Economic Report

Number 2 February 2012

Introduction

This is the second in our new series of TUC reports, analysing the UK economy. In this edition, we take a closer look at investment, especially corporate investment.

Key economic data

According to the second estimate for the 4th quarter of 2011, the economy grew 0.8 per cent over the year as a whole, but shrank by 0.2 per cent in the last quarter.

From late spring 2011, employment fell and unemployment rose and at the end of the year passed the unemployment rate in the USA for the first time since the start of the recession. Despite this, the overall employment figures showed signs of improvement at the end of the year. This was largely because of a rise in part-time and self-employment, which masked a fall in the number of employees working full-time.

2011 began with an increase in inflation due to the government's decision to raise VAT to 20 per cent, a move that added 0.76 points to the Consumer Price Index compared with December 2011 (according to the Office for National Statistics). The Consumer Price Index rose throughout 2011, but then fell in January 2012. This was mainly due to the VAT increase, which dropped out of the 12 month inflation rate that month, and CPI annual inflation therefore fell from 4.2 per cent in December to 3.6 per cent in January.

Trade improved in the last quarter of 2011, with the highest ever goods exports to non-EU countries; the last month of the year saw the lowest trade deficit in goods and services since 2003. The Index of Production declined a little in 2011, but is essentially unchanged since the recession ended in 2009. There were substantial declines in mining and energy; the Index of Manufacturing moved very little in the second half of 2011, though there was an improvement right at the end of the year.

Indicator	Latest
GDP growth (yoy)	0.8% (Q4 2011)
RPI inflation	3.6% (Jan 2012)
CPI inflation	3.9% (Jan 2012)
Av. earnings growth (regular pay)	2.0% (Nov 2011)
Claimant count	1,604,500 (Jan 2012)
ILO unemployment rate	8.4% (Nov 2011)
Industrial production (yoy)	- 3.3% (Dec 2011)
Manufacturing production (yoy)	0.7% (Dec 2011)
Trade in Goods & Services Quarterly Balance	- £5.9bn (Q4 2011)
Business investment (yoy)	- 0.2% (Q3 2011, SA)

There were a number of depressing reports and surveys in January and February, and it was noticeable that results that were not as bad as expected were usually reported as good news. Notable reports included:

- In February, the Treasury's comparison of *Forecasts for the UK Economy* revealed that independent economists were not only less optimistic about prospects for GDP growth in 2012 – 16 than the Office for Budget Responsibility, but more negative than they had been in November.
- The National Institute for Economic and Social Research forecast that GDP would shrink 0.1 per cent in 2012, but grow 2.3 per cent in 2013. They expect unemployment to rise to 9 per cent this year and then "remain elevated throughout the forecast period".

- The Chartered Institute for Personnel and Development's Labour Market Outlook reported that employment intentions "have fallen to their lowest level since the recession."
- The CBI Economic Forecast revised down their 2012 expectations for GDP growth to 0.9 per cent, rising to 2.0 per cent in 2013. They forecast unemployment at 2.87m in 2012, 2.91m in 2013.
- The British Chambers of Commerce Quarterly Economic Survey reported "signs of stagnation in the first quarter" with domestic order books at their lowest level since 2009 and employment expectations falling.

Investment

Investment as a macro-economic issue

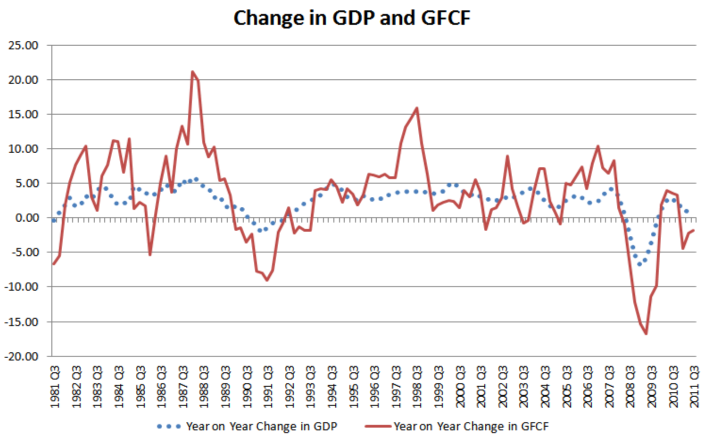
Investment is one of the building blocks of aggregate demand. In the statistics for expenditure approach to GDP, the relevant category is "gross capital formation":

GDP, 2011

	£million	Percentage of GDP
Consumption	972,350	64.4
Government spending	342,168	22.7
Gross capital formation	222,058	14.7
Net trade	- 27,588	-1.8

The data for gross capital formation includes small amounts for changes in inventories and acquisition and disposal of valuables, but well over 90 per cent is gross fixed capital formation. Such fixed assets are defined in the ONS guide to the *UK National Accounts* as "items which contribute to a productive process for more than a year and are not used up in the process of production."

