UK Productivity Challenge

Ken Warwick

Director of Analysis and Deputy Chief Economic Adviser

Department for Business Innovation & Skills

Outline

1. Where we are now
2. Improved supply performance (productivity and employment)
3. Imbalances
4. Impact of the recession
5. Post-recession rebalancing

The current economic context

UK economy has experienced a recession (combined with a global financial crisis), which was longer and deeper than any since the 1930s.

Fragile recovery - both in UK and Europe

High levels of private debt. Public borrowing amounting to 12% of GDP.

Growth depends on the recovery in demand in the short term; sustainable growth depends on enhancing supply over the longer term.

Difficult trade-offs between fiscal tightening and investing for growth & employment..

Important role for BIS as a major economics department complementary to the Treasury.

Department for Business Innovation & Skills

UK economy summary

OBR central economic forecast

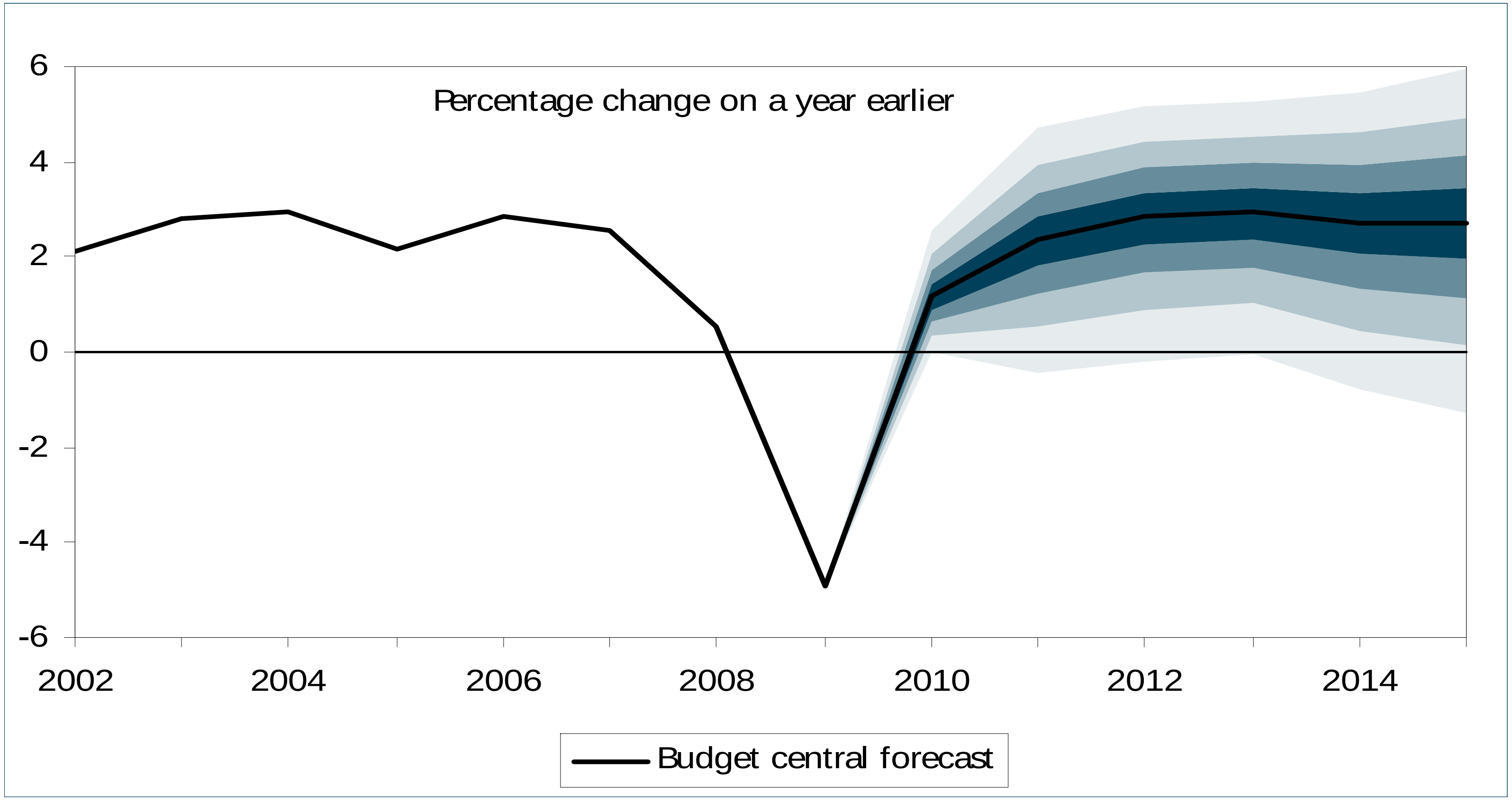
	Percentage change on a year earlier, unless otherwise stated						
				Forecasts			
	2009	2010	2011	2012	2013	2014	2015
Gross domestic product (GDP)	-4.9	1.2	2.3	2.8	2.9	2.7	2.7
CPI inflation (Q4)	2.1	2.7	2.4	1.9	2.0	2.0	2.0

The economic recovery is forecast to strengthen through 2010.

GDP growth rises to above-trend rates after 2011 as the private-sector led recovery takes hold and the economy becomes more balanced.

BIS Department for Business Innovation & Skills

UK GDP growth



The UK's Productivity record

UK has had a long-standing productivity deficit with its major competitors.

Explanations focus on lower business investment, infrastructure investment, R&D, intermediate and management skills.

But progress has been made in closing productivity gaps. Over 1998-2008, productivity gap (GDP per worker) with Germany was closed, with France narrowed from 14% to 9%, though gap with US has not changed significantly.

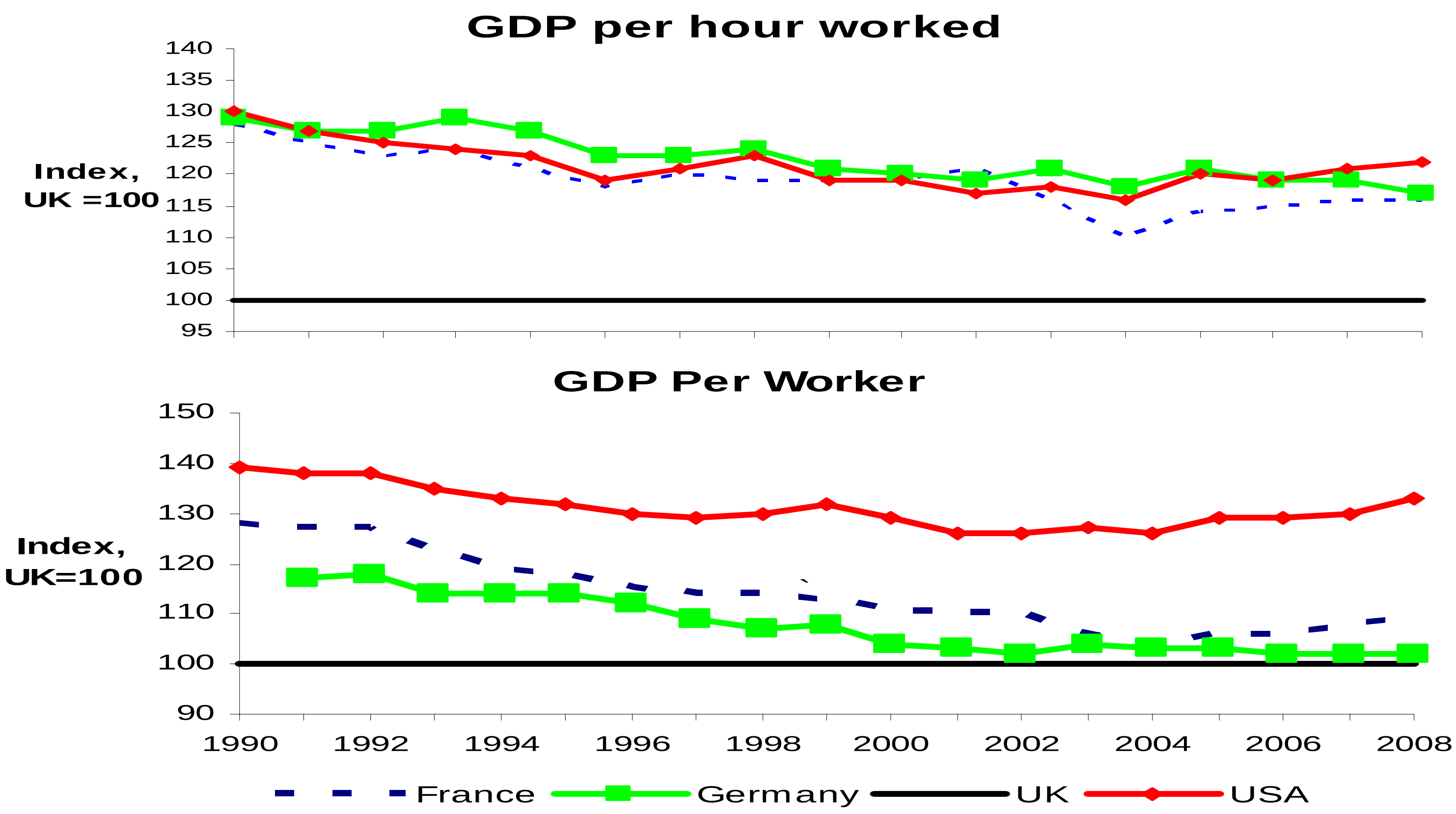
The UK retains strengths in its science base, high-level skills, openness to international competition and effectiveness of regulatory and competition regimes.

