Business in the economy

Reviewing some of the necessary conditions for continued business growth in the 1990s, the **Governor**[1] *stresses the interdependence of the various sectors of the economy, and in particular the links between the service and manufacturing sectors. Despite the move in the United Kingdom and in other industrialised countries towards high-tech and service industries, the manufacturing sector remains an important and integral part of the UK economy, with a share of total output which is similar to most of the other G7 countries. Turning to the necessary ingredients for future business growth, the* **Governor** *highlights the importance of free trade and free markets, the need for greater flexibility in the labour market, and in particular the need for innovation and technological advance to maintain productivity and profitability. The quality of investment, however, is just as important, if not more so, than the amount; rather than being artificially stimulated, investment should be undertaken in response to adequate demand for a product. In this context, the* **Governor** *argues that investment decisions, with long-term interests in mind, can only sensibly be taken within a predictable medium-term macroeconomic framework which ensures both price stability and policy stability.*

It is a very great pleasure to be here in Manchester this evening for the first of your 1992 series of Vital Topics meetings. That the forum should be provided by the Business School is particularly welcome and appropriate to what I have to say, bringing together as it does practitioners and trainers, if that is not too mundane a term for those involved in schooling our future managers and business leaders. Indeed, one of the encouraging trends of the past few years has been the increasing awareness of the importance of training, and this obviously extends to management. The growth of business schools or faculties around the country perhaps suggests that we have at long last returned to a climate where the pre-eminent importance of business and trade to our lives is recognised and acted upon. This is something on which we can unite in welcoming, and I think should not be under-estimated as one of those intangible but very positive developments which should make us confident about the longer term.

Success in business—which is obviously the basis of a prosperous economy—is not something which can ever come automatically or easily, however. It has to be worked for, and moreover requires a number of ingredients. As all of you here will be acutely aware, there has for some years been considerable debate about the underlying potential of our businesses, with varying points of view on the relative importance of the different sectors of the economy and on whether we could—should—do more on the supply side to encourage greater investment in research and development, in training and in closer relations between industry and finance. I thought I would say something about these issues this evening, as I would not want it to be thought that the central bank's main concern with the pursuit of price stability causes us to overlook these other, supply-side or micro issues, although towards the end of my remarks I shall also want to say something about the course and objectives of macroeconomic policy and its importance to the climate for investment generally.

Sectors of the economy

But perhaps I can begin with that perennial topic of debate: whether some sectors of the economy are more important than others. You will have noticed that up to now I have referred to 'business' and 'businesses', carefully avoiding terms such as 'industry', 'manufacturing', 'services' or 'commerce'. This is not just out of deference to my hosts: the point is often raised whether we should concentrate our effort in manufacturing or services—whether one is more important than the other. And I have deliberately referred to business because I do not believe that the two are mutually exclusive or that a choice has to be made.

The debate has of course been around for years, but with greater intensity over the past decade and a half. This perhaps began with the North Sea Oil boom, some of the revenues from which were in effect spent on imported investment goods and imported consumer goods, and this was indeed accompanied by some reduction in the scale of domestic manufacturing output. Now, as you will recall, some argued that manufacturing had literally been crowded out. But I do not think that is a particularly illuminating way of looking at what has happened over the past two decades and, much more importantly, it overlooks the fundamental point that our standard of living is determined not by the output of any one particular sector, but rather by the value of our total output and the terms on which we can exchange domestically produced goods and services for foreign goods and services.

(1) In the annual inaugural lecture at the Manchester Business School on 22 January 1992.

The crude facts are well enough known. Output in services—including public services—represents nearly 70% of GDP, while manufactured output represents around a quarter. Collectively, the service industries currently employ around 15 million people, which compares with manufacturing employment—excluding self-employment —of some 4½ million. During the 1980s, approaching 2½ million jobs are estimated to have been created in the private service sector, while over the same period manufacturing employment declined by around 1½ million.

