Citi Research

Economics

5 April 2013 | 12 pages

**Europe**

# UK Economics Weekly

## Why Is Investment So Weak?

- In contrast to the OBR and consensus forecasts for investment-led growth, investment spending is still 19% down from the peak reached five years ago, a far worse performance than at the same stage of prior recession/recovery cycles. The share of investment in GDP is among the lowest in Europe and the lowest in the G7. Net of depreciation, the ratio of investment to GDP is the lowest for more than 50 years.
- The OBR and consensus have assumed that the large corporate sector financial surplus and improving liquidity will produce a sharp rebound in business investment. We disagree. In our view, it would be better to regard the improvement in the corporate sector's finances as a side effect of the pressure on firms to cut investment spending in the UK and allocate the proceeds to repaying debt, accumulating cash and expanding investment overseas. With poor credit availability, sluggish demand and low capital allowances, business investment is likely to remain sluggish in the UK. Rather, with the price of labour falling relative to the price of capital goods (reversal of the precrisis trend), the UK is shifting to a labour-intensive and capital-light mix, that implies weakness in productivity and real wages. The economy needs more stimulus and we expect that, over time, the MPC will loosen further through a variety of channels.


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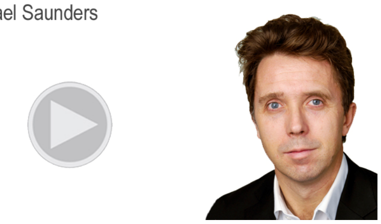
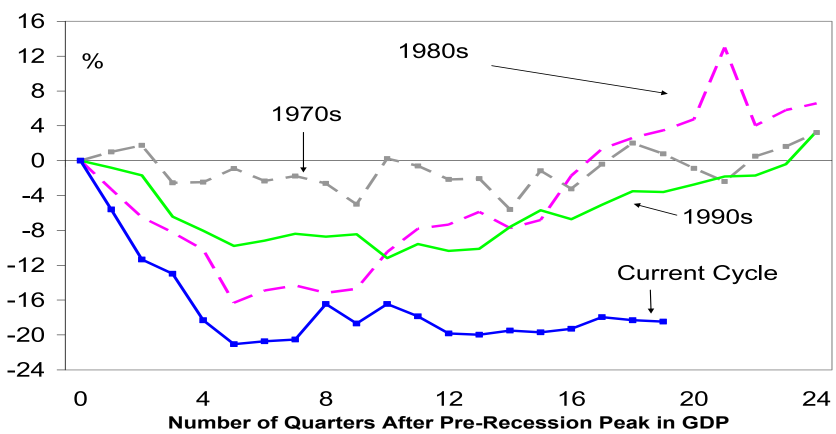


**Figure 1. Citi Market Forecasts**

| | Base Rate | QE Target | 10 Year Yield | Spread vs. Bunds | $/£ | £/€ |
|---|---|---|---|---|---|---|
| End-2013 | 0.50 | £450bn | 2.40 | 86bp | 1.42 | 0.91 |
| Mid-2014 | 0.50 | £450bn | 2.45 | 92bp | 1.47 | 0.88 |

Source: Citi Research

**Figure 2. UK – Cumulative Change in Real Investment Spending From Pre-Recession Peak in GDP, 1970-2012**




Sources: ONS and Citi Research

**See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.**

# Why Is Investment So Weak?

**Investment has remained weak since the financial crisis began, markedly undershooting previous recession/recovery cycles…**

Remember the idea of rebalancing the economy away from consumption to export-led and investment-led growth? We have highlighted recently the UK's inability to achieve export-led growth[1]. But the other part of the UK's hoped-for rebalancing also has failed to materialize, with repeated disappointment -- and deferred recovery hopes -- in investment spending.

- In real terms, investment is 19% down from the peak reached five years ago (2007-Q4), a far worse performance than at the same stage of prior recession/recovery cycles: investment was around its pre-recession peak at this stage of the cycles of the 1970s, 1980s and 1990s.

