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Acuity

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Economics 101: A bluffer's guide

> It [economics] is a method rather than a doctrine, an apparatus of the mind, a technique of thinking which helps its possessor to draw correct conclusions
>
> John Maynard Keynes (1883 to 1946)

A whistle-stop tour of the UK economy

Every morning when you turn on the news you will be bombarded with facts and figures on the economy - things like the improving budget deficit, the growth in GDP, a rise in the RPI and a new round of quantitative easing. What does it all mean and does it matter?

Given that economists spend years studying and trying to understand the economy – and very often fail to predict what is going to happen, or why what has happened, happened – this volume of Acuity attempts only to provide some insights into how the economy works in very broad brush terms and what lies behind some of the numbers and concepts bandied around by the media. Here goes.

Inflation and its impact on purchasing power

Inflation and purchasing power: You may be able to recall hearing your grandparents tut-tutting about the price of apples with indignant outrage, harking back to a time when you could buy a buy a pound of apples for thruppence. They of course failed to mention that they only got paid £300 a year! We are all familiar with the concept of inflation - the upward movement in prices - and that it erodes our purchasing power, so that a pound buys fewer and fewer goods over time.

Inflation since 1948: The average rate of inflation from 1948 to 2012 in the UK has been 5.5% p.a., although it ranged from a high of 25% in 1975 to a low of 0.95% in 2008. Since 2000 inflation has averaged 3% per annum. Using the 'Rule of 72' provides an indication of how corrosive inflation can be to our purchasing power. Dividing the rate of inflation into 72 gives us an estimate of how quickly the purchasing power of £1 halves. So using the 5.5% rate from 1948 to the present we find that it has halved every 13 years (72/5.5), on average.

The UK Retail Price Index or RPI: We often talk about inflation but rarely stop to think what makes up the rate of inflation. It is calculated by the Office for National Statistics (www.ons.gov.uk) using price changes to a basket of 180,000 prices relating to about 700 areas of consumer goods and services, which are weighted out of a possible score of 1,000. These weights are derived from the Living Costs and Food Survey, and reflect expenditure patterns by private households, excluding the top 4 per cent of households by income and those pensioner households mainly dependent on state benefits. The weights in the basket are set out in the figure overleaf.

The issue with RPI is that it may not reflect your own lifestyle expenditure. Items such as the rise in costs of long-term care, private schooling and university education have soared, whereas the cost of TVs and computers has fallen dramatically. There are a number of calculators available where you can calculate a personal rate of expenditure inflation such as the ONS's Personal Inflation Calculator[1].

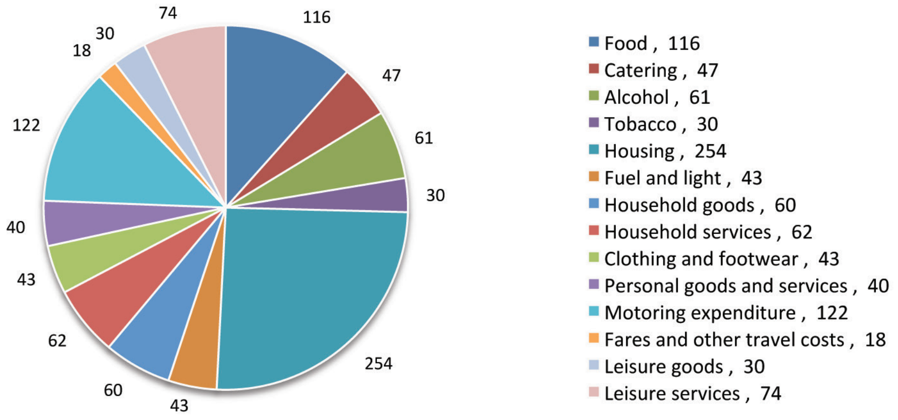

Figure 1: Weightings in the UK RPI basket in 2013

Data source: Office for National Statistics

The UK Consumer Price (CPI): CPI and RPI are pretty similar, but vary in the way in which items are weighted. For example, the RPI basket includes housing costs such as mortgage interest payments, council tax, building insurance and depreciation costs. These are excluded from the CPI although some occupier costs are included. The CPI on the other hand captures items such as university accommodation costs. CPI is the government's target measure of inflation.

