REBALANCING
THE BRITISH ECONOMY

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Tony Greenham is head of finance and business at the New Economics Foundation, leading the programme of research into reforming the financial sector and aligning the interests of society and business. Since 2010 he has advised the government on regional economic regeneration as a member of the Regional Growth Fund Advisory Panel. After qualifying as a chartered accountant with PricewaterhouseCoopers in 1996, he worked in UK Equity Capital Markets and then spent several years in the commercial sector. Tony is a regular media commentator on banking issues. He has a BA in Politics, Philosophy and Economics from the University of Oxford and an MSc in Environmental Assessment and Evaluation from the London School of Economics.

Jan Hall, dubbed by *The Guardian* as 'the doyenne of City headhunters', is one of the UK's top headhunters. In 2005 she founded the globally-leading executive search firm the JCA Group, having previously spent eight years as a senior partner at the global search firm Spencer Stuart. Before that she was the European Chief Executive of the GGT Group plc, where she was a main board director and responsible for the company's 16 businesses across Europe.

Julia Hobsbawm is currently Chief Executive Officer of the media networking business Editorial Intelligence and the world's first professor in Networking at Cass Business School in London. In February 2011 she was invited by David Cameron to join him at the Northern Future Forum in Stockholm with the Prime Ministers of eight Nordic and Baltic countries to be part of the British panel of experts on women entrepreneurs and leadership. She has worked for over a decade in public relations, founding the first 'integrity PR' firm and founding the first degree course in the subject, when she was made London's first Visiting Professor in Public Relations by the London College of Communication, University of the Arts.

Tristram Hunt is Member of Parliament (Labour Party) for Stoke-on-Trent Central and Senior Lecturer in Modern British History at Queen Mary, University of London. He is a Member of the Select Committee on Political and Constitutional Reform and Chair of the All-Party Parliamentary Group on Energy Intensive Industries.

He is the author of *The English Civil War: At First Hand* (2002), *Building Jerusalem: The Rise and Fall of the Victorian City* (2004), and the award-winning biography, *The Frock-coated Communist: The Revolutionary Life of Friedrich Engels* (2009). Previously, he was Special Adviser to Science Minister Lord Sainsbury (1997-2000), Associate Fellow at the Centre for History and Economics, King's College, Cambridge and Senior Fellow at the Institute for Public Policy Research.

Since entering Parliament, Tristram Hunt has focused on the regeneration needs of Stoke-on-Trent; the ceramics industry and energy intensive sector; educational excellence; constitutional reform; and the Labour Party policy review. He is a trustee of the History of Parliament Trust and fellow of the Royal Historical Society.

Jo Johnson has been MP for Orpington since May 2010. Jo currently serves as a Government Whip. Between January 2012 and September 2012, he was Parliamentary Private Secretary (PPS) to Mark Prisk MP, Minister of State for Business and Enterprise. Prior to this appointment, he served as an elected member of the Public Accounts Committee. As Co-chairman of the Indo-UK All Party Parliamentary Group, he co-edited *Reconnecting Britain and India: Ideas for an Enhanced Partnership* (Academic Foundation 2011). He worked at the *Financial Times* between 1997-2010 in various roles including Associate Editor, Editor of the Lex Column, South Asia Bureau Chief and Paris Correspondent.

Lord (Peter) Mandelson has been a life peer in the House of Lords since 2008 and is currently President of the international think tank Policy Network. Before becoming a peer, he served as the European Commissioner for Trade from 2004 to 2008. He was the Member of Parliament for Hartlepool from 1992 to 2004. He was a key architect in the rebranding of the Labour Party as 'New Labour' and its subsequent landslide victory in the 1997 general election. During his time as an MP he served in a number of Cabinet positions under both Tony Blair and Gordon Brown.

Helena Morrissey was born in Altringham, Cheshire in 1966. She attended Bishop Luffa comprehensive in Chichester and then completed a degree at Cambridge University. She lives with her husband and nine children in London. She has been the Chief Executive of Newton Investment Management since 2001, the firm which she first joined as an investment manager in 1994. She is also a director of the Investment Management Association and sits on the FSA's practitioner panel. In November 2010 Morrissey set up the 30% Club, a group aimed at increasing the number of boardroom positions occupied by women in the FTSE 100 index of Britain's biggest companies from 12.5 per cent to 30 per cent by 2015.

Wolfgang Neumann is Director of the EU Representation of Deutscher Sparkassen-und Giroverband, the German Savings Bank Association, in Brussels, a post he has held since 1995. Prior to this he worked in the economic research department of a major bank. He graduated from Cologne University with a degree in economics and business administration.

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Terry Scuoler has been the Chief Executive of the Engineering Employers' Federation since March 2010. Before this he was the Managing Director of Ferranti Technologies Ltd and with a supportive team returned the company from years of decline and a loss-making situation to one of substantial growth and high profitability. He has also worked for Royal Ordnance (now part of BAE Systems) as European Marketing Manager and has worked in the UK, Western Europe, North America and the Middle East. He has a passion for manufacturing and engineering and argues that the industry has a critical role in the UK economy.

David Tinsley is Chief UK Economist at BNP Paribas. He has extensive experience in forecasting, economic analysis and related client advice in the banking, consultancy and public sectors. David spent six years working as an economist at the Bank of England, where he was involved in forecasting UK and Eurozone economic developments for the Monetary Policy Committee. He then worked at Oxford Economics, combining macroeconomic forecasting and analysis with bespoke consultancy work covering topics including the European housing market, regional economics, and product market analysis. David has been in his present role since August 2011.

Karel Williams is Professor of Accounting and Political Economy at the University of Manchester's Business School. He is the director of the ESRC funded Centre for Research on Socio Cultural Change (CRESC) where he leads research by an MBS team into financialization and financial innovation. He supervises PhD students in these areas of interest and currently teaches an MBA elective in Strategic Finance.

Foreword

Tristram Hunt MP

In the wake of the deepest recession since the 1930s, there is a cross-party commitment to the rebalancing of the British economy. This stems from a general recognition in all the major parties that unsustainable levels of public spending, financed by frothy tax revenues from a bloated financial services sector, had been used to disguise a fundamental lack of economic competitiveness.

In his March 2011 Budget Speech, George Osborne lamented the economy's reliance on financial services to generate tax receipts, calling for a 'March of the Makers' to lift the economy out of its post-2008 doldrums. In his 2011 Autumn Statement, he similarly pledged to rebalance expenditure in the UK economy 'away from government and consumer spending toward net trade and investment'. Such rebalancing, he said, would require an 'active enterprise policy' in order to move the British economy decisively 'in the right direction'.[1] Exports and manufacturing were described as 'crucial to rebalancing the economy'.

