Short-term roads to a fool's paradise

In My View

Gerard Lyons

THE UK trade figures have been improving in recent months. Inflation is at or near its peak and will start to fall sharply soon.

These were the twin messages from the main economic figures of the last week and the Parliamentary debate on the European Exchange Rate Mechanism (ERM).

Anyone who believes that these developments signal anything more than a temporary improvement in the UK economy is either a supreme optimist or living in a fool's paradise.

The UK recession should lead to an improvement in the current account as imports fall, and to a reduction in the headline rate of inflation as producers and retailers try to restrain price rises in an attempt to maintain market share.

Despite this it is important to realise that the UK's problems of high inflation and a large trade deficit are not just the result of the recent strength of domestic demand.

The UK suffers from deep-rooted problems relating to inefficiencies on the supply side of the economy, illustrated by the UK's continued low level of investment and savings.

International events are likely to play an increasingly important role in determining how the UK economy faces its problems. Sterling's membership of the ERM will impose constraints on UK economic policy.

Furthermore, the ability to learn how countries such as Japan have established strong economies may hold the key as to whether the UK can address its longer-term inadequacies.

The UK's sizeable current account deficit is unsustainable. A reduction is necessary to prevent sterling from coming under strong downward pressure.

Eventually the economy must have a growth rate consistent with a balance of payments equilibrium. However, a reduction in the deficit is likely to exacerbate the impact of the recession and highlight the economy's imbalances.

The movement of the Government into a budget deficit means that there is a need to boost private sector savings in order to reduce the current account deficit.

The burden of adjustment is likely to fall upon the corporate sector, but with debt levels so high this could lead to a severe reduction in stocks, a significant curtailing of investment intentions and a large rise in unemployment.

As the recession deepens, political pressure for a cut in interest rates will grow. However, the ability of interest rates to fall will depend upon sterling's performance within the ERM. At present there are a number of factors which suggest that rates will have to remain high.

While ERM entry has proved successful in curbing inflation in other countries this has generally occurred after a long period.

Experience from other countries shows that the UK Government must clearly demonstrate its anti-inflation credentials by adopting a tight fiscal policy. Essentially the ERM implies that output will fall and unemployment rise as the trade-off for reducing inflation.

Inflationary expectations, particularly of wage bargainers, will not be reduced immediately, simply because sterling is in the ERM. The pay settlements agreed in the car sector over the last fortnight are testimony to this.

Nor are financial markets convinced that it is possible for sterling to sustain its level within the ERM without high interest rates. In part this is because sterling has entered the ERM at an uncompetitive level.

Sterling thus remains very vulnerable. This is clearly demonstrated by the dependence of the UK last year on around £30 billion of short-term funds.

Such 'hot money' could move out of sterling very quickly, particularly if confidence in the UK economy deteriorated or if UK interest rates were no longer attractive relative to rates overseas.

In a recession we would not expect to see a surge of investment inflows. Whilst increased direct investment in the UK, particularly by the Japanese, will reduce sterling's dependence on hot money, it will not remove it.

While Japanese investment in some areas, such as electronics, has led to a growth in UK export markets, some investment is occurring in areas where it could displace domestic production.

Although the local content of the goods produced may be high, this begs the question as to why the UK has to rely on such 'Trojan horse' imports, and why we can't produce the goods ourselves.

It is hard to make bilateral comparisons, particularly when cultural differences are great. None the less, there are certain features of the Japanese economy which are particularly relevant to the UK.

The ability of the Japanese to be major exporters of capital is due to their large current account surplus. This surplus has grown because of Japan's powerful manufacturing sector, which produces high quality goods.

A strong manufacturing base allows Japan to satisfy domestic demand, whilst also exporting to overseas countries. Although the Japanese current account surplus will fall as companies relocate production overseas, the benefits will still accrue to Japan, through interest, profit and dividend payments.

One of the most striking differences between the UK and Japan is the UK's very low rate of investment. The latest comparable data from the Organisation for Economic Co-operation and Development (OECD) shows that the UK performs badly, in terms of direct investment, with a large number of countries.

Comparing investment in the G7 nations over the period 1960-88, the UK ranks bottom alongside the US. Over this period, UK investment as measured by gross fixed capital formation was only 18.2 per cent of GDP. For Japan, the comparable figure was 31.4 per cent.

Even in the 1980s, the UK ranks bottom.

The low level of UK investment could explain why the UK fails to produce sufficient high quality goods that can satisfy high-income export markets.

The UK has a trade deficit with 18 of the 21 other OECD countries. The low level of investment can also lead to capacity constraints, thereby capping industry's potential output.

The financial environment in Japan appears more geared to the manufacturing sector. Historically, there have been greater connections between the corporate and financial sectors in Japan.

This was reflected in the *zaibatsu*, or large industrial conglomerates that existed until their break-up by the Americans in 1945. The principle of these still exist, making the relationship between companies and capital in Japan very strong. In the UK the relationship is much weaker.

Furthermore, the UK Government's reliance on high interest rates is not conducive to long-term manufacturing investment. The impact of high UK interest rates is particularly severe for small and medium-sized companies.

In Japan, companies not only face much lower interest rates but also small companies can rely on their banks to see them through short-term problems, including the threat of bankruptcy.

There are many other issues, but these too seem to confirm the longer-term tendency. Japanese companies attach a higher value to the quality of the labour force, with emphasis being placed on training and developing skills.

