Britain's just not working

Insight from Gary Reynolds, Courtiers Chief Investment Officer

August 2022

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When the UK Retail Price Index (RPI) shot to a double-digit annual increase of 11.1% in April, and the RMT and Public Sector workers unions threatened to bring the country to a standstill, I imagined all us sexagenarians saying to our children and grandchildren *"…see, that's what it was like in the seventies!"*.

Whilst rampant inflation is a worldwide issue, this should be little comfort to whoever replaces Boris as PM because Britain has some thorny problems that are entirely of its own making.

The pandemic threw a large spanner into the workings of what had become a highly efficient and sophisticated global supply chain. Businesses and governments mothballed large swathes of their productive capacity and were then wrong-footed by consumers' rapacious appetite for online merchandise and Amazon's ability to deliver it.

In the summer of 2021, central bankers attributed rising prices as little more than a transition back to a normal economy, but the weight of spending for goods remained high even though the demand for services began to rise as consumers threw off the shackles of lockdown, determined to make up for all the missed experiences of the last two years. In short, as the global economy cannot currently meet the demand for goods and services prices have, and are, rising.

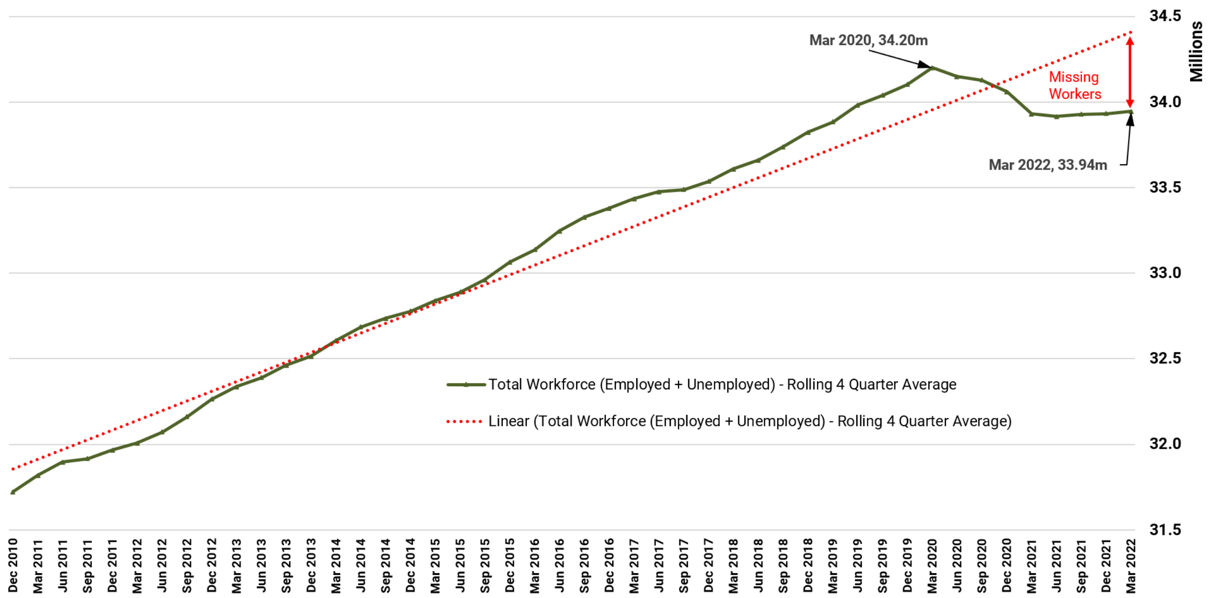
Central Bankers, tasked with keeping price rises under control and not wanting to be labelled as being at the helm when the inflation genie was let out of the bottle, have ditched their "transitory" explanation and started increasing interest rates.

