Making Business Sense

Is there a shortage of spending power?

Fifth Gresham Lecture

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Objective

To examine the implications of the excess savings in the emerging economies

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Overview

The context – previous lectures in the series

Savings in China and impact on the world's savings rate

How this contributed to the financial crisis

Getting out of the financial crisis – and regulation

How misuse of Keynesian remedies made the economic crisis worse than it needed to be by providing a false rationale for boosting public spending during the upswing

The impact of the Chinese savings glut on pensions

The impact of the Chinese savings glut on ownership of assets

Postscript – why it is so difficult for the UK to match world economic growth

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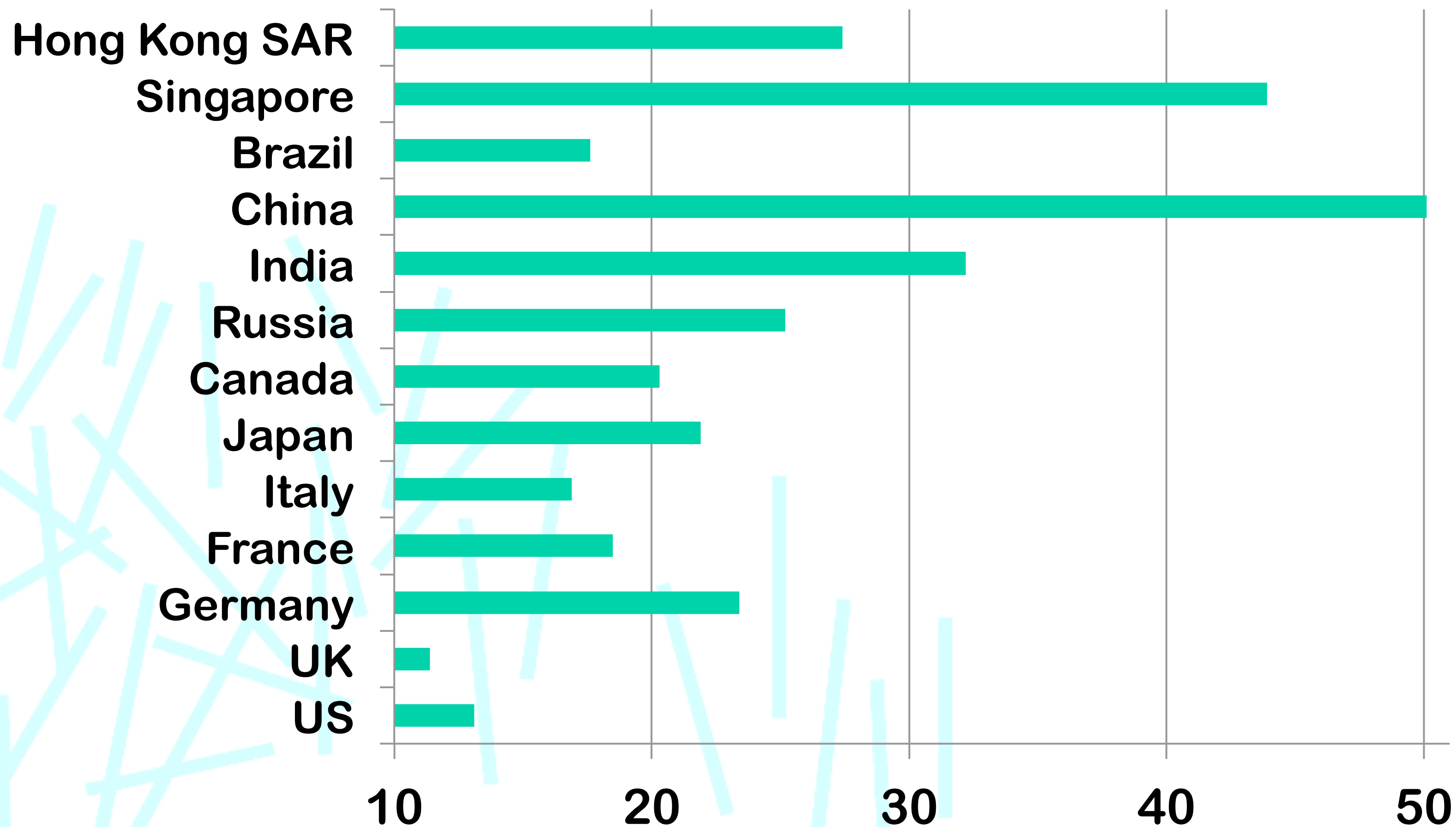
Gross National Savings Ratios in 2012 by country

Percentage of GDP



Source: IMF World Economic Outlook

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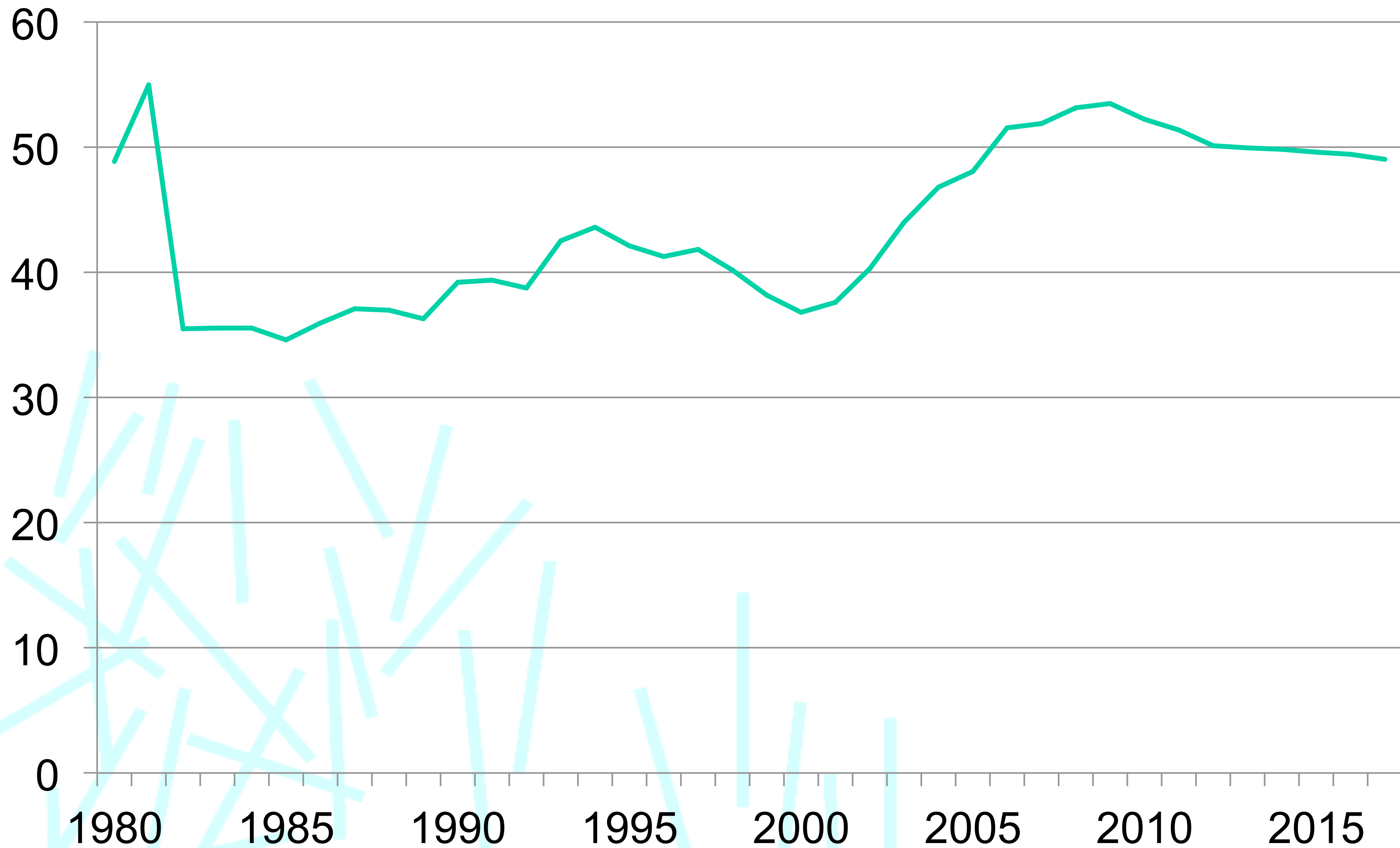
Chinese savings ratio (gross savings as % of GDP)