**…and as a share of nominal GDP, UK investment is below levels seen in any other G7 country in recent decades**

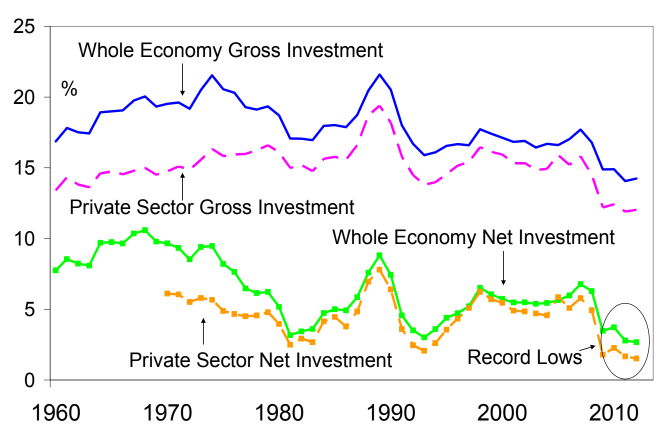
- The share of investment in GDP (14.2% in nominal terms) in 2012 is close to the record low (14.1%) seen in 2011. Investment has now been below 15% of GDP for four consecutive years. To put that in context, no other G7 country has recorded an investment/GDP ratio below 15% in any year in the last 30 years.

- In 1998, investment (£156.5bn, 17.8% of GDP) roughly matched government consumption in nominal terms (£156.7bn, also 17.8% of GDP). In 2012, government consumption (£341bn, 22.1% of GDP) was 56% bigger than investment spending (£218bn, 14.2% of GDP).

**Net of depreciation, investment is the lowest for more than 50 years**

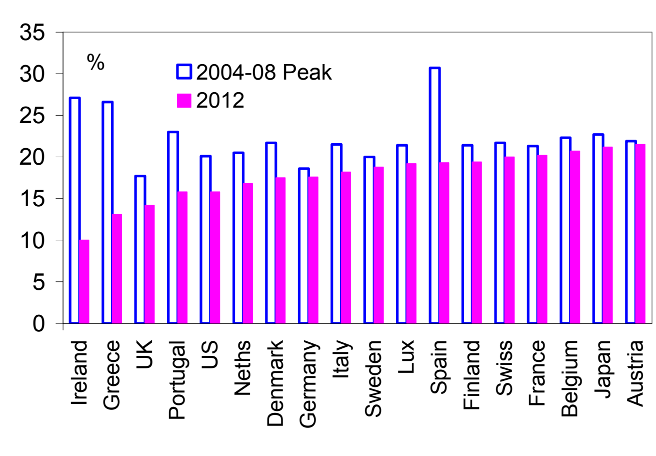
- Net of depreciation, investment in the whole UK economy equalled 2.7% of GDP in 2012 -- the lowest since data began in 1960 -- down from 6.8% of GDP in 2007 and the average of 5.3% of GDP in 1990-2008[2]. Net private investment fell to just 1.5% of GDP in 2012, also a record low, from 5.8% of GDP in 2007: this measure averaged 4.6% of GDP in 1990-08.

**Figure 3. UK – Gross and Net Investment as Pct GDP, Nominal Terms, 1960-2012**




Sources: AMECO Database, ONS and Citi Research

**Figure 4. Selected Countries – Investment as Pct of GDP, Nominal Terms, 2004-12**




Note: We show all EU15 countries, plus the US and Japan.
Sources: Eurostat and Citi Research

**The ratio of investment to GDP is among the lowest in Europe**

- The UK is not unique in having weak investment, and the decline in investment (real terms) from the peak has been similar for the EU as a whole. However, the UK did not have such an excess over-investment surge in the boom. Eurostat data show that only four EU countries (Ireland, Malta, Cyprus and Greece) have a lower investment-GDP ratio than the UK. Of course, more investment is not

[1] See *The "Great Stagnation" Continues*, Michael Saunders, UK Economics Weekly, 11 January 2013, Citi.