Gross capital formation is the smallest of the categories in the table above, showing that it made a proportionally small contribution to output in 2011. But it is a vital component of aggregate demand. Firstly, it is far more volatile than overall GDP, as the chart below shows:



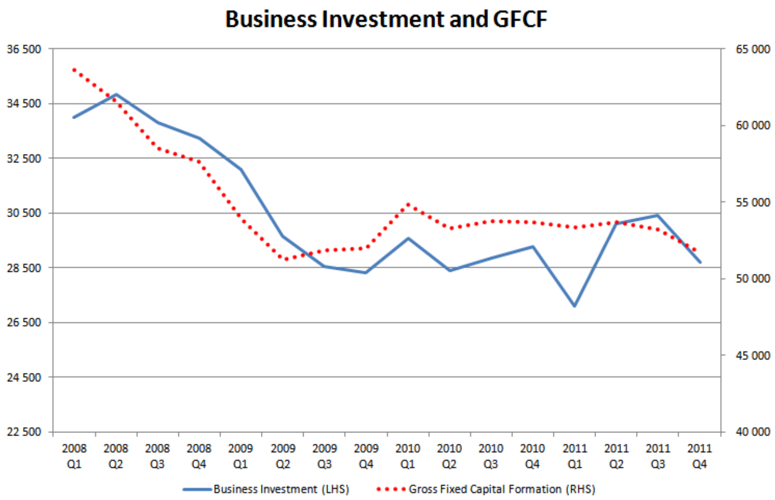
This means that changes in investment have a strong influence on the economic cycle – known as the 'accelerator'. When the other sources of demand start to rise, businesses may increase their productive capacity to meet that demand, so total demand rises, creating an expansionary cycle. The same process can go into reverse, with a contraction in demand leading to a reduction in planned investment and so on.

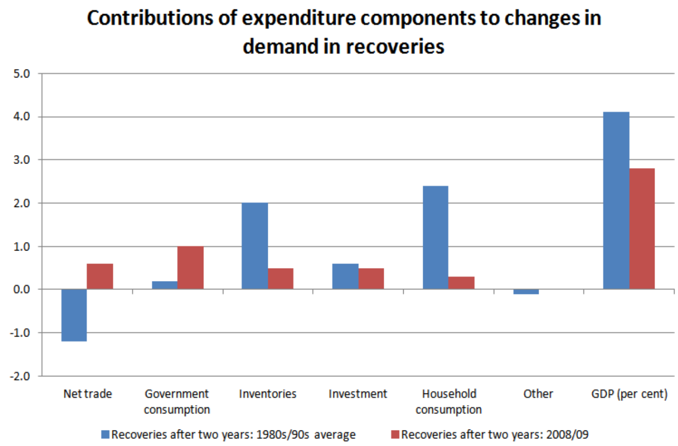
If we look at what happened during the most recent recession, measuring from the last peak of GDP to the lowest quarter, we can see that the reduction in gross fixed capital formation accounted for nearly half the fall in GDP:

GDP and GFCF, change during the recession, £million

	GDP	GFCF	GFCF % of GDP
2008 Q1	367,519	63,621	17.3
2008 Q2	362,869	61,567	17.0
2008 Q3	355,752	58,520	16.4
2008 Q4	347,731	57,655	16.6
2009 Q1	342,283	53,870	15.7
2009 Q2	341,591	51,272	15.0
Reduction	**25,928**	**12,349**	**2.3**

Gross fixed capital formation includes household and government investment, but about half is business investment. (Over the past five years, the average has been 55.1 per cent.) Since the start of the recession, the picture for both Business Investment and for total Gross Fixed Capital Formation is that they fell until the middle of 2009 and have essentially flat-lined since then:





In the fourth quarter of 2011, total Gross Fixed Capital Formation was 4.7 per cent lower than it had been 12 months before, the second successive quarter with a year-on-year fall.