Given the recent history of British public policy, even to profess the need for an explicitly defined industrial strategy seems faintly radical. In no other country – including the USA – has the anti-interventionist argument taken a firmer hold. Influenced by the notable disasters of the 1970s, it has long been received wisdom that government is better off standing aside at all times. Laissez-faire has ruled the ideological roost.

However, support for a new industrial policy now carries varying degrees of support from across the political spectrum. Ed Miliband has said that a rebalanced economy is an important part of the Labour Party's vision for a reformed, more responsible model of capitalism. Meanwhile Vince Cable has called for 'a more sophisticated alternative to the old industrial policy which recognises that governments play a role in the economy, which works with the grain of markets but is not passive'. Support is

1 Autumn Statement; H.M. Treasury, London; 2011.

similarly pervasive in the business community – both the British Chambers of Commerce and the Confederation of British Industry have teams dedicated to developing a rebalanced industrial strategy – and the Trades Union Congress has long campaigned for a more interventionist strategy and a strong manufacturing sector.

The UK is still an industrial powerhouse, the ninth largest manufacturing economy in the world. Manufacturing has been, and continues to be, an important part of the UK economy, with well-established strengths in sectors such as aerospace, pharmaceuticals and electronics. Manufacturing contributes £140 billion per annum to the economy. It accounts for 55 per cent of UK exports, over 2.5 million workforce jobs and 74 per cent of business R&D. Furthermore, the UK is the third largest destination for inward foreign direct investment in manufacturing in the OECD (behind the US and the Netherlands). Yet, despite these strengths, there is a growing concern that the UK economy's centre of gravity has shifted too far away from industry and we need to think seriously about what a twenty-first century industrial strategy will look like.

For there to be a genuine cross-party consensus, the underlying precept of any new approach to industrial policy must be that the government should first do no harm. The term 'industrial policy' acquired its bad reputation because of misguided and clumsy interventionism of the 1970s. No one wants to see a return to state subsidies; economic planning; and most notoriously of all, attempts to 'pick winners', a process which, as Lord Mandelson put it, all too often ended up with 'losers picking the government'. Few MPs now believe that governments can assess commercial potential more effectively than markets.

The second reason why policymakers must approach this gingerly is because Britain has traditionally been the greatest champion of the Single Market, of market opening and of a vigorous EU-wide competition policy. A strong British voice in support of the principles underpinning the Single Market is all the more important at a time when many EU countries, facing acute economic difficulties, are tempted to distort markets through state aid, government subsidies, concessional credit, privileged access to public tenders or trade protection targeted at particular firms or industries. Balancing the need for a more active industrial policy without encouraging a European descent into economic nationalism will be a key intellectual challenge of developing a new industrial policy.

The third reason why a twenty-first century industrial policy will have to be very different from any twentieth-century incarnation is because of the brute economic reality: there is very little money available for it. No one wants a proliferation of 'pea-shooter' initiatives that are sub-scale and underfinanced, schemes that don't amount to much and don't change much. Therefore interventions must be carefully considered and targeted.

Demystifying the term 'industrial policy', identifying the various obstacles facing the creation of a more stable and balanced British economy and, above all, exploring competing policy solutions to overcoming these challenges, are the tasks to which this book is dedicated.

No analysis of the British economy would be complete without an investigation into the role of financial services. Even the staunchest defender of the City of London would acknowledge that we were overly reliant on financial services during the boom. As the Independent Commission on Banking led by Sir John Vickers noted, the assets of UK banks were nearly five times the size of GDP in 2009. In Germany and France, the figure was around three times, whilst in the US it was one-to-one. And yet financial services remain an enormous source of strength for the UK, a sector in which Britain has a global comparative advantage. Part 1 is devoted to an explanation of what a balanced role for financial services might be and how to achieve it.

Tony Greenham focuses on improving the competitiveness of the domestic banking sector which, he argues, cannot be done in isolation from reforming investment banking. Meanwhile, David Green offers a range of financial reforms designed to improve business competitiveness. In his essay, Wolfgang Neumann draws upon his extensive experience at Deutscher Sparkassen und Girvoverband, the German Savings Bank Association, to provide an analysis of the much lauded German banking system. Finally, Chris Cummings argues that we must not weaken the strength of the financial services sector, articulating the central importance of 'Brand UK' to its international competitiveness, whilst Stuart Fraser defends the City and accuses regulators of deterring risk-taking and thus stymieing its wealth-creating potential.

In opposition, David Cameron said that one of his priorities was to re-imagine the role and size of the state with a view to creating a smaller state and a more civically engaged 'big society'. Public spending as a percentage of GDP remains at levels not seen since the early 1980s and the challenge of reducing the deficit is the defining goal of his government. And yet arguably, one of the stories of the financial crash was of a re-emergence of state power within the market, as global financial markets were saved by swift state action in the immediate aftermath. Part 2 asks whether there is a single 'right size' for the state in a developed economy, whether there is a growth-maximising level of public spending in the UK, and what a focus on the 'core' functions of the state might entail for public services.

Roger Bootle argues for an enhanced role for the state as catalyser of business investment, correcting existing flaws in the shareholder return model of capitalism. Karel Williams suggests that the state has had to fill in for a private sector unable to revitalise British manufacturing, before offering a strategy for encouraging its growth. Jonathan Portes offers some thoughts about the future shape of the state, concluding that the key factor is efficiency of spending rather than overall size. And Chris Giles calls for a state with a narrower focus on its core functions.

For its remarkable capacity to drive productivity growth through innovation; its ability to boost exports that reduce the trade deficit; and its ability to produce sustainable growth, it is increasingly accepted that a rebalanced economy means a greater role for Britain's manufacturing sector. Part 3 looks at how this might be achieved.

Peter Mandelson argues for a strategic role for government intervention in the economy, whilst Tristram Hunt grounds the importance of manufacturing in its ability to encourage innovation, based on the experience of the ceramics sector in Stoke-on-Trent. With disposable incomes having fallen between 2003 and 2008 in every region outside of London, Professor David Bailey explores the regional element to rebalancing. Terry Scuoler of the EEF provides a perspective from the manufacturing coal-face, calling for focus on export-led manufacturing in order to close the UK's trade deficit. Finally, Dr Elizabeth Garnsey provides a comprehensive analysis of one of Britain's regional manufacturing success stories, the Cambridge Hi-Tech cluster.

