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Employee Share Schemes And The Impact Of Inflation

David Craddock, Founder & Director, David Craddock Consultancy Services

Thursday, 23 June 2022, 15:00 GMT

A Word From Today's Chairman

Ian Harris

Managing Director

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Today's Agenda

- 15:00 – 15:05 Chairman's Introduction
- 15:05 – 15:25 Keynote Presentation – David Craddock
- 15:25 – 15:45 Question & Answer

Today’s Speaker

David Craddock

Founder & Director

David Craddock Consultancy Services

DAVID CRADDOCK CONSULTANCY SERVICES

Specialist in Employee Share Ownership and Reward Management,
Share Valuation, Management Buyouts,
Employee Ownership Trusts (EOT)
& Investment Education

Founder, Principal and Director:
David Craddock, MA(Oxon)
Consultant and Lecturer
Author of ***"Tolley's Guide to Employee Share Schemes"***

★ *Expertise and Experience* ★

A Webinar Presentation on

Employee Share Schemes And The Impact Of Inflation

for

The ESOP Centre and The FS Club

by

David Craddock, MA(Oxon)

Specialist in
Employee Share Ownership
and Reward Management,
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Thursday, 23rd June, 2022

Employee Share Schemes and the Impact of Inflation

The Cost-of-Living Crisis

The practical manifestation of the harmful effects of inflation is the cost-of-living crisis that increasingly dominates the news cycle and at the present time shows little sign of abating.

This focus from the television and radio stations in a democracy is fully justified, given the impact of inflation on everyday lives, taking the equivalent form of a regressive tax by consuming a higher proportion of the income of poorer people who are forced to make stark choices, even to the point in some cases of "eating or heating". The resort of many is to be forced either to go into hard-earned savings or to take out debt or to go into arrears, with the mental trauma that any of those responses has the propensity to create. At the extreme, the consequences can be homelessness and hospitalisation – it is that serious!

The impact of inflation is truly uneven, not only hitting low-income people worse but affecting public sector employees disproportionately worse than private sector employees to whom companies typically award higher wage rate increases than government bodies do.

By contrast to the plight of poorer people, for the wealthy, capital asset values increase with inflation and the debt taken out by the wealthy to fund capital projects reduces in value.

Furthermore, the conundrum of how to cure the UK economy from the impact of inflation is compounded by the fact that the costs of food, home energy and vehicle fuel – all absolute necessities for living – seem outside the control of government.

Employee Share Schemes and the Impact of Inflation

The Response of the Bank of England

A sure indication of concern within the Western economies came last week with the increase in interest rates, notably for the UK on 16th June 2022 with the Bank of England increasing the Bank Rate from 1% to 1.25%, presumably a response to the initiative of the US Federal Reserve the day before to increase its rate by 0.75%.

For the Bank of England, the gravity of the issue is best illustrated in the comparison between the target inflation rate as measured by the Consumer Price Index of 9%, expected to reach 11% by the autumn, and the Bank of England's own target rate of 2%, a level estimated to keep the economy buoyant and avoid the recession-inducing effects of deflation.

The assumption must be that the Bank of England with its interest rate increase is seeking to stabilise sterling in the exchange rate markets and keep the demand for sterling high to lower the cost of imports. The converse effect, though, is to increase the cost of exports, with a stifling effect on export-led growth and contributing to the fears of a recession.

Employee Share Schemes and the Impact of Inflation

The Economic Lessons of the 1970s

The inevitable question is to ask is: Are we witnessing a return to the 1970s when inflation in the UK reached 25%, with interest rates reaching 17% in valiant attempts to break the inflationary price-wage spiral? That was a time when expectations had gone out of control with trade union demands for ever-increasing wage hikes to maintain purchasing power, chasing to keep up with price increases as businesses sought to maintain profit margins.

The key in the current economic crisis, therefore, is to learn from the 1970s that expectations of further price increases must be kept under control and that requires cooperation from all decision makers at the macroeconomic level, i.e., governments, banks, employers and trade unions. If the combination of: (1) fiscal policy from the UK Government, (2) monetary policy from the Bank of England, (3) the management of industrial relations by company employers and (4) restraint from the trade unions cannot control expectations then further interest rate rises will almost certainly follow.

However, the difference from the 1970s is that the evidence indicates that the UK economy is slowing down with 0% growth projected for the 2022 year as a whole, in which case the slow- down in the economy may do the job that the massive hikes in interest rates in the 1970s were intended to do. The point is that somehow inflation has to be squeezed out of the economy.

Employee Share Schemes and the Impact of Inflation

The Dangers of Stagflation in 2022

Ultimately the danger is that inflation, if left unchecked in any given country, will reduce demand in the economy through lower purchasing power, with a consequential downward spiral of the nation's economy into recession.