Terminology – 'nominal' and 'real': Given that inflation erodes purchasing power it is sometimes easier to think about things in 'today's money terms' or 'current 2013 prices'. An example might be a need for £50,000 of retirement income in 15 years time, in today's money i.e. £50,000 of future purchasing power. Rates of return and other numbers where inflation has been taken into account (its effects deducted) are known as 'real' numbers, whereas those where no due allowance has been given for inflation are known as 'nominal' numbers. The £50,000 in today's money terms will in fact be almost £78,000 in nominal terms in 15 years time at 3% inflation per annum. Real numbers are easier to get your head around.

Growth and recession – the output of the economy

Economists have always been obsessed with measuring the growth of the economy, and several terms are bandied around by the financial media. Again, we rarely take much time to think about what they actually mean. Below we cover off the basics of what makes up the UK economy, how we measure growth and what recession and depression mean in an economist's eyes.

Gross Domestic Product (GDP): The most common measure of the size of an economy is Gross Domestic Product. It is the value of everything produced in the country – both goods and services - by both UK and foreign owned firms. It is usually valued at market prices. Growth rates of the economy are derived from it, such as year-on-year, or quarter-on-quarter changes. The figures are usually described in constant or real terms i.e. after inflation.

The size of the UK economy: At the end of 2012, the UK's economy was the 6th largest economy in the world behind the US, China, Japan, Germany and France with an output of $2.4 trillion (equivalent to around £1.5tn at 1.6 dollars to the pound), which is around 3% of global output[2]. This point perhaps validates the decision to diversify any equity holdings globally.

The make-up of the UK economy: By and large, the UK has become a services-oriented economy. This sector now makes up over 70% of our domestic output. Industry represents around 20% and agriculture less than 1%. Figure 2 below breaks this down further.

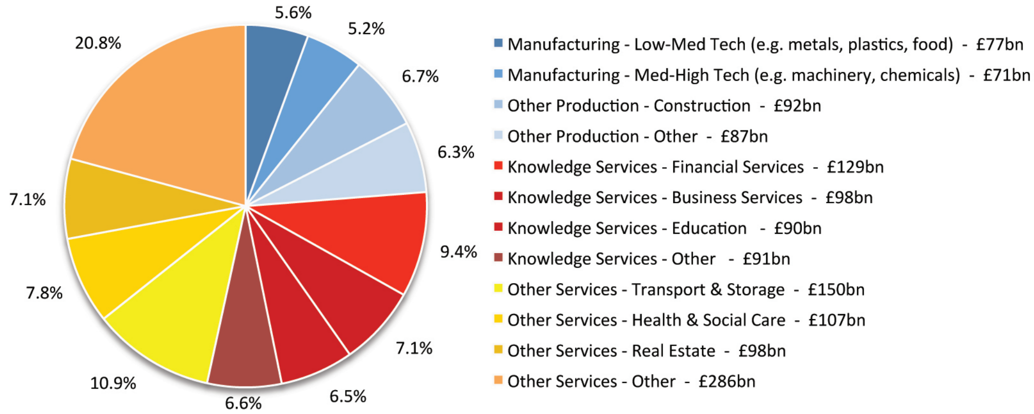

Figure 2: The UK economy – output by sector 20113

Data source: Department for Business Innovation and Skills[3]

Long-term rates of UK growth: The UK is a post-industrial, developed economy and is unlikely to see sustained high levels of growth, such as that evidenced in developing economies such as China, India and Brazil. As a rule of thumb, longer term real (above inflation) rates of growth are expected to be around 2% to 3%, although, as we well know, all economies are subject to slower or negative rates of growth at some points in the economic cycle. The figure below illustrates the total output of the UK economy and the change in GDP on a year-on-year basis over the past 10 years. The International Monetary Fund (IMF) now estimates UK growth at 1.4% for 2013. The UK economy is now only 2.5% below its peak, although some sectors such as construction and manufacturing remain in the doldrums. Services, on the other hand, are at an all-time peak.

