

Economics Update

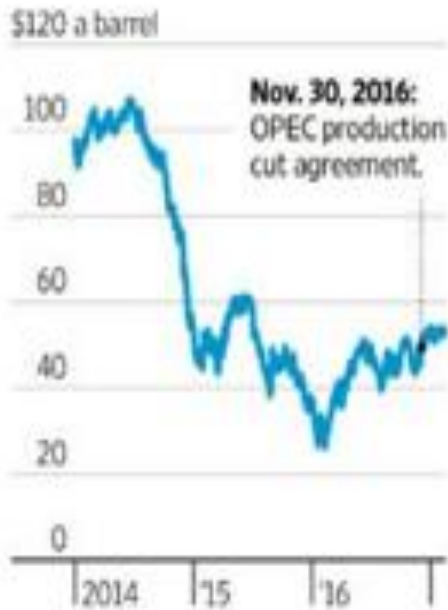
Andrew Smith

February 2017

Twitter: @AndrewSmithEcon

World economy reflating?

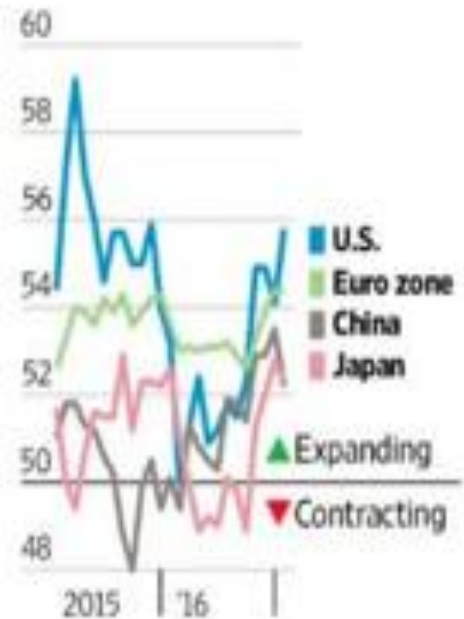
West Texas Intermediate oil prices



Projected inflation in five years, based on bond yields



Purchasing managers' indexes



Annual growth forecasts

(%)	2013	2014	2015	2016 (e)	2017 (f)	2018 (f)
US	2.2	2.4	2.6	1.6	2.3	2.5
Japan	1.6	0	1.2	0.9	0.8	0.5
Eurozone	-0.5	0.9	2.0	1.7	1.6	1.6
India	6.9	7.3	7.6	6.6	7.2	7.7
China	7.8	7.6	6.9	6.7	6.5	6.0
Brazil	2.7	0.1	-3.8	-3.5	0.2	1.5
Sub-Saharan Africa	5.2	5.0	3.4	1.6	2.8	3.7

Trump's economic plans – low tax, small government, protectionism

- **Trump Income tax** (2016 plan analysis by *Tax Foundation* static basis)
 - Reduction of individual and corporate income tax (35% to 15%) rates to raise net income of bottom 80% by 1-2% and top 1% by 10-16%
 - Boost GDP (extra 7-8% over 10 yrs) and employment (+2mn) mainly via investment
 - Revenue loss of \$4-6tr so larger deficit
- **Trump Spending plan** where's the money for infrastructure to come from?
- **Ryan/Brady Blueprint for Tax Reform** – replace corporate income tax with 20% cash-flow tax and “border tax adjustments”
 - 20% tax on imports; exports tax free
 - *Ceteris paribus* encourages exports, penalises imports, eliminates *tax* incentive to move operations overseas
 - Huge wrench to international trading system – race to bottom? WTO case?
- **America First** Protectionism, kill TPP
 - Trump threatened punitive tariffs against Mexico, China, calls Germany currency manipulator too
 - Problems: US consumers pay; currency strengthens; move production abroad to combine US tech with cheap labour?
 - And it's not trade but automation which takes away jobs
- **US linchpin of liberal global trading order for last 70 years – open, rules-based regime of trade and investment**

Will Trump be good for economy?

Real GDP Growth

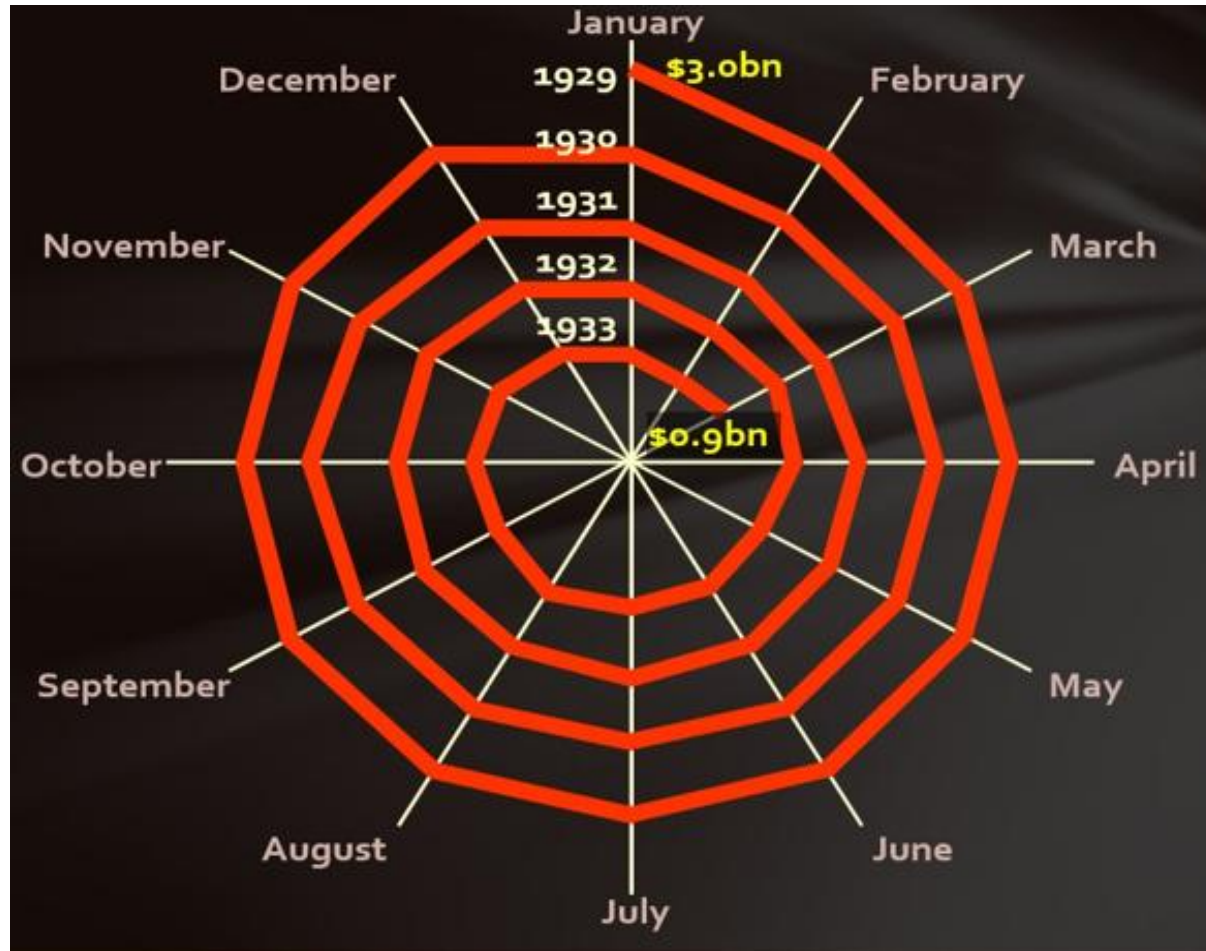
Baseline Full GS Expectation



Source: Goldman Sachs Group Inc.