Increased capital per worker accounted for about two thirds of the growth in productivity over 1995-2004.

Another key feature is that, since the mid-1990s, the UK experienced increases in both productivity and employment rate.

Department for Business Innovation & Skills

International productivity performance has improved but gaps remain…



The government’s productivity agenda

Government’s long-term objective is to achieve high rates of economic growth as it is essential to improving the standards of living, and achieving other objectives such as environmental quality, social opportunity and national security.

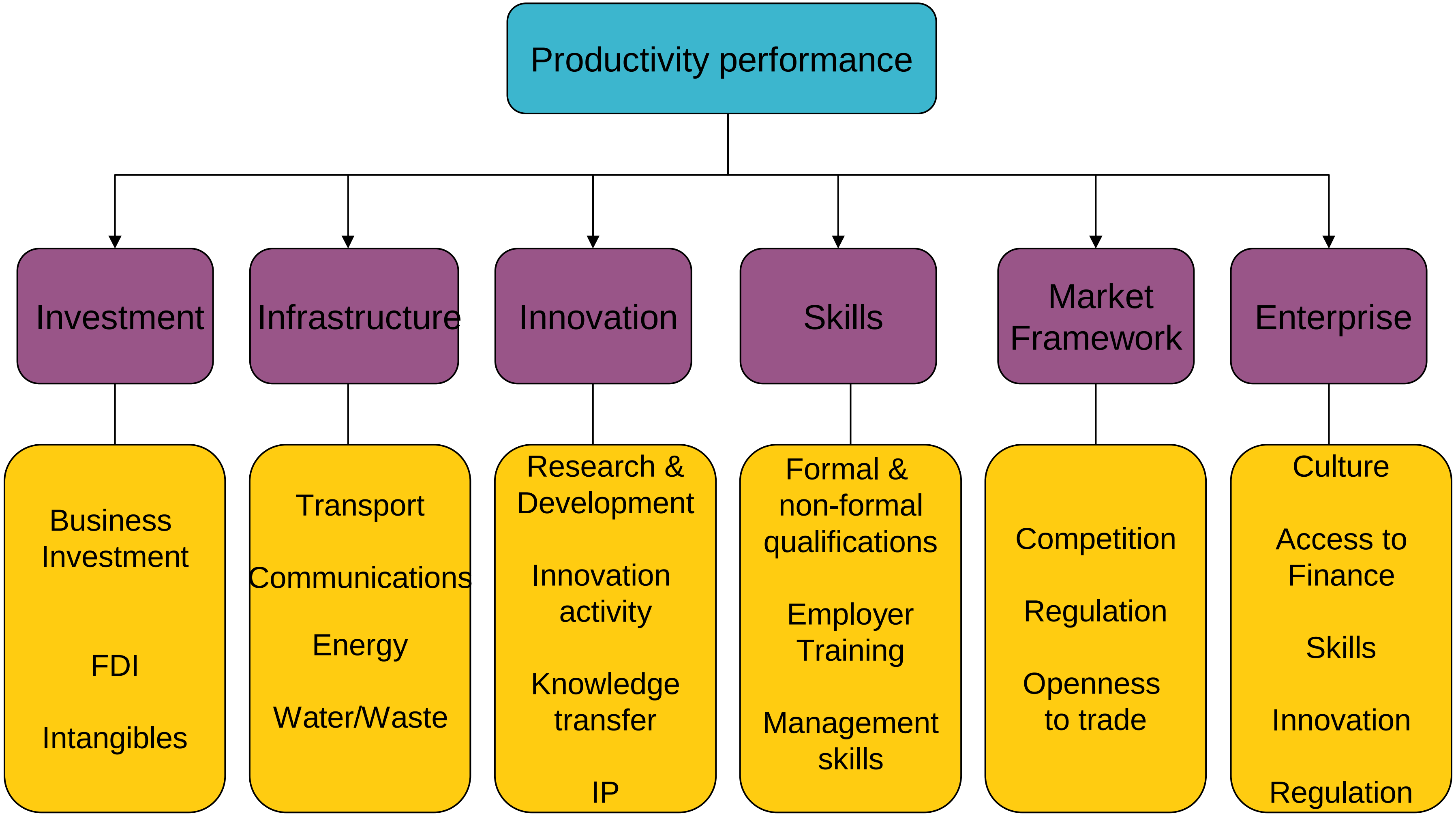
Raising UK productivity has been a driving force towards increasing long-term growth, as there are limits to how much employment can be increased in the long-term.

Reporting and analysis of productivity in government tends to use a categorisation loosely corresponding to the main determinants of productivity and growth.

Since 1999, the UK’s performance on productivity has been monitored via the annual publication of the ***Productivity and Competitiveness Indicators***.

- International comparisons are included, which allow the benchmarking of UK performance relative to the UK’s main competitors (US, Germany and France).
- Broad range of measures across the fundamental determinants of productivity (investment, skills, innovation, competition, enterprise) analysed.
- Limitations to any simple categorisation of productivity drivers, but the 5 drivers framework intended as a vehicle for presenting progress on broad policy areas, rather than a rigorous economic framework.

Key determinants of productivity



Business Investment

The share of business investment in UK GDP has risen over the last couple of decades.

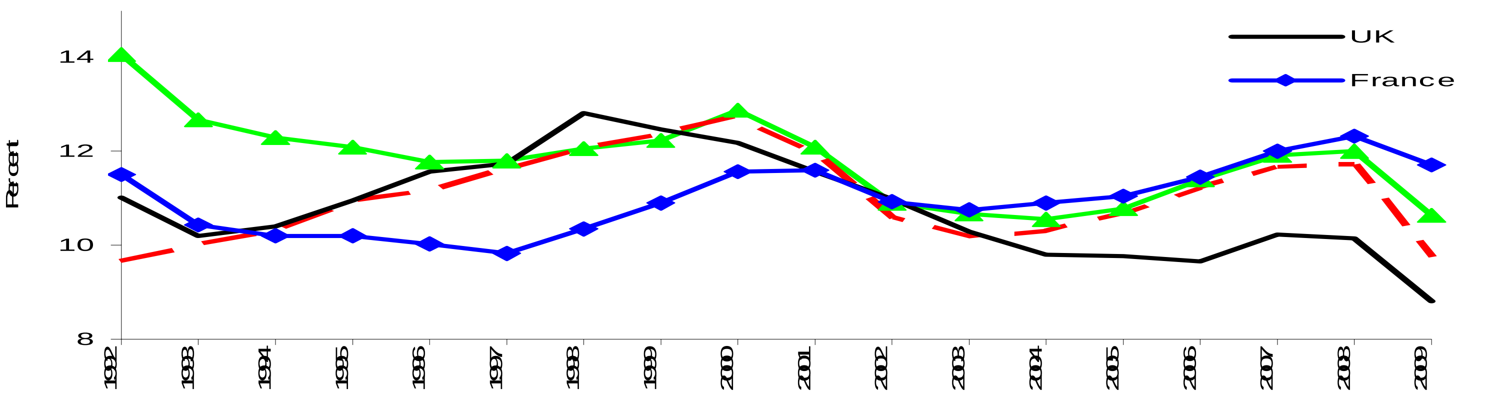
Nevertheless, UK business investment intensity remained lower than its main competitors.

