The scope for industrial expansion

*The **Deputy Governor** describes[1] the impressive way in which British industry has responded to the pressures put upon it over the last four years to emerge in a notably stronger position. Fundamental to a sustained recovery will be an expansion in investment and he charts the causes and consequences of the long-run underlying decline in investment which began well before the present recession.*

*Looking ahead at ways we may exploit the more cheerful economic environment, the **Deputy Governor** outlines the roles of government, industry and the banks. Government most of all should provide a stable environment for business to flourish and expand. The survival and prosperity of industry depends on further increases in profitability, competitiveness and investment. And the banks must continue to adapt the types of finance they provide to meet the needs of business, and to be involved in appraising projects on the basis of projected cash flow rather than balance sheet positions.*

Most people would probably agree that manufacturing industry in Britain has been through a period of great trauma. The pressures for structural change have impinged particularly sharply on the West Midlands with its heavy involvement in engineering; and the region today provides an unhappy contrast with its economic strength twenty years ago.

In relative terms, it has suffered more than most other areas from the decline over the last four years in the country's manufacturing base. About 37% of employment in the area is in manufacturing industry compared with 26% nationally. The region is still dominated by the vehicle industry which accounts for almost two-thirds of employment.

In the past, the level of unemployment in the West Midlands has been normally well below that of the country as a whole, only approaching the national average at low points in the economic cycle. But over the last three years, the rise in unemployment here has been so rapid that the level in December 1983 was, at 14.5%, significantly higher than the 12.9% recorded nationally.

Some might therefore think that a speech on the scope for industrial expansion is rather premature—even a bit tactless. But I hope I can convince you that it is not. Behind the superficially depressing figures of low output and high unemployment there lies a complex mixture not only of failures and difficulties, but of achievement and opportunity.

My aims will be threefold. First, to describe the quite remarkably effective way in which British industry has on the whole responded to the pressures put upon it to emerge in a notably stronger position. Second, and more sombrely, to chart the causes and consequences of the long-run underlying decline in investment, which began well before the present recession, but has of course been exacerbated by it. Third, I shall try to indicate some of the ways in which we may hope to build on the strengthened corporate position in the somewhat more cheerful world economic environment that now seems likely, so that an expansion in the investment that will be fundamental to a sustained recovery in the United Kingdom can be achieved.

An impressive response to economic pressures

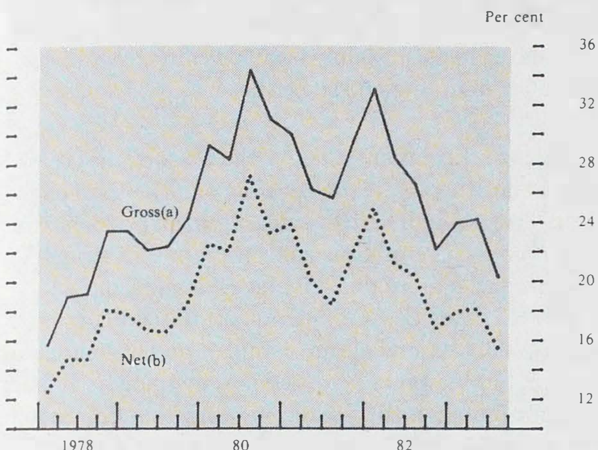
There is increasing evidence that, for many companies, the period of acute financial pressure—requiring sharp retrenchment—is coming to an end. Official statistics suggest that in 1983, profits of industrial and commercial companies (excluding North Sea operations) were as much as 25% higher than in 1982. Even more strikingly, the real rate of return improved to an average level of around 6%, representing a doubling since the worst point of the profits squeeze at the turn of 1980 and 1981.

The financial position of the company sector has of course been strengthened by this, but also by the fact that company appropriations have not risen as fast as their profits. In the first place, the rise in interest payments has been checked, thanks mainly to the decline in interest rates over the last three years. As a result, companies' income gearing—that is, the ratio of their gross interest payments to their net disposable income—has now fallen to its lowest level since 1978. In the second place, the past year or so has seen a halt to the earlier rapid growth of dividends, which had pushed earnings cover to uncomfortably low levels. In parallel with these developments, companies, especially manufacturers, have cut back on fixed investment and run down their stocks.

