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Politeia Lecture: Green Shoots, Shallow Roots: Where next for UK Business?

The UK economy is undergoing a massive course of steroids.

The big question for policymakers is about how to generate sustainable growth once the impact of the medication starts to wear off.

The CBI, like most other forecasters, expects that after what we can now see was a truly terrible first quarter, the pace of the recession will moderate over the rest of this year. By the beginning of 2010, we hope to see the beginnings of a fragile recovery.

But the worry is that the sources of this badly needed stability are essentially temporary in nature, and don't provide the basis for long-term recovery.

One part of the medication is the huge monetary stimulus coming from the Bank of England, which has cut interest rates to all-time lows, and which by the end of this month (July) expects to have injected £125bn directly into the economy through its so-called quantitative easing programme.

Couple all that with a substantial devaluation, and the potential impact is enormous.

The second is the fiscal relaxation that is pushing public borrowing up to levels never before seen in peace time. That's the result of falling tax revenues and rising benefit payments driven by the recession, as well as the last splurge in the Government's spending plans before austerity bites.

And the third source of the expected stability comes from the fact that many companies have now got rid of the excess stocks they were left with when demand for goods and services all round the world fell off a cliff last autumn.

Output is still bumping along at a very low level. But the end of this period of stock liquidation - the most dramatic since World War Two - should by itself bump up the figures for economic activity in the next few months.

But what then?

Monetary and fiscal easing can't go on forever. And unless demand starts to recover soon, the impact of the inventory cycle won't last long either.

The need to rebuild household balance sheets may hold back consumer spending for some time. And the signs are that companies just about everywhere are hunkering down against the storm. Even those that are doing well are being very cautious when it comes to new investment.

That's because they are worried about a number of major economic uncertainties that have yet to be resolved.

My plan this afternoon is to discuss the nature of these concerns. Then I will suggest how policymakers might best address them.

Worry number one remains the state of the credit markets. Enormous interventions by the taxpayer over the past nine months have pulled the banking system well back from the edge of the precipice. But credit conditions are still a long way away from anything approaching normality.

Thus the flow of net lending to business suffered its largest monthly fall in nearly ten years during the month of April. The figure was minus £5.4bn, compared with a monthly average of plus £7bn in 2007, and May was another bad month. Measurements of financial market liquidity remain far below average. And bank balance sheets are still under strain.

According to the Bank of England, leverage of the major UK banks remained broadly unchanged during 2008, with the median level at just over 30 times capital. And the so-called funding gap, the difference between customer loans and customer deposits - continued to rise.

Four years ago, it stood at around £400bn. By the end of 2008, it was more than twice that figure. And the institutions that in the past had helped to finance that gap - foreign banks, purchasers of asset backed securities and the like - had more or less disappeared.

This means that the banks are still heavily dependent on short-term wholesale funding.

All this helps to explain why confidence is as low as it is among both borrowers and lenders. Even very profitable companies are thinking twice about borrowing more money in these circumstances - itself an important reason why business investment is likely to fall by a record figure of 12 per cent or more in the coming year.

One sign of this is that a number of companies have been refinancing their debt well before the agreed deadline. This costs them a lot of money, because spreads are much higher than they were a couple of years ago. But it gives them greater certainty about their future funding – and helps to keep their auditors happy.

It's not all bad news for business borrowers. The capital markets are reopening for companies who are able to raise new debt and equity. The issuance of sterling investment-grade bonds in the first six months of this year was the largest on record.

But the capital markets are unlikely to provide significant funds for small and medium sized companies, which remain reliant on bank lending for their funding. And even big companies which don't have a good story to tell are facing big financing worries.

All this helps to explain the very cautious language of Bank of England officials, in contrast to the more optimistic noises coming from the Treasury.

As the Governor put it at the Mansion House the other week, "With current market sentiment, it may take further additions to equity capital before the banking system will be able to supply credit at a price and on a scale to finance a sustained recovery. That is likely to take time."

The banks themselves are much more confident than this about their capacity to lend. But there is no doubt that credit conditions remain very tough indeed for the majority of business borrowers.

Then comes big worry number two, which is of course the state of the public finances.

The budget deficit is likely to climb to around 12 per cent of gross domestic product by 2011, and to decline only slowly over the following seven years. Even more alarming, the structural deficit - that part of the deficit that will not be eliminated by a return to growth - now stands at around 10 per cent of GDP. And by 2018, government debt - even on some quite optimistic assumptions - will have risen from around 40 per cent of GDP to over 80 per cent.

Almost everyone now recognises that the current pathway is unsustainable, and that whoever wins the next election will face some painful choices. George Osborne wrote as much in the Times a couple of weeks ago, although he has yet to spell what his priorities will be if he makes it to the Treasury.

