BANK OF ENGLAND

Speech

The Puzzle of UK Business Investment

Speech given by

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At the University of the West of England

26 September 2006

I am grateful to Lavan Mahadeva, Jumana Saleheen, Chris Shadforth and Nicola Dufty for their help in preparing this speech. I would also like to thank Kate Barker, Charlie Bean, Martin Brooke, Andrew Holder, and Andrew Wardlow for their helpful comments.

Vice Chancellor, Ladies and Gentlemen, it is a great pleasure to be speaking to you this evening at the University of the West of England.

The Bank's connection with this region has been a long one. Our Agents have been working here since 1827, when the Bank first established a role in the regions to distribute banknotes and gather intelligence about business and economic conditions.

A great deal has changed in Bristol and its economy since then. But we retain close links with the area. Our Agent, Kevin Butler, and his deputy, Geoff Harding, meet up to 100 contacts a month in order to chart economic developments in the South West. I know many of you are involved in that process and I assure you that the insights you and others provide are an important part of the MPC's monthly deliberations on interest rates. Thank you for your help.

I want to talk today about the current state of our economy and in particular to discuss the puzzle of British investment.

The two are of course related. Investment is an important component of demand on our economy’s resources, accounting for about a fifth of total demand. But it is also an important determinant of supply. Investment adds to the capital stock which determines how much we can produce. Provided it is well directed, the more we invest, the faster output can grow without putting upwards pressure on inflation.

As far back as I can recall, governments and commentators have been concerned by the relatively low level of investment in the United Kingdom. The 1960’s National Plan was designed to raise it; all the parties in the fractious 1970s, when I started work in the Treasury, saw it as a major drag on our growth and a reason for our lagging behind our competitors in America and Europe. While the context has changed since then, low investment remains a concern to this day. For example, in its most recent report on competitiveness, the DTI concluded that "the UK still has low levels of business investment, which hinders productivity and growth".[1] Chart 1 shows how investment rates for the UK have tended to be below those in the US, France, Germany and Japan over recent years. Chart 2 shows how this is reflected in a lower ratio of capital to output in the UK.

Chart 3 shows very clearly the booms and busts of the early 80s and early 90s. Twice business investment seemed to take off only to collapse again as economic policy tightened. More recently, in the late 1990s investment increased very sharply, especially in IT and communications equipment. This was the time of the Dotcom boom and fears about the millennium bug. When the boom burst and the millennium passed without disaster, investment fell back in many countries, including the United Kingdom.

In the 1970s and 1980s, of course, it was natural to attribute the low levels of investment in the United Kingdom, at least in part, to instability in the economy. With big fluctuations in inflation, interest rates, exchange rates and growth, it did not seem surprising that businesses were wary of investing heavily in long term capacity. Alongside microeconomic policies to encourage investment, governments in those decades all wished to establish a stable pattern of growth and inflation which would give business the confidence to invest.

And that brings me to the puzzle. Since 1992, when an explicit target for inflation was introduced, the economy has been much less turbulent (Chart 4). To anyone, like me, who lived through the booms and busts of the previous decades, this remarkable stability and steady growth

[1] Page 15 of DTI 'UK productivity and competitiveness indicators 2006'.

has looked like a golden age. In the last three years, with the UK having suffered less than most economies from the post millennium hangover, we have been benefiting from the strong recovery in the world economy. Yet in 2005, business spending on investment in the UK was at its lowest relative to whole economy income since 1965, when official data were first collected[2] (Chart 5). So what is going on?

As usual in economics, a number of explanations have been put forward – first of course the figures may be misleading, second companies may be facing financial constraints or finding that investment isn't profitable enough in the UK, and third the rapid globalisation of the world's economy may be channelling investment elsewhere.