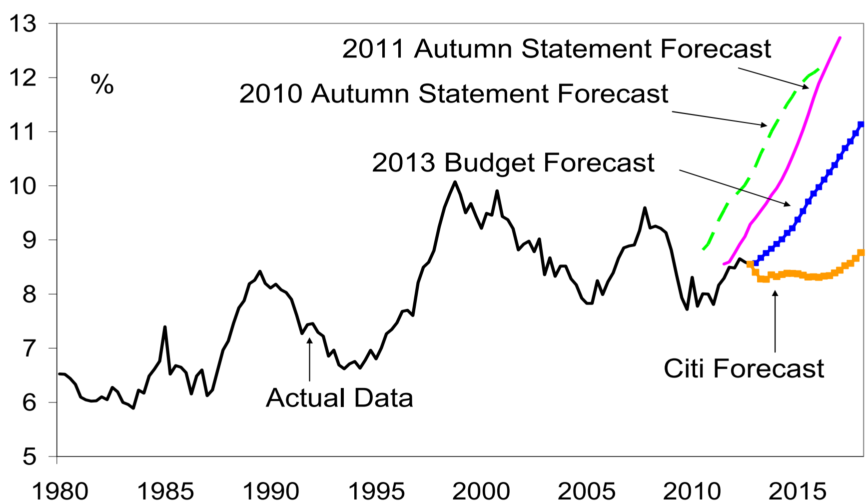
[2] Source: European Commission AMECO database.

always a good thing. There certainly have been cases of over-exuberant investment in recent years that left economies and companies weaker, not stronger. But the UK is at the other end of the spectrum, with persistent under-investment rather than over-investment.

**The OBR has had to repeatedly postpone its forecast for a strong recovery in business investment**

The weakness in investment partly reflects declines in housebuilding and public investment: private housebuilding in Q4-12 was 38% below the mid-07 peak, while real general government investment is down by 21% over the last three years. But, the main problem is the failure of business investment to match the OBR and consensus expectations. The OBR has repeatedly forecast that business investment is about to rebound strongly and rise to a record high as a share of GDP in real terms – repeatedly rolling that forecast forward while the actual data remain sluggish. Indeed, in nominal terms, business investment was only 7.9% of GDP in Q4-12, versus 10.1% a decade earlier and near the record low of 7.4% in Q4-09.

**Figure 5. UK – Real Business Investment as Pct Real GDP, 1980-2017F**




F Forecasts. Sources: OBR, ONS and Citi Research

**The corporate sector is running a large financial surplus and has strong liquidity…**

To be sure, the OBR and consensus view of a rapid move to investment-led growth does have some foundations. The non-financial corporate sector is running a large surplus of £41.1bn, 2.7% of GDP in 2012), and has a colossal cashpile of £708bn (45.6%) in sterling and FX deposits at banks, up from £272bn (22.5% of GDP) ten years ago. Debt of the non-financial corporate sector has fallen from 121% of GDP in Q4-08 to 108% of GDP in Q4-12. The sterling corporate liquidity ratio (ratio of non-financial companies' sterling bank deposits to their sterling debts) rose to 63.6% in Q4-12 (highest since 1987) and (using monthly data) hit 66.2% in Feb-13.

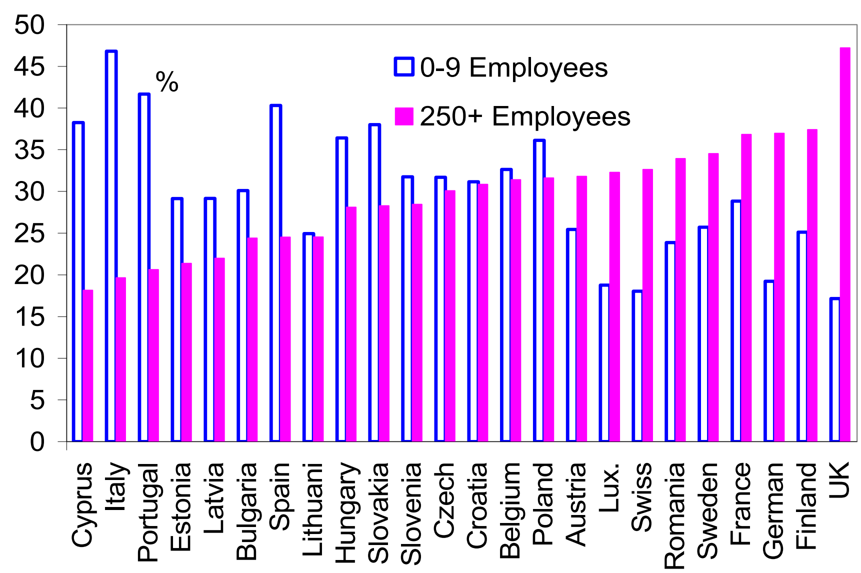
**…but a lot of this financial improvement reflects the allocation of investment overseas**

