EY ITEM Club

Special report on business investment

October 2017

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EY is the sole sponsor of the ITEM Club, which is the only non-governmental economic forecasting group to use the HM Treasury model of the UK economy. Its forecasts are independent of any political, economic or business bias.

Foreword

EY Chief Economist UK
@MarkGregoryEY

A new investment landscape …

Much has changed since the *EY ITEM Club: Special report on business investment* in 2015. At that time, the UK was in the fifth year of a strong recovery in business capital spending and the expectations were that this would continue as the economy appeared set to carry on growing strongly.

… shaped by political uncertainty …

The new EY ITEM Club report sets out how much the environment for investment has changed with the UK's vote to leave the European Union (EU) a clear source of increased uncertainty. 2016 was a poor year for business investment in the UK, as activity fell and the UK growth rate slipped relative to our peers in Europe.

Uncertainty over the terms on which the UK will leave the EU casts a shadow over business decision-making, but business investment has performed reasonably strongly in 2017, reversing at least some of 2016's decline.

… is making forecasting difficult …

Forecasting future levels of UK business investment is therefore very challenging against this backdrop. Nevertheless, it is encouraging that EY ITEM Club remain optimistic that there is still time for the UK and the EU to agree on a transition arrangement that will support steady growth in expenditure in the coming years.

EY ITEM Club believe that growth of 1.5% in 2018 could be followed by increases of 2.7% in 2019, 3.4% in 2020 and 3.3% in 2021. These projections are of course very dependent on progress being made in the Brexit negotiations.

… but underlying concerns remain …

However, while I am encouraged that EY ITEM Club are more optimistic around business investment than I expected, challenges remain. In particular, I am concerned that the UK is not investing enough to maintain and improve our competitiveness and productivity levels.

Despite improved performance between 2010 and 2015, the UK's record on business investment still lags some way behind its international competitors — with the UK consistently falling short of its G7 peers in terms of share of GDP devoted to business investment. While it is true that the more service-intensive nature of the UK economy may mean that the UK requires less business investment than its peers, I do not believe this supports the current disparity in investment levels.

This issue has become more acute since the 2015 report as there are now a number of factors that suggest that UK businesses need to invest more:

- Adjusting to the consequences of Brexit will require shifts in the UK economy, especially in domestic supply chains, and this will require investment.

- ► As the global economy recovers, UK businesses should be investing in enhancing their export capability to capture new export opportunities.

- ► The UK's productivity performance remains weak and increased business investment is almost certainly required as part of the approach to improving current levels.

- ► Technological change continues apace and businesses will need to ensure they are investing sufficiently to capture the benefits and hence retain their competitiveness.

… and policy support is required.

Brexit is likely to give a significant shock to the economy and makes the case for policy to incentivise investment even stronger. Government can improve the investment climate by providing increased resources to improve skills, training and the provision of infrastructure — this will serve to de-risk business investment by creating an environment in which businesses believe their chances of earning a return on their capital investment are increased.

As EY ITEM Club note, financial conditions remain favourable for investment as profits and returns on capital are at relatively high levels, and corporates have access to both cash and credit. Nevertheless, investment is not increasing at the rate we might expect. Uncertainty is clearly a factor, but more direct incentives, such as increased capital allowances, should be considered as ways to increase investment levels.

Highlights

- Business investment dipped in 2016 for the first time since 2009, falling 0.4%. This decline was clearly influenced by heightened uncertainties in the run-up to the June referendum on EU membership. The vote for Brexit has contributed to a decline in business confidence, but nevertheless, business investment grew 0.8% quarter-on-quarter (q/q) in Q1 2017 and 0.5% q/q in Q2.

- With the consumer currently under pressure from squeezed purchasing power, sustained weakened business investment would increase the risk of the economy suffering prolonged muted activity. From a long-term perspective, it is clearly desirable for business investment and exports to make greater contributions to UK GDP growth so the economy can become less dependent on the consumer and hence more balanced. Healthy business investment is also seen as key to improving the UK economy's weakened productivity performance, evident since the 2008/9 downturn.

- Business investment is urgently needed to build new export capacity and to buttress the domestic supply chain to position the UK to maximise its performance in the post-Brexit environment.

- A move towards less offshoring and more domestic sourcing of productive inputs could be reinforced by Brexit. Businesses may be keener to secure domestic sources of supply, due to concerns about increased potential obstacles and delays to supply chains resulting from increased regulations once the UK is outside the EU's single market. This is especially likely to be the case for "just-in-time" supply chains.

- On the positive side, several fundamentals for business investment are currently favourable. Companies' net rates of return are relatively high overall while corporate balance sheets and finances are largely healthy. Additionally, if companies want or need to borrow to invest, the cost of capital currently remains low and availability of credit is at a healthy level. Last, but perhaps not least, is the incentive to invest — provided by sterling's weakness — for UK exporters and domestic firms competing with imports.

- However, businesses' motivation to invest has clearly been diluted by heightened uncertainties over Brexit. Furthermore, domestic political uncertainties have increased following the Conservative Party losing its parliamentary majority in the June 2017 general election. Meanwhile, businesses currently face a struggling UK economy.

- We suspect growth in business investment will be limited in the near term, especially as the likely ongoing low cost of labour will make it relatively attractive for companies to take on additional workers to meet any extra demand rather than make a long-term commitment through investment in plant and machinery.

- We believe it is most likely that the UK will avoid a "cliff edge" Brexit at the end of March 2019, with the Government ultimately agreeing a transitional period with the EU. If this is the case, the nature of the transitional agreement will really need to be in place by the latter months of 2018 to allow sufficient time for the agreement to be ratified across the EU before the end of March 2019. While a transitional agreement would still not tackle the longer-term Brexit uncertainties, we believe it would be sufficient to encourage businesses to take a more positive approach to investment from the latter months of 2018.

- In addition to trade arrangements — not only with the EU but also with non-EU countries and regions — an important factor determining the strength of business investment after Brexit will likely be the regulatory environment prevailing in the UK as well as the immigration regime ultimately adopted.

- There is serious concern that a restraint on future business investment could be a lack of skilled workers able to operate complex machinery and productive processes — and this risk will be magnified if the post-Brexit immigration regime fuels a shortage of workers in high-tech sectors. This underlines the pressing need for UK Government policies to boost investment in education, skills and training. Investment in robots and other labour-saving machinery could also help in dealing with this problem. Tax incentives for business investment and training in these areas would be supportive, as would be increased public funding of R&D and grants for pilot schemes in robotics and artificial intelligence.

EY ITEM Club: Special report on business investment

UK business investment consists of spending on machinery and plant, transport equipment, commercial property, software and R&D.

How business investment performs going forward has a vital role to play in both the short-term and longer-term outlook for the UK economy. In the near term, with the consumer under pressure from squeezed purchasing power resulting from inflation running above earnings growth, weakened business investment would increase the risk of the economy suffering a prolonged and marked slowdown.

From a long-term perspective, it is clearly desirable for business investment and exports to make greater contributions to UK GDP growth so the economy can become better balanced and less dependent on the consumer. Healthy business investment is also seen as key to improving the UK economy's weakened productivity performance evident since the 2008/9 downturn.

Also as Brexit looms, business investment is urgently needed to build new export capacity and buttress the domestic supply chain.

1. Brexit vote moved business investment goalposts

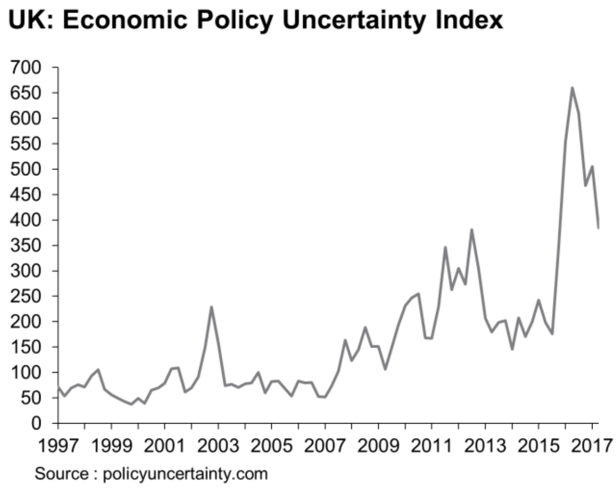
A challenging two years

Our September 2015 special report on business investment[1] was largely upbeat about the prospects for investment. The report concluded that "a consideration of factors which drive business investment, including rates of return, taxes, the cost and availability of finance, the level of economic uncertainty and the relative price of capital goods all point to plenty of support for this area of spending over the next few years. The return on capital is at a historically high level and will be supported by future cuts in corporation tax, corporate liquidity is plentiful and traditional constraints on investment faced by firms — such as uncertainty around future demand and the cost of external finance — have eased significantly."