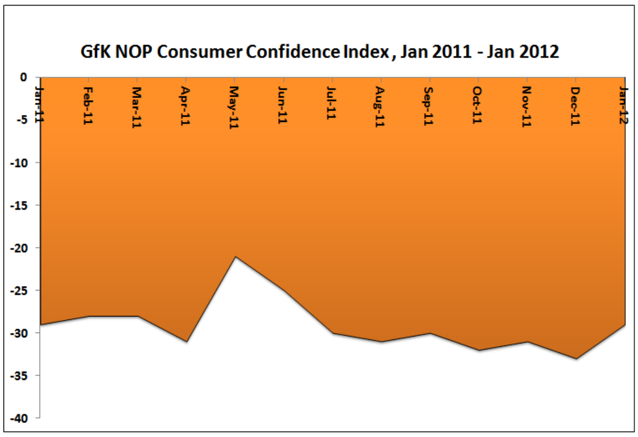
In the long-run, investment (both business and government investment) is even more important as one of the determinants of the productive capacity of the economy. The OECD argues that the rate of accumulation of physical capital is "one of the main factors determining the level of real output per capita".

Even when an economy has a healthy capital stock, new investment is necessary. Innovation depends to some degree on investment and the fact of gradual technological improvement means that new capital tends to be more productive than old capital. There is an academic argument about whether investment in equipment or human capital is more likely to promote growth, but there is little disagreement that both are needed.

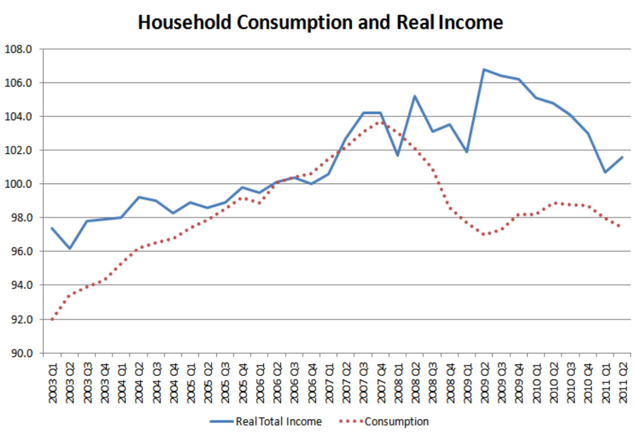
How important is investment for recovery?

One of the key characteristics of the current recovery is the limited part so far played by household consumption. In the table below, adapted from data in the latest Bank of England *Inflation Report*, we can see that after the recessions of the 1980s and 1990s, household consumption accounted for about half the growth in GDP in the first two years, but hardly any in the current recovery:

The prospects for a recovery in household consumption are not good. The GfK-NOP Consumer Confidence Index has been very depressed since the start of last year:



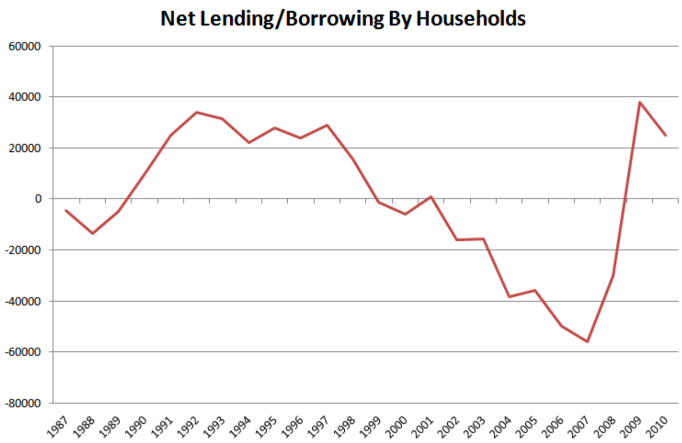
Data in the Bank of England's *Inflation Report* shows that household consumption and real income have been falling for some time:

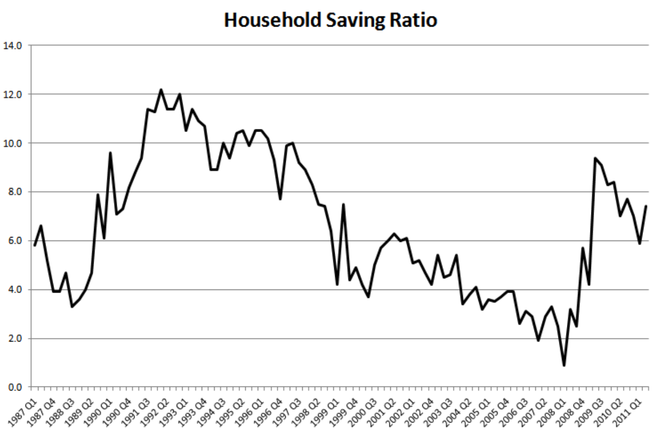


This undoubtedly has a great deal to do with the low level of pay increases. Increases in average weekly earnings have lagged RPI inflation for more than two years:

Although the Bank of England expects "a gradual rise in pay growth" from later this year, they believe that "a persistent margin of slack in the labour market should continue to weigh on earnings, exerting some degree of downward pressure on inflation throughout the forecast [2011 – 2014]."