However, we do not regard the improvements in these financial guides as reliable triggers for an investment recovery in the UK. Rather, in our view, it would be better to regard the improvement in the corporate sector's finances as a side effect of the desire among firms to cut investment in the UK and allocate the proceeds to repaying debt, accumulating liquidity and expanding investment overseas. The level of outward FDI has increased from £232bn (27% of annual GDP) at end-97 to £637bn (58% of annual GDP) at end-02 and to £1146bn (74% of GDP) at end-12. Alongside that, the stock of inward FDI in the UK has surged from £174bn (20% of GDP) at end-97 to £837bn (54% of GDP) at end-12. UK firms have been on an investment spree, but not in the UK. The UK has become something of a cash cow to generate funds for corporate expansion overseas.

**The UK is a highly globalised economy, with very high levels of inward and outward FDI and a high share of employment at large firms**

As a result, the UK corporate sector has become far more global in ownership and business operations, and is one of the most globalised economies among major countries, with exceptionally high levels of foreign ownership and employment in large firms. The levels of both inward FDI and outward FDI, relative to UK GDP, are by far the highest among the G7 countries. Moreover, 47% of aggregate employment in the UK business sector (ie outside the public sector) is in firms with more than 250 employees, by far the highest share among the EU27 countries[3]. We suspect that larger firms are more likely to be more global in structure, outlook and ownership.

**Figure 6. Selected Countries – Pct of Aggregate Employment That Is In Firms With Less Than 10 Employees (Including Sole Traders) and More Than 250 Employees, 2010**




Sources: Eurostat and Citi Research

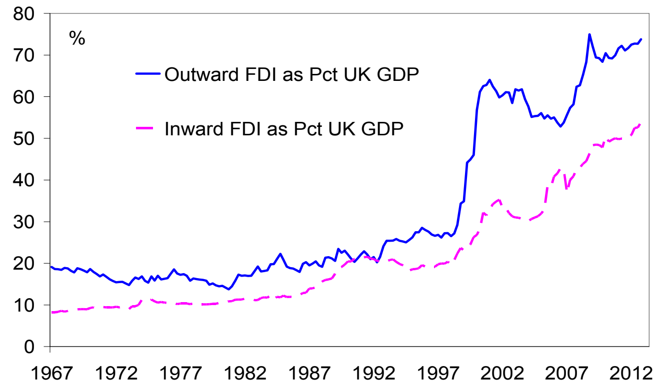
**The link from the corporate sector financial balance and liquidity to investment in the UK is much weaker than it used to be**

With such a highly globalised corporate sector, the link from the overall corporate sector financial balance and liquidity to investment in the UK is much looser than 10 or 20 years ago. If UK firms accumulate liquidity, it may well continue to flow overseas. Indeed, a substantial part of the corporate sector financial surplus is directly accounted for by profits earned overseas. Profits on outward FDI (net of earnings on FDI in the UK) for UK non-financial companies have totalled £321bn over the last 15 years, accounting for 84% of the aggregate non-financial corporate sector surplus in that period (£384bn). And most of these profits earned overseas are reallocated to external investment, either as M&A or FDI loans to foreign subsidiaries. Similarly, most of the rise in corporate deposits reflects FX deposits and deposits held outside the UK, which probably also are destined for overseas use[4]. Aggregate bank deposits held by non-financial companies have risen by £463bn over the last 10 years: of this, £69bn reflects FX deposits held at UK banks, £284bn reflects deposits held outside the UK banking system and just £110bn (a quarter of the total rise) reflects sterling deposits held at UK banks – ie funds that appear destined to support business operations in the UK.

[3] Data are available for all EU countries apart from Ireland, Denmark and the Netherlands.

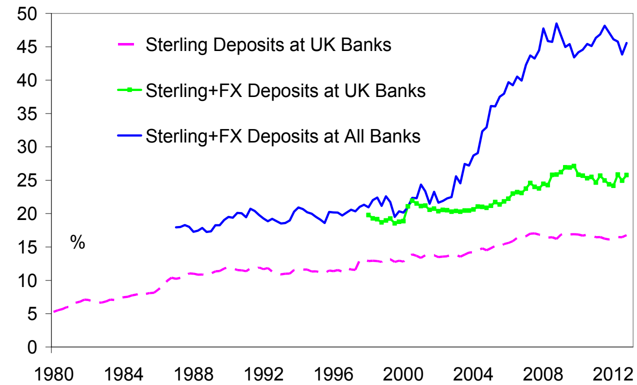
[4] It is also possible that some of the rise in deposits really reflects funds held by financial companies and incorrectly labeled as deposits of non-financial companies.