Part 4 deals with another vital component of the government's economic strategy: rebalancing the current account through export-led growth. If a large trade deficit is a symptom of a lack of industrial competitiveness, then the UK has serious problems – in only six years since 1900 has there been a surplus, with the most recent of those back in 1984, largely the result of North Sea oil revenues. The trade deficit widened in October 2012 from £2.5 billion to £3.6 billion; while over the three months to October, the goods deficit reached £28 billion, its highest level since records began.

Furthermore, as global economic power begins to shift away from the developed west, there is an urgent need to re-orientate export priorities towards the faster growing parts of the world. Only 6.5 per cent of UK exports went to the BRIC countries (Brazil, Russia, India and China) in 2010 and the recession-hit EU still accounts for 45 per cent of our trade. In his chapter, Jo Johnson provides an analysis of how to effect such a shift in priorities, with a detailed case study of trade with India. Sir Alan Rudge rejects the description of the UK as a post-industrial nation, before offering strategies for closing our trade gap. Meanwhile, Will Butler-Adams, CEO of Bromptons, and David Tinsley provide a businessman's and an economist's perspective on UK trade respectively.

Finally, Part 5 discusses an entirely different sort of rebalancing, that of the nation's boardrooms. Helena Morrissey shares her experience of campaigning for better representation for women in the boardroom with the 30% Club; Julia Hobsbawm suggests that we must not overly focus on the boardroom and must open up networking opportunities for women throughout the managerial structure; and Jan Hall explores the fairness of corporate remuneration.

As the government has rightly stated, we cannot rebalance overnight. To change the structure of a nation's economy is a task that requires sustained and concentrated action. Moreover, such is the long-term nature of this challenge that it will need to be addressed by successive governments and, possibly, by different political parties, with greater effort to establish a shared agenda. As Peter Mandelson notes in his essay, failure to do this has been a consistent weakness of the UK's political system over the years. I hope that this collection of essays can make a modest contribution to that challenge.

PART 1

A Balanced Role for Financial Services

1

Re-invigorating the Banking Industry

Tony Greenham

The UK has a very unusual economy in the sense of the overweening importance of financial services. The UK plays host to an international financial services sector which is disproportionately large to the size of the economy. This international sector, epitomised by the industry based in the City of London, is often lumped together with high street banking but in fact it is absolutely vital to distinguish the domestic financial services industry from the export-earning part and to analyse and deal with them completely separately.

The domestic arm of financial services in the UK cannot be described as world-beating. Domestic banking is dysfunctional, monopolistic and failing to support the real economy. In contrast, there are some world-class export-orientated financial services institutions in the City, as well as world-class legal, accounting and other business services firms. The UK is an essential centre for wholesale insurance, with Lloyd's of London, and a great deal of shipping and other international business is based here because of the stability and quality of the legal system and services on offer.

Considering first the domestic banking and financial services industry, there are several problems to address. The UK has a small number of large banks that dominate domestic banking. This enables them to gather monopoly power and to get away with poor customer service. This is something that should be addressed in the rebalancing equation.

Information asymmetries are the second problem. This means that somebody who sells financial services is always going to know more about what is going on than the customer, which enables them to knowingly or unknowingly exploit their informational advantage over the customer. When combined with badly designed sales incentives, this can be disastrous, as a string of misselling scandals has shown. This is a difficult problem to solve, but it can be addressed.

The third problem with banking in the UK is that it is essentially backed by the state because of deposit guarantees and the implicit state guarantee that too-big-to-fail banks will be bailed out. This means that there must be a different approach to banking, compared with making cars or any other industry. There needs to be a structural solution, not just a regulatory solution. It is necessary to have institutions whose purpose is to serve particular markets and to do particular things. Banking institutions must see their fortunes as tied to particular areas of the country and must define their mission in terms of the success of their local area and of their clients. It used to be thought that the profit motive in a free competitive market would be sufficient to deliver this – it quite clearly can't and it didn't. Structural and regulatory reforms need to be part of the solutions to ensuring a banking sector that truly serves the economy.

Turning to the export-orientated or international financial services sector, this has arguably become more of a problem than a solution to our search for economic prosperity. Many of the activities that investment banks carry out are essentially to do with tax avoidance and gaming regulations. Much of the innovation has gone many steps too far to have any underlying social use, and has instead multiplied systemic risk. The conflicts of interest inherent in investment banking are so deep and insurmountable that it is almost inevitable that those institutions will profit from the other institutions in the City. The costs of financial services for those seeking to raise capital is much higher than it needs to be in the UK and it is not serving the needs of the providers of capital or the users of capital if the charges are disproportionately high. It would undoubtedly be beneficial to develop access to capital markets, while appreciating that bank lending is likely to continue to be the main source of financing for most firms in the near future. The cost of credit remains high as banks seek to recapitalise themselves through the spread between their borrowing and lending rates.

There are five possible approaches to investigate when considering how to fix the domestic banking sector. One is to grow the community finance sector. Growing community banks and credit unions which are by their nature tied to particular markets is a good strategy. Second, state banks should be created, or at least banks that are governed under public law, which is how the Trustee Savings Banks were originally set up. Third, new entrants should be encouraged to provide new sources of funding for businesses. Fourth, create mutual credit networks among small businesses that allow cheaper access to working capital by pooling their working capital. This works in Switzerland, where there is a national version called the Swiss WIR, set up in the last Great Depression when small businesses had problems accessing working capital. The fifth solution that should be investigated is to take the bank that the UK owns, RBS, and split it into its constituent parts. Split the investment bank from the retail bank, and split the retail bank into a system of local and regional banks that might emulate the German Sparkassen model.

There are many policy options for re-invigorating the domestic banking sector to make sure it serves all sectors and all parts of the country. It is also vitally important that the different but equally serious problems in the investment banking market are addressed.

2

Three Solutions to the Funding Crisis in the UK

David G. Green

It has been a long-standing problem that small and medium-sized businesses find it difficult to raise funds to develop. Some say that this is a demand problem and the banks are not to blame. A recent survey carried out by the Office for National Statistics, however, suggests otherwise. The ONS surveyed a large number of SMEs and compared the results from 2007 with results from 2010. In 2007, loan applications to banks by SMEs were successful in around ninety per cent of cases. In 2010 only 65 per cent of loan applications were successful.