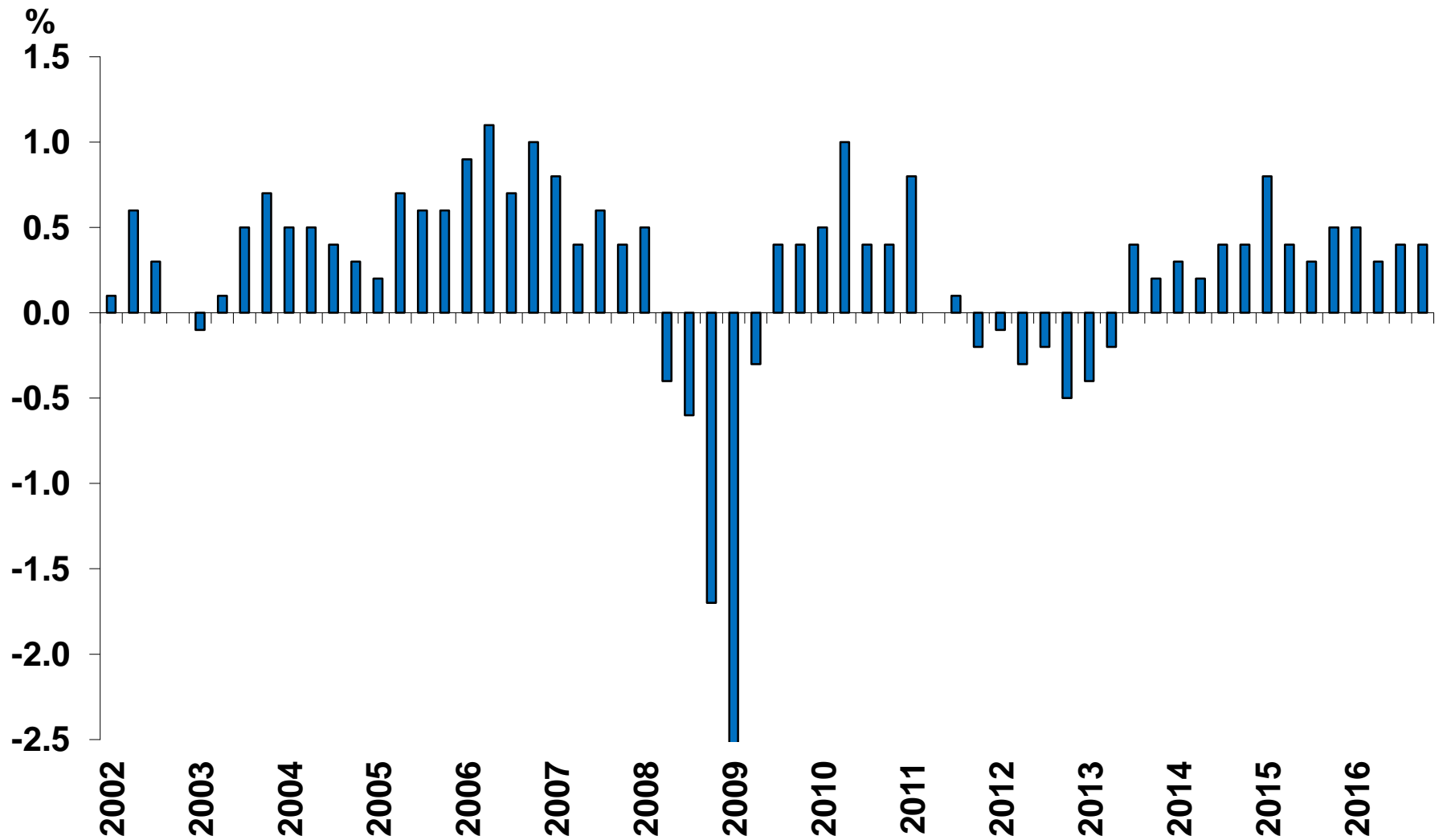
Bloomberg

Effect of protectionism and depression on world trade 1929-33

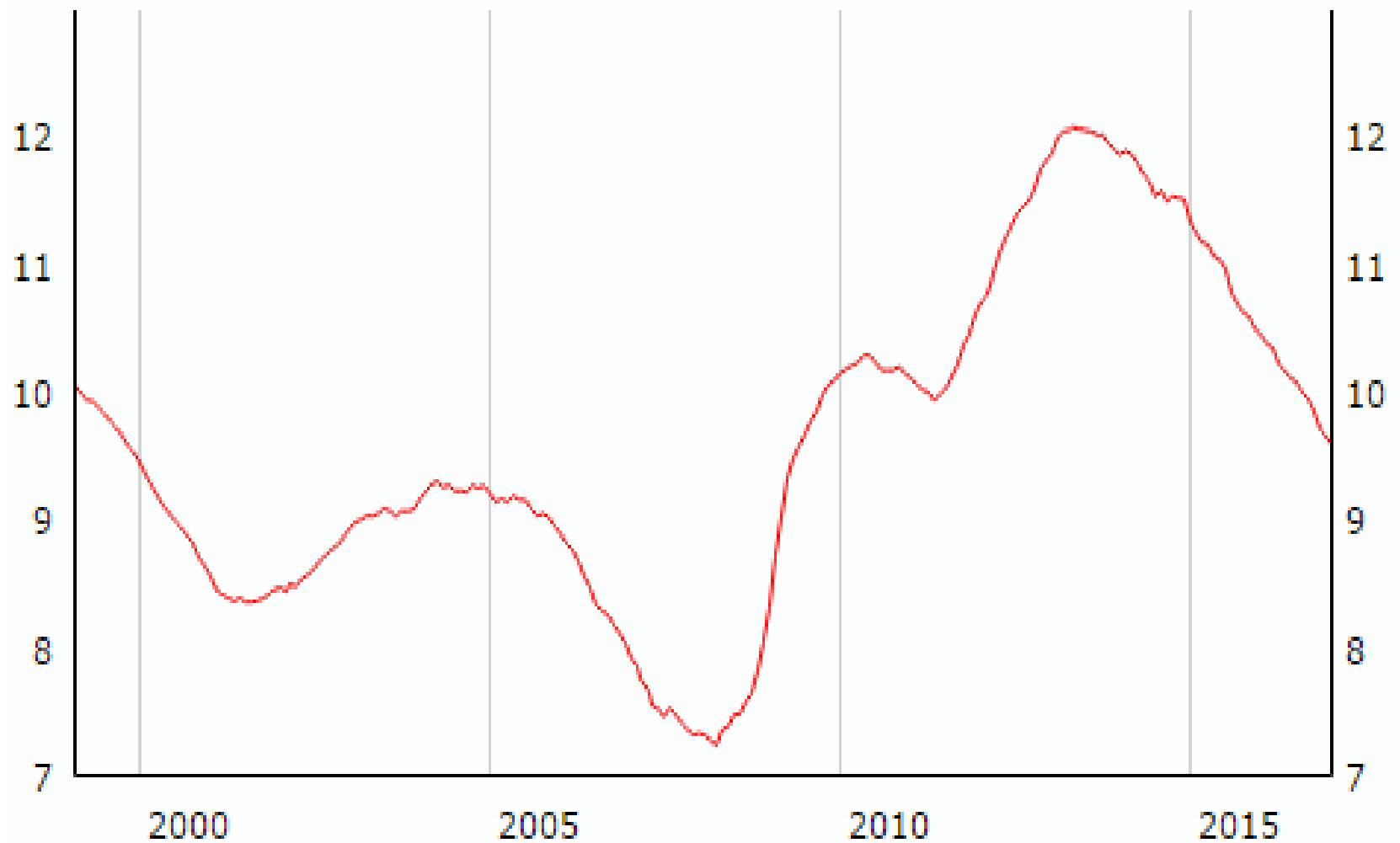


Trade figures: per month. Source: Charles P Kindleberger, *The World in Depression 1929–1939*, University of California Press, 1973 and 1986. citing League of Nations *Monthly Bulletin of Statistics*, February 1934, page 51. (Total imports of 75 countries, monthly values in terms of old US gold dollars)

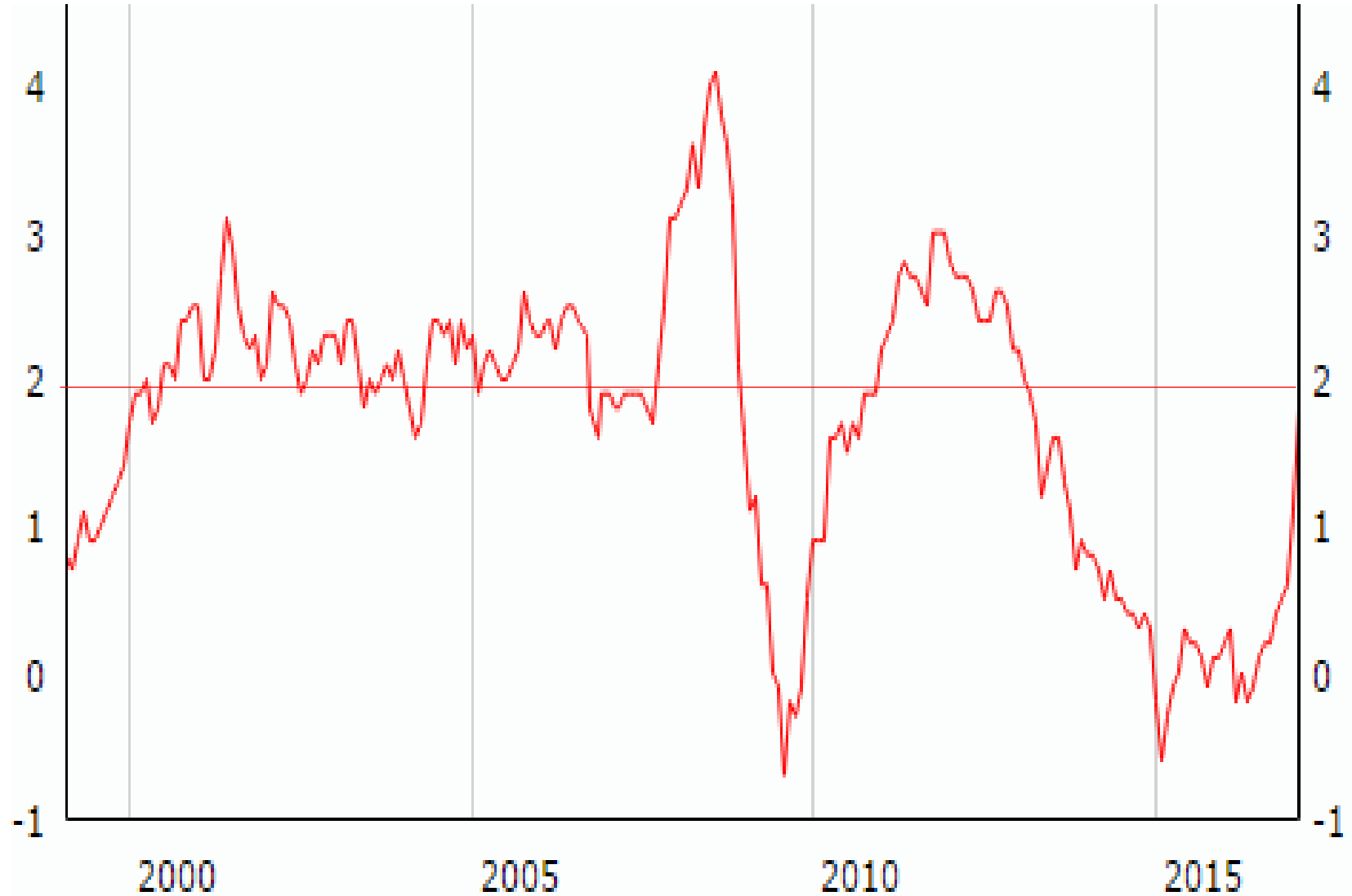
Eurozone GDP (quarter-on-quarter)