Source: IMF World Economic Outlook and Cebr forecasts

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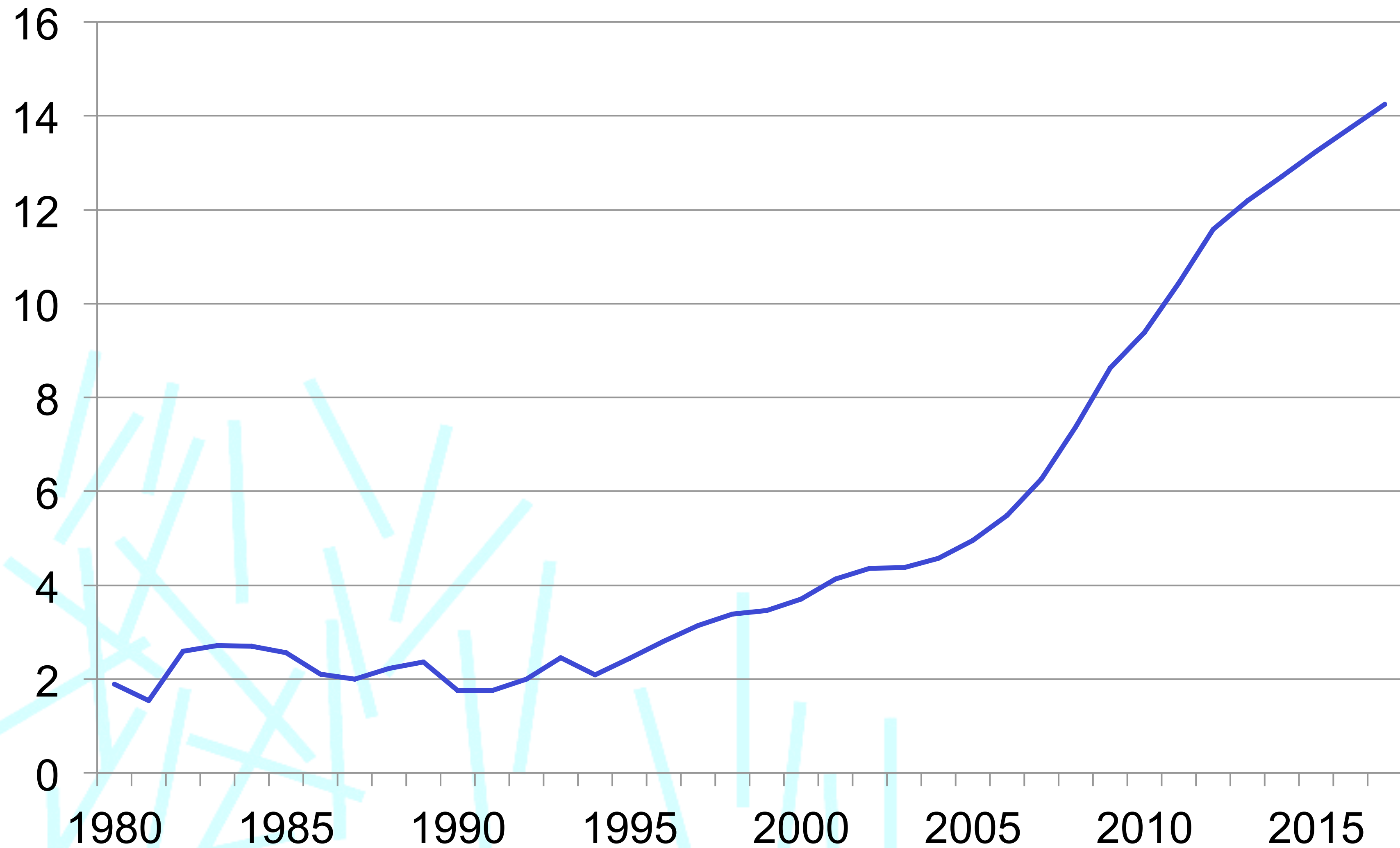
Chinese GDP as a percentage of world GDP