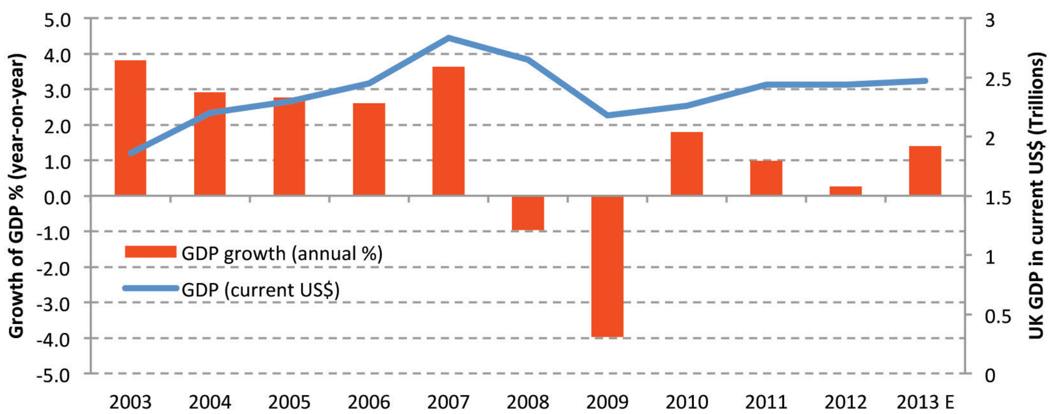

Figure 3: UK GDP and GDP growth rates 2003-2013

Data source: The World Bank to 2012, IMF estimate for 2013

Recession: Recession is when the economy begins to shrink (i.e. when its growth rate is negative). In Figure 3 above, the economy shrank in real terms in 2008 and 2009. The technical definition of recession is two consecutive quarters of negative GDP growth. Media and political commentators make much about whether the economy is in a technical recession, arguing and point scoring over negative growth as insignificant as 0.1%, which is just noise. Official GDP growth figures are frequently amended up or down by more than this figure. Double dip recession is when the economy, after a period of decline, recovers for a brief time and then returns to a technical recession. In July 2013 the ONS revised the GDP figures to show zero, rather than negative, growth over the previous three quarters, meaning that the UK did not actually suffer a double dip recession at all! A key element in recovery from recession is confidence and commentators and opposition politicians do little to provide sensible perspective.

Depression: A depression is a severe recession. While there is no absolute definition, a prolonged fall in GDP of more than 10% would most likely be considered a depression.

Government spending and revenue

Sources of government revenue: The income that the government receives comes from a number of sources. What is perhaps most revealing is that income tax only represents around one quarter of all government revenue – although when combined with National Insurance the proportion of government revenues coming directly from our gross incomes is 43.3%. Capital taxes, such as inheritance tax, capital gains and stamp duty account for less than 3% in all. During recessions, company profits and employee incomes may fall, reducing the tax take. The estimated revenue for 2012-2013 was £591 billion .