Measurement issues

There are a number of measurement problems and official data almost certainly are understating actual spending on investment. In the summer the investment figures for past years were revised up and it would be no surprise if there were further revisions to come. Second, the official figures largely cover so-called tangible items, from the construction of factories, offices or shops to the purchase of vehicles, computers and telecoms equipment. It includes only some spending on intangibles and even those, notably software, are known to be under-recorded. Other countries face similar measurement difficulties of course but to the extent that the UK economy has a high service share in GDP, this factor may help to explain some of the gap.

I might add that the investment figures do not cover research and development or expenditure on re-engineering business processes or investment in human capital, like staff training. But again this is true internationally and I don't think there is evidence that we are investing unusually

[2] The original published version of the speech referred to 1967, which is when volumes data were first available. Values data have been available from the ONS since 1965.

heavily in these areas – in fact management failures and poor skills and training are sometimes cited as explanations of the low rate of investment.

Lastly, we need to look not just at what is spent on investment in cash but what it buys. The price of many investment goods has been falling (Chart 6), so companies have been getting more for their money. In particular, each new generation of IT is far more powerful than the last but it is cheaper too. In other words, businesses in the United Kingdom have been keeping up the volume of investment, but because of price falls, they haven't had to spend so much.

But if the real level of investment has been higher than it appears in the UK, other countries too have benefited from the global fall in the prices of capital goods. Indeed you might have expected a fall in the relative cost of capital goods to lead to a larger increase in the volume of investment.

So while the official figures may understate our level of investment, it seems unlikely that the difficulties in measuring investment fully account for the relatively low rate of investment in the UK.

Corporate finances and profitability

A second possible solution to our puzzle could be that either corporate finances have been constrained or returns on investment have been inadequate.

Certainly the surge in investment in the late 1990s was funded in part by a sharp rise in corporate debt which rose to record levels relative to corporate valuations. But since then, the corporate sector has held spending in check, relative to profits. So by 2004, non financial corporations enjoyed the largest financial surplus relative to GDP since 1969, and high surpluses have continued since then (Chart 7).

One recent concern is that funds may have been diverted from investment to finance pension fund deficits. In 2005, companies made one-off payments of almost £11 billion to reduce pension deficits, five times more than payments in 2001. In a recent survey of Bank contacts conducted by our Agents, we found little evidence of that in aggregate, although a fifth of small firms expected there to be some impact on their investment plans. Moreover the strong overall corporate financial position and the ready availability of lending should mean that one-off cash flow pressures should not prevent the financing of productive investment. There is no shortage of cash available to companies at the moment. Indeed the cost of borrowing has rarely been lower.

One of the most striking features of the world economy in recent years has been the very low rates of interest both in real and nominal terms. I don't just mean short-term interest rates, but also long-term bond yields. Some, including the Chairman of the Federal Reserve, Ben Bernanke[3], have attributed that to a global savings "glut", which should stimulate investment. But others, including the IMF[4], suggest low interest rates actually reflect a lack of investment opportunities across the world.[5]

So is the problem on the other side of the calculation – namely that UK investments do not offer a high enough return? The evidence here is that, if anything, the achieved rate of return on

[3] Bernanke, B (2005) 'The global savings glut and the US current account deficit' *Remarks at the Homer Jones lecture, St Loius Missouri.*

[4] IMF (2005) 'Global imbalances: a saving and investment perspective' *Chapter 2 of the World Economic Outlook.*

[5] Of course the imbalances appear at different levels in different economies – our savings rate is currently 15% and investment 17%; compare that with China where investment is around 40% and savings – mainly by households - is several points higher.

investments in the United Kingdom has tended to be higher than in other advanced countries.[6] That might indicate that the financial hurdle rate for UK investments has been higher than in some other countries, which has choked off some investment. However, as the financial market becomes increasingly global, I would expect any differences in national, risk adjusted hurdle rates to disappear. As I have said, in recent years, it is not obvious that UK investment has been depressed by a shortage of available funds.

