The Telegraph

Lighten up – pay is rising faster than prices at last

The year has given us some pleasant surprises, says economist Roger Bootle

Average pay is rising faster than prices in the shops, and the gap between the two is set to widen Photo: ALAMY

By **Roger Bootle**

6:30PM GMT 28 Dec 2014

48 Comments

This is the time of year when we economists usually look back over the year just passed and assess our performance as forecasters.

Just as when the police force is asked to investigate itself, when economists review their own performance they tend to skate over things that other mortals might think worthy of adverse comment – while, of course, trumpeting their successes. But not me!

This time last year, I gave myself very poor marks for 2013 because I got it largely wrong. In fact, to be blunt, for me 2013 was a shocker. This year, modesty forbids me from giving you an entirely honest assessment of my own performance in 2014. Let me put it this way, events developed not entirely against the thrust of my prognostications.

In the world at large, the striking feature of the past year has been the decent economic recovery in America, contrasted with another appallingly weak performance from the eurozone, and a slowdown in the emerging markets.

Over recent years, the Chinese economy has slowed markedly, but in fact only in line with what you would have expected, given China's stage of development. In 2014, the economic growth rate fell only marginally. Widely-heard fears of a Chinese economic collapse are wholly misplaced. Indeed, I expect growth this year to be only modestly lower than last year.

And lest you should think that the Chinese slowdown means that the impact of China on the world economy is set to be smaller, let me point out that the increase in China's gross domestic product over the past year was just as large as the biggest increases in earlier years, including those when the economy was growing by 14pc.

This is simply an arithmetic point, but it is an important one. A smaller growth rate applied to a larger number can produce a bigger rise in GDP than a higher growth rate applied to a smaller number. Incidentally, the increase in Chinese GDP since the euro was created roughly corresponds to the current level of GDP in Germany and Italy combined. So methinks that the Chinese influence on the world is still pretty large, to put it mildly.

Another striking feature of the past year was the continued strong growth of the UK economy, despite this sluggish world picture, and despite our largest market on the Continent experiencing almost no growth at all. Unlike the previous year, however, although consumption did grow nicely, this expansion was not entirely a consumer affair. Corporate investment picked up strongly.

Once again, that perennial source of imbalance and danger in our economy, overseas trade, performed badly – hardly surprising when you consider that about 45pc of our exports go to a part of the world that has become a growth–free zone.

It looks as though the current account deficit in 2014 was about 5.5pc of GDP. In the third quarter alone it was running at 6pc. If the UK were an emerging market, the hedge funds would have pulled the plug on it years ago. Instead of this, people around the world have continued to view the UK as a safe haven and accordingly they have piled money into UK assets. This has meant that, despite falling against the dollar, the pound's average value has risen on the exchanges.

One of my big successes, not just this past year but over many years now, has been to foresee a prolonged period of low interest rates. This has also extended to the yields on gilt-edged securities. Since I began my career in the City decades ago, I have repeatedly shocked people by saying that the yield on bonds has little or nothing to do with the size of the government's deficit. Accordingly, it is perfectly possible to have gargantuan borrowing and for bond yields still to be low.

The reason is that the supply of government securities is only part of the story. You also have to look at the demand. And usually when the supply of new government securities is high the demand is also high.

The key for gilt yields is the level of short-term interest rates, with a considerable influence, at the longer end of the yield curve, from inflation prospects – as was proved again last year. Indeed, it was recently announced that the iconic gilt, War Loan, first issued in 1917 to fund the First World War, and refinanced in 1932, which has been the graveyard of many an investor (but more recently their salvation), would be redeemed at par (that is, £100), having been below £20 per £100 of stock in the mid-1970s.

Just to make the point again, low gilt yields in 2014 coincided with one of the year's largely unforeseen bits of bad news, namely the underperformance of the public finances. If you had told most economists (including yours truly) a year ago that the economy would grow by a solid 2.5pc, they would naturally have assumed that the government borrowing figures would come down smartly.

But this is not what has happened. For most of the year, the monthly borrowing numbers have been extremely disappointing.

We think we know the reason why, that is to say, the combination of the growth in employment being centred on low-paying jobs which don't pay much tax even in normal circumstances, with the big increase in the tax-free personal allowance, coupled with very low pay rises for the economy as a whole.

Anyway, it looks as if this problem may be gradually resolving itself. The most recent borrowing figures were better, and it is perfectly possible that pay rises will from now on pick up enough to bring the Chancellor a reasonable increase in tax receipts.

The year's other "surprises", however, were favourable. As I predicted a year ago, inflation has fallen sharply. In the past couple of months, this fall has been increased by the sharp drop in oil prices, which was one of my big calls at the end of last year. Now, at last, average pay is rising faster than prices in the shops, and the gap between the two, that is to say, the rate of increase of real pay, is set to widen.

Of all the things that did – and did not – happen last year, this was the most important, brightening up the closing, darkest, months of the year and holding out the prospect that, for most people in this country, as the days start to lengthen in the new year, so also the economic climate will brighten.

Roger Bootle is executive chairman of Capital Economics