

# Viewpoint

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## Elephants in the room

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The developed world is pulling itself up from its nasty tumble; with the exception of the UK, all the G20 nations showed positive quarterly growth in the third quarter of last year. It is a bit early for reliable fourth quarter numbers as yet but we can reasonably expect the momentum to have carried over; given the scale of the stimulus packages around the world it would be extraordinary for the outcome to be any different.

So now the talk is of 'recovery' with the word 'sustainable' usually not far away. Businesses and consumers are becoming more confident and there's no doubt that the macro data is looking better across most of the piece. Pundits who prefer to forecast using extrapolating rulers rather than their brains are shifting from last year's predictions of endless slump to rosy pictures of steadily increasing growth. We seem to be losing sight of those elephants.

Actually it's not entirely clear how many of them there are or which of them will finally emerge to frighten us. Events may pan out in a number of unexpected ways and within uncertain timescales; what

we do know is that the later the elephant appears the bigger it will be.

Our first little elephant is a nerdy one, the sort that gets avoided at parties because he's so boring. He's called Money Supply, or 'M' for short. M doesn't get the attention he used to in the 1980s but that doesn't mean he can be ignored. While everyone is focusing on bank lending, it is the money supply outside the banking and financial sectors that matters. The linkage between money and economic activity is complex and sometimes less than robust but I don't think there has ever been a post-recession recovery that has not been accompanied by an increase in broad non-bank money. And that isn't happening.

M's buddy, 'D' (for Debt), is bigger, more bumptious and harder to ignore. UK households came into this recession heavily indebted and with historically low savings ratios. In the UK, as elsewhere, households have recognised the problem and been quick to react; balance sheets have started to improve and savings ratios have risen. Yet consumer demand has



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remained strong, a paradox explained by an unusual combination of favourable circumstances that have given households significant increases in net disposable incomes. Almost all of those favourable factors have now reversed which, on its own, should bring a note of caution into the forecasts.

Debt levels have reduced but there's a lot of pass-the-parcel going on here. Government has assumed much of the debt that the private sector has paid down. Most of us think this is a good thing (most of us complain that it was the prior state of the public finances rather than just what has happened in the last two years



that is the problem) but we can't lose sight of the reality that total debt in the economy has not reduced.

Now, going through the first decade of the 21st century we all knew that something wasn't quite right. Countries like China, Germany and so on were growing their economies by selling more and more stuff to the rest of us, without spending very much themselves. This is how they came to build up the so-called 'excessive savings', the flip side of which is the excessive indebtedness of the consuming nations. Merry-go-rounds are fun: China makes stuff, sells it to us and lends us the money back to pay for the next stuff – everyone's a winner. Ponzi schemes are fun too, until they fall over. One of many factors that made this recession different was that the merry-go-round came off its rails.

What's odd about our elephant-infested room is that while the sustainability of that global imbalance is widely doubted, people seem to be assuming that the consuming nations can track back to previous rates of growth, albeit at lower actual levels of activity, with relatively short-lived pain. This is nuts. If the world has to put right its imbalances, the saving nations need to change the

habit of a lifetime and spend more; we need to face a similar wrench and spend less. Action by Governments is – rightly – aimed at smoothing that potentially catastrophic adjustment but it surely cannot somehow magic it away.

So our second elephant, D, insists that we are in for a long hard slog as we painfully save our way out of our over-indebtedness, irrespective of whether the debt is in public or private hands.

Enter elephant number three, 'IDL', or I Don't Like Pain. For all my fulminations about paying down debt and years of sub par growth, it might be different. We might go back to the soft life; we refuse to tighten our belts, the excess savers refuse to slacken. But IDLP doesn't just have the biggest name; he's biggest because he's eaten the others and he's the most scary because with him in the room we really are doomed to the eventual slump we seem to have avoided this time.

OK I'm not going to push this elephant thing too much further but hopefully a point is beginning to emerge from all this. Forecasts for growth look over optimistic to me, in which case a lot of people are going to be disappointed at some point. But if I'm wrong and

they are right, then the bigger risk is that the outcome implies a return to the status quo ante, a bit like putting a plug in a volcano.

Our friends M and D make for a dull but generally progressive outlook. Risk assets can be okay so long as they are reasonably priced as, indeed, they appear to be today. But if the light comes on and it's IDLP in the room – head for the exit fast and put your affairs in order.

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Now some not so merry news from the alpacas; here's a message from Alice, our first-born and the (self appointed) leader of the pack.

"One of our number (Freddie) has been smitten with bovine TB. We are in for many months, years even, of regular testing which we shall not enjoy. We know that some of us will not survive but as yet we do not know who or how many. This is all bad for us but we do appreciate the nice feedback we have had from Viewpoint readers over the years. To keep up with how we are doing, you can ask one of the humans who feed us by mailing

[peter@oakhillalpacas.fsnet.co.uk](mailto:peter@oakhillalpacas.fsnet.co.uk)"

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