The 2015 report further observed that "since 2008, the price of capital relative to labour has moved heavily in favour of the latter, reflecting historically weak pay growth. But the ongoing recovery in pay combined with the introduction of the 'living wage' next year should spur firms to invest more in labour-saving technology and improving efficiency."

The 2015 report concluded "contrary to common perceptions and fears of 'secular stagnation', UK business investment has performed impressively in recent years, substantially outgrowing other components of GDP since 2010, and as a share of output, currently standing at the highest level since 2000." Furthermore, "changes in working practices, notably the rise of self-employment and home working, mean that the official numbers probably understate what already appears to be a robust performance. And the emergence of the 'sharing economy' points to the understatement growing over time." This is because if people buy computers or other technology items for personal use, these count as retail sales. However, they may also be used substantially for business purposes.

[1] *'EY ITEM Club: Special report on business investment'*, September 2015. ey.com/Publication/vwLUAssets/EY_ITEM_Club_Special_Report_on_Business_Investment_v2/$FILE/Updated_FINAL%20_ITEM%20Special%20Report%20on%20Business%20Investment.pdf.

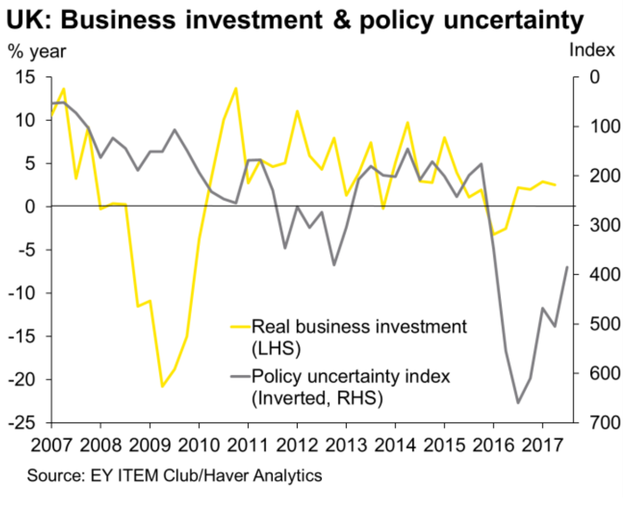


Circumstances have changed markedly since our 2015 business investment report was written. The major development, of course, has been the June 2016 referendum vote for the UK to leave the EU. After initial resilience through the second half of 2016, the Brexit vote weighed down markedly on UK economic activity during 2017, primarily through consumers being sharply squeezed by higher inflation resulting from a sharp drop in the pound following the referendum. In addition, uncertainties over the longer-term outlook for the UK have risen markedly overall.

Another significant development since 2015 has been a continuation of limited earnings growth for workers, meaning the price of labour has remained very attractive relative to capital. This is despite the introduction of the National Living Wage in April 2016 and the unemployment rate falling to the lowest level since 1975 (standing at 4.3% in the three months to August 2017).

This combination of weakened UK economic activity, heightened uncertainty over the UK's exact future relationship with the EU and cheap labour relative to capital does not appear to be conducive to robust growth in business investment.

This is significant not only for UK companies but also for overseas companies considering their investment options in the UK relative to other locations. Indeed, the head of the Association of German Chambers of Industry and Commerce (DIHK), Martin Wansleben, indicated in late August that many German businesses are beginning to shift investments away from Britain due to uncertainties over the future UK trading relationship with the EU and concerns that there will be increased trade barriers after Brexit, including more bureaucracy, increased waiting times and stricter border controls, all resulting in higher costs.



Yet in several respects, the fundamentals are positive for business investment; these include current high returns on capital employed, healthy corporate balance sheets overall, decent credit availability, low costs of capital and the boost to the tradable sector's profits and prospects from the cheap pound. Indeed, the marked overall weakening of sterling since the June 2016 Brexit vote seemingly provides a strong incentive to invest in the UK's export sector and for firms to seriously think about increasing their domestic sourcing of inputs to the production process.

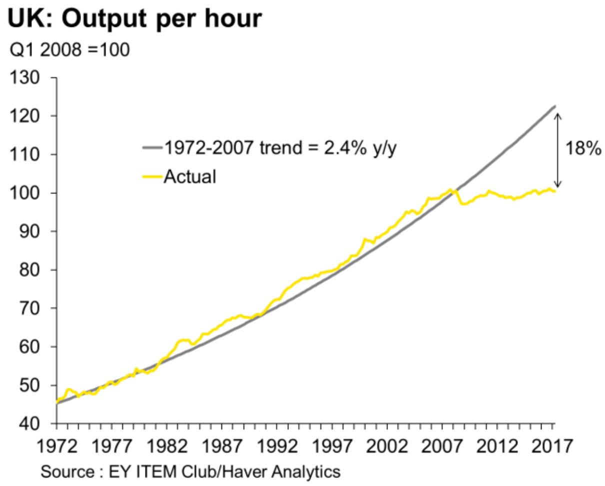
Business investment important to economy's short-term and longer-term prospects

Granted, business investment is a relatively modest part of the economy, accounting for just over 9% of GDP. But that smallish weight in output belies its importance to the UK economy's prospects in both the short term and the longer term.

In the near term, with the consumer squeezed hard by higher inflation and weak earnings growth, decent business investment, alongside improved exports, could be key to the economy avoiding a marked, prolonged slowdown. The Bank of England's Monetary Policy Committee (MPC) has highlighted the performance of business investment as one of the factors that they are particularly closely monitoring in deciding how fast the economy is likely to grow, and whether or not to raise interest rates.[2]

Furthermore, from a long-term perspective, it has long been seen as desirable for business investment and exports to make greater contributions to UK GDP growth so that the economy can become better balanced and less dependent on the consumer.

Healthy business investment is also seen as a key element in trying to improve the UK economy's weakened productivity performance evident since the 2008/9 downturn. For example, productivity in terms of output per hour worked in Q2 2017 was some 18% lower than it would have been if the 1972–2007 trend growth rate had continued. Of course, there is a lot of debate and dispute over exactly why the UK's productivity performance has been so disappointing recently, focusing on such influences as the cheap cost of labour, the nature of the recent jobs being created (in more low-skilled areas), the possibility that ultra-low interest rates have resulted in an inefficient allocation of resources (e.g. zombie companies being kept alive) and problems in measuring economic activity. However, there is little doubt that healthy investment aimed at improving production and businesses processes would be a positive step.



As Brexit looms, business investment is urgently needed to build new export capacity and strengthen the domestic supply chain. With the UK looking certain to leave the EU's single market, there is certainly a case for businesses to increasingly secure domestic sources of supply in order to avoid potential obstacles, extra costs and delays to supply chains resulting from increased regulations and procedures. Furthermore, European immigration has provided much of the extra labour employed by UK business in recent years but it is likely to be curtailed whatever the outcome of the Brexit negotiations. Respondents to a recent CBI survey indicated that a shortage of skilled labour is the biggest impediment to new investment. This could prove to be a major headache for employers over the next few years, underlining the pressing need for more investment in education, skills and training. Investment in robots and other labour-saving machinery could also help in dealing with this problem.