**Figure 7. UK – Stock of Inward and Outward FDI as Pct Annual GDP, 1967-2012**




Sources: ONS and Citi Research

**Figure 8. UK – Bank Deposits Held By Non-Financial Companies, Pct of Annual GDP, 1980-2012**




Sources: ONS and Citi Research

Several structural factors probably lie behind this reluctance to invest in the UK, and the shift of investment overseas:

**Credit availability is poor in the UK…**

- In the UK, demand is sluggish and credit availability remains poor, a typical pattern for the aftermath of boom-bust credit cycles. As a result, UK firms probably see little reason to expand capacity for domestic markets, and have good reasons to repay debt and hold more cash as a buffer in case banks will not lend when they need funds. The BCC survey shows that cashflow continues to worsen among micro firms (less than 20 employees) in both the manufacturing and services sector, and these micro firms report much weaker investment intentions than large firms (and the larger firms are more likely to have non-UK operations which may the destination for new investment).

**…while many emerging markets offer faster growth and/or lower costs**

- Many overseas countries, especially in emerging markets, offer faster growth and lower costs as investment locations than the UK. Whereas investment is weak in the UK and many other advanced economies, globally the ratio of investment to GDP (23.9% on the IMF data) is the highest for more than 20 years.

**Capital allowances have been cut markedly in the UK…**

- With cutbacks to UK capital allowances in the Budgets of 2008 and 2010, the present value of capital allowances in the UK is now the lowest among the G20 countries[5]. The government has repeatedly cut the UK's headline corporation tax rate and, on current plans, the UK in 2015 will have the lowest corporation tax rate among the G20 countries. However, with the erosion of capital allowances in the UK, the effective marginal tax rate on new investment has not fallen in recent years, whereas it has fallen elsewhere – and this structure will tend to encourage internationally mobile companies to allocate new investment-intensive projects outside the UK.

**…and the weak fiscal position probably creates fears of future tax hikes**

- The UK's large fiscal deficit probably creates some fear of future tax hikes or windfall taxes that, at the margin, may discourage extra investment in the UK.

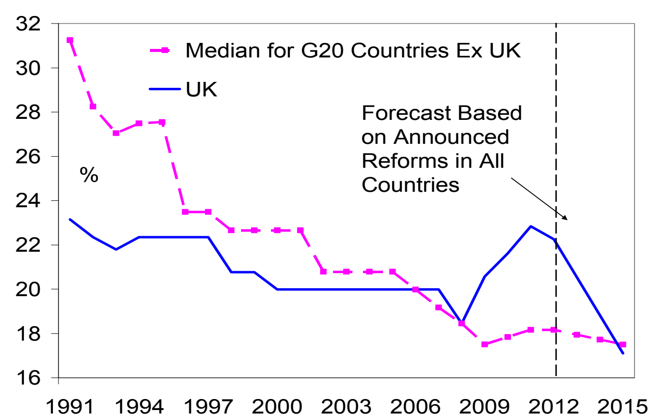
**The relative cost of capital has risen, in contrast to the precrisis trend, encouraging firms to expand via jobs rather than investment**

- The combination of currency-induced gains in prices of capital goods and weakness in wage costs has tilted the relative costs of labour and capital, encouraging firms to hire people rather than invest. From Q1-1998 to Q1-2007, the strong pound caused prices of imported capital goods to fall by 35%, whereas nominal weekly earnings rose by 52% over that period. This sharp

[5] Source: Oxford University Centre for Business Taxation.

