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A View from the Bridge

In the UK, the British speak English

Welcome to the eleventh edition of A View from the Bridge. Our articles this time are not actually about language or the definitions of the UK and Great Britain, or what is meant by the British Isles, Britain or British but they do look at three areas that affect the whole nation, the propensity to save in Britain, the ownership of the UK equity market and the Bank of England.

Given that most people enjoy spending money, saving is not always easy. It is also true that, for many, rising interest rates are unwelcome, but they may actually help the savings ratio. Our first article suggests that the good people of Britain are not saving enough.

Many will be aware of the increasing proportion of the UK equity market owned by 'other financial institutions', which includes Hedge Funds, and the media certainly makes us all very aware of the short-term gyrations in markets that dealing by Hedge Funds can cause. However, probably of greater long-term concern is the increasing proportion of the UK equity market owned by overseas investors. Our second article looks at where the UK stands on protectionism.

In our third article, we return to the subject of interest rates. The level of interest rates in the UK is something that many of us focus on frequently, perhaps even on a daily basis. For the last ten years, the Bank of England has had responsibility for setting interest rates and we review its performance over this period.

We are very conscious that many of our readers are clients. For those who are exposed to equities, it is worth remembering that, at the time of going to press, the FTSE 100 is higher than where it started the year (6221). Whilst markets may remain volatile in the short term, the medium and long-term arguments for equity investing remain intact.

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Britain is simply not saving enough

Saving means different things to different people, so perhaps a few definitions might be helpful. Saving is the act of postponing consumption, so total savings equate to disposable income less consumption. Gross income can be spent, saved or paid in tax. The average propensity to save is the proportion of disposable income that is saved rather than spent and this is known as the household savings ratio.

It is widely believed that savings are positively related to the level of disposable income. At low levels of income, total spending may exceed income, causing negative saving; as income rises, total savings rise. For most of the post-war period, the trend in the savings ratio was upward as rising real incomes and living standards gave people the basic resources to save. High inflation and high interest rates in the 1970s also acted as an incentive to save. However, the expansionary policies adopted in the 1980s fuelled consumer demand. Lower interest rates, much easier access to consumer credit and a booming housing market caused a surge in borrowing. This allowed millions of households to increase their spending, way in excess of the growth of income, which ultimately brought about inflation and recession. In contrast, the 1990s saw a more

cautious approach as consumers repaid accumulated debts and repaired their personal 'balance sheets'.

In 1995, the British on average saved a little over a tenth (10.2%) of disposable income. By 2006 this proportion had halved to a twentieth (5%) and the beginning of this year saw it more than halve again: in the first three months of this year, the savings ratio fell to 2.1%, its lowest level since the start of 1960 when Harold Macmillan was prime minister and the economy grew by a massive 5.3%.

These rates are a long way off guidance issued by a spectrum of specialists who recommend people save at least 10–15% of their pay in order to secure adequate retirement income. However, Britons are now saving as little as they did in the 1960s and it is argued that it is higher taxes that have squeezed disposable incomes in the recent past. Such a squeeze has not been seen since 1998/9 with recent research clearly indicating that households are now dipping into savings to fund current spending. While the overall savings ratio remains positive, a major proportion of this is from pension contributions. When these are excluded, the savings ratio is negative.

It is argued that higher taxes have squeezed disposable incomes, contributing to the current low levels of savings. The Office for National Statistics (ONS) revealed a sharp rise of 9.8% in capital gains and income tax in the first three months of this year, the highest increase for two years ago and sharply up on the final three months of last year. It also said that disposable income fell 0.3% in the first quarter, yet despite having less cash, UK consumers increased their spending by 0.5%, as they continue to run down their savings. And although combined personal debt in the UK is well in excess of £1,000 billion, it is estimated that consumers are adding something in the region of £10 billion to this figure per month.

Demographic forecasts for the UK suggest a natural rise in the savings rate of just under 2% over the next 40 years. However, this slow impact on the savings rate is often obscured by major events which have a far greater (albeit perhaps shorter term) effect. Historically in the UK, the savings rate is at its highest when the economy is in recession and when house prices are declining. Highs include 1980 and 1982, when the ratio was at 12.4% and 11.6% respectively. Examples of recent lows include 1988 and 1999, when the ratio dipped below 5%, but the most recent dip in the headline numbers is more worrying. Statistics from the Bank of England show that mortgage equity withdrawal hit a two-year high in the fourth quarter of 2006, rising to £14.6 billion or 6.7% of incomes and confirming that the recent strength in the housing market is supporting consumer spending.

It seems that a combination of a lack of trust and poor investment returns has become a significant issue, with many consumers preferring to invest in property rather than savings products, particularly given the perceived complexity of many such schemes. Means-tested benefits are also believed to be a disincentive, while savings packages with tax incentives are generally well supported, suggesting that taxation policy would influence savers. Individuals thought to be particularly vulnerable to the savings deficit are 'middle England' and the so-called 'middle-aged' who, unlike the low income and high income individuals who benefit from safety nets and private savings, tend to rely disproportionately on traditional private and public benefit schemes.

