Industrial investment—can the market respond?

Howard Davies, the ***Deputy Governor*** *discusses*[(1)] *the United Kingdom's investment record. He argues that the single most important factor behind the low level of investment relative to other industrialised nations has been macroeconomic instability. He points out that investment has been slow to recover in this upturn, but that the conditions are now in place for a possible pick-up this year. He argues that although businesses do not face a generalised shortage of finance, gaps remain; particularly for technology-based growth companies and for Private Finance Initiative projects.*

The NAPF is run, it would seem, by earnest folk who take a delight in setting their guests difficult examination questions as subjects for their conference contributions.

But in fact the precise examination question set does not seem to me to be particularly taxing. It is more key stage three than doctoral dissertation standard. Because I think it is clear that the market can respond to such demands as industrial companies may make on it in support of their investment intentions now and in the likely future. So those of you who came along in search of a yes/no answer can have it—yes.

But for those who do not have another pressing engagement, I would like to extend my brief a little, and to try to answer a few related questions, which might perhaps be a little more taxing.

First, what has been happening to investment in this recovery? Are there any signs that the United Kingdom is beginning to devote a larger proportion of GDP to investment, or has investment been disappointingly weak?

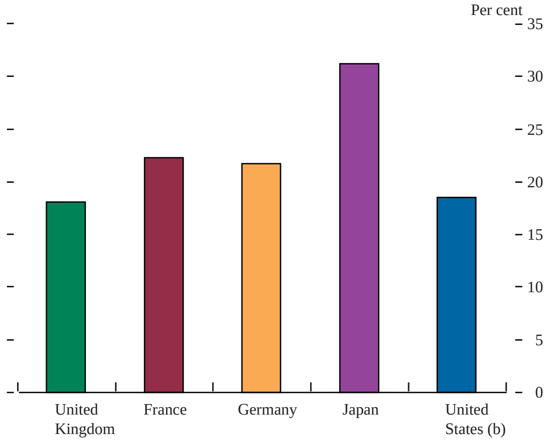
The next questions rather give the game away on the first, because they are: 'why has investment growth not been stronger in this recovery, indeed why has it been significantly weaker than in the early 1980s?'.

What can we expect from now on? Will investment pick up in 1996 and 1997? What do recent trends in the financing of industrial and commercial companies tell us? Are financial markets performing well in support of industrial investment? Are there market failures we should try to correct?

These are the questions with which the Bank of England's economists wrestle from day to day in their lonely garrets above Threadneedle Street.

The United Kingdom's overall investment record is depressingly familiar (Chart 1). Over a lengthy period we have invested a lower proportion of GDP than our main industrial competitors. Over the last 30 years the UK average is around 18% versus 22% for France and Germany and around 30% for Japan. Even the US share of investment has been slightly higher than the United Kingdom's.

Chart 1
Comparison of the United Kingdom with other major industrial nations 1965–94: total investment[(a)] as a proportion of GDP



(a) Current prices.
(b) 1965–93.

This poor investment record is associated with a lower trend growth rate, though the correlation is not simple and the direction of causation is not entirely clear.

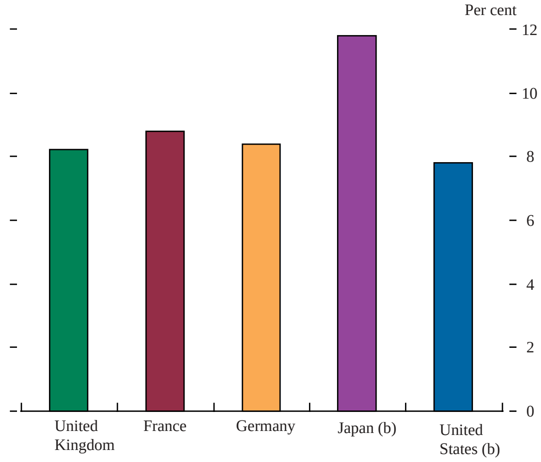
It is common ground that we would like to increase this investment share of GDP. But of course it would only be sensible to do so if we could ensure that the investment generated was productive. And some of the measures advocated to boost investment, associated with tax concessions of various kinds, would not necessarily achieve that happy outcome.

And it is also, of course, vital to look at the composition of investment, to identify the areas in which this shortfall has occurred. There one can see that in recent years much of the difference between Britain and the other comparable

(1) In a speech to the annual conference of the National Association of Pension Funds on 21 February.

western economies over a long period has been found in the lower share of dwellings and non-housing construction, rather than of investment in plant and machinery, where our expenditure has been roughly on a par with Germany and France, and slightly above the United States (Chart 2).