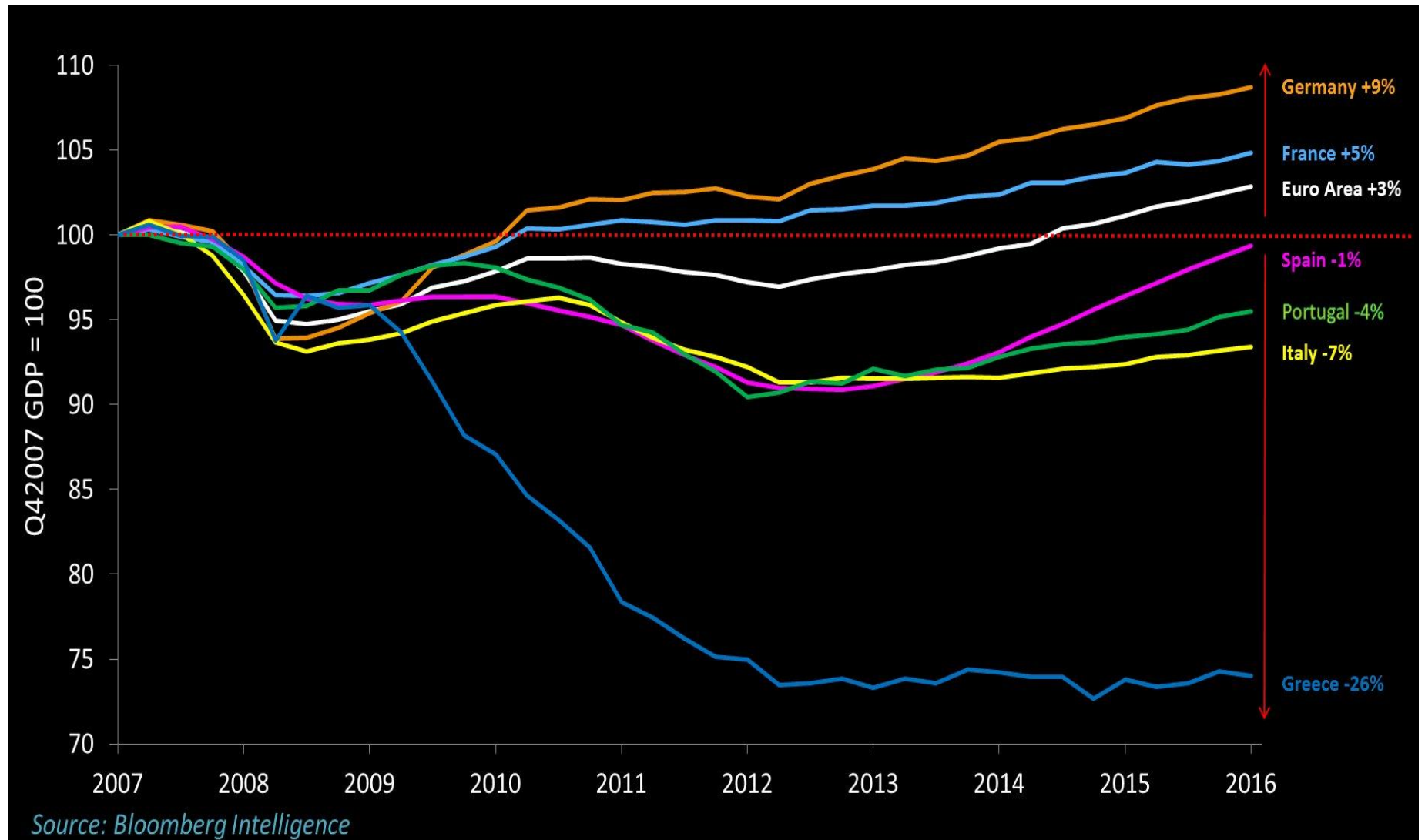
Eurozone unemployment rate (%)



Eurozone inflation rate (HICP%)



Leaders and laggards



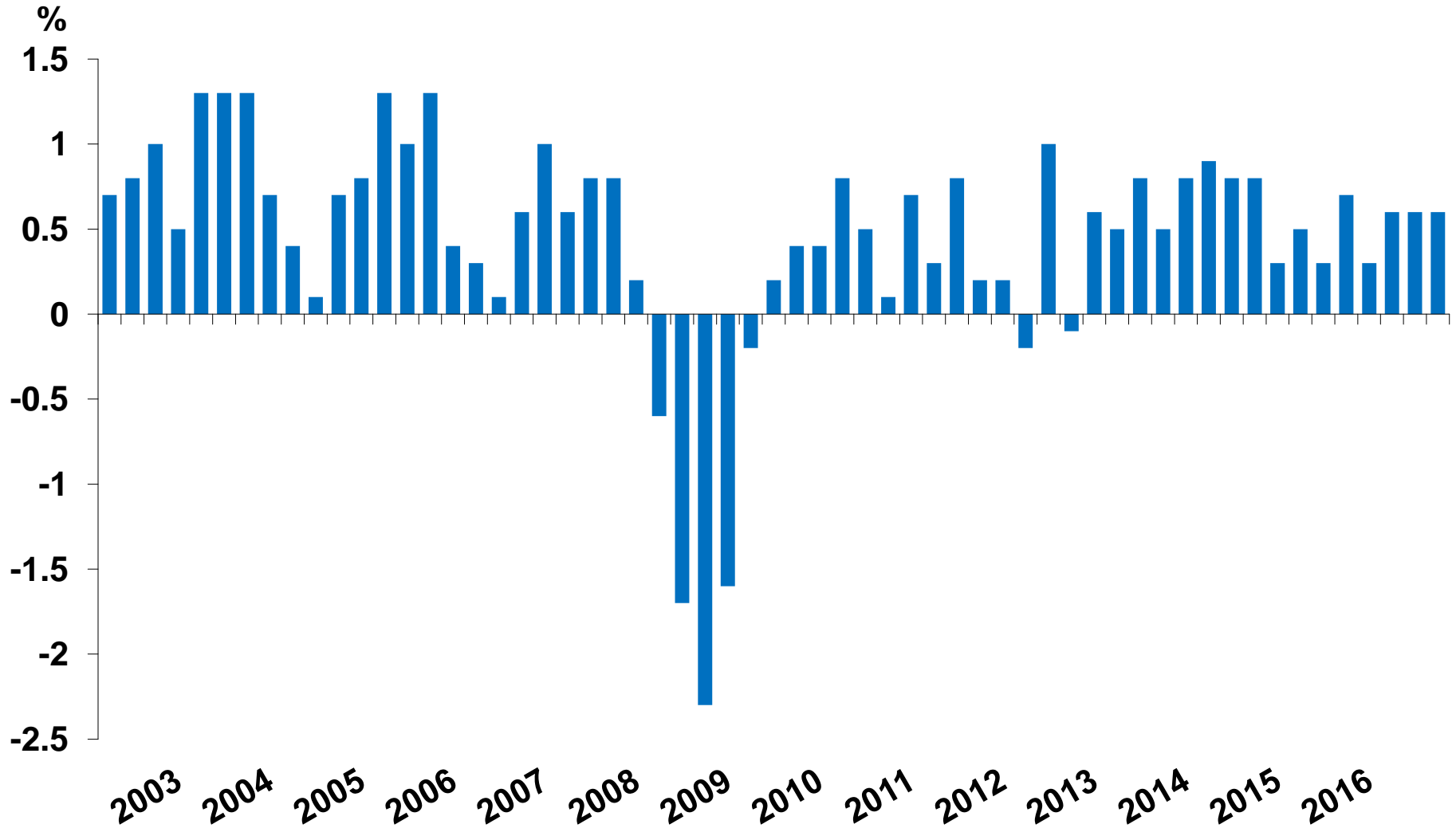
EU stability risks

- Growth imbalances and continuing high unemployment in south
- Germany's current account surplus getting embarrassing (and political issue with US)
- Greece in need of public debt write-offs – but another fudge?
- Public and bank finances in other countries (France, Italy) also worrying markets
- Elections
 - Netherlands general election in March
 - France Presidential election in May
 - Germany Presidential election in October
- Le Pen and Frexit
 - Leave Eurozone and return to FFr, re-denominate govt debt
 - Direct B de F to print money to finance government spending
 - Referendum on EU membership
- EU would also suffer from “Hard Brexit”
- Can EU and eurozone hold together? Ever closer union or two-speed Europe?
- Geo-politics – Russia, US, Nato

Europe growth forecasts

(%)	2013	2014	2015	2016 (e)	2017 (f)	2018 (f)
Germany	0.5	1.6	1.7	1.9	1.6	1.8
Greece	-3.2	0.4	-0.2	0.3	2.7	3.1
Spain	-1.7	1.4	3.2	3.2	2.3	2.1
France	0.6	0.6	1.3	1.2	1.4	1.7
Italy	-1.7	0.1	0.7	0.9	0.9	1.1
N'lands	-0.2	1.4	2.0	2.1	2.0	1.8
Euro area	-0.3	1.2	2.0	1.7	1.6	1.8

