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# An Investment Bank For The UK

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# 1. Introduction

**Few subjects have generated such intense debate in recent years as the deteriorating performance of Britain's manufacturing industries, but there can be no disagreement that the UK's industrial record over the past 20-25 years compares unfavourably with that of its major competitors. Furthermore, both the importance of a competitive manufacturing sector and the need to reverse its relative decline are generally accepted across a wide spectrum of opinion. The Labour Party has identified itself as the 'Party of Production', and has the reversal of manufacturing's malaise at the core of its economic strategy. Concerns about the diminished manufacturing base have also been voiced by groups as diverse as the House of Lords and the Church of England, and by numerous economic analysts and former Conservative prime ministers.**

This broad measure of agreement on the general desirability of regenerating manufacturing has not, however, led to a common view on the policies required to achieve it. In large measure, the differences in the proposed remedies reflect different diagnoses of the underlying problem. It has been argued, for example, that with the exploitation of North Sea oil and the emergence of the UK as a net oil exporter, a relative decline in the share of manufacturing in the UK gross domestic product and a deterioriation in the balance of trade in manufactured goods were inevitable. A surplus on oil, coupled with the traditional positive balance on invisibles, kept the exchange rate at a level which made it difficult for manufacturing to compete, especially in the hostile world trading conditions which followed the second oil price rise of 1979. On this diagnosis, the decline in the contribution of North Sea oil to economic activity should lead to a positive response from manufacturing industry.

An alternative view is that North Sea oil has been only one of many factors which influenced the course of events. Whilst a *relative* decline in manufacturing's share of GDP could be explained by North Sea oil, it does not account for the *absolute* fall in manufacturing output. In 1986, output was still below the 1979 level which in turn was below the 1973 peak. None of 1973-9 decline can be attributed to the North Sea oil factor, and, on this analysis, the circumstances causing that decline are still present, the period (and policies) of 1979-86 simply continuing and aggravating the process.

The rapid fall in oil prices in 1986 has added urgency to the debate. In 1986, the value of the UK's oil surplus was just about half that of 1985, and the balance of payments in 1987-8 will, it is widely predicted, be in deficit. The world trade benefits of the oil price fall should provide an opportunity for UK manufacturing industry, but the extent to which it is grasped will depend largely on our ability to compete more effectively in the faster growing markets and to recover a proportion of the home market lost to imports.

The ability to compete, of course, is partly a function of price, and those who stress the exchange rate as a cause of manufacturing's decline will expect an exchange rate adjustment consequent on the disappearance of the oil surplus to bring manufacturing trade back into balance, or even surplus. Those who have argued that the problems are more deeply rooted point to the distribution of manufacturing capacity, sector by sector, and ask whether the UK will be any more able in the late 1980s to produce the goods demanded by the faster growing, high-income markets than was the case in the 1960s and 1970s.

The Labour Party, like the House of Lords Select Committee on Overseas Trade, rightly rejects the 'inevitability' of manufacturing's decline as a consequence of the oil surplus and the 'automaticity' argument, which implies a comforting mechanism which re-establishes manufacturing as the oil surplus disappears, through the exchange rate effect. Rather than rely on market forces to bring about an adjustment, it believes a more active policy to stimulate manufacturing's ability to compete, even in favourable exchange rate conditions. This pamphlet is designed to re-examine the causes of the decline, to indicate an essential feature of any recovery programme, and to focus on one of a number of policy measures necessary for its achievement.

# 2. De-industrialisation: how far has it gone?

**Throughout the post-war period, the production of manufactured goods in the UK has expanded at a slower rate than in almost all other advanced industrialised nations. In the decade prior to the first oil crisis, manufacturing production, measured at constant prices, grew at an average annual rate of 3.4 per cent in the UK, while the other seven major industrialised countries in the OECD area, with the exception of the US, managed increases averaging more than 5.5 per cent a year. The manufacturing sectors in the industrialised countries have all suffered to some degree from the effects of two worldwide economic recessions since 1973, but only the UK has experienced an absolute decline in production.**

Between 1973 and 1985, manufacturing output in the UK fell at an average rate of 0.5 per cent a year. As Table 2 shows, this compares with average annual growth rates ranging from 0.4 per cent in France to 3.1 per cent in Japan. The severity of the decline in manufacturing output in the most recent recession was greater in the UK than in any other of the major seven countries, most of which have also recovered more rapidly.

In terms of the size of its manufacturing output, the UK currently ranks as the sixth largest in the OECD area, having been overtaken by Italy in the late 1970s. It now ranks on a par with Brazil, the largest producer among developing countries. The UK's share of the total manufactured output of market economies is estimated to have fallen from 5.2 per cent in 1973 to 3.1 per cent in 1984.

In spite of the modest revival enjoyed by the UK's manufacturing industries since 1981, total output in 1985 was still nearly 10 per cent below the peak achieved in 1973 and 5 per cent below the 1979 level. The sector has undergone a radical restructuring as it grappled with the effects of two recessions and a general intensification of international competition. Its weak performance has been largely responsible for the substantial rise in unemployment. Since the early 1970s, the number of people employed in manufacturing has shrunk by more than two million, with a decline of three quarters of a million in the space of 12 months to June 1981.

When viewed in the context of declining output, the trend towards increasing deficits in the UK's trade in manufactured goods since 1983 provides further evidence of structural weakness. In 1983, for the first time except in periods of war, the UK moved sharply into deficit on its trade in manufactured goods. The trade deficit in manufactures (ie goods classified under Sections 5-8 of the Standard International Trade Classification) widened from £4.9 billion in 1983 to £5.8 billion in 1985, having been in surplus by more than £3 billion in 1980. There has been a marked increase in the proportion of the UK market accounted for by imported manufactures (currently running at 35 per cent), all but 10 per

## Table 1
## Contributions to UK GDP, 1965-85
## (% shares)

| | 1965 | 1970 | 1975 | 1980 | 1985 |
|---|---|---|---|---|---|
| Agriculture, forestry and fishing | 3.3 | 2.9 | 2.7 | 2.1 | 1.8 |
| Energy and water supply | 5.6 | 4.9 | 5.4 | 10.3 | 11.3 |
| Manufacturing | 34.6 | 33.5 | 29.9 | 27.5 | 25.2 |
| Construction | 7.0 | 6.7 | 6.8 | 6.3 | 6.1 |
| Distribution | 11.7 | 8.9 | 12.9 | 12.6 | 13.2 |
| Transport and communications | 8.6 | 10.4 | 8.4 | 7.3 | 6.8 |
| Banking and finance | 6.8 | 8.0 | 10.8 | 11.8 | 13.9 |
| Public and miscellaneous services | 22.4 | 24.6 | 23.1 | 22.0 | 21.6 |
| **Total** | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

*UK National Accounts, various issues*

## Table 2
## Trends in manufacturing output, 1973-85

| | 1973 | 1975 | 1977 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|---|---|---|---|
| United States | 100 | 89 | 103 | 116 | 112 | 115 | 106 | 115 | 129 | 131 |
| Canada | 100 | 98 | 107 | 118 | 115 | 116 | 103 | 109 | 117 | 123 |
| Japan | 100 | 85 | 99 | 113 | 118 | 119 | 119 | 124 | 138 | 144 |
| West Germany | 100 | 90 | 92 | 109 | 109 | 107 | 103 | 104 | 108 | 113 |
| France | 100 | 93 | 103 | 101 | 110 | 108 | 107 | 103 | 105 | 104 |
| Italy | 100 | 94 | 107 | 116 | 123 | 121 | 117 | 114 | 117 | 120 |
| United Kingdom | 100 | 92 | 95 | 96 | 88 | 82 | 82 | 85 | 89 | 91 |

*UN: Yearbook of Industrial Statistics and Monthly Bulletin*
*OECD: Industrial Activity*

cent of which come from other industrialised countries. At the same time, the UK's position as a supplier of manufactures to other OECD countries has been eroded. These countries account for almost three-quarters of Britain's exports of manufactured goods. The position has been made worse by the particularly sharp decline of the UK's market share in some important high value-added sectors, notably motor vehicles, data-processing equipment, and telecommunications and audio equipment.

What overall assessment can be made of what the loss of competitivenesss has meant to the UK economy? Comparisons can be made with 1966, the peak year of manufacturing employment, when the UK had a surplus on trade in manufactures equivalent to 5.7 per cent of GNP. To have achieved a similar performance in 1985 would have added 10.8 per cent to manufacturing output. Even comparing 1985 with 1978, when the surplus was worth 3.4 per cent of GNP, manufacturing output would have been 6.6 per cent higher than the level actually recorded.

# 3. Why has it happened?

**Perhaps the least plausible explanation of recent trends is that a drift from manufacturing to services is to be expected in advanced industrial countries. It overlooks two facts: that in the UK the drift has been more like an avalanche, and that, in many respects, manufacturing and services are interdependent rather than discrete sectors.**

This latter phenomenon is easiest to understand in a regional context. It is convenient in many ways to regard each region in the UK as a small, open economy, the growth of which depends crucially on the expansion of 'exports' relative to 'imports'. Trade in this instance refers to trade with other regions as well as other countries. Local economic development is not brought about by firms within a given trading area trading more and more with each other. Growth occurs by the expansion of those sectors which sell their products outside the area.

There is, therefore, a distinction between industries which lead economic growth in an area by selling outside the territory, ie basic industries, and those which sell to the local market, ie dependent industries. Basic industries are the key to growth, whilst dependent industries' output and employment respond to the growth in basic industries. In the UK, agriculture, mining and manufacturing are largely basic activities, since the vast majority of the outputs are sold outside the regions in which they are produced. Areas of high growth in basic industries have tended to experience high growth in the service sectors.