Simply encouraging household borrowing would be dangerous; pre-recession levels were unsustainable:





Policy will therefore be aiming to raise consumption in a way that does not increase household indebtedness and enabling stronger wage growth could be a key part of such a strategy. In the TUC's judgement, where unions can negotiate increases in real wages they will make a substantial contribution to economic recovery.

But these increases are more likely in the medium term. At present, with 2.67 million people unemployed and underemployment at nearly seven million, the scope for significant real wage increases will be limited. We therefore agree with those policy makers and commentators who argue that exports and investment must play a bigger part than in any recovery in recent memory.

The Office for Budget Responsibility's *Economic and Fiscal Outlook* forecasts that investment (and especially business investment) will grow significantly over the coming years:

Expenditure components of GDP, percentage change on one year earlier

	2012	2013	2014	2015	2016
Household consumption	0.2	1.2	2.2	2.7	2.9
Business investment	7.7	8.9	9.4	12.6	12.4
General gov't consumption	- 0.1	- 1.6	- 2.3	- 3.2	- 3.5
General gov't investment	- 9.4	- 4.2	- 0.1	- 1.1	- 2.3
Net trade	0.3	0.6	0.3	0.2	0.1
GDP	**0.7**	**2.1**	**2.7**	**3.0**	**3.0**

Unfortunately, the OBR has found that its initial forecasts were over-optimistic. Their November *Economic and Fiscal Outlook* reduced forecast GDP growth for 2011 by 0.8 points, for 2012 by 1.8 points and for 2013 by 0.8 points. And with specific reference to investment the OBR stated that:

"We overestimated the contribution that business investment would make to GDP growth by 1 percentage point. Although credit conditions began to deteriorate after the first quarter of 2011, corporate profits were higher than forecast in 2010. It therefore seems most likely that business investment was scaled back in reaction to the weaker demand outlook from lower private consumption."

This demonstrates the extent to which wider demand and confidence can impact upon investment intentions.

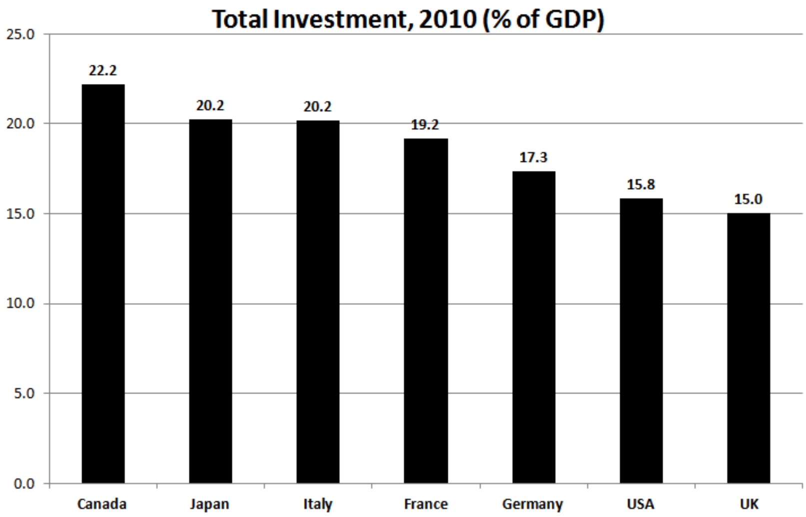
The OBR expects investment to grow from 14.8 per cent of GDP in the first quarter of 2012 to 19.5 per cent in the first quarter of 2017. Indeed, from the second quarter of 2016 they expect expenditure on investment to overtake government consumption – a remarkable shift. During this period they expect investment to account for more than a third of GDP growth:

Expenditure components of GDP, £billion, increase to 2017

	2012 Q1	2017 Q1	Increase	Share of increase (%)
Private consumption	247.1	312.7	65.6	59.0
Government consumption	87.5	88.8	1.3	1.2
Fixed investment	57.0	96.7	39.7	35.7
Net trade	-8.6	-3.9	4.7	4.2
Statistical discrepancy	0.4	0.4	0.0	0.0
GDP at market prices	385.0	496.2	111.2	100.0

Is the UK an under-investment economy?