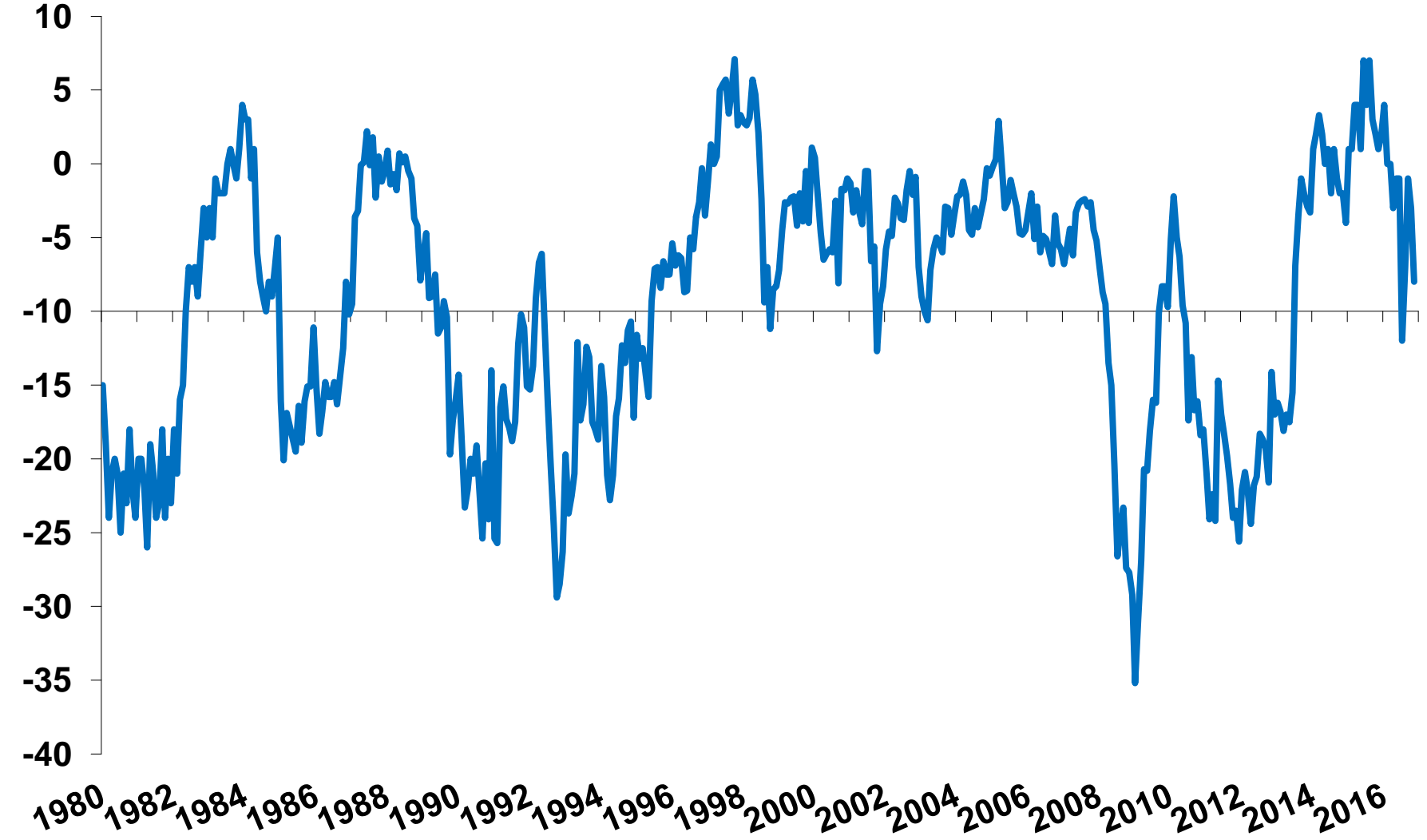
UK GDP growth (quarter-on-quarter)



Source: ONS

UK consumer confidence

Balance



UK employment



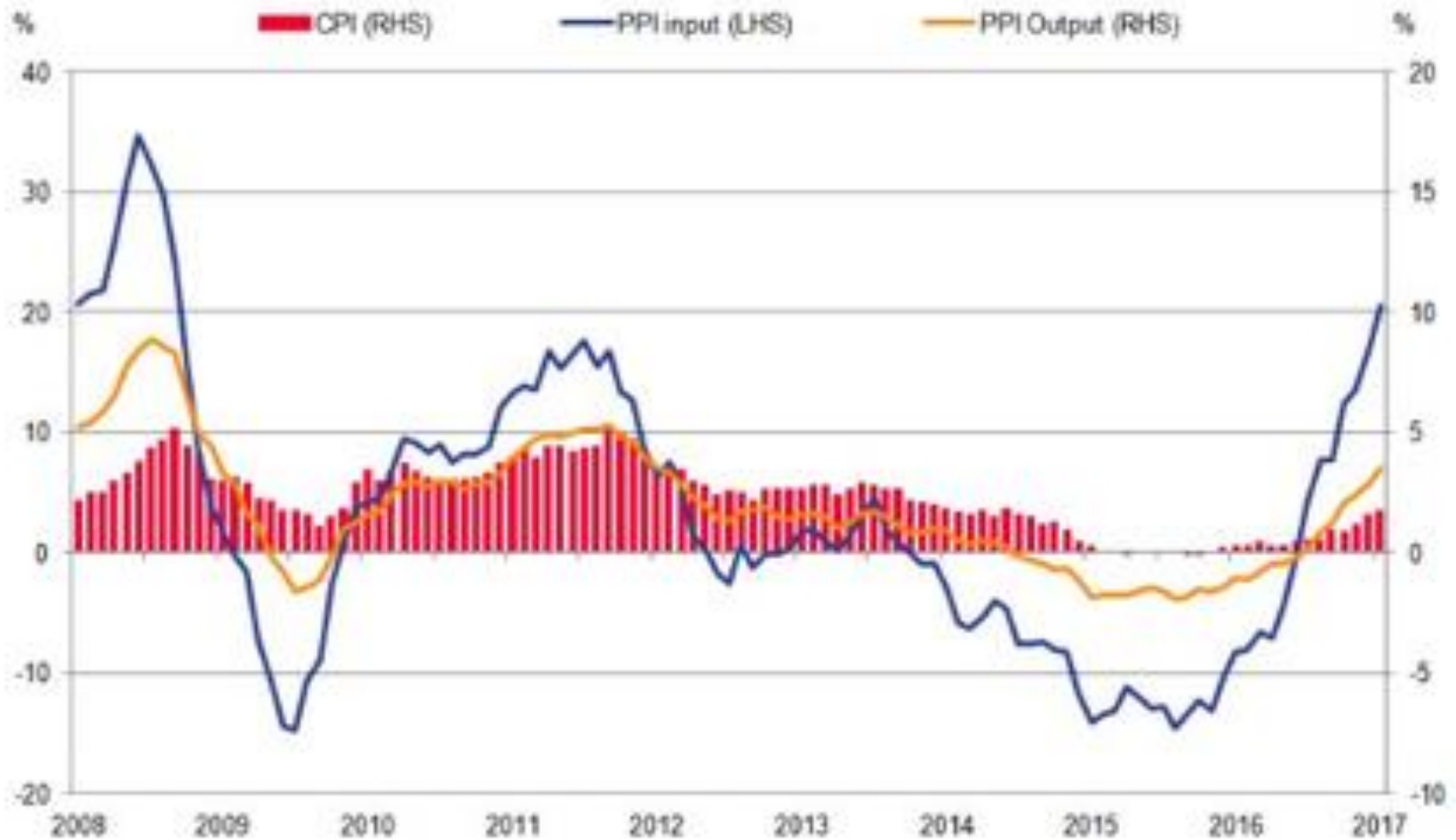
Notes: Total includes unpaid family workers and those on government employment and training schemes.

Source: Resolution Foundation analysis, ONS

£/\$ rate (2016-17)