2. Recent performance of business investment

A significant improvement in business investment since 2010

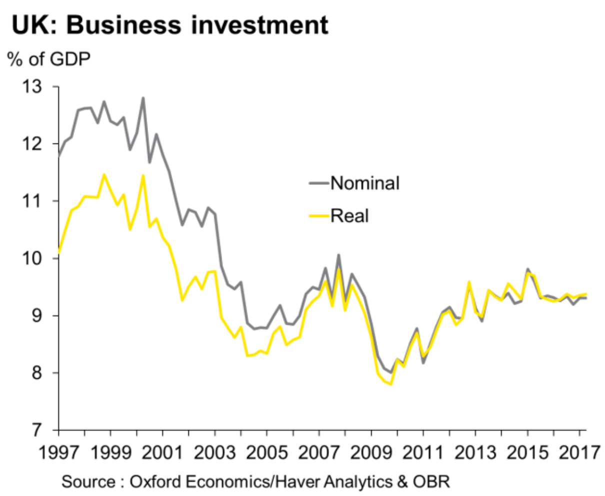
Having taken a substantial hit during the 2008/9 downturn (including a drop of 16.4% in 2009), business investment saw a pretty solid recovery from 2010 to 2015. Indeed, annual real growth in business investment averaged 4.9% a year over the six-year period. This compared with annual average GDP growth of 2.0% and indicated that perceptions and fears of "secular stagnation" in UK business investment had been exaggerated. [3] Nevertheless, it was not until Q2 2014 that the level of business investment surpassed the level seen in Q4 2007. As at Q2 2017, the level of business investment was 39.4% above the trough seen in Q4 2009, although it was only 4.8% above the pre-crisis peak seen in Q4 2007.

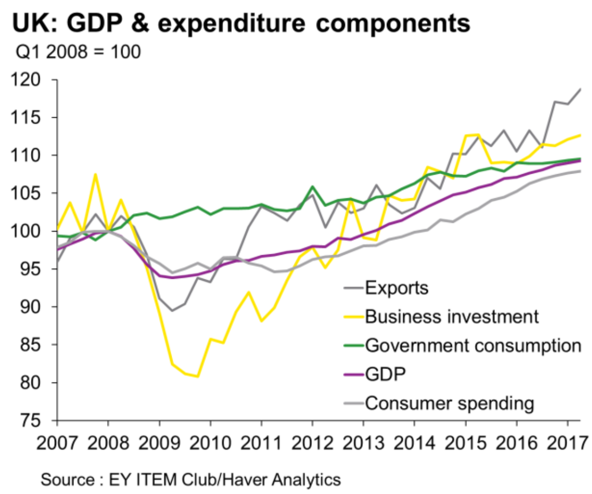
[2] For example, see page 3 of '*A Fine Balance*', a speech by given by Mark Carney, Governor of the Bank of England at The Mansion House, London, 20 June 2017. bankofengland.co.uk/publications/Documents/speeches/2017/speech983.pdf.20 June 2017.
[3] *The financial system and productive investment: new survey evidence* – Bank of England *Quarterly Bulletin* 2017 Q1 pre-release article bankofengland.co.uk/publications/Pages/quarterlybulletin/2017/q1/prerelease.aspx

The weakness of business investment during 2008/9 was clearly a consequence of the major demand shock that hit the UK economy. With GDP contracting, less investment was required to maintain the capital stock at a desired level relative to GDP. However, a serious concern is that the lower investment had some damaging longer-term impact on the productive capacity of the economy. Specifically, there is the possibility that the demand shock could well have had an adverse supply effect on the economy that has been a factor contributing to the largely disappointing UK productivity performance since the 2008/9 recession.

The pick-up in business investment during 2010 to 2015 reflected the recovery in the UK economy that started gradually in the second half of 2009. Growth in business investment tends to lag economic upturns, so it was not until Q1 2010 that business investment expanded quarter-on-quarter (q/q) for the first time since Q2 2008.

Meanwhile, among the various components of GDP and compared with the situation immediately prior to the financial crisis, business investment has outpaced growth in overall GDP and the other major expenditure components of output, with the exception of exports.

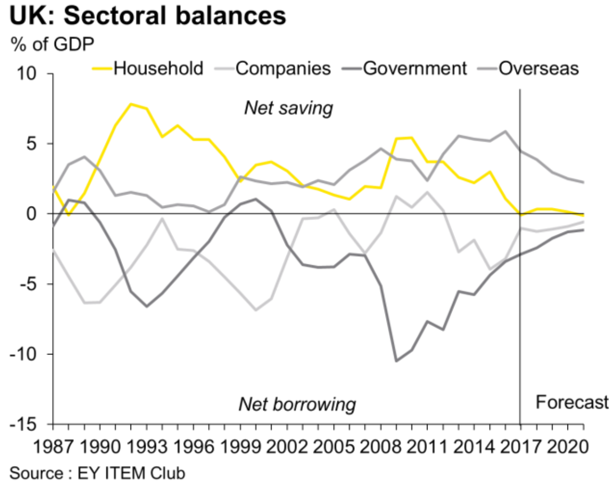




2016 saw the first drop in UK business investment since 2009

However, there was a relapse in 2016 when business investment dropped 0.4%, which was the first decline since 2009. This followed growth of 3.7% in 2015 and 5.1% in 2014. Spending on information and communications technology (ICT) equipment and on other machinery and equipment contracted 6.0% in 2016 but there was a 20.6% increase in spending on transport equipment.

It is apparent that mounting uncertainty ahead of the June 2016 referendum followed by the actual vote to leave the EU had an appreciable dampening impact on capital spending in 2016. Following the Brexit vote, surveys indicated that an increasing number of companies were delaying or cancelling major investment projects until there was clarity over exactly how the UK will leave the EU, as well as the UK's future trading arrangements outside the EU. The mounting caution of businesses was evident in companies lifting their net savings in 2016 and early 2017 after these fell in 2014 and 2015.



It should be noted that there were other significant factors which contributed to the drop in investment in 2016 — notably, weaker global growth prospects in the first half of 2016 and a fall in extraction sector investment following the decline in oil prices during 2014—15. Excluding the extraction sector, business investment actually rose by 2.8% in 2016, albeit a marked slowdown on 2015's 7.5% expansion.

Business investment expanded during H1 2017

Business investment returned to growth in the first half of 2017, expanding 0.8% q/q in Q1 and 0.5% q/q in Q2. However, Q1 growth was largely due to increases in spending on dwellings and on other buildings and structures and transfer costs. Spending on ICT equipment and other machinery and equipment fell 4.2% q/q in Q1 while it declined 3.6% q/q on transportation equipment. There was a further decline of 1.5% q/q in spending on transportation equipment in Q2 2017 but spending on ICT equipment and other machinery and equipment spiked 8.1% q/q.

Survey evidence suggested that some companies lifted their investment intentions modestly early on in 2017, influenced by the economy's overall resilience through the second half of 2016. There were also reports that sterling's weakness and healthy global growth were encouraging exporting companies to invest.

Nevertheless, some sectors appear to have been particularly cautious over investment in the first half of 2017, including the car industry. The *Financial Times* reported that Society of Motor Manufacturers and Traders (SMMT) data showed investment in the UK car industry was limited to £322m in the first half of 2017, suggesting companies are delaying or cancelling spending ahead of the UK leaving the EU. This follows on from investment in the car sector falling more than 30% to £1.66bn in 2016 from £2.5bn in 2015, as carmakers and their suppliers delayed non-essential investment following the EU referendum of June 2016.

While business investment saw only a modest overall dip in 2016 and registered growth over the first half of 2017, it needs to be kept in mind that many major capital spending projects (especially construction-related) take a long time to complete so current investment levels and growth rates are being significantly influenced by decisions that were taken before the June 2016 Brexit vote. Consequently, it could take time for any marked slowdown in major capital spending projects since the referendum to be fully reflected in the business investment data.

Recent UK investment performance similar to other G7 countries except for 2016 dip

Business investment as a share of UK GDP stood at 9.5% in 2007, immediately prior to the economic downturn. It had averaged 9.4% of GDP over the period 1990—2007, with a peak of 11.2% of GDP occurring in 1998.

