

The Bank seeks to slow the economy some more

As I have reported before, the Bank of England has been tightening money conditions for sometime because it wishes to slow the UK economy. It has recently increased the base rate to 0.5%. It used macro prudential policy to seek to rein in consumer credit. It has been particularly successful at reducing car loans and it refers to this in the latest Inflation Report. The government has also been active in cutting car demand with its high VED taxes on dearer vehicles introduced last spring and its attack on diesels. Mortgages are a bit dearer and higher Stamp duties and BTL taxes have also hit the housing market.

This month the Bank ends the Term Funding Scheme for the commercial banks, a scheme designed to ease credit conditions a bit. Now in this Report we hear that the Bank wants to get back to the inflation target faster, and expects to have to raise rates again to do so. Meanwhile there has also been an additional monetary tightening through the increase in the exchange rate in recent months. So why is the Bank doing this when most people want to see a bit more growth?

The Bank has gone back to its idea that the UK economy can only grow at a fixed pace, and if it starts to grow faster than the trend increase in capacity it will cause more rapid inflation. The Governor himself has questioned this theory in a good lecture he gave pointing out that if you are capacity constrained then you can simply import more, keeping prices down. You can also invite in more workers from abroad, keeping wages down as has been happening on a large scale in recent years. It is difficult to know why the Bank thinks the UK trend growth can now only manage 1.5%, and why they ignore the sensible thoughts of the Governor on the impact of the global economy on prices and wages. They also need to ask how flexible the economy is to scale up capacity. We see new capacity going in and there is plenty of corporate cashflow to invest. Many companies are expanding capacity considerably by continuing to recruit extra staff.

It is also curious that they seem to have an asymmetric and distorted view of sterling and its role in inflation. Apparently a recent devaluation is causing most of the price rises we are seeing, but the more recent strengthening of sterling will not redress this sufficiently. They tell us sterling is 15-20% down on the levels of November 2015. That was of course a peak level. Sterling on the trade weighted is currently around the levels it was at for a long period from 2009 to 2014. Against the dollar is almost back to the pre referendum vote level. If you want to see a big devaluation which did not reverse you need to go back to 2008-9 when sterling was badly damaged by the banking crisis. That devaluation did not generate as much inflation as some expected.

The Bank claims that Brexit uncertainty is a big factor in the UK economic performance. There is precious little evidence to support that. The Bank,

after all, has had again to scale up its growth forecast for the UK, which paradoxically gives it a better excuse to tighten money more. Consumption remains the main driver of the UK economy. I don't meet lots of people telling me they have cut back on their shopping because of Brexit. If, as the Bank now thinks, wages are going to pick up a bit that should be good news for consumption and therefore for economic activity.

Negotiating a deal

Both the EU and the UK government would be wise to study why their last negotiation before the referendum went so wrong. The two parties wanted the same outcome – a deal which enable the UK to vote to stay in the EU. Their failure has left the EU struggling with the departure of one of its largest paymasters, and saw the end of the Prime Minister and Chancellor in the UK who signed off the deal.

On that occasion with full civil service encouragement the UK Prime Minister went round the EU asking leaders what they might grant the UK. They told him they could not grant much, so he asked for not much. As this was always going to be a negotiation the EU did not feel they could let him have all he asked for, so a low bid which he had made was scaled back further. When the UK voters saw it gave us no remission from high financial contributions, prevented us running our own migration policy and did not even fix the issue of letting us make our own decisions about benefit payments, they rejected it.

There is now a strange German movement to say they might be able to fix some of the things Mr Cameron said he wanted fixed, now they have seen the outcome. The truth is it's too late to do that. Many UK voters anyway do not think Mr Cameron asked for enough. He made a mistake, but so did the EU in refusing even his modest demands.

Today the UK government now needs to be sure to ask for enough from a Future Trade and Partnership Agreement, otherwise what has currently been outlined will be judged a bad deal by many UK voters. The EU would be wise to understand if they deliberately set out to make a tough deal which the UK thinks is an unfair deal that could backfire. It might result in the UK leaving with no deal. The UK government has rightly said on many occasions No deal is better than a bad deal. Past experience shows the EU quite likes bad deals. That is why it is facing the exit of one of its major paymasters and one of its main single country export markets.

What is a Customs Union – a set of restrictions on trade

It is most important not to confuse a free trade policy with a Customs Union policy. The main point about a Customs Union is the wish to impose tariffs and barriers against the rest of the world that are legal under WTO rules, knowing that the WTO would prefer the members of the Customs Union to lower tariffs and barriers for all.