In general, therefore, it is the growth or decline of agriculture, mining and manufacturing which is the motor behind growth and decline in the local economy. There are some service activities which can be classified as basic: financial services, international ports and airports, tourism etc, are the obvious examples. In total, these are estimated to account for 2.5 million jobs, which means that only one in five service jobs are in basic sectors. This proportion has changed little through time, though the total number has increased in line with the growth of services as a whole.

In this context, the decline of manufacturing is neither inevitable nor desirable. Of the basic industries, it is clearly the most important, but it is also the most footloose. Unlike agriculture and mining, manufacturing is not constrained by an immobility of the fundamental factor of production. Much of manufacturing is now potentially profitable in a wide variety of locations, both regional in the UK and international, and significant shifts in the location of production can and do occur.

Trade in services cannot seriously be expected to expand at a sufficient rate to offset the decline in oil or fill the gap left by manufactured exports. Whilst the UK enjoys a substantial surplus on trade in services, much of which is related to visible trade, credits on services amount to only 39 per cent of the value of non-oil visible exports. In real terms, moreover, exports of services fell by 7.5 per cent between 1979 and 1982, and only in 1985 did they recover the 1979 level. This is reflected in the UK's diminishing share of world invisible receipts, which has declined from 12.4 per cent to 7.7 per cent since 1979.

This analysis reinforces the conclusion made on many occasions

elsewhere that service activity is not sufficiently broadly based to offer the required trade and employment potential. The overall contribution of services to growth since 1981 masks the fact that it was concentrated largely in financial services and communications, whilst some other sectors declined. It is also debatable whether growth in banking and communications can be sustained at the previous rates for very much longer.

It is, moreover, perfectly feasible to expect a degree of re-industrialisation as income rises. An obvious example from the recent past is motor cars. Until the mid-1950s, people used public transport, a service, but now higher living standards have encouraged private vehicle ownership, to the benefit of car manufacturers. Similarly, in the entertainment field where televisions, videos, hi-fis and home computers have superseded the music halls, cinemas and theatres. Higher incomes have also stimulated the demand for consumer durables such as washing machines, vacuum cleaners and freezers, which have reduced the service element in the domestic environment.

Industrialised countries as a whole still retain enormous comparative advantages over the 'low-cost' producers of the Third World. There are opportunities in virtually all industries to retain some market share not only through the development of new products and new production methods, but also through the exploitation of their one great advantage, proximity to the larger, high-income markets. Equally, there are many skill and innovation-intensive manufactured product areas in which industrialised countries will continue to dominate world markets. Within the OECD area, moreover, there will also be opportunities for intra-industry specialisation to exploit product differentiation and economies of scale.

Poor performance in home markets is thus a symptom of industrial decay, not the underlying cause, and the decline in British industry has been so protracted and affects so many sectors, that it is naive to suggest that any one factor is principally responsible.

## Industrial decay

A comparative analysis of trade patterns reveals where the UK is losing out. While we have withstood competition in the traditional industries rather better than many European countries, or the US, we have fared less well in higher value-added, more skill and innovation-intensive products. Since a disproportionate amount of limited investment in manufacturing in the UK has been directed towards cost cutting and labour saving in the more mature industries, there has been a failure to exploit new products and markets embodying new designs and technology. This has allowed others to exploit their proximity to our high-income market, and prevented us from exploiting our proximity to theirs.

This general conclusion is not a new one. It has long been established that the UK's income elasticity of demand for exports is well above unity, whereas the rest of the world's income elasticity of demand from UK exports is well below unity. Thus, the UK has been unable to grow at more than half the rate of the rest of the western world without facing a balance of payments constraint. The implication of the elasticities is that our manufacturing industry produces goods not only that other nations do not want but also that the British consumer does not want in sufficient volume.

The issue is more complex than one merely of price. The government's own measures of price competitiveness for exports, imports and relative labour costs have all moved in the UK's favour since 1980, yet the volume of manufactured imports has increased four times faster than exports. Over an even longer period, the Germans and French have not only been able to increase the volume of their manufactured exports

at a faster rate than the UK, but also the unit price, indicating an ability to sell higher priced products.

This is not to suggest that price is an irrelevant consideration in home and international markets, merely that it is not the only, or even the most significant one.

The areas where the UK's European competitors have scored more highly come under the broad heading of 'non-price' factors. These embrace product design, reliability, distribution, marketing, delivery dates and after sales service, and while not independent of one another, or of price, together they constitute the customer's perception of the quality of the product. Design plays a key role in the whole range of non-price factors. Research and development is also of importance as is training.

It is hard to assess quantitatively the importance of non-price factors in relative performance, but specific industry studies and surveys confirm that in world markets the price is negotiable but the quality is not. Academic research suggests that non-price factors account for something in the range of half to three-quarters or more of the balance of customer decisions. To compete effectively, Japanese companies have relied on technological innovations and an emphasis on quality differentials, because they realise price cutting can be taken only so far if average costs are to be covered. This strategy probably explains the apparent pre-occupation of Japanese management with the product itself rather than with financial management. The neglect of these supply side considerations has led to the UK importing relatively sophisticated up-market products and exporting basic down-market goods.

A National Economic Development Council paper recently concluded that improvements in non-price competitiveness, and the consequent effects on UK

**Table 3**
**Industrial specialisation by country**

| | US | Japan | EEC Total | UK | Germany | France |
|---|---|---|---|---|---|---|
| **High research intensity** | **1.1** | **1.4** | **1.0** | **0.6** | **1.5** | **1.2** |
| Aerospace | 1.7 | — | 0.7 | 0.7 | 0.5 | 1.7 |
| Office equipment | 1.8 | 0.4 | 0.2 | 0.2 | 0.2 | 0.3 |
| Electronics and appliances | 0.8 | 2.1 | 1.0 | 0.9 | 1.2 | 1.2 |
| Instrument engineering | 1.6 | 1.3 | 0.2 | — | 0.6 | — |
| Speciality chemicals | 0.7 | 1.1 | 1.6 | 0.8 | 3.0 | 1.0 |
| Pharmaceuticals | 1.5 | 0.6 | 0.5 | 0.9 | 0.7 | 0.4 |
| Motor vehicles | 0.9 | 1.9 | 1.0 | 0.4 | 1.8 | 1.6 |
| **Medium research intensity** | **0.6** | **1.4** | **1.2** | **1.2** | **1.8** | **1.5** |
| Industrial equipment | 0.9 | 1.4 | 0.8 | 1.2 | 1.6 | 0.4 |
| Other transport equipment | 0.2 | 1.1 | 0.3 | 0.9 | — | — |
| Rubber | 1.0 | 1.2 | 0.9 | 0.8 | 0.5 | 2.8 |
| Building materials | 0.7 | 1.3 | 1.5 | 2.5 | | 4.5 |
| Metal manufacturing and goods | 0.5 | 1.4 | 1.4 | 1.0 | 2.6 | 1.3 |
| **Low research intensity** | **1.1** | **0.8** | **0.9** | **2.0** | **0.2** | **0.5** |
| Textiles and clothing | 0.8 | 2.5 | 0.7 | 1.7 | 0.4 | 0.5 |
| Paper and wood | 1.3 | 0.8 | 0.4 | 1.0 | 0.2 | — |
| Publishing and printing | 1.1 | 1.1 | 0.6 | 0.4 | 1.5 | 0.7 |
| Food | 1.1 | 0.8 | 1.0 | 1.6 | — | 0.7 |
| Drink | 1.0 | 0.3 | 1.4 | 4.3 | — | — |
| Tobacco | 1.0 | — | 1.5 | 4.7 | 0.3 | 0.3 |
| Petroleum | 1.1 | 0.4 | 0.9 | 0.8 | 0.2 | 0.9 |
| Other manufacturing | 0.6 | 0.4 | 1.2 | 1.6 | 2.6 | — |

trade, are capable of generating a large increase in employment in the future. Certainly this route offered more potential than focusing entirely on international prices, and pointed the way for the UK being as productive as its competitors in internationally traded goods, while simultaneously returning to much higher employment in non-traded areas of activity.

## Sectoral issues

At a micro-economic level, the nature of the manufacturing sector's problems can be put into sharper focus. Examining trends by sector helps to explain why the income elasticities are of the wrong magnitude in the UK.

Table 3 is based on an analysis of the world's largest industrial companies, 806 in total. They have been categorised by country of the parent and by principal industrial activity. In addition, the industries have been placed in one of three groups, according to a measure of research intensity (ie the proportion of turnover devoted to research and development (R and D). In the highest category, upwards of 2.8 per cent of sales is spent on R and D, and in the lowest, less than 1.1 per cent. The High Research Intensity (HRI) industry group has been the fastest growing internationally over the last 20 years, and the return on capital for the major companies the highest. Moving down the research intensity scale, growth and profitability fall.

The table illustrates which countries have a comparative advantage in which industries, calculated by dividing its share of the industry's sales by its overall share of all sales. A number in excess of 1.0 denotes a relative advantage, and less than 1.0 a disadvantage.

It can be seen that every country other than the UK has a comparative advantage in at least three of the HRI sectors. The UK, on the other hand, is most competitive in the LRI sectors, the slow growing, low value-added activities. Using this approach with more conventional Central Statistical Office output and trade data highlights the problem. Although the HRI sectors have been the fastest growing in the UK over the last 10-15 years, this growth has not kept pace with the rise in world demand. The UK's trade balance in these high value-added products has moved from a surplus in 1980 to a deficit in 1985, and import penetration has risen from 34 per cent to 46 per cent. In the LRI industries, on the other hand, exports as a proportion of imports has been unchanged since 1980 and import penetration is currently just 21 per cent.