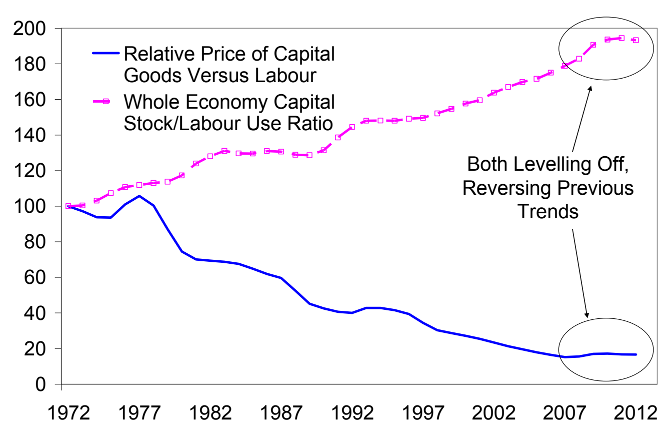
decline in the relative price of capital goods versus labour prompted firms to shift to capital-intensive and labour-saving structures, reflected in buoyant investment, rising productivity and sizeable real wage gains. By contrast, from Q1-07 to Q4-12, prices of imported capital goods rose by 30% whereas (with strong labour supply and widespread fears of unemployment) nominal private sector weekly earnings rose by just 9%. In addition, decisions to hire people are more easily reversible than decisions to invest – and hence may be preferable when (as now) demand prospects are very uncertain. Hence, in aggregate, the UK economy is shifting to a capital-light and labour-intensive mix of inputs, reflected in weak investment, resilient employment, falling labour productivity and declines in real wages. Data from the European Commission's AMECO database shows that the growth of the net UK capital stock slowed from an average of 2.5% YoY in 1998-2008 to 1.1% YoY in 2012, the lowest growth since 1993. By contrast, total hours worked (ie labour use) rose by 1.7% YoY, the highest growth since 1989 and, also for the first time since 1989, outpacing capital stock growth.

**Figure 9. UK and G20 – Effective Marginal Tax Rate on New Business Investment, 1991-2015F**




Sources: Oxford University Centre for Business Taxation and Citi Research

**Figure 10. UK – Relative Price of Capital Goods Versus Labour, and Whole Economy Capital/Labour Use Ratio, Indexed to 100 in 1972, 1972-2012**




Note: We compare capital goods import prices with private sector earnings (whole economy earnings pre-1990). Net capital stock is in real terms, labour use measured by total hours worked. Sources: European Commission, ONS and Citi Research

**We expect that business investment will again undershoot the OBR forecasts…**

With these longterm drivers still intact, we doubt that business investment in the UK will recover as spectacularly as the OBR assume. Demand is sluggish, credit availability remains poor (especially among small firms), capacity use is stable, and surveys suggest that investment intentions have not changed much over the last year. In many business surveys, it is hard to distinguish between general investment intentions (including expansion overseas) and investment intentions in the UK. But, the Deloitte's CFO survey suggests that UK-focused firms are far more defensive in their balance sheet policies and plans than international companies.

**…with overall investment remaining sluggish for an extended period**

We expect that aggregate investment spending will fall by about 2% this year, dragged down by declines in business investment and housebuilding, with little change to public investment, followed by only modest gains (averaging about 1½% YoY) in 2014-15. In our base case, overall investment will not regain the precrisis peak until around the very end of this decade; even then, real investment per head will probably still be below the precrisis peak. Rather than simply assume the economy will recover significantly, in our view the MPC should – and, we expect, eventually will – loosen further through a variety of channels (QE, credit easing, forward guidance).

## Economic Indicators

| | | | |
|---|---|---|---|
| Tue 9 Apr | ***Trade Balance – Goods & Services (Feb)*** | **Forecast: £-3.0 billion** | **Prior: £-2.4 billion** |

The trade deficit has been roughly stable in recent months, with exports hit by the EMU crisis and imports capped by weak domestic demand. The 2012 trade deficit hit a record high of £36bn in 2012 and may well rise even a little further in 2013.

| | | | |
|---|---|---|---|
| Tue 9 Apr | ***Industrial Production (Feb)*** | **Forecast: 0.5% MoM, -2.6% YoY** | **Prior: -1.2% MoM, -2.9% YoY** |
| | ***Manufacturing Output (Feb)*** | **Forecast: 0.5% MoM, -1.3% YoY** | **Prior: -1.5% MoM, -3.0% YoY** |

Surveys suggest that manufacturing output is soft, but it is possible that the sharp drop in January exaggerated the underlying weakness in the sector and hence we look for a slight rebound in the February data. Even so, a figure in line with our forecast would leave the average level of IP in Jan-Feb 0.2% below the Q4 average – hence pointing to a soft overall Q1 GDP figure.