I will suggest three possible approaches. First, let people get rich. Cut personal taxes and let people become wealthy. The University of Warwick carries out a regular survey which looks at how business start-ups are financed. The most recent survey found that 88 per cent of business start-ups were funded by personal savings or loans from family and friends. To invest in a business, people have to be able to earn the money in the first place. Some will squander their earnings, but many will set up businesses. This is one reason why America is more dynamic as a nation than the UK.

Second, make it easier for SMEs to generate cash internally. Large companies don't rely as heavily on the banks; they generate profits and use the profits to reinvest. There is a different approach to this problem in America. Since 1958, American companies have been able to register either as a C corporation or an S corporation, the equivalent of large and small companies in the UK. S corporations don't pay corporation tax. All profits and losses are 'passed through' to the individual shareholders. Shareholders are limited to one hundred, in an effort to recreate genuine proprietorship and responsible private ownership. It has proved to be very effective. In 2007, there were 4.5 million S corporations, more than twice as many as the number of conventional C corporations. In the UK, large companies pay a higher rate of corporation tax than small companies. Copying the American model and not charging corporation tax to small companies would allow these companies to generate cash internally and become less dependent on the banks.

The third solution is to focus on local relationship banking. The German savings banks have about one-third of the country's banking assets, not including the co-ops. There are three characteristics that would be of interest to the UK if it chooses to follow this model. One is that German companies often have a dual board structure, with a supervisory board and an executive board. The German Sparkassen have a similar system: two-thirds of the members of the supervisory board are nominated by the local authority and one-third by the employees. This has the potential to allow councillors to give loans to friends and acquaintances on the understanding that the recipient will make a donation to one political party or the other. However, the second characteristic of the Sparkassen prevents this happening. The executive board is required by law to act on strictly commercial lines and so politicisation has been eliminated from the process; there is no question of the ruling party abusing its power. Third, loans can only be made within a local authority area. As a result, the banks are familiar with the local businesses. Business leaders will be known to bank staff as neighbours and can be judged by their reputation.

This is very different to what happens now in the UK. A parts supplier in the Midlands had been very successful in supplying Toyota's Derby factory. The Japanese owners of the factory asked the company to supply the same parts to their factories in Japan. The owner approached a bank to ask for working capital to develop the capacity to meet the new demand. The bank refused the loan, explaining that it was not presently lending to the automotive parts sector because it was not considered to be profitable. The owner asked the bank not to classify him as 'the automotive parts sector', but to take into account his record over the last twenty years and the order Toyota had asked him to fulfil. The bank turned him down.

The German Sparkassen function differently. The Sparkassen increased their lending by 17 per cent between 2006 and 2011. The German commercial banks, for example Commerzbank and Deutschebank, reduced lending by nearly 10 per cent over the same period. The Sparkassen also lent more in total than the commercial banks. In July 2008, just before Lehman Brothers collapsed, the Sparkassen lent €290 billion and the commercial banks nearly €200 billion. In 2011, the Sparkassen lent €320 billion and the commercial banks lent €180 billion. Sparkassen lending increased from €290 billion to €320 billion and commercial bank lending went down from €200 billion to €180 billion. This is not an example of local politicians picking winners, nor is it a slide towards collectivism. The Germans have accomplished the creation of local banking institutions with the power to react to changing events. Local banks have the power to help local firms. The local councils are the guardians of an infrastructure that puts financial power into the hands of free enterprise in each locality.

There is a structural problem with bank loans in the UK. Banks like collateral, which means that lending for domestic mortgages or commercial property is more attractive than lending to SMEs. In such cases there is a potential cash flow to pay the interest and to pay back the loan, and there is collateral if things go wrong. SMEs are at a disadvantage because often there is no asset to act as collateral. Sometimes the banks deal with that problem by requiring personal guarantees, including taking a charge on the domestic residence of the directors; sometimes the banks don't make the loan. Banks will make loans against cash flow to big companies but not to smaller companies.

The Germans, and the Americans through the Small Business Administration, have replaced collateral with a system of guarantees and geographical risk spreading. Local banks are part of a national and regional system, which means that they can spread the risks, nationally and regionally. In addition, Germany has a system of credit guarantee banks. These are non-profit associations of lenders that historically provided sureties of 80 per cent of any loan. This has risen to 90 per cent recently but is likely to go back to the traditional level of 80 per cent. That part of the loan is split between the guarantee bank, the regional bank or Landesbank, and the federal government. The borrower pays around one to one-and-a-half per cent of the loan up front, plus an annual commission of one to one-and-a-half per cent on the outstanding balance.

Not everybody who requests a loan is creditworthy, but there are many creditworthy organisations in the UK that are unable to access finance. In Germany, the collateral is replaced with their guarantee system to great effect. In the UK, the Enterprise Finance Guarantee scheme works along similar lines, but the total amount of money involved is small. Last year around £600 million was made available to 6,000 organisations. It is less generous than the German approach and it doesn't work as well. The UK should aim to build a local banking system based on the German model. A bank dedicated to the support of industry, a service similar to the one provided by the Industrial and Commercial Finance Corporation before its privatisation, would be welcome. This could either be in the form of a development bank to lend to businesses, along German lines, or a government agency to take the credit risk away from commercial banks, following the US model.

In conclusion, we should allow individuals to accumulate wealth by lowering taxes. We should stop requiring small businesses to pay corporation tax to allow them to grow their own working capital. And we should encourage local authorities to establish local banks to service local economies. The effects of these three measures could transform the wider economy.

3

The German Model – An Analysis

Wolfgang Neumann

The German savings bank sector has an aggregated balance sheet total of approximately €2,500 billion. Deposits in the savings banks alone run up to around €783 billion, loans to €677 billion, and loans to enterprises and the self-employed to €326 billion. Approximately 600 individual enterprises belong to the network, including over 400 individual savings banks which form the core of the organisation. There are 350,000 employees, almost all based in Germany. There are more than 15,000 branches and the Sparkassen have an overall banking market share of 40 per cent. When combined with the co-operative banks, around 70 per cent of German banking is locally-owned and locally-controlled. It is a highly decentralised group, with almost 430 local savings banks at its core, all independent in their decision-making. In addition, seven Landesbank groups and some specialised financial service providers, including building societies, regional insurance companies, leasing and factoring companies, belong to the network.