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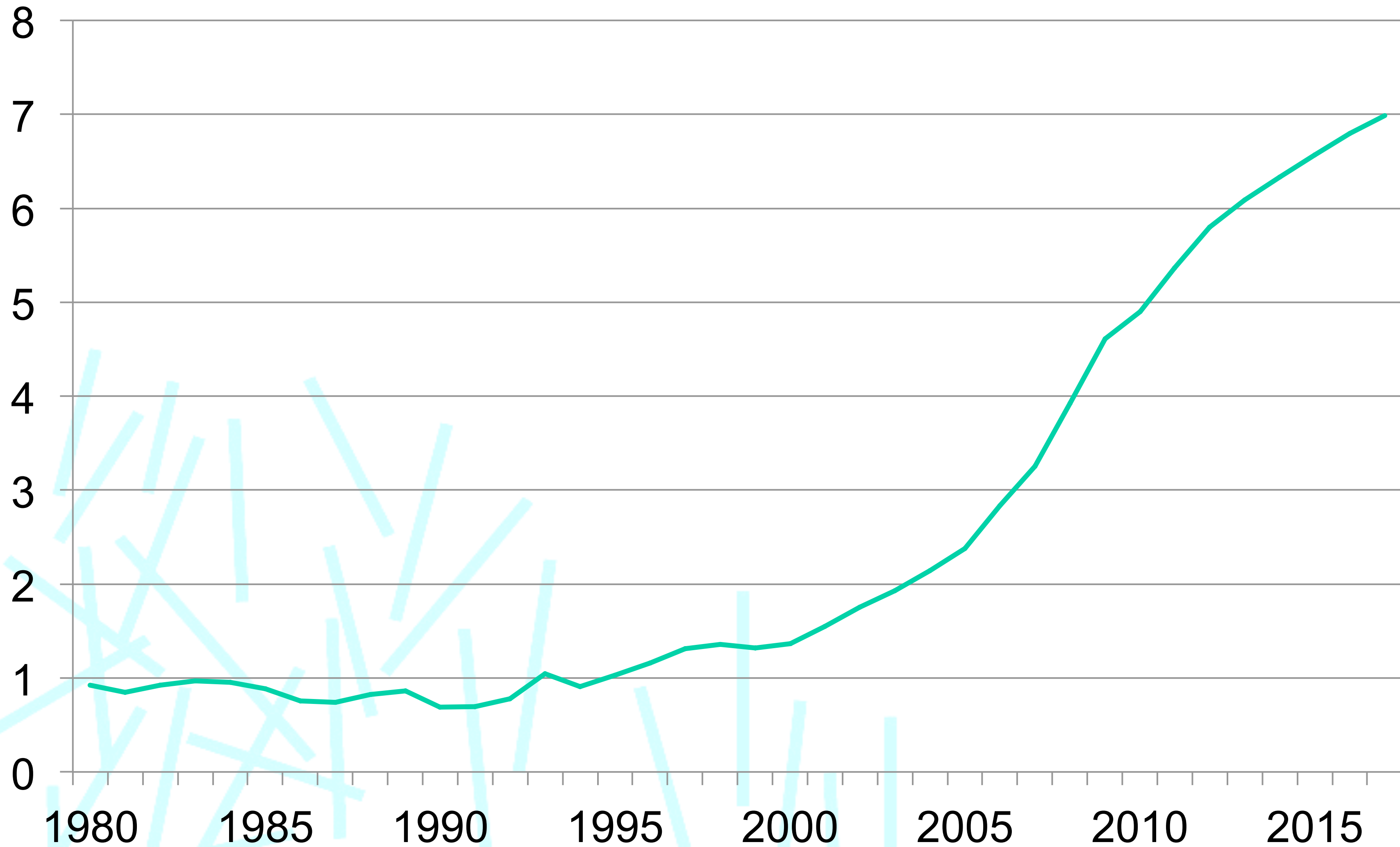
Chinese savings as a percentage of world GDP



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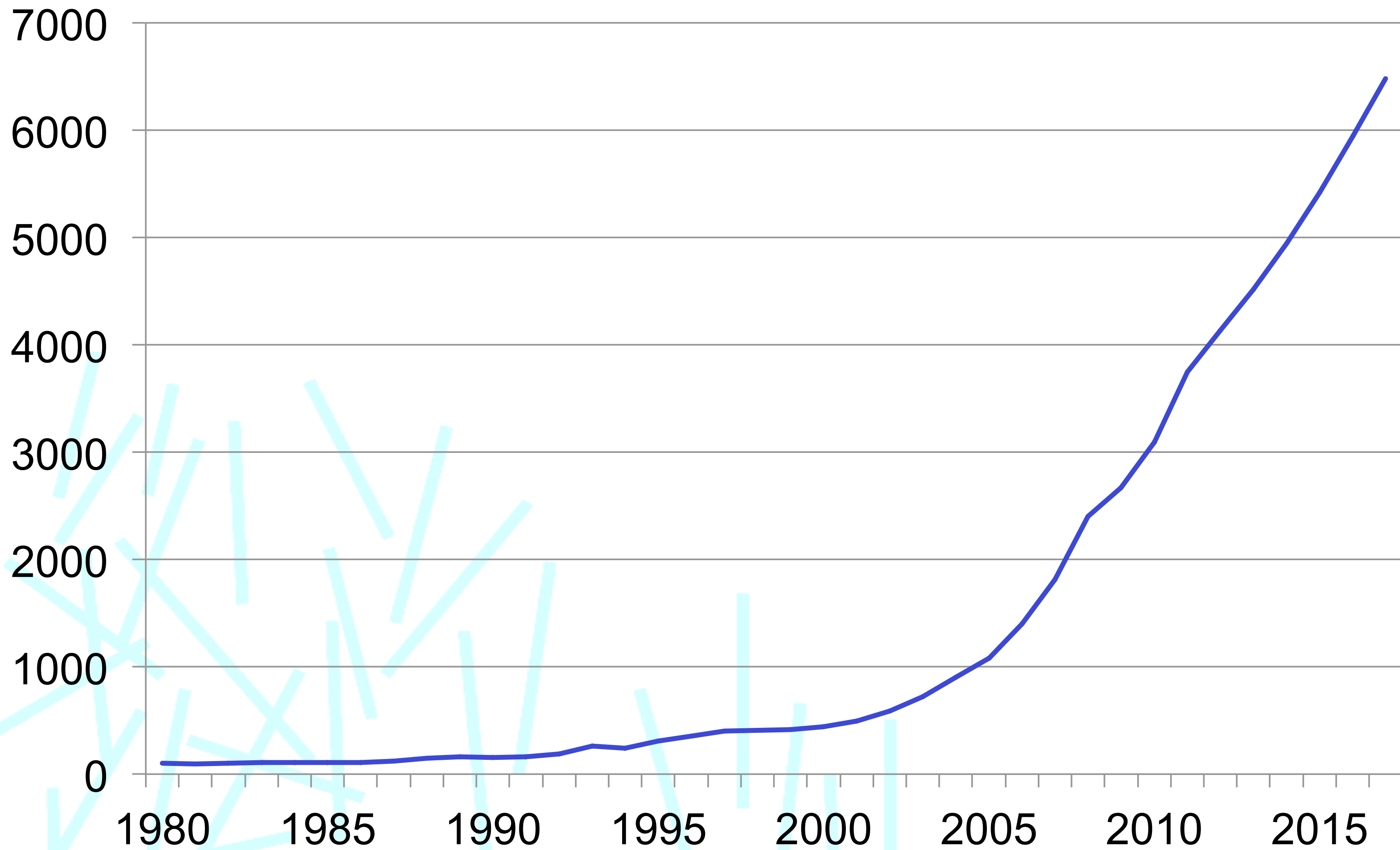
Chinese savings $ billions