The collapse in business investment during 2008/9 saw its share of UK GDP fall to 8.1% in 2009, which was the lowest level since 1995. However, the recovery in business investment during 2010—2015 resulted in its share of GDP steadily moving back up to reach 9.1% of GDP in 2012 and a peak of 9.5% of GDP in 2015, which was the highest share since 2001. The 2016 relapse in business investment took its share of GDP back down to 9.3%.

In comparison with other G7 countries, the decline in business investment's share of GDP in the UK during 2008/9 was not unduly large. Similarly, the rebound in the share of GDP of business investment in the UK from 2010 to 2015 generally stands up well compared to other G7 countries.

For example, business investment in Germany dropped from 13.0% of GDP in 2008 to 11.6% of GDP before recovering to 12.3% in 2011. It has since hovered around 12.0%. In France, business investment fell from 13.6% of GDP in 2008 to 12.4% of GDP in 2009, before recovering to 12.9% in 2011. It then hovered around 13.0% of GDP before rising to 13.3% in 2015 and 13.6% in 2016. In the US, business investment fell from 13.1% of GDP in 2007 to 11.3% of GDP in 2009 before reaching a peak of 13.6% in 2014. It has since dipped to 13.2% of GDP in 2016.

However, it is notable that in contrast to the 0.4% drop in business investment in the UK in 2016, it rose in all European G7 countries – Germany (+1.8%), France (+1.1%) and, marginally, Italy (+0.1%). While this was likely influenced by the Eurozone upturn becoming more firmly established, it also suggests that some different factors were at play in the UK.

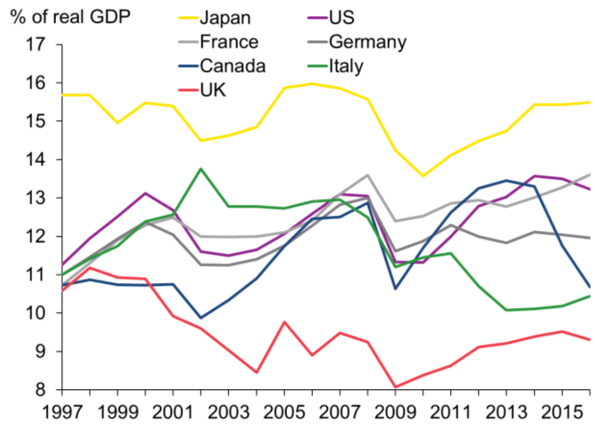
UK business investment lower as share of GDP than in other G7 countries

While the 2010–15 rebound in business investment in the UK stands up well on an international comparison, the level of capital spending by UK firms appears much less impressive. The UK has consistently fallen short of its G7 peers in terms of the share of GDP devoted to business investment. In 2016, that ratio (9.6% of GDP) was lower than that of any other G7 economy: Japan (15.5%), France (13.6%), US (13.2%), Germany (12.0%), Canada (10.7%) and Italy (10.4%).

But using this comparison to argue that investment by UK firms has been, and is, too low is not clear-cut. Composition effects represent one reason for this. The share of GDP accounted for by services is larger in the UK than any other G7 economy.[4] Since service activity is less capital intensive than other sectors, a lower ratio of business investment to GDP in the UK is unsurprising. Having said that, the US and French economies are only slightly less services-orientated than the UK, but investment is noticeably higher as a share of GDP.

Another reason to be cautious is the extent to which business investment delivers "bang for the buck" in the form of GDP growth. Over the last 20 years, Japanese companies have consistently invested a larger share of GDP than any other advanced economy. But that has not prevented mediocre Japanese GDP growth – in 2016 real output was only 5% higher than the level in 2004, compared to the 18% rise seen in the UK. Furthermore, both the US (21%) and Germany (19%) saw only modestly larger overall gains in GDP during 2014–16 despite being bigger investors than the UK on the business side.

G7: Business investment



Source : EY Item Club/Haver Analytics

It is also worth noting that the measured level of business investment (both in the UK and elsewhere) may effectively currently be understated because of the growth in self-employment alongside advances in personal technology. For example, if a self-employed person buys a laptop computer for personal reasons but also uses it for business, it counts as retail sales and hence consumption in the national accounts rather than business investment. Additionally, the rise in people working at home has reduced the need for spending on such items as office facilities and equipment. If workers' personal devices allow them to access work-related emails, there is little need to buy smartphones for them.

A final point to bear in mind is that when analysing business investment, it needs to be remembered that the data can be highly volatile and it can also be subject to substantial revisions. Indeed, the Office for Budget Responsibility (OBR) noted in its Economic and Fiscal Outlook accompanying the March 2017 Budget that over the past two decades "Comparing the first estimates with the latest data – which will reflect methodological changes as well as new information – the average absolute revision to quarterly growth in business investment is 2.9 percentage points, whereas for consumption it is just 0.4 percentage points." Furthermore, "Large revisions are not restricted to the initial estimates, so we may not be much wiser about the 'true' path of business investment growth even after considerable time has elapsed."

It follows that it is not easy to get a grasp on what constitutes the "right" level of business investment. But there is certainly a strong case for saying that more spending in this category is better than less.

[4] Comparison from World Bank: data.worldbank.org/indicator/NV.SRV.TETC.ZS

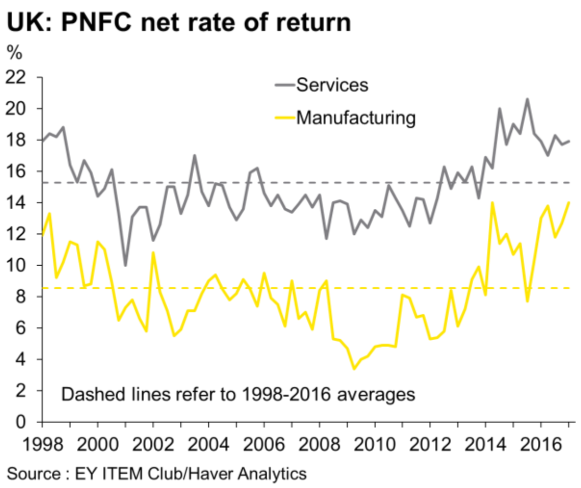
Spending by firms on investment has the dual advantage of boosting activity in the economy and, if directed wisely, expanding the potential of the economy to grow before inflation takes off. So growth in business investment is a prerequisite for sustained growth in the wider economy. Moreover, by boosting capital per worker and labour productivity, investment should also feed into higher wages and profits.

3. Supportive factors for business investment

So given the challenges, can business investment be a significant growth driver for the UK economy in the short term and further out?

In several respects, the fundamentals currently look positive for business investment; these include high returns on capital employed, healthy corporate balance sheets overall, decent credit availability and low costs of capital. Furthermore, the marked overall weakening of sterling since the June 2016 Brexit vote seemingly provides a strong incentive to invest in the UK's export sector and for firms to seriously think about increasing their domestic sourcing of inputs to the production process.

The net rate of return employed by UK private non-financial companies (PNFCs) improved to a two-and-a-half-year high in Q1 2017 and was well above the historical average. Meanwhile, company balance sheets and finances are largely healthy pointing to funds being available for investment. Additionally, if companies want or need to borrow to invest, the cost of capital currently remains low and availability of credit is at a healthy level.