The German model is a bottom-up system, rather than a top-down system. The local savings banks partly own the Landesbanks, not the other way round. This decentralised system is backed-up by the 'regional principle'. By law, the individual Sparkasse has to focus its business on the geographic region of its municipality or district. Some important economic consequences stem from this principle: reinvestment in the local community and economy; provision of financial means for local development, local employment and education; taxes remain in the region; the existence of a profound knowledge of the local market and the creation of an identity of interests between the bank and the local community. The network system means that certain service functions are centralised on the regional or even national level, for example the IT system, product development proposals, strategic advice, training and education, the management of the brand and the joint institutional protection system. The network system allows the combination of the exploitation of economies of scale while at the same time keeping full decision-making power as close as possible to the local community.

The Sparkassen have a public mission. They are not state-owned institutions, but civil foundations chartered under public law. The concrete formulation of the public mission differs from Land to Land, but generally speaking include the following elements: to provide access to finance to all layers of the population; to finance the local real economy, especially SMEs; to foster social and economic development in their community and to keep up competition in financial services.

Sparkassen and regional co-operative banks cannot 'escape' from their region. That has an impact on how they conduct their business. Germany does not face significant problems with social redlining or financial exclusion: the local banks provide access to finance to all layers of the population. Eighty per cent of people who receive state income support have their account with the local Sparkasse. In Germany the Sparkassen have 50 million customers out of a population of 82 million. The savings banks' reputation is extremely high. The logo, a red S with a dot on it, is more widely recognised than the Mercedes Benz star. There is no geographic redlining: neither entire regions nor problematic parts of big cities are excluded from the supply of financial infrastructure. Sparkassen run more than 15,000 branches all over Germany. More important than a dense branch network, however, is the fact that top level decision-making power is kept in the regions. There is no redlining of economic sectors: companies of all sizes receive loans and other financial services from the Sparkassen. In times of crisis, in an economic downturn or a recession, centralised banks with distant headquarters start to cut credit lines. The local banks usually do not. They know their customers and due to their business model they tend to have liquidity-surplus of deposits over loans. This was an important factor during the recent financial crisis. Sparkassen and co-operative banks did not reduce their engagement in fresh loans to the real economy – on the contrary. There was no danger of a credit crunch and this played an important role in the quick recovery of the German economy.

Sparkassen and co-operative banks have a stabilising effect on the financial markets. They focus on intermediation business, taking in deposits and giving retail loans. This is bread-and-butter business, usually with low risk. It is not casino banking and it is based on long-term customer relationships. Sparkassen keep economic decision-making power in the regions when deciding on loans and they often take a leading role in improving the business environment in their region. Sparkassen may participate in regional development projects, working closely with the Chambers of Commerce and Industry, universities, the municipalities and other local partners. Community reinvestment is an extremely important aspect of Sparkassen. They take deposits from the local population and this money is reinvested to a large extent in local business. They pay taxes to the municipalities – in many cities and regions the local Sparkasse is the largest payer of trade tax. Profits, as far as they do not have to be used to build up the Sparkassen's own funds and reserves, are invested in corporate social responsibility activities. The Sparkassen sponsor a wide variety of community-based activities including charitable causes, cultural and sports activities, research and environmental development.

There is a further important function of the Sparkassen for the society and the economy which has become clear in the aftermath of the most recent financial crisis. This is its role in financing the real economy. A specific feature of the German economy is the extremely strong sector of small and medium-sized enterprises. More than three million family-run enterprises exist, many of them export-oriented and world leaders in specialised products, especially in engineering. This is no coincidence. There is a close link between the strength of the SME-sector and the matching decentralised structure of medium-sized local financial institutions. There exists a kind of symbiosis between the SMEs and the local banks. The local banks are strong because they have strong SME customers. The SMEs are strong because the Sparkassen and the co-operative banks are strong and reliable local financial partners.

It would be impossible to 'cut and paste' the German model and transpose it to the UK. A version of the German model – locally-oriented, mission-driven and with a degree of protection from acquisition – reflecting British culture and requirements, could contribute to the rebalancing of the UK economy.

4

Brand UK: The International Appeal

Chris Cummings

TheCityUK was set up in 2010 as the overarching body for financial and professional services. It has three objectives as an organisation. The first objective is to recapture the reputation of financial and professional services in the UK, to restore the public confidence in the industry. The second objective is to champion the competitiveness of the sector, to work with policy makers, to ensure a good taxation environment and to ensure the regulatory environment reassures the public that they can trust the sector again. The third objective is to support UK-based financial services to develop export-led growth, to play a part in the emerging economies around the world.

Three years after the financial crisis, the financial services industry plays a vital part in the UK economy. The financial services sector employs over two million people in financial and professional services, around seven per cent of the UK's workforce. There is a view that the financial services are a London-based sector, and certainly London, the global pre-eminent financial centre, is hugely important to the UK. In terms of employment, however, London is a terrific shop window, but two-thirds of financial services jobs are located outside of the capital. Twenty-five parliamentary constituencies have over a thousand people employed in financial services; seventeen of those are outside of London and the South East. There are over three thousand people working in the financial services sector in 23 per cent of all parliamentary constituencies.

The UK needs to focus on growth. The financial services sector has been a national champion for the last decade and now it must aim to help the development of other national champions. This should form a core part of the rebalancing strategy. The financial services sector must earn the right to be part of the rebalancing story, to prove that it is part of the answer and not a symptom of the problem.

The financial services sector needs to recognise that it was a major part of the financial crisis and needs to prove that it has learned lessons from the crisis. There is a great deal of media attention around bank lending. There were mistakes made in some bank models and the industry must prove that it has learned from those mistakes. The too-big-to-fail issue needs to be resolved and it must be made clear that taxpayers should never again have to bail out the banks, nor indeed any other industry. The financial services industry is now approaching conversations about regulatory reform with a sense of humility, aiming to work with the regulators to recapture its reputation. TheCityUK has run focus groups and research which show that the public is looking to regulators to be more intrusive and to reassure them that the financial services industry has learned its lessons. The sector needs to make it clear to policy makers, the media and its customers that it is competent and can be trusted.

The core role of financial services is to channel savers' and investors' money into businesses and then deploy those funds into the economy, creating jobs and driving economic growth. It is important that credit is available to viable businesses which want to borrow. It is also important to remember that not all businesses are viable and that not all businesses want to grow. Indeed, about half of the current SME market has no intention of growing; they are organisations that have reached a certain stage in their development which, whether because of the economic cycle or whether because of the scope of their ambition, simply do not wish to grow. There is a great deal to learn from the German example. The UK must try to create a medium-sized sector of which it can be proud.