This confirms the view that manufacturing investment in the UK since 1980 has gone into the traditional (LRI) industries and has been aimed at reducing costs as a way of improving competitiveness. In the key industries, there has been a steady erosion of market share, both domestic and international. The issues contributing to this poor performance are complex, and to rely on exchange rate adjustments to restore competitiveness will make only a modest contribution to an improvement. The problems are most acute in the HRI industries, those which are probably least price sensitive: the LRI products, which are more price sensitive, have not suffered to the same extent.

# 4. What needs to be done?

**If manufacturing has declined for reasons of product failure (in the broadest sense) rather than price failure, the decline will not be reversed by policy measures acting on price alone. In other words, improving the macro-economic environment, and in particular enhancing price competitiveness by exchange rate adjustments, will at best offer only a partial answer. The key question is what can be done about product failure, and this question can only be answered if it is addressed at sectoral level. A more intensive sectoral policy is the only way in which the UK can stake a claim in world markets for the HRI industries which are essential for success.**

Such a policy cannot be implemented without support from government. The competition is fierce, and markets are not won overnight. HRI industries, moreover, are dominated by large multinational companies which have developed their products and markets over a long period. It will be expensive for companies to invest in new technology which is essential; unattractive, unless there is a clear and continuing concept of manufacturing's role in a modern economy; confusing, if there are contradictory policies; and difficult for the unions to accept unless it offers the opportunity to improve total employment and real earnings. This is not an argument for an increase in government's role as a producer of tradeable goods; rather, it suggests that government has a pivotal part to play in creating the right climate for manufacturing to adjust and expand, and in improving the basic economic infrastructure to support corporate activities.

Although the key actions will take place at the micro level, a sympathetic macro-economic policy is a pre-requisite for success. To undertake the necessary modernisation, industry requires the incentive of a higher level of effective demand for domestic manufactured output. Private sector investment will not be forthcoming without the prospect of a period of sustained buoyant demand. This will require macro-economic policy initiatives (on government spending, taxation, interest rates and exchange rates) that encourage sustainable growth but do not lead to balance of payments constraints or stoke up inflationary pressures. On its own, however, demand expansion will be insufficient. It should be complementary to the aims of an industrial policy which will attempt to change the way the economy operates and performs.

## Role of investment

At the heart of the programme for manufacturing industry there must be measures to stimulate a major programme of investment in new capacity, to raise both the quality and quantity of capital stock. Recent past trends and international comparisons indicate the magnitude of the task. In comparison with the other major industrialised economies, the UK has traditionally recorded a relatively low ratio of gross investment to GDP. Since 1960, it has

averaged 18.4 per cent: the US is the only other country where the proportion has been below 20 per cent, while in Japan it has exceeded 30 per cent.

Gross investment in manufacturing as a percentage of GDP in the mid-1980s, moreover, has been at its lowest level since the late 1950s. Furthermore, since 1981, capital consumption has exceeded new investment in manufacturing, and there was therefore a reduction in the capital stock (even allowing for the distortions caused by leasing). In each year from 1981 to 1983, this exceeded £1.5 billion, and, although it has since declined, net disinvestment still exceeds £0.6 billion. The Bank of England has estimated that between 1979 and 1985, the net capital stock of manufacturing industry contracted by 2.75 per cent. During this same period, new investment in sectors such as banking and distribution outstripped capital consumption by £5 billion and £2 billion respectively.

Improvements in performance are not just a matter of levels of investment but also of its quality and direction. A core component of a successful innovative investment programme is R and D expenditure. As has been well documented elsewhere, this has been increasing at a slower rate in the UK than in any major industrialised country other than the US. In addition, a higher proportion of R and D expenditure in the UK is devoted to defence, and the spin-off to civilian commercial activities has been limited. The consequences are apparent from the UK's share of the key HRI sectors discussed above, and the declining competitiveness is as much a reflection of capital productivity (low capital/output ratios) as the volume of capital expenditure.

Investment, therefore, has a critical role to play in restoring international competitiveness in manufacturing. Previous governments have tried to increase the rate of investment through a range of subsidies and tax incentives, with varying degrees of success. There has, however, been no concerted effort to improve both the quality and quantity of investment with the objective of raising performance. It is this combination that has eluded governments in the past. Total investment has at times been increased by government action, but incentives have just as frequently been used for low quality investment (witness the boom in property in the early 1970s). The quality of investment has at times been improved, notably by the industrial strategy of the mid-1970s. To achieve the combination of the two requires both that the machinery of government, in other words the bureaucracy, be kept at a distance, at one remove, from the decision to finance any particular investment project and that the weight of government support be behind the general programme. The question now is whether this combination can be achieved with existing institutions, or whether a new institution (or an existing institution with an enhanced role) is necessary for the purpose.

# 5. How can it be done?

**The Wilson's Committee's investigation into the functioning of the UK's financial institutions concluded that there was no evidence of any general shortage of finance for industry at prevailing rates of interest and levels of demand, and with existing perceptions of the risks involved. It expressed the view that industry had not been held back by an inability to obtain external funds (*Report of the Committee to Review the Functioning of Financial Institutions* (Wilson Committee), Cmnd. 7937, 1980).**

In their submission to the Wilson Committee, the clearing banks justified their emphasis on short-term lending to industry in terms of the constraints placed on them, by the need to honour agreed lending facilities, and also by competitive forces which had eroded their market share of lending. In practice, the clearing banks believed that bank lending was used to finance fixed investment as well as working capital since a good deal of overdraft lending was in fact term lending with limits regularly revised. Their general view was that investment had not been held back by lack of finance nor had the total amount lent, or its allocation between sectors, contributed to the general economic decline.

Underlying the specific points made by the banks was the assumption that the decision to raise funds to add to the capital stock of industry depended essentially on the borrower not on the lender. It was also related to the rate of return which the borrower could secure from the productive use of the assets. The problem for manufacturing industry in the banks' view, therefore, was that the real pre-tax rates of return on manufacturing were lower in the UK than elsewhere, and this had had a discouraging effect on the demand for capital for new investment.

Pre-tax rates of return on manufacturing have improved since the publication of the Wilson Committee's report and are currently the highest for a decade yet investment has not responded. Some of the fundamental questions raised by Wilson are being asked of the banks once again, often by industry — in particular, the cost of capital and the extent of banks' willingness to lend long term have become important issues. Industrial banks in other countries provide facilities on more favourable terms than the clearers are able or willing to do in the UK.

## Cost of capital

In the UK, nominal interest rates peaked in 1980-1, and are now not significantly higher than in many European countries. The problem, however, is that after adjusting for inflation, real interest rates are higher: currently, the UK is the only major industrialised country with real interest rates to the corporate sector above 10 per cent. This clearly adds to the real cost of investing for UK companies and reduces the profit margin.

Detailed analysis of the importance of the cost of capital in international competitiveness has been undertaken by two Americans, G. Hatsopoulas and S. Brooks. Their study concludes that over the past 25 years, American manufacturers have paid three times as

much for capital as the Japanese. The result is that investment per worker is twice as high in Japan than in the US, and much of America's loss of industrial competitiveness is attributed to the high cost of capital (G Hatsopoulos and S Brooks, *The gap in the cost of capital: causes, effects and remedies*, 1986). Two other Americans, D. Bernhelm and J. Shoven, have argued that domestic credit market conditions are the single most important determinant of capital costs, even in the face of global capital mobility (D Bernhelm and J Shoven, *Taxation and the cost of capital: an international comparison*, 1986).

The clear message from these two analyses is that the cost of capital is important and this problem should be attacked. The Wilson Committee concluded that there was no shortage of funds "at prevailing rates of interest", but it is apparent that the rate of interest needs closer attention. It is equally obvious that the clearing banks have obligations to shareholders which preclude them from subsidising loans to industry. Since the general level of interest rates are largely determined by macro-economic factors, moreover, new sources of lending to manufacturing at cheap rates must be sought.

## Long-term finance

The length of loans is also an important factor. Comparisons have been made between the banks' willingness to lend for 20-25 years for mortgages but their reluctance to make similarly long-term advances to industry. A loan over 20 years rather than 5 has obvious cash flow advantages to the borrower, and can reduce the risk (the likelihood of default). The banks claim that more of their advances have been medium/long term, certainly since the publication of the Wilson Committee's report. Of the UK clearing banks' advances to UK non-personal customers in 1986, however, only 13 per cent were for a period of 5 years or more, whilst 50 per cent was on overdraft, and a further 21 per cent was for less than 12 months.

Although the banks have responded to a limited extent to the Wilson Committee's recommendations (particularly in their attitude to small and medium sized firms), the failure of the corporate bond market to revive means that financing long-term investment, even for larger companies, remains difficult and perplexing. The overdraft remains the single most important instrument the banks offer industry, and its significance has grown during the 1980s. It is hardly the most appropriate method of financing long-term investment, nor is it intended to be.

Despite these criticisms, little would be gained from redirecting the banking system, even if it were possible. Not only would a different kind of banker be required, but there would be a serious risk of damaging the international competitiveness of the banks. Between 1974 and 1985, when manufacturing production *fell* by an average of 0.8 per cent per year, the output of the banking and financial community *rose* at an average annual rate of 6.2 per cent. Medium and long-term projections show a slowing down in the rate of growth of the financial sector, but it is nevertheless expected to grow two or three times faster than manufacturing.