In the US, with its ultra-flexible work force and dynamic domestic market, providers of goods and services will probably gear up quickly to increase supply. But even if this proves true, it still makes sense for the Fed (US Federal Reserve Board) to use the excuse of a bit of inflation to get long-term interest rates back to more normal levels so that they have the ammunition to fight the next deflationary battle, whenever that may be. The Bank of England is also increasing the UK base rate for similar reasons, but unlike the majority of other major developed economies, the UK has a toxic combination of supply-side problems in the form of a weak labour market and a shocking shortage of investment.

Britain's Labour Market Woes

Between 2010 and 2020 the UK economy grew, if not spectacularly, at least quite steadily and our workforce similarly grew from 31.7 million in December 2010 to 34.2 million in March 2021. Had that trend continued the figure would now be approaching 34.5 million, but it isn't – in fact our workforce has declined. By March 2022 it had fallen to 33.4 million. In little over two years, Britain lost around 500,000 workers, as highlighted by chart A:

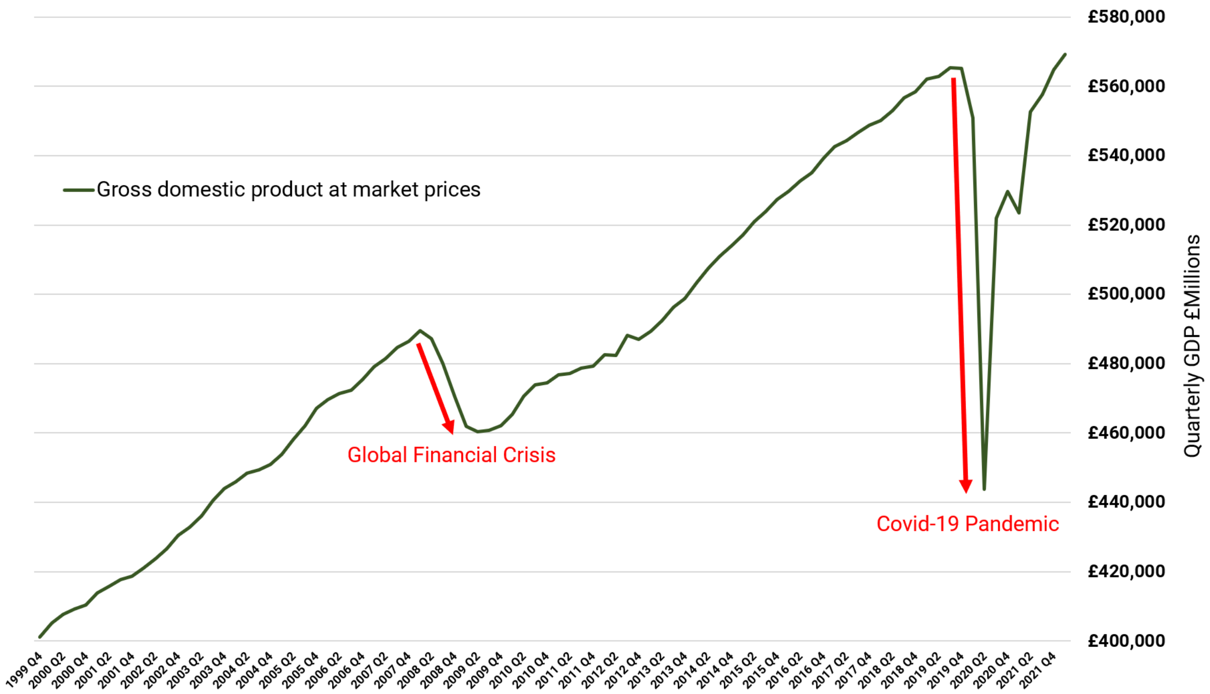
Chart A – UK total workforce (rolling 4 quarter average)



Source: ONS/Courtiers

One explanation for our declining workforce would be that Covid-19 has shrunk the economy thus reducing the demand for labour, but that's not true, as highlighted by chart B below, which shows that GDP now exceeds its pre-pandemic levels:

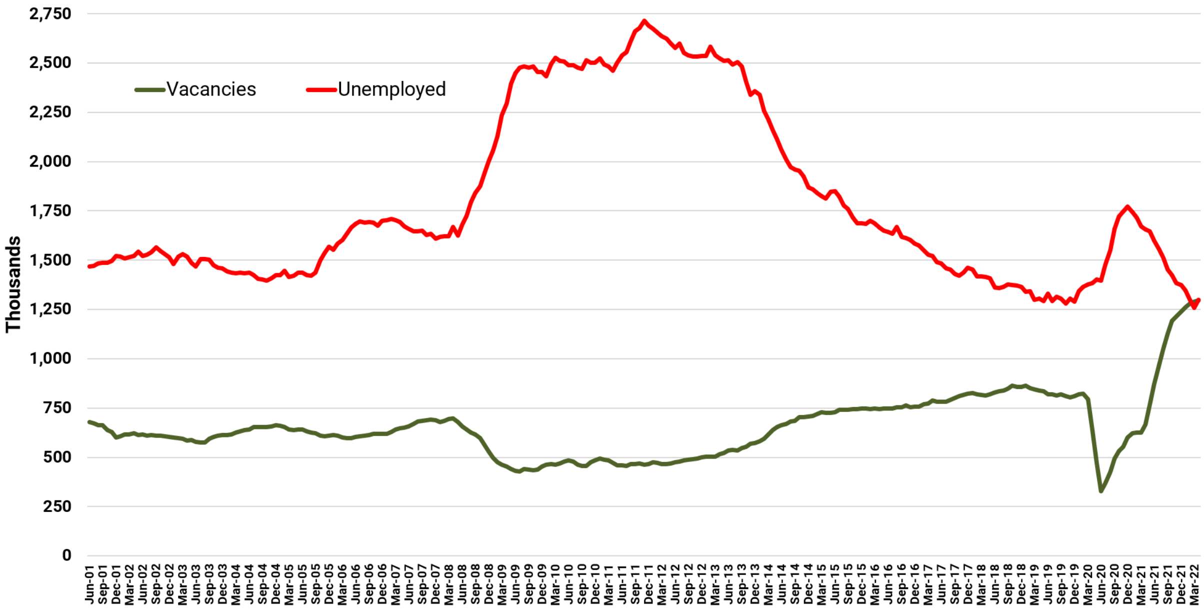
Chart B – UK quarterly GDP (chain linked SA)



Source: Courtiers/ONS

Another argument for the missing workers is that the economy isn't creating jobs, so the labour market isn't supplying the workers to meet them. But that's not true either. The UK economy has created jobs at breathtaking speed and job openings are at record levels. With vacancies now exceeding the number of unemployed, there is at least one job for every unemployed person in the UK, as highlighted by Chart C:

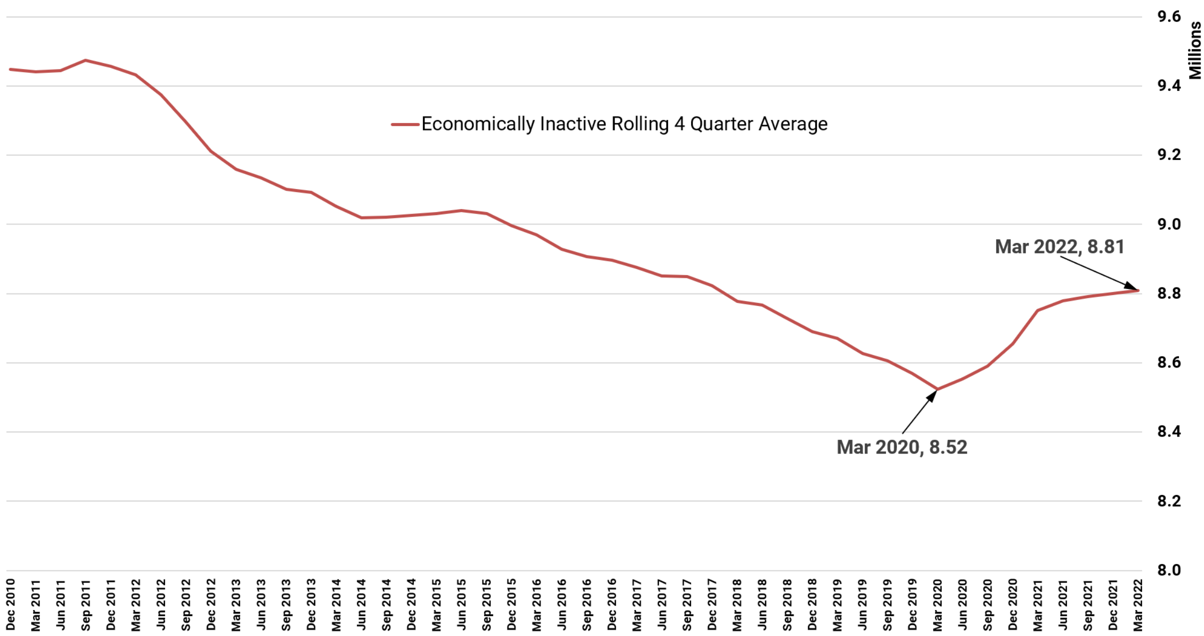
Chart C – UK unemployed and job vacancies



Source: Courtiers/ONS

One reason for Britain's declining workforce is that more people have become economically inactive. i.e. they are not seeking work as a result of either retiring or being too sick to do so. Long-Covid may have something to do with this. Chart D shows that the number of economically inactive people in the UK has risen by nearly 300,000 during the pandemic:

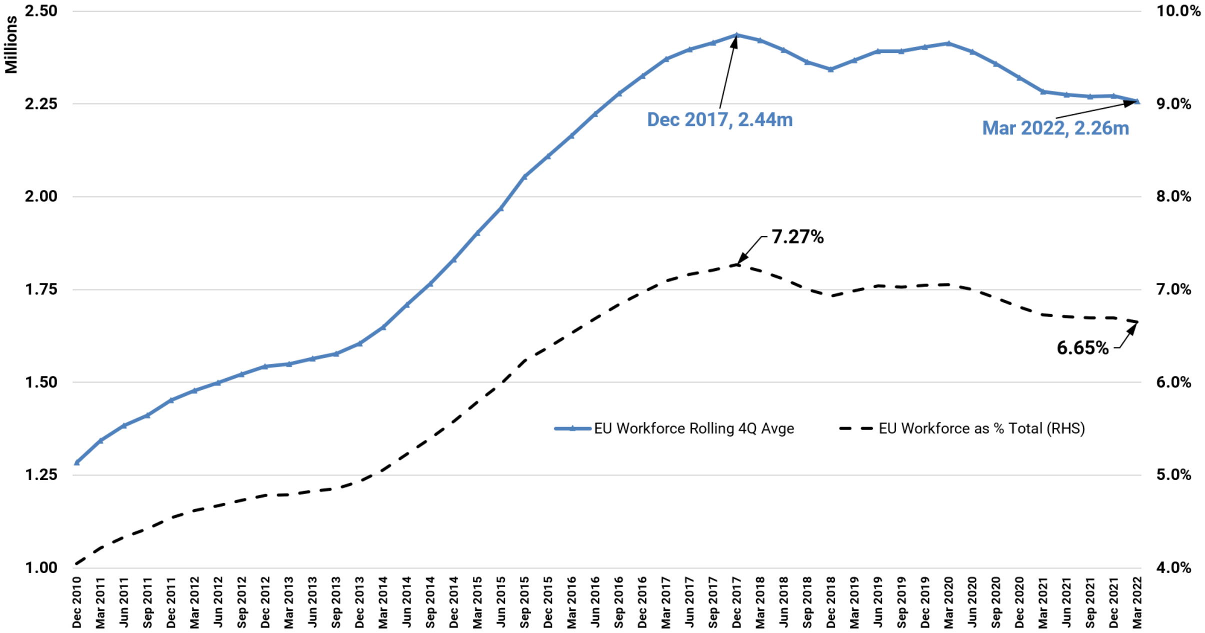
Chart D – UK economically inactive persons in the UK (rolling 4 quarter average)



