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Is it an economic recovery or a false dawn?

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Background
Much has happened both to the world economy and UK politics since we published our Spring 09 newsletter. As part of our engagement with HM Treasury and main political parties, EMBG has consulted with a core group of its members to gauge the impact the economy is having on their businesses and which political party they feel has a better chance of turning things around.

In this article we concentrate on our view of the economy and some suggestions on the appropriate policy responses to deal with the problems areas identified.

The economic backdrop
In the aftermath of the credit crunch the financial markets seem to be stabilising in the absence of more shocks to the system. The leading stock markets are all substantially higher in percentage terms than they were in the beginning of 2009. Most economists and market watchers now think that economies will bottom out at the end of 2009 and then start to recover. Unfortunately, some greed is now also returning to the stock markets as they rise and many are ignoring the fundamentals.

The market's confidence seems to be driven by better than expected results, much of which has been achieved by aggressive cost cutting and not by underlying revenue growth. Those companies that are achieving revenue growth are mostly doing this on the back of big discounts that are reducing margins and profitability.

The recent multi-billion pound profits announced by Barclays and HSBC have grabbed the headlines as heralding the beginning of the end of the banking crisis but they ignore the poor profits and rising bad debts from retail banking. Barclays are not paying a dividend this time but are likely to pay big bonuses which could all turn out to be bad news for their shareholders going forward. The profits of these banks are well under previous years but they have been helped by income from investment banking and fatter margins on their book arising from the low base rate.

Going forward as base rates increase, with retail savers demanding higher returns and bad debts continuing to rise with growing unemployment, retail banking is unlikely to return to its former profitability for some time. Other major banks including RBS and Lloyds whose investment banking income is not as significant as Barclays are likely to disclose more losses and a decrease in credit quality.

In the case of Barclays their strong investment results were shored up by the acquisition of Lehman and the reduction in competition in the aftermath of the credit crunch. Investment banking returns are very volatile and it is sometimes hard to quantify their long term return. Therefore future strong growth is far from certain.

All the above indicates to us that although some of the indicators are moving in the right direction it would be wise to take a more cautious stance when planning for the long term. We would refer you back to our article "Beyond the Crunch" in which it is explained why markets are recovering and why they could fall again even harder. We have yet to see convincing evidence to suggest that history will not repeat itself again.

Whilst there is much debate as to whether there will be a V, W, L or U shaped recovery there is a general belief that the recovery will be a long time coming and most people will not see any real increase in their living standards until growth returns to trend. This could take some years to achieve.

Sustained recovery
Sustained recovery is more likely to be achieved once the balance sheets of both companies and individuals are repaired, and unemployment and economic growth return to their long term trend.

Business needs to see the easing and free flowing of credit. For this to happen we need to see economic stability, a sustained fall in unemployment and the recovery of the housing market. In addition, the toxic debts need to be quantified and dealt with so that wholesale credit markets start to function properly. For now, lending is likely to be dependent on attracting customer deposits and this is likely to mean higher interest rates for consumers and a continuing shortage of available credit.

Although the general consensus is that inflation is likely to rise from the expansion of the money supply and lower interest rates, the economic indicators point to deflation as being the likely scenario in the near term. This is based on much quantifiable evidence including the fact that unemployment is still rising in the western economy. The US treasury expects the unemployment rate to exceed the 10.2% post war high reached in 1982 and job cuts are still rising fast. In the US less than 60% of the adults are at work now. In the UK official unemployment is likely to approach 4 million. However, when one includes the adults on incapacity benefits and those who do not register for unemployment benefits the real unemployment figure in the UK is probably over 10% now. Coupled with the fact that real salaries and pensions outside the public sector are falling, a trend that is set to continue into the future, it all indicates that inflation is unlikely to be a problem in the near term.

There needs to be a global structural adjustment where the West saves more and spends less and the East saves less and spends more and at the same time the western Anglo Saxon economies need to become less reliant on the service sector and invest more in value added manufacturing.

From a government policy standpoint, it would be better to support small businesses as they are much more likely to pull the UK out of recession than increased consumer spending. Consumers are likely to be more cautious and save more in the face of rising unemployment, falling incomes and reduced future pension benefits.

Suggested policies for sustained recovery

Banking and financial regulation
As the market mood turns bullish the banks are already showing signs of returning to business as usual. The problem appears to be that those that got us into this financial and economic mess have still largely been given the task of getting us out. It is therefore not surprising that in the absence of new thinking and a vigorous challenge of the old guard we are heading back to high bonuses and a rehash of the failed policies of the past.

When deciding who should regulate the financial sector the key is not so much as to whether it is the Bank of England (BOE) or the FSA and Treasury (there is evidence to suggest that the BOE have not done a good job in the past either) but what is done and by whom.

Our policy suggestions are as follows:

1. Whilst we agree that a unitary body should be given overall control of regulating the banks, their role should be more biased to supervision than rules based. This would allow them to look at the substance over the form of the transactions being carried out. This should go some way towards ensuing that unsuitable transactions do not pass through the net simply by meeting the current rules.

2. The people employed by the supervising authorities should be of a high calibre, who are able to understand the mathematics and implications of using structured products and derivatives. Many of these people should ideally be from the industry and have had several years experience of creating and trading such products. "Poachers turned Gamekeepers"

3. Although not popular with bankers, there is a good case for separating retail banking from investment banking. The latter is more of a brokering operation requiring a different set of skills and risk profile from retail banking. We should go even further than the Glass-Steagall provisions to ensure that when the high risk strategy of investment bankers fails it does not lead to global risk to the economy that requires the tax payers to bail them out.