In employment terms, this sector is significant, with over 2 million people in 1986 (almost half of whom are female), and expanding. This is equivalent to some 40 per cent of the manufacturing labour force, which is contracting. The financial services sector appears to be a good, as well as a large, employer, with average pay above that of most other industries.

The same is true of the wider range of financial institutions. The overall net earnings of all UK financial institutions in 1985 was £7.6 billion which covered almost 75 per cent of the deficit on non-oil visible trade. Even more striking is the huge growth in credits attributable to banking activities. From £4.4 billion in 1975, these rose to £41.6

billion ten years later, a rate of increase three and a half times faster than non-oil visible exports. The UK ranks amongst the world's leading exporters of financial services, a position any future government would be anxious to maintain.

Redirecting the machinery of those institutions, if it means diverting their attention from international business, would be to put at risk an industry which is basic, and therefore likely to be self-defeating as a policy measure.

Nevertheless, there is an increasing feeling that the gulf between industry and finance is widening. Several claims are made against financial institutions, particularly those forming what is known as the "City". It is said that UK banks have been too preoccupied with the financing of overseas trade and other international activities to ensure an adequate supply of investment finance for domestic industry; that by their preference for short-term rather than long-term lending they have forced lower gearing levels on companies than is the practice in other industrial countries; that they have overpriced or demanded unreasonable security for funds for small-scale or high-risk innovative ventures; that their traditional arms-length, passive role implies a lack of involvement in or commitment to their industrial customers until problems arise, which is often too late; and, above all that they place a higher priority on short-term performance than long-term growth.

There is much anecdotal and some statistical evidence to support these charges. The analysis of bank advances to UK residents, for instance, lends credence to the claim that banks' priorities lie in sectors othan than manufacturing. In 1975, 25.3 per cent of outstanding bank loans and advances were to manufacturing, a proportion which had fallen to 20.1 per cent by 1983: since then, there has been a further decline, and in May 1986 the share was only 13.3 per cent. There has, however, been a corresponding rise in the proportion of loans going to the personal sector, from 13.6 cent to 26.1 per cent between 1975 and 1986. Loans to other financial institutions have also increased in relative importance, while the proportions accounted for by construction and government and public utilities have fallen (the latter reflecting privatisation).

## Market-based v bank-based systems

The institutional environment in which banks in the UK and in the other major industrialised countries operate help put the supposed inadequacies of British financial institutions in context. It also adds further weight to the argument that redirection of existing institutions would be inappropriate and that the establishment of a new body is the most effective way to promote industrial investment.

The critical distinction in organisational structures is between bank-based and market-based systems. Bank-based financial systems are those in which the banking sector plays a major role in the financing of industry, whilst the securities market is neither very active nor well developed. In contrast, market-based systems are those in which the securities markets are both highly active and provide a major source of finance for industrial companies, but where the banking sector plays a less dominant role.

Bank-based systems are a feature of the industrial environment in Japan, West Germany and France, whilst the UK and US are the most obvious examples of market-based systems. In general, relations between banks and industry are closer in countries with bank-based systems. The effect different systems can have on the corporate customer was highlighted in an article by Will Hutton in The Listener (13 February 1986), contrasting the experiences of two major motor vehicle manufacturers, BL in the UK

and Toyo Kogyo in Japan, manufacturers of Mazda, when both ran into financial trouble in 1974.

BL was then producing 1.2 million cars a year; Toyo Kogyo 750,000. The Japanese company was more in debt than BL, losing more money, had far greater unsold stocks and an obsolete product range. Yet today, BL (now Rover) produces fewer than a million cars, whilst Toyo Kogyo's annual production is three times higher. Critical to the subsequent histories of the companies were the attitudes shown by their principal bankers in 1974. In the UK, the banks refused to put more money into BL when the debt equalled the shareholders' equity. The government assumed responsibility for funding the company and a long-delayed recovery programme was put into effect, but on a much reduced base. In Japan, when Toyo Kogyo's debts exceeded equity by four to one, the main bank was instrumental in putting together a radical plan for restructuring the company, which included substantial new investment. The results are reflected in the current production figures of the two companies.

This may be an extreme example. There is however ample evidence at the other end of the size scale to support the view that the banks' arms-length relationships with their corporate customers have not served either party very well. In 1981, the government introduced the Small Business Loan Guarantee Scheme, the purpose of which was to provide potentially profitable (small) firms with access to funds for projects that did not attract financing from conventional sources. A review of the scheme, undertaken by a firm of chartered accountants on behalf of the Department of Trade and Industry, was critical of the support banks were able to give companies in this context (Robson Rhodes, *A study of business financed under the Small Business Loan Guarantee Scheme,* DTI, 1984).

Acknowledging that the banks offer the single most direct route for influencing and contacting (small) businesses, the report concluded that "many managers ... saw the administration of their branch, and the volume of transactions through their branch, as precluding giving small businesses special attention. (T)heir ideas of how to cope were often limited ...". Equally critical was the conclusion that "only a minority of bank managers are suited to lend at the fringe of commercial prospects ...".

The National Economic Development Council's Committee on Finance for Industry's report on 'Lending to Small Firms' also had some harsh criticisms to make of the financial literacy and judgemental skills of many branch managers (NEDC, *Lending to small firms 1986, External capital for small firms* 1986).

In many respects, these criticisms are understandable, and from the bank's viewpoint defensible. As the corporate market is changing, so are the banks trying to restructure their own activities in response. Separating the high street retail business from the corporate customer is a fundamental issue which all the clearers are examining, but none has yet grasped. The role of the manager, the nature of the relationship with the corporate customer and the key products the banks have to offer will all be affected by how the restructuring is implemented.

This is not to criticise the banks, but to argue that, in spite of their traditional links with UK industry and their comprehensive geographical network of branches, they may not be the most appropriate institutions for spearheading the drive to improve industrial performance. The arms-length relationship which is an almost inevitable consequence of the market-based system has not encouraged traditional clearing bankers to understand industries or to evaluate a lending propositions on anything but a 'gone-concern' basis. The clearers' high cost base precludes the development of proper relationship management for all but the most profitable accounts, while

the spread down-market of multi-banking has made it harder for a bank to develop a special lead bank relationship with its larger corporate customers. It is, in addition, still largely the case that the bigger companies, usually with Head Offices in London or the South East, get the best service from the banks, yet these are often the least profitable accounts, and ones which do not need high-level account management.

## 'Short-termism'

In the case of financial institutions other than the clearing banks, the criticism that is most fiercely advanced by industry relates to the time horizon. 'Short-termism' was a subject which provoked intense debate at the CBI's last National Conference in November 1986. The City had few supporters from industry, and it had to rely on representatives of the banking sector to defend its record. "An obsession among financiers with bottom-line results" was the charge most commonly levelled against financial institutions, and respected City commentators have identified a growing tension between industry and finance.

In some ways, the timing of this changing climate is strange. In 1985, non-North Sea industrial and commercial companies' profitability increased for the fourth successive year, whilst the pre-tax rate of return, at 8 per cent, was the highest since 1973. In addition, the de-regulation of financial markets has intensified competitive pressures within the City, and supposedly given companies easier and cheaper access to funds. The point has already been made, however, that improved corporate performance has not resulted in a corresponding increase in investment in new assets, and part of the explanation for this has been attributed to the attitudes of the City, particularly the short-term view taken by the market-based institutions.

Although investment in new assets has stagnated, there has been a surge in expenditure on the transfer of ownership of existing assets. Merger activity has gathered pace during the 1980s, and in 1985, the value of takeovers by industrial and commercial companies was £7.1 billion, the highest figure for a decade and equivalent to 90 per cent of new investment in manufacturing. These mergers often reduce capacity, and are increasingly of the 'conglomerate' type owing more to financial sleight of hand than industrial logic. This has implications for any serious programme to increase and improve industrial investment and competition policy will have a role to play here.

The financial system in general does not encourage organic growth by companies. On the contrary, it puts pressure on them to ward off predators by putting the short-term interests of shareholders (other large institutions) ahead of the longer-term development of the company. The threat of a takeover is a constraint to growth, since faster growth requires companies to retain a higher proportion of profits. The resulting lower dividend leads to a lower relative share price, thus increasing the likelihood of acquisition. If, on the other hand, growth is financed by external borrowings, it increases debt in relation to equity. In a period of high interest rates, high gearing ratios make for potential danger if profits fall.

## Conclusions

The UK's financial system, whilst efficient and internationally competitive, is not able to respond to the needs of manufacturing industry. The historical development of British financial institutions has encouraged an arms-length relationship with all but the largest of their corporate customers, whilst there has been an increasing tendency in recent years to take a short-term view of lending opportunities. This has come at a critical time

for manufacturing industry, when domestic and international pressures have increased the need for a more sympathetic response to its problems. The need for a more integrated approach between industry and finance is highlighted if the practices common amongst the UK's principal industrial competitors are considered.

# 6. What is done elsewhere?

**In the UK's market-based financial system, the three key sectors of government, industry and finance all appear to pursue their interests separately. There have been few peacetime attempts to develop a framework around which all three could coalesce, and no agreed objective of national interest. The arms-length relationship between industry and banks extends to industry and government and to banks and government. In this environment, government leadership is regarded as interference or intervention, and attempts to change behaviour or attitudes amount to little more than exhortation.**

In most other European countries, and (especially) in Japan, there is a greater integration of the various sectors of the economy. Government involvement in the running of the economy at the micro-economic level is more readily accepted, and as a consequence more effective. This involvement is usually termed 'industrial policy', at the core of which is the government's ability to promote, stimulate and regulate industrial development through the financial system.