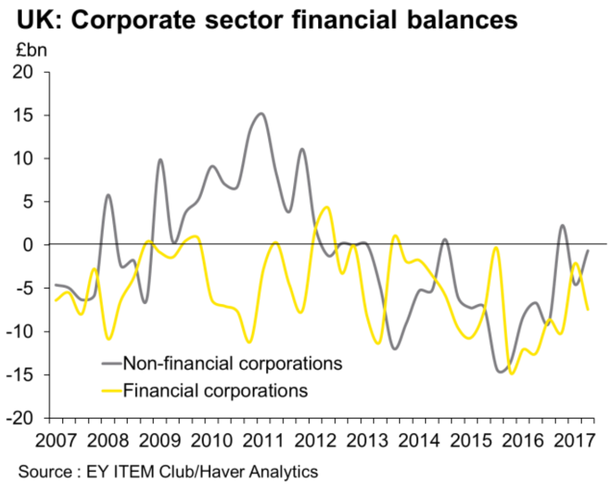


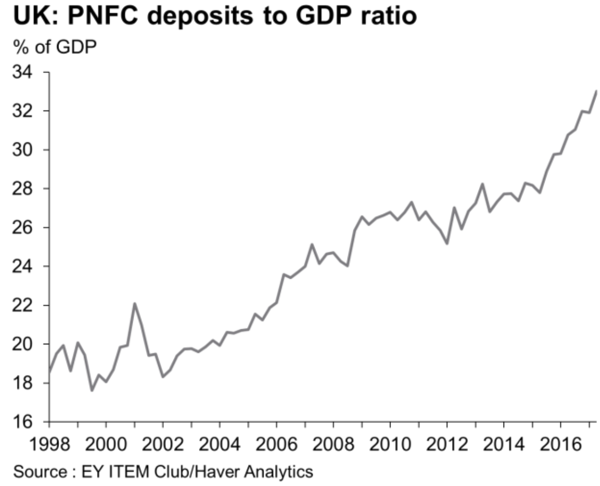
Specifically, the net rate of return for PNFCs improved to 12.7% in Q1 2017, which was the best level since Q3 2014. It was up from an average level of 12.4% in 2016 and 12.1% in 2015, and was comfortably above the lifetime (1997–2016) average of 11.8%. Furthermore, at 12.7% in Q1 2017, the net rate of return was comfortably above the average 12.0% "hurdle" rate that many companies impose on investment, according to the February 2017 Bank of England survey on the *Financial System and Productive Investment*. [5]

Indeed, at 14.0% in the manufacturing sector, the net rate of return was at the equal highest level (with Q3 2014) in the manufacturing sector since Q3 1997. The net rate of return for the services sector improved to 17.9% in Q1 2017 after dipping to 17.7% in Q4 2016 and was above the 1997–2016 average of 15.2%. However, the net rate of return for Continental Shelf companies (those engaged in oil and natural gas extraction in the North Sea) remained very low by historical standards in Q1 2017, despite rising to a two-year high, reflecting the modest pick-up in oil prices from their long-term lows in early 2016.

Additionally, corporate liquidity is plentiful, with currency and deposits held by non-financial companies reaching a record 33% of GDP in Q2 2017. This was up from 25.2% of GDP in Q1 2012. Bank of England MPC member Ian McCafferty noted in a speech back in 2014 that "given that around 60% of UK business investment is financed from internal funds, such a plentiful supply of funds is potentially highly supportive to capital spending."[6]

[5] The Financial System and productive investment: new survey evidence, Bank of England February 2017.bankofengland.co.uk/Pages/reader/index.aspx?pub=q1pre&page=1
[6] *Achieving a sustainable recovery: where next for business investment?* Speech given by Ian McCafferty, External Member of the Monetary Policy Committee, Bank of England, Nottingham Business School, 22 January 2014 bankofengland.co.uk/publications/Documents/speeches/2014/speech703.pdf.



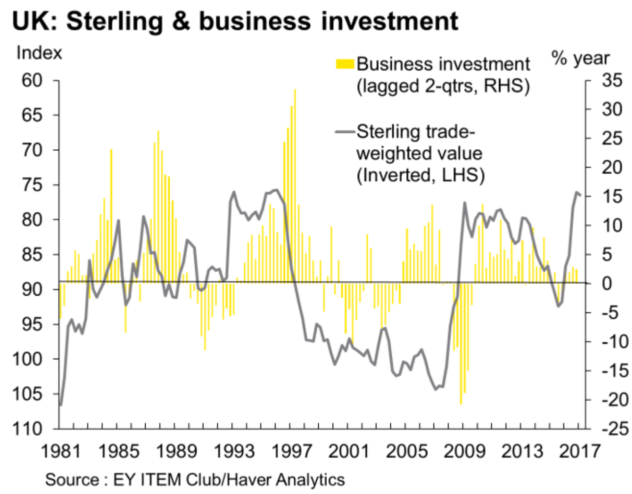


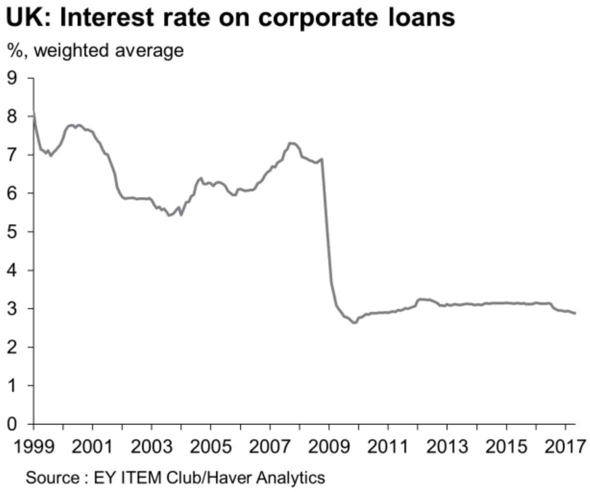
Furthermore, both post-tax rates of return and cash holdings should benefit from a more favourable tax regime. The rate of corporation tax paid by firms was cut from 20% to 19% in April 2017. It is due to be cut further to 17% by April 2020.

Should firms want to borrow, corporate borrowing rates remain at historically very low levels. Meanwhile, credit availability remains relatively plentiful for UK corporates. The Bank of England's quarterly *Credit Conditions Survey* in July 2017 indicated credit availability to corporates was unchanged in Q2 2017 and was expected to be stable in Q3. This was applicable to small, medium and larger companies. It is notable that the survey reported that "as in recent quarters, lower capital investment was reported to be acting as a drag on corporate demand for credit, although balance sheet restructuring and demand from the commercial real estate sector were reported to have pushed up on demand in Q2."[7]

Sterling weakness provides incentive for business investment in UK

Last, but perhaps not least is the incentive to invest — provided by sterling's weakness — for UK exporters and domestic firms competing with imports. By raising the profitability of firms in the tradable sector, sterling's drop should encourage those firms to expand, assisted by a more buoyant world economy and the fact that, for now, UK firms selling into the EU market face no new barriers. The Deputy Governor of the Bank of England, Ben Broadbent, memorably described the position of such firms as a "sweet spot".[8]





[7] *Credit Conditions Survey, Q2 2017* bankofengland.co.uk/publications/Documents/other/monetary/ccs/2017/17q2.pdf.
[8] *Brexit and the pound*. Speech by Ben Broadbent, Deputy Governor Monetary Policy, Bank of England, 23 March 2017. bankofengland.co.uk/publications/Documents/speeches/2017/speech969.pdf.

However, in his speech, Broadbent also acknowledged that "currency moves generally have to endure for quite a while before multinationals decide to shift production from one location to another."

Indeed, history suggests a clear lagged association between moves in sterling and growth in business investment, with a weaker pound tending to be followed by stronger investment growth and vice versa. Of course, there are numerous factors driving business investment, so it would not be wise to put too much weight on any particular one. But it is striking to observe how weak business investment was in the early 2000s despite low interest rates and decent economic growth suggesting a favourable investment environment. What distinguished this period was a consistently high exchange rate for the pound.

Switching supply chains to the UK from overseas could be reinforced by Brexit

The sustained weakness of sterling since the June 2016 vote to leave the EU provides a significant incentive for UK firms to review their supply chains. It could potentially result in at least a partial reversal of the outsourcing trend of recent years to perceived low-cost international locations and encourage companies to invest domestically to secure productive inputs.

The move towards more domestic sourcing of productive inputs could well be reinforced by Brexit factors. Businesses may be keener to secure domestic sources of supply, due to concerns about increased potential obstacles and delays to supply chains resulting from increased regulations once the UK is outside the EU's single market. This is likely to be especially the case for "just-in-time" supply chains, where parts are delivered as they are needed in the production process, and where even a short delay could potentially have a very damaging impact.