But these crude figures are just that—crude. In the first place, this kind of representation cannot reflect the enormous inter-dependency of the manufacturing and service sectors. Large parts of the service sector are very obviously *directly* dependent on other industries—road hauliers, metal stockholders, maintenance contractors, advertising agencies and consultancies, even the odd banker. In fact, industrial demand counts for something like 40% of total demand for private services, which is not much less than the amount accounted for by individual customers. Indeed, the fastest growing part of the service sector in the 1980s was business services, which was in part the product of extensive contracting-out of work previously undertaken in-house by manufacturing companies, and recorded in the statistics as 'manufacturing'.

But the connections obviously go wider than this. Retailers and restauranteurs, for example, are obviously dependent on incomes provided by other parts of the economy, but equally are a source of demand for goods from industrial companies.

So I would suggest that manufacturing industry not only remains a very important part of the UK economy but is also inextricably linked with our growing services sector. And perhaps the important point is that we should concentrate on those activities where we have a comparative advantage, and that means allowing resources to be allocated efficiently through the workings of the market. If that sounds rather theoretical, perhaps I can put it in a more concrete way by suggesting that it is not too surprising that newly industrialised countries with comparatively cheap manual labour should have been taking an increasing share of worldwide manufacturing output, while the highly educated and skilled workforces of the major economies have been moving towards high-tech industries and services.

And, in fact, the contribution of manufacturing to total output in the United Kingdom is *not* out of line with the position in most other G7 countries. While it is lower here than in Japan or Germany, it is higher than in either the United States or Canada, and much the same as in France and Italy. Furthermore, *all* the industrial countries have seen major changes in the structure of their economies over the past 20 years or so, and in every case in favour of services. Here in the United Kingdom, putting the armed forces on one side, jobs provided by the services sector have over the past 20 years increased from 52% of total employment in the economy to 69%. This increase of 17 percentage points is clearly considerable but it is not at all out of line with the pattern in our European Community partners; France, Italy and Germany have seen increases of 17%, 18% and 14% respectively over the same period.

I am conscious that those most concerned about these trends often raise possible implications for our foreign trade, and of course manufactures, being typically relatively easy to transport, are especially important here. But it should not be forgotten that many services can be traded internationally, including obviously financial services, where I think it is widely accepted that we have competed successfully internationally over a very long period. But there are also other, totally unrelated areas such as tourism and even foreign students coming to British universities, for which incidentally the LSE won a Queen's Award for Exports.

Now I know very well that some might feel these points—indeed, more generally, the development of the economy over the past few decades, at least as I have described it—reflect a lack of sympathy for or empathy with manufacturing or, in plainer terms, are simply out of touch. Let me just say then on a slightly personal note that I am one who has acted as a director and chairman of industrial companies, and have been proud to do so. And I place great emphasis on our Agent's contacts with industry, and I have been keen to promote a policy whereby some high-flying Bank officials become non-executive directors of industrial companies. I have also obviously been glad to see productivity growth in the UK manufacturing sector outstrip that of our main industrialised competitors during the 1980s. Yes, we had some catching up to do, and, yes, we obviously still lag somewhere behind western Germany for example, but that is no reason to play down the improvements already secured. These are substantial. So that notwithstanding our having a smaller proportion of the work force employed in manufacturing than either western Germany or France, import penetration here is in fact very similar to western Germany and only slightly higher than France.

The ingredients of business success

The question is how we can go forward, how our businesses can prosper, how our economy can thrive and our standard of living continue to rise. The list of potential ingredients for such success would obviously be very long and if exhaustive would, as I suggested earlier, include such intangible things as our culture being supportive of enterprise and the profit-motive. But I want to pick out four things in particular:

- First, a macroeconomic framework which secures price stability and promotes *sustainable* growth.

- Second, free trade and free markets, which amongst other things means continuing to remove tax and regulatory distortions and structural obstacles to business.

- Third, greater flexibility in the labour market, which I mean to cover wage flexibility and mobility but also, as laying the basis for that, education and training so that we match skills to jobs. Perhaps I should say that I place particular emphasis here since I *do* think that greater wage flexibility is needed if the economy is to respond more smoothly to changes in monetary policy, but that is for another occasion.

- And fourth, innovation and technological advances.