A consequence—and a hard-won one at that—of all these various changes on income, appropriation and expenditure accounts has been a transformation of the financial position

(1) In a lecture to the Birmingham and Midlands Institute of Bankers on 22 February.

Chart 1
Income gearing of all industrial and commercial companies



(a) Gross interest payments as a percentage of income net of stock appreciation, tax payments and profits due abroad.
(b) Net interest payments as a percentage of non-interest income net of stock appreciation, tax payments and profits due abroad.

of the corporate sector as a whole. Companies have strengthened their balance sheets substantially, adding to their holdings of financial assets and improving their liquidity.

These improvements in profitability and financial strength have, in large part, reflected companies' own efforts. For manufacturers, in particular, the rise in profits has resulted primarily from a widening of margins rather than an increase in volume. It has been achieved at a time when market conditions were especially adverse, and was the result of a prolonged and determined process of rationalisation and cost cutting. In the last year, however, other more benign influences have also been at work. Trading conditions have been eased by the pick-up in domestic demand, most notably consumer demand; and by some recovery in demand abroad, especially in the United States. So far, however, the benefits to UK industry from strengthening markets at home and abroad have been relatively modest. In response to an increase in domestic demand of 9% from the low point of the recession, UK manufacturing output has increased by less than 4%, while imports of finished manufactures have risen by as much as a third. Non-oil export volumes remained broadly static for much of the last two years, though recent trends are encouraging.

Of course, increased demand at home and abroad will only be met by British producers to the extent that they are competitive. Here again there is a story of earlier sharp pressure and set-back, followed by an impressive response. There has been a particularly welcome improvement in the area where the United Kingdom has been notoriously unsuccessful for decades: the containment of labour costs per unit of output. Over the last three years, the annual growth of earnings in manufacturing has slowed from about 13% to $9\frac{1}{2}$%. While this development has not quite matched that of our major competitors, the productivity improvements in UK manufacturing industry have far surpassed those recorded overseas: over the past three years we have achieved the impressive rate of increase in productivity of over 6% per annum. This all makes a happy contrast with the chronic tendency over the previous two decades for earnings in the United Kingdom to grow at a markedly faster rate than that of our competitors, while our productivity grew more slowly.

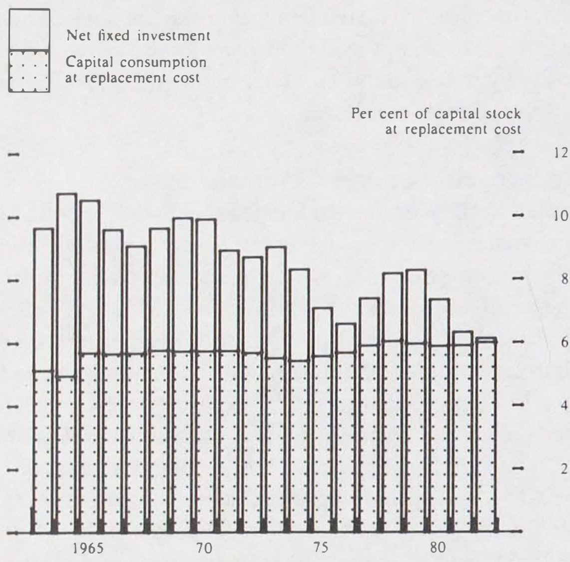
These developments, combined with the downward adjustment in the nominal exchange rate, have given rise to an improvement of about 25% in our cost competitiveness since the beginning of 1981, when the competitiveness of British manufactures reached its low point. Much of this improvement has fed through to improved price competitiveness, but a significant proportion has been used to help rebuild profit margins. British industry has reason to be satisfied with this performance though it cannot afford to rest on its laurels. Current levels of competitiveness are still markedly worse than those which prevailed in the mid-1970s, because of the sharp loss of competitiveness prior to 1981. Part of that exceptional decline was doubtless due to the impact on sterling of international recognition of the United Kingdom as a major oil producer: a once-for-all adjustment and a development obviously beyond the control of British industry. But it was not entirely a 'North Sea' effect: the contribution which the surge in domestic cost pressures between 1978 and 1980 made to the deterioration in competitiveness indicates the vigilance that companies will have to continue to exercise in respect of their unit labour costs.