The longer that politicians fail to grasp the nettle, the greater the risk that the cost of capital will rise through the next economic cycle, as the public sector competes with the private sector for funding. That in turn would mean less investment in jobs and wealth creation.

This year, the Government has to sell a total of £220 billion of gilt-edged securities, and the size of the gilts market will have to double in the next four years. This is doable - provided the government retains the confidence of international investors. Otherwise, the price will be higher long-term interest rates and a weaker currency.

As the OECD pointed out politely this week, credit default swap rates for UK 10-year government bonds have climbed considerably above those for Germany, France and the US. We are now challenging Italy in this particular league table.

Getting a grip will mean running very tight fiscal policies for five years or more. Expansive government spending has been one of the prime drivers of economic growth for the past half dozen years.

Over the decade to 2008, total Government outlays as a share of GDP in the UK increased by almost 5 percentage points, which was by a wide margin the biggest rise in the G7 (Germany, France, Italy and Canada actually saw declines in this ratio).

It’s clear that game is now over, for quite a while to come.

Along with government consumption, growth in the UK economy in the late

1990s and early 2000s was strongly driven by private consumer spending, rising well above its long run trend at more than 3.5 per cent a year. Indeed as Andrew Sentance of the Monetary Policy Committee pointed out recently, the proportion of national output devoted to private and public consumption has jumped way above its historic average of 82 per cent. Recently it’s been at its highest point since the early 1950s, at nearly 88 per cent.

And the uncertain outlook for domestic consumption represents big problem number three.

Right now, consumer spending power is being boosted by lower mortgage costs and the slower pace of inflation. ASDA, the supermarket group, tracks the discretionary spending power of the average family in the UK, and found it was nearly £7 a week higher this May than it had been a year earlier. Spending power is set to increase further in the coming months.

But earnings are under pressure, unemployment is on the rise, and the impact of lower interest rates will start to fade later in the year.

Falls in house prices are also restricting consumers’ access to credit. The Bank of England estimates that the incidence of negative equity had increased to between 7 and 11 per cent of UK mortgagors by the first quarter of this year.

For all these reasons, it’s hard to see a buoyant outlook for household spending over the next year or two.

Take all these three problems together - the damaged credit markets, the coming fiscal squeeze, and the highly uncertain outlook for household spending - and you can see why there is a real question as to whether the green shoots which everyone’s been spotting lately will turn out to have any sustainable roots.

What initiatives might policymakers be able to take in order to help things along? I’ll start with the credit markets and the public finances - if we can get those right, domestic consumption should be able to take care of itself.

Then finally I will briefly shift to other areas of public policy.

On the credit market side, step one must be to do more of the same. The implication of the Bank of England’s latest Financial Stability Report, published at the end of last week, is that unless financial market liquidity starts to recover and more long-term debt finance becomes available, the Bank's current arrangements for supporting the liquidity of the banking system may have to remain in place for some time to come.

More radical steps might even be necessary if conditions don't improve. It's noteworthy that the Financial Stability Report goes into some detail about the pros and cons of restructuring a distressed bank's balance sheet into a good and bad bank model - not, presumably, an idea you would discuss if you thought it was completely irrelevant.

But other, less dramatic, ideas are also worth considering - especially those that might help to get long-term capital to small and medium-sized companies to help them rebuild their working capital and to grow. One such idea which is being considered by both the Government and the Conservative party would be to recreate an institution along the lines of the Industrial and Commercial Finance Corporation, or ICFC, which was set up at the end of the second war as a partnership between the Bank of England and the big clearing banks, and which for fifty years and more provided loan and equity capital to thousands of SMEs on a commercial basis across the country.

But it's terribly important that any such institution should not be in state ownership. Old timers from the ICFC insist that its success was built on its commercial approach, and that entrepreneurs would go a long way to avoid borrowing from government.

Other possible sources of new capital include the sovereign wealth funds and private equity houses. It's interesting, for example, that some PE firms are starting to take more minority stakes into their portfolios rather than insisting on outright control. That could be a good way of strengthening corporate balance sheets.

UK Financial Investments, the holding company for the taxpayers' shareholdings in the banking system, has an important part to play in rebuilding the stability of the system. Its overarching objectives, we are told, "will be to protect and create value for the taxpayer as shareholder".

Sensible enough.

But what will best serve the interests of the taxpayer?

One answer might be to seek to maximise the share price of each institution, and sell it back to the private sector as quickly as possible.

But taxpayers also have a longer-term interest in these institutions. It may be rational for an individual bank to act as quickly as it possibly can to knock is balance sheet back into shape. But the interest of the broader economy is that the banking system as a whole should take a little time to rebuild its profits and its balance sheets, so that the process does not lead to a sharp contraction in credit.

It would be good to have more clarity about policy in this area.