Centralisation and regionalisation were measures taken within the banking industry for good business reasons in terms of credit quality, asset control and portfolio management. However, in the process, the banks lost some of their direct customer experience. They are trying to rediscover that and the £2.5 billion business growth fund that the banking community has recently established will go some way towards opening up new avenues to finance. There is more to do and the UK needs to pursue alternative sources of finance to develop a richer eco-system for business financing. A discussion about business finance in this country usually involves a conversation about bank lending. There are a whole variety of other sources of finance and capital available: everything from business angels to private equity to venture capital. These need to be explored more fully in future.

London continues to be the nation's shop window and attracts the best businesses in the world. However, the financial services story is about the whole of the UK. London is sometimes accused of being a centripetal force, drawing the best around the country into the centre. In fact, financial services show that London has a centrifugal influence, spreading jobs around the nation. Three examples: JP Morgan is the largest employer in Dorset; Citigroup is an anchor tenant in the Titanic Quarter in Belfast; and Deutschebank is a major employer in Birmingham. There are examples of organisations that arrive in London and grow out to the regions. There are also organisations which look through the shop window of London and decide that other parts of the UK provide them with the resources they need at a slightly cheaper rent. London is the top city in the UK in terms of creating jobs and growth in financial services, but there are others across the nation which deliberately attract new investment from around the world, including Edinburgh, Manchester, Birmingham, Leeds and Glasgow.

TheCityUK undertook a tax study in 2011 which looked at the contribution of financial services to the exchequer and found that £63 billion comes from the financial services sector. This figure was analysed by looking at three types of firms: one, traditional UK firms, for example Nationwide building society; two, UK firms which are based here, which have legacy and heritage in the UK but which could move elsewhere, for example HSBC or Standard Chartered; three, international organisations which choose to be based in the UK even though they have no heritage here, for example JP Morgan. Over £20 billion of the £63 billion tax take came from organisations that choose to be based in the UK. This is because the UK has been a very good business hotel and has provided access into the Eurozone.

Brand UK is incredibly powerful. The international appeal of the UK is at the heart of our future and an important factor in how we will continue to develop jobs and new growth.

5

Risk-taking for the Future

Stuart Fraser

The City is often seen as a homogenous entity, which it is not. It is both an industry in its own right – it earns £40 billion of surplus on its trade – and it employs many people who are not conducting business within the UK. Ninety per cent of the revenues of some of the foreign banks and other institutions in the City come from overseas; these organisations book their business in London and employ the expertise in London. The City's leadership must not be taken for granted. The City needs to continue to challenge itself if it hopes to stay at the top.

As the amount of money that travels around the globe grows, the risks grow and the consequences of mistakes multiply. The financial services industry needs to face these risks and learn how to manage them in the future. Technology will play a role in making finance safer, through better transparency and risk management. A great deal of energy is spent on removing the risk of human error from many areas of life through the use of technology, for example in rail and air travel. This trend will also apply in the finance industry.

Rebalancing the UK economy is not going to be achieved by shrinking the financial services industry. Instead, other parts of the economy need to be encouraged to do well. New and growing businesses require capital in many different forms and circumstances. The UK needs to create a multitude of financing avenues to substantially reduce the dependence on bank lending. There needs to be more focus on job creation. There are many unemployed in the UK, registered and hidden, yet talent is imported to create businesses and run businesses. The UK does very well in car manufacturing, but this is largely thanks to Japanese management. The UK must be open to the world and bring in the best people until such time as the domestic talent base has grown. This is the way the City operates – it brings in talent from around the world.

New company formation, particularly in areas such as technology and life sciences, does not necessarily create jobs. It does create wealth. Rebalancing and job creation must be considered in the round. There needs to be less focus on public-private and more on services and other activities. There needs to be more focus on how UK plc can earn enough money to pay for the services that the population will require in the future. The UK's ageing population will require more one-to-one management. More people are needed in education, with better provision for one-to-one tuition and smaller class sizes. However, these activities do not earn a surplus for the country and will have to be paid for from surpluses in other areas.

Wealth creation is at the heart of this debate, and the finance industry has an important role to play. It is discouraging to find that wealth is now a derided word in this country and attitudes towards this must be changed. In China, for example, people want to improve their lives and grow the economy. In the UK people appear to talk about how to divide the cake rather than how to bake a bigger one. The supply of capital is available. It is easy to make the mistake of thinking domestically when looking at capital supply, but this is an international market and there are vast pools of capital around the world looking to invest in something more exciting than a toll road. It is important to look beyond the banking sector for a greater range of channels for credit intermediation – the captial markets and in particular the equity markets could have a role to play here.

The UK must try to harness that capital and develop businesses with it before it goes elsewhere. Great businesses and inventions are often created by people who do not conform to a pattern – 'thinking out of the box' or 'pushing the envelope' are terms used to describe the concept of challenging the conventional. It is this kind of thinking which is required when looking at rebalancing the UK economy. This approach will undoubtedly be unpopular with those who like control. There is no magic bullet, no big lever to pull. There needs to be experimentation and alongside that comes the risk of failure.

Risk needs to be put back into the UK's economy. The regulators are destroying risk-taking. In a totally safe world there is no innovation and all the best people go where they can innovate.

This must be guarded against at all costs. It must be accepted that there will be accidents, that some people will lose money. The only duty is to ensure that money is lost by people who knew there was risk involved, rather than by the innocent.

PART 2

Rebalancing the Role of the State

6

An Enhanced State

Roger Bootle

Re-energising the British economy can't be envisioned without a clear and enhanced role for the state. It would be a mistake to imagine that an enhanced state correlates necessarily with a higher share or even the same share of government expenditure in GDP. The importance of the state to the economy and how effective the state is at righting some of the inefficiencies in the economy is not measured accurately by the proportion of GDP spent by the state. The modern, shareholder corporation is part of the problem with the British economy. It will not be possible to sort this problem out without substantial state intervention.

Classic models of capitalist systems feature entrepreneurs. Entrepreneurs are now overwhelmingly in the minority against massive corporations owned by institutional shareholders. That was not the case in the nineteenth century, the classic age of capitalism, when owner-managers dominated the economy. In the immediate period after the Second World War, after the dominance of the owner-managers, shares were still predominantly owned by individuals. In the decades following the war, the current situation evolved, and now investing institutions dominate the economy. These investing institutions are themselves often quoted companies subject to the same financial forces as so many of the companies that they own. This problem needs to be given more weight.