Historically, the wage bargaining process also appears more co-operative than confrontational. The 'I'm all right Jack' syndrome is replaced by wage negotiations on the basis of what is in the interests of the nation, the company and, indeed, the workforce.

In my view there is a tendency among some commentators and the Government to focus exclusively on the short-term problems, without addressing the longer-term structural deficiencies.

The longer-term solution to the economy requires the need to boost investment and savings and to promote a strong manufacturing base.

An improvement in the relationship between industry and finance and between management and workers would appear to be essential parts of this process.

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William Keegan returns next week.

British manufacturing: How we can stop the rot

Centre Stage

Investment and training are key priorities if our industry is to benefit from ERM, argues Labour's **Gordon Brown**

BRITAIN waited too long to join the Exchange Rate Mechanism. The risk now is that the we will wait too long before implementing the policies for manufacturing industry to ensure that Britain benefits from greater exchange rate stability.

A decade ago Margaret Thatcher seemed to appreciate the importance of the industries that make things. 'Some say we must export or die,' she said. 'I say we must manufacture or die even more quickly.' Yet since 1979 her government has consistently failed to give manufacturing industries the support they can rely on in Japan, Germany and France.

Then Britain's manufacturers had a 10 per cent share of the world's manufacturing trade. Now we have 8 per cent. Then manufacturing contributed 25 per cent of our national income. Now it contributes barely 20 per cent.

Since 1979 manufacturing output has fallen in a wide range of sectors, from textiles to mechanical engineering.

We are now producing a third as many cars as France, fewer ships than Denmark, the Netherlands or Norway, less steel than Italy, and fewer manufactured goods than France. Over 10 years our export growth is the worst of all our competitor countries.

The more modern the industry the bigger the trade gap. Import penetration has risen from 26.9 per cent to 36.7 per cent in manufacturing as a whole, but from 31 per cent to 52 per cent in electrical and electronic engineering and to more than 95 per cent in office machinery and computers.

After 10 years of contraction, during which 133,000 manufacturing companies have ceased trading, British manufacturing is now facing its worst winter for a decade.

This month, one manufacturing job is being lost every two minutes of the working day — and three small businesses are going into receivership every working hour. Cambridge economists recently forecast that if current trends continue the 1.8 million manufacturing jobs we lost in the 1980s will be followed by a further 1.4 million in the 1990s.

But it appears that no one in Government — and certainly not the Department of Trade and Industry — will speak up for the needs of industry. The policies that command consensus in our competitor countries are treated with scorn and contempt by Mr Lilley and his No Turning Back Group associates.

I believe that the long trend against manufacturing in Britain can be reversed and that manufacturing can again increase its share of our national income, but to do that we must learn from the growing European and Japanese economies where governments and industry work together.

The lesson of the past is that government should not attempt everything; the lesson of the present is that it is folly for governments to do nothing.

Sensible policies for industry concentrate on the four major failures undermining competitiveness: the failure to back technology, the failure to invest for the long term, the failure to ensure regionally balanced growth and most of all the failure to train.

In the 1960s it was assumed that the modernisation of Britain would involve the displacement of skilled workers by technology. We now know that advanced technologies can only be managed by a highly skilled and adaptable workforce.

The 1990s will be a decade of continuous innovation in which manufacturing will be concerned with the flexible application of technology and a highly skilled workforce to custom-build products.

Our competitors recognise this truth. Training and education budgets in Europe far exceed our own. Britain now has fewer in education after 16, fewer in university, fewer with technicians' qualifications and fewer craftsmen than Germany, France or Japan. A far lower proportion of our managers are fully trained. And under this Government the proportion of employees in manufacturing who are trainees has actually fallen from 3.9 per cent to 1.9 per cent. Skills must be the first priority of any government that is serious about the future of British industry.

The second priority is to make Britain once again the technology capital of Europe and to end the failure to translate ideas, designs and inventions into productive opportunities for British industry. Britain has been an impressive source of new innovations. Yet all too often they are manufactured abroad to be sold back to us. Liquid crystal displays, magnetic resonance imaging and fibre optic cables are just a few recent examples.

Britain must ensure adequate venture capital for technology, assist the transfer of technologies from academic institutions into industry, back the small firm in taking new ideas into the market, and provide support for patenting and safeguarding intellectual property. Yet we invest less than a third as much as France on non-military research into information technology, and less than a third as much as Germany on new environmental technologies.

Even in Whitehall, outside the Cabinet, a consensus is developing for policies that address the problems of short-termism, and create a framework for incentives to invest in research and technology.

The Government's own Acost committee has argued that the venture capital market is not meeting equity capital needs and the Bank of England has reported that the investment gap facing small firms seeking longer-term finance is growing. Yet no new initiatives are forthcoming from the DTI.

The CBI's report on technology has called for a nationwide network of technology transfer. Yet the DTI plans to cut technology spending by 35 per cent over the next three years. Common sense demands support for a one-stop small business service, yet the Government has *cut* the consultancy budget by 18 per cent and innovation grants by 46 per cent.

Throughout the first industrial revolution Britain was the workshop of the world. Now that all the Tory remedies and all their simple free market nostrums have so clearly failed, we run the risk of being left behind by the third industrial revolution that is sweeping through the world economy.

Training, investment, technology transfer, balanced regional growth have worked elsewhere and can work here. Only then will we be able to benefit to the full from ERM.

Gordon Brown is Shadow Spokesman for Trade & Industry.