Perhaps the most important point in a discussion on credit conditions is this.

In one important respect, the UK is in a far better position to cope with today's difficulties than it was during the recessions of the early 1980s and 1990s. That's because it has a well-established framework for sustaining low and stable inflation, underpinned by an independent decision-making body - the Monetary Policy Committee of the Bank of England.

It is going to be absolutely vital to preserve that hard won credibility in the years ahead. At some point in the not too distant future, the Bank will have to start mopping up the ton of money that has been pumped in to support bank liquidity, and return to a regime in which movements in interest rates are the main determinant of monetary conditions.

This will not be easy. And if the Bank gets things wrong, it could derail the economy - in one of two ways.

The first would be if it left too much money in the system, generating big inflationary pressures. But moving too quickly could also cause trouble. Given the lags in the impact of monetary tightening in the real economy, the Bank will need to start reversing the stimulus even before the recovery really gets going. And that in turn could spook market confidence.

Two points follow.

The first is that the Bank's communication skills are going to be tested as never before in the next year or two. It's going to have to get some very complex arguments across to market participants in a clear and consistent fashion.

The second is that the Government, the Financial Services Authority and the Bank itself need to wake up every morning determined to do whatever is necessary to preserve and strengthen the credibility of the independent central bank.

It’s clear that some tricky issues have to be resolved about who is going to do what in the new regulatory regime. But confidence will be damaged if the main players are seen to be falling out with each other - and from that, there would be costs.

There don’t seem to be big points of principle at stake here in the current discussion. So let’s not get into a fight about angels on a pinhead.

Choosing the moment to squeeze the public finances will be almost as difficult as deciding when to start monetary tightening.

The economy is still too fragile for strong medicine, in the form of rapid moves to cut spending or raise taxes. As evidence of what not to do, you only have to look back to Japan in the mid 1990s, when a sudden fit of fiscal austerity led the government to push up taxes too soon, and sent the country spinning back into recession.

That’s why it’s so important that politicians make credible commitments to get spending under control well before the process gets under way. Sitting around doing nothing will only make the problems worse.

All the evidence from history is that a focus on expenditure cuts, rather than on tax increases, is the best way forward. That approach is more likely to result in lower interest rate spreads, and to instil confidence that government means business.

For the UK today, that will require radical changes in the way our public services are designed and delivered, with a new emphasis on value for money at every stage of the process. And it means big changes, too, in the way public money is managed and disbursed.

Cuts simply handed down from the centre, salami style, cannot improve efficiency in the way that is required. Talk of billions of pounds of efficiency savings imposed from above fairly chill the blood. Instead managers at all levels of the public service should be empowered to change their way of working in order to deliver more with less.

Have a bonfire of centrally imposed targets, and encourage managers to manage.

Clues about what might be possible here are to be found in a recent analysis from the Office of National Statistics showing how productivity in the public services had changed in the ten years to 2007.

After allowing for improvements in the quality of service, the statisticians conclude that total productivity across the piece actually *fell* by an average of 0.3 per cent a year.

That may not sound like much, But think about how increased competition, together with improvements and technology and work processes, have transformed the productivity of the private sector over that same period of time.

While the public sector number was falling by 3.2 per cent, productivity in the market sector rose by nearly a quarter - and very much more than that in the tradable goods sector.

The back of my envelope says that if the public sector had matched the private sector's performance over that period, we could have had overall output increases of 11 per cent from unchanged resources.

Plainly that's unrealistic. Public sector services are not businesses, and they can never match the performance of competitive private industry.

But these numbers do point to what has to happen over the next few years.

We've seen an enormous increase both in the pace of public spending and the number of public sector jobs.

Now the emphasis has to change. We have to start squeezing more out of all this extra capacity - finding better ways of giving citizens services of the quality and breadth they have a right to expect.

We need more market testing, and much more engagement with the private and voluntary sectors in the delivery of our public services.

Fair completion between these providers is the best single tool policymakers have at their disposal for controlling costs and increasing quality.

Above all, we need to get away from the narrow focus on inputs that seem to dominate political discourse at the moment, and to concentrate instead on what drives good outputs.

Take the police service as just one example.

What's striking here is the way that politicians of every colour seem to regard changes in the number of police officer numbers as the prime purpose of policymaking.

Of course there are reasons for this. Politicians want to be seen to be tough on crime, and the numbers of boots on the ground are an obvious measure of their determination. They also want to support an institution which, despite what you might read from time to time, remains one of which our country is rightly proud.

But this focus on headline numbers blunts the drive for the improved use of existing resources.

The Police Federation has argued that an extra 2,000 officers will be needed over the next three years to cope with the effects of the recession on the crime rate and the extra strain of the London Olympics.