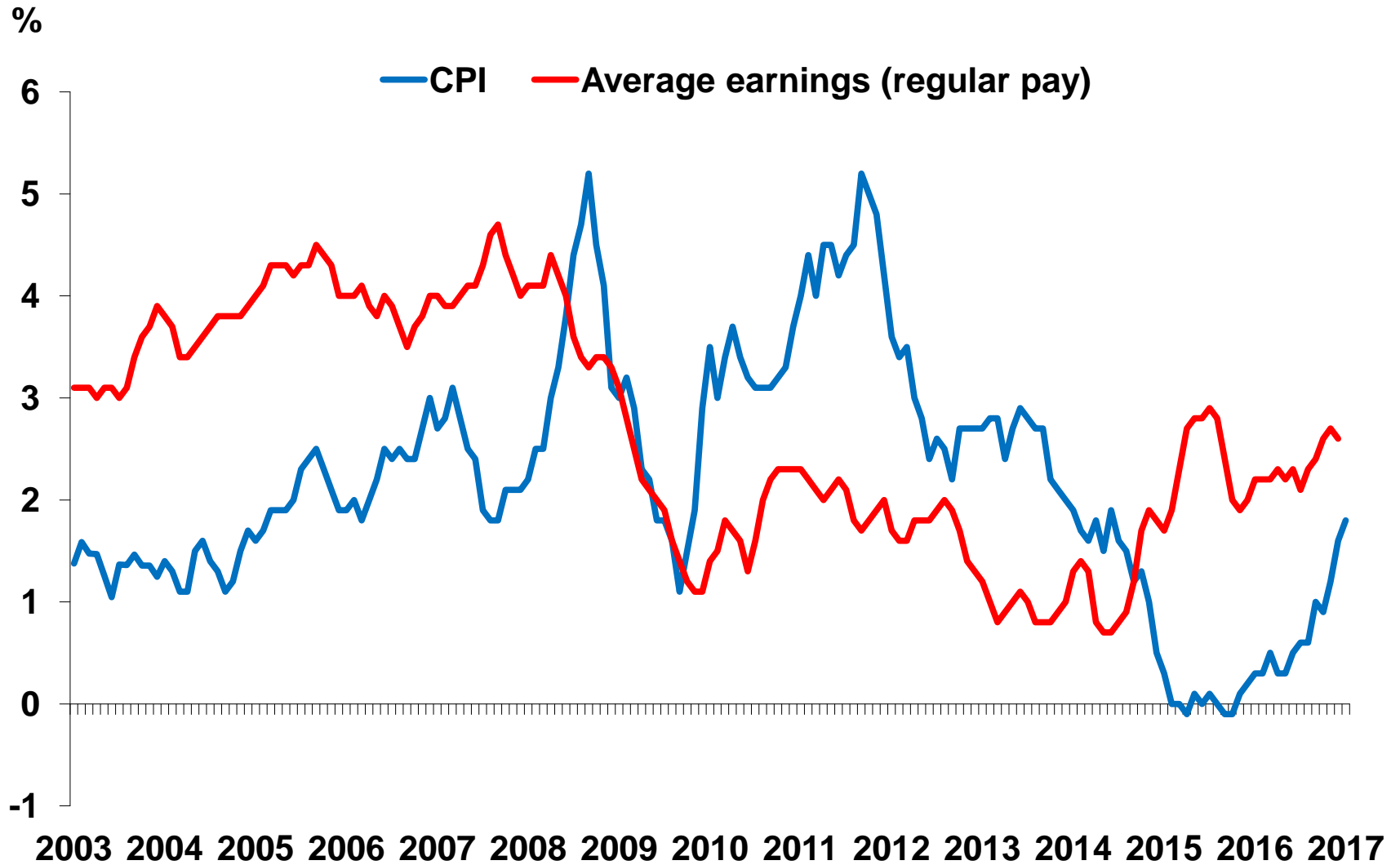


More price pressures in the pipeline



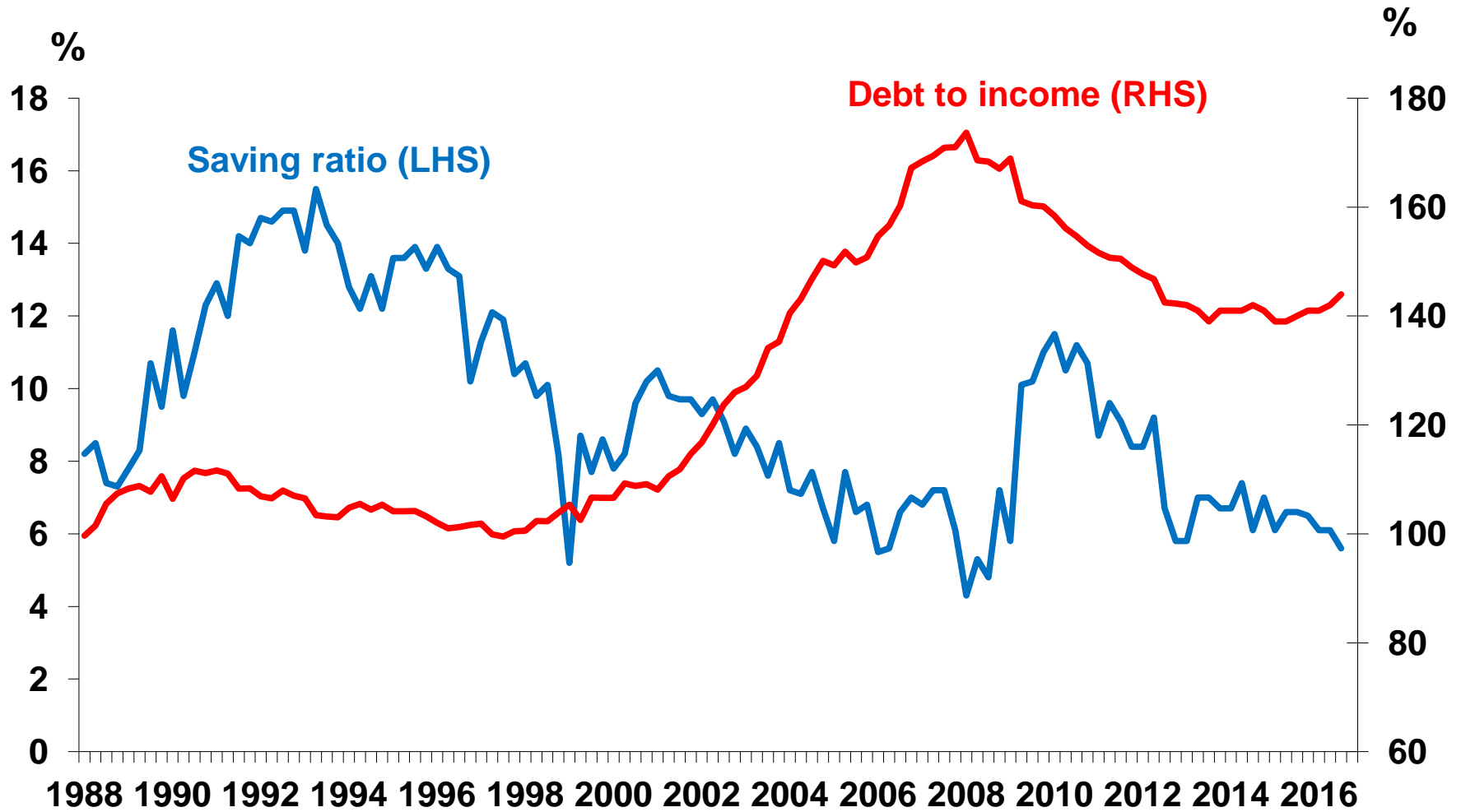
Source: Office for National Statistics

UK: inflation and earnings



Source: ONS

UK household debt to income ratio and saving ratio



Source: OBR/ ONS/ Datastream

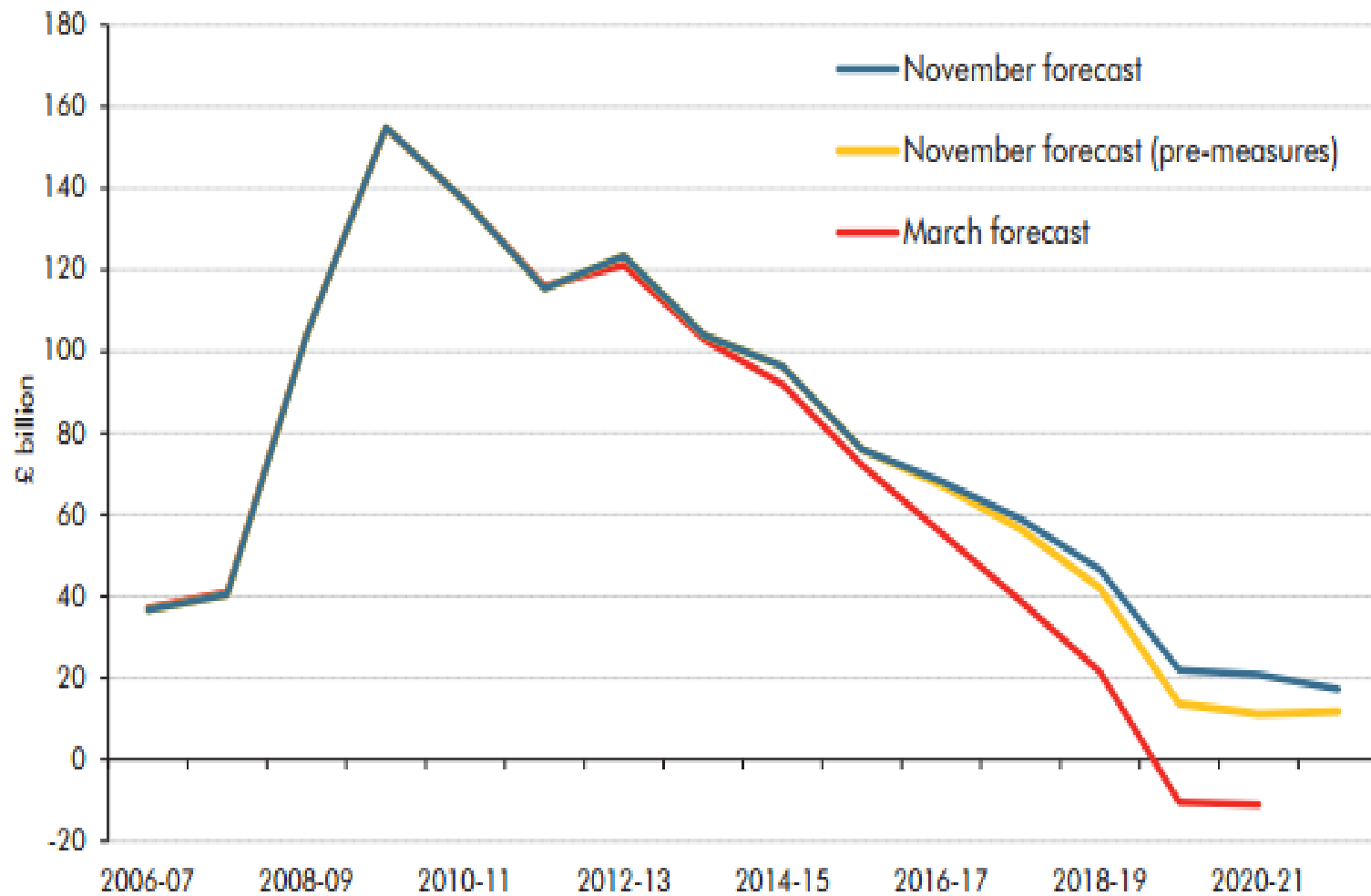
Autumn Statement 2016

% change y-o-y	2014	2015	2016	2017	2018	2019
GDP	2.9	2.2	2.1	1.4	1.7	2.1
Household consumption	2.6	2.5	2.8	1.2	1.1	2.1
Business investment	4.6	5.1	-2.2	-0.3	4.1	5.3
Govt consumption	1.9	-2.0	2.3	3.3	2.1	1.9
Exports	0.4	4.5	2.3	2.7	3.2	1.6
BoP Current A/C %GDP	-5.1	-5.4	-5.7	-5.0	-4.2	-3.4
Public borrowing £bn	94.7	76.0	68.2	59.0	46.5	21.9
CPI Inflation	1.5	0.0	0.7	2.3	2.5	2.1