But business investment is only an input. If we look at outcomes, a very different picture emerges, e.g. since 1995, the UK GDP expanded by around 35%, faster than France (+27%), Germany (+15%), and Japan (+9%), although slower than the US (+43%).

Also, UK predominantly service sector economy and has a relatively stronger performance in intangible investment.

Business investment

Comparison, 1992-2009, % of GDP in current prices



Source: OECD Economic Outlook

Business Investment

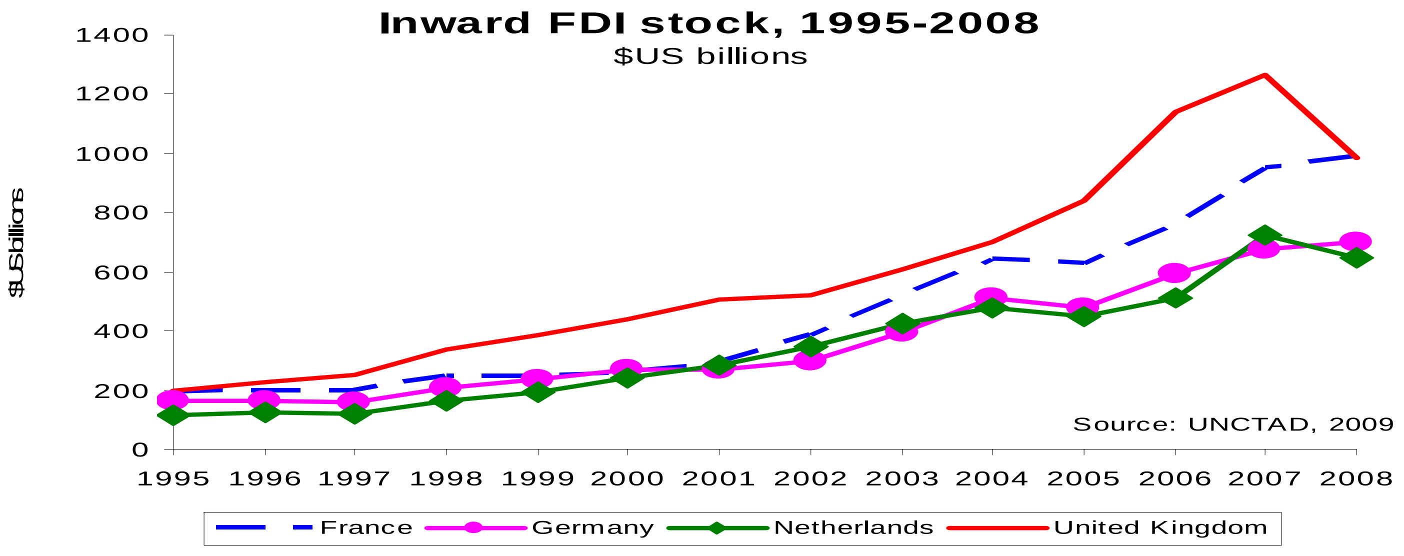
Foreign Direct Investment

UK has historically attracted more FDI stock than its main competitors[2].

UK has highest concentration of foreign owned firms with over 57,000 compared to 20,000 in Germany and under 5000 in France.

Strengths lie in openness to foreign business, ease of doing business and stable business environment

UK remains one of the most attractive destinations for inward investments in Europe.



[2]UNCTAD 2009 World Investment Report

BIS Department for Business Innovation & Skills

Business Investment

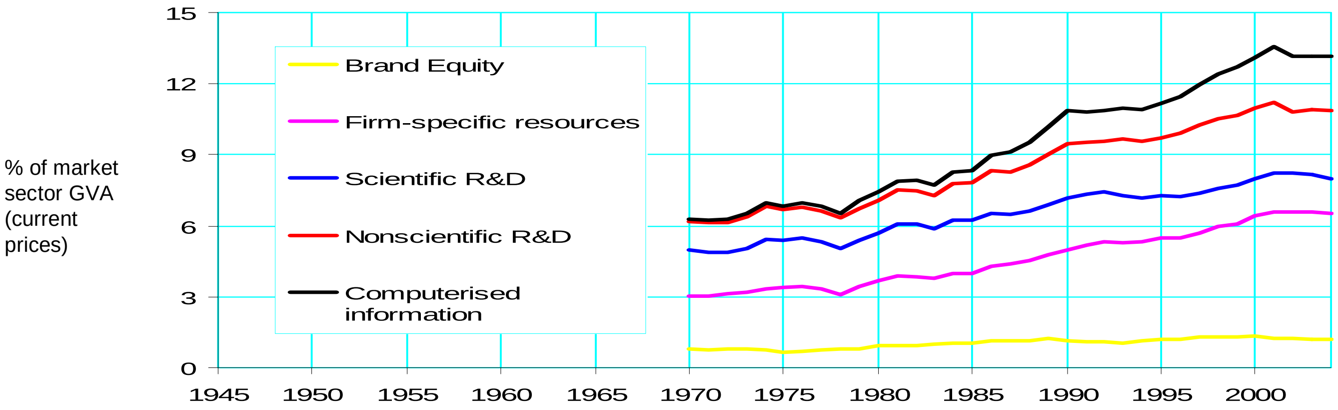
Intangibles Investment

Intangible assets can be divided into:

- Computerised information (software)
- Innovative property (scientific and non-scientific R&D)
- Firm-specific resources (company spending on reputation, human and organisational capital)

Intangibles are important drivers of growth, and ***investment in intangibles has overtaken investment in tangibles in the UK***. By 2004, £123bn was invested in intangibles compared with tangible investment of £96bn.

Intangible investment in the UK rose from around 6% of market sector gross value added in the 1970s to 13% in 2004.



Infrastructure

Strengths

UK is world leader in use of public-private partnerships to fund infrastructure projects.

Well established legal and regulatory regimes for private ownership of infrastructure.

Weaknesses

UK's current infrastructure is inadequate. UK is placed 33rd of 133 countries in terms of infrastructure quality (behind majority of G7 countries[1].

Business surveys suggesting that 80% of businesses had experienced problems due to deficiencies in the UK's transport infrastructure, while 63% experienced problems as a result of deficiencies in digital communications infrastructure

The financial crisis poses a challenge for Private Finance Initiative (PFI) funding of infrastructure projects as developers find it more difficult to access debt and equity finance.

[1] WEF's 2009/10 Global Competitiveness Index (2009-2010).

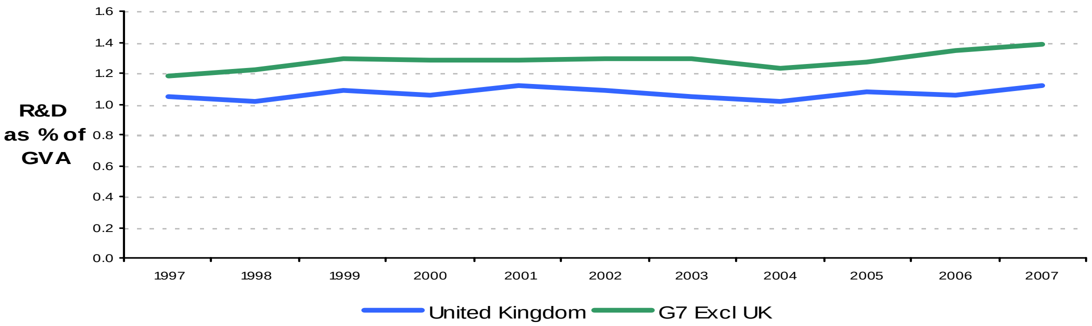
BIS Department for Business Innovation & Skills

Innovation

Research and Development

UK expenditure on R&D is relatively low as a share of GDP. This is mainly because of UK's relative specialisation in services.