The hidden danger in 2022 is that successive increases in interest rates, should that be the policy adopted by the Bank of England, may fail to reduce inflation. Why? The answer is that the conditions that have created the inflation may remain unaffected by a monetary policy that revolves around rises in interest rates. Those conditions are (1) the massive increase in the money supply to fund the Covid-19 lockdowns, (2) the food shortages through the war in Ukraine, (3) the restrictions in the supply of fossil-based fuel supplies through the resolve to combat climate change (4) the supply chain bottlenecks from China and (5) the shortage of labour arising from lifestyle changes in response to the pandemic.

The absence of any policy to address these supply-side distortions in the market combined with the rises in interest rates represents a recipe to create the conditions for stagflation,
i.e., **stag**nant growth combined with rampant in**flation**. The path away from this outcome has to be navigated carefully. The point is that even if demand is strong, the failure to address the supply-side issues contaminates the demand-side within the quest to bring demand and supply into equilibrium at a place that creates a healthy economic outcome.

Employee Share Schemes and the Impact of Inflation

The Economic Evolution from the 2000s to the Present Day

The received wisdom in the 2000s among the economist elite was that lower prices were assured through the organisation of supply from low-cost countries in relation to food supplies, pharmaceuticals, component parts, etc. and that there was ample supply of oil and gas – problem solved! However, the realization slowly dawned among the Western nations that supply chains should not be entrusted to non-democratic nations that were not natural geopolitical allies, coming to a stark conclusion in 2020 with the Covid-19 pandemic emanating from China and in 2022 with the war in Ukraine arising from the unprovoked aggression from Russia.

The process of deglobalisation has begun, though, prior to the pandemic with the trend to organise world economics into regional areas and the UK going to the extreme in this process through Brexit. What has come together at the same time now are two key factors:

1. the response to Covid-19 that has seen a massive increase in the money supply, creating excessive liquidity in the market and increased velocity of circulation of the money that has caused prices to rise through demand-pull inflation, and,
2. a contraction in the supply of goods and services from previously reliable supply sources with a reduction in productivity both at home and overseas.

The increase in the money supply in 2020/2021 has gone directly into people’s bank accounts, unlike the quantitative easing in response to the 2008 financial crisis when the newly created money went to store up the banks’ balance sheets and stayed there.

Employee Share Schemes and the Impact of Inflation

The Summary Position on the Causes of the Current Cost-of-Living Crisis in the UK

1. The printing of money through a distorted form of quantitative easing that devalues the currency at the same time as creating demand-pull inflation.
2. The reduction in the supply of energy with the impact on cost-push inflation and supply restriction that creates supply chain bottlenecks.
3. The developed historical dependence for supply on nations that are at root neither natural friends of the West nor the tradition of representative government.
4. The flooding of the US with illegal immigrants that loosens the labour market and lowers wages and, therefore, purchasing power.
5. The pursuit of the green agenda which, while a worthy and absolutely necessary pursuit, requires a balanced introduction into Western economics.
6. The lockdowns, curfews and stay-at-home orders that pay people not to work, reduce the supply of labour, contributing to demand-pull inflation at a lower level of productivity.
7. The pent-up demand during the pandemic combined with the cash build-up during the pandemic creating an unusually high demand for goods and services all at the same time.
8. The recognition that the American and Chinese economies are so large that (a) imported inflation from the US, both of the demand-pull type and the cost-push type, and (b) supply scarcity from China with consequential supply restrictions, are factors that require insulation for the UK economy that can only be achieved through developing self-sufficiency – especially in food production through the agricultural sector pharmaceuticals through UK innovation and similarly throughout the rest of the UK scientific community.

Employee Share Schemes and the Impact of Inflation

The Search for a Solution to the Present Crisis

How then can inflation be combated in 2022? Is it the case that there are only two alternatives:

Either:

For the government to allow the economy to drift into recession and use that brutal technique to eliminate the inflation out of the economic system.

Or:

For the government to reduce taxes with a view to keeping the economy operating while the issue of productivity is properly addressed, and responsibility and efficiency are re-introduced into the economic system.

The approach of reducing taxes was taken by President Ronald Reagan in the USA in the I980s while Prime Minister Margaret Thatcher pursued a similar strategy in the UK. Such an approach recognises that inflation is a symptom of a deeper malaise relating to productivity and supply and that to appeal to the motivational and incentive instincts of the human condition is the basis for navigating a path to recovery.

For the UK, the approach of reducing taxes, combined with the introduction of incentive, finds its natural ally in employee share schemes, working with its natural sister policies of profit-sharing, training and development, devolved decision-taking and a strong emphasis on purposeful goal-setting.