The key question for British industry is whether these beneficial developments can be sustained. Can the UK economy enter a virtuous circle of higher profits, increased investment and sustained expansion? Or will increased company liquidity give rise to a vicious circle of unwarranted pay increases and other failures to control costs; higher inflation leading to tighter government policies; and a return to recession? To a large extent the answer lies with company managements, their workforces, and the trade unions who represent them. I shall return to what can be done here a little later.

Investment—why the long-run decline?

I come now to my second theme, the role of investment. It is by no means easy to establish what level of fixed investment is required to underpin sustained growth, let alone to discover and create the conditions necessary to achieve such a level of investment. It seems arguable, however, that current levels of investment are insufficient to support sustained expansion of the supply side of the economy. Net investment by non-North Sea industrial and commercial companies as a proportion of their net capital stock fell from 5% per annum in the mid-1960s, to less than 2% in the mid-1970s, and is now below 1%. Some of this decline in purchases of fixed assets by companies will have been offset by the growth of leasing of such assets in recent years. But even allowing for this, it is clear that in manufacturing industry, the decline in gross investment has been such that

Chart 2
Gross fixed investment by non-North Sea industrial and commercial companies



it no longer covers depreciation. Net investment in manufacturing has been negative for the past three years.

It seems likely that the reduced level of investment was one reason why the average rate of productivity growth in manufacturing industry fell from 3% per annum in the 1960s to $1\frac{1}{2}$% per annum in the 1970s. More recently of course there have been dramatic improvements in the level of productivity to which I have already referred. But these latest improvements have probably been achieved largely by discarding high-cost plant, shedding labour and improving working practices in existing plant. Such gains were important, necessary and in many cases overdue; but this does not alter the fact that they represent once-and-for-all improvements. Sustained productivity gains from the now smaller and more efficient industrial base are likely to require higher levels of investment. Much can be achieved through what may be described as simply replacement investment, because of the possibilities of incorporating new technology. But this is unlikely to be sufficient. We shall need to see net new investment also rising.

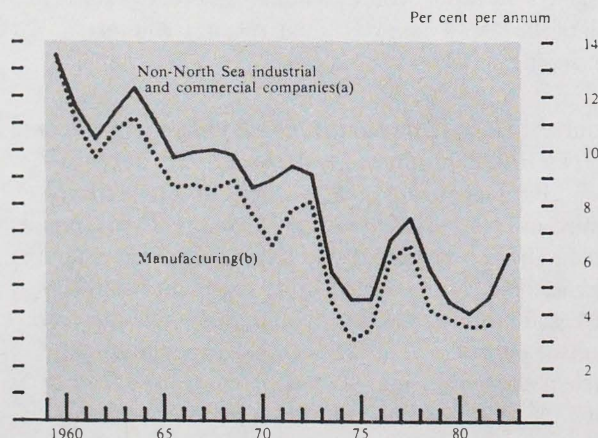
The long-term decline in the rate of investment may have reflected, in part, companies' pessimism about prospective returns relative to the cost of finance. Unfortunately, developments in both the rate of return and the cost of capital appear to have been adverse in the United Kingdom in recent decades. According to national accounts data, the pre-tax real rate of return on capital for non-North Sea industries has shown a trend decline for two decades. From above 10% in the late 1960s, it fell to about 5% in 1974–76, recovered to a little over 7% in 1978 but then fell to the extremely low levels of 1980–81 mentioned earlier.

Of course companies' decisions to invest depend more on post-tax than pre-tax profitability. For a number of reasons it is difficult properly to measure real profitability net of tax. In particular, in recent years, calculation of precise post-tax rates of return has been bedevilled by the rapid accumulation of unused tax allowances, currently estimated at over £30 billion. But the fact that allowances have been underutilised on this massive scale indicates that post-tax returns have almost certainly been lower in recent years than pre-tax figures would suggest.

