Understanding the economic crisis

This is a personal perspective from Robert Leach.

It is my view that the economic crisis will be better understood if it is seen in terms of accountancy rather than economics.

A crisis happens when people stop believing in fundamental principles, and start believing that financial laws have been rewritten.

"Value of companies"

News media are fond of making statements like "£5 billion has been wiped off the value of British companies" when the Stock Market index has fallen.

This is not so. The value of British companies has not fallen at all. BP, Tesco and the thousands of other companies are worth just the same.

The value of a company can be expressed as:

value of company = net assets + goodwill.

Net assets is simply the value of everything the company owns: its land, buildings, machinery, vehicles, stock, bank balances, investments etc. From this is subtracted what the company owes to others.

Goodwill recognises that a company is worth more than its net assets. Imagine an established engineering company. It might be possible to set up a new company. You could buy premises, equipment, stock and all other assets to the same value as the established company. But they would not be worth the same.

The established company has acquired customers, built relationships, established a reputation. This has a value above the net assets. That value is called goodwill. It dates from a past century when a person would demonstrate his goodwill to a person by letting them take over his business.

For the value of a company to fall, either or both of net assets and goodwill must reduce in value. But neither has. The value of Tesco's premises and stock has not reduced in value. The goodwill from its customers has not reduced in value. The company is worth the same.

If the value of the company has not reduced, then the value of the **shares** has not reduced. The value of a share is:

value of share = value of company ÷ number of shares.

If neither the value of the company nor the number of shares has changed, then the value of the share has not changed either.

What can happen is that the **price** of the share can change.

An analogy may be a shop sale. A television selling for £500 is put in a sale for £300 because the shop wants to clear out old stock.

The *value* of the television is unchanged. It still has the same functions as before. It still has the same specification as before. It can still cost-justify its acquisition in terms of benefit provided to the customer.

The *price* has changed because of an economic circumstance that does not relate to the product or the customer.

Similarly share *prices* can change because of economic circumstances, but the underlying value is entirely unaffected.

So what does affect share prices?

Sentiment.

Markets move on what the **perceptions** of buyers and sellers. This includes what they expect to happen.

These perceptions can relate to the company. If investors believe that a company has good products, good marketing, a good reputation and a good management, its share price will rise. Investors expect that such a company will do well and so the future value will of its shares will rise.

Markets in shares are also affected, like other markets, by the law of **supply and demand.** The price of flowers always increases just before St Valentine' Day. The value of the flowers is unchanged from 13 February to 15 February, but the demand on the former day is greater.

For shares, supply and demand is often another manifestation of the perceptions factor, rather than being a separate factor. What creates or reduces the demand? Usually investor perception.

Share prices are broadly affected by two sets of factors:

- those that relate to the company
- those that relate to the economy as a whole.

Equity investors refer to these as alpha and beta risks.

If investors believe that the economy will suffer, that means that consumers and businesses have less to spend. That means reduced sales and reduced profits, leading to a reduction in goodwill, which will lead to a reduced *future* value of the share. And shares are only bought for what benefits they will provide in the future.

Often this sentiment becomes a self-fulfilling prophecy. Because businesses *believe* that bad times are coming, they take defensive actions. These actions themselves can then cause the bad times. This can lead investors to financial commentators to indulge in self-congratulation, ignoring the fact that it is always easy to predict events that you have caused.

Share prices, as measured by the FT-SE 100 index, reached a record high of 6930.2 on the last working day of 1999. This was largely buoyed by dot.com companies.

Investors started to believe that the laws of economics had been rewritten. Companies were not valued on the basis of net assets + goodwill, but by more fanciful measures such as EBITDA and mindshare. Companies that consisted of nothing more than ideas had no real value and yet were given price tags in billions.

The bubble burst, and the index fell to 3480.8 on 27 January 2003. It then climbed back up unevenly until it breached 6000 on 22 March 2006 where it remained until the economic crisis started in 2007. The index again fell below 4000, but has now climbed back to about 6000.

By 5 August 2011, the index had fallen to 5280 after dropping 9% in a week. That is a large drop but still above where they were in August 2010.

Government policy

Leadership in any sphere of life depends on retaining the confidence of those you lead.