There are signs that this is already happening to a limited extent in the motor industry. McLaren has replaced an Austrian supplier by investing £50m in a new carbon-fibre chassis facility in Sheffield, which has increased the share of its parts being made in the UK from 50% to 58%. Additionally, Jaguar Land Rover supplier Magna is building an aluminium casting factory in Telford while Gestamp (a Spanish car body parts manufacturer) is investing £70m in its Cannock plant.[9] The car sector is particularly keen to build up the local content element of production to ensure that it satisfies EU requirements if the UK ends up with some form of free trade agreement with the EU.

4. Deterrents to business investment

A challenging outlook

However, while the fundamentals for business investment look relatively healthy, the motivation to invest looks far more questionable. In particular, business surveys repeatedly highlight that heightened uncertainty over Brexit is a major factor weighing down on investment intentions. Companies are concerned about exactly what will happen at the end of March 2019 when the UK formally leaves the EU. Will there be a transitional agreement in place, and if so how long is it likely to last and what form will it take? Further out businesses want to know exactly what form the UK's relationship with the EU will take, as well as what relationships the UK will form with other countries/regions.

Businesses' reluctance to invest in this highly uncertain environment may well be reinforced by the fact that the cost of labour is currently very cheap relative to capital. This increases the incentive for businesses to try and meet or generate any extra business by employing more workers rather than committing to potentially costly and lengthy capital investment projects.

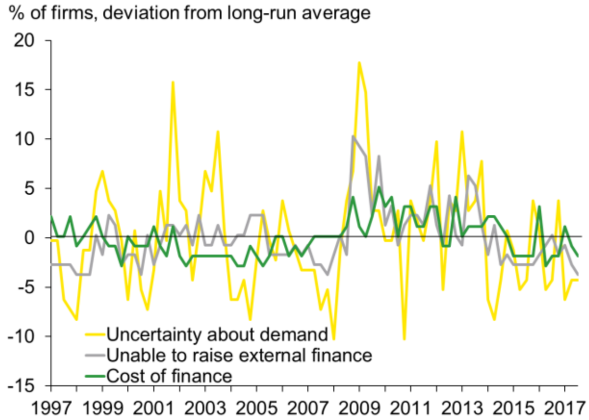
[9] Profiting from Brexit: McLaren shifts supply chain back to the UK, Financial Times, 9 September 2017. ft.com/content/b3d67800-9475-11e7-bdfa-eda243196c2c

Uncertainty increases business investment risks

The dampening impact that uncertainty can have on business investment was encapsulated in the aforementioned speech by MPC member Ian McCafferty. Specifically, McCafferty pointed out that "For business investment, the mechanism by which a rise in uncertainty operates is simple. Because investment is costly to reverse, when a firm decides to undertake a project, it gives up the option of waiting to gather more information. But that option has a value, which increases with the level of uncertainty about future conditions. So to give up this 'option to wait', a firm will require a higher rate of return from investment, net of costs, as compensation. In other words, uncertainty reduces the incentive to invest by pushing up on the opportunity cost of undertaking an investment project. So it is not surprising that, in business surveys, when firms are asked which factors are restraining capital spending, 'uncertainty about future demand' is quoted by the greatest number of firms."

Interestingly, the survey by the Bank of England released in February 2017 indicated that about two-thirds of UK companies believed that their investment levels had been at an appropriate level in recent years. One-third regarded their investment levels as too low, citing financial and real economic barriers. Lack of internal funds was given as the most common obstacle followed by high cost of finance, lack of access to finance and financial market pressures for short-term returns. Financial obstacles were most prevalent for smaller companies. Uncertainty over the future, inertia and discouragement from lower than desired returns on existing investment were also cited as reasons for underinvestment. [10]

UK: Factors holding back investment



Source : Oxford Economics/Haver Analytics

Surveys of business investment intentions generally showed improvement during the early months of 2017, as companies were encouraged by the UK economy's resilience through the second half of 2016 following the Brexit vote. For example, the second quarter survey of business conditions by the Bank of England's regional agents observed that "Investment intentions had strengthened a little further. Investment in technology to drive efficiencies was prevalent across most sectors. And a few manufacturing exporters were expanding capacity on the back of improving demand. In services, there were several reports of business services companies investing in modernising offices, in part to aid recruitment and retention of staff. Spending had also remained robust within leisure industries."

Nevertheless, the regional agents also reported that "heightened uncertainty remained a drag on some businesses' willingness to invest." The agents indicated that firms most cautious to invest were those heavily exposed to domestic consumer demand or trade with the EU.

Weakness of UK economy in H1 2017 reinforces business uncertainties already fuelled by Brexit

More recently, there have been signs that companies are becoming more cautious again in their investment decisions as the UK economy saw a marked slowdown in the first half of 2017. GDP growth halved from 0.6% q/q in Q4 2016 to 0.3% q/q in Q1 2017 and was then limited to 0.3% q/q again in Q2. This was the weakest six-month performance for the UK economy since the first half of 2012.

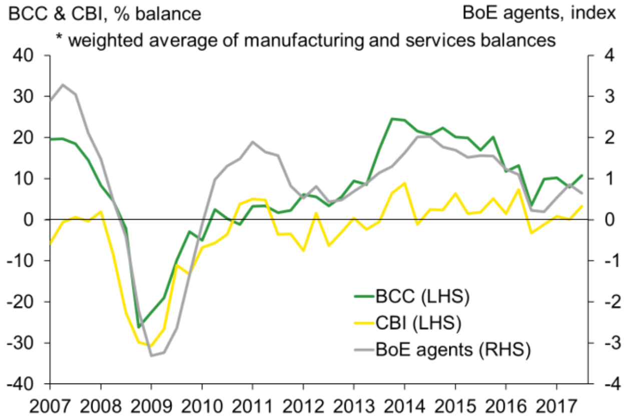
Heightened political uncertainties following the Conservative Party losing their parliamentary majority in June's general election are clearly affecting companies, while Brexit considerations have moved increasingly to the forefront after the UK triggered Article 50 at the end of March and negotiations over the UK's terms of exit from the EU got underway.

[10] The Financial System and productive investment: new survey evidence, Bank of England February 2017. bankofengland.co.uk/Pages/reader/index.aspx?pub=q1pre&page=1

A July CBI survey reported that the investment plans of over 40% of companies had been affected by Brexit, with 98% of those saying the effect had been negative. Uncertainty over the UK's future relationship with the EU was widely cited. Nearly 60% of companies said the Brexit vote had not affected investment decisions. The CBI's director-general, Carolyn Fairbairn, argued that businesses need to know as soon as possible what will happen after the UK leaves the EU. "The urgency is simply growing. March 2019 is tomorrow for a lot of businesses. They are having to make their plans now." [11]

A particularly downbeat assessment came from the August quarterly survey by the Institute of Chartered Accountants in England and Wales (ICAEW), which reported that business confidence had suffered a major relapse over the past three months. Indeed, the index deteriorated to -8 in the third quarter from +6.7 in the second quarter. This was attributed to increased uncertainties following the general election result and to perceived hesitant progress in Brexit negotiations. Consequently, the ICAEW reported that "The industrial strategy has been lost in the void, coupled with no clear signal towards post-Brexit policy. As a result, businesses cannot see through this haze of uncertainty and are struggling to look further than the end of the next quarter in terms of their decision-making."

UK: Investment intentions*



Source: EY ITEM Club/Haver Analytics

Meanwhile, a survey by the Recruitment & Employment Confederation (REC) reported that employers' willingness to invest had weakened in August to the lowest level since the Brexit vote in June 2016. This was reportedly influenced by concerns over Brexit negotiations, political uncertainty and pressurised consumers. The REC called strongly for the Government to do more to provide an environment of clarity for businesses, particularly on Brexit plans.

In late August, a survey reported that 41% of smaller and medium-sized enterprises (SMEs) believed that the process of leaving the EU has already adversely affected their business. The quarterly *National Manufacturing Barometer*, published by business consultancies SWMAS and Economic Growth Solutions, cited SMEs' uncertainty over future UK trading arrangements with the EU as well as the increase in their costs coming from the markedly weaker pound. The survey reported that SMEs' investment intentions had weakened compared to the previous quarter.