Source: Courtiers/ONS

The final piece of the puzzle in the mystery of the shrinking UK workforce is Brexit. Chart E below shows the total of EU nationals working in Britain:

Chart E – EU workers in Britain – total and as percentage of UK workforce (rolling 4 quarter average)

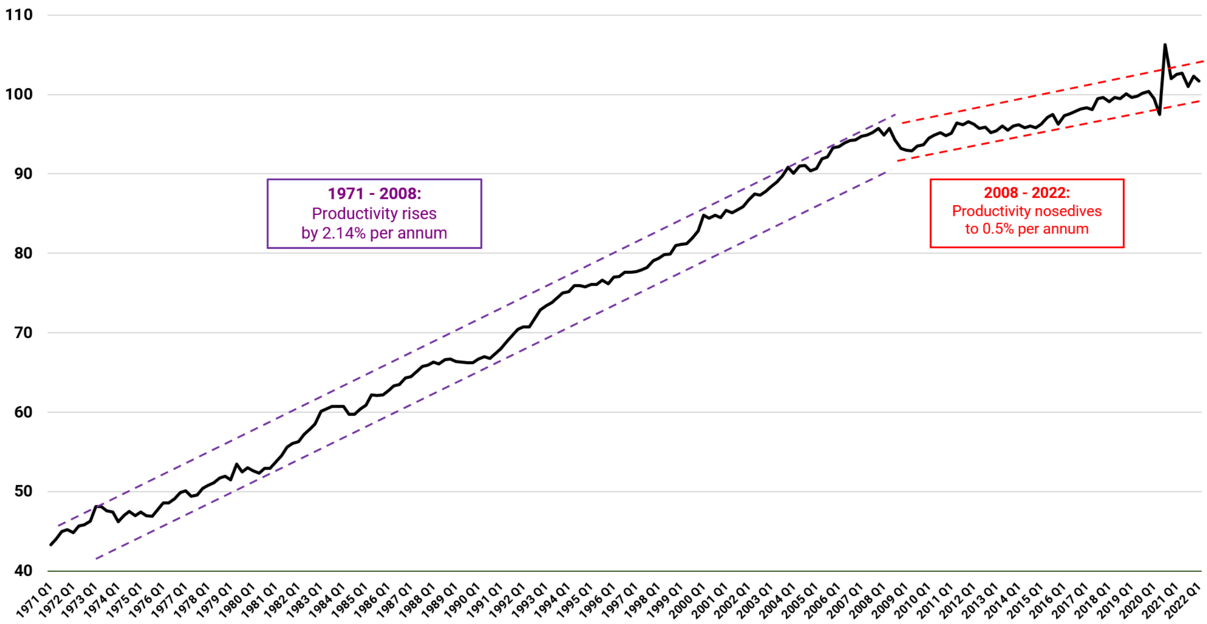


Source: Courtiers/ONS

EU workers in Britain peaked as a percentage of the total workforce at 7.27% in December 2017 but by March 2022 had declined to 6.65%. The UK made sensible arrangements for EU nationals to remain in this country post Brexit, but those that returned home are not being replaced.