| | | | |
|---|---|---|---|
| Tue 16 Apr | ***Consumer Prices (Mar)*** | **Forecast: 0.3% MoM, 2.8% YoY** | **Prior: 0.7% MoM, 2.8% YoY** |
| | ***CPI Ex Food, Drink, Tobacco, Energy (Mar)*** | **Forecast: 0.3% MoM, 2.3% YoY** | **Prior: 0.6% MoM, 2.3% YoY** |
| | ***Retail Prices (Mar)*** | **Forecast: 0.4% MoM, 3.2% YoY** | **Prior: 0.7% MoM, 3.3% YoY** |
| | ***RPIX – Excludes Mortgages (Mar)*** | **Forecast: 0.4% MoM, 3.2% YoY** | **Prior: 0.7% MoM, 3.2% YoY** |

A further gain in petrol prices probably will keep CPI inflation roughly stable in March, with the AA reporting that prices rose by a further 2p/litre (1.5%), bringing the total rise over the last two months to about 6%. Food price inflation also may tick up slightly, Going forward, we expect that CPI inflation will edge above 3% YoY around midyear, with the June figure a particular candidate given adverse base effects from the weak reading a year ago.

| | | | |
|---|---|---|---|
| Tue 16 Apr | ***Producer Input Prices (Mar)*** | **Forecast: 0.5% MoM, 1.4% YoY** | **Prior: 3.2% MoM, 2.5% YoY** |

Base effects from the relatively large MoM rise in input prices a year ago (1.6% MoM in March 2012) may keep a lid on the YoY rate this month, but nevertheless we expect that these figures will mark the ninth consecutive monthly rise in input prices, with input prices up by a total of 8% since mid-2012. These cost pressures will continue to feed through to CPI inflation in coming months and quarters.

| | | | |
|---|---|---|---|
| Tue 16 Apr | ***Producer Output Prices (Mar)*** | **Forecast: 0.3% MoM, 2.0% YoY** | **Prior: 0.8% MoM, 2.3% YoY** |
| | ***Output Prices Ex Tax (Mar)*** | **Forecast: 0.3% MoM, 1.9% YoY** | **Prior: 0.8% MoM, 2.1% YoY** |
| | ***Excluding Food, Drink, Tobacco, Energy (Mar)*** | **Forecast: 0.2% MoM, 1.4% YoY** | **Prior: 0.3% MoM, 1.3% YoY** |

The CBI survey suggests that pricing intentions have picked up among manufacturing firms, probably because of some pass through from the rise in external costs, and we expect these figures to give further signs that the YoY rate for output prices excluding food, drink, tobacco and energy is stabilising and troughing at 1%-1.5% YoY.

| | | | |
|---|---|---|---|
| Wed 17 Apr | ***Claimant Count Unemployment (Mar)*** | **Forecast: -5,000 MoM, 4.7% Rate** | **Prior: -1,500 MoM, 4.7% Rate** |
| | ***LFS Unemployment (Dec-Feb)*** | **Forecast: +90,000 QoQ, 8.0% Rate** | **Prior: +7,000 QoQ, 7.8% Rate** |

The single month figures for the LFS unemployment total showed a sharp jump in January and we expect the 3-month average (which is the headline rate) to jump higher this month as the low November figure drops out. More broadly, both labour supply and employment have been rising exceptionally rapidly over the last year, leaving the jobless rate roughly stable and with real wages falling.

| | | | |
|---|---|---|---|
| Thu 18 Apr | ***Retail Sales Volumes (Mar)*** | **Forecast: -1.0% MoM, -0.7% YoY** | **Prior: 2.1% MoM, 2.6% YoY** |

We suspect that the retail sales in March were badly hit by the relatively cold weather: it was the coldest March since a matching figure in 1892, with an average temperature that was roughly 4 degrees centigrade below the March average – a very large undershoot. The correlation between MoM retail sales growth and the average temperature is positive in March and hence the markedly colder weather probably hit sales. A figure in line with our forecast would leave volumes in Q1 up by 0.3% QoQ.