Chancellor Philip Hammond, who has been seeking a business-friendly Brexit, has argued that "a large amount of business investment is being postponed because of uncertainty over the future of Brexit negotiations." The Chancellor is pushing hard for early agreement on an extended transitional arrangement after Brexit as "the earlier we can give business that reassurance the more quickly we will get businesses investing again."

These business uncertainties over Brexit have been reinforced by increased uncertainties over the domestic UK political situation following the Conservative Party losing its parliamentary majority in the June 2017 general election.

Uncertainty over Brexit, likely deterring investment by foreign companies in UK

It is also notable that uncertainty over Brexit has been cited as deterring investment by German companies in the UK. In a joint statement with the British Chambers of Commerce (BCC), the head of the Association of German Chambers of Industry and Commerce (DIHK), Martin Wansleben, stated in late August that German businesses "are very concerned that Brexit will have a major negative impact."

[11] Brexit is affecting investment decisions, CBI, cbi.org.uk/news/brexit-is-affecting-investment-decisions/

Specific concerns included that Brexit could lead to "additional bureaucracy, increased waiting times and stricter border controls resulting in higher costs." He concluded that the "terms of exit are still completely unclear. Many of our members are reporting that they are already shifting investments away from the UK in anticipation of these barriers." Consequently, both the BCC and the DIHK called for priority to be given to "business critical" issues such as workers' rights, tax and customs arrangements which needed to be tackled. The BCC also indicated that most of their members favoured "at least" a three-year transition period.

Cost of labour currently very cheap relative to cost of capital

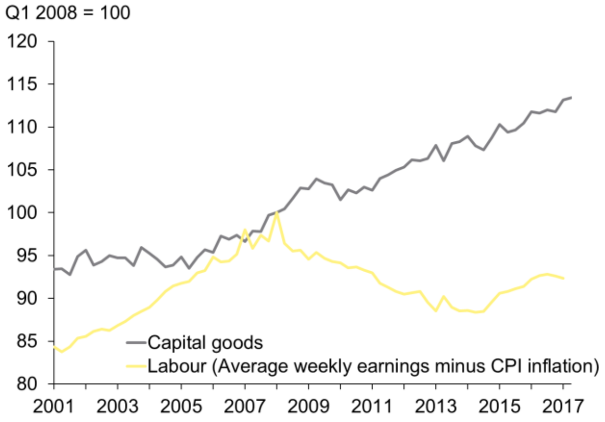
Moreover, with labour extremely cheap relative to capital goods, in the current uncertain environment it makes a lot of sense for companies to look to meet extra business by taking on more workers rather than by a major long-term commitment through undertaking substantial investment.

Indeed, this may well help to explain why the UK labour market has held up so well during 2017 so far, despite significantly weaker economic growth. UK employment was up 181,000 in the three months to July at a record high of 32.136 million. The employment rate was up to an all-time high of 75.3%. While employment came slightly off these highs in the three months to August, it remained elevated.

Despite the UK unemployment rate falling to 4.3% in the three months to July, where it remained in August (the lowest level since 1975), earnings growth has remained very weak (with Bank of England Governor Mark Carney describing it as "anaemic"). Specifically, total annual average weekly earnings growth in the three months to August amounted to 2.2%, still well below the pre-financial crisis norm of 4.5–5%.

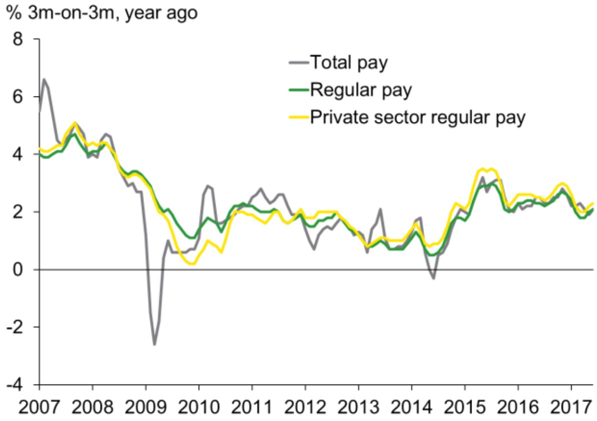
Facing a highly challenging and uncertain economic environment, UK companies have clearly been very keen to hold down pay growth in order to contain their total costs — especially as imported costs have been lifted by sterling's weakness. Indeed, the year-on-year increase in producer input costs was as high as 19.9% in January; it had come down to a still-elevated 8.4% by September.

UK: Real cost of capital goods and labour



Source : EY ITEM Club/Haver Analytics

UK: Average weekly earnings



Source : EY ITEM Clubs/Haver Analytics

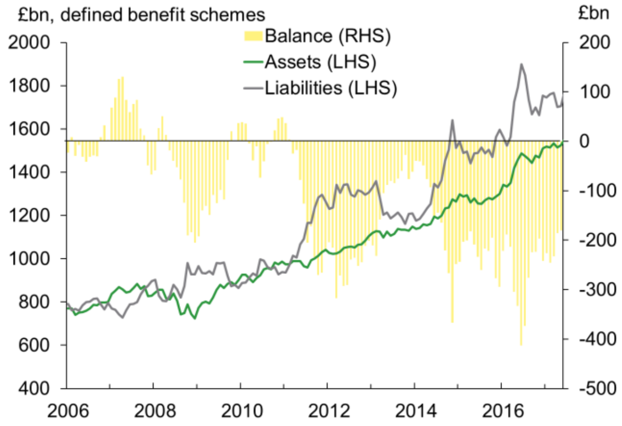
Latest surveys indicate that companies continue to aim to limit pay growth. The September survey of business conditions by the Bank of England's regional agents indicated that pay awards continued to be clustered around 2–3%.

Another deterrent to business investment is that sterling's weakness is likely to have pushed up the cost of capital goods for many companies. This obviously reinforces the relative attractiveness of labour costs to capital goods. Significantly, the Bank of England observed in their August 2017 quarterly Inflation Report that *"with the exception of buildings (around one-quarter of the total), investment is relatively import-intensive."* [12]

Deficits on pension funds may be hampering business investment

Additionally, it is apparent that some companies' ability and/or willingness to invest has been limited in recent years by the pressure on their finances coming from increased deficits on their pension funds. In his 2014 speech, Ian McCafferty observed that "micro data show that listed firms which reported pension deficits have spent less on investment as a proportion of their assets following the crisis, particularly in 2012 when deficits rose sharply." He further reported "the link between pension deficits and investment seems to be important. This is confirmed by a recent survey of companies with defined benefit pension schemes by the Bank's Agents. Twenty-four percent of the firms surveyed, the majority of which had a scheme in deficit, reported a major impact on investment decisions, with a further 28% reporting a minor impact."

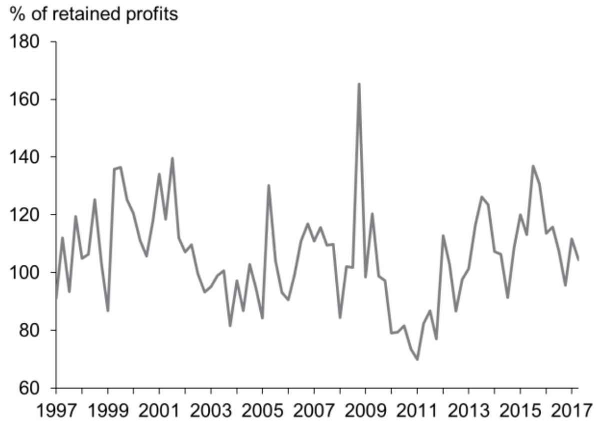
UK: Pension funds' position



Source : EY ITEM Club/Pension Protection Fund

There is also evidence to suggest that that in an environment of muted growth and heightened economic and political uncertainties, high equity prices have reinforced the reluctance of some UK companies to engage in business investment as they are keen to support their share price by keeping their profits as high as possible, paying healthy dividends and engaging in share buybacks. Certainly, business investment as a share of retained profits has fallen back sharply overall since Q4 2015, having previously trended up from a trough in 2011. Under normal circumstances, strong equity prices are usually seen as supportive to business investment.

