, fingers would be pointed accusing them of moral turpitude, like Greece or Italy, and they would be urged to follow the example of the virtuous, like Germany.
- 3.10. Looking for political unity across the Eurozone, let alone the wider EU, is utopian. But that only increases the importance of putting the responsibility

for reducing trade and financial imbalances more evenly on those running persistent surpluses on a scale that distorts the equilibrium.

- 3.11. There is one particular gift-horse whose mouth needs very careful inspection. It has been widely suggested that the existing emergency fund which has €440 billion available to buy sovereign Euro bonds to support markets under pressure, should be leveraged up to, perhaps €2 trillion by an undertaking that the fund itself would accept the first 20 per cent of any loss on the bonds purchased. But that is to overlook that leverage works both ways: if the fund did in fact bear the first 20 per cent of any loss, it could quickly lose the whole of its capital and see its 'fire-power' immediately exhausted.

4. The Italian Job

- 4.1. Over the decades the competition to be identified as the weak man of Europe has thrown up a constantly shifting cast of contenders. Now, after the Greece, the clear leader, Italy, is hitting the front, with France – an unexpected outsider – coming up fast on the rails.
- 4.2. On a first examination of the statistics, Italy is actually not all that a convincing candidate. It has a much lower current account deficit than the US, Greece or Spain and a slightly smaller one than the UK. Its external liabilities are a third of Spain's; about a quarter of Greek and Irish debts, and a fifth of Portugal's.



- 4.3. Against that, net public debt is running at 120 per cent of GDP, and while its budget deficit is only 4 per cent of GDP the average maturity of its borrowings is on the low side, at 7 years. That means that the Italian government needs to go to the markets to raise an average of about 17 per cent of GDP annually.
- 4.4. While Italy's budgetary position is in fact in good health on the usual criterias, enough of its debt is held by foreigners for there to be increasing concern over the country's ability to persuade holders to roll over their loans. The potential final nail in the coffin is the lack of growth in the economy itself.

- 4.5. One rule that applies to both private and public sectors is that if interest on debt is rising faster than income, a point is reached all too soon where the burden of repayments becomes unsustainable.
- 4.6. Italy is hovering on this dangerous threshold. If the return of 6 per cent which the market is now demanding on 10-year bonds spreads to an increasing proportion of the country's borrowing, interest at that rate on just a third of the outstanding debt will more than swallow up the whole annual increase in GDP unless this rises at a highly improbable 2.5 per cent.

5. China to the rescue?

- 5.1. It was inevitable that the search for funds to fill yawning gaps in future Eurozone debt financing should seize on the mammoth cash reserves of China (and, to a lesser extent, the oil-rich countries of the Middle East). But great caution is needed in pursuing this – not least the danger of a negative response from the Chinese should they feel they are being patronisingly taken for granted.
- 5.2. There is a need for much more clarity over what Chinese money would be required for, and the effects of injecting it into the wider world economy.
- 5.3. What should be clear is that Chinese stimulus is not needed to boost the international trade of Euro countries. As an earlier table showed, the Eurozone is in trading balance both on its imports and exports of goods (as it also is on financial transfers).
- 5.4. Should any Chinese funds simply result in a capital inflow it would have the perverse effect of worsening the Eurozone's trade balance. While it is clearly desirable, from China's own point of view, and that of the world economy as a whole, for part of the country's reserves to be put back to work in lubricating trade, the basic objective must be to achieve this very largely by boosting China's own imports. Investment in European economies rather than buying up public sector debt seems a much more promising route.
- 5.5. However, this may well prove more difficult than it seems at first sight. At the moment China accounts for around 10 per cent of world imports – and it needs to be remembered that half of this is in the form of raw materials and semi-processed products subsequently to be incorporated into finished exports.
- 5.6. The corresponding combined share of the US and the EU is 30 per cent – three times as much. It has been calculated that if the level of those imports were to fall by as little as 5 per cent and China were to bear the burden of ensuring that world imports were held level, China would need to increase its own purchases by a full 15 per cent. That would not be easily achieved – particularly over a short period of time.
- 5.7. The brighter, reverse, side of this coin is that, if properly handled, an even larger expansion of Chinese imports is clearly feasible, and, with it, a very substantial and beneficial recycling of Chinese currency reserves.

- 5.8. A first step along this road is to knock on the head the knee-jerk response, encountered mainly in America, which holds that the biggest distorting element in world trade is Chinese insistence on keeping the renminbi undervalued, thus maintaining an export surplus by dumping goods on the US and depressing its national economy.
- 5.9. In reality, the renminbi has been allowed to appreciate by almost 30 per cent in the past six years, and, more important, large increases in Chinese wages have heavily eroded the competitive price advantage enjoyed by Chinese goods.
- 5.10. It is also the case that a high proportion of Chinese exports are simply assembled there from imported components, and that the net added export value is a small fraction of the invoiced price. It is an illustration that levying some form of charge or penalty on imports from China to offset the perceived 'dumping' would do anything much to reduce America's trade deficit, as American firms would switch their purchases to other Asian exporters, whose costs are increasingly competitive with China's. It is often overlooked that China's exports tend to incorporate sophisticated and high-precision parts made in, and imported into China, from high-wage manufacturers in South Korea and Japan.