At this point, it is perhaps worth noting that aggregate statistics can be very misleading with regard to the majority of households, since they are dominated by the savings patterns and wealth of the very richest households. In addition, the UK does not have an official survey of household wealth and debt that could be used to provide adequate empirical evidence for government policy. Perhaps the most comprehensive set of data is the Family Resources Survey, but this does not collect sufficient information on asset ownership or wealth levels, nor does it collect information on outstanding debts.

When making comparisons abroad, data shows that economies with relatively low rates of saving, including the UK, have tended to outperform higher saving nations in terms of economic performance in the past five years. Central banks in most countries have continued to raise interest rates throughout 2006/7 to temper inflation. This, coupled with strong corporate profits, has fuelled a global rise in savings rates. The personal savings rate in the US has been negative since the second quarter of 2005. For 2005 as a whole, data from the Bureau of Economic Analysis (BEA) show a personal savings rate of -0.4%, with this figure dropping to -1.1% in 2006. These numbers compare with averages of 2.2% between 1999 and 2004, 4.6% between 1993 and 1998, and 8.6% between 1950 and 1992. Again, negative savings would seem to point to growing indebtedness and, ultimately, a likely decline in living standards as debts are paid off.

Regulation of the savings industry has been made increasingly onerous, while the growth of the consumer credit market and access to credit is far easier than was the case even five years ago. Today almost anyone is able to secure a credit card or loan, even if they do not have full-time employment. More than six in ten adults are believed to be saving towards something, but it is estimated that only half of these are by way of a pension. Thus, almost half of adults are saving for non-retirement related reasons and only a minority of consumers are investing in equity-based products. It seems increasingly likely that the workplace will be the next major delivery channel for savings – via the Government's proposed personal accounts scheme – thus providing a savings mechanism for those who do not currently have good pension provision. It is proposed that all employees will be automatically enrolled into either a new personal account or else a suitable workplace scheme. Policy makers are hoping that 6–10 million more people will be saving for retirement as a result.

Meanwhile, a significant proportion of individuals continue to face rising debt levels and the prospect of negative equity.

This is set against those with greater exposure to equities, generally medium- to high-earners, which over the long term tend to produce better returns than cash deposits or gilts, and are significantly better provided for, in relative terms, than those on lower incomes. Weak disposable income trends and rising interest rates are a bad combination for consumption and growth, and therefore a major concern, but they may actually help the savings ratio in the second half of this year and into the next.

Who owns the UK equity market?

One of the more graphic headlines on newspaper billboards recently was 'Billions Wiped Off Shares'. This perhaps conjures up a particularly interesting image of some kind of giant sponge which descends periodically on London's capital markets, causing distress and volatility throughout its transit. However, in light of recent movements, it is worth looking at who might be applying this sponge, given that the owners of the UK equity market have changed radically over the past ten years.

Recent data from the Office for National Statistics (ONS) indicate that overseas investors now own some 40% (by value) of the UK equity market compared with around 28% for domestic insurance companies and pension funds combined. The percentage of the equity market owned by private individuals has been declining for many years and now stands at 13%, only 3% above that accounted for by 'other financial institutions', which one can interpret as being hedge funds and other strategic investors. This category has been sharply increasing in influence as it accounted for only 3% of the market only seven years ago. The rationale for these moves is all too clear: for a number of years now pension funds in the UK have been reducing their exposure to domestic equities and increasing their holdings of less volatile assets, such as bonds, both domestic and overseas, in order to align their assets and liabilities more closely over the long term. However, bonds have sharply underperformed equities over the past four years and actuarial assumptions about how long pensioners will live have apparently been significantly understated. Longevity is increasing amongst pensioners in developed economies and, therefore, the liabilities of pension funds have been significantly increasing over time.

The net effect of developments over the past four years has been a significant transfer of wealth away from policy holders and shareholders in UK insurance companies and pensioners in UK pension funds to a wide variety of overseas investors. Indeed, this trend began in earnest back in 1997 when Gordon Brown, as Chancellor of the Exchequer, made a significant change regarding tax treatment of dividends for pension funds, rendering equities less appealing as an asset class. The implications of this change is deeply concerning, in particular as it has resulted in decisions concerning corporate Britain being taken more and more by overseas investors, whose agendas may be very different from the traditional long-term owners based in the UK. The most obvious manifestation of this trend has been the takeover of a number of UK corporate household names by overseas companies or by financial entities backed and funded by sovereign governments. The takeover of P&O and the proposed takeover of J. Sainsbury clearly fall into this latter category. Also noteworthy has been the stake-building in Standard Chartered Bank by Temasek, a strategic investor backed by the Singaporean Government.