Public finances

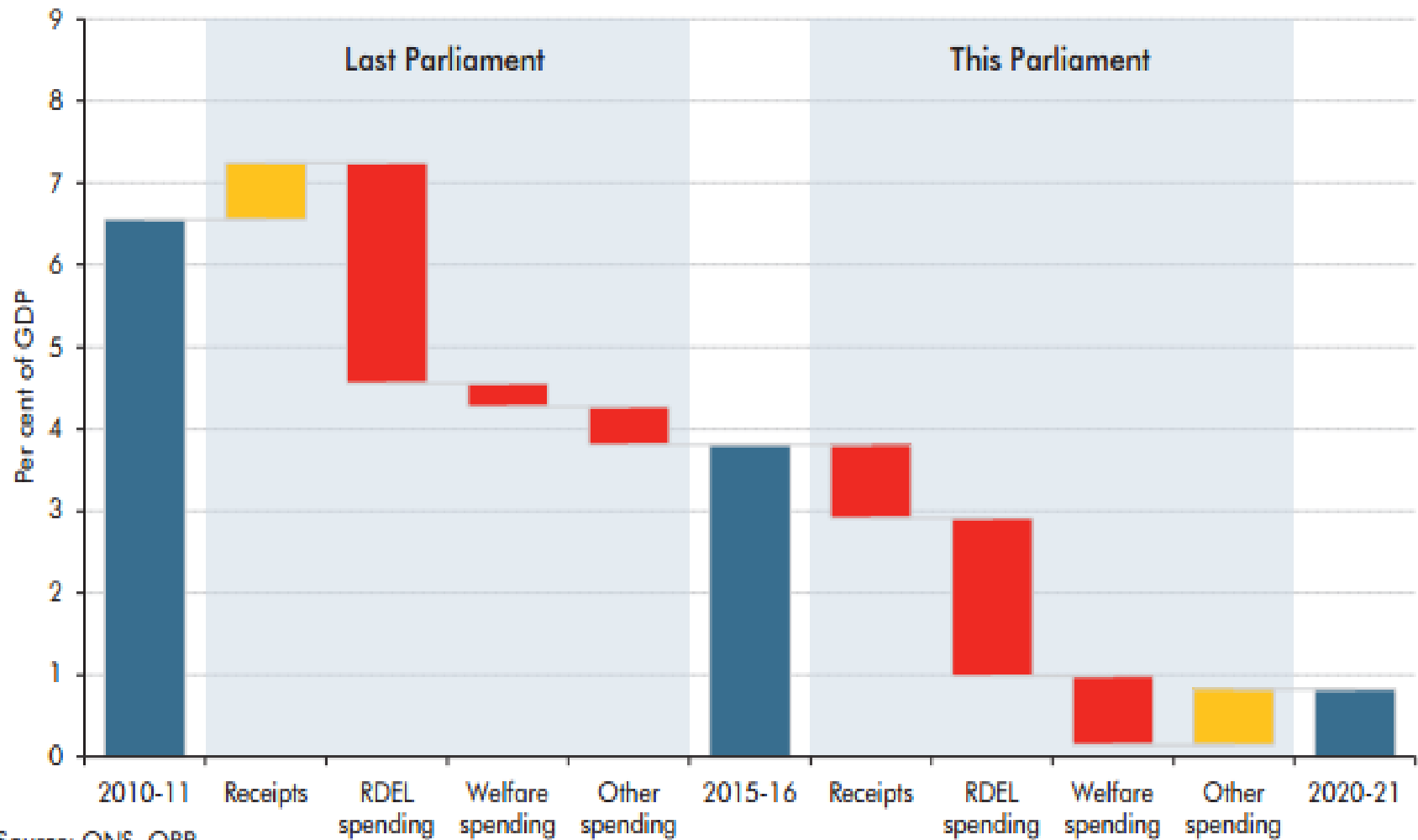
- **AS 2016 forecast of slower growth, higher public investment and £100bn BoE Term Funding Scheme made Osborne's Fiscal Rules unattainable**
- **New Fiscal Charter objective: “return the public finances to balance at the earliest possible date in the next Parliament”** (*was to be surplus in 2019-20 and thereafter*)
 - the structural deficit (cyclically adjusted public sector net borrowing) to be below 2 per cent of GDP in 2020-21
 - public sector net debt to fall as a percentage of GDP by 2020-21 (*was to fall in every year of current parliament*)
 - a subset of welfare spending to be below a new welfare cap that has been set for 2021-22 only and in line with latest official forecast, with no formal assessment to be made until the start of the next Parliament
- **Chancellor cut himself some slack compared to Osborne's plans (adding £120bn to net borrowing over this Parliament) but still aims to cut the structural deficit by 3% of GDP this Parliament after cutting 2.8% last**

PSNB AS 2016



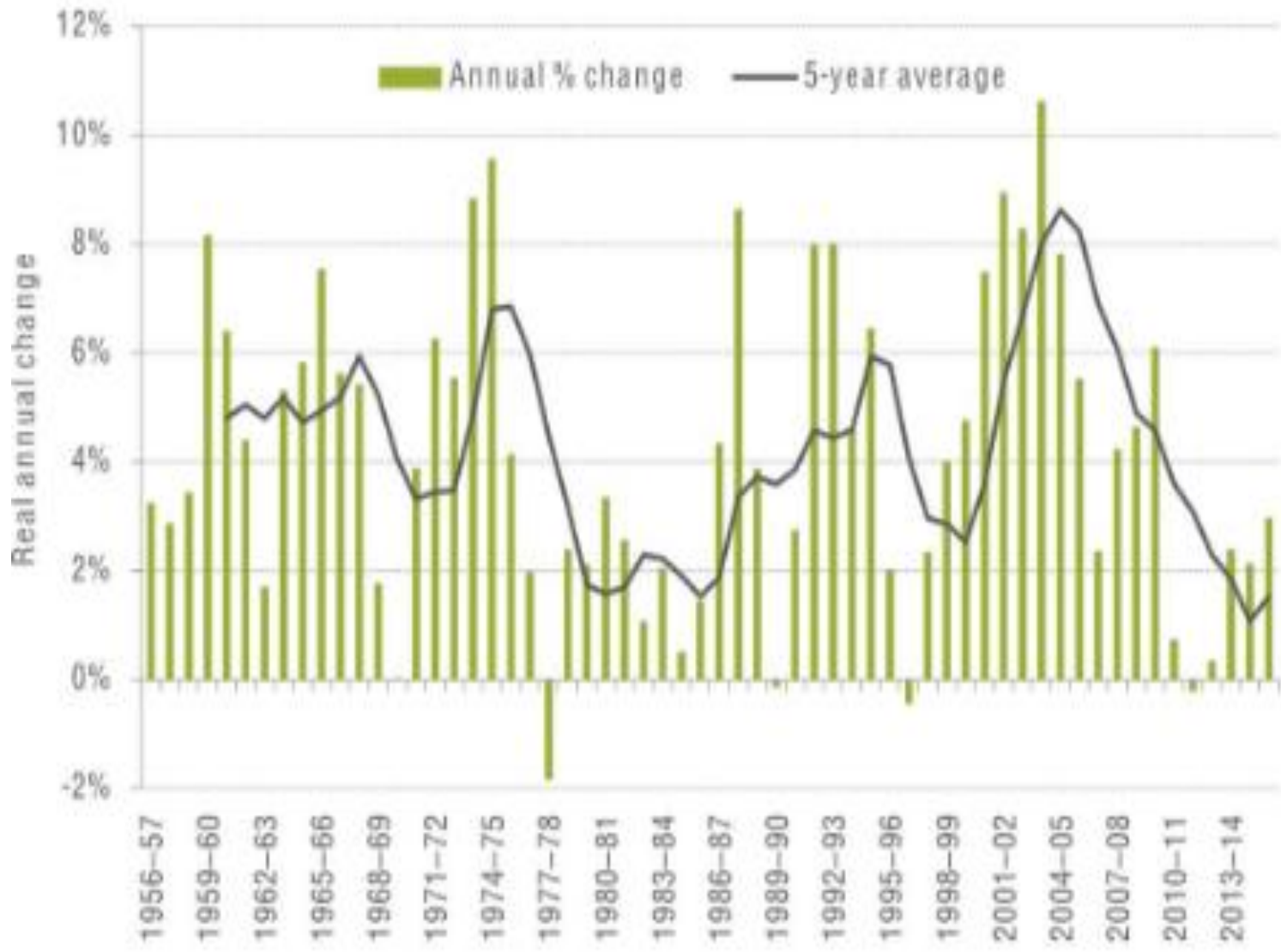
Source: ONS, OBR

Contributions to reduction of structural deficit (% GDP)