Employee Share Schemes and the Impact of Inflation

The Unique Features and Characteristics of Stocks and Shares

An employee share scheme links employee incentive to the growth in the share price, a concept that is predicated on the properties and characteristics that are embodied in a share, fundamentally the capacity in a market economy to capture value that is generated as a result of genuine human endeavour and purpose.

The testimony of economic history is that the shares of a company whose underlying foundations are strong will ultimately rise in value and deliver gains. How short-sighted it is, therefore, to take the view that cash holdings subject to say a permanent 9% inflation erosion represent a hedge against say a temporary 20% reduction in share values! Surely that is nonsense! Volatility at varying degrees of severity is part of the behaviour of how stocks and shares work when tossed around on stormy seas but if the ship is built of sturdy material, then it will in time once again find a safe harbour laden with new gains for those who put their faith in its mission. The way to hedge, therefore, is the other way round, i.e., a carefully chosen portfolio of stocks and shares is a hedge longer-term against how the vicissitudes of inflation seek to attack cash reserves by inflicting permanent damage on cash values.

Remember that confidence in the stocks and shares of your choice is a good reason for staying in the market and indeed also benefiting from new share investment through the wonders of pound cost averaging. Stocks and shares are like people who grow as human beings when subject to the trials and tribulations of life and ultimately are better people for the experience.

Employee Share Schemes and the Impact of Inflation

The Blueprint for the Path to Recovery for the UK Economy

The path to recovery is first to recognise that inflation is the most aggressive symptom of the deeper underlying malaise of deficiencies in productivity and supply. Very important!

The credible and meaningful approach to recovery that is consistent with how the human spirit works is to combine the following:

1. Lowering taxes with the effect of increasing private investment and releasing the growth potential in the economy.
2. Increasing wages but only in line with productivity, i.e., pay rises and business rewards only <u>after</u> productivity has been achieved and not before.

In the execution of the latter employee share schemes make their unique contribution.

This approach represents a firm alternative to the approach currently being pursued by the US Government which has embraced increased spending and higher taxation as surprisingly the solution to inflation! The present US Government does not appear to have learnt the lessons of the 1970s that it is not possible to spend your way out of inflation or to high tax an economy into growth. Such an approach denies the naturally creative human spirit the liberty required to maximize the benefits of human endeavour acting individually, as a business team and as a vibrant and growing nation.

Employee Share Schemes and the Impact of Inflation

The Unique Contribution of Employee Share Schemes on the Productivity/Pay/Prices Matrix

The unique contribution of employee share schemes is in facilitating business reward through matching wages with productivity and rewarding productivity once it has been achieved, after the evidence of the achievement and not before. Surely that is consistent with best business practice, the equivalent of invoicing once the job has been completed or invoicing on a step basis as the project work develops. In business terms, paying before the job has been done does not make any sense at all!

The point is this: (1) wages then create the demand in the economy while (2) the productivity creates the supply, and the matching occurs. The principle has to be applied at the microeconomic level of individual companies, then to be extrapolated at the macroeconomic level to the economy as a whole, and, in that context, employee share schemes assumes a role in the management of national economies.

With the wage reward as the incentive, augmented by the employee share scheme rewards, truly "The Wages of Capital" as envisaged by Louis Kelso, historically the foremost contributor to employee share scheme economics, the reward is extended for the employees to include dividends, profit share and capital gains. Furthermore, through that mechanism, the employees receive their true worth from the business. Kelso had always predicated his work on the premise that capital values rose faster than wages and, that capital values in practice required a fusion with the labour factor of production to truly flourish.

Also, by fostering good and improved industrial relations, productivity improves, the employees come into a deeper understanding of how businesses work through their employee share scheme involvement and, most importantly, they reap the rewards – "The Wages of Capital" – to pay for goods and services at prices that are commensurate with the productivity and pay outcomes.

Employee Share Schemes and the Impact of Inflation

The Unique Contribution of Employee Share Schemes to Self-Sufficiency and Self-Regulation

The renewed capacity for efficient productivity in turn enhances the capacity for self-sufficiency for companies and for national economies which is best achieved by the decentralisation of economic activity, lessening dependence on overseas economies, bringing the supply chains home, working with a tight labour market to enhance employment levels and keeping wage levels buoyant but always in line with productivity.

The traditional remedy for inflation is to reduce growth but growth is at “a slow low” at the present time so how can that approach constitute a remedy? and in any economic circumstances it is a negative debunked economic philosophy anyway. There is a better way but only if it is recognised that the key matter that needs to be addressed is productivity and its relationship with pay and prices. Inflation is a symptom and not the underlying cause of the economic predicament.