If the rate of return is one blade of the scissors, the cost of capital is the other. Here too developments have probably been adverse, though here too measurement problems are severe. A comprehensive measure of the cost of capital should take account of the different types of finance available to companies. Calculations of this kind for the company sector as a whole are complex, and by their nature imprecise, but the general impression emerging from Bank of England studies is that, in recent years, the cost of capital has been significantly higher in relation to real profitability than in either the 1960s or the 1970s. Real interest rates, which offer a rather rough and ready measure of the cost of capital, show a similar picture. When account is taken of expected inflation and the underutilisation of tax relief on company interest payments, real interest rates have risen sharply since the mid-1970s and are now not far short of the levels seen in the 1960s. Set against the trend decline in real profitability over this period, the disincentive to fixed investment is unmistakable.

No doubt other factors have influenced the level of investment in the United Kingdom. In some sectors a low level of demand, associated with an underutilised capital stock, may have obviated the need for new investment. Finance will also have constrained many spending decisions: even where there appears to have been a prospect of a satisfactory return in the long run, corporate treasurers may sometimes have been reluctant to countenance long periods during which they would have to face an adverse cash flow. Before 1973, companies typically financed the bulk of their investment from internally-generated funds with only modest amounts of external finance making up the difference. But in the mid-1970s, when savings net of stock appreciation dropped sharply because of declining

Chart 3
Pre-tax real rates of return



(a) The figure for 1983 has been estimated from the first three quarters.
(b) The figure for 1983 is not yet available.

profitability and sharp increases in interest and tax payments, companies had to turn to external finance—and particularly to bank finance—on a large scale. More recently, as we have seen, companies appear to have made the protection of their financial position their highest priority, cutting back on real expenditure to do so. On present indications, this financial caution seems likely to prevail for some time ahead. Although investment intentions surveys point to some growth, company spending plans are unlikely to have much impact on the substantial cushion of liquidity that has been built up over the last year or so. This cautious behaviour is no doubt a reflection of the heavy toll taken on business confidence by the experience of the past decade.

The pressure on companies' net saving—that is to say their retained earnings available for net investment after providing for depreciation and stock appreciation—has been aggravated by a number of factors other than falling levels of profitability. Higher levels of inflation and nominal interest rates over the last two decades have increased nominal borrowing costs and worsened the front-loading effect on conventional fixed and floating rate debt. Companies' income gearing—interest payments relative to disposable income—therefore tended to deteriorate during periods of high inflation, acting as a drain on cash flow.

Faced with the increasing tendency for internal funds to be pre-empted by interest payments, firms have been caught between the desire to keep up their dividend payments in an attempt to maintain their future access to the equity market—not to mention their desire to sustain their equity price and fend off predators—and the need to retain a greater proportion of their earnings for internal use. During the profits' squeeze in the early 1980s, earnings cover for dividends fell to an all-time low in relation to profits, even when measured on a historic cost basis. In relation to profits on a current cost accounting basis, our research suggests that uncovered dividends have been even more widespread: aggregate payments in each of the three years 1980–82 were uncovered in as many as half of the twenty-four industrial sectors monitored by the Bank. After a sharp increase in dividends in 1982, earnings cover rose again in 1983 as profits recovered, but only to a level broadly in line with the previous low point in 1974. The high level of dividend payments relative to earnings in this period may in part reflect a short-term response to the removal of dividend controls in 1979. But even when allowance is made for this, it would appear that the fall in profits was not matched by a commensurate adjustment in the level of dividends.

In principle, a more generous dividend policy and greater reliance on equity finance can be regarded as a sensible response during a period of uncertainty about future inflation. The prospect of high and uncertain levels of inflation in the late 1960s and 1970s effectively curtailed the use of debentures as a means of raising long-term finance for industrial and commercial companies. Companies grew increasingly dependent on floating rate finance provided by banks but have rather naturally been reluctant to rely on this type of finance for long-term investment. For the company sector as a whole, net capital gearing—that is to say bank and debenture borrowing net of liquid assets relative to trading assets—rose in the early 1960s from 12% to around 20% (on a replacement cost basis), but has declined since to around 10%.