In comparison with other advanced industrialised economies, the UK spends a comparatively low proportion of GDP on investment. In this chart, which uses IMF data for 2010, the UK spends the lowest proportion of the seven countries that constituted the G7:



This is not a recent problem – in the IMF data, the UK has ranked seventh out these seven countries since 1999. Since 1980, the UK has ranked 6th twice, in every other year it ranked 7th. Angus Maddison's research into historical savings indicates that the UK would have occupied a similar place in such tables if they had been constructed between 1950 and 1980. Before that, the difference was even more marked: between 1870 and 1949 the UK typically devoted between 7 and 9 per cent of GDP to gross fixed domestic investment, while for Canada, France, Germany, Japan and the USA the typical proportion was between 12 and 20 per cent. (Up to the First World War, the difference is explained by the much higher proportion of UK GDP assigned to net investment abroad.)

There are, of course, debates about the significance of low investment levels, but it seems likely that it has had a long-term negative impact on UK performance. A famous 1999 study by Mary O'Mahony of *Britain's Productivity Performance* (updated in 2002) compared the UK with France, Germany and the United States, which all had significantly higher labour productivity. She found that, over the market economy as a whole, capital per hour worked was 25 per cent higher in the USA, 32 per cent higher in Germany and 60 per cent higher in France.

Michael Porter's 2003 report into *UK Competitiveness* found that the UK's main competitive disadvantages were:

- Low capital stock
- Low investments in innovation
- Compete less on unique value (versus cost) than advanced nation peers
- Some indications of low uptake of modern management techniques
- Some indications that manufacturing is lagging the overall economy

Just as low investment may explain some British economic problems, so may some other countries' successes be explained by higher levels of investment. In *German Lessons*, the recent TUC report, we noted that investment ran at 20 - 25 per cent of German GDP in the 1950s and 60, when Germany was laying the foundations of her current industrial strength.

Prospects for investment

The prospects for investment are mixed. The government plans to cut public investment by 46 per cent by 2014-15, which the TUC believes is a mistake that will act as a drag on the overall economic contribution of investment to the recovery.

Reform of the banks will certainly have an important part to play in promoting investment. As the TUC noted in our recent report, *Banking After Vickers*, the UK has underdeveloped corporate bond markets, an equity market dominated by foreign operating firms and little bank lending to non-financial firms, all of which suggest that the availability of finance is a key issue for increasing UK investment levels. The TUC supports rebalancing of the banking sector to help SMEs to grow, to fund green projects and increase the overall level of investment in the economy. In particular, the TUC supports calls for adequate capitalisation of the Green Investment Bank and faster movement towards implementation of the Chancellor's promise of "credit easing" to help small businesses. (Adam Posen, of the Monetary Policy Committee, has also emphasised the need to "really move forward" on this issue.) But the delays in giving effect to the plans for bank reform and support for SMEs underline the need for speedy action.

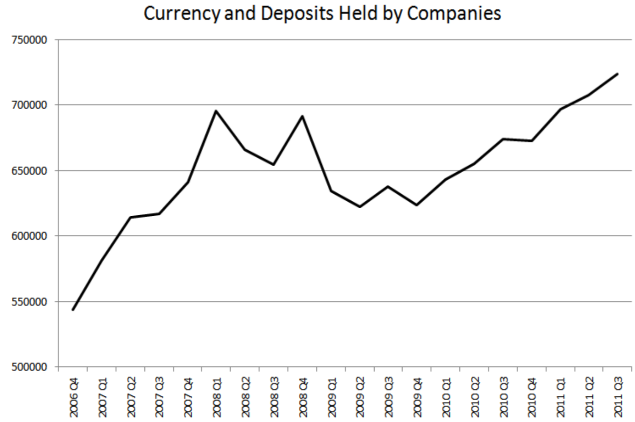
Fortunately, there is a source of investment funds quite readily to hand: the currency and cash deposits currently held by UK businesses. The key question here is whether the years ahead will see firms invest these reserves or whether they will continue to stockpile them

The first thing to notice is that business investment has so far recovered more slowly than GDP overall:

GDP and business investment in the recovery

	GDP	Business Investment
2009 Q2	341,591	29,647
2009 Q3	342,382	28,554
2009 Q4	344,907	28,317
2010 Q1	346,312	29,576
2010 Q2	350,174	28,398
2010 Q3	352,552	28,861
2010 Q4	350,812	29,278
2011 Q1	352,254	27,428
2011 Q2	352,212	30,024
2011 Q3	354,224	30,117
Increase (£m)	12,633	470
Increase (%)	3.7	1.6

UK companies have large "cash piles" – currently worth £724 billion – equivalent to about half of GDP. This sum fell a little after the recession, but it has been growing since the end of 2009:



A great deal of research has been carried out into the determinants of investment. The clearest finding is that expectations matter and that uncertainty plays a key role. Firms only invest if they expect to make a return on that investment and that return depends on a number of inherently uncertain factors, such as likely costs, interest rates, taxes and, especially, demand.