UK business R&D intensity in the six most R&D intensive industries relative to the G7 economies



Innovation activity

The UK performs well compared with competitor countries in terms of the proportion of innovation-active firms. Some 58% of UK firms were innovation active during 2006-08.

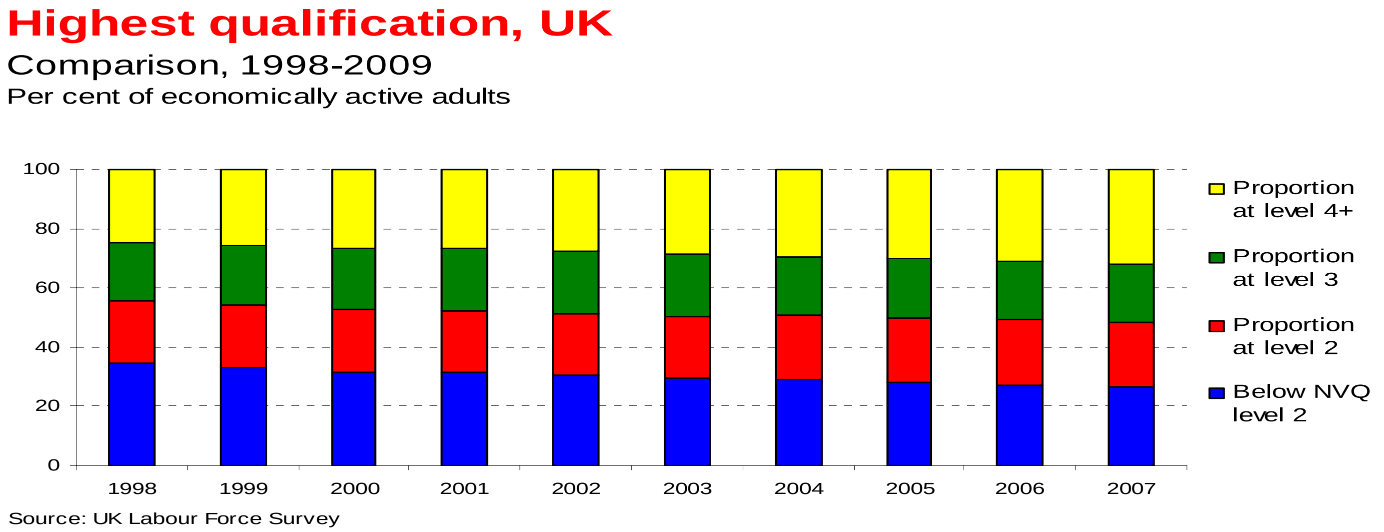
Innovation is pervasive across the system – not just in high-tech sectors. Low-tech industries such as food, clothing, wood, paper and printing have more than 60 percent of firms innovating.

Generation of intellectual property

Although UK had considerably fewer patents granted per million of population than Germany and US in 2008, UK patents are worth on average £10.1 million, more than twice those in Germany.

Skills

UK performs well on higher level skills and has been improving on lower and intermediate level skills, yet persistent gaps remain in management quality.



UK remains a middle-ranking country in terms of qualifications compared to other OECD countries.

- Ranked 18th for adults who have achieved at least upper secondary education.
- For tertiary education (equivalent to a degree), the UK is better placed, at 11th.

Department for Business Innovation & Skills

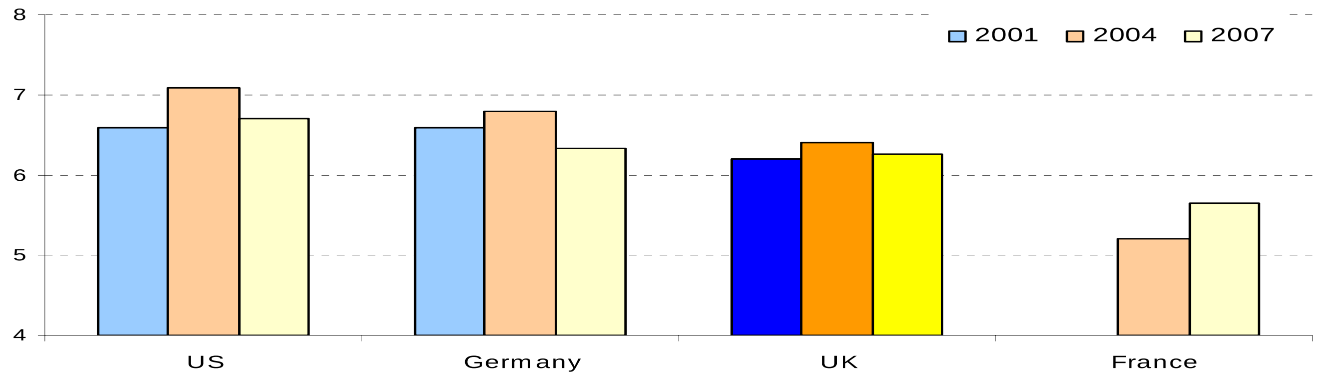
Market Framework

Competition

The competition regime in the UK and its regulatory environment is recognised among the best in the world.

The 2006-07 ‘Peer Review of Competition Policy’ ranked the UK competition regime third behind the USA and Germany.

Ranking of competition regime - peer review
Comparison, 2001, 2004 & 2007
Index (scale 0 - 10) - EU result is set equal to 6 in each year



Source: PricewaterhouseCoopers, 2001; KPMG 2004, KPMG 2007
Note: Sample size for France in 2001 was too small for reliable results to be produced.

The Global Competition Review (2009) showed the OFT improving its ranking in the 'Very Good' group, compared to 2008 and the Competition Commission remained in the ‘Elite’ group.

Regulation

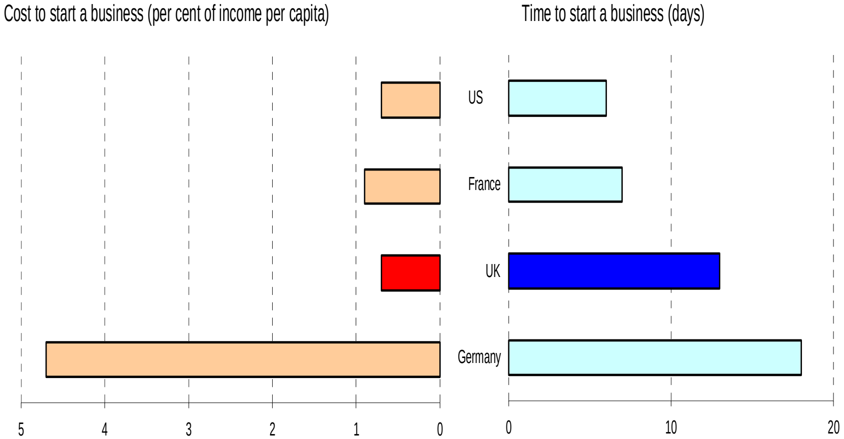
The World Bank (2009) ranks the UK 3rd in the OECD and 5th across the world in terms of the 'ease of doing business'.

The time to start a business is a weaker area in the UK relative to the US, but the cost to start a business is relatively low.