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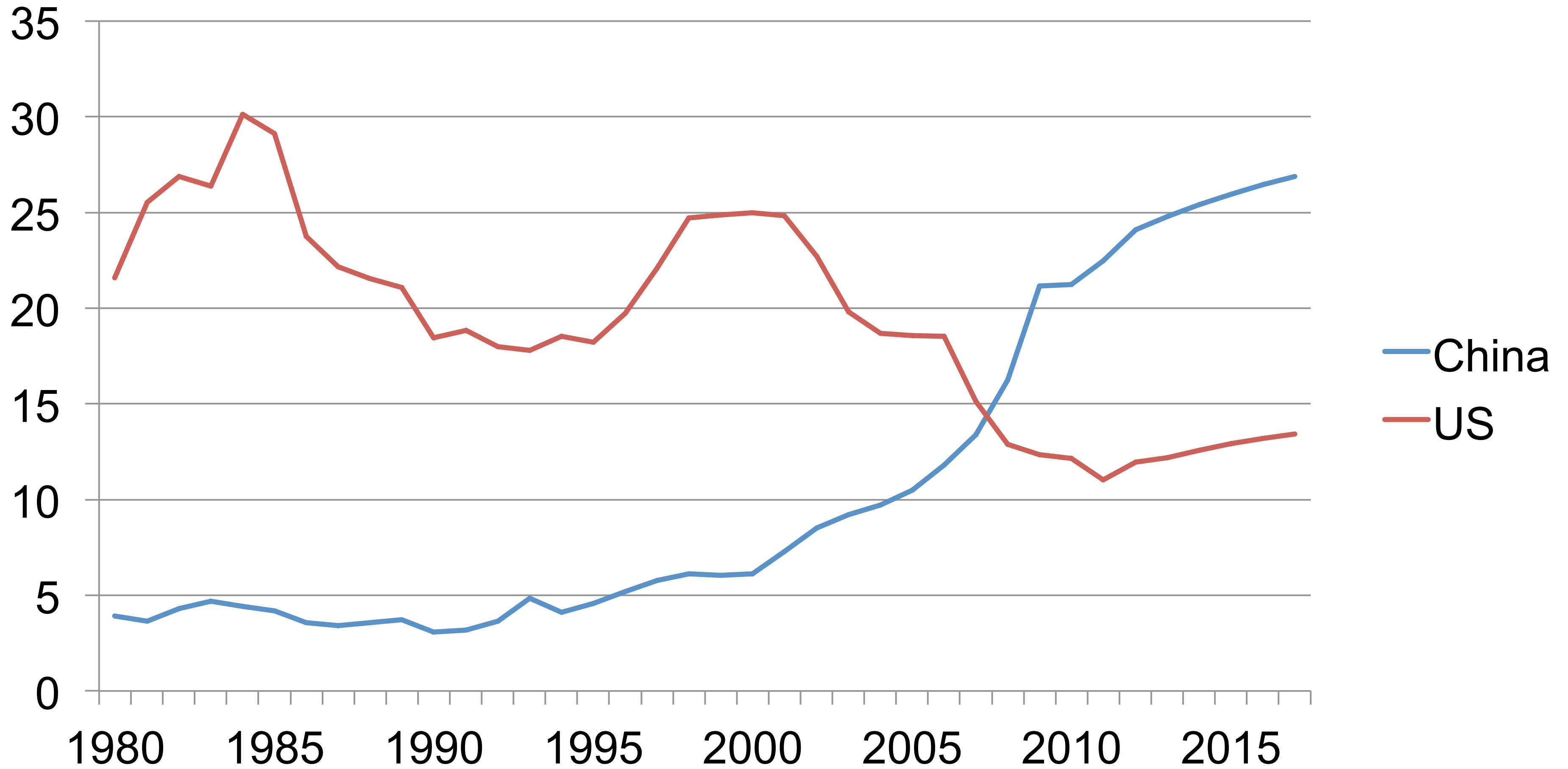
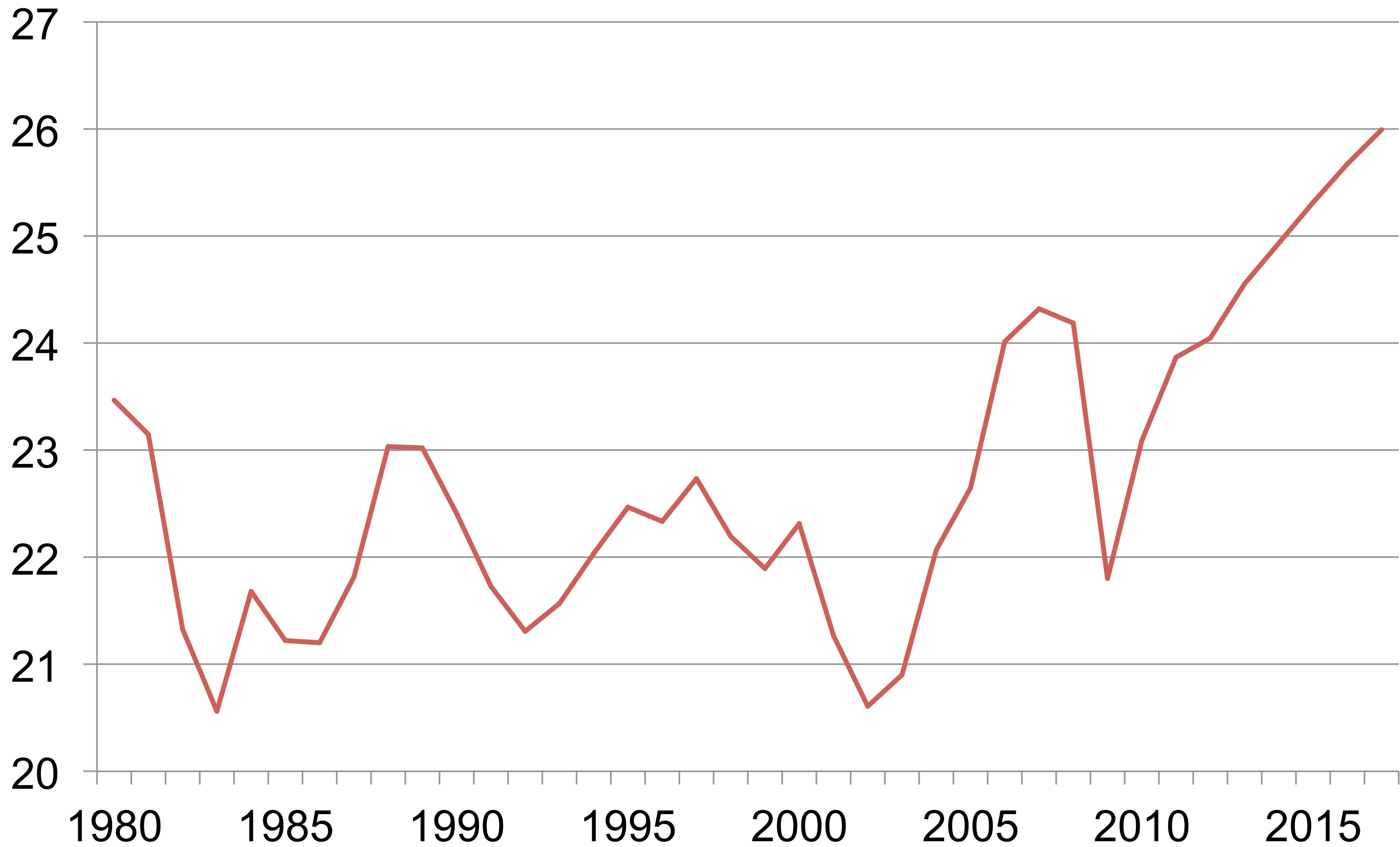
US and Chinese savings as a proportion of total world savings