Globalisation

Finally could globalisation have been depressing UK investment? We frequently hear from large businesses that they are rebalancing their investment programmes not just to take advantage of lower costs abroad but to get closer to the strong growing economies in South East Asia and elsewhere. And UK companies and investors do tend to be particularly outward looking. Certainly, relative to other large advanced economies, the United Kingdom has a disproportionately large stock of overseas investments.[7]

But we should bear in mind that globalisation has also created very lucrative opportunities in the UK. Despite increased outsourcing of production, more people are employed in the UK economy than ever before and some of our sectors – finance for example – have been expanding rapidly as markets have become genuinely global. It is true that as a result of competitive pressure, the manufacturing sector has continued to decline, relative to other sectors. But the service sector has been thriving. It is often suggested that business investment will be depressed as we move out of manufacturing and towards services. But that assumes that manufacturing is more capital intensive than the service sector and the facts do not bear that out (Chart 8).

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[6] Citron, L and Walton, R, (2002) 'International comparisons of company profitability' *ONS Economic Trends, No 587, October 2002*

[7] See for example, the statistics supplied by the United Nations Conference on Trade and development, (http://www.unctad.org/Templates/Page.asp?intItemID=3277&lang=1) which shows that the UK stock of FDI was equivalent to 65% of GDP in 2004, compared to an average of 27% for all developed economies.

Globalisation has also been a strong force driving inward investment in the UK. You may have read that in 2005 we received more inward investment than any other country, including China or the United States. Now our position was flattered by the inclusion of purchases of UK companies by foreign companies and in the 2005 figures by the restructuring of Shell. Nonetheless we were indeed the location for many greenfield investments.

Conclusions on investment

I confess I remain puzzled. The macro environment has never been more stable. Companies have been achieving high rates of return on their investments in the United Kingdom, and finance is readily available. For some years the UK has had a low capital stock per worker relative to most similar economies and – in a truly global market – we might expect that gap to narrow. It is difficult not to think that opportunities are there and in time we will see the long awaited sustained recovery in investment.

Monetary policy

It is against that background that we have had an upturn in investment in the first half of this year. Could that be the start of a long term increase? And what implications does that have for monetary policy?

First, while investment offers the prospect of greater prosperity tomorrow, it is one source of pressure on demand for resources today. So if we are to find room for more investment without putting too much pressure on resources we will need to see a rebalancing of demand. On the MPC we have only one instrument so we have to focus on the overall pressure of demand; we cannot determine the balance between consumption and investment however desirable that may be. The best we can do is to aim to keep inflation stable. In doing so we can reduce uncertainty among decision makers in industry and services and allow them to focus on the big decisions they need to make, without being misled by sharp changes in prices.

The stronger growth of investment in the first half of the year was one of the factors behind the MPC's decision to raise the Bank Rate by 25 basis points to 4.75%. I voted for that increase for two main reasons. First, the accumulating news through the summer showed that the UK's recovery from the downturn in 2005 was well established and the doubts about that recovery had been allayed. Second, with CPI inflation above target and with signs of inflation expectations creeping up, I thought it was a good time to send a signal of our determination to bring inflation back to target well in advance of the coming pay round.