This aspect of the capitalist system does not work at all well. Attention needs to be paid to faults that have emerged in the banking system. The financial crisis was not simply to do with the role of banks; it revealed that this fundamental part of the capitalist system just does not work. On the whole, business leaders were not being restrained by the investing institutions. On the contrary, they were being encouraged by the investing institutions, where there was any reaction from the institutions at all. This position has been characterised by Lord Myners as a phenomenon of the ownerless corporation and it seems to be absolutely fundamental to the way the current system works. Executive pay is one aspect of this which receives a great deal of media attention and should not be underestimated as an important issue.

The more important issue is the level of investment in the UK – and in the United States – which is low relative to countries which do not operate the same economic model, and also low relative to the past. Why it is low is a complicated question to try to answer, but delve into the workings of large corporations and there are some disturbing answers as to how the process gets going. In theory, companies look at the cost of capital, and then decide on the basis of various internal measures whether they can generate a return to exceed the cost of capital. The role of the financial markets in facilitating investment is highly questionable because the markets are obsessed with short-term returns and the managers, not properly controlled by the owners, are very concerned about their own short-term financial interests. The result of all this is a weak level of investment, with bias in favour of short-term investment in services and against long-term investment in manufacturing.

This issue is a fundamental failure and active intervention by the state is required to re-model the workings of the shareholder corporation. There need to be changes to the law and in tax treatment. These changes would not require more state spending, but would require the state to be more ambitious and to acknowledge the limitations of 'the market'. The nature of the market and the pressures it imposes have emerged over time. They have not been planned. This is an area where the state needs to be significantly involved.

The state also has a role to play in terms of investing in people and skills for the future. It is unrealistic to expect a profit-making private corporation to take training and preservation of skills as main objectives, but the state can be expected to focus on funding for training and apprenticeships for the long-term success of the economy.

There is no conclusive evidence that a smaller share of government spending in GDP necessarily leads to a higher level of GDP or a higher rate of growth of GDP. There are interesting questions, however, about the efficiency of the state. It is possible to imagine a large state which manages its economy well, and a small state which manages its economy poorly. There are some paradoxes here. Why does the public sector in France appear better at running publicly owned enterprises than the public sector in the UK? The UK has not been very good at getting value for money from public expenditure and public involvement in business and the economy. A smaller state does not necessarily lead to greater efficiency.

But in the UK's case it probably would. Nevertheless, that still leaves plenty of room for the state to play an active role in economic life – not least by ensuring that markets behave the way they are supposed to.

7

Crowding Out or Filling In?

Karel Williams

The size of the state has been a quasi-academic issue in the UK since Bacon and Eltis published their book on crowding out in the 1970s. CRESC research, however, suggests that the historical trajectory has not been one of crowding out. The state has unarguably increased employment. Bacon and Eltis noted in their book that Oxford County Council employed more people than British Leyland in the 1970s. This is not crowding out, but the state filling in for a private sector that is chronically unable to create jobs.

The growth of employment in the UK is in health, education and welfare. Those are the sectors that are increasing employment. The expansion of health, education and welfare is tied up with public funding, the expansion of the state and the para-state. The para-state is publically funded private firms, for example G4S and local nursery schools, which currently employ one-third of the total number of direct state employees.

This is not a party political point – under both Thatcher and Blair more than half the increased jobs were state or para-state jobs. The problem is worst in regions including Wales, the West Midlands and the North East, where private sector employment has been static or declining. Without the multiplier effects of publicly funded jobs there would have been a sharp decline in private employment in those areas. The issue here is not to restrain the state, but to revitalise the private sector so that it can create the jobs in Wales, the West Midlands and the North East.

The task within manufacturing is one of rebuilding, not rebalancing. There is a fundamental problem of broken supply chains. A JCB digger is 36 per cent British by value; the rest is made of high-wage North European components. Bombardier imports its trains' bogies. Manufacturing inevitably involves importing semi-manufactures, but the Germans and the French do not import their bogies. There is a back story to this about shareholder value and inept privatisation, taking out lead firms such as GEC, ICI and Lucas, which could have sustained the supply chain. The back story is also about vicious downturns leaving capacity gaps.

The UK has been left with foreign firms with limited ambition and British firms with limited capability. A third of the UK's manufacturing employment is in foreign firms. Their role in the UK economy is broadly determined as part of a global division of labour – for example, BMW makes engines and assembles in the UK, but doesn't do any research and development here. British firms have become small-scale workshop fabricators. The average British-owned firm employs 14 workers; foreign-owned firms employ an average of 200 workers.

The policies so far proposed to revitalise the UK economy are inadequate. The rebalancing agenda has highlighted the fact that a new vision is needed, but the new vision largely consists of financial incentives. The Bamford Report, for example, proposes more investment incentives and export credits for exporters. The neo-Keynesian line suggests investment banks provide soft loans. In an economy where credit has been chronically oversupplied at low rates for the last 25 years, are more financial incentives the answer? In fact, the UK economy needs a much more fundamental change.

That change means coming to terms with the state of British manufacturing. Manufacturing output has been flat-lining in the UK since the 1970s, leading to the loss of large manufacturing firms and the consequent erosion of skills training. To engage in a fundamental exercise of rebuilding the state, rather than making minor adjustments, thought needs to be given to new policies.

Firstly, the policy objective should be import substitution not export success. Why is 80 per cent of Britain's bacon imported?

Secondly, the firms and sectors to be encouraged will often be in mundane activities. Food processing is one of the most important manufacturing sectors in the UK, both in terms of employment and as the largest consumer of machinery. Wind turbines and nanotechnology are sectors which will be dominated by better-resourced German and Japanese firms and should be left to them.

Thirdly, there needs to be more focus on chain linkages, rather than point success. Cheap loans are irrelevant. The key issue is that no company will install foundry or forging capacity unless they are assured of long-term base demand and price. The opportunist transactionalism which has been such a feature of the post-Thatcherite economy has to be questioned.

Finally, the importance of output needs to be recognised. Employment is tied in with output. There is a strong case for value added promotion in various tax forms. This all requires sectoral expertise in the civil service and a different mind-set from the political classes.

8

The Future of the State

Jonathan Portes

What is the optimal size for a state? There is no exact answer. There are successful economies which tax and spend heavily, for example Sweden, and there are successful economies which tax and spend lightly, for example Hong Kong. The composition and the efficiency on both the tax and the spending side determine whether the state contributes to a successful economic outcome. The structure of the UK's taxation and spending system needs to be considered, taking into account the historical, economic and political conditions. The UK's spending has increased considerably over recent decades. This is not about 'crowding out' or 'filling-in'. The fact is the UK would have spent more on health in recent years regardless of whether services were provided by the private sector, by the public, or a mixture of both. In the absence of a national health service the UK would be spending as much on health through the private sector.