I cannot discuss all of these things, but would like instead to spend a few moments on this last ingredient since it lies most within the direct power of firms themselves; it is management and the workforce which improves efficiency, product quality and standards of service. And here no one can doubt the strides made by British industry, not only in terms of the productivity growth I was describing earlier but also in the renewed reputation for quality and reliability. It is against this background that the long-term decline in Britain's share in world trade has been abated, a real achievement in the face of intensifying competition from all parts of the world.

There is, I think, a growing consensus—reflected in recent reports from the House of Lords Select Committee on Science and Technology, the CBI, the DTI's Innovation Advisory Board and the National Economic Development Corporation—a consensus that for productivity and profitability improvements to be maintained, innovation and product development will have to be high on the agenda. And I mean innovation in the broad sense of covering all advances in products, processes and services achieved through a variety of technological or other means, some of which would very obviously be management techniques and be of particular interest and concern to this School.

I stress innovation because while business expenditure on research and development rose quite considerably over the 1980s, the average amongst *large* UK firms—which amount for the lion's share of the total—is estimated by a recent study by the CBI still to fall somewhere short of our competitors in Japan and Germany. Indeed, I have heard it said that the general weight of evidence suggests that many British firms are simply being 'out-spent' by our competitors. Quite frankly, I think this puts it rather strongly and pessimistically, but there is unquestionably an issue here.

City/industry relations

Most debates about this lead, one way or another, to the thorny question of City/industry relations and, more particularly, the short-termism issue. I have to say, however, I think it is absolutely essential to avoid generalisations about the behaviour of firms or of the financial markets. Many businessmen certainly disagree with the valuation placed on their company by the stock market, and some would argue that the market fails to take account of the true long-term value of their R&D spending. But this is not universally the case. In sectors like pharmaceuticals, for example, the market does seem to accept the link between R&D and profitability. I agree that this does not happen in every other sector. But this raises questions not just about City values but also about the way companies present their strategies to their shareholders. After all, none of you would dispute that just spending money on R&D does not produce value: that depends on spending money wisely, and making the best use of the result. So any suggestion that expenditure on R&D should in some way be capitalised, regardless of its long-term value, I would regard with considerable scepticism.

The macroeconomic environment

This issue of 'short-termism'—which I believe is an unhelpful slogan—and also the question of our investment performance have to be seen in a macroeconomic context.

From the *long-term* point of view, the key thing is that investment decisions should be taken in a stable environment, by which I mean one where the general price level is stable and where economic policies are steady and set for the medium-term. The greatest inducement to short-term thinking—on the part of managers in business and similarly investors in the City—is the presence or threat of inflation and abrupt policy switches, which can quickly make nonsense of cost-benefit calculations which do not allow for them. In those circumstances, quite frankly it does make sense to plan for the short term, and given the inflationary problems of which we are still ridding ourselves, no-one should be too surprised that short-termism has at times seemed like becoming a feature of our business life. It does not need to be.

But we should be on our guard against regarding greater investment alone as the only important objective of economic policy or as a magic ingredient for economic success. Earlier, I was addressing the instinct which says 'manufacturing —good; services—bad'. We equally need to avoid falling into the trap of saying 'investment—good; consumption—bad'. The point is a very obvious one, and I hope you will forgive me for making it, but the only circumstances in which investment makes sense is where there will be adequate demand for the product.

At ground level, this means, as each of you in your business lives knows very well, making difficult and uncertain judgements about product design, quality, targetted markets and so on. It also has significance for economic policy. Since in aggregate terms investment is a derived demand, one cannot promote a successful economy by artificially stimulating investment. Rather consumption and investment have to grow together, without total demand lurching from peak to trough. This requires stability of both prices and policies, and I do believe that we have the necessary medium-term policies in place—critically, in our adherence to our ERM obligations—at last to move closer to achieving that goal.

Perhaps I could conclude on this note of optimism, and I say that in full knowledge that 1991 was a difficult year. But I hope you will agree that taking a longer-term look at our recent performance and of the fundamental improvements which are within our reach, there are indeed plenty of grounds for optimism.