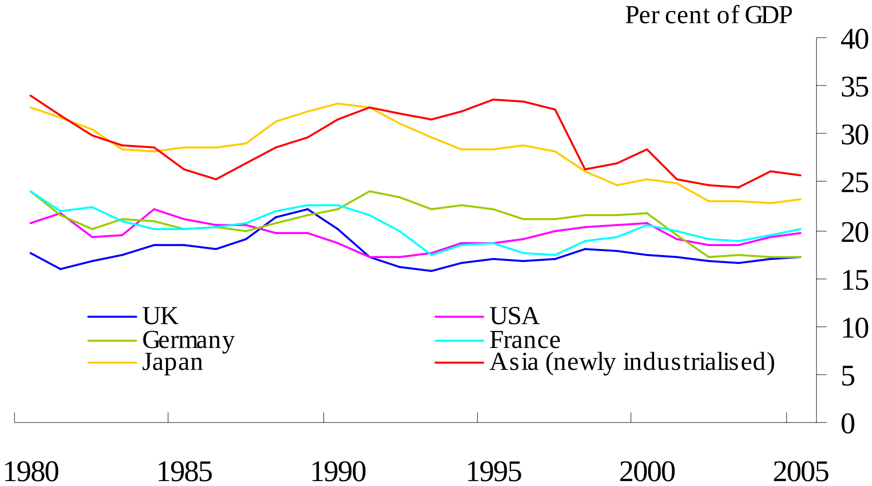
As to the future, the central projection of inflation that we published in August showed it rising at the end of this year and falling back to target by 2008, assuming that interest rates pick up to 5%. Most commentators are expecting us to raise rates again – probably in November, the next month we revise our forecast.

But in practice the real world rarely does follow the central forecast precisely. There are many uncertainties in the outlook – from the strength of the US economy as the housing market turns down, to the future of oil prices, or at home, how the growth in the labour force will affect wages and unemployment, and – as I have been discussing today – whether the recent upturn in investment will persist. We will learn a little more on all these issues in the coming weeks and months.

That is why, as Mervyn King has explained, the MPC makes its decisions one month at a time and is therefore very wary of giving forecasts of our own future behaviour.

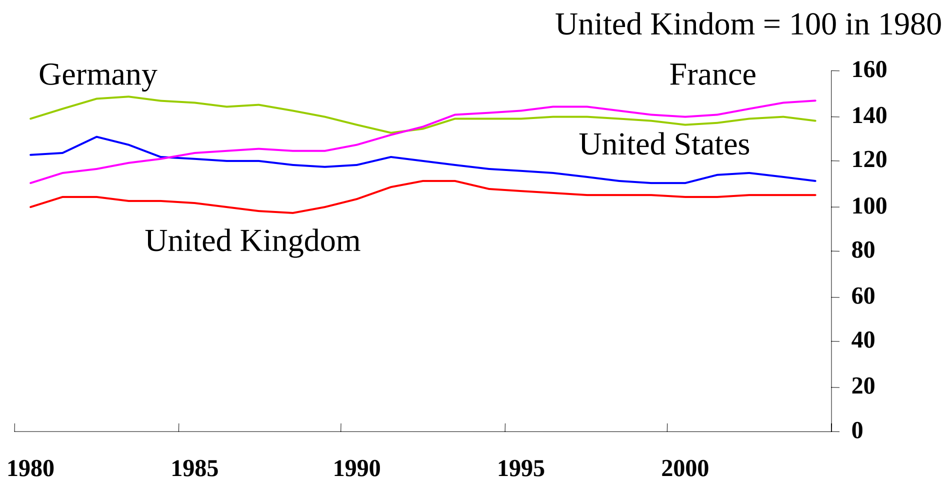
What we can commit to is doing whatever we can to maintain the remarkable period of economic stability since inflation targeting was first adopted and to keep inflation low and close to 2%. That is what we can do to provide an environment in which businesses will have confidence to invest where they believe it will bring a return.

Chart 1:
Whole economy investment in different countries (nominal)



Source: IMF, September 2006 WEO

Chart 2: Capital Stock / GDP ratio (2002 prices)



Source: Groningen University Growth and Development Centre data set

Chart 3:
UK Business investment and GDP (chained volume measures)