I think the caution of companies, and their bankers, over capital gearing has proved to be a sound judgement, even though until recently the lack of buoyancy in the equity market has meant that this approach has severely constrained investment spending. Latterly, of course, the strength of the equity market has provided an opportunity for a welcome spate of rights issues.

What then is required to build on the recent improvement in companies' profit performance and reverse the secular declines in both profitability and investment of the last two decades? We may look for contributions from three sources: from the authorities; from the companies themselves and those who work in them at every level; and last, but certainly not least, from the banking system.

What the Government can do

The main official contribution must be to provide a healthy and benign climate for business to flourish and expand. This has several aspects. Most fundamentally, the continued success of counter-inflationary policy is a pre-requisite for sustained expansion. The recent growth of consumer expenditure has been due, in considerable part, to the reduced rate of inflation and the consequential reduced need by consumers to rebuild the real value of their liquid assets. Greater price stability may also facilitate the rebirth of the domestic debenture market enabling companies to secure long-term finance and reduce their dependence on bank borrowing. In such circumstances, it might be acceptable for companies to increase their capital gearing. Lower inflation will, through lower nominal interest rates, mean that this need not imply any increase in income gearing.

The key benefit from lower inflation and greater price stability, however, should be the improved confidence with which companies can make judgements about, and plan, their investments and the related financing. In principle, it may be possible to devise financing arrangements, such as index-linking, which can overcome problems arising from inflationary conditions; but, however sophisticated the financing arrangements, price instability can still undermine firms' ability to evaluate future investments. Improved price stability should therefore help to improve the quality of firms' investments, as well as their quantity.

There are further, more indirect, ways in which an environment where prices are relatively stable, and expected to continue to be so, can benefit industry and stimulate investment. The exchange rate is more likely to be stable in such an environment. One cannot pronounce on this with great confidence. The factors which influence a country's exchange rate are so complex, and so many of

them are outside the country's own control, that even the best run economies must expect substantial fluctuations in their exchange rates unrelated to so-called 'fundamentals' from time to time. But the prospects for stability must be improved. And that must be a good thing for industry. Large swings in the United Kingdom's competitiveness, or real exchange rate, over a number of years can introduce great uncertainty into the flow of profits. This is of course particularly true of profits earned from long-term investment in plant which produces internationally traded goods.

Another, more subtle, benefit from the expectation that prices will remain more or less stable for the foreseeable future, is that companies can have more confidence that official policy will be steady and relatively predictable. One of the most insidious effects of an upsurge in inflation is the well-found expectation that develops in the private sector that sooner or later the authorities will have to take unpleasant measures to rectify the situation.

A belief in the importance for the private economy that official policies should as far as possible be stable and predictable is at the heart of current fiscal and monetary strategy. This is expressed not merely in the overwhelming priority which has been given to fighting inflation; but in the explicit belief that it is incumbent on the authorities to specify their policy objectives and to indicate in advance their likely response to deviations from their intermediate objectives. The Medium-Term Financial Strategy, with its clear exposition of future target paths or objectives for monetary aggregates and the public sector borrowing requirement, has provided this crucial role.

Although the precise paths and variables to be targeted have been subject to refinement and adaptation, it is important that the medium-term nature of government economic policy should continue to be clearly stated and understood. This creates a more certain environment over an appropriate horizon in which companies can plan more securely. In this regard the Government's proposed Green Paper on its long-term financing needs should initiate a much-needed debate on, and greater understanding of, trends in public expenditure and its financing.

There are, of course, many other things that government can do to help industry—most notably supply-side measures such as will encourage competition, labour mobility and risk-taking. But it is time to turn from what industry may expect from the authorities, to what we all may expect from industry.