But the fact is that police resources have been increased massively over the past fifteen years. In the ten years to 2008, central spending on the service rose by nearly £5bn, or very nearly two-fifths after allowing for inflation. This extra funding resulted in a 25 per cent growth in the overall police workforce and a 10 per cent increase in the number of police officers, which stand today at around 140,000.

In his review of policing published last year, Sir Ronnie Flanagan judged that "there is significant scope for improving productivity." And a little later on in the document, he added: "Given the emerging evidence of the workplace reform pilots, I am persuaded that we would not be making the most effective use of the resources dedicated to the police if police officer numbers were sustained at their current level."

The same approach is required right across the public sector. Just one further illustration: a quote in yesterday's Guardian from the chairman of the Audit Commission.

"Schools are not wasting money deliberately, he said. "But I don't think the focus has been enough on economy and efficiency. The focus has been the drive to raise standards – that's not incompatible with economy and efficiency, but if you take your eye off the ball, you lose that focus."

In its review of the UK published this week, the OECD seemed to take it for granted that the UK was heading for another spending review. That's hardly surprising. The process has taken place every two or three years since it was introduced in 1997 – and the last one was in 2007.

The change in our economic circumstances since then has been so marked that a reappraisal of spending priorities is now necessary. Of course the economic outlook remains very uncertain. But as the FT put it yesterday, that's a reason for drawing up contingency plans, as well as a plan based on the Treasury's current central forecast.

A failure to do this would have two damaging consequences.

The first would be that it that it would leave all those institutions who rely on public finance in a state of suspended animation. They know that a squeeze is coming, but they don't know when and where. Many of them are now preparing budget cuts in the dark.

The second is that the next government is going to need a mandate for change – one that has been secured by informed debate in the coming election period. That will absolutely require the political parties to set out their stalls in a clear and open fashion.

We also need a more strategic approach to the revenue side of public finances - something that has been badly missing in tax policy over the past few years.

All too often, business and personal tax changes appear to have been driven more by political tactics and a wish to wrong foot the opposition than by a careful study of the long term consequences. Consistency, clarity, and fairness are the essential foundations of sound tax policy. And that's why, for example, the decision to attack the pension arrangements of high-income earners in the last Budget seemed so wrong-headed.

The announcement reversed a policy that had been introduced with great fanfares just three years earlier. The new arrangements are so complex that they can't be introduced for two years. They will mean a marginal tax rate of well over 100 per cent for some of those most affected. And they are unlikely to raise anything like the amount projected by the Treasury, since many of those concerned will simply pull out of their company's pension arrangements

Only the tax advisers are happy.

Sound policies for the credit markets and the public finances are an essential precondition of economic stability and recovery.

But of course other policies are important as well.

A key strength of the UK economy relative to its big continental neighbours is the flexibility of its labour market, much enhanced since the recession of the early 1980s. We have already seen some of the benefits of this flexibility in recent months, as companies have sought to minimise redundancies by negotiating temporary changes to pay and working hours.

Along with our flexible currency, this is one of the main reasons for hoping that the UK will emerge from the downturn sooner and in better shape so far as its employment figures are concerned than most of the Eurozone.

These flexibilities have to be defended, against attacks from Brussels and the trade unions. And the Government has done a pretty good job here.

But there's an extra point to be made under this heading.

This recession may have originated in the financial markets, but its main victims are not stockbrokers in the Home Counties. Instead, those most affected are young men with few skills who live in the poorest parts of the country - and who have very little to fall back on in terms of savings or unemployment benefit.

Low-skilled young men are now more than five times more likely to be unemployed than their more skilled counterparts. The ratio has worsened over the past decade, and is one of the highest in the OECD.

This is a challenge for the whole of our society. There's plenty of evidence that long-term unemployment can scar the lives of young people, with heavy social and economic costs. So it's in all our interests - Government and business - to tackle this problem as a national priority.

Business will be in a stronger position to preserve vital labour market flexibility if it can play a constructive part in this important process.

For the short term, that means collaborating with Government to support relevant work experience and training. For the longer term, it means redoubling efforts to raise core literacy and numeracy achievement. In the OECD's view, the focus on raising the school leaving age and meeting performance targets may be distracting attention from this vital goal.

The main responsibility for Government is to support the macroeconomic stability that the private sector needs in order to create new jobs and generate national wealth.

That in turn requires low and stable inflation, a properly functioning credit market, and credible fiscal policies.

At least we are starting to understand the problems, and in the case of the credit markets, to do something serious about them.

But my conclusion this morning is first, that we still have some way to go. And second, the engines of economic growth are going to have to be different from those of the last decade. Rather than debt-fuelled consumption by the government and household sectors, we are going to need a new emphasis on investment and trade. We are not going to return to business as usual.

It's time for government and business to start thinking about the opportunities.