It is the bank-based financial systems which are the most integrated. In some of these countries, the government takes the lead in defining the long-term objectives, whilst in others it adopts a lower profile, preferring to operate obliquely and indirectly. These countries have recorded faster rates of manufacturing growth than the UK over a long period, and it is believed increasingly that part of this success is attributable to the integrationalist approach that is adopted.

In spite of the fact that the UK was the first to industrialise, and that its financial system has long been amongst the most sophisticated in the world, the two sectors have operated independently and developed separately. It was perhaps because the UK was the first to industrialise that this happened. Industry was funded initially by private capital and subsequently by internal funds arising out of high profits. For their part, the banks developed their interests elsewhere since it was apparent that industry was able to grow without their help.

From the outset, industrial development in the major European countries was more co-ordinated than in the UK. This involved closer links between the industrialists and the financiers, to the extent that new institutions were established to meet the needs of industry or special skills developed by the large commercial banks. Thus, industrial banking can be a service provided by a general bank as much as a specialised institution engaged exclusively in industrial banking. It is, however, the special credit institutions in continental Europe and Japan which have been a conspicuous feature of their systems. This is a 20th century phenomenon, born out of the general industrial banking which emerged in the last century. Whilst the role and organisation of each of these special credit institutions is determined by the unique financial and industrial structure in each country, there are features common to most of them:

- there is formal state direction and/or financing;

- the credit institutions have concentrated largely on providing long-term loan capital to companies, rather than equity finance;
- re-developing existing enterprises is the focus of the activities, rather than promoting new businesses;
- small and medium sized enterprises are as, if not more, important than the larger companies; and
- the special credit institutions are more lending than deposit-taking bodies, raising much of their finance at long maturities.

In some ways, the distinction between the industrial banking services provided by the general banks and the facilities offered by the special credit institutions is an arbitrary one. The demarcation is even more blurred in some countries where the special credit institutions work entirely through the banking system. Since much of what is being proposed for the UK, however, is based on the special credit institutions, the distinction is worth making. It should, nevertheless, be remembered that these bodies do not represent the sum of industrial banking expertise in any one country, but they can be regarded as the catalyst around which the relationships between industry, finance and government revolve.

## Structural characteristics

A summary of the operations of the major credit institutions in the leading industrialised countries is given in the Appendix. The structure of each of these organisations is determined largely by the peculiar financial and industrial environment in that country, and any similar body in the UK must be organised in a way which takes into account this country's institutional framework. There is, therefore, no single foreign example which can be transplanted in the UK. The brief summaries of the main characteristics of these other long-term credit institutions,however, reveal the general factors which have contributed to their success.

In terms of status, ownership and control, the credit institutions function most successfully where there is a close relationship with the state on policy issues but autonomy on operational matters. Since the state is, in most cases, a major provider of funds and sets the national economic objectives, a close relationship on policy matters is essential. Independence at the operational level is just as critical because the institution:

- needs to be able to reject bad propositions and poor quality borrowers;
- has to maintain its credibility with other financial institutions;
- needs to minimise bureaucratic delays and political interference; and
- has to ensure continuity when governments change.

Although their precise legal status varies, the major credit institutions in Europe and Japan qualify under both criteria. The three Japanese banks are all in private hands, having once been government-owned, but they continue to enjoy a very close relationship with the state. In Germany, the KfW is owned by the government, but its independence is undoubted. CN in France is privately owned and has its shares traded in the Stock Exchange, but enjoys special legal provisions and has a number of top posts filled by government appointment.

## Lending policy

The central role of the credit institutions is to provide general support for industrial investment by lending funds of medium and long-term maturities at a cost which is generally below the prevailing market rate. In Japan, loans are, on average, for 5-7 years, from the KfW for 4-10 years and in

France, the CN lends from 10-15 years.

Just as the financial institutions argue that it is inappropriate for them to borrow short and lend long, so industrial companies can claim it is unwise for them to borrow short in order to invest long-term. Since floating rate finance makes the calculation of returns on investment hazardous, the availability of long-term money at fixed rates is considered to be a necessary investment incentive. These are services the credit institutions are able to offer, together with the important interest rate subsidy.

This should not be taken to mean that these banks lend to any applicant. An integral part of the institutions' operations is the closeness of the relationship they develop with the borrower. There is often active monitoring of company performance, to the extent of involvement in discussing management plans and exerting direct influence over corporate policy. Some of these loans are made against targets for specific objectives (eg exports) or after the submission of a plan detailing the company's future activities.

## Markets and products

Most of the credit institutions have a specific remit to support small/medium sized enterprises (SMEs). In most countries it is felt that the larger enterprises have easier access to equity markets. In Germany, for example, 70 per cent of the KfW's domestic investment loans are to SMEs: other institutions, such as the Industriekreditbank AG-Deutsche Industriebank, are also involved in this sector. In France, the CN focusses on larger companies, but there are 15 Societies de Developpement (SDR) and the CEPME which compete fiercely for the small/medium firms. It is estimated that CN has a 45 per cent share of long-term loans to industrial and commercial sectors, CEPME 35 per cent and the SDRs 18 per cent. The situation is similar in Japan, where there is a host of smaller banks specialising in SME financing.

The emphasis of the credit institutions' activities is on providing long-term loans for investment. Few are interested in taking direct equity stakes in borrowing firms. Similarly, these institutions do not provide funds to rescue ailing companies, concentrating instead on investments which have long-term potential. In the major European countries, there are other publicly-funded institutions which are prepared to take a stake in a company or help it through short-term difficulties, in rather the same way as the National Enterprise Board tried to do in the UK during the 1970s.

Advice is an important service offered by these institutions. They have developed industrial expertise in dealing with borrowers and in approving loans. Large research departments are a common feature which can advise not only on the economic environment in which companies operate, but also on the development of standard loan contracts and rules for security. The credit institutions' approach to lending is based on whether or not expected cash flows will be sufficient to cover interest and capital payments. British banks, on the other hand, tend to adopt the 'gone concern' or 'carcass' evaluation, which requires no industrial expertise or understanding of the borrower's business: it is a decision reached at arms length, based on accounting valuations of a company's assets. The cash flow approach does not mean no security is taken. The collateral, however, is mainly a protection of the bank's position against the borrower or other creditors: the decision on whether or not to lend does not depend on the security. The cash flow approach is meant to encourage companies and projects with good future prospects and additional criteria are designed to encourage investments which meet national economic objectives.

Equally important is the credit institutions' role as advisers to governments. Their close contact with compa-

nies and their understanding of industry and finance places them in a unique position for advising on industrial policy issues. The Japanese banks and CN in France have been most closely involved in such discussions.

It is hard to assess quantitatively the impact these banks have had on investment. Some indication can be obtained from a survey undertaken by Germany's KfW of its corporate customers in 1983. This revealed that only 20 per cent of respondents would have carried out the project in the same way had they not received favourable loan finance. Of the remainder, 70 per cent reported that they would have cut down their investment plans or postponed the project without KfW assistance, and 10 per cent claimed the project would not have been carried out at all. The three most commonly cited reasons for using the KfW were low interest rates, the length of the loan and the fact that the rate was fixed. The majority of respondents regarded the procedure for loans as straightforward, which encouraged them to apply, and it was also felt that lower interest rates were preferable to investment grants or allowances.

## UK gap

There is no UK equivalent for the credit institutions that have been described here. The nearest approximation is Investors in Industry Group (3i), which acts as the holding company for the Industrial and Commercial Finance Corporation (ICFC), Finance Corporation for Industry (FCI), Finance for Shipping (FFS), and other subsidiaries involved in leasing, property and consultancy services. 3i owns substantially all the investments and other assets of the group, and carries on the group's investment activities in the UK.

ICFC and FCI were formed in 1945 at the request of the Labour government, and in 1973 the holding company Finance for Industry was formed, which in 1983 was renamed Investors in Industry. It is owned by the Bank of England (15 per cent), Bank of Scotland (3 per cent), Barclays (18.8 per cent), Lloyds (13.7 per cent), Midland and Clydesdale Banks (18 per cent), Royal Bank of Scotland (7.6 per cent), National Westminster (23.7 per cent) and Waterloo Trustee Co. (0.1 per cent). The group operates under five divisions, ICFC, Head Office, Ventures, Shipping and Energy, and Property. Shareholders' funds in 1986 amounted to £277 million and total liabilities were £1,877 million on which a surplus (after tax and interest) of £29.7 million was earned. Gross investment in the year was £318 million.

The group provides permanent and long-term investment capital, as well as advice, to businesses of all types. These facilities are provided through specialist groups, with particular skills in different market segments, either direct or through its network of 23 regional offices. 3i's long-term investments come in many different combinations of loans and shares, and it also provides hire purchase, leasing and guarantees. The present government's emphasis on and fiscal support for the establishment of new businesses and the accumulation of private capital has proved the stimulus for the growth of new venture capital and Business Expansion Scheme funds.

On the surface, it appears that 3i fulfills a similar function to the European credit institutions. There are, however, critical differences in its operations which sets it apart from its European counterparts.

In the first place, the ICFC was not welcomed by the British banks other than the Bank of England: it was imposed by government, and for many years did not enjoy a close relationship with its parents. In 1959, it was able to raise money on its own by means of quoted debenture and loan stock issues, since when it has become totally independent of the state and the banks. In raising funds, however, 3i receives no interest subsidy. None of its borrowings are guaranteed, either by the govern-

ment or the shareholders (except European Investment Bank or European Coal and Steel Community funds). The group also has to pay tax and dividends, all of which means that its lending rates must cover its own cost of funds plus the required margin. There is therefore no scope to offer any form of substantial lending at below market rates.