The work of Professor Martin Weitzman, author of “The Share Economy”, demonstrated that the operation of the self-regulatory mechanism of variable employee rewards through employee share ownership, potentially combined with cash profit-sharing, mitigates against fluctuating company wage bill levels over a given business cycle. The effect is to avoid the need for the government to introduce heavy stimulus through fiscal and monetary measures to recover from a trough recession, thereby curtailing inflationary pressures in the economy that would otherwise arise through either a cost-push and/or a demand-pull impact on prices.

Employee Share Schemes and the Impact of Inflation

The Immediate Impact on Employee Share Schemes for Employees and Companies

For existing discretionary employee share option schemes:

- The message to the employees is to sit tight and, provided they are confident about the underlying strengths of the company, have confidence to keep contributing, keep the vision and the dream and look forward individually and as a team to the reward.

For the existing all-employee savings-related share option scheme:

- The message for the employees is to keep contributing, if you can afford, for the same reason as for the discretionary schemes.
- The message for the companies is to keep the employee communications on coping with a downturn on the share price.

For free share employee share schemes:

- The message for the companies is to consider an escalation of free shares for their employees, potentially as profit share in shares, and as an alternative to cash, thereby preserving cash as profit margins tighten and cash is applied to putting into place alternative supply chains through either vertical integration initiatives or partnership with other UK-based third-party businesses.

Employee Share Schemes

All Best Wishes for Your Business Initiative

from David Craddock MA(Oxon)
Consultant, Lecturer, Author
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and Reward Management,
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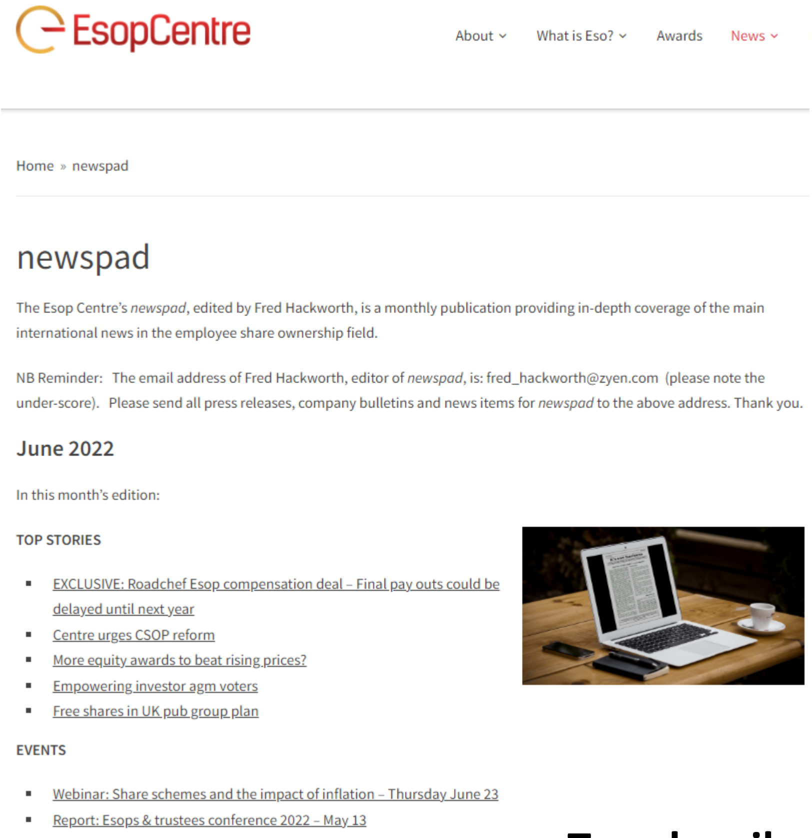
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June 2022

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EVENTS

- Webinar: Share schemes and the impact of inflation – Thursday June 23
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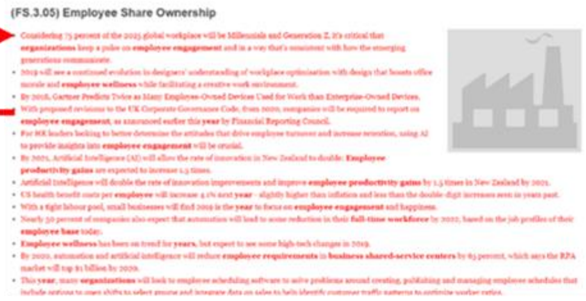

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- Wed, 29 June (10:30-11:15) The Missing Link In Sanctions Screening - i2 Intelligence Led Investigations To Really Understand Risk
- Tue, 5 July (15:00-15:45) An Update On EU Financial Services Legislation & Associated Initiatives
- Tue, 12 July (10:00-10:45) What Does It Really Mean To Be A Purpose-Driven Company?
- Tue, 19 July (16:00-16:45) When It Really Starts Raining You Need More Than An ARKK

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