In 2008, the UK had the least restrictive product market regulation in the OECD (OECD, 2009)

Costs and time to start a business

Comparison, 2009

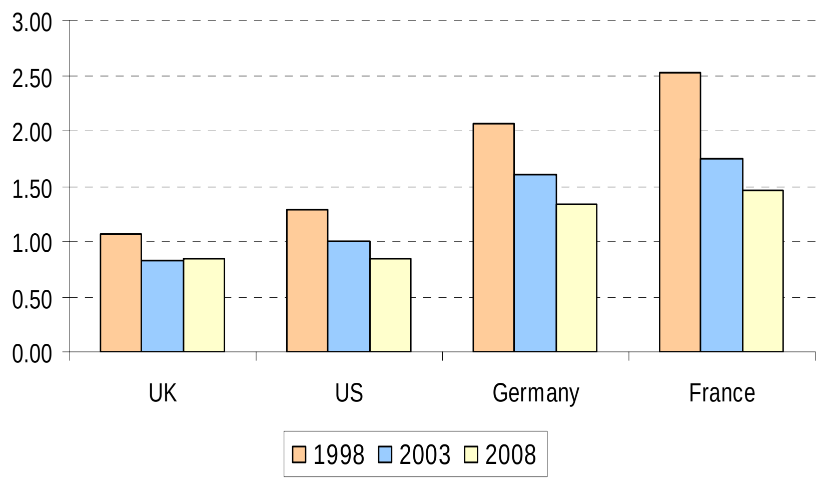


Source: World Bank

Product market regulation

Comparison, 1998, 2003 and 2008

Ratings, 0 = least restrictive, 6 = most restrictive



Enterprise

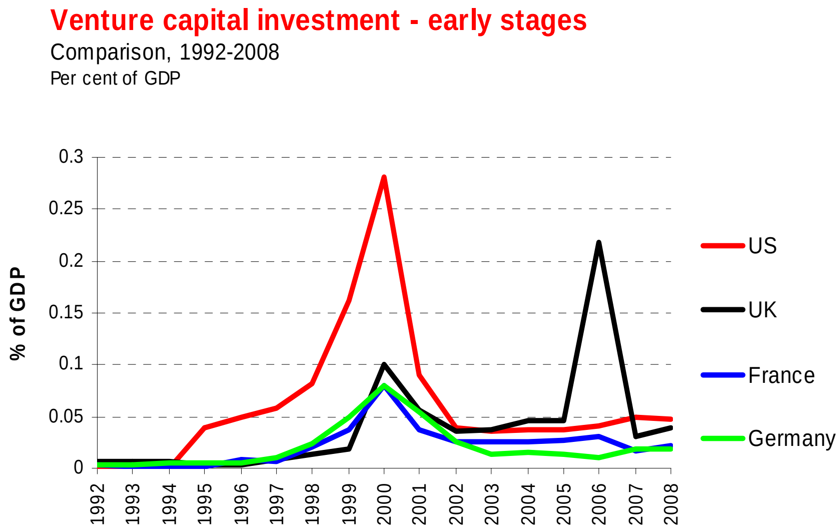
SMEs employ 59.4% of the total private sector workforce and generate around half of private sector output in UK.

Strengths

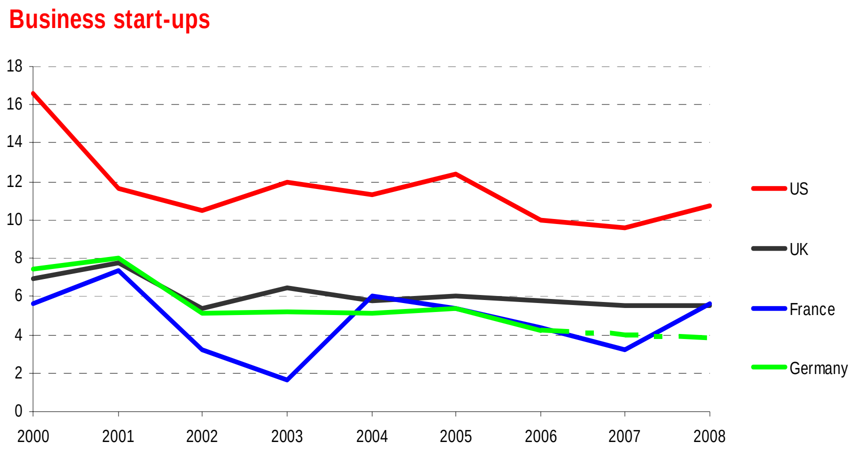
UK has one of the best business environments to start and grow a business.
The UK performs well in comparison to the US, France and Germany on venture capital investment as a proportion of GDP

Weaknesses

There is little change in start-up activity in the past 10 years.



Source: Eurostat (EVCA & PriceWaterhouseCoopers)



Source: Global Entrepreneurship Monitor 2008 Report

Challenges for SMEs centre around access to finance, skills, take up of business support and regulation.

The UK’s employment record

Labour markets which facilitate the full participation in economic activity across the population support growth by making best use of human resources.

Since the mid-1990s, UK experienced increases in both productivity and employment.

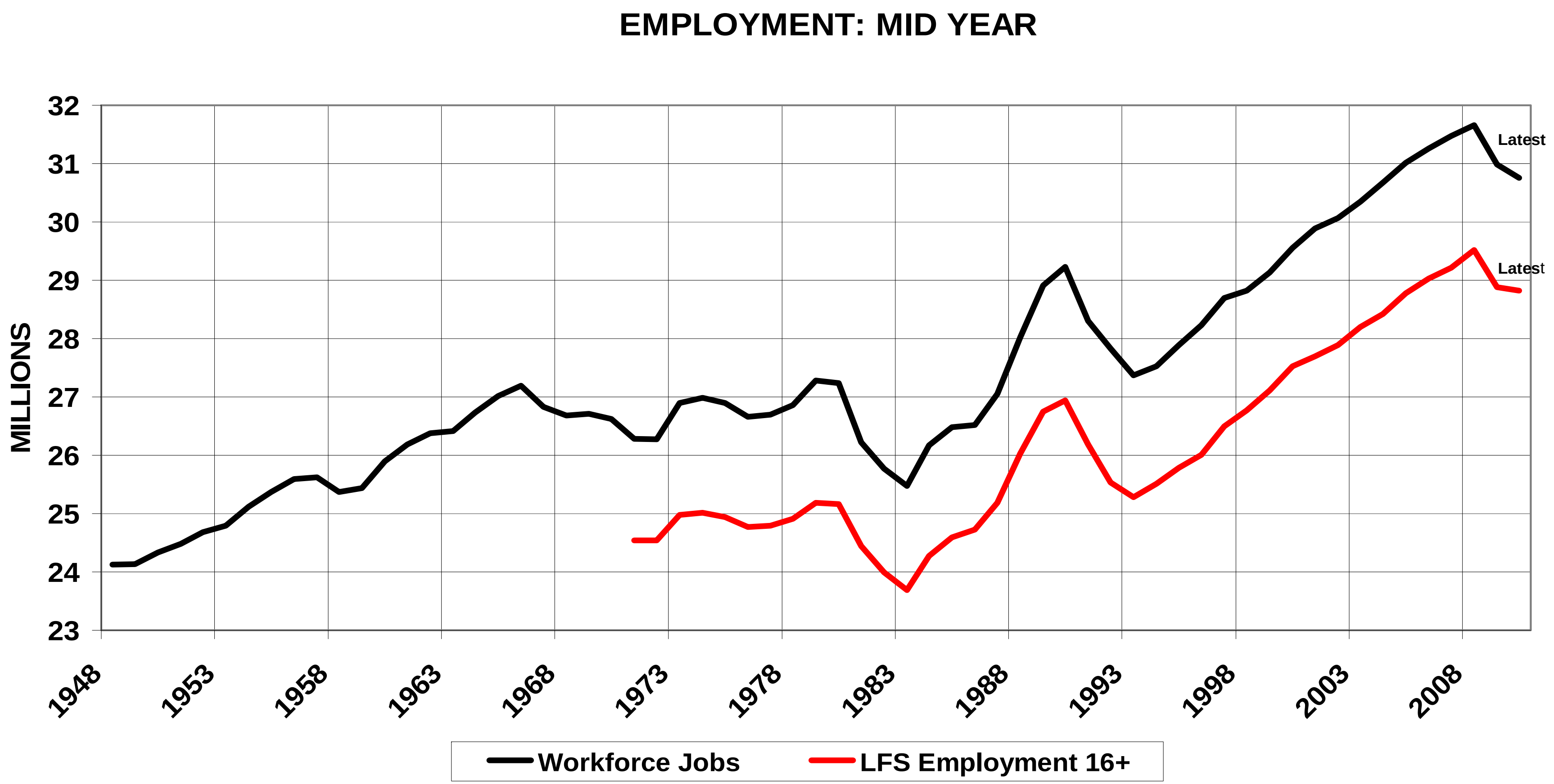
However, previous periods of strong productivity growth often occurred during periods of flat or negative employment growth, and vice versa.

May be short-run trade-offs between employment and productivity, since capital is fixed in the short-run and firms may not be choosing the optimal ratio of capital and labour in the short run. Also, new workers will take some time to adjust to new jobs and accumulate human capital.

However, in the long run, flexible labour markets may improve productivity by improving the matching of workers to jobs.