Chart 2
Comparison of the United Kingdom with other major industrial nations 1970–94: machinery and equipment(a) as a proportion of GDP



(a) Current prices.
(b) 1970–93.

What are the reasons for this weaker overall investment performance in the United Kingdom? Probably the single most important factor behind it has been the United Kingdom's relative instability in macroeconomic terms. We have had a more volatile growth rate and a more volatile inflation rate than many of our major competitors. That volatility is difficult to manage for industrial companies, particularly those with lumpy investment demands, where the business cycle they face amplifies movements in the economy as a whole. It tends to depress all long-term investment, whether by the private or public sectors. Indeed public sector investment can be especially vulnerable, given the impact of downturns on the government's finances. Cutting back on investment projects is one of the easier options when money is tight.

So, in our view, the single most important remedy for an investment deficit is price stability. We believe we are making good progress in that direction. We are now entering our fourth year of inflation in very low single figures, and the Bank's *Inflation Report* published last week shows that we expect to drop down within the Government's target of 2.5% or less during the course of this year. The central projection is that we remain below 2.5% in 1997, too. Of course there are risks around that central projection. But the inflation prospect is as good now as it has been for decades.

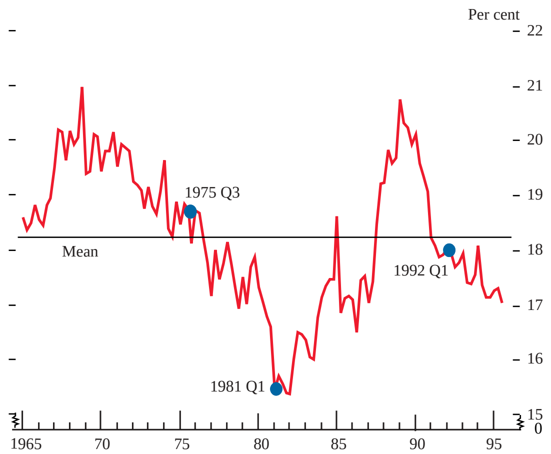
Price instability affects investment in a number of ways. Volatile nominal interest rates conceal the real rates available to savers, tending to reduce domestic saving, a decisive influence on investment. The Bank has argued, too, that British companies may have looked for higher returns than companies in other developed countries—using higher hurdle rates to screen investment projects. And research I commissioned at the CBI—with the aim of disproving the Bank's contention—tended unfortunately to support it. Many firms have not yet been persuaded to lower their nominal hurdle rates.

But rather than allowing myself to be diverted into sluggish tributaries of the short-termism debate, let us look instead at what has happened recently. Are there any signs that, against this more stable price background, investment is recovering?

Sadly, no. Indeed the bald figures would suggest that investment growth has been considerably weaker in this recovery than it was a decade ago. In the first three years of the 1980s recovery investment grew by almost 20% more than in the first three years of this upturn. But there are special factors to consider, which may cause us to be less depressed by that conclusion than we might be.

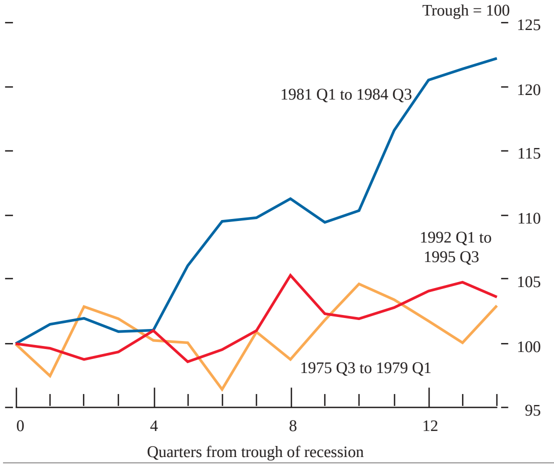
The first point to make is that, in the last recession, whole economy investment did not fall as far or as fast as it did in the early 1980s (Chart 3). In the trough of the most recent recession, in the first quarter of 1992, investment as a percentage of GDP was 18%, very close to the long-term average, while in the first quarter of 1981 it was only 15.5% of GDP. So it is arguable that investment had more ground to make up in the early 1980s than in the 1990s and 1970s, and therefore recovered more strongly as a result (Chart 4).