A lack of available workers would be less of an inflation problem if we were increasing the productivity of those in jobs at a reasonable rate, but unfortunately productivity has been a problem in the UK for over 10 years. Chart F shows the trend in productivity (increases in the rate of output per hour worked) from 1971:

Chart F – Index of UK output per hour worked

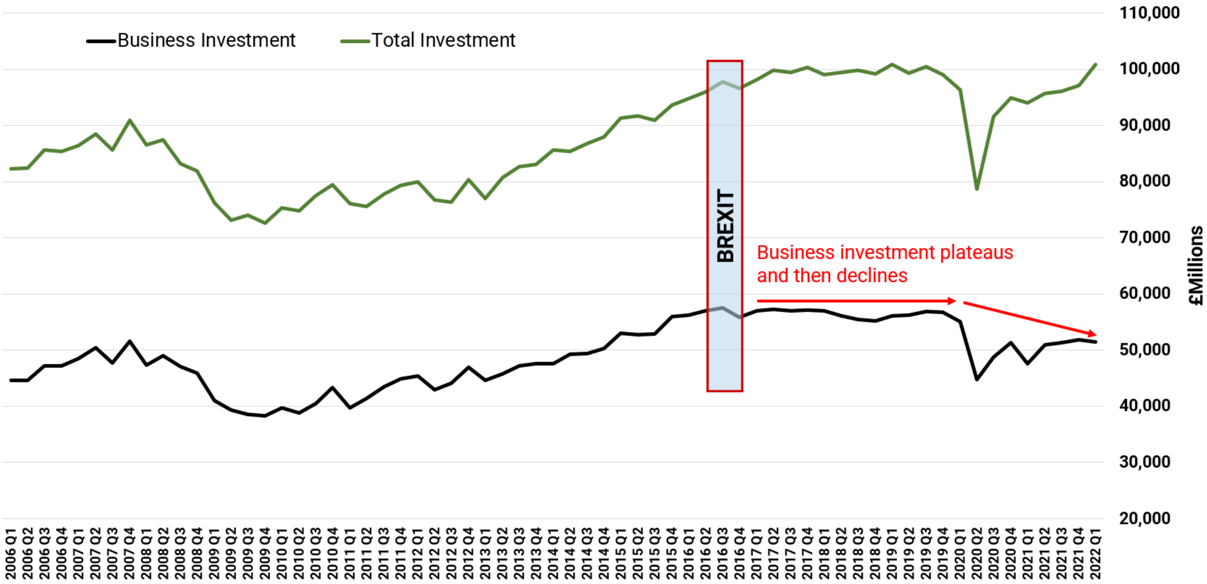


Source: Courtiers/ONS

UK productivity increased at over 2% per annum from 1971 to 2008 but post the global financial crisis it declined to just 0.5% per annum.

Increases in the quantity and quality of plant machinery and tools available to workers along with improvements in infrastructure can significantly boost productivity, but this requires investment and the UK's record in this regard is wanting, as highlighted by Chart G:

Chart G – UK gross fixed capital investment Q1 2006 – Q1 2002 (chain linked 2019 prices – £Millions)



Source Courtiers/ONS

The above chart shows total investment (the top green line) and business investment (the bottom black line). Investment dipped during the global financial crisis, trended upwards through to 2016 and then levelled-off. Business investment plateaued post 2016 and then declined.

An explanation for the plateauing of businesses investment post 2016 is probably Brexit as companies waited to see how things would turn out and delayed investment decisions in the interim. I don't think our departure from the EU per se necessarily adversely affected UK business investment in the medium term, but the way in which Brexit has been handled damaged confidence and likely caused business investment to be directed elsewhere or delayed. Either way, business investment post Brexit is down.

Summary

Businesses around the world have been wrong-footed by the strength of demand for goods during lockdowns and consumers' subsequent appetite for services. Coping with the ups and downs of the first major pandemic for over 100 years is bad enough, but in addition suppliers are having to navigate the additional difficulties caused by the outbreak of the first major conflict in mainland Europe for 80 years and a trade war between the US and China, the world's two biggest economies.

For the UK a bad situation is made worse by a shortage of both labour and capital which are ramping up domestic inflation. As the UK economy navigates these choppy waters it needs a chart to calmer seas and a sure hand on the tiller. Let's hope the next PM provides both.

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Find Gary's profile and more commentary at courtiers.co.uk

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