Researchers in different countries have found that the more uncertain the environment the more cautious firms are about investment. Major shocks to demand will make corporate executives even more careful. The obverse side of this factor is that when firms are confident/less uncertain they are much more willing to invest. This tendency amplifies economies' tendency to boom and bust. A few years ago, during the dotcom boom, we saw an example of a boom when what Keynes called the "animal spirits" of investors led some to under-estimate the risks they faced.

At present, various surveys suggest that firms are very uncertain, and are therefore likely to see their cash as better used provide insulation from an adverse quarter than invested:

- The BDO Monthly Business Trends Indices (based on the results of all the main UK business surveys) were all negative in January, and a further fall in the Output Index indicates "another marginal contraction for Q1 of 2012." The Optimism Index improved on the previous month, but remained below average.
- The Federation of Small Businesses' "Voice of Small Business Index" for the fourth quarter of 2011 reported that small businesses' confidence about their prospects fell to – 24.5, the lowest level since the survey began in 2010. Small business confidence was negative in 12 of 13 regions.
- The CBI's SME Trends Survey reported a balance of 20% of firms less optimistic than they had been three months previously.
- The ICAEW/Grant Thornton *Business Confidence Monitor* for the first quarter of 2012 rose slightly to – 9.3, from – 0.7 in Q4 2011, but well below the + 8.1 of Q3. Significantly, the authors report that businesses "**plan to cut back on capital investment in response to growing concerns about the economic outlook**" (emphasis in original).
- The British Chambers of Commerce Trade Confidence Index for Q4 2011found exporters forecasting "muted growth" and "sluggish investment" in 2012. Confidence that turnover will increase was at its lowest level since the second quarter of 2009.
- In January, the Bank of England's regional agents reported that businesses still intended increasing investment over the coming year, but the positive net balance had been weakening throughout the second half of 2011. Investment plans were strongest among exporters, but the agents noted that "heightened uncertainty had caused some investment to be put on hold, or scaled back, with a greater focus on the preservation of cash flow, particularly among smaller firms."

But there are more encouraging indications:

- The January Markit Purchasing Managers' Index for Manufacturing was positive, standing at its highest level for 10 months and the Services PMI recorded the biggest monthly improvement in optimism in the history of the survey.
- This was followed by good January figures for retail sales, which did not suffer the post-Christmas fall many had expected.

The Markit surveys are very good, possibly the best forward-looking evidence we have about business trends. The good news on retail may well have been due to ruthless discounting, so profits may well not have been as healthy but it is still likely to be positive for investment.

The balance of these surveys suggests that, in the immediate future, investment may well be slow, but there is a chance it will pick up later in the year. As the European Commission remarked in the UK section of their latest *Interim Forecast*, "investment is expected to start increasing in the second half of 2012, from a low base."

Even if investment does pick up, it seems unlikely that it will achieve levels that were expected as recently as the last OBR forecast, three months ago. The CBI forecasts that trade and investment will make the most positive contributions to growth this year and next year, but their expectations – 4.3 per cent this year and 5.0 per cent in 2013 – are well below the OBR's figures of 7.7 and 8.9 per cent.

Conclusion

Overall, this is a negative picture and the immediate prospects for investment-led growth are poor. At present it is hard to believe that 2012 will see investment at the level expected by the OBR, and even the lower CBI assessment seems optimistic in relation to wider reports of market sentiment. Austerity and below-inflation pay increases will mean that household consumption continues to be below the level seen in previous recoveries, so a great deal of our prospects for the year ahead will hang on whether the Budget can implement measures which will act to boost confidence and unlock significant levels of investment. The Chancellor has promised ‘credit easing’ measures to free up investment; six months on, the patience of business and unions is wearing thin. If Budget 2012 is to play a significant part in securing growth, it will need to introduce real action to take this proposal forward, along with wider measures to support demand and encourage employers who can to start to invest.