Source: ONS, OBR

Annual real growth of public spending on health

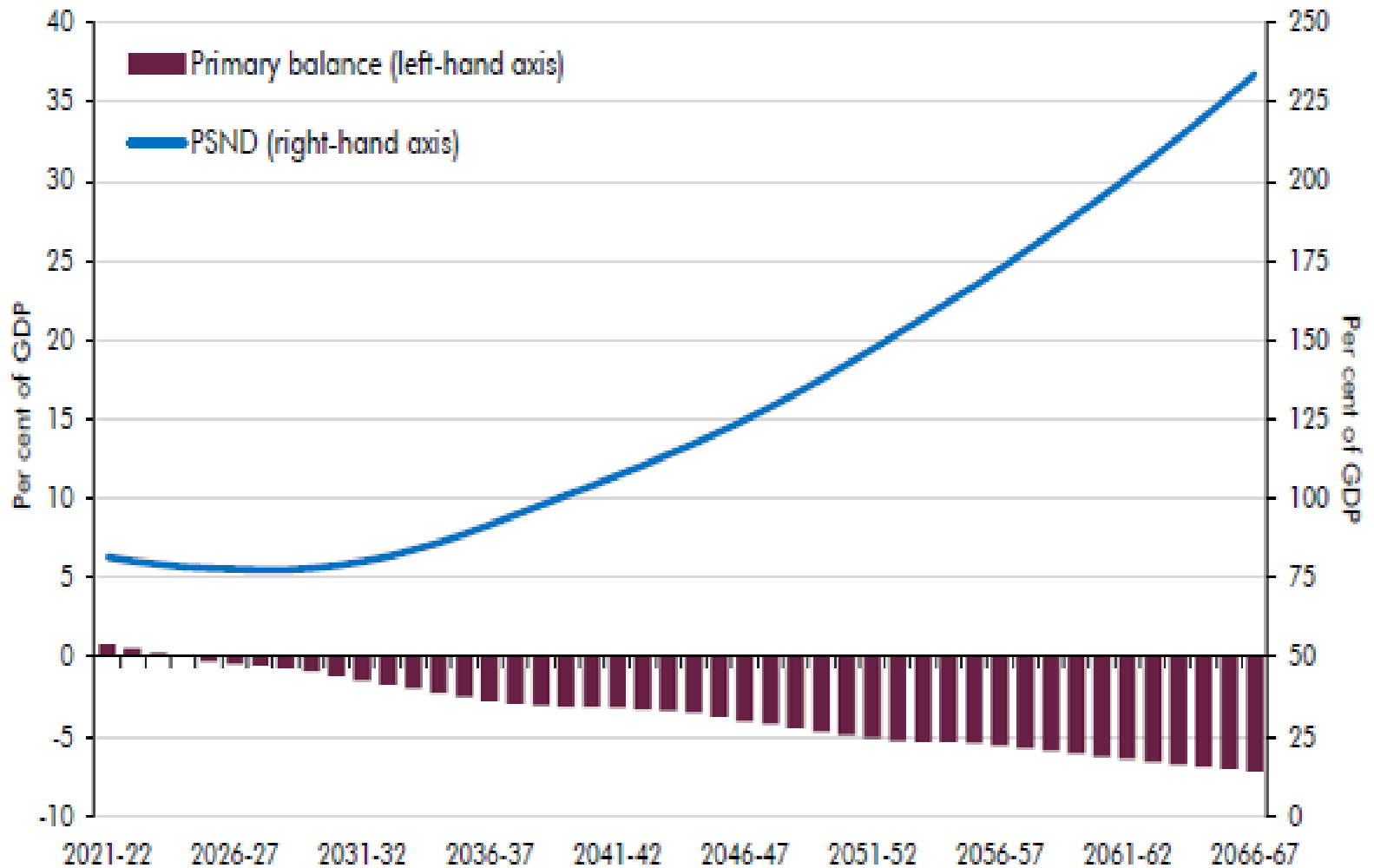


Source: IFS

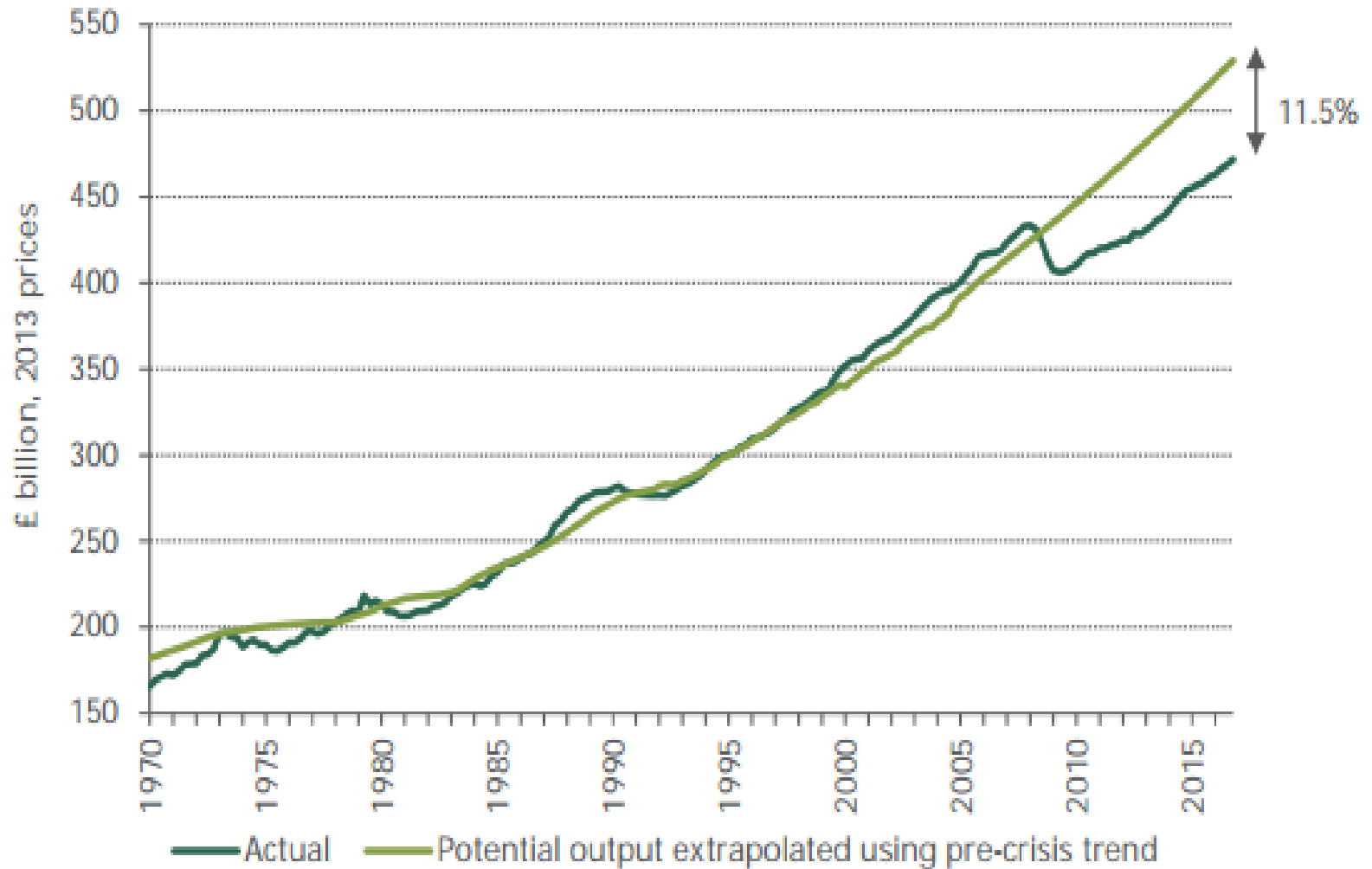
Public spending and receipts since 1970



Primary balance and PSND 2021-2066



UK output relative to pre-crisis trend



Brexit: NO to free movement and ECJ = NO to single market and CU

- ***“Whilst Parliament has remained sovereign throughout our membership of the EU, it has not always felt like that”*** *Brexit White Paper*
- Article 50 – aim to invoke by end-March
 - Divorce terms (UK’s share of liabilities/assets)
 - Framework for future relationship with EU
 - Transition/interim agreement
- Negotiate FTA deal with EU
 - UK/EU and intra-EU interests not aligned
 - If we want special deal for eg autos and financials, what will we sacrifice in return?
 - No deal NOT better than bad deal: WTO “default” also involves tariff/quota negotiations and MRAs lost
- Negotiate FTAs with third countries
 - No-one in right mind will seriously negotiate ahead of EU FTA and WTO reset
 - UK not really on radar. It’s all about blocs of 500mn – EU, US, China
 - FTAs pretty much limited to manufactures – UK dependent on services
 - Common regulations/standards are more important than tariffs for trade – and if not ECJ have to comply with something eg Investor-State Dispute Settlement (ISDS) schemes