The world's gross savings ratio has been edging up



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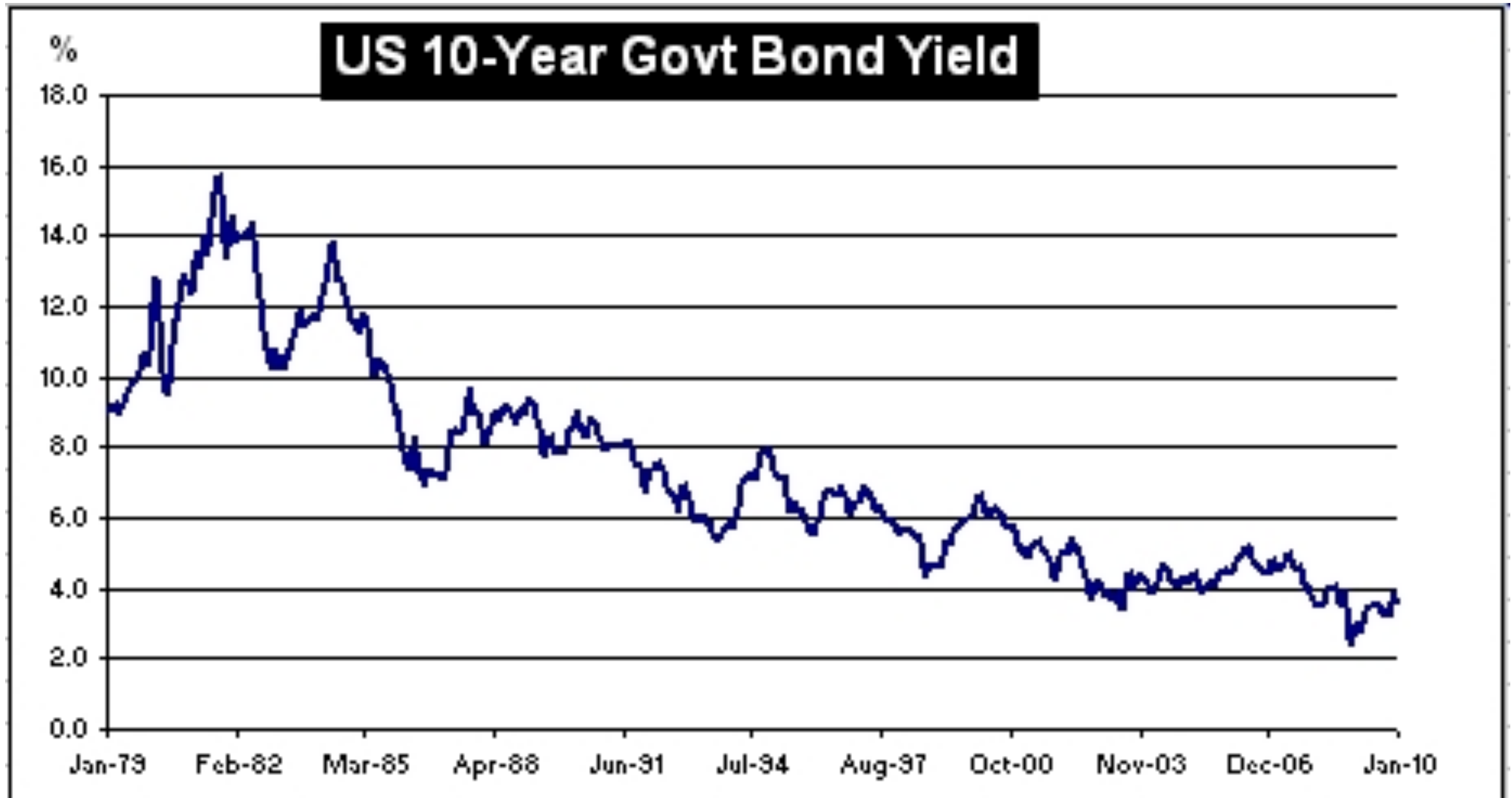
Bond yields have been falling



FSA guidance for medium term investment returns

Table 1: Medium-term investment returns assumptions

Recommended assumption	2007 (%)	2011 (%)	Change in percentage points
Inflation: RPI (2007), GDP deflator (2011)	2¾	2½	– ¼
Real government bond returns	1¾ – 2	½ – 1	– 1¼ to – 1
EMRP	3 – 4	3½ – 4½	+ ½
Real equity returns	4¾ – 6	4 – 5½	–¾ to – ½
Real corporate bond returns	2½ – 3	1½ – 3	– 1 to 0
Real property returns	3¾ – 4	3 – 4	–¾ to 0
Nominal government bond returns	4½ – 4¾	3 – 3½	– 1½ to – 1¼
Nominal equity returns	7½ – 8¾	6½ – 8	–1 to – ¾
Nominal corporate bond returns	5¼ – 5¾	4 – 5½	–1¼ to – ¼
Nominal property returns	6½ – 6¾	5½ – 6½	–1 to – ¼

Source: PwC analysis

Note: Nominal returns on government bonds are estimated by adding inflation (RPI in 2007, GDP deflator now) to the real returns on government bonds shown in the table.