Much of the design of the EU Customs Union was to protect French and German industry from better value or smarter competition from elsewhere in the world, and to protect the exploitation of market niches that they had done well so far. One of the features I most dislike about the EU Customs Union is its aggressive stance towards emerging economies which rely heavily on agricultural production, as the EU Customs Union takes full advantage of the WTO permission to have strong restrictions on agriculture.

Germany, for example, has a profitable and large industry processing raw coffee. This is made possible by imposing tariffs on processed coffee from outside the EU whilst allowing import of raw coffee tariff free. It means the coffee producers find it more difficult to capture the extra added value and create the extra jobs that are needed to turn an agricultural product into coffee to drink in supermarket packaging.

Once out of the EU Customs Union the UK could unilaterally cut all tariffs on products we do not grow for ourselves, or could offer to do so in return for some free trade response from those who would benefit. Inside the EU Customs Union we cannot do this, as the others do not agree with such a strategy. Trade is often better than aid in promoting economic development and greater prosperity amongst emerging economies. The UK will be able to have a better policy for this once we are free to negotiate our own trade system.

The costs of belonging to the single market and customs union

In what passes for a debate about Brexit I have got used to the barrage of commentary that thinks it is wholly or mainly about trading arrangements, when it is really about how we are governed, to whom our government is accountable, who raises and spends the tax money and who makes the laws. Many people voted leave to take back control, to bring back self government.

The commentary also usually wrongly assumes that membership of the single market and customs union has been wholly benign, and that if we just leave we

will be worse off. The facts of our past membership do not prove this supposition. As I have often pointed out, our growth rate was faster in the years before we joined, than after we joined. There was no benefit or acceleration of growth when they “completed” the single market.

More importantly, lop sided reductions in tariffs and barriers meant we lost a lot of industry to continental competition, but were given no parallel benefits to compete in areas where we were stronger. Our fishing industry was badly damaged by the CFP and we plunged from net exporter to net importers. Our farming industry saw its domestic market share eroded badly, aided by EU policies on beef and milk which did not help.

The EU argues that single market membership added just over 1% to our economy over the whole time we were in it – yet it is difficult to see from the actual growth figures any positive contribution. You clearly need to knock off from the figures the 5% loss of GDP compared to trend caused by membership of the European Exchange Rate Mechanism, which the EU study leaves out. You also need to take into account the £12 bn net a year contribution or cost, which is a drag of around 0.6% of GDP every year. If we spent that all at home instead that would give us a welcome boost.

There is more intergenerational co-operation than battles

I have long disagreed with my old friend David Willetts and those who think the baby boomer generation have done too well at the expense of the generations that follow. I am not pessimistic like them about the upcoming generations, who may well go on to harness new ideas and new technologies to make themselves considerably more comfortable and richer than the baby boomers. Meanwhile, let me explore some of the errors of the present belief that the older generation are having it too good.

There is nothing new about most of the wealth of a country residing in the hands of people over 40 rather than under 40 years old. By definition babies come into the world with no wealth of their own, and no capacity to earn until they have grown up. We do not agree with child labour, so we support our children from our income instead.

In contrast many of the older generations have spent years struggling with a mortgage until they reach the day when they own a home outright. Given usually rising house prices they get gradually richer even with a mortgage. Most save for their retirements, so over their lifetimes their savings in financial assets build up to secure them that pension at 65 or beyond. 20-40 year olds have not normally managed to save much for their retirement, and are still struggling with home buying. So did the baby boomers in their younger days when house prices were a lot cheaper but mortgages were a lot

dearer. Current affordability as judged by mortgage payments as a proportion of income are not overextended in the way the house price to income ratio is.

In practice the baby boomer generation is sharing their wealth and income with the younger generations in conventional ways. The Bank of Mum and Dad is flourishing where parents have a surplus. It is paying educational fees and providing deposits for homes. The Bank of Grandma and Granddad is also often working overtime for similar purposes. Many of the younger generation will stand to inherit decent sums, though we hope they will have to wait a good long time for that.

The more active retired who have some wealth are keen to spend on exotic holidays, meals out, leisure breaks, sporting and cultural events and much else which creates income for those setting up businesses to service these markets, and creates jobs for many younger people. The frail and disabled better off spend much of their money on care homes, which again generate work and income for many people. The better off tend to be generous with charities.

The present imbalance in wealth between older and younger people is nothing new. It is inevitable given the way we work, earn and save. The money is recirculated, as it would be unhelpful if the elderly just sat on their wealth and did nothing with it. Many of them make conscious decisions to move it on by buying things and by giving it away to those who have more need of it. To those who do not, they leave it in a bank or savings scheme, so their money gets reused anyway by younger people who borrow it for their own purposes. I do not think there is a great intergenerational war. Most people see the elderly have money which they need to spend, and the younger people have energy to work, to earn that money. In their turn they will expect the same in their old age.