In other areas also there are important differences. 3i takes deposits from the general public and is involved in equity financing, neither of which are common in Europe. Its independence of both the banks and the state means it does not have the important advisory roles played by its European and Japanese counterparts. In addition, its loan appraisal techniques, whilst paying more attention to the company's future prospects and development than the clearing banks, still places a high priority on taking appropriate security.

The most important difference between 3i and the European credit institutions is the scale of operation. The volume of lending by 3i is small by international standards, perhaps one-tenth of the size of Germany's KfW. In the year ending March 1986, it made 914 loans, over half of which were in the £20,000-£200,000 range. The number of loans in 1986 compares with 1,076 by the group in 1982 and with KfW's 20,000 a year.

The general view of 3i is that it is a well-managed, efficient and sound credit institution. In view of its limited size, however, it has not had a major impact on investment, and its operations are closer to those of the British clearers than the KfW or CN. There is a clear distinction between a small, well-managed credit institution serving a well-defined market segment and large institutions designed as instruments of national policy.

# 7. An investment bank for the UK

**The analysis in previous chapters leads to several conclusions. First, the long-term decline in British manufacturing is not inevitable; it can be reversed, but not with short-term policies and not by relying solely on macro-economic adjustments. Second, an essential feature of manufacturing resurgence will be a shift of emphasis from LRI industries to HRI industries. Third, this shift will only be achieved by a carefully studied sectoral policy. Fourth, an essential feature of this policy will be a programme to increase the quantity and quality of investment at the same time. Fifth, existing financial institutions are unable to lead this programme, although they may contribute to it.**

It follows that a specialist institution must be devised to perform the essential function of leading the investment drive. To judge from examples in other countries, such an institution, to be successful, must be able to offer longer-term finance in substantial amounts, at an overall cost equal to or lower than the market and with payback arrangements to suit the borrower and the projected timing of returns from a given investment project. It must also be able, by virtue of its expertise, to advise on, evaluate and assist in industrial investment plans, with techniques of risk assessment that search beyond the balance sheet and immediate security and that understand the future threats and opportunities faced by companies. Finally, it must be able to link its lending and investment activities with the overall strategy for industry followed both by central government and by organisations such as regional development agencies and local enterprise boards which will be increasingly important in promoting projects based on the strengths of local communities. The British Investment Bank (BIB) as proposed by the Labour Party will be such an institution.

The proposal for such a bank is certainly not the first of its kind. A National Investment Board to direct investment was in fact proposed in 1918, and was Labour Party policy for most of the inter-war period. More recently, the subject was also debated at length by the Wilson Committee, which managed to split three ways over the need for a new institution. While subsidising the cost of capital was felt by the Committee to be an acceptable (but not unanimously popular) method of trying to improve the competitiveness of British industry, the idea of a new bank to finance investment attracted fierce opposition. There were, in particular, three basic objections to the idea; firstly that if the projects promoted by the body concerned were profitable, they would be financed by existing institutions, especially if finance at the same subsidised rates was available; secondly that the new institution would operate at a loss and thus be a waste of resources; and finally that if subsidised finance is all that is required, arrangements already existed under the Industry Act for giving subsidies by

means of interest relief grants.

Since the publication of the Wilson Committee's report, the UK has experienced its deepest and most prolonged post-war recession. Manufacturing competitiveness has continued to decline, unemployment has risen and the banks have become more remote from their industrial customers. A new and more radical approach is required than Wilson was prepared to recommend, one which is born out of the Note of Dissent, signed by the Chairman (Wilson) and the trade union members (Lord Allen and Messrs. Jenkins, Mills and Murray). This called for a new investment facility, jointly funded by the institutions and the public sector, and managed by a tripartite steering committee.

This proposal now has been adopted by the Labour Party and is an integral part of its programme to revive the manufacturing sector. But new ideas on funding a British Investment Bank and on its activities make the scheme more original and radical than its predecessors.

In the preparatory work leading up to the announcement of the BIB proposal, four questions were considered in some detail:

- What should be its relation with government and other financial institutions?
- How will the bank be funded?
- What will it actually do?
- Should the institution be an existing one or one newly set up?

The answers to these questions were to a certain extent left deliberately imprecise, as is bound to be the case when setting out Party policy in digestible form. It is worth developing further the thoughts that were expressed at the time, and incorporating modifications which have resulted from the discussion of the major proposal after it was launched.

In its relations with government, the Investment Bank will have to tread a difficult path, and there is no virtue in disguising this. Government will wish to impose its objectives on the Bank, and to a certain extent must be able to do so. Nevertheless, the Bank must be the decision maker. The only way to resolve this problem is by means which have been used in guiding the Office of Fair Trading (under the Fair Trading Act 1973) and the Price Commission (under the Price Commission Act 1977). In these cases, Parliament set out criteria for the operation of those institutions when it passed the legislation. The criteria were sufficiently rigorous to direct attention, but sufficiently flexible to allow operational decisions to remain with the OFT and PC respectively. In the case of the Investment Bank, it might well be desirable to leave the criteria to subordinate legislation rather than primary legislation, to allow for changes as and when different general objectives appear relevant, as they surely will over time. That, however, is a matter of convenience rather than dogma.

The Investment Bank's relations with other financial institutions will depend to some extent on the ownership and funding of the Bank itself. There is no self-evident reason why the Bank should be a wholly-owned state entity. A mixed ownership would be perfectly feasible, and give perhaps greater protection for the independence of its decisions. On the other hand, a wholly-owned entity would be closer to the objectives of government. There are only two principles which are essential: first, that control of the Bank rest firmly with the government or a government agency (the analogy of the French Credit National is relevant here); second, if there is to be mixed ownership, the activities of the Bank that involve investment or lending on other than free market criteria should be clearly stated and should attract the appropriate government subvention or guarantee (the analogy here being the schemes devised to identify the social element in the railway system or rural

bus system and to subsidise that in isolation).

The problem of funding the Bank is linked to its ownership. In its most simple form, it is tempting to see a direct relationship between the funding of the Bank and the Labour Party's proposals for the repatriation of portfolio capital.

## Repatriation proposals

These proposals (often referred to as a limited form of exchange control) are designed to restrict overseas investment by pooled investment schemes and individuals, though not by companies with operations abroad. Pooled investment schemes comprise pension funds, life assurance funds, general assurance funds, charities, investment and unit trusts and major companies with large portfolios. Under a Labour government, 'fiscal privileges' will be removed from institutions (and possibly individuals and charities) which do not reduce the proportion of their assets held overseas to comply with a new quota (this is assumed to be 5 per cent, the levy which applied up to the abolition of exchange controls in 1979).

Most of the pooled investment schemes enjoy some tax advantages which would be affected by the introduction of Labour's repatriation proposals. Occupational pension funds, for instance, would lose tax exemption and the employees right to deduct contributions; life assurance funds would lose the right to issue qualifying policies; whilst investment trusts would no longer have a special capital gains tax rate and their share would be treated as 'foreign securities'.

This policy has certain merits of its own, not least on the balance of payments. It may, however, be linked to the Investment Bank proposals. In one version, pooled investment schemes would not only have to conform to the repatriation requirements, but would also have to invest a proportion of their total funds ("roughly equivalent to average repatriation and future retention") in loan stock of the British Investment Bank. Institutions will have to maintain the ratio of their BIB investments to other assets at the level prevailing when repatriation was complete. The BIB loan stock will be priced at market rates, be guaranteed by the Bank of England, not be subject to stamp duty, and be treated in the same way as gilts for capital gains tax. It is intended that it will trade alongside gilts with equivalent liquidity.

These proposals have, not surprisingly, attracted a great deal of public comment, principally from academics and City institutions. Detailed analyses of the technical aspects of the repatriation proposals have been undertaken by authoritative bodies such as the Stock Exchange and the Institute for Fiscal Studies (IFS). Whilst neither institution supported the Labour Party's proposals, both were generally sceptical of their likely effectiveness rather than hostile (Stock Exchange, *Opposition parties' plans for the City: their content and effects*, 1986. Institute for Fiscal Studies, *Capital controls. The implications of restricting overseas portfolio capital*, 1987).

The IFS examined various aspects of the proposals, including enforcement, the likelihood of countervailing outflows, the possibility of the institutions taking pre-emptive action and the effects on the financial sector. It concluded that none of these were likely to prove significant obstacles to the implementation or effectiveness of the scheme. More importantly, it argued that the inflows of capital should prevent the exchange rate falling too far and/or too quickly, thus promoting greater stability in the foreign exchange markets and containing inflationary pressures in the UK. The effect of the repatriation policy on the balance of payments would be such as to remove a constraint on domestic expansion, which is one of the macro-economic pre-conditions for a successful industrial policy. The effect of the repatria-

tion policy, therefore, is to reinforce the main thrust of the industrial strategy.

The link between the repatriation scheme and BIB funding might, on the other hand, be less direct than that set out in its most simple form. In the case of a mixed ownership of the Bank, an equity interest would clearly qualify as an appropriate investment for repatriated funds. Moving on from there, it would be equally possible to devise a further extension under which investments made alongside the BIB, and under BIB leadership, would also qualify. To give an example; suppose that the BIB were to undertake at government invitation the arrangement of the finance of a project such as the Severn Barrage; instead of putting up all the funds itself, the BIB might wish to syndicate the financing, and it might look to those pooled investment schemes with excess amounts of repatriated funds. The commercial decision would, of course, rest with the outside investors, but it would be perfectly possible to arrange for such investments to replace an investment in BIB loan stock as qualifying under the repatriation arrangements. A variety of formulae of this nature could be devised.