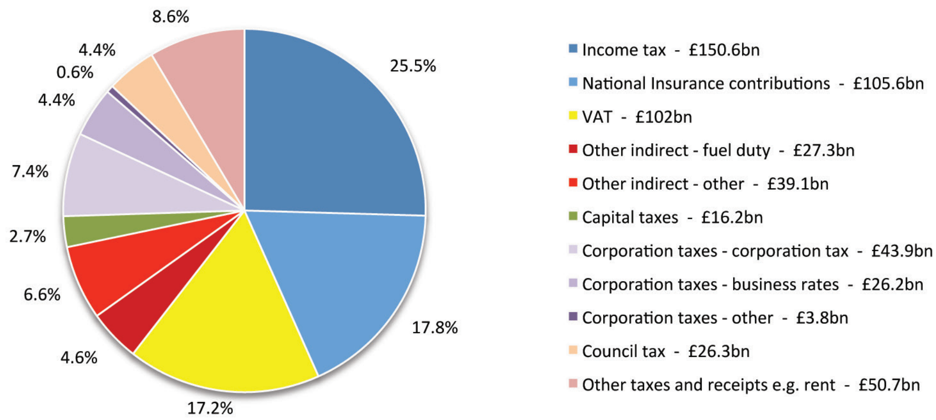

Figure 4: UK government revenues estimate for 2012-2013

Data source: Institute for Fiscal Studies, 2012

Government expenditure: This is the amount that the government intends or is already committed to spending. Figure 5 below provides some interesting insights into how the government spends the tax payers' money. It is worthy of note that we spend more on paying interest on the public debt than we do on defence. Welfare (not including state pensions) is one of the largest components of government expenditure and has been growing fast. The new welfare reforms are an attempt to limit its rate of growth. The total government spending forecast for 2013 is in the region of £675 billion[4].

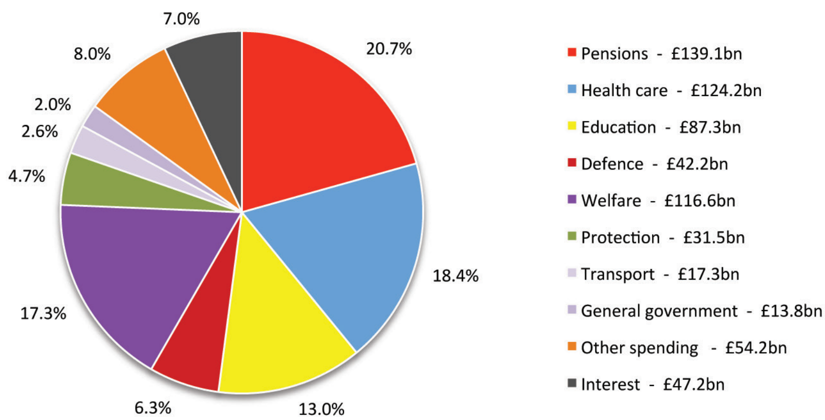

Figure 5: Total UK government expenditure – fiscal year 2013

Source: www.ukpublicspending.co.uk

Budget surplus and budget deficit: When government revenue is higher than expenditure, there is a budget surplus. When it is less than expenditure there is a budget deficit. If this is due to an ongoing imbalance, rather than temporary reasons, then it is termed a 'structural' deficit. In other words, it is a persistent inability to live within our means. The budget deficit was around 11% of GDP when the coalition government took over and now stands at around 6% of GDP, as a result of the government's austerity plan and now some GDP growth. A budget surplus can be used to pay down government (public) debt, whereas a budget deficit needs to be financed by government borrowing, through the sale of gilts and index linked gilts. Net borrowing for 2013 could end up at around £105 billion – if the recovery is sustained – against an estimate by the government of £120bn in March, 2013.

Austerity: A key financial and political term since 2010. In common language it is a tightening of the purse strings. The UK spends more than its income – the budget deficit – and needs to rein in. Although the deficit has been reduced to 6% of GDP, it is still a deficit and, as such, the indebtedness of the UK will continue to rise. Only when the budget is balanced will the level of debt stop rising. The current Chancellor estimates that the books will finally be balanced in 2020. The last time there was a budget surplus was when the previous Conservative government handed over the reins to New Labour. Their period in office ended with the infamous note from Labour's Treasury Secretary, Liam Byrne to his successor: 'There's no money left!'

Public Sector Net Debt: The total Public Sector Net Debt (PSND) - not including monies used to support the failed, nationalised banks - stands at over £1.2 trillion, or around 80% of GDP. If the liabilities relating to the bail-out of the banks and other financial guarantees are taken into account, the 'unadjusted' PSND is closer to £2.3 trillion or nearly 150% of GDP. Given the heavy interest bill - £47 billion a year – it is evident that the UK's government needs to try hard to balance the books.