UK: Business investment



Source : EY ITEM Club/Haver Analytics

[12] *Inflation Report* Bank of England, page 16, August 2017.
bankofengland.co.uk/publications/Pages/inflationreport/2017/aug.aspx

5. Progress on Brexit transition important for boosting attractiveness of business investment

It is evident from numerous surveys that a key factor in the outlook for business investment going forward will be progress — or lack of progress — on Brexit. Given that businesses have repeatedly expressed major concern over the potential major economic shock of a "cliff edge" UK departure from the EU after March 2019, the immediate focus for companies is on a transition agreement between the UK and the EU and the form that this is likely to take. Further out, of course, businesses want to see exactly what trading and non-trading relationship the UK is likely to have with the EU and also what policies the UK Government will have on key issues such as immigration and regulation.

Prime Minister Theresa May aimed to provide more clarity on the UK Government's position on Brexit and move negotiations with the EU forward in a major speech in Florence on 22 September. In the speech, the Prime Minister stated that the UK wanted a transition (or implementation) arrangement after the UK leaves the EU in late March 2019, most likely lasting two years (but possibly longer). During this period, current arrangements would essentially continue. UK and EU access to each other's markets will remain the same, the UK will continue to make payments to the EU budget, there will be continued freedom of movement (albeit with EU visitors to the UK being registered as they arrive), and the rulings of the European Court of Justice will be taken into consideration by UK courts.

While the EU has largely seen Mrs May's speech in a positive light, and as being made in a much more constructive spirit than her Lancaster House speech back in January, its chief negotiator Michel Barnier is still pushing for more clarity on the terms of the UK exit from the EU before agreeing to discuss a transition agreement. The EU continues to want more progress on exactly how much the UK will pay to settle its divorce bill from the EU (the UK Government has so far indicated a payment of around €20 billion to the EU budget during the two-year transition period) as well as sorting out the Irish border and citizens' rights.

It is also notable that while the UK Government has now established its position on a transition agreement, it remains very far from clear what relationship it favours with the EU over the long term. In her Florence speech, Mrs May rejected both the Norwegian and Canadian arrangements with the EU as inadequate for the UK. While the Norwegian model would allow the UK to remain close to the EU in regulatory terms, it would come at a price regarding freedom of movement and payments to the EU with the UK being essentially a rule taker and having limited say. Meanwhile, although the Canadian model offers greater freedom in terms of rules, the scope of the agreement is much more limited. The indication is that the UK believes that it can come to a better, bespoke arrangement with the EU which would build on the regulatory harmonisation that the two sides currently enjoy. However, this is likely to prove difficult to agree on as the EU's chief negotiator Michel Barnier has already observed that "one thing is sure: it is not — and will not — be possible for a third country to have the same benefits as the Norwegian model but the limited obligations of the Canadian model."

With respect to future relationships with non-EU countries, Mrs May indicated in late August that the UK would look to replicate the EU's trade deals with other countries in the immediate aftermath of Brexit before possibly "recasting" its own deals further out.

6. Conclusions

Businesses are generally in a healthy financial position to invest, should they want to. Furthermore, credit availability is currently still ample for most companies and the cost of borrowing remains relatively low. Meanwhile, the marked overall weakening of sterling since the June 2016 Brexit vote seemingly provides a particularly strong incentive to invest in the UK's export sector and for firms to seriously think about increasing their domestic sourcing of inputs to the production process

However, it is apparent that businesses' motivation and willingness to invest are being pressurised significantly by major economic and political uncertainties over the future which are centred on Brexit. This includes uncertainties over both a transitional (or implementation) period, and exactly what relationships the UK will have with the EU — and also with non-EU countries — when Brexit is fully complete.

We suspect business investment will be limited in the near term, especially as the likely ongoing low cost of labour relative to capital will make it relatively attractive for companies — where possible — to take on additional labour to meet any extra demand rather than make a long-term commitment through investment in plant and machinery.

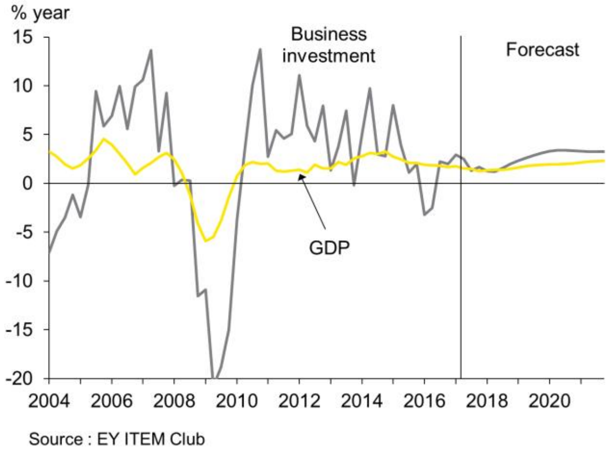
Importantly, we believe it is much more likely than not that the UK will avoid a "cliff edge" Brexit at the end of March 2019, and that the Government will ultimately come to an agreement with the EU on a transition arrangement. If this is the case, the nature of the transitional arrangement will really need to be in place around October 2018 in order to allow sufficient time for the agreement to be ratified across the EU before the end of March 2019.

While a transitional arrangement would still not tackle the longer-term Brexit uncertainties, we believe it would be sufficient to encourage businesses to take a more positive approach to investment from the latter months of 2018. Businesses would also likely see a transitional arrangement as a hopeful sign that the UK would be able to form at least a comprehensive trade agreement with the EU and engage in a business-friendly relationship post-Brexit.

Overall, we expect business investment to rise 2.1% over 2017 (helped by the increases of 0.8% q/q in Q1 and 0.5% q/q in Q2) followed by growth of 1.5% in 2018. However, while the forecast overall growth rate is lower in 2018 than in 2017, this masks an expected pick-up in business investment late on in 2018, which becomes more solid in 2019 as a Brexit transitional agreement comes into effect.

While businesses are likely to remain relatively cautious over investment until it becomes fully clear exactly what form the UK's long-term relationship will take with the EU — including access to EU markets as well as trade arrangements — we expect business investment to see decent growth of 2.7% in 2019, 3.4% in 2020 and 3.3% in 2021.

UK: Business investment & GDP



Source : EY ITEM Club

Regulatory environment and immigration regime will be important factors

In addition to trade arrangements — not only with the EU but also with non-EU countries and regions — an important factor determining the strength of business investment in the UK after Brexit will likely be the regulatory environment prevailing in the UK as well as the immigration regime that is ultimately adopted. Proponents of Brexit have argued that the UK will be able to adopt a less regulatory and more entrepreneurial-friendly business environment once it is free of EU shackles, and that this will be conducive to business investment and supportive to overseas companies contemplating operations in the UK. However, it is questionable as to how much this will really be the case, given that many of the regulatory restraints on UK companies are actually based on UK legislation rather than the EU.

Furthermore, there is serious concern that a restraint on future business investment could be a lack of skilled workers in the UK able to operate complex machinery and productive processes. If the immigration regime that is ultimately adopted by the UK following Brexit fuels a shortage of workers in high-tech sectors, this risk would be magnified. Reinforcing this potential danger, it is worth reiterating the CBI's July 2017 survey indicating that a shortage of skilled labour is a serious impediment to new investment.

This underlines the pressing need for UK Government policies aimed at boosting investment in education, skills and training. Investment in robots and other labour-saving machinery could also help in dealing with this problem, including measures aimed at the promotion of artificial intelligence. This would fit in with a policy of using Government power to promote certain key industries and technologies, which Mrs May announced in January as a new industrial strategy. Tax incentives for business investment and training in these areas would be supportive as would be increased public funding of R&D and grants for pilot schemes in robotics and in artificial intelligence.

It goes without saying that there are major uncertainties surrounding these business investment forecasts, with substantial risks to the upside as well as the downside.

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