The UK will be spending even more on health and education in twenty years' time. The question that will determine whether the UK is more efficient and more prosperous as a society is how well that money is spent. The last forty years have revealed that the British people, in contrast to those of some other electorates, want almost all of that money to be channelled through the public sector. This government and the previous Conservative government decided to accommodate that, rather than to try and change the public's mind. How does the government ensure that that spending is more efficient?

Economic research offers some answers. For example, poorly regulated private insurance markets, as seen in the US, can deliver terrible outcomes, whereas properly structured competition in the provision of health services, as seen in the UK, can improve outcomes. That points a way forward which both this government and previous governments have tried to take, with mixed success.

The public wants most of the money spent on health and education to go through the taxpayer and most of the services to be provided by public bodies or influenced by public regulation. However, competition will improve outcomes. Delivering all of this will be difficult because of the mechanisms of the public sector and civil service and the way they interact with the political system. If this is managed more efficiently, however, it could contribute to the economic success and prosperity of the UK.

The UK will have to continue to raise a lot of money through taxation. There is the inherent problem that the British people want to see high spending, but want to pay low taxes. This is a small open economy, where there is some degree of labour mobility, capital mobility, and some people are able to shift their income around. However, the UK must also deal with high land prices, a structural shortage of housing and is home to a number of extremely rich people. The UK should tax land and immovable wealth much more heavily. The aim should be to also tax consumption more heavily and to redistribute money through the income tax and welfare system. On balance, an income tax rate of fifty pence is probably too high and it would be sensible to reduce that alongside a shift towards higher taxes on land and wealth.

The UK should not be distracted by how other countries achieve success, and should focus on its strengths. There is a good regulatory and competition framework and improving on that would be a beneficial approach for the government to take. The UK now needs to move towards becoming a state focused on investment in infrastructure and education to ensure its future success.

9

The Core Functions of the State

Chris Giles

The state does three things. It consumes goods and services, some of which it buys, like roads, and some of which it makes, like health. It redistributes, from rich to poor and from young to old. It regulates, by passing laws. All of these three things are interconnected, so how much the state consumes is closely linked to what it redistributes.

The private sector could produce a health system or an education system, but in the UK these activities are largely provided by the state and are used as a form of redistribution. Poorer people would not be able to purchase as much health or education as they can when it is provided through the tax and spending system.

Spending as a share of GDP is unhelpful because it blends the state's three roles and reveals nothing specifically about regulation, which is the most important of the three. An example of where this figure is unhelpful is when it is claimed that the state has a bigger share of the economy in Northern Ireland and in the North East of England than it had in Eastern Germany before the Berlin Wall came down. This is an imprecise regional spending measure with the regional gross value added calculated on a completely different basis. There is confusion between the redistributive aspect of the state and its purchasing function. Giving pensions to old people which are then spent in Tesco – which most people would consider to be private sector activities – appears part of the state, akin to East German communism.

The importance of regulation versus spending measures is neatly illustrated by an example from Ofcom's work on public service broadcasting. Depending on your point of view, public service broadcasting is either good television, posh television or unprofitable television. It is quite straightforward for the BBC. Parliament decides how much money to give the BBC and leaves it up to them to decide what to produce. ITV, however, face an enormous number of rules and regulations because politicians across parties forced ITV to screen public service broadcasting in return for access to the analogue spectrum at a discount. As the analogue spectrum becomes worthless, the regulatory impact of the state will wither. Parliament, MPs and the public have not had any say in this. The regulatory power was hidden and not part of the tax and spending numbers, and therefore its loss has been a result of the value of the analogue spectrum falling. Society no longer has any leverage to hold ITV to account. On the regulatory side, most laws and regulations enable a market economy to function. It is important, however, not to over-regulate.

National accounts show that total spending within national income is around 46 per cent this financial year. Government consumption and government investment is around 25 per cent of national income. Predominantly, health, education and capital investment are making up a quarter of the economy. That figure has risen from 20 per cent in 2000. Most of this rise was planned by the last government. The figure went up to 23 per cent before the financial crisis; the last two per cent was unplanned and was because the financial crisis reduced the denominator, the size of GDP. The Office of Budget Responsibility's figures show that this 25 per cent figure is scheduled to fall to 19 per cent by the first quarter of 2017. This is because of the unprecedented cut in government consumption that society will make – huge cuts in the services that government buys. The redistributive element of the state's expenditure is currently about 21 per cent of GDP and is forecast to remain at 21 per cent. The government is cutting the services the state buys but not cutting the cash transfers. Is that the right solution?

The UK should aim for a state in which GDP is high and growing and generating good jobs, a state which welcomes and enables competition, which has a pattern of redistribution and values and a culture that the country can support. Crude tax and spending measures should not be measured as a share of GDP. Parliament must be allowed to focus on the state's core functions.

PART 3

Rebalancing Sectorally: Encouraging Competitiveness in Manufacturing

10

Rebalancing, Reshoring and Creating an Industrial Commons

Tristram Hunt MP

For the past four decades, the UK, along with the US and most of Western Europe has undergone what we might call the 'grand experiment' of post-industrialisation. In many ways the UK has led the way: in the late 1970s manufacturing accounted for almost 30 per cent of our output, employing 6.8 million people. We may still be the sixth largest manufacturing country in the world but those figures now stand at 12 per cent for output and around 2.5 million for employment. Since 1985 alone some 2.5 million manufacturing jobs have been lost. In regions like North Staffordshire, heavily reliant on the manufacturing sector to generate jobs, it has been a particularly painful experiment.

When President Obama can say that 'an economy that is built to last starts with manufacturing', it would appear that those days, mercifully, are over. Among the many myths about our political economy shattered by the collapse of Lehman Brothers in 2008 was the idea that manufacturing doesn't matter; that to have an industrial strategy was shorthand for propping up lame-ducks and swimming against an inevitable tide of decline. We should not underestimate how profound a shift it is for a government and a Conservative-led one at that, to feel comfortable stating its intention to have an industrial 'strategy', such is our 1970s hangover.

But this idea of inevitability has its own pre-history. Heavy industry did not leave our communities just because of government mistakes in policy and political economy. For the past thirty years, British firms have, naturally, sought to increase their efficiency through lowering their cost base. All too frequently this has meant off-shoring – outsourcing production East, to China, to Indonesia and to