# Box C: Finance, business investment and productivity

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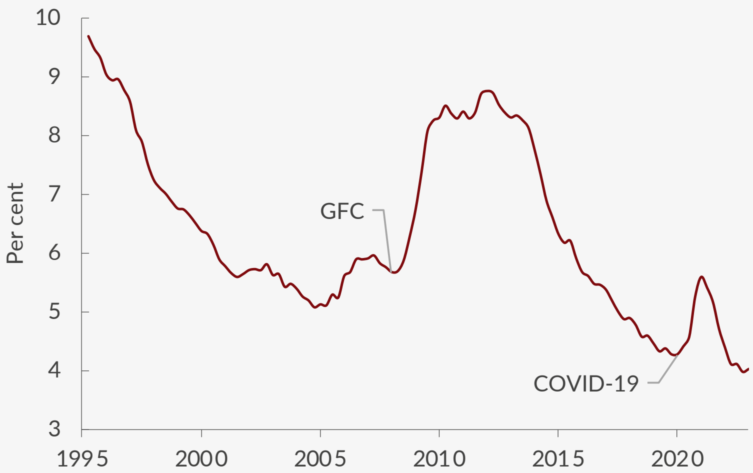
As labour supply in the United Kingdom nears capacity, the performance of labour productivity, defined as output per hour worked is crucial to future growth. Labour productivity growth is typically attributed to three factors: changes in labour force quality, changes in the capital stock, and a total factor productivity residual (TFP), which represents the state of available technology.[1] Here, I concentrate on the potential impact of the recent Bank of England tightening, and changing financial conditions more generally, on business investment, which ultimately influences labour productivity growth.

### As the UK labour market nears capacity, productivity becomes key to economic growth

The UK labour market is currently very tight, with a low unemployment rate of 3.8 per cent and total hours worked approaching pre-pandemic levels. Economic inactivity is slightly higher than before the pandemic, but still low compared to historical standards. The Office for National Statistics (ONS) measures of underutilised labour are also close to their lowest recorded levels. Figure C1 displays an average of the six ONS measures for labour market availability, which has been trending downwards since the mid-1990s and, as of the fourth quarter of 2022, stands near its historic low at 4 per cent. The UK labour market is currently operating at near-capacity levels, which underscores the significance of labour productivity as a key driver of economic growth.

**Figure C1** Underutilised labour in the United Kingdom




Source: ONS and author's calculations.

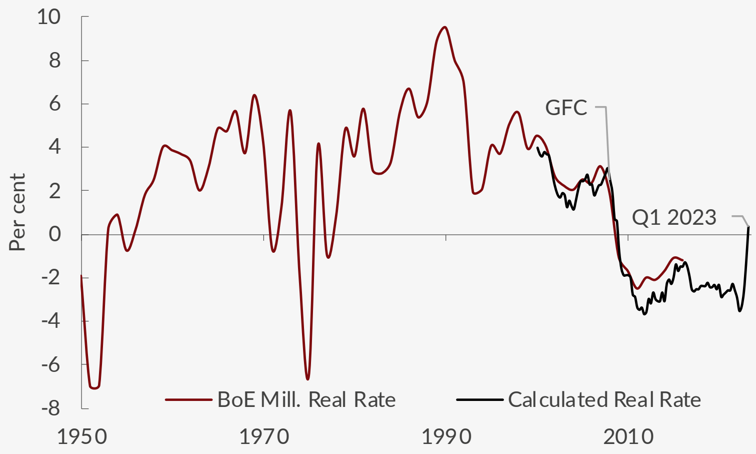
Note: Calculated as the unweighted average of the U-1 to U-6 measures.

### Is this the end of the post-Global Financial Crisis ample liquidity, low financing cost period?

Figure C2 illustrates a long-term downward trend in real interest rates that began in the early 1990s. The Global Financial Crisis (GFC) further accelerated this trend, pushing real interest rates into negative territory. Despite the recent tightening by the Bank of England, real interest rates remained negative until the fourth quarter of 2022 before turning slightly positive in the first quarter of 2023, the first time since 2008.