The contribution of industry

The first point is a familiar one, but it has particular force at the present moment. This is the need for most firms in most industries in the United Kingdom not to rest on the welcome recovery in profits which we have recently seen but substantially to increase them further, and out of those increased profits to increase their investment. Of course there is always a case for greater distribution to shareholders to improve a company's ability to raise more finance in the future; and of course there is always a case for higher wage settlements to keep or attract essential people or to reward a loyal workforce that has been through a difficult time. But the background against which such decisions have to be taken has been set out earlier in this talk. Certainly there have been welcome improvements in cash flow, in profitability and in competitiveness; but the figures show clearly how recent these developments have been and how far they have to go to reach levels which match what should be our own proper aspirations or the levels achieved in other major countries.

If the three constituents of a typical firm, the shareholders, the management and the workforce, were to think and act as one entity it would in most cases be patently clear that the survival and prosperity of the firm depended on much further increases in profitability, competitiveness and investment. Perhaps the challenge to management, as the natural leaders, is to see that the three constituent parts recognise this basic identity of interest.

It must be admitted that until the outlook at home and abroad is more firmly assured, some firms with existing capacity still underutilised may not wish substantially to add to it. But even where this is true there are many other forms of investment expenditure which can prove cost effective—in particular all those which are directed towards improving the product in the widest possible sense: making it cheaper, work better, more cost effective; making what the market wants—or, perhaps even more important, what the market is coming to want and will increasingly be buying as the product comes off the production lines. All this can be summed up in terms of concentration on the design of the product, the word 'design' covering much more than aesthetic appeal. This is an area where British industry has often been vulnerable to criticism in the past. We have often made less than full use of our native resources of invention, ingenuity and talent, too often leaving it to foreign competitors to employ the best British designers and win British markets with their help.

In this connection the Department of Trade and Industry—and in particular Mr John Butcher, the West Midlands' own designated Minister—has been involved in running a series of seminars with the help of the Design Council. I have myself attended one of these and commend them to you. They make a fascinating, disturbing and powerful case for the cost-effectiveness of good design —something to be borne in mind not only by companies but by those who finance them.

The role of the banks

Which brings me to the banking system. What contribution can they make to turning a hard-won recovery into a steady and sustained expansion? The banking system has exercised much patience and care in nursing many companies through the difficulties of the past few years. The banks—sometimes depicted as the villains in insolvency proceedings—have perhaps not received sufficient credit for

the efforts they make to help their clients in difficulties. But we at the Bank of England who have seen much of this from very close quarters are glad to pay tribute to them. It is to be hoped that such a role will be in much less demand in the future. To help ensure this there is probably still a need for banks to develop further the ability to identify companies with problems at an earlier stage, and sometimes in co-operation with major shareholders to seek to influence the board and management of these companies to take remedial action before it is too late.

During a period when other sources of external finance have proved to be less responsive, the banks have proved to be adept at meeting companies' financing needs. They have been markedly successful at rapidly providing a high proportion of company requirements for fixed or floating rate medium-term finance, either via leasing or by direct lending. The banking system, both directly and through the eurobond market, has adapted rapidly to the changing demands for foreign currency borrowing.

Now perhaps we shall increasingly see new challenges. To a growing extent, for example, the banks are likely to find themselves called upon to finance and thus to appraise projects, both large and small, on the basis of projected cash flow rather than the balance sheet position. In an increasing number of cases, they are going to have to assess the design—in the widest sense—of the projects they are asked to finance. This will put new demands on banks, with associated shifts in the type and quality of personnel. But of course it will really represent only an extension of the fundamental principle of credit appraisal, that it is the individual or the firm or the project whose creditworthiness is being assessed—not some wider abstraction such as the industry or the region involved.

Nor will this be the only kind of change to challenge and stimulate British bankers. Technical innovation in the retail deposit market, in payments clearance and in funds transfer are also putting increasing strains on the current structure of the financial system and banking in particular. It is essential that the banks continue to welcome these innovations, and seek continually to improve and upgrade the services which they provide, particularly to business, in a rapidly evolving environment.

These are the challenges open both to industry and to the financial community. The success with which they are met by all concerned will be of the utmost importance in bringing about the sustained expansion of the UK economy which we all so earnestly wish to see and will determine, to a great extent, the future outlook.