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22 January 2014

Achieving a sustainable recovery: where next for business investment? - speech by Ian McCafferty

Speaking at Nottingham Business School, in light of the latest unemployment data, Ian McCafferty reaffirmed the MPC's message (which was published today in the minutes from their January meeting) that "the MPC sees no immediate need to increase interest rates, even if unemployment reaches 7% in the near future". He also repeated the message that "when the time comes to reduce the current degree of stimulus, it would be appropriate to do so only gradually".

The main theme of Ian's speech is the prospects for investment. He argues that "the conditions for a recovery in business investment are finally falling in place" but "more rapid investment growth may not show through until later this year and into 2015".

He notes that some commentators complain that we are seeing the "wrong sort of growth" – too much reliance on consumption and housing, not enough on investment and exports. But he argues that investment is often a "late cycle contributor to growth" rather than leading recovery. Indeed a recovery in household spending is a "prerequisite for a recovery in business investment". He also argues that there are "good reasons why the investment recovery might take a little longer to get going than in other more normal cycles".

Ian notes that "during the financial crisis, "businesses became more pessimistic about the future and cut their spending. They also became much more uncertain" about the future and that was "compounded in 2011-12 by the escalation of the sovereign debt crisis within the Eurozone". He suggests that "any recovery in business investment will require...a sustained decline in uncertainty. There are encouraging signs that this is now happening".

Ian acknowledges that "the dearth of bank lending has no doubt been a factor holding back business investment". But he argues that the link may "not be as direct as sometimes perceived". Very large firms, responsible, for 65% of investment, "have turned to alternative sources of finance – raising funds from public markets". The majority of firms, small and mid-size, are more reliant on banks, but they also "finance investment most heavily from internal funds". Indeed "over the last 20 years, the median listed firm without bond market access has on average generated sufficient cash from its operations in an average year to cover more than 80% of capital expenditure". Given the importance of retained earnings, the link between pension deficits and investment may be important, as suggested by a recent survey of companies with defined benefit pension schemes. But overall, Ian argues that the recovery in business confidence "may lead firms to dip into their retained profits to finance investment."

Ian believes that to date, firms have adapted a "make do and mend approach – stretching their capital utilisation by repairing aging pieces of equipment, working their existing staff more effectively and so on...”. But he notes that at the current rate of investment, “it is likely that the economy should return to a capital/output ratio consistent with full capacity working over the course of the next 12-18 months” which should “provide a further incentive to invest”. Indeed according to business surveys, “we now appear close to the point at which additional investment will be required to cope with future increases in demand.”

Ian concludes that all of these factors are “laying the ground for businesses to start investing” and that “should help to restore productivity growth….leading to higher wages and more sustainable growth in consumption” and, more generally, leading to a sustainable recovery, something to which we all aspire.