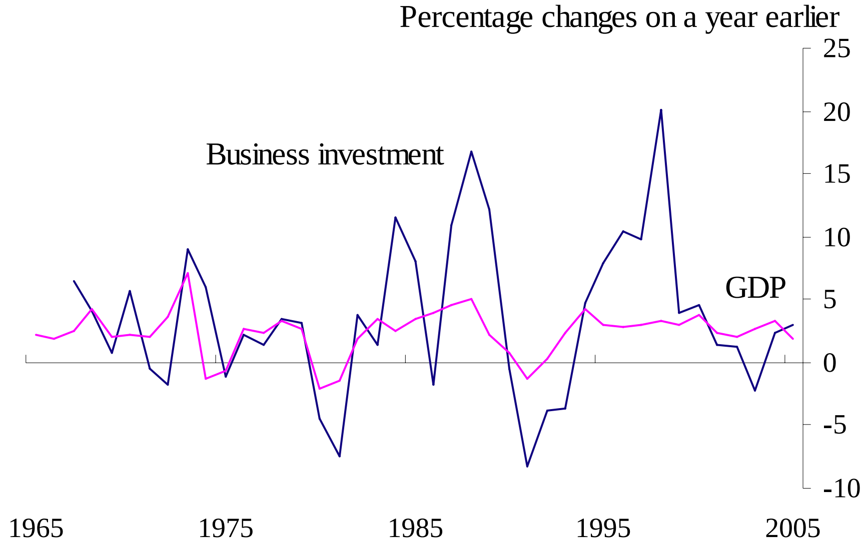
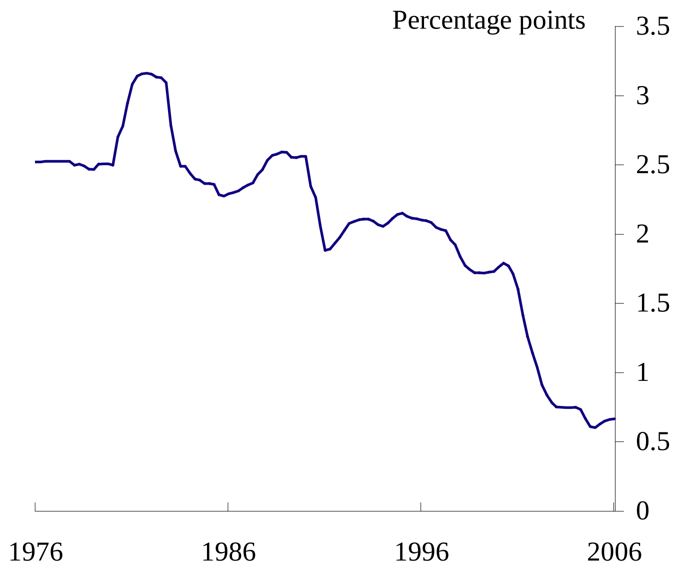


Chart 4:
Macroeconomic Volatility in the UK (1976 – 2006)



Rolling 10-year standard deviations of UK GDP growth
Sources: ONS and Bank of England