6. Banks still dragging their feet

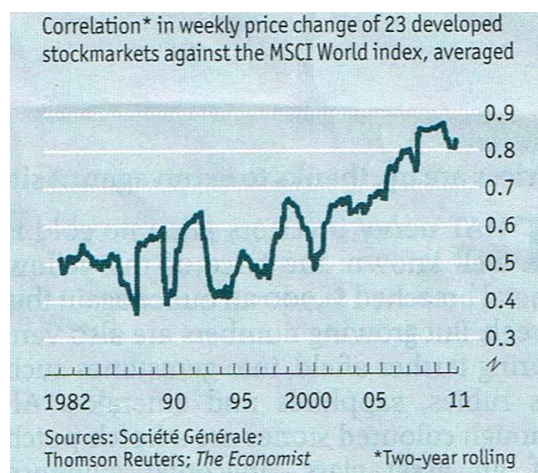
- 6.1. One of the main scapegoats for the crash of 2008 was the proliferation of so-called 'off-balance sheet' entities constructed and set up by investment banks and other institutions to avoid compliance with relevant regulation. The large, and concealed, losses which these ran up, and the contagion that spread as a result, was responsible for much of the damage caused. It is therefore rather surprising, and highly unsettling, to learn that these 'special investment vehicles', and the rest of the so-called shadow banking system, is now larger in the eleven biggest economies than ever before.
- 6.2. The credit they provide has recently been estimated at \$51 trillion, having stood at \$50 trillion in 2007 before dropping – but only to \$47 trillion – in 2008. They are thought to account for half as much credit as the total extended by traditional banks.
- 6.3. Together with the 'proprietary' trade of the investment banks, this amounts to a continuing huge but unquantifiable threat looming over the precarious stability of the whole credit system. This remains problematical because the banks still appear reluctant to produce complete and realistic valuations for their assets and liabilities, while also resisting moves to restrict recourse to the funds they hold against traditional banking activities to underpin the proprietary ventures. These provide in many cases most of the profits, virtually all the bonuses, and such dividends as are deemed appropriate for shareholders.
- 6.4. Banks clearly have a vital function to perform in the complex modern financial world, but the right balance between meeting the credit needs of the business community and private account holders on the one hand, and supporting proprietary ventures of banks acting for their own account has

still to be struck. While the Glass-Steagall Act in the US was far from perfect, it was probably the best attempt so far to try and mark out the boundaries once the scene had been transformed by limited liability companies replacing partnerships across much of the range of financial services.

- 6.5. Clearly, the banks themselves have contributed to the widespread current distrust and unpopularity that have been experiencing. But it does not help that their instinctive reaction to suggestions that they should employ more capital and reduce their leverage seems to be to work out the amount they would need to raise their charges in order to maintain the present level of profits – and bonuses.

7. Amber light for emerging markets?

- 7.1. Correlation between equity markets across the world has increased sharply over the last 30 years or so. As the chart shows, while there have been some sharp fluctuations, the trend since 1982 has been steadily upwards, and in the last few years has been running at around a significant 0.8 to 0.9.



- 7.2. But, contrary to what might be expected, returns and performance across the range of equity markets have not followed a similar pattern. While indices have moved closely in line, returns to investors have not. Over the first three quarters of 2011, returns in the MSCI emerging markets index dropped by over 10 per cent, while developed markets were down only some 6 per cent. This actually stems from globalisation, the increase in trade and the growing proportion of earnings companies quoted in one market derive from operating abroad. Thus, 20 per cent of earnings by Dow Jones index shares derives from emerging markets; 36 per cent of those of UK FTSE 100 companies from North America, and 14 per cent of South Korean listed firms from Europe.
- 7.3. With the share of world GDP taken by emerging markets up from less than a quarter in 2001 to 30 per cent now, the trend will continue. This underlines the fact that successful stock selection needs to go much wider than picking out growth areas as these are not automatically to be identified with growing profitability.

- 7.4. In more detail, the indices with an 87 per cent correlation since 2001 between FT Multinationals in Developed Countries and FT Emerging Markets showed the former underperforming by 31 per cent to 230 per cent over 10 years, but a sharp reversal of the gap in the last five years – to 42 per cent against less than 10 per cent.
- 7.5. An analysis by Goldman Sachs also shows that involvement by many large international companies in emerging markets may be less than many people might assume. Among them the following have been extracted, in terms of their exposure to emerging markets.

	Per cent
Rolls Royce	48
HSBC	48
Unilever	43
SAB Miller	38
BAT	33
Anglo American	25

- 7.6. Success or otherwise in investing in emerging markets is strongly affected by trends besides those in equity markets. In particular, movements in bonds and changes in inflation levels have to be taken into account.
- 7.7. Emerging countries have piled up reserves of over \$6,400 billion in (mainly foreign) assets, including sovereign bonds which are hopefully regarded as safe, and which are being used as a bulwark against repetition of the Asian crisis of 2007. There is also an inflow of funds from developed countries looking for better fixed interest returns than are available in the US and UK, Europe and Japan. Much of this seems to derive from the QE programmes operated by the first two.
- 7.8. In turn this has been pushing up inflation in emerging countries and is beginning to affect the competitiveness of their exports. The search for yield is turning some emerging markets into havens which are less safe than they used to be.

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 this report.

2. Impact on Crime and Disorder:

- 2.1. This report is 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