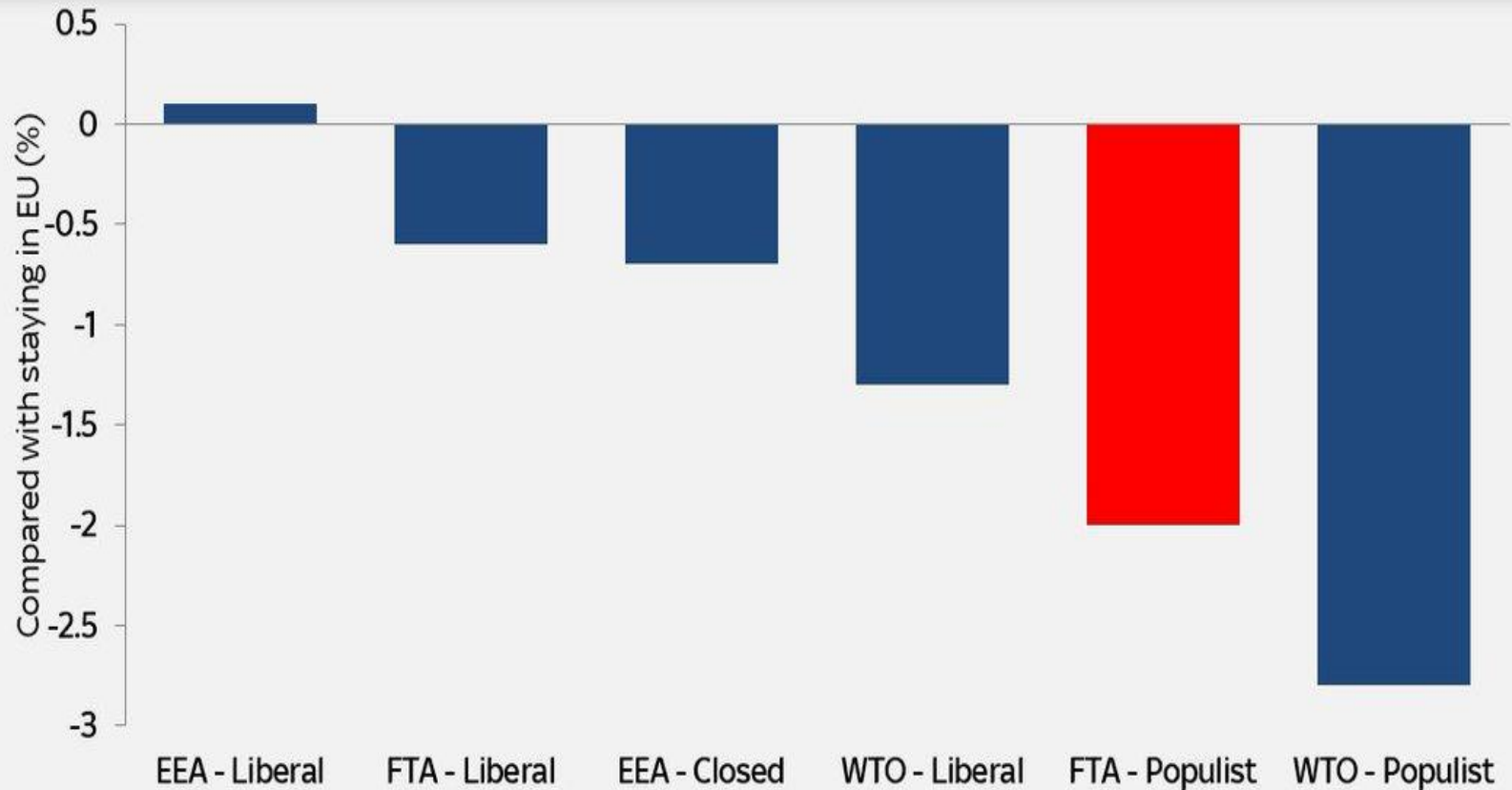
Effect on economy

- We are currently a member of the world's biggest Free Trade Area with a market of >500mn which takes 50% of our exports representing 12% of GDP
- ANY arrangement with the EU (short of fully replicating current one) leaves us worse off
 - Single Market is a very deep/comprehensive trade agreement aimed at reducing *non-tariff* barriers which is important for services trade. FTAs don't replicate this
- It's madness to think that RoW trade will grow fast enough to compensate for lost EU trade
 - Gravity model still works – trade halves as distance doubles
 - Trade deals don't guarantee increased trade, in fact evidence suggests only small impact
- NIESR estimates that even with favourable FTAs, trade with EU would decline by 20-30% and ex-EU trade increase by only 3% over 10 years
- Risk is permanent damage to UK's long term growth potential and living standards
 - Depend on labour supply, investment and export capacity
 - All threatened by Brexit
- We will all be poorer than otherwise, public finances weaker and public services poorer

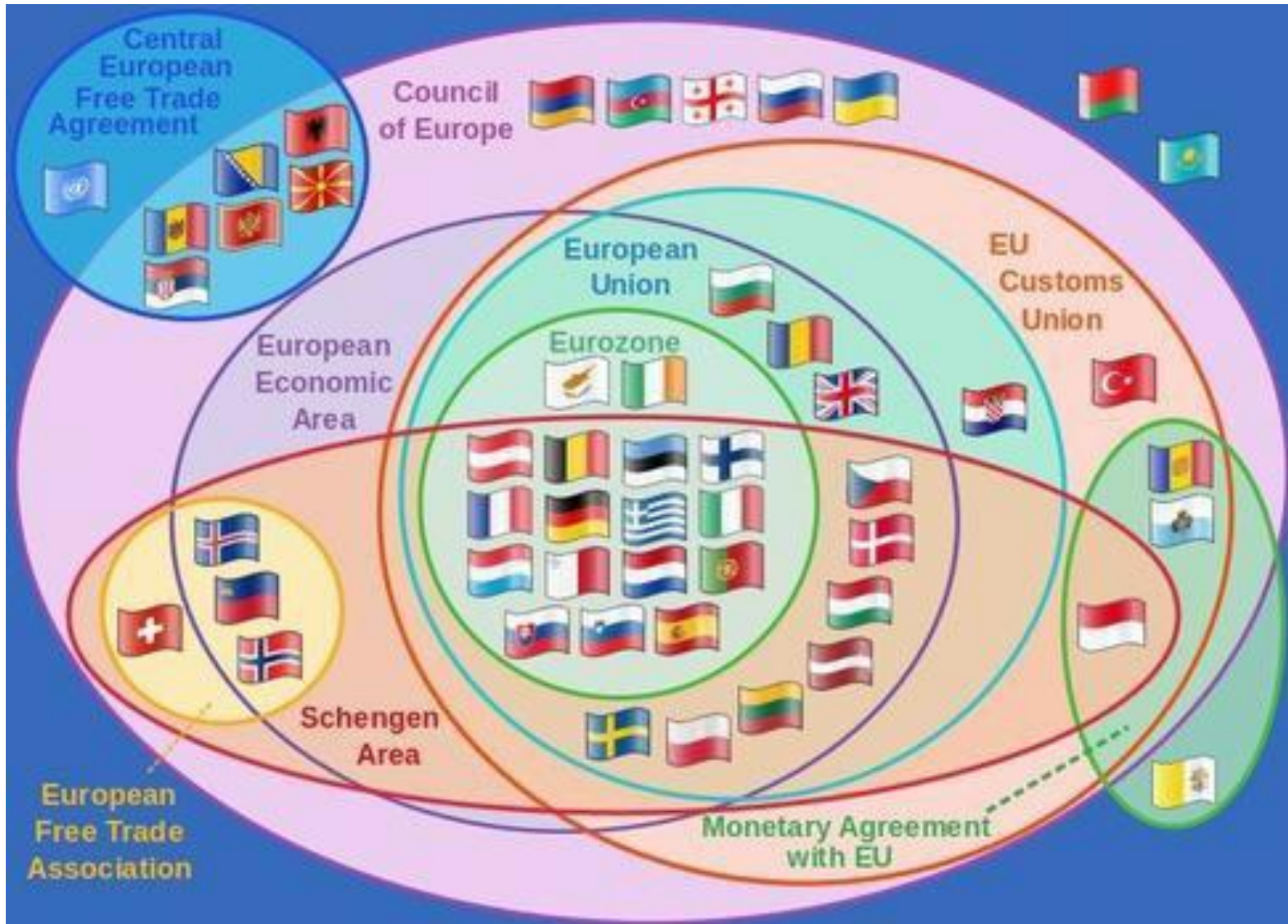
Free trade deal with immigration controls

POST-BREXIT: GDP PER CAPITA IN 2030

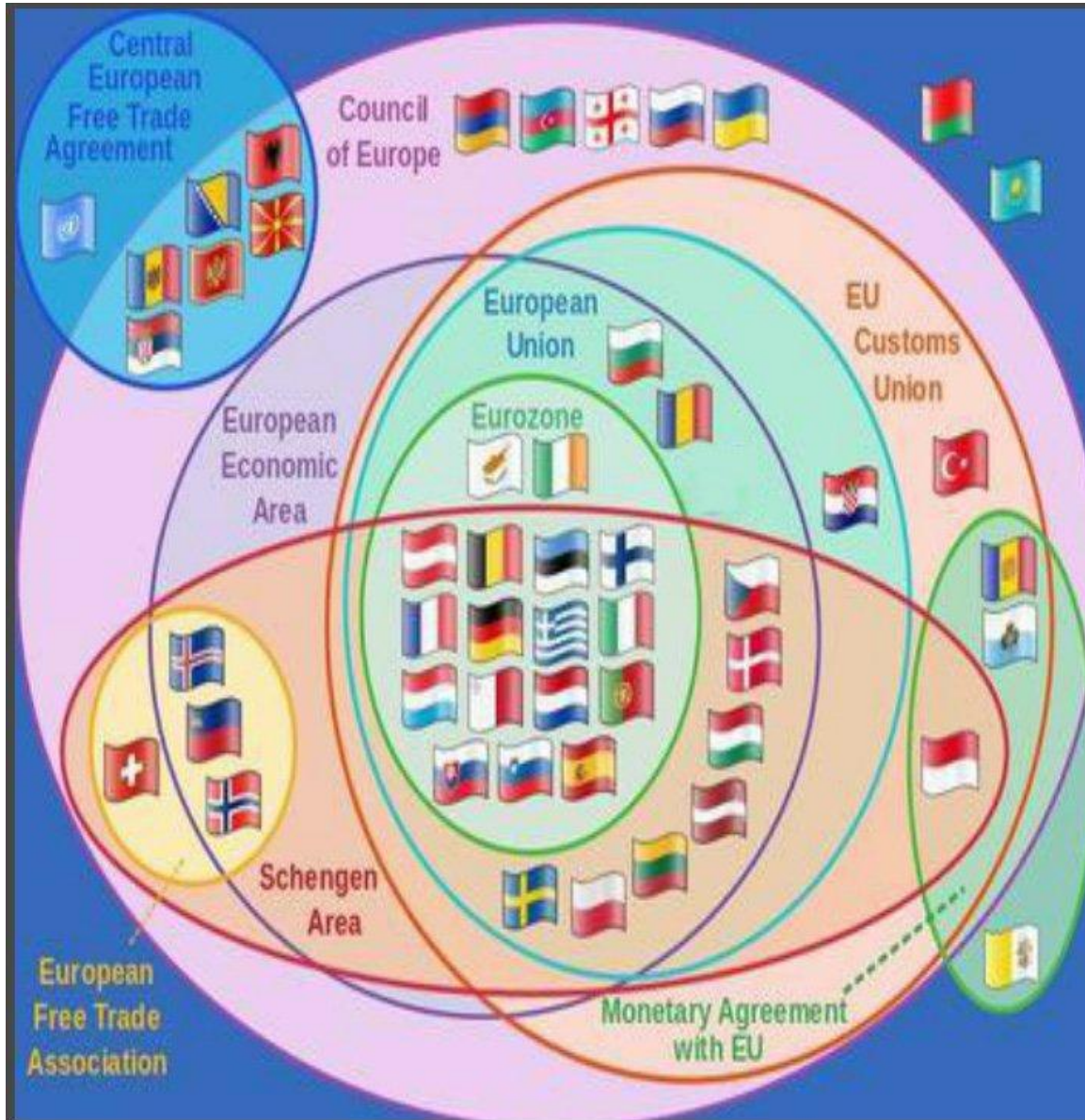
SOURCE: OXFORD ECONOMICS



UK position pre-Brexit



UK position post-Brexit



If we turn our back on EU, UK's only credible strategic option is alignment with US

Shit Creek

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