Chart 5:
UK Business investment

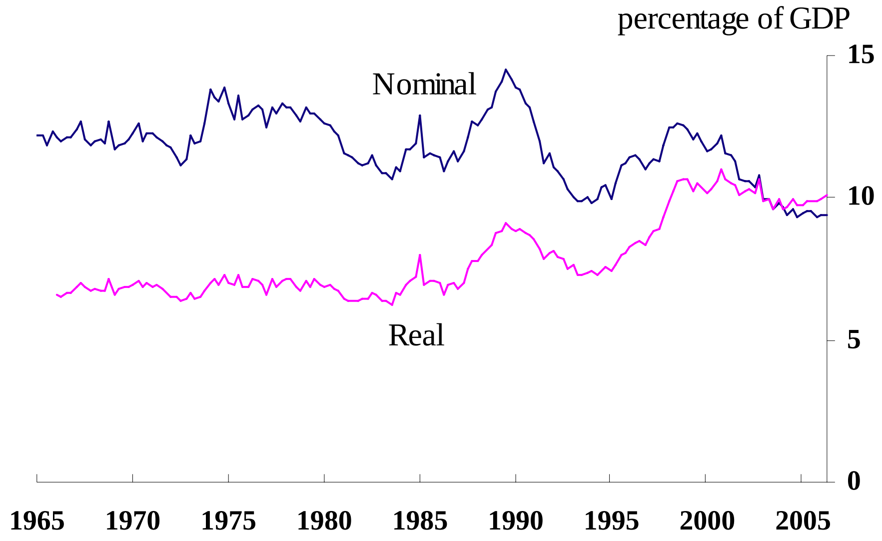


Chart 6:
The price of investment goods in the United Kingdom

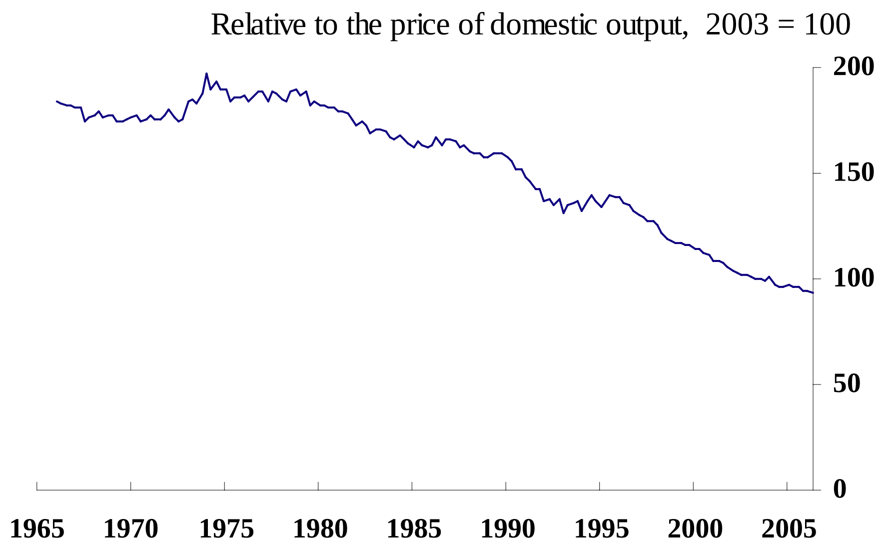


Chart 7:
UK Non-financial corporations' financial balance (nominal)

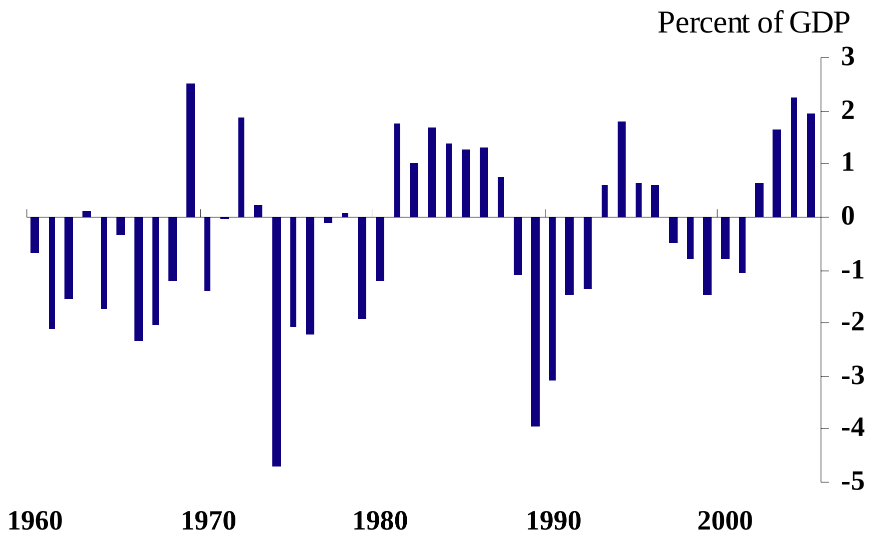


Chart 8:
Capital to output ratios in different sectors in the United Kingdom in 2004