It is, of course, one of the great strengths of the London capital markets that they are particularly transparent and liquid in order to encourage overseas investment. There are currently only two companies in the FTSE 100 Index in which the Government retains a so-called 'golden share': British Aerospace and Rolls-Royce. Indeed, the Government was compelled to give up its golden share in BAA in 2003, which allowed the company to be taken over by the Spanish group Ferrovial in 2006. Standards of service and quality have not notably improved since then and it could be argued that in this case foreign owners have been less responsive to the problems encountered by British travellers than a domestically based company might be. A more strategic concern would be an approach by a company backed by a country such as Russia towards UK companies involved in, for example, the energy or mineral sectors. It could be argued that companies, such as Centrica or BG are important strategically for the UK economy as oil and gas fields in the North Sea decline, and that perhaps they too should be protected from foreign takeover by 'golden shares'. What is certain is that the Government would be put in an awkward position were Russia to start building stakes in such sensitive companies, with protectionism for certain areas of the UK capital market a retrograde step in the promotion of London as a premier financial centre.

This appears to be the essence of a problem which will increasingly come into focus in the future. It has been London's good fortune to be in a time zone between the markets of the USA and the increasing economic power represented by China and the Pacific Rim economies. The capital markets are, as has been noted, liquid and globally tradable. English has the advantage of being, without doubt, the international language of business. However, these very advantages leave the British corporate economy open to either takeover or increasing foreign influence. So far, the net effect of this is undoubtedly beneficial, but given the current enormous strategic reserves that have been built up by the oil-producing states in the Middle East, together with the new found prosperity of China and Russia over the past five years, it does appear that foreign influence over the course of the UK economy can only increase as time goes by, with consequences that may in the long term prove uncomfortable for UK residents.

The Bank of England – ten years of operational independence

In May 1997, five days after the General Election, the new Labour Government granted the Bank of England operational independence, allowing it to set domestic interest rates, although the Government retained control of the ultimate aim of monetary policy through the setting of the domestic inflation target. In the same year, responsibilities for the gilt-edged market and financial supervision were removed from the Bank, with a transfer of the regulatory functions to the Financial Services Authority (FSA) and of responsibility for the national debt to the Debt Management Office (DMO). Over the last ten years, the Bank's performance has been a strong one. Inflation has stayed remarkably close to the official market measure and it is widely felt that the Bank has added to economic stability, although most recently we have witnessed acceleration in the measure of inflation to 3.1% in March 2007.

As its contribution to a healthy economy, the Bank has two core purposes: monetary stability, which means stable prices and confidence in the currency, and financial stability. Stable prices are defined by the Government's inflation target, which the Bank seeks to meet through the decisions on interest rates taken by the Monetary Policy Committee (MPC), explaining those decisions transparently and implementing them effectively in the money markets. As part of this work, the Bank collects substantial data and economic analysis, and the information provided by the Bank's regional agents act as an essential complement to the Office for National Statistics (ONS).

Once the MPC has set the Bank of England's official rate, the main instrument of monetary policy, the Bank implements this rate through its framework for operations in the sterling money markets, and its dealings in the foreign exchange market as part of its day-to-day management of the 'Exchange Equalisation Account', which holds the UK's foreign currency and gold reserves. These reserves may be used, subject to policy objectives, to attempt to influence the exchange rate in case of need.

Financial stability also entails detecting and reducing threats to the financial system as a whole. Such threats are detected through the Bank's surveillance and market intelligence functions, and are reduced by strengthening infrastructure and by financial and other operations, at home and abroad, including, in exceptional circumstances, by acting as the lender of last resort. The FSA is responsible for individual institutions and the Bank for the system as a whole. The Bank was directly responsible for supervising individual deposit taking institutions before 1997, although it did not supervise Building Societies (whose deposits are also included in M4 broad money).

The Bank is clear in its policy and seeks to be open in communicating its views and analysis and looks to work closely with others, including other central banks and international organisations with a view to improving the international monetary system, and with HM Treasury and the FSA, under the terms of the Memorandum of Understanding, to pursue financial stability. The Bank also aims to promote an open and internationally competitive financial centre in the UK, using its expertise to help make the UK financial system more efficient, where such efforts would be in the public interest and provided that they do not conflict with its primary responsibilities or those of other agencies.

The regulatory framework is vital, as demonstrated by the damage done by Sarbanes-Oxley – the wide-ranging financial regulations introduced in the US in 2002 following the Enron and WorldCom scandals – to New York's competitiveness and the consequent speed at which business has been lost to other markets and exchanges.

We must continue to strive for improvements in a rapidly changing system. Whether, for example, it was right to detach the DMO from the Bank's core activities, and whether we should consider restoring to the Bank responsibility for the supervision of wholesale markets and deposit-taking institutions, raises subjects for further and future debate and we will look to discuss these in upcoming editions of 'A View from the Bridge'.

Please send your views and comments on any of the articles above to Nick Rundle at:
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