Chart 3
Investment as a proportion of GDP at constant prices



Another plausible explanation as to why investment has grown slowly in this recovery relates to capacity. The investment boom of the late 1980s added greatly to industrial capacity. The early 1990s recession was deep and prolonged and as a result created large amounts of spare capacity. That was particularly the case in the service sector where output contracted in 1991 and 1992, the only recorded fall in service output in two consecutive years since the 1940s.

Chart 4
Investment in three recoveries



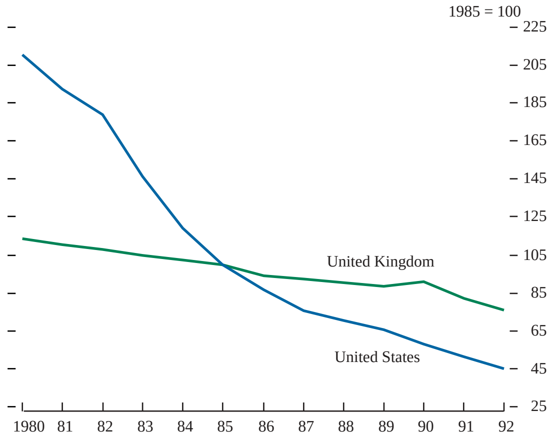
It may be, too, that the structure of companies' balance sheets at the beginning of the 1990s temporarily held investment back. The investment and takeover boom at the end of the 1980s led to heavy borrowing by companies, mainly from the banks, leaving many with high levels of debt on their balance sheets. It is not surprising, therefore, that companies have used rising incomes in the recovery to reduce their bank borrowings. That trend was very visible, at least until 1995. Net repayments of bank borrowings from 1991 to 1994 were equivalent to 10% of fixed investment over the same period and those years were the only ones in which companies made net repayments to the banking sector, over the last three decades.

These factors go some way towards explaining the profile of investment in the last few years. But two other factors are also worth consideration. One applies particularly to industrial investment in plant and machinery; the other to construction.

Measuring industrial investment and, in particular, adjusting for improvements in quality over time, has always been difficult. Data series which seem straightforward have always embodied within them judgements about changing prices and quality improvements.

And there is some evidence that the uncertainty inherent in all measurement of investment has been even greater than usual in the recent past. One particular reason relates to the prices of computers and other IT equipment. International comparisons suggest that UK statisticians have made less allowance than their counterparts in the United States, for example, for improvements in the quality of computers. The recorded fall in computer prices, used as the basis for assessing the quantity of IT investment, is much greater in the United States than it is in the United Kingdom (Chart 5). Expenditure on computers and related equipment has become more important to industry over the last decade. It is therefore quite possible that a conservative approach to quality adjustment in the United Kingdom has led to some underrecording of constant price investment in plant and machinery.

Chart 5
Price indices for office and computer machinery

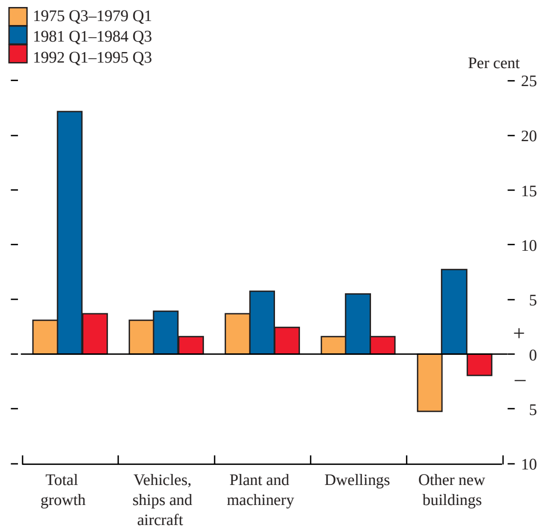


Source: *OECD Information Technology Outlook 1994.*

Indeed, if we were simply to apply the US price assumptions to UK data, we could produce quite a different picture for the growth of investment in the last four years.

Just how much better the investment profile would look is a matter of conjecture. To make accurate estimates we would need to know more about the composition of investment expenditure in the United Kingdom, which may be somewhat less biased towards information technology equipment than it is in the United States. But the impact could be considerable.

Chart 6
Asset contribution to total investment growth



The last point I would like to make about the recent investment record concerns investment in buildings. Comparing the last recovery and this in asset terms (Chart 6) shows that the biggest difference in investment this time has been seen in buildings, even though vehicles, ships and aircraft, and plant and machinery have, if we can believe the price bases, been relatively weak too. And within the construction sector it is apparent that non-residential building has not picked up at all (Chart 7).