4. There should be a requirement that the financial risk and obligations arising from off balance sheet finance is brought on to the balance sheet.

5. The amount of retail deposits that can be risked for non lending activities should be restricted.

6. Bonuses for employees should be paid on a matching basis to actual earned profits after taking into account any contingent risks attached to the income generated and the long term profitability of the company. At the moment bonuses are paid on accounting profits, and losses created in chasing high returns are ignored.

7. The ordinary shareholder should be given a greater voice in what the management does. In law and in theory it is the shareholders who control the actions of the Board and what the company does, but in reality most shareholders do not have much say at all.

8. The non executive directors should be given statutory obligations and powers to ensure that they play a more effective role in keeping a check on their Boards. The selection process, the skill and experience required of non executive directors all need to be reviewed as well. The present system has been shown to be largely ineffective.

9. Although not popular, it may be better to let some banks go bust than throw good money after bad. If done properly it need not lead to a systemic risk. Indeed many banks have been allowed to fail in the US; including Lehman's in the last 12 months and it has not created a meltdown of their banking system.

To implement the above policies in an effective way will require global co-operation so that no one country can benefit by running a more relaxed regulatory regime. There is also a need to exchange information between governments and their regulators so that multinational companies operating in different jurisdictions can be adequately monitored and supervised.

Helping businesses
We believe that small and medium sized businesses (SMEs) are an important key to our economic recovery. However, rather than encouraging them, the current tax and regulatory systems are working to slow their progress.

Our policy suggestions are as follows:

1. Reduce regulatory burdens especially for the small and micro SMEs particularly in regards to creating employment.

2. Reduce the burden of taxation. This could be done to encourage employment by reducing employer NI and a reduction in corporation tax. This would encourage greater investment as profits are ploughed back in to growing the business. It may even increase the tax take as it would also encourage more businesses to incorporate and pay a lower rate of tax rather than operating within the black economy.

3. Provide greater relief from business rates for SMEs especially for start ups.

4. Provide a government backed credit insurance scheme as commercial insurance companies have largely withdrawn from the market.

5. Provide real financial incentives which makes taking on trainees and apprentices financially worthwhile.

6. Encourage schools and universities to work more closely with business so that they produce the kind of future employees that the economy needs.

7. Provide financial incentives and tax breaks to individuals who want to re-skill or retrain to develop skills for the changing job markets. Sole traders for example cannot set off the training cost of acquiring new skills against their profits.

8. Provide more encouragement for risk taking, innovation and R & D both from a funding and tax point of view. Although there are tax breaks for some of this, they could be made less restrictive and easier to obtain.

9. Simplify the government procurement process so that SMEs have a chance of getting a fairer share of public sector contacts.

10. Ensure that the government procurement contracts given to large and often foreign companies are required to be broken up so that SMEs are not barred from bidding.

11. Review the way business support is currently being delivered as the current Business Link support using the IDB (information, diagnostic and brokerage) model is flawed and, in our view, not fit for purpose.

12. Britain has a lot of BAME businesses who would be in a good position to help lead a boom in exports and overseas trade. In our view this area has not been encouraged or exploited to anything like its real potential by government policy. If done properly this area could improve employment and corporate profits.

The above are some ideas which could be developed. The reduction of taxes and financial incentives required to help businesses are unlikely to be able to be made available without a significant cut in public spending.

Public spending cuts
Although this is a hot issue amongst the main parties, the public understand that the public sector needs to be cut. We therefore think that frank public discussions needs to take place in the run up to the general election. The public expects priority to be given to protecting the National Health Service, education and probably defence, but cuts can still be made and sold to the voters.

Our policy suggestions are as follows:

1. One of the biggest and most unsustainable parts of public expenditure is being spent on maintaining final salary inflation linked pension schemes. Given that such schemes have all but disappeared in the private sector the public are likely to be sympathetic if similar cuts were made in the public sector. The pain needs to be shared by the whole country.

2. In the NHS the huge increases in salaries paid to doctors to do less should be clawed back either by pay cuts or freezes coupled with greater productivity.

3. The NHS administration and computer systems take up a significant part of the budget and these could be looked at for greater saving and productivity.

4. The public sector procurement system especially in relation to the acquiring of services such as IT services should be reviewed. Too many projects seem to over run and fail to deliver their intended purpose. Much of the problem relates to the desire to pass the risks on to the contractors and relying on this to prevent loss to the public sector. However, the reality is that contractors can and do go bust but the public sector still has to deliver the service and will have to spend more money if the contractor fails. The public sector needs to improve its risk management.

5. The civil service controls large amounts of public money and yet they seem to have very poor financial management skills. This area needs urgent action to improve financial competence.

6. Any review of the public sector should identify whole functions which can be taken out rather than just cutting them. The public sector are very adept at finding imaginative ways to increase expenditure so that their department is kept going.

7. A more controversial proposal and one that may be difficult to sell to the public is to provide tax breaks for private health insurance and to parents who use private education. The current plan to take away charity status from private schools may yet prove counter productive from the standpoint of reducing public expenditure. We believe that ultimately it would help improve educational standards and the health of the nation if we encouraged the private sector to provide some of the services through tax breaks. However, we accept that it will require a change in social altitudes for this to be politically doable.

We believe that the composition of those looking at policy issues should include people from outside the industry being regulated who can challenge the status quo. In the absence of this it will be harder to get real change. Let's hope the policy makers show the foresight to do this.