BIS Department for Business Innovation & Skills

Since the early 1980s the UK has been a job generation machine…



Imbalances

Even though some success was achieved in productivity performance over the past decade, it has proved to be unsustainable in the context of macroeconomic shocks.

Unbalanced growth

Growing imbalances in the UK economy, owing to increasing reliance on debt-financed consumer & government spending and on the financial sector.

Between 1997-2007, government consumption increased from 18 to 21% of GDP, while business investment fell from 11¾ to 10% of GDP.

Private sector imbalance

By 2008, household saving ratio had fallen to the lowest level since the 1950s and household debt had risen to 100% of GDP, as households borrowed to purchase increasingly expensive property.

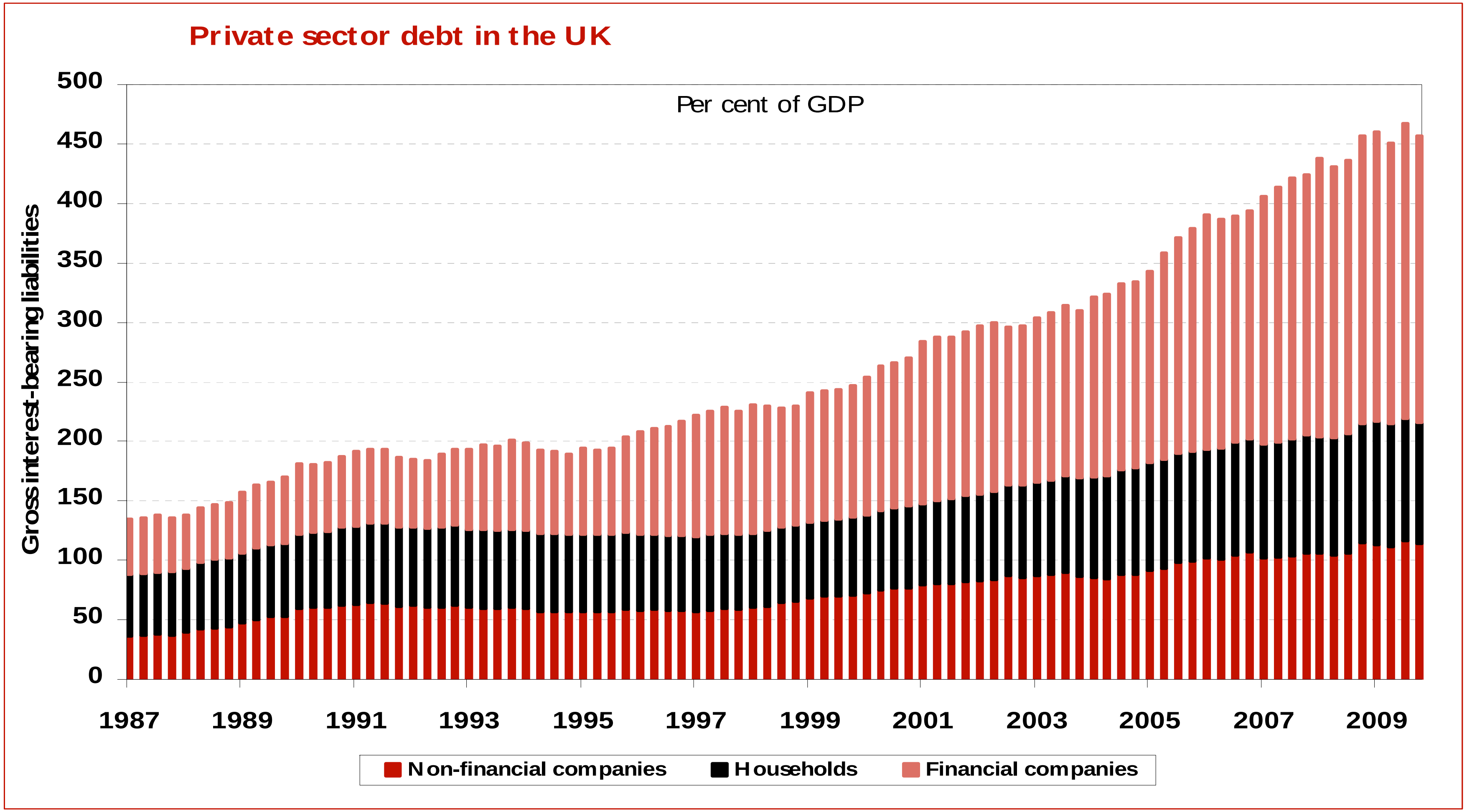
Debt levels by companies reached 110% of GDP by 2008. Within the financial sector, the accumulation of debt was even greater.

While rising debt was an international phenomenon, it was more pronounced in the UK than in most other countries.

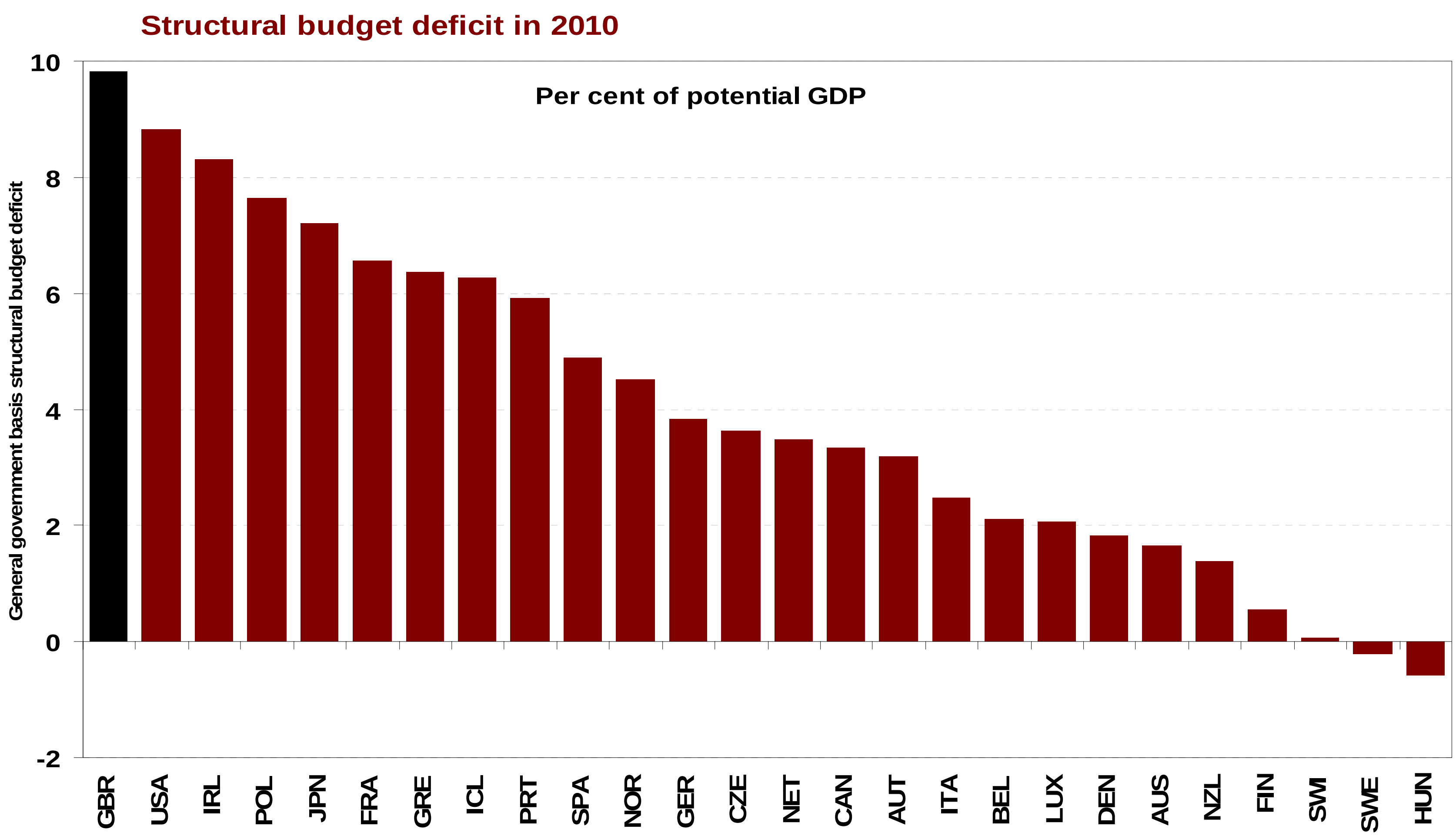
Public sector imbalance

Public spending increased from 41% of GDP in 2006-07 to 48% of GDP in 2009-10, while tax receipts fell by 2% of GDP over the same period. According to the OECD, by 2007 the UK had the largest structural budget deficit in the G7.

