The key to unlock that feelgood factor again

ECONOMIC VIEWPOINT

Britain is more competitive than most of its European rivals but it needs to take action to stay ahead, warns **Dr Gerard Lyons**

LAST year was a good one for the British economy but many people did not notice. There is a danger the same could happen again in 1995. Higher taxes and further increases in interest rates could dampen consumer confidence. People are finding it hard to come to terms with low inflation. As the last year has shown, the flip side of good inflation news is sluggish wage growth, little movement in house prices and lack of a feelgood factor.

Even though many people would like to see their house prices rise and wages soar, this would not be good news for the economy. It would merely create a fool's gold feelgood factor. The key for a healthy economy that would deliver higher income, increased affluence and higher confidence, is a well-balanced recovery.

The key to achieving this is higher investment. Those countries that have invested heavily are those that enjoy higher living standards. Look at Germany. These improved living standards do not occur overnight, they take time. But they require higher investment.

If British companies can build on the healthy export performance of 1994 and invest in 1995, this would allow growth prospects for future years to improve. And it would go some way to ensuring that unemployment continues to fall.

So far in this recovery, firms have repaid debt, improving their balance sheets. Now they are cash-rich and have the ability to invest.

The trouble, however, is that one of the British economy's key problems has been a low level of investment. There has been investment in some crucial areas, such as the City, and among many top companies, allowing them to remain competitive internationally.

The problem is that for the whole economy, particularly the manufacturing sector, investment has not been as high as it could have been and has not matched that of our competitors.

In the past 20 years, the volatility of inflation, interest rates and sterling has not helped. It has led firms to demand very high rates of return before undertaking investment. But this is not the only reason. Thus the fact that we are entering a period of low inflation is no guarantee that investment will recover strongly.

Criticism is often levied at the City. There is certainly no bias against British industry in the City but British firms appear to be at a disadvantage. In Germany and Japan, there are specific banks that aim to service industry's longer-term needs. In Britain, like the US, this role is filled by the equity market.

This seems to result in British firms having to achieve higher rates of return than our competitors, which can seriously reduce the investment that takes place. As the recession showed, the relationship between banks and small firms may not be so long-term.

Relative to our major competitors, except the US, Britain appears to face a gap in the finance available to small and medium-size firms for longer-term investment. This raises the question as to whether we need a long-term investment bank.

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Not only do we need to invest but we also require the right type of investment. We don't just want labour-saving investment. This type of investment is less risky for firms, as the overall savings and returns can often be assessed with accuracy.

We need investment in new products and research and development that will bring with it high-income, value-added jobs. But this investment is riskier and requires more time and hence firms are less likely to undertake it.

This is a problem. Foreign firms, particularly from Japan, have been heavy investors in Britain. Contrary to popular belief, they have found British workers to be skilled and hard-working.

New techniques introduced by Japanese firms have been adopted by British firms, helping efficiency. The success of such foreign investment here shows what can be achieved but it also begs the question why we cannot do it ourselves.

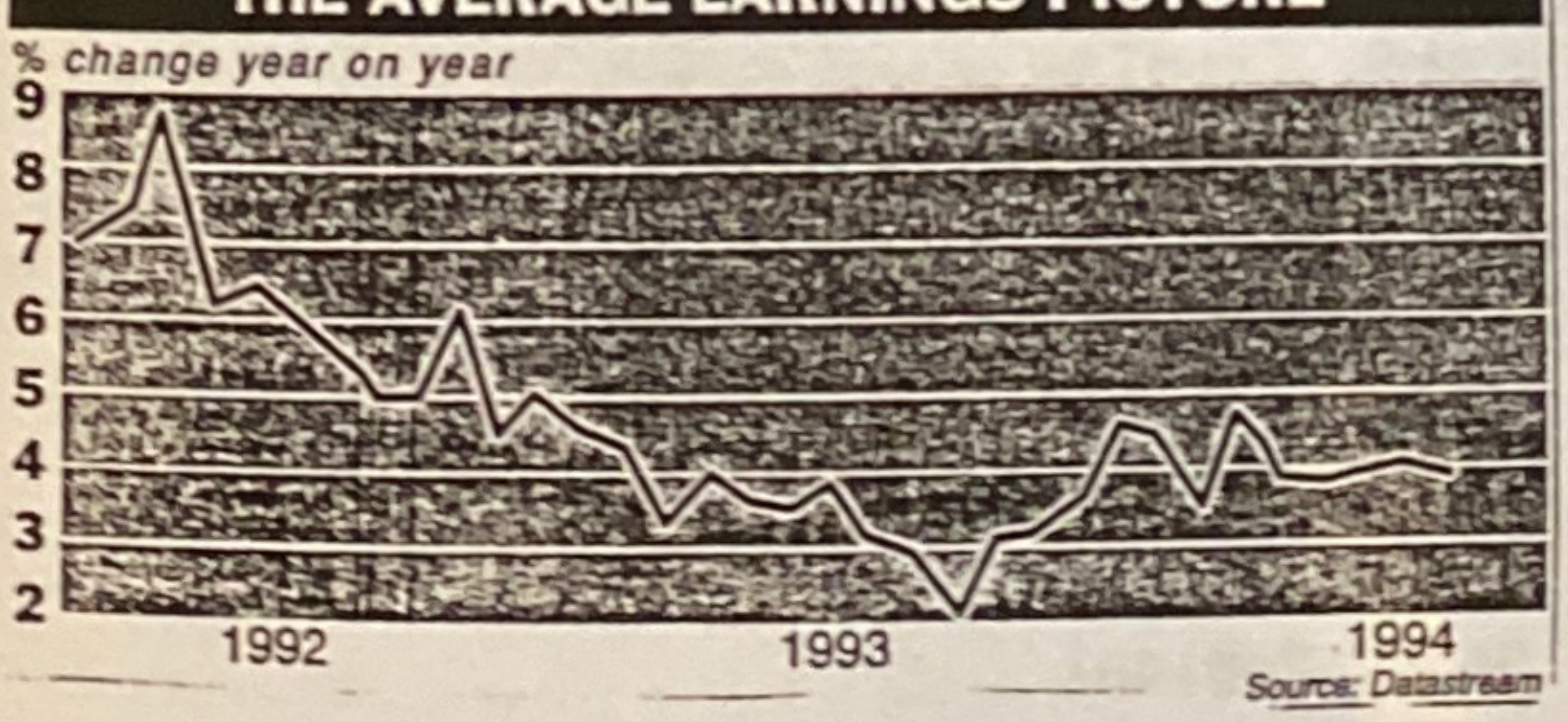
Britain is now more competitive than much of Europe. While we must remain competitive, we cannot just rely on staying ahead by keeping costs down. We need to invest.

The Government's approach is hands-off. It has set low rates of corporation tax and eased regulations. This is welcome but a more proactive stance needs to be taken.

I favour direct capital allowances. Some argue that these merely subsidise investment that would have taken place anyway. But the risk that investment will not take place is greater than the price of ensuring that it does.

• *Dr Gerard Lyons is chief economist and executive director of DKB International, the London-based subsidiary of Japan's Dai-Ichi Kangyo Bank*

THE AVERAGE EARNINGS PICTURE



The Evening Standard

Tuesday 21 February 1995