The gilt market: The budget deficit needs to be financed by borrowing money from investors. This is handled by the Debt Management Office which sells government IOUs in the form of gilts and index linked gilts. Each has a set maturity date and rate of interest associated with it. In the case of index linked gilts, the principal amount and interest rate are linked to the UK RPI (see above). Figure 6 below provides an insight into who is holding the UK's debts.

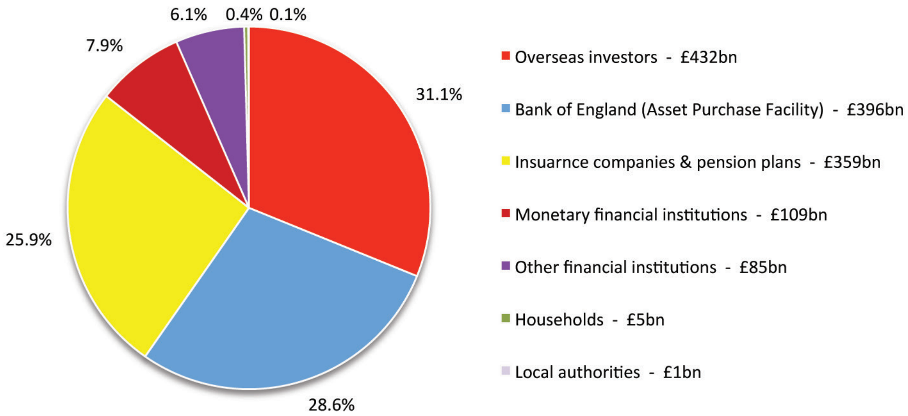

Figure 6: Owners of UK gilts i.e. lenders to the UK government – Q1 2013

Source: UK Debt Management Office[5]

Quantitative easing: Much has been discussed and written about quantitative easing, or QE as it is known. In 2009 the Bank of England was asked by the Chancellor to establish the Asset Purchase Facility to provide liquidity to the credit markets. The idea is that the Bank of England electronically 'prints' money – creating new central bank reserves – and lends this money to the Bank of England Asset Purchase Facility Fund Limited (BEAPFFL), who in turn purchase high quality assets from institutions such as commercial banks, insurance companies and pension funds. It is hoped that the cash received will be put to use by lending more to individuals and businesses, or buying new assets, helping to boost economic activity. In Figure 6 above, you can see that a little under £400 billion of new money has been created as part of this programme. Quantitative easing has driven down the yields on gilts, as this buying programme pushes prices up.

A serendipitous outcome is that the government can fund its borrowing more cheaply as yields are lower. In addition, because the BEAPFFL borrows money from the Bank of England at the base rate, and buys assets with higher yields, it makes a spread between the two. This net interest gain is transferred to HM Treasury and used to reduce the PSND. In the future, if losses are made on unwinding the bond holdings, then HM Treasury will transfer funds back to the BEAPFFL.

The recent worry that the US's Federal Reserve was about to begin tapering its own QE plan resulted in bond yields rising and bond prices falling. No one quite knows what the effects will be longer term when the economy really takes off. Will the Bank of England be able to unwind its programme effectively or will the printing of this new money result in inflationary pressures? No one can be too sure.

Conclusion

We hope that this brief insight into some of the key terms that are bandied around, particularly by the media, has provided a sense of how the economy works and the challenges that any government faces, particularly over the size and focus of 'the state'. Whilst there is little we can do directly to influence the state of the economy – except spend a little more – we each have a vote which can, amongst other considerations, register the extent to which we see fiscal rectitude as a key priority for the government we elect. The outcome of the next election is unclear but, in any case, let's hope that the economy continues to recover and politicians make sound decisions on our behalf.

End notes

1. http://www.neighbourhood.statistics.gov.uk/HTMLDocs/dvc14/index.html
2. World Development Indicators database: World Bank data September 2013
3. BIS (2012) Economics Paper No. 18, Industrial Strategy: UK Sector Analysis
4. Office for Budget Responsibility, Economic and Fiscal Outlook March 2012
5. UK Debt Management Office, Quarterly Review, April-June 2013. www.dmo.gov.uk

Other notes and risk warnings

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