Our belief in democracy can lead us to believe that everyone must be involved in every decision that affects us. This is not so. In most cases, people are happy to delegate most decisions to those whose judgments they trust. That is why in the 20th century, Britain had 25 general elections but only one referendum.

If people trust the government, that will move sentiment and move markets. At present, investors and commentators both at home and abroad have faith in the coalition government. In 2011, the government of Greece lost the confidence of much of its citizenry.

In short, the extent to which the people *believe* in our government (of whatever party) will largely determine how quickly the country emerges from the crisis and returns to prosperity.

Exchange rates

What causes **exchange rates** to vary? The answer is inflation.

Suppose between 2000 and 2010 country A has 10% inflation and country B has 32% inflation.

In 2000: 100 units of currency A are worth 100 units of currency B.
In 2010: 110 units of currency A are worth 132 units of currency B.

The exchange rate in 2000 is: 1 A = 1 B
The exchange rate in 2010 is: 1 A = 1.2 B

And that is it.

Exchange rates are not determined by interest rates or gold reserves. They are ultimately determined solely by inflation.

In the *short term*, exchange rates *can* be affected by interest rates and all sorts of other factors. But these are just eddies. The main stream of exchange rates reflects inflation and only inflation.

Inflation

So what causes **inflation**?

At its simplest:

inflation = wage and price increases – productivity.

And here we must go right back to basics.

Suppose a farmer produces 1000 apples that he sells for £100. By being more productive, he then manages to produce 1200 apples. He can sell these for £120. He is £20 richer, no-one is £20 poorer.

This increase in wealth is entirely caused by a commensurate increase in productivity. Wealth is the capitalisation of productivity.

But suppose he sells 1,000 apples for £120. There is no increased productivity. All that has happened is that the currency has lost value from inflation. The price of apples has risen by 20%. We are back to exchange rates but this time looking at a commodity.

old rate: 1000 apples = £100
new rate: 1000 apples = £120

The "exchange rate" has moved from

old rate: 1 apple = 10p
new rate: 1 apple = 8.3p

The currency has lost value against an unchanged commodity. That is inflation.

In other words, if we all produced 10% more, we could all be paid 10% more, and there would be no inflation.

In the short term this main stream statement can be affected by all sorts of eddies, but ultimately inflation is cured by either:

- increasing productivity, or
- reducing wages

or both.

The latter has been tried in various prices and incomes policies over the decades, and they have always failed.

The key to economic recovery and prosperity is down to productivity.

Nothing else is relevant, except to the extent that it influences productivity.

The Eurozone

To me, the only surprise about Eurozone problems is that they have taken so long to occur. The Eurozone ignores basic rules of economics.

You can only have a single currency if you have a single economy.
You can only have a single economy if you have a single government.

Many countries, including Britain, have huge disparities in productivity between regions. If Sutherland and the City of London were independent states, Sutherland would have much higher inflation. It does not because it is part of the same country. Government spending on welfare, health, education, roads and defence depends on need and not on local income.

In other words, because Sunderland and London are part of the same country, we are happy for profits to move from one region to another. Both places are part of the same nation family. Money is not lent between regions, it is given.

Greece has long been a badly run country. The disciplines of the European Union, plus generous grants, helped bring its runaway inflation under control. But the problems are tax evasion on a massive scale, retirement at 51, and low productivity. Greece is simply not comparable with Germany.

In 1950, Greece fixed the rate of the drachma at $1 = 30 dr.
On 19 June 2000, it fixed its rate €1 = 340.75 dr.
At the dollar exchange rate for that date, this is $1 = 327.8 dr.

In other words, over 50 years, the drachma lost more than 90% of its value against the dollar (which also suffered inflation).

The Eurozone countries have widely differing economies with Germany and Greece probably marking the extremes. The only way they function with one currency is to regard them as one country. This means that any “bail-out” must be a gift not a loan. If that is politically unacceptable, the countries cannot be linked by a common currency.

Another long-term solution is for countries to leave the Eurozone and use another currency. Yet another is for more powers over euro-economies to be centralised in Brussels.

Whatever happens is likely to lead to tensions between European countries. Those countries that have been industrious and prudent will resent supporting those countries that have been profligate.

Ironically, the European Union was originally established in the 1950s to make the economies of Europe so interdependent that war between them would be impossible.