The funding of the BIB would therefore only in part come from repatriating funds, and those funds would only be invested in part in the BIB, either as equity or in loan stock. But even BIB loan stock must be distinguished from gilt-edged, since it would be absurd if the creation of the BIB, and the issue of possibly large amounts of its loan stock, were simply to result in a diminished institutional appetite for gilt-edged stock; if, in other words, institutions were to perceive BIB stock as a gilt equivalent, and include it as a gilt when assessing the proportion of their portfolios that they wished at any one time to see in government stock. The distinction between gilts and BIB loan stock would seem to be best achieved by introducing an equity element into BIB stock. This could itself be done by giving investing institutions a right, along with their subscription to stock, to buy into the underlying BIB investment at a preferential price, which in turn requires the BIB to ensure that its investments are not all, or even predominantly, straight loans, but have an equity feature. This, of course is a common feature of 3i operations, and there is no reason why it should not be adopted by the BIB.

## British Investment Bank

As to what the Investment Bank would actually do, it is important to emphasise that the Labour Party's proposal for an Investment Bank is a response to the parlous state of British manufacturing industry, the observed weaknesses of the financial services available to promote investment and an understanding of how similar institutions operate in other industrialised countries. Critics have flippantly dismissed the idea as yet another in a long line of institutions set up by Labour governments to solve all the country's long-term problems at once (for example, J Scouller: *Old Hat, or Son of NEB: A critical view of the Labour Party's proposed National Investment Bank*, Department of Economics, University of Strathclyde, 1986).

It would, however, be a mistake to see the BIB as merely the re-incarnation of earlier devices. Its role is a specific one, to raise the rates of fixed capital formation in the private sector, and it will be encouraged to become "close to the industry, sensitive to its needs and conversant with its problems and prospects" as Roy Hattersley has said. The proposal recognises, moreover, that there are critical problems on the supply side of industry, which traditional demand stimulation will do little to correct. It also accepts that profits in manufacturing have been too low to justify higher investment. Whilst a government can do little to improve the return on investment, it can reduce the costs, thereby improving the margin. Subsequent investment could, therefore, be financed from higher

profits. This sensitivity to the role of profits also marks a change in approach from the Industrial Reorganisation Corporation and the National Enterprise Board.

The role of the Bank will be to complement existing sources of finance. Its operational guidelines will be set by Parliament and it will be expected to consider sympathetically requests for loans to support a wide range of activities. These will include, in the initial phases at least, funding for major infrastructure projects. There is no reason at all why such projects should not be viable in commercial terms: the Manchester sewers (to mention a now famous example) could easily be financed with the security of attached revenue from the rates. The BIB will raise funds and act as a catalyst for private sector financing for such large-scale projects. Its activities in mobilising private sector funds for socially desirable public sector building is analogous to the work of many development banks, of which the World Bank is the best example. This Bank's full title is, of course, the International Bank for Reconstruction and Development, and it has both financed projects itself and made lines of credit available to local development banks (some 70 Development Finance Companies in more than 40 countries) for on-lending to enterprises in the industrial sector. Conceptually the activities of development and industrial banks are the same. Indeed, reconstruction and development could be taken as the main theme for the BIB.

There will, in addition, be substantial spin-offs for a large number of UK firms from these major projects. The whole range of suppliers to the construction and civil engineering industries could benefit from an increase in activity, if they are competitive. The building materials sector traditionally records lower than average import penetration, and thus most of the higher demand should be met from UK sources. At the firm level, however, increased investment may well be necessary to ensure that its products are competitively produced: the BIB will be in a position to fund such investments.

The Bank will also be supportive of UK companies bidding for government contracts in other areas, such as electronics and aerospace, which are at the forefront of technological change. It is in the HRI sectors that the UK's international performance has deteriorated most markedly. Improved competitiveness in these sectors, to which increased investment will make a major contribution, should help UK firms in export markets as well as raise domestic performance. Finally, as a Labour government pursues a more expansionary macro-economic policy, the demand for investment funds should come from many other sectors of manufacturing which offer potential export, import substitution, employment or regional benefits.

In short, the BIB can be expected to provide the same sort of facilities to UK firms as does 3i, but on a greatly expanded scale, and adopting more flexible approaches to pricing, loan maturities and credit assessment. The fact that lending will be below market rates implies that the Bank will run an accounting deficit. This will be the government subsidy to industry and will be the only item in the Bank's balance sheet calculated as public expenditure. It will be a direct charge on the Exchequer and reviewed annually by Parliament.

A low interest loan is the generic title for a range of products, and the precise 'subsidy' can be structured to suit an individual firm's specific needs. The package could, for example, involve straight lending at soft rates, lending which is convertible into equity capital, participating loans or finance related to the success of the project, some of which could have options for 'capital holidays' or for the capitalisation of interest. Thus firms with balance sheets insufficiently strong to raise adequate levels of debt finance from conventional sources, and with past track records which discour-

age new equity subscribers, will have access to funds to develop potentially profitable activities.

It is not only the interest subsidy which differentiates the BIB's products from those of the other institutions. The emphasis will be on term lending, an area which accounts for a relatively small proportion of the clearing banks' activities, and there will also be a conscious effort to link repayments with the timing of income from the investment. The BIB will give special consideration to small/medium sized companies. This is a market segment in which the clearing banks earn the highest margins, and is, therefore, where the benefit of the subsidy will be most marked. A final difference relates to fixed rate lending, common in Europe, rare and expensive in the UK but critical for corporate planning; it will be an important feature of the BIB's product range.

This approach should do much to increase the rate of investment. It will not, however, help improve the quality of the investment or raise the productivity of capital. This objective will be tackled by the relationships the BIB will develop with UK companies. The credit assessment procedures to be adopted will rely less on the 'gone concern' approach so typical of the traditional financial institutions, or on the taking of security. Rather it will be based more on an understanding of the industrial environment in which the company is operating, of the market prospects and the company's strengths and weaknesses. This implies that the BIB will use industry specialists in its assessments, who will also advise the company on the viability of its proposals. As the BIB's portfolio increases, so will the quality of the inputs from its industry analysts.

A second way in which the Bank can influence the quality of investment is to ensure that each loan application is accompanied by a project plan. This again is standard practice in industrial banks in Europe, and there are a number of areas for inclusion in such a plan, ie product and market strategy, location, employment levels and conditions (including equal opportunities policies), pricing policy, financial projections, including cash flow forecasts, profit and loss accounts, past and present trading accounts, future investment, technological innovation and training and re-training policy.

These are not, moreover, the areas on which critics of the proposal have focussed. Serious and thoughtful commentators, such as Professor Alan Budd (of the London Business School) and the IFS, whilst accepting that some form of investment subsidy can be justified, doubt the necessity to set up a new institution to help direct the subsidies (Professor A Budd. *Do we need a National Investment Bank?* National Westminster Bank Quarterly, August 1986). The IFS suggests the cost of finance could be subsidised in more familiar ways, through the corporation tax system, by payment of subsidies related to financing costs or by payment of investment grants.

This is because the IFS appears to doubt the feasibility of improving the quality and quantity of investment at the same time. The likely response of the volume of investment to interest rate subsidies is questioned, largely on the basis of econometric analysis and the response to enquiries such as the CBI's Industry Trends Survey. These, however, are based on the traditional industry-City-government relationships, and it is part of the Labour Party's policy objectives to change these relationships: past trends in the interest sensitivity of investment demand may not be the best guide to the future in a new environment.

The question remains whether it makes sense to set up a new institution de novo or whether an existing institution, suitably modified, would fit the bill. To a large extent, the answer is a matter of timing. It is a long and difficult process to set up a new banking institution. Qualified staff have to be recruited, premises found, accounting and control systems established, and so

on. On reasonable expectations, it would take three to five years before such an institution, starting from nothing, would be able to assume the role cast for it in this pamphlet, and indeed in Labour Party policy documents.

There is only one existing institution that comes anywhere near the requirement: 3i. Although it is small in relation to what will be expected, and fits uneasily into the existing cast of financial institutions, 3i has the basic essential infrastructure that the British Investment Bank will need, as well as the all-important regional network. Furthermore, if a publicly-owned or controlled investment bank were to be created successfully, it would render the present 3i virtually useless. Finally, it would appear from the public comment that some of the private sector shareholders of 3i are, to say the least, footloose, and it is too valuable an organisation to be left hanging in the air.

## Conclusion

The proposal to establish a British Investment Bank is a radical response to Britain's manufacturing decline. It should be seen as an integral part of Labour's overall programme for industrial revival, which tries to adopt the best of successful foreign practice into the UK's unique environment.

Above all, and as a final word, the psychology is right. BIB will, and must, be an organisation that will help success, without being shy of helping entrepreneurs to achieve that success and reap the rewards. The general criticism of Labour's policies, that they concentrate on redistributing the cake rather than increasing it, can be shown to be mistaken, and the investment bank proposal is one initiative to show it. The political will is there. All that is needed is to put it into practice.

# Appendix: The major credit institutions

## JAPAN

### Industrial Bank of Japan (IBJ)

### Long-Term Credit Bank of Japan (LTCB)

### Nippon Credit Bank (NCB)

The long-term credit banks specialise in providing 5-7 year funds to Japanese industry. These are wholesale banks, established in the 19th century by the government, and have been the main source of finance for the major sectors of the economy. These banks raised funds by issuing debentures sold to the City banks at below market rates. They only accepted deposits from corporate clients and government, not from the public.

Until the early 1970s, the three credit banks channelled loans into industries considered by the government to be essential for Japan's economic development. Although now privately owned, they enjoy a special relationship with government and exercise considerable influence in the formulation of policy.

