update
November 2009

Uncertain times, uncertain futures?

Keith Wade – Schroders Chief Economist

Are we through the worst?

"While the crash took place only six months ago, I am convinced we have now past the worst – and with continued unity of effort we shall rapidly recover. There has been no significant bank or industrial failure. That danger is safely behind us." This quote could have been from Obama, Geithner, Bernanke or even Mervyn King. Unfortunately, it was none of those; it was Herbert Hoover in May 1931 at the time of the great depression.

Whilst we are not in a great depression, we could go through several waves of optimism and pessimism before we reach that level of sustainable activity.

Is the recovery sustainable?

Your view of the world, inflationary or deflationary, stems from your answer to this question.

We are generally quite optimistic at the moment. The recovery over the next 6, maybe 9 months is going to be pretty sustainable. There has been a visible synchronised upturn around the world. Asia and Latin America have been in the vanguard of that, followed by America and then finally Europe.

The current expansion is the result of an inventory cycle. Companies reduced their output aggressively and are now having to increase their output to get back in line with sales. This is a characteristic of virtually every recession and every recovery. This can lead to some quite strong gains in GDP growth. This cycle creates scope for a trampoline effect where we see a bounce back in productivity.

There is a 'short squeeze' taking place in the housing market. The level of transactions in the housing market remains low. Mortgage approval rates are still at only half the level of 2007. This is creating a short squeeze in the market and pushing up prices, which is not likely to be sustainable. When prices increase, there is a lot of potential supply that could come into the market, which will probably mean prices will fall back again.

People are starting to save more. We are now seeing what the economist Keynes called the "Paradox of Thrift". The paradox of thrift is simply that it is very good if individuals save more but from a macro perspective if everyone is saving more then consumption is very weak and you get yourself into a recession or even a depression, as it was in the 1930's when Keynes was writing about that. As Mervyn King said earlier this year, everything we are doing now is diametrically opposite to the direction in which we need to go in the long run.

The classic Keynesian economic response is that if the private sector aren't borrowing, then the government sector needs to borrow for them. That is exactly what is happening. The result is to solve a private debt problem we create a public debt problem and that we won't be better off in the long run. We currently rely on inflow of capital from overseas to fund our borrowing. The risk being that the inflow stops temporarily which would put pressure on the pound sterling and on gilt yields. This has not been a problem recently as the Bank of England has been buying all of the gilts by printing money (Quantitative Easing). We will have effectively funded the entire budget deficit (c. £180billion) by printing money. That is not a sustainable trend either. The challenge is can we transition from this period of enormous support from the authorities to get the economy off life support and to stand on its own two feet.

Where we are at the moment:

- The US has had one quarter of positive growth, so their recovery has started. The recovery will continue but concern remains for next year when the inventory cycle ends.
- The UK is a more worrying picture. The UK has fallen further and we are still in recession. Looking to come out of recession in the fourth quarter and we will see some recovery. But the UK is one of the most badly affected of all the economies in this crisis.

This is not a completely synchronised crisis as the emerging markets are continuing to grow quite rapidly. This is one of the key themes, the emerging markets have decoupled to a large degree. They have brought forward projects that needed to be done, compressing their 5 year plans into 2 years to help support growth. Following the Asia and emerging markets crises in 1998, companies and banks have already rebuilt their balance sheets and reserves. So when this crisis hit, they were in a much stronger position.

Are the emerging markets the new driver for global growth?

Yes and no. The marginal consumption in the US and China may be the same, but what they are consuming is different. About half of a Chinese person's consumption is on food and energy, on necessities. It is therefore a very different consumption basket if you are selling to China, to what you would sell to the US. The world economy needs to adjust to that. The BRIC (Brazil, Russia, India and China) countries will drive growth in commodities and materials.

Will interest rates remain low?

Yes. If unemployment is rising, the Federal Reserve doesn't raise interest rates. On the evidence of the last three cycles, they have not even started to raise interest rates until after unemployment has been falling for several months. Unemployment is still rising and is likely to peak in spring next year.

T. 0161 835 2266
W. www.robpar.co.uk

Are we moving into a deflationary or inflationary period?

My current view is that Inflation is not going to be a problem, which is not a very fashionable view at the moment.

There is a very big output gap in the world economy at the moment. The output gap is a measure of the amount of spare capacity in the world. This means companies will price competitively or even decrease prices as they want to increase their output. The output gap is as big as it has been since 1970 that suggests that inflation should fall.

Central banks want to keep inflation under control. Nothing worries the central bank more than deflation. If you get deflation, no matter how far you cut interest rates, if prices are falling then real interest rates will be rising and you get what economists call debt deflation. Debt deflation is very hard to get out of, so central banks want to avoid if at all costs. That is more of a worry than inflation.

Uncertain times, uncertain future?

By the second half of next year we will see unemployment coming down and we will start to see a sustainable recovery. It won't be a strong recovery, but it will be sustainable based on a foundation of profitability. There are shades of recovery and it probably won't feel like a recovery for a long time. Interest rates will stay low as a result. Inflation will not be a problem in the near future.