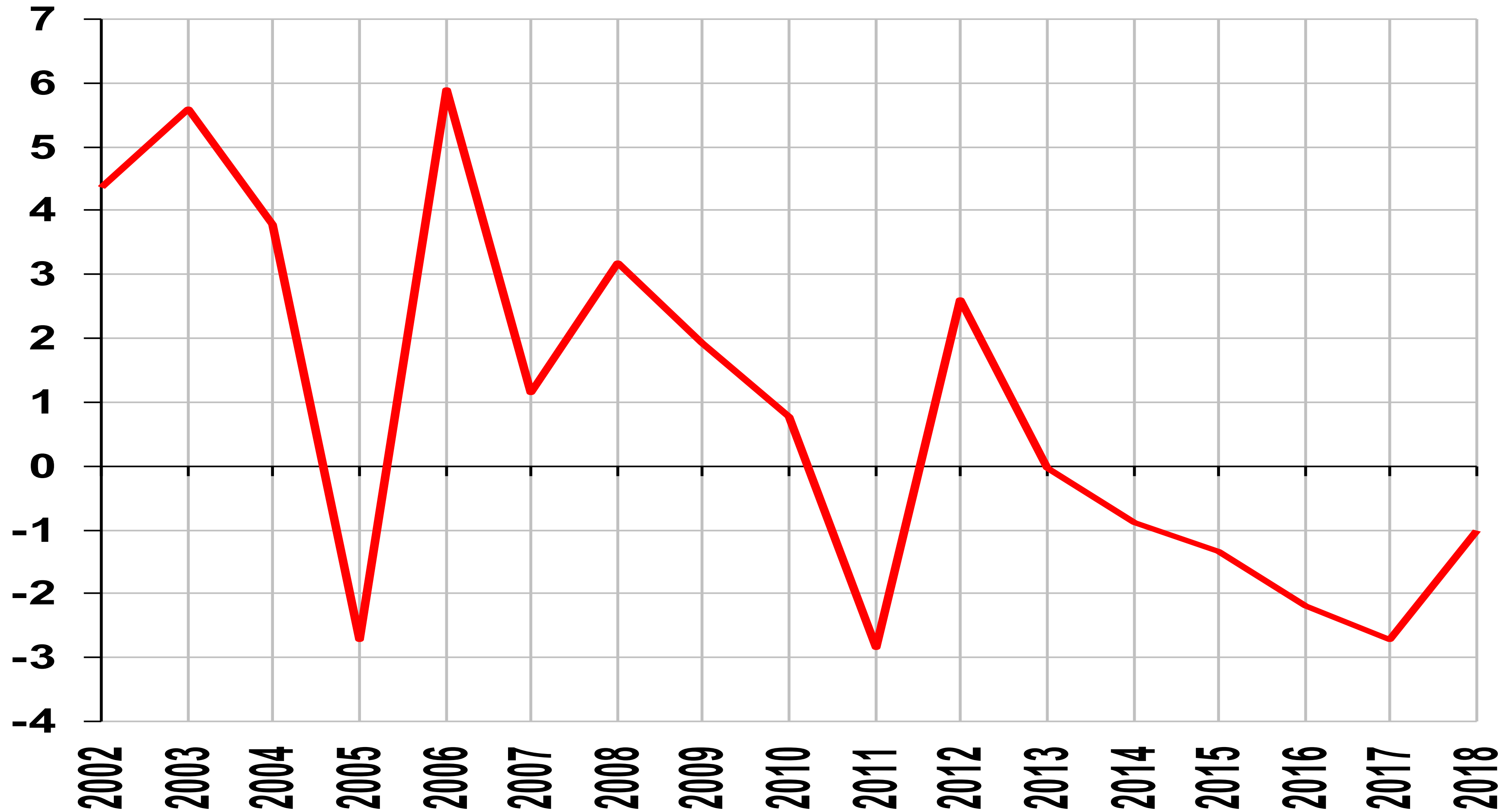
The cause of the financial crisis

- Investors chased historical nominal returns – encouraged by regulators
- Because prime interest rates were much lower than they had assumed, they took on much greater risks to achieve these historic levels of returns
- Lax monetary policy and inappropriate banking regulation encouraged the development of risky financial products
- Meanwhile governments responded to the Chinese savings glut with deficit financing and spending of unsustainable tax receipts from the financial sector to boost public spending way beyond its financible limits
- The bubbles were bound to burst leading to painful periods of austerity as financial institutions refinanced themselves and while public finances were cleaned up

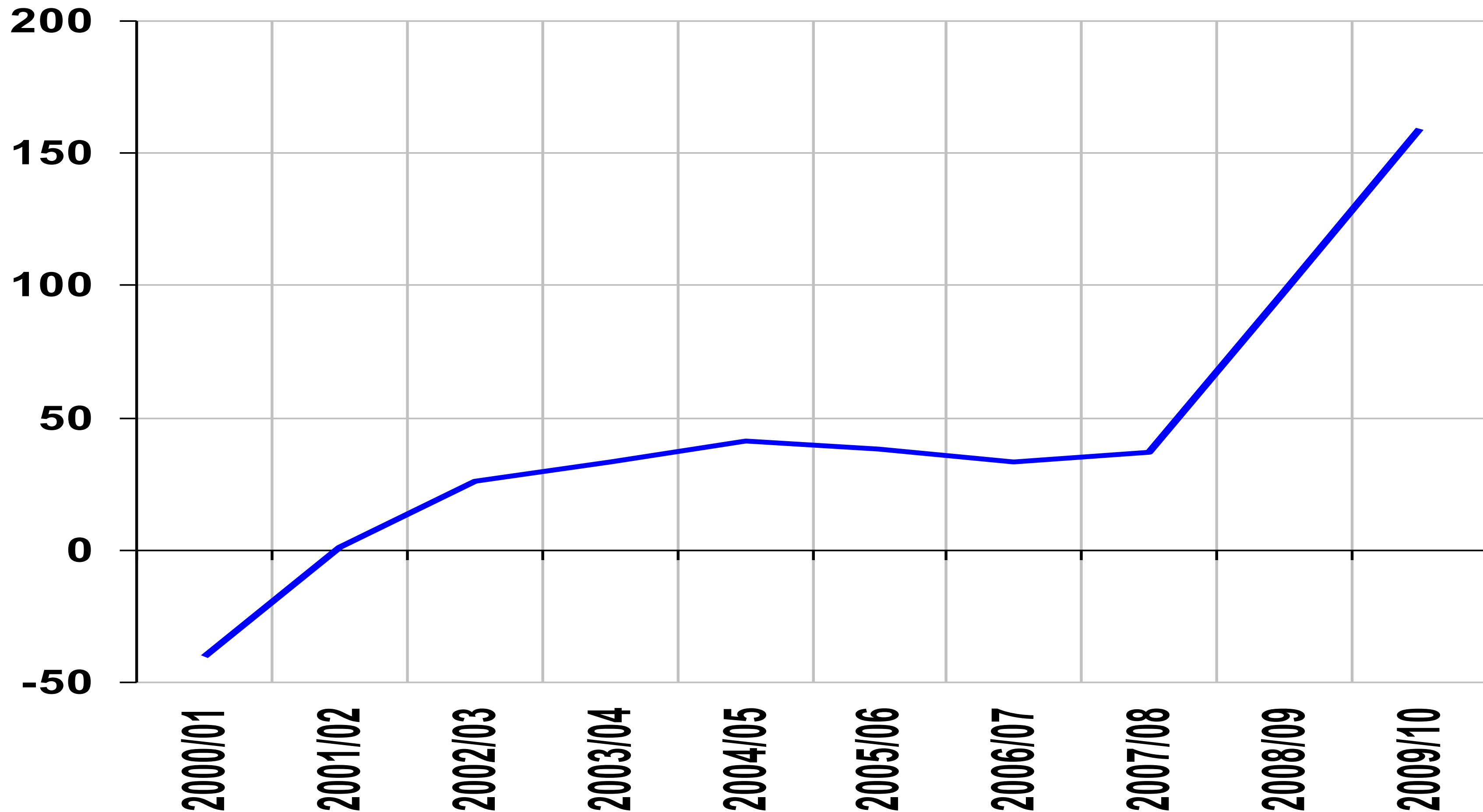
Regulating bankers

- Time to stop banker bashing
- Deal with problem of excess pay by transparency, corporate governance and competition
- Excess pay has typically been caused excess profits – use competition to squeeze out excess profits rather than focussing on pay itself. That way the customer gets the benefits.
- Punish individuals, not institutions by making strong rules for corporate governance of bailed out banks
- Create a culture of responsibility for retail banks
- But in a climate of low yields, those investing funds have to accept radically lower returns – unreasonable to charge 1% or more to manage a fund where the yield is not much more than 3%. The business model has to change.

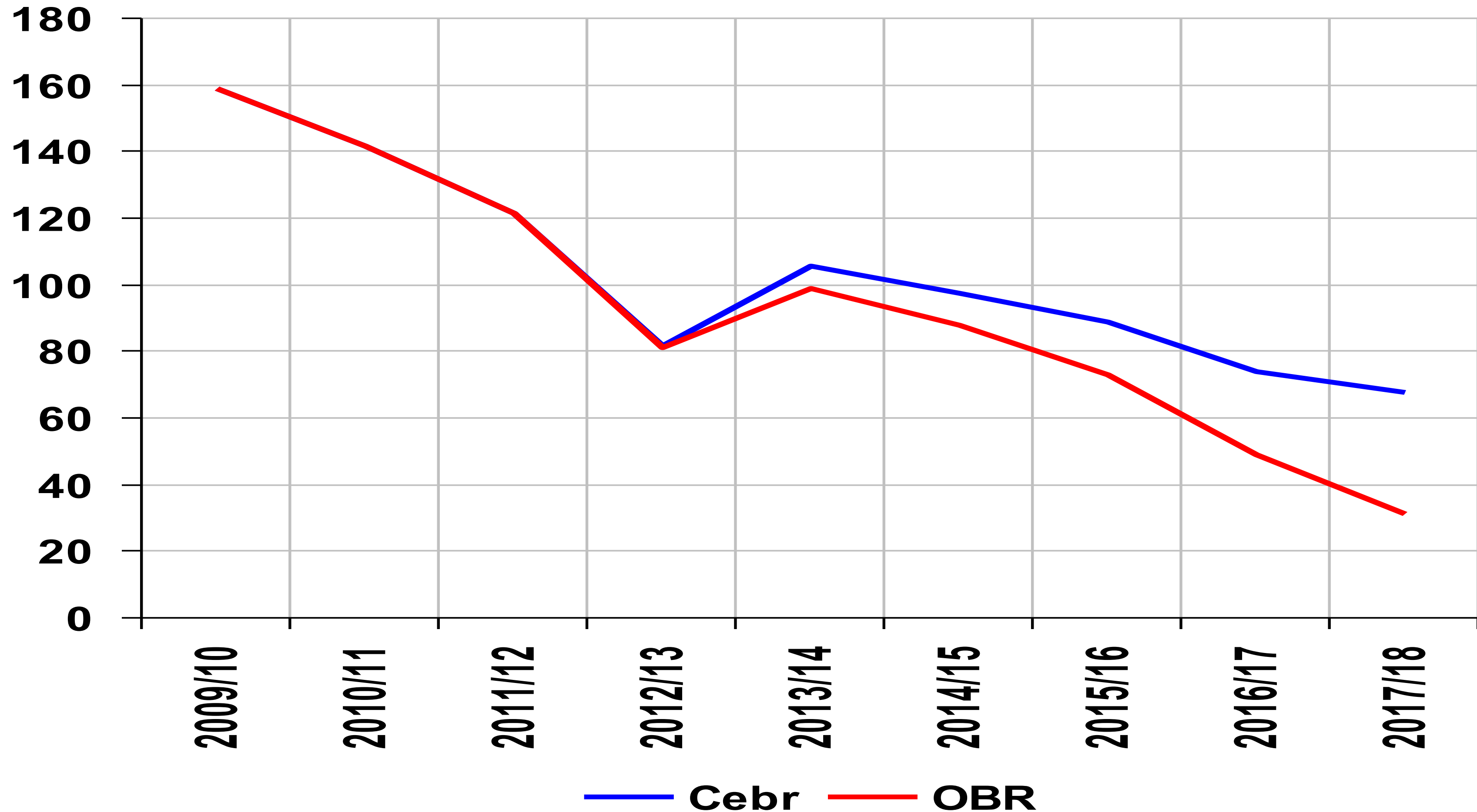
Government spending cuts at least a two Parliament problem



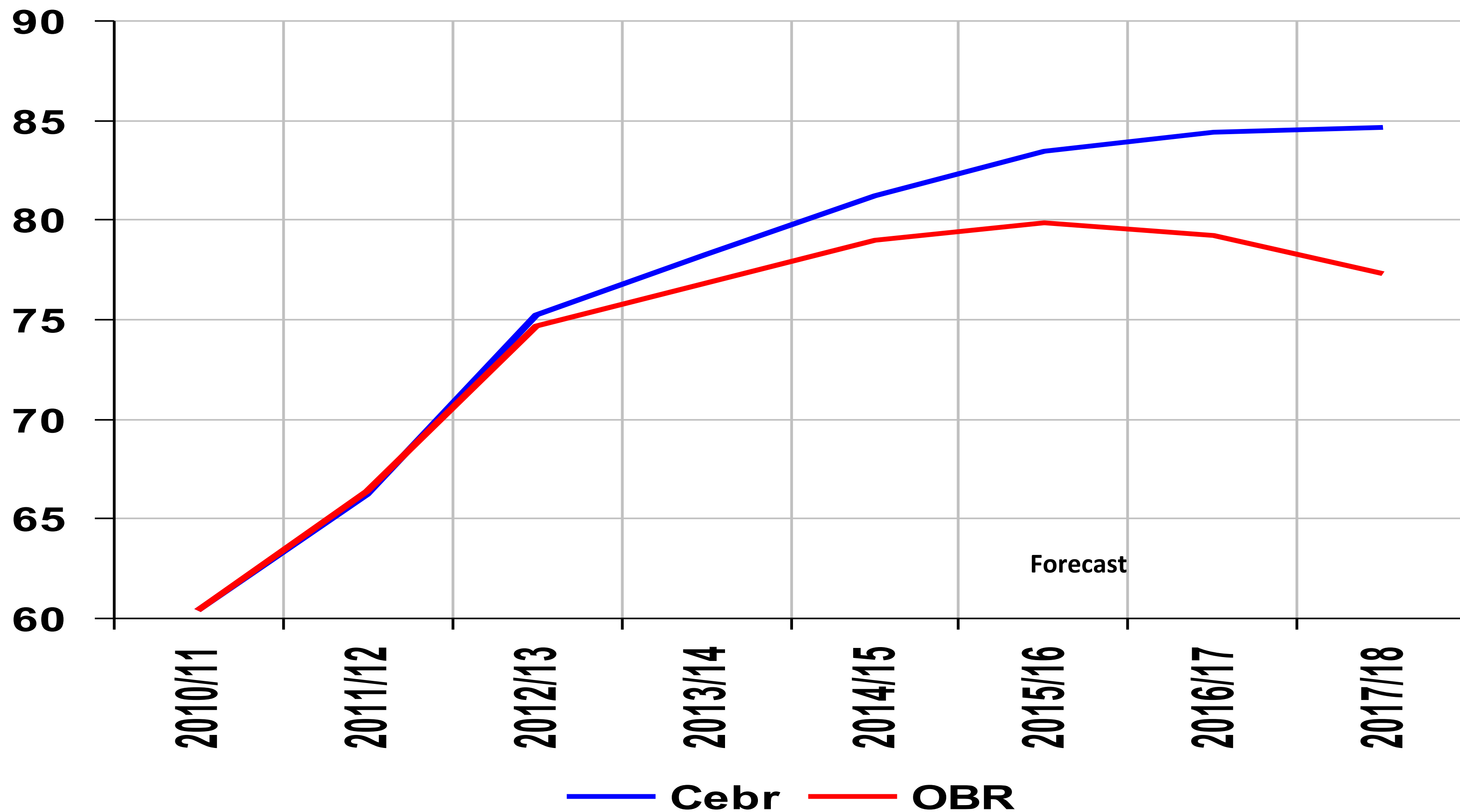
How UK borrowing soared during the upswing



Borrowing to be nearly £40bn above target in 2017/18



Debt-to-GDP ratio to breach 80% as deficit reduction struggles to take off



Impact of low yields on pensioners

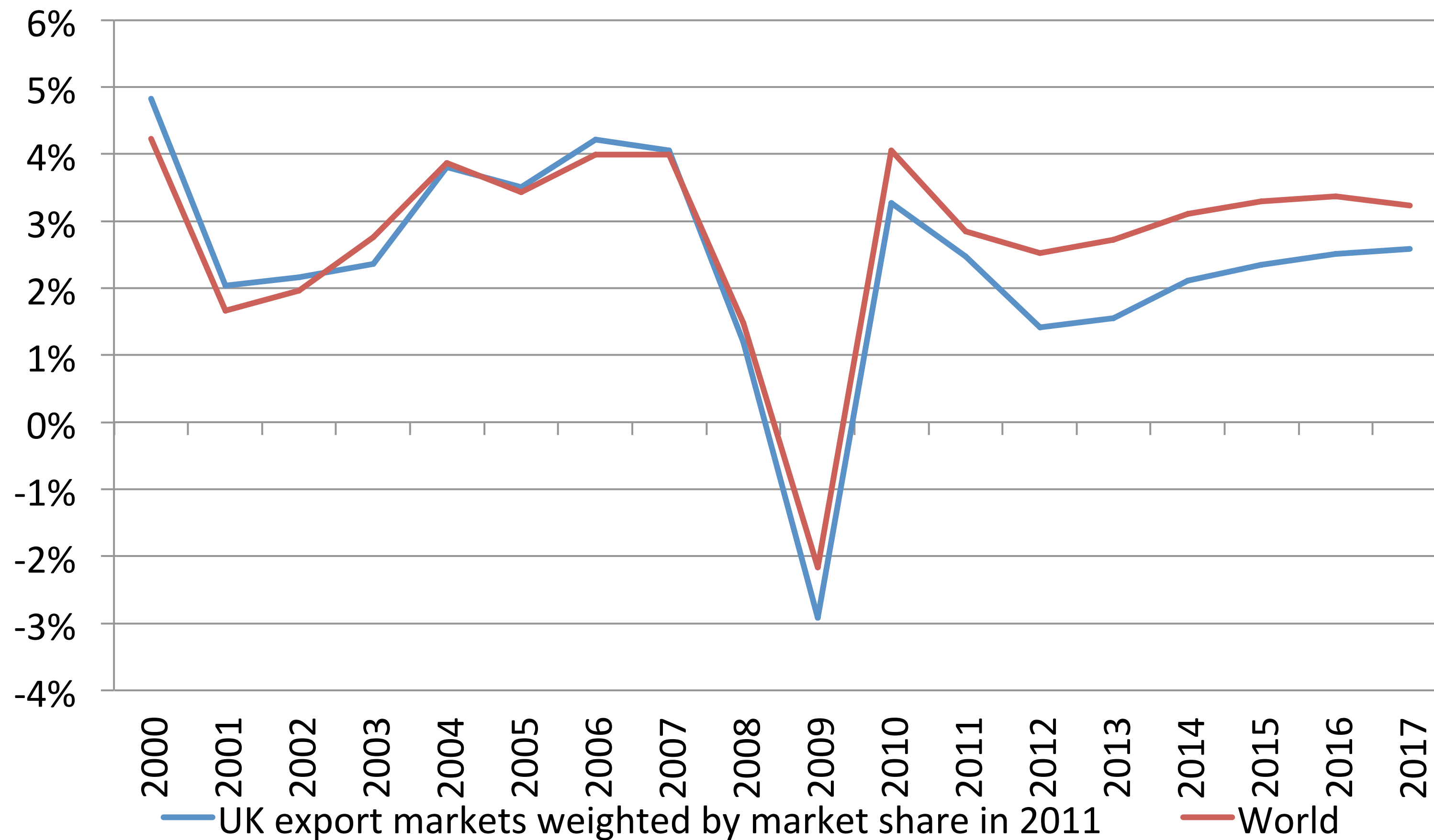
- Interest rates are likely to stay low as long as the savings glut persists, particularly with the background of slow growth in the Western world
- This is starting to translate into falling investment yields for assets besides bonds like property and equities
- With longevity increasing and low yields, it now would cost 45% of pre-tax income to provide the traditional 2/3rds final salary pension
- Since most people pay 30-40% of pretax income in tax, this wouldn't leave much to spend on other things like food or rent let alone luxuries!
- And if we did save that much, it would only add to the savings glut and further depress yields
- So in practice the only solution is to extend working lives – Japanese men now work till they are 70 and their retirement age will rise further. We will have to follow them and work till we are at least 75

Impact of Chinese savings glut on assets

- China now provides 25% of the world's savings (and rising)
- Unless their investment track record under or over performs (difficult when it is such a large component of the total) this means that over time 25% of the world's assets (and rising) will be Chinese owned
- China's share of world GDP is 12% and as growth slows, its share of world assets should be roughly proportional to its share of GDP
- So even if all the assets in China are Chinese owned, they will still have roughly half their savings that will have to be invested outside China
- So far they have invested heavily in Africa and South America which have been neglected by the West. They have also long holdings of US government debt
- But they will eventually need to spread into Western assets like equities and property to a much greater extent than hitherto
- So many UK assets and companies will become Chinese owned
- Better start learning Mandarin!

While the world economy has recovered, the UK's main export markets have not

World GDP growth – weighted by GDP at current prices compared with UK export markets weighted by 2011 market shares



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