The three banks have responded to the changing environment since the early 1970s by placing more emphasis on helping customers (with advice and money) to move into higher value-added activities. They also act as lead commission banks for the issue of new bonds and as underwriters of government bonds.

The three banks are very large: the IBJ is the 18th largest bank in the world, LTCB the 25th and NCB the 55th. The IBJ accounts for 40 per cent of the loans and discounts extended by the three. Each also has interests in particular sectors, eg the IBJ is traditionally strong in the heavy industries, whilst the NCB has concentrated on companies with less than 500 employees.

As the nature of the Japanese financial market changes, the long-term credit banks have entered international money markets. Syndicated loans, bond underwriting and project finance are becoming increasingly important areas of activity. The project financing is obviously a spin-off from their relationships with Japanese companies.

## WEST GERMANY

### Kreditanstalt fur Wiederaufbau (KfW)

The KfW was established in 1948 with one of its main tasks to administer the European Recovery Programme Loan. It has capital of DM1,000 million, of which 80 per cent is provided by the Federal government and the rest by the Lander governments. The board of the KfW is made up of government ministers, board members of other German banks, trade union leaders and representatives of industry. It is a bank whose functions are largely politico-economic.

The KfW raises funds by means of loans and bond issues, and also receives grants directly from the Federal government, particularly in relation to government regional programmes. As the central credit institution, the KfW works closely with the commercial banks and serves as a link between public budget, the capital market, the credit system and the investing business world.

The Bank lends up to 10 years, at below market rates and at fixed rates. Premature repayment is possible at any time and follow-up loans are available if companies need to spread repayments over a longer period. It never lends directly, but through the medium of the firm's house bank: the KfW, however, takes security from the borrowing firms. For large loans (DM300,000+), the KfW provides 50 per cent of the funding, and for smaller loans, up to two-thirds.

Programmes include loans to facilitate structural adjustments in individual sectors, loans to mitigate the specific financing problems of small/medium sized businesses in order to increase

efficiency and competitiveness, and long-term finance for the exports of capital goods. Other programmes are concerned with the improvement of the regional economic structure, the acquisition of data-processing equipment, environment protection and shipyard assistance.
The KfW is the 10th largest bank in Germany. In 1985, it had assets of DM86.8 billion. Its loan commitments exceeded DM13 billion, of which two-thirds was for domestic investment purposes. About 20,000 investment projects a year receive assistance. In 1985, the KfW made a surplus of DM149 million on its operations.

## FRANCE

### Credit National (CN)

Founded in 1919, Credit National became the main provider of long-term investment finance in France in the 20 years after 1945. Owned privately, CN nevertheless operates as an instrument of public policy. It has a board made up of civil servants and relies on the French Treasury for permission to raise funds on the bond market.
CN lends long-term on its own account, is a guarantor of medium-term bank lending to industry and carries out various lending operations as an agent of government. Funds are provided for the development of new technology and for the automation of production processes. CN lending is subsidised by up to 5 per cent by government. In 1983, commitments amounted to almost £2 billion.
As important is CN's role as a key advisor to the rest of the banking system and government on industry. Many of the financial yardsticks applied by French banks to industrial loan analysis were developed by CN which has an extensive statistical, advisory and liaison function with the government, public authorities, banks and industry. The Bank has close relations with both the Treasury and the Industry Ministry, and is usually consulted on legislative measures which will effect industry.
Although its pivotal role had declined since the early 1970s, following changes in banking regulations and the impact of recession, CN continues to make a significant contribution to French industry. It currently meets some 10 per cent of industry's borrowing needs. About 50 per cent of French industrial investment is self-financed, with CN providing 15 per cent of the balance. It meets roughly 30 per cent of long-term industrial borrowing needs and makes 1300-1400 loans a year.

## SWEDEN

### State Investment Bank (SIB)

The SIB was founded in 1967, and is 100 per cent owned by the state. Its role is to provide long-term financing of productive investments and has assets in excess of £0.5 billion. The board of directors includes representatives of industry, commercial banks, trade unions, management organisations and government.
The Bank specialises in providing medium and long-term credit at fixed interest, but with an interest rate adjustment clause. It adopts a flexible approach to collateral: in some cases, none is taken or loans made on the basis of a negative pledge. The SIB also provides loans on a fixed rate/profit sharing basis or convertible loans, and the repayment schedule can be structured to meet the cash flow projections of the investment project.
Although it is assumed that the SIB operates according to the normal profitability criteria of commercial banks, it enjoys much greater freedom in the evaluation of long-term risks and demands for bonded security. Through a subsidiary, the SIB gives financial and moral support to socially desirable industrial mergers; it co-operates closely with 24 regional development funds; and it acts as the contact point for

foreign companies wanting to raise funds for investment in Sweden.

## BELGIUM

### National Company for Industrial Credit (NMKN)

The NMKN (or SNCI in French) is one of the earliest special credit institutions, and was set up in 1919. It has evolved into one of the major credit institutions in Belgium. Its objectives are to promote the restructuring and development of Belgian industrial and commercial firms and to stimulate the development of new products and new technologies. It does this through the provision of medium and long-term credit. It does not take equity participation in companies; this is the function of the National Investment Company (NIM).

The NMKN/SNCI accounts for a substantial proportion of total bank credit in Belgium. Although the commercial banks have increased their share in the medium and long-term credit market since the early 1970s, over 20 per cent of total bank credit in Belgium is attributable to the special credit institution.

## NETHERLANDS

### Nationale Investeringsbank (NIB)

Founded in 1945 as a bank for recovery and reconstruction, it became the NIB in 1963. Dutch commercial banks have traditionally been reluctant to provide long-term credit for industrial projects, and the role of the new bank was to fill this gap. The NIB is owned by the government (50.3 per cent) and the Dutch banks and financial institutions. It borrows and lends on its own account and operates the governments' subordinated loan scheme. The Dutch bond market is the main source of funds, with some finance coming from loans from institutional lenders and a small amount from the state.

The NIB provides long-term credits for manufacturing industry but does not compete with the commercial banks, which are shareholders in the Bank. Loan applications are evaluated by the Bank's industrial as well as financial experts, who also advise on the most appropriate form of package. The Bank can provide 5-15 year loans, subordinated loans or credits at its own risk or the government's (the state accepted risk accounts for over 75 per cent of outstanding loans and guarantees). The largest proportion of the NIB's lending is for medium sized companies.

The NIB is the major agent of the Dutch Government in the implementation of industrial policy. Its activities have in recent years been extended to include financial assistance to failing companies under the Special Credit System. This allows the NIB to grant long-term credit, guaranteed by the state, to private companies which have short-term problems but promising long-term prospects.

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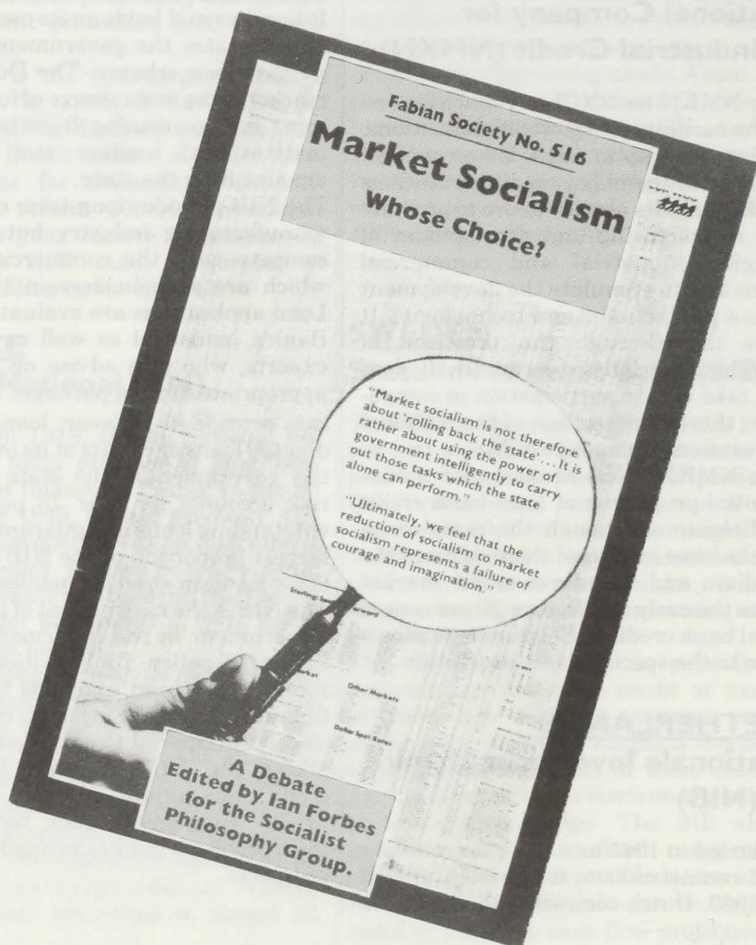


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A British Investment Bank would stimulate a major programme of investment in new capacity to raise the quality and quantity of capital stock. Complementing the existing sources of finance, the Bank would be expected to consider sympathetically requests for loans to support a wide range of activities including:

- projects/businesses in industrial sectors which are identified as high growth areas;
- projects with significant regional importance and employment potential;
- businesses with significant export or import substitution potential;
- major infrastructure projects.

A key instrument of the Bank would be low interest loans, the precise terms of which would be varied to suit individual firms' specific needs. These would include options for capital holidays or capitalisation of interest, loans convertible into equity share capital and other mechanisms for matching repayments to cash flows.

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