Chart 7
Non-residential constant price building investment as a proportion of GDP

One special factor has been the performance of government construction investment. In the current upturn, expenditure has been temporarily depressed by the Private Finance Initiative. The Government's plans for publicly funded investment to be replaced by privately financed and managed projects have been over-optimistic. While there are welcome signs that the flow of new privately financed investment projects in the public sector may be increasing now, the Initiative has taken some considerable time to get moving. Construction companies have not been reticent in making that point to us, and no doubt to the Treasury.

Putting all this together, how concerned should we be about the performance of investment in this recovery? My conclusion is that the figures do not at this stage justify an argument that we have moved on to a lower investment path. While we, and most other forecasters, had expected a stronger performance, there are many plausible reasons to explain why that did not occur. On the other hand, we are, unfortunately, far from being able to argue that our long-term trend has improved.

But what of the prospect looking forward?

There are some optimistic signs. CBI survey evidence suggests that investment intentions remain strong. Though the January survey showed that the balance of companies planning to invest more in the next year has slipped back a little, it remains significantly above its long-run average.

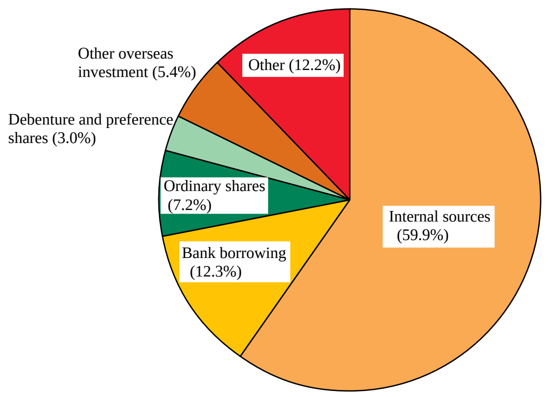
And bank and building society lending to the corporate sector has been growing strongly. Part of that borrowing may be related to investment in fixed capital. Nominal investment expenditure by industrial and commercial companies increased in 1995 and by the third quarter was almost 8% higher than a year earlier.

But a considerable part of this increased lending to business is certainly associated with more takeover activity, which expanded very sharply in 1995, as you know well. These indications, the investment intentions and the scale of new borrowing lead us to expect a pick-up in investment this year and next, though perhaps not on the scale which we were looking for last summer. That reflects a less optimistic view of output growth and a judgment that construction related investment, in both the private and public sectors, will remain relatively weak.

Against that background, as I said at the start, the answer to the specific question posed seems straightforward. We are not predicting a rapid pick-up in investment overall such as to threaten the capacity of the market to finance it.

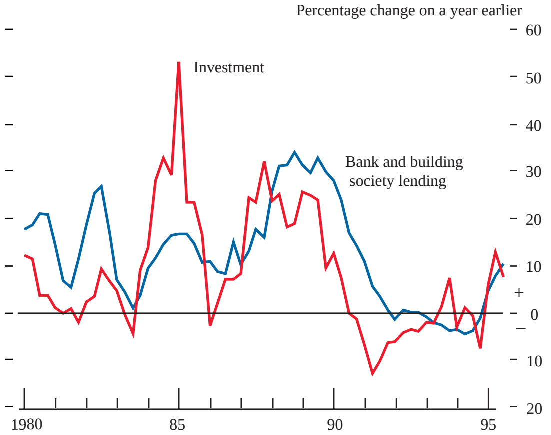
But it is nonetheless worth looking briefly at the way in which companies are currently financing investment to try to identify any particular problem areas. The first point to note is that internal funds provide most of the financing needs of industrial and commercial companies (Chart 8), typically around 60%, with the balance coming from banks and other financial institutions, and from the stock market.

Chart 8
Sources of finance for UK industrial and commercial companies



But while that is the case for ICCs' financing needs overall, investment expenditure does nonetheless seem to be quite closely related to bank lending. There is a reasonably tight correlation between the amount of bank lending to

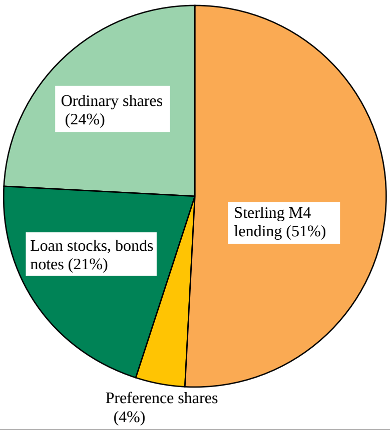
Chart 9
Growth in bank and building society borrowing and nominal investment expenditure by ICCs



Sources: CSO and Bank of England.