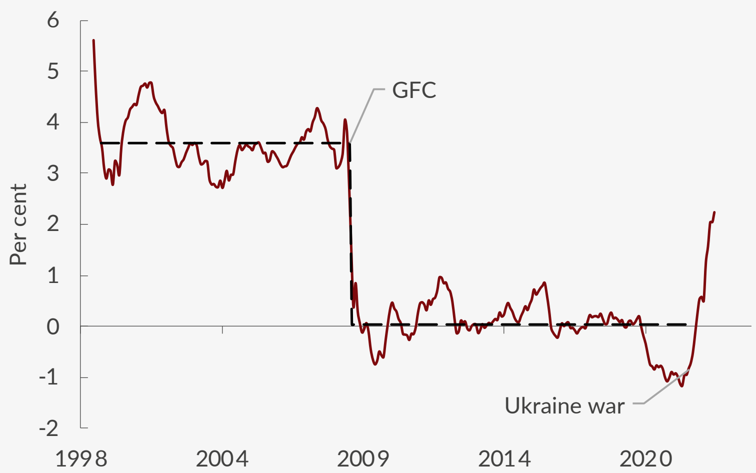
1 See Chadha and Samiri (2022) for more details on the decomposition of labour productivity growth and its implications. The paper also comments on the issue of weak business investment in the United Kingdom despite low real interest rates in the post-GFC period.

**Figure C2** Real interest rates in the United Kingdom




Source: Bank of England Millennium Dataset, Datastream and author's calculations.
Notes: Data from 1950 to 2016 are from the Bank of England. Data from Q4 1999 to Q1 2023 calculated as the difference between the Bank of England's base rate and the Bank of England's expected price change over the next 12 months.

**Figure C3** Real loan interest rate facing safer PNFCs




Source: Bank of England Millennium Dataset, Datastream and author's calculations.
Notes: Data from 1950 to 2016 are from the Bank of England. Data from Q4 1999 to Q1 2023 calculated as the difference between the Bank of England's base rate and the Bank of England's expected price change over the next 12 months.

The post-GFC drop in long-term real financing costs for safer private non-financial UK companies (PNFCs) has been even more striking, falling from an average of around 3.5 per cent to near zero in the decade following the GFC (Figure C3). As of February 2023, the real cost of financing safer PNFCs stood at 2.2 per cent, its highest level since December 2008. Confirming these trends, the March 2023 Decision Maker Panel Survey (DMP) reported a 1.4 percentage point increase in interest rates on firms' current borrowing, with expectations of a further small increase within a year (Figure C4).

**Figure C4** Effective interest rates on respondents' bank and non-bank borrowing


Source: Bank of England Decision Makers Panel.

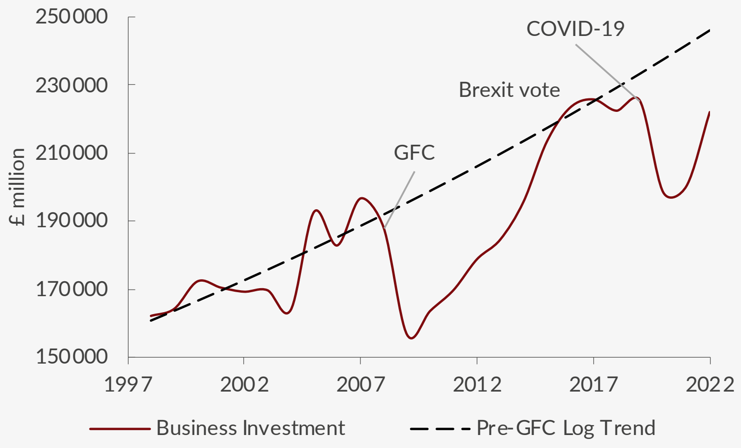
After a prolonged period of cheap financing and ample liquidity in the post-GFC era, firms are now facing positive real financing costs for the first time since the Great Recession. This is expected to have a negative impact on business investment and, consequently, on the prospects for productivity growth in the United Kingdom. In the medium term, the impact on the business capital stock will depend on future developments regarding inflation and their implications for monetary policy in the United Kingdom.

## No persistent recovery of business investment after the GFC and the role of uncertainty

According to standard economic models, low real financing rates are expected to encourage private investment. However, UK business investment remained weak in the years following the GFC (Figure C5). While there was a temporary increase in investment in the years leading up to the Brexit vote, this trend was cut short by the referendum result. The subsequent uncertainty surrounding Brexit and the more significant disruptions caused by COVID-19 led to a collapse in business investment in 2020, followed by a partial recovery to pre-pandemic levels by 2022. This persistence of uncertainty has become a significant roadblock in reviving business investment to pre-GFC trends. The recent high inflation episode has introduced a new source of uncertainty for businesses to consider.