Imbalances in the UK economy: Private sector



Imbalances: Public sector structural budget deficit



Source: OECD Economic Outlook, May 2010.

Sectoral Performance

US, followed by UK has seen financial services account for the largest proportion of overall growth in the economy (amongst major industrialised economies).

UK now ranks amongst the lowest such economies in terms of the share of output from manufacturing.

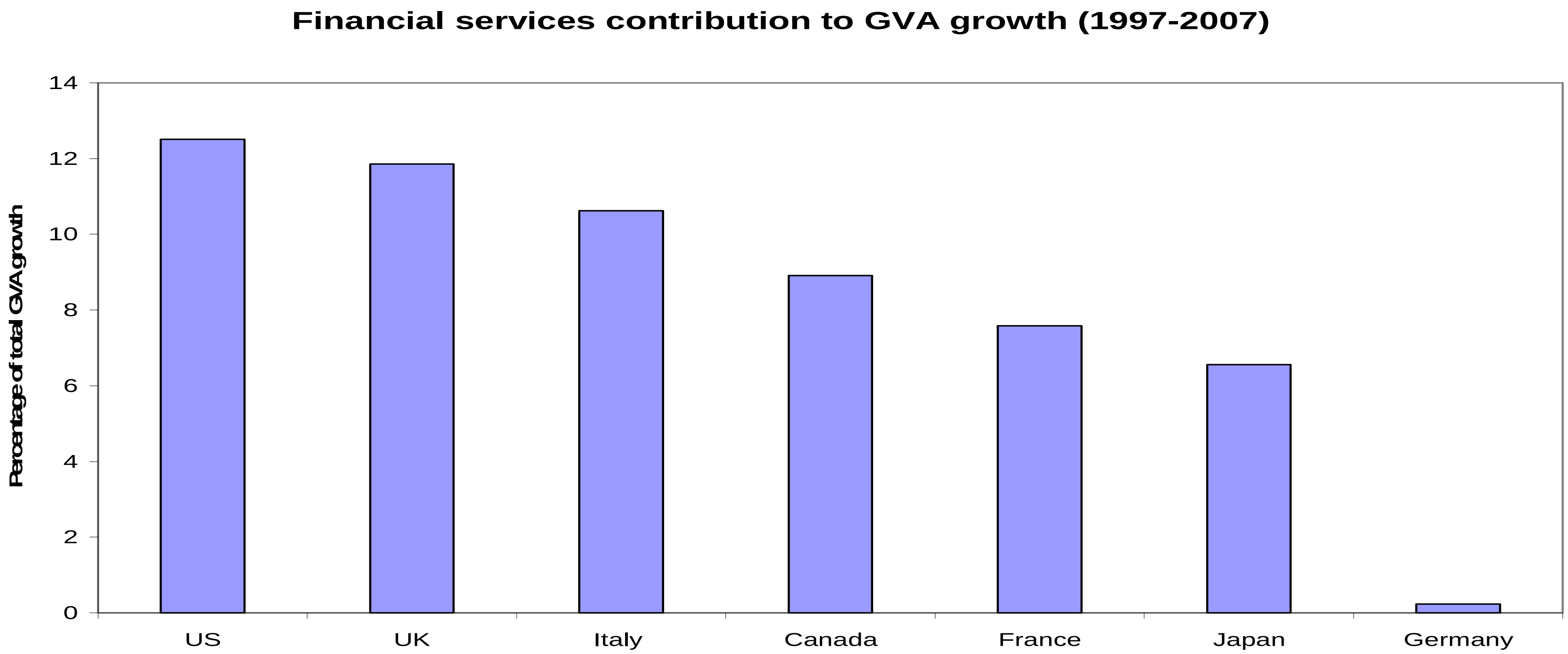
The recession has also made it clear that the UK has suffered from being over reliant upon growth in one sector.

Regional Performance

No significant convergence between regions in terms of earnings, employment, education. Annual growth in GVA per head stood at 2.5% in London, 1.8% in East of England and 0.9% in the West Midland region (2002-2008).

Growth in all regions of UK slowed since 2002, except London.

Growth has been too reliant upon financial services…



Financial crisis and recession

As a result of the underlying imbalances in the economy, the UK was particularly vulnerable to financial instability and was hit hard by the financial crisis.

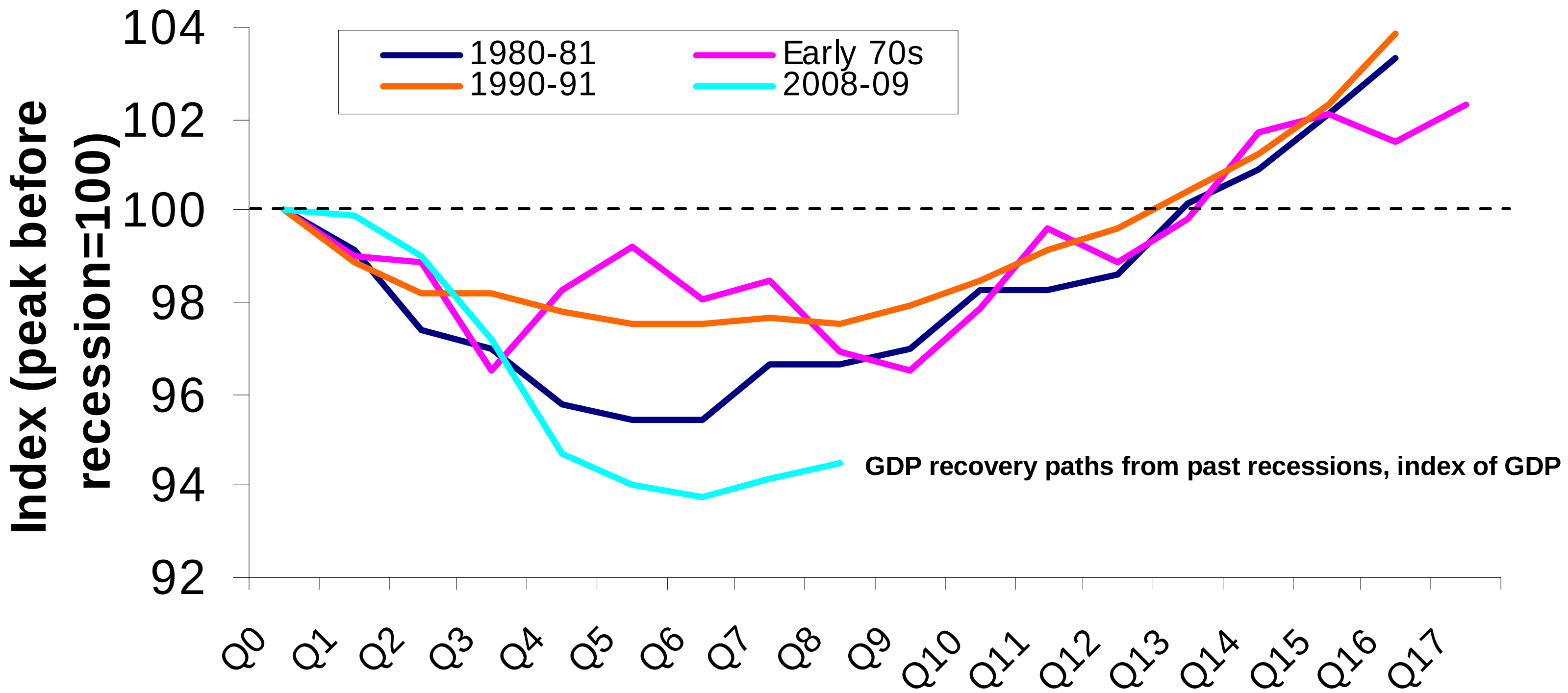
This then led to the longest and deepest recession since second world war precipitated by the loss of confidence and withdrawal of credit.