**Economic Calendar, 1 April — 19 April 2013**

| 1 April | 2 April | 3 April | 4 April | 5 April |
|---|---|---|---|---|
| **Easter Monday holiday** | **British Chambers of Commerce Quarterly Economic Survey**<br>(00:01)<br><br>**Manufacturing PMI (Mar)**<br>Feb 47.9<br>Mar 48.3<br><br>**Mortgage Approvals for House Purchase (Feb)**<br>Jan 54,187 MoM, -5.6% YoY<br>Feb 51,653 MoM, +4.5% YoY | **Deficit & Debt on Maastricht Basis (% of GDP)**<br>Deficit Debt<br>2011 7.8% 85.5%<br>2012 6.3% 90.0%<br><br>**Housing Equity Withdrawal, % of Post-Tax Income (Q4)**<br>Q3 -2.9%<br>Q4 -3.1%<br><br>**BoE Credit Conditions Survey (Q1)** | **Services PMI (Mar)**<br>Feb 51.8<br>Mar 52.4<br><br>**MPC Outcome:**<br>Rates Unchanged at 0.5%<br>QE Unchanged at £375bn<br><br>**ECB Outcome:**<br>Rates Unchanged at 0.75% | *Around Now*<br>**Halifax House Prices**<br>(Mar, 08:00)<br><br>**Record of FPC Meeting Of 19 March 2013** |
| **8 April** | **9 April** | **10 April** | **11 April** | **12 April** |
| | **RICS House Price Survey (Mar, 00:01)**<br><br>**Trade Balance – Goods & Services (Feb)**<br>Jan £-2.4bn<br>FebE £-3.0bn<br><br>**Industrial Production (Feb)**<br>Jan -1.2% MoM, -2.9% YoY<br>FebE 0.5% MoM, -2.6% YoY<br>**Manufacturing Output (Feb)**<br>Jan -1.5% MoM, -3.0% YoY<br>FebE 0.5% MoM, -1.3% YoY | | **Informal Eurogroup/EcoFin Meeting (Dublin, Apr 11-13)** | |
| **15 April** | **16 April** | **17 April** | **18 April** | **19 April** |
| | **Consumer Prices (Mar)**<br>Feb 0.7% MoM, 2.8% YoY<br>MarE 0.3% MoM, 2.8% YoY<br>**CPI Ex Food, Drink, Tobacco, Energy (Mar)**<br>Feb 0.6% MoM, 2.3% YoY<br>MarE 0.3% MoM, 2.3% YoY<br>**Retail Prices (Mar)**<br>Feb 0.7% MoM, 3.3% YoY<br>MarE 0.4% MoM, 3.2% YoY<br>**RPIX – Ex Mortgages (Mar)**<br>Feb 0.7% MoM, 3.2% YoY<br>MarE 0.4% MoM, 3.2% YoY<br>**Producer Input Prices (Mar)**<br>Feb 3.2% MoM, 2.5% YoY<br>MarE 0.5% MoM, 1.4% YoY<br>**Prod. Output Prices (Mar)**<br>Feb 0.8% MoM, 2.3% YoY<br>MarE 0.3% MoM, 2.0% YoY<br><br>**IMF's *World Economic Outlook* and *Fiscal Monitor Report* released** | **Claimant Count Unemployment (Mar)**<br>Feb -1,500 MoM, 4.7% Rate<br>MarE -5,000 MoM, 4.7% Rate<br>**LFS Unemployment (Dec-Feb)**<br>Nov-Jan +7,000 QoQ<br>Dec-FebE +90,000 QoQ<br>**LFS Unemploym't Rate**<br>Nov-Jan 7.8%<br>Dec-FebE 8.0%<br><br>**MPC Minutes**<br><br>**BoE Agents' Summary of Business Conditions (Apr)**<br><br>**Riksbank MPC Outcome**<br>(08:30)<br>**Bank of Canada Outcome**<br>(15:00)<br>**IMF's *Global Financial Stability Report* released** | **Retail Sales Volumes (Mar)**<br>Feb 2.1% MoM, 2.6% YoY<br>MarE -1.0% MoM, -0.7% YoY<br><br>**G-20 Meeting of Finance Ministers & Central Bank Governors (Washington DC, to Apr 19)** | **BoE Trends in Lending (Apr)**<br><br>**IMF Spring Meeting (Washington DC, to Apr 21)** |

E Citi estimate. B Billion. P Provisional. R Revised. Note: All data are released at 9.30 a.m., except those marked otherwise.
Sources: BoE, CBI, CML, ONS, national sources and Citi Research.

# Appendix A-1

## Analyst Certification

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