Clearing the investment hurdle

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Low investment has been a hallmark of the British economy for a long time. Some economists believe this does not matter. They are wrong, argues **Gerard Lyons**

Economic growth over the next year will be led by higher consumption, as previous cuts in interest rates and taxes feed through. A key question is whether higher demand will trigger a rebound in investment. It should, but there is no guarantee it will.

Capital expenditure by the manufacturing sector fell sharply during the recession, declining 25.8% between 1989 and 1993. Although such investment rebounded in the last two years, it is still a sizeable 15% below the level seen at the height of the Lawson Boom. There is no sign it is about to gather momentum, despite the UK's competitive position and the high profits enjoyed by the corporate sector. Indeed, manufacturing sector investment has fallen by 6.8% in the last two quarters.

Low investment has been a hallmark of the British economy for a long time. Some economists argue that this does not matter. They is wrong. The benefits of investment are beyond dispute.

Germany and Japan owe much of their post-war success to high investment, allowing them to develop and produce high-quality goods, enjoy higher trend growth and high standards of living. While both economies are now experiencing problems this is due to their high labour costs and the need to deregulate; but for their high investment they would be in worse shape.

Although Britain's investment level is low, those industrial, service and financial sector companies that have invested are able to compete globally. The trouble is, we don't have enough investment throughout the economy. Why is this?

After all, British firms invest heavily overseas, whilst many foreign firms, particularly from Japan, are heavy investors in the UK, taking advantage of Britain's competitive position in Europe.

Two years ago, a Bank of England survey of 250 firms found, on average, they demanded an incredibly high rate of return and over a very short time before they would undertake an investment. The average nominal return required was 20%, over three years. This is an excessively high target and poses a big hurdle to many investment projects.

Why are these rates so high? Many different factors are important but the common explanation is Britain's poor inflation record, which has led to sharp swings in monetary policy and high interest rates. Witness the doubling in base rates from 7.5% to 15% during the Lawson boom years. Such experiences undoubtedly force companies to require a higher risk premium; they need to see a high rate of return before an investment project goes ahead.

This could be one explanation as to why firms are reluctant to invest now. They need to be convinced that inflation and interest rates are going to stay low, hence lowering the cost of capital and uncertainty about future monetary policy, before investing.

There is another explanation: short-termism. The City is often blamed for this. Worried by the threat of takeover, firms reward shareholders with high dividend payments, and steer clear of longer-term investment. It is difficult to quantify this effect but there certainly is a problem with not enough focus directed on the longer-term. The problem is particularly acute for smaller firms, who do not have the free access to the capital markets enjoyed by large companies.

If firms continue to demand high returns it will remain a big hurdle to a full recovery in investment, as it would limit not only the level of investment, but also the type of investment.

In the current disinflationary environment, investment in cost cutting areas may take preference, particularly as the gains can be seen immediately. Meanwhile investment in research and development, where the gains take longer to be seen, could be delayed. Whilst cost cutting and remaining competitive is important, it is only half the story. Quality and developing new products are very important too.

There are two lessons. The first is the economy needs to remain competitive. This has already attracted inward investment. Such investment will continue, despite uncertainty over the single currency. But it begs the question as to why we cannot invest more ourselves.

Thus the second lesson is important. We cannot rely just on price competitiveness. Just look at the south-east Asian economies. Like them, we need to invest heavily, particularly in education, the infrastructure and value added areas of the economy, whether they be in the manufacturing, service or financial sector.

One way for the authorities to ensure the latter is to offer tax advantages for longer-term investment. An argument against this is that the general public subsidises investment that would have taken place anyway. This is true, but also it will encourage new investment. If industry is reluctant to invest in the current environment, which is favourable for investment, then it needs an incentive to do so.

The price of ensuring that investment takes place is far less than the risk for the economy that it doesn't. If investment doesn't pick up significantly then the rebound in consumption over the next year could result in another fool's gold recovery: here today, gone tomorrow. A sustainable recovery requires higher investment with firms showing faith and confidence in the economy's potential. It is the only way.

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