The UK business sector missed the opportunity to increase capital expenditure during the decade following the financial crisis, despite the availability of low financing rates. The current tighter financial conditions are unlikely to help reverse this trend. DMP data indicates that decision-makers have consistently reported an 8 per cent decline in investment due to the increase in nominal rates over the past three quarters. Meanwhile, UK companies exhibit more optimism regarding their future sales as the economy recovers from the COVID-19 disruption. However, this newfound optimism has yet to translate into a revival of business investment, as business investment in the first quarter of 2023 remained slightly below pre-pandemic levels. A revival of business investment is essential to promote productivity growth and compensate for the capital the economy failed to accumulate following the GFC.

**Figure C5** Business investment




Source: ONS and author's calculations.

Bunn et al. (2022) used DMP data to demonstrate that inflation rates among firms became more dispersed and skewed during the post-pandemic recovery. Moreover, their findings reveal that firms have become more uncertain about future inflation. Fischer (2013) studied loan-level data for small businesses and discovered that higher inflation leads to a significant reduction in investments, with businesses shifting their investments away from fixed investment to working capital, a more flexible production factor. This literature suggests that as other sources of uncertainty begin to diminish, firms' revenues are now vulnerable to a new source of uncertainty: firm-specific inflation.

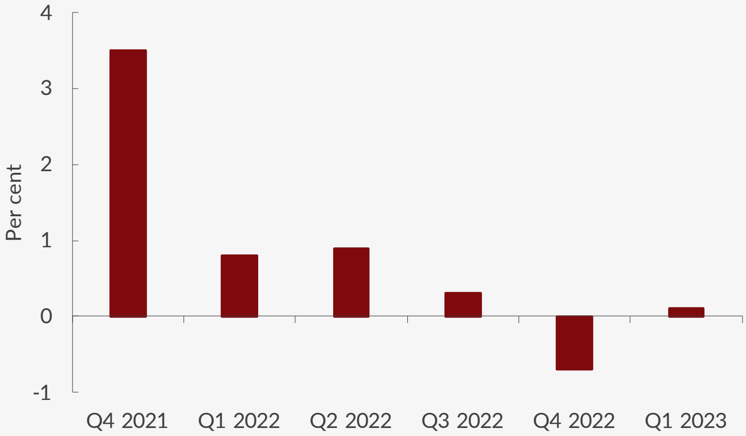
## Bank lending to UK businesses is stable but risks remain in the nonbank sector

The potential effects of inflation on business investment extend beyond the direct impact on firms, as inflation can create ripple effects within the financial sector. As noted in Bejarano Carbo et al. (2023), the current cycle of monetary policy tightening implemented by the Bank of England is aggressive by historical standards. This raises concerns about potential instability within the UK financial system.

The Bank of England's Credit Conditions Report indicates that the availability of credit provided to the corporate sector slightly deteriorated in the fourth quarter of 2022, while the most recent data from the first quarter of 2023 suggests that lending to the corporate sector has stabilized (Figure C6). This indicates that the recent tightening of monetary policy has not materially impacted bank lending.

It is important to note that bank lending is just one aspect of the financial system. Nonbank lending is becoming increasingly important in the supply of financing to the business sector. The nonbank sector includes various entities such as pension funds, insurance companies, asset managers, hedge funds, and structured finance vehicles. IMF (2022) reports that nonbanks in the United Kingdom are very large and diverse. Despite the available data not including non-UK-domiciled hedge funds operating in the United Kingdom and other non-domiciled sterling money market funds, it suggests that the size of the nonbank sector by balance sheet is just below that of banks. The events surrounding the 'mini-budget' in September 2022 showed how quickly problems can develop in the nonbank sector, with potential implications for business investment. These events underscored the need to control systemic risks emanating from all parts of the financial sector.

**Figure C6** Availability of credit to the UK corporate sector




Source: Bank of England Financing Conditions Survey.
Notes: Net percentage balances are calculated by weighting together the responses of those lenders who answered the question 'How has the availability of credit provided to the corporate sector overall changed?'. Positive balance indicates an increase in credit availability.

Given the sequence of events that have kept uncertainty high for businesses after the global financial crisis, the UK economy may remain on its low business investment trajectory if the current uncertainty surrounding inflation persists or is compounded by other systemic disruptions in the financial system. And, if the United Kingdom continues with such low levels of business investment, then its poor productivity performance will likely continue.

## References

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