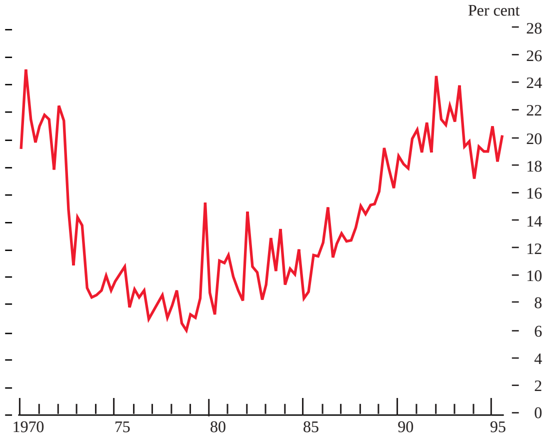
companies, and the volume of their investment, over quite a lengthy period (Chart 9). But the process to which I referred earlier, whereby companies used strong internal fund generation in the early 1990s, to pay back bank debt, is evident here, and only in 1995 did companies once again begin to look to the banks for finance on a large scale (Chart 10).

Chart 10
ICCs' financial position for 1995



At the same time, companies' dividend payouts have remained at a high level (Chart 11), but there is little sign that these payouts are imposing any strain on corporate balance sheets.

Chart 11
Dividend payout ratio(a)



(a) ICCs' dividends on ordinary and preference shares divided by ICCs' total income less ICCs' UK taxes on income.

This overall picture, demonstrating that there is no systematic shortage of funds for corporate investment, should not, however, cause us to think that the market is operating perfectly. We remain aware of many concerns among smaller firms, particularly high technology startups, about their difficulties in raising finance, notably venture capital. We are now looking at the needs of those companies, trying to assess whether there is a market failure and, if so, how it might be corrected.

There have been some encouraging trends in the small firms sector recently, with reduced reliance on overdraft finance, and more use of term loans. But these medium-term financings tend to be at the shorter end, up to three years. And longer maturities are accessed primarily by the very largest companies through the euro bond markets. The United Kingdom still lacks a high yield bond market, which could be particularly appropriate for technology-based companies, and perhaps for Private Finance Initiative projects, too.

That is another area in which we would like to see innovation. We have seen one PFI-oriented fund launched recently. It would be good to think that more would follow. At the moment, the main route to financing PFI projects is through the contractor or consortium, rather than the project itself. That introduces another element of risk—the cohesiveness of the consortium and the stamina of its members. Perhaps we should be looking of ways to finance the project itself, through an operating company raising its own finance. If that is to happen, then we shall need a secondary market in the financial assets of those projects. It may be that we need new instruments, perhaps in convertible form, which can reflect the varying risks and returns at different stages in a project's lifecycle and offer strategic options to an investor exercisable over time to help balance an institutional portfolio.

Let me briefly summarise the state of our thinking, which I have tried—somewhat discursively—to sketch out for you today.

First, this recovery has been characterised by weak capital expenditure, particularly non-residential building.

But second, we should recognise that investment was at a higher level in the last trough than it was in the early 1980s recession. As a result, investment had less ground to recover in the 1990s.

Third, there are some other plausible explanations for slow investment growth—an overhang of capacity from the boom in investment in the late 1980s, continued uncertainty (though declining) about growth and inflation reflected in high hurdle rates, and a continued process of corporate financial restructuring as companies paid back bank borrowing which they saw as uncomfortably high.

Fourth, there is a reasonable case for saying that investment growth might be underestimated by our present methods of calculation. IT prices adjusted for quality improvements may be falling more quickly than the CSO now estimate.

Fifth, businesses do not seem to face a shortage of overall finance. Internally generated funds are buoyant. Real interest rates have fallen and equity prices have strengthened considerably, some evidence that growth in supply has outstripped demand.

Sixth, and lastly, there nonetheless remain financing gaps, particularly for high technology-based growth companies, and for PFI projects. Those are subjects which we shall be investigating further over the next year, and where we would hope to see increasing innovation.