The recession has only compounded the imbalances, with government consumption accounting for 23½ per cent of GDP in 2009 and business investment falling over 25 per cent from its peak, to trough at just 8¼ per cent of GDP.

Additionally, OBR forecasts are for long-term GDP growth around 2¼ per cent over the next three years, slowing to just over 2 per cent from 2014; implying that some of the 2.4 per cent growth over 1990-2008 was not sustainable in the long term.

BIS Department for Business Innovation & Skills

GDP recovery paths from past recessions



Economy now out of recession, though growth weak.

It will take time to achieve the levels of per capita income achieved before the recession.

Department for Business Innovation & Skills

Impact of the recession

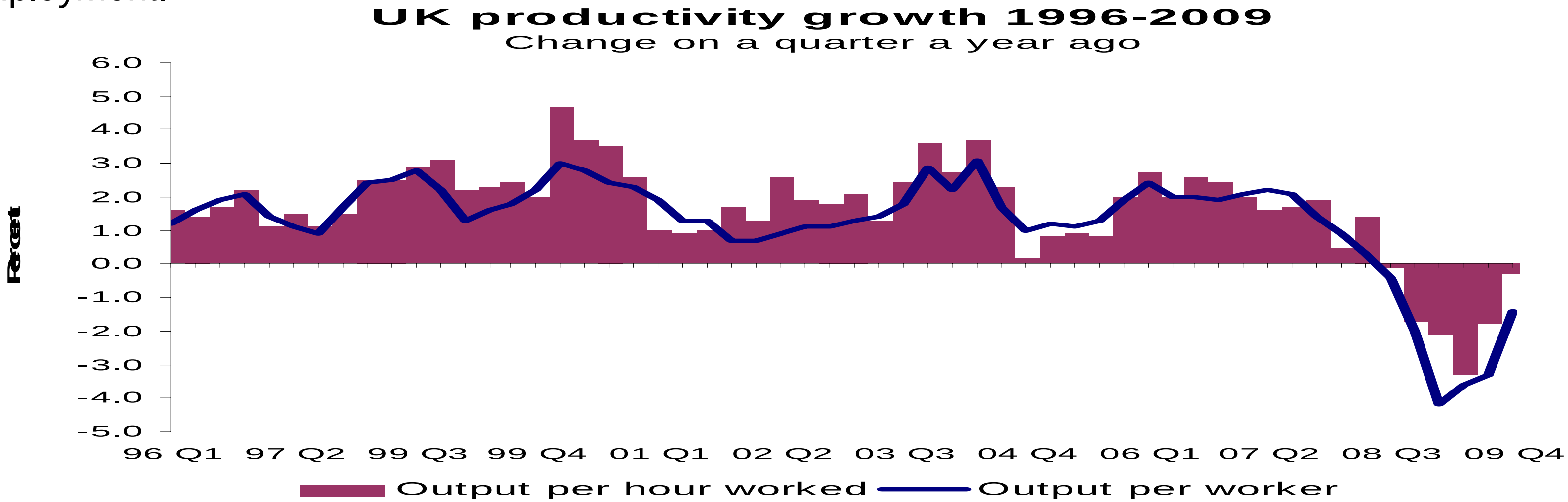
Productivity growth contracted and turned negative due to the economic slowdown.

Much of this due to cyclical factors (employment adjusts more slowly that GDP in the UK), but recession may have had a damaging effect over the medium term, particularly due to the damaging effect of the recession.

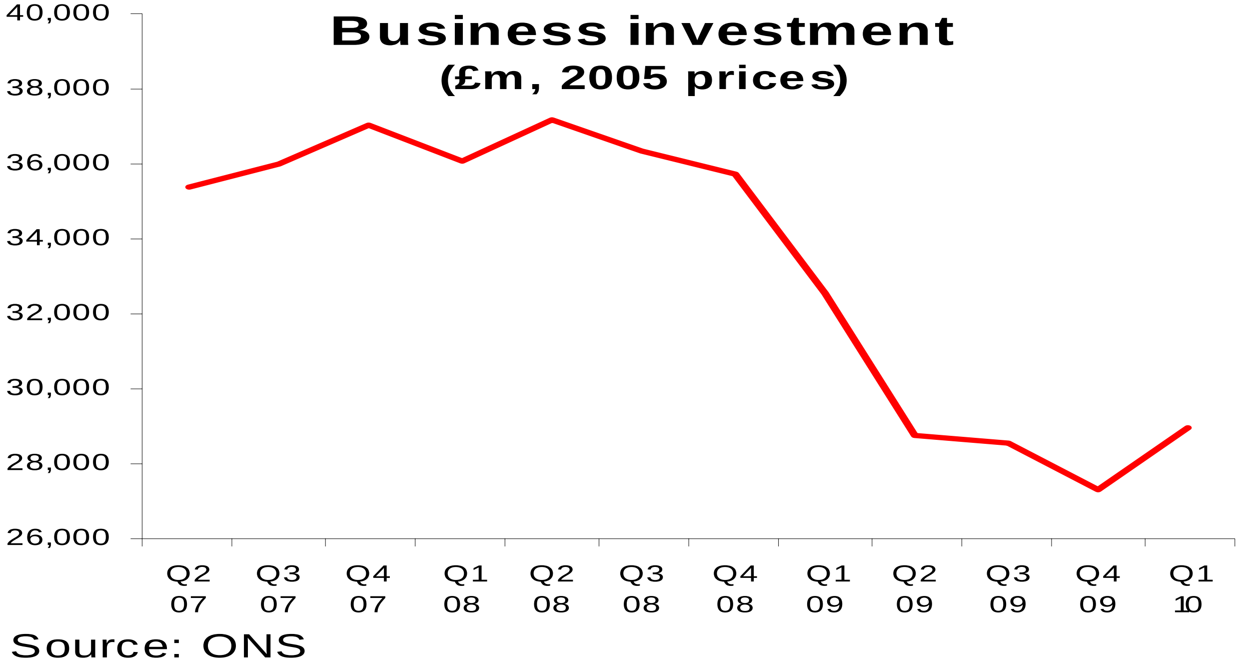
Unlike in previous recessions the fall in employment (around 2%) has not been as large given the fall in output (around 6%). Unemployment also did not increase by as much as expected.

Reasons range from reduction in pay/hours worked and increase in ‘part-time’ and ‘second-choice’ employment.

Uncertainty of future employment performance due to uncertain business conditions & falls in public sector employment.



Impact of the recession



Business Investment has been exceptionally hard-hit, having fallen over six successive quarters by a total of 26.5%, the largest cumulative fall since 1965.

OBR expect investment not to return to its pre-recession peak until 2013.

Post-Crisis Rebalancing of the UK economy

UK economy expected to undergo **significant adjustment over the next couple of years**.

Private consumption is expected to grow more slowly relative to UK GDP, as households repair their balance sheets by reducing net borrowing; and businesses engage in stock-building.

Rebalancing between domestic and external demand with net trade making a more positive contribution to annual GDP growth than it has done in the recent past.

This would be supported by the recovery in world demand and sterling's depreciation.

But challenging to have an export-led recovery with weak growth in Europe.

Rebalancing of relative contributions that the private and public sectors make to final demand: due to the fiscal consolidation that is needed to improve the public finances.

Government consumption and general government investment will almost certainly make a much smaller contribution to GDP.

Sectoral: Recession accelerated the process of structural change at the sectoral level, with strengths continuing to lie where UK is less exposed to competition from low-wage economies and where competition is on the basis of high-level skills and innovation.

BIS Agenda - Making UK a good place to do business

Large deficit implies government is no longer in a position to promote growth through fiscal stimulus and private consumers are building up their balance sheets.

Hence, growth will have to come from business sector and trade.

However, public sector still has a role to play in improving UK's competitiveness by:

- Keeping tax-system enterprise friendly
- Keeping borders open to goods and services and to highly skilled workers.
- Ensuring a competitive market framework, as market discipline makes companies more productive, boosting growth.
- Simplifying regulation to ensure it does not hinder business.
- Ensuring banks are lending to small businesses.

Also, some forms of investment are key to rising productivity and growth.

- UK cannot compete internationally without high-levels of public and private investment in skills, knowledge, technology and innovation.