

Economic review of:

June 2011

Our monthly economic review is intended to provide background to recent developments in investment markets as well as to give an indication of how some key issues could impact in the future.

It is not intended that individual investment decisions should be taken based on this information; my colleagues and I are always ready to discuss your individual requirements. I hope you will find this review to be of interest.



Paul Smith

During the past month or so, the situation in Greece has given considerable cause for concern.

It is not just that the country's economy is deeply in debt - that applies to several others! The main issue is that its population appears not to understand the need for sacrifice if the county is not to go bankrupt. Whatever they may think about 'external interference' with their economy, they owe banks in different countries considerable amounts of money; this needs to be repaid, or the loans replaced.



A Greek tragedy could envelop Europe

Unfortunately, there is no money to repay the loans and governments and banks are becoming increasingly unwilling to bail them out for much longer. Rioting on the streets against much-needed austerity measures is doing little to encourage lenders and it is hardly surprising that Greek sovereign debt has been relegated to almost 'junk' status (at "CCC" from its previous level of "B") by the leading international credit rating agency Standard & Poor's.

UK banks are not as deeply involved as those in Germany and France, but the exposure is significant enough to raise fears that we will by no means be exempt from the fallout of any potential failure in Greece. In any event, we are likely to become involved through our shareholding in the IMF, even if we do not lend to them directly and, while Greece represents less than 2% of the Eurozone's GDP, its economic collapse could financially devastate Europe for a long time - and they are our major trading partners.

Growth

It appears that government borrowing fell by more than expected during May at £17.4 billion, from £18.5 billion in May 2010 - eye-watering, but better than expected. Conversely, April was so bad that the cumulative figure for the fiscal year is still £1.5 billion up on last year. Because the May figure includes VAT receipts from the January hike to 20%, commentators are asking whether there is scope for a cut in



Domestic consumption is not what the economy needs

tax, to help boost economic growth.

Some argue that, because families are "£165 a month worse off than two years ago" (The Times 22nd June 2011) VAT should be reduced in order to boost spending; others suggest that removing the additional (50%) income tax rate would encourage businesses to remain in (or return to) the UK.

It is possible, however, that neither would be the right thing to do. The real issue is that we need to manufacture and export far more than we do. Anyone watching Evan Davis's excellent BBC2 television series "Made in Britain" will know that we actually do make things, but that our primary focus has for decades been on invention, marketing and services rather than simply making things. While there is some merit in playing to our strengths, this has created an imbalance in our economy that means we import more than we export. It is fair to say that since we are short on physical resources, we will always need to import some things; but we then consume them rather than adding value and re-exporting them. This is by no means universal and the decision of Nissan and BMW to extend UK production of the Qashqai and Mini, respectively, is very good news; less encouraging is the Department for Transport's decision to award a £1.5 billion contract for 1,200 new railway carriages to a German firm. Whatever happened to the home of the Railway?

Perhaps it would be better to spend any 'spare' tax revenues on helping manufacturers and exporters.

Inflation and interest rates

Latest inflation figures show a worrying propensity for defying gravity; remaining unchanged in May at 5.2% for the RPI and 4.5% for the more restricted CPI. In normal times, the Bank of England could increase interest rates in order to reduce inflation, but in this case poor growth figures



The doves are winning ... currently

would make such a move extremely risky; not something that the newly knighted Sir Mervyn King is likely to wish to do. The latest appointee to the Monetary Policy Committee Dr Ben Broadbent (replacing 'interest rate hawk' Dr Andrew Sentance) sided with the 'doves' to keep the rate at 0.5%; only two voices now call for an increase.

The prospect of an increase in base rate is not universally welcomed outside the MPC. Some exporters fear that higher interest rates would result in money flooding into sterling, making it more expensive compared with our main customers' currencies, the euro and dollar. This would make exporting more expensive - and importing (which we do not really want) relatively cheaper. Others fear that higher interest rates could trigger an avalanche of mortgage defaults, harming the housing market as well as lenders' asset bases.

Interest rates round the world		
UK	0.50%	No change for 27 months
USA	0.25%	No change for 30 months
Europe	1.25%	No change for 2 month
Japan	0.10%	No change for 30 months

One potential way of helping the economy would be by increased quantitative easing - so-called printing money. The idea is that this would release capital into

the market, helping businesses to borrow (at least in theory). Paul Fisher, who is Executive Director of Markets at the Bank of England, has publicly stated that releasing further liquidity into the market remains on the agenda and at least one member of the committee, Dr Adam Posen, appears to agree, voting yet again in June for a further £50 billion in quantitative easing.

Markets (Data compiled by the Insurance Marketing Department Ltd.)

There are unlikely to be any prizes awarded to anyone predicting that the main indices we follow were mainly in the red, this month. The FTSE100 ended **-0.74%** lower, while the FTSE250 lost **-1.05%**; however, in the US the Dow Jones lost **-1.24%** while the Nasdaq100 lost **-2.18%**. Perhaps surprisingly, in view of the problems in Greece, the Eurostoxx50 only lost **-0.47%** during June, while the Japanese Nikkei225 actually gained **1.53%**, going some way towards recovering its May losses. The principal reasons for stockmarket losses, which mainly affected the first half of the month, were poor economic data from the US as well as the debt crisis in Greece, which hit UK bank shares (a major constituent of the FTSE100) hard. However, returning optimism about a further bailout of Athens and a return of confidence in the US led markets up towards the end of the month. The FTSE100 is almost 21% higher than this time last year, while the Dow Jones is 27% up.



If Banks suffer, so do stockmarkets

Gold prices weakened by **-2.07%** during June and are now 21% higher than a year ago at just over US\$1,500 per troy ounce. Oil, which had reached as low as US\$105 for Brent crude 1-month futures, ended just **-1.92%** lower at US\$112.48.

Oil

We regularly consider oil price movements as part of the Markets section, but it may be worth expanding on the

current situation, which has seen prices fall during June, before partly bouncing back.



Fortunately, we have 'excess' oil storage

It had been hoped that OPEC, which represents the main oil producing countries, would increase production in order to make up for that being lost during the Libyan civil war. Unfortunately, it declined to do so, even though high oil prices are potentially damaging to members' own interests, by weakening the world economy. They not only need a strong world economy into which they can sell oil, but also to invest heavily in the economies that suffer most from high oil prices.

Fortunately, the richest nations have announced that they will release oil from the stockpiles they have built up since the 1970s as a bulwark against possible interruptions of supplies. This immediately forced down prices that had been partly pushed up by speculators hoping to cash in on Libya's misery although prices subsequently hardened somewhat.

Cheques

According to the Payments Council, we have at least until 2016 to carry on making payments by cheque. This comes as something of a surprise to those who had been relying on previous statements suggesting that cheques would not become obsolete until 2018; it will come as an even bigger shock to those who were unaware that this payment method was under threat at all.



Cheque writing - already a dying art

In fact, the cheque guarantee card facility came to an end on 30th June, although the announcements have not been particularly high profile; so while it is still possible to write cheques for a further five years, or so, they are not now so 'safe' for businesses accepting this method of payment. Is this the first stage in trying to convince us that cheques no longer 'work' anyway?

The demise of cheques themselves could damage small businesses that frequently rely on cheque payments and may not be able easily to cope with (or trust) on-line banking. They could easily find it difficult to obtain payment from customers who do not wish to use cash or cards to pay. After all, many older people do not trust cards or the internet and will be reluctant to make the move; in some cases, they may simply not be able to do so.

At least this will kill off the old excuse: "the cheque is in the post". In future, it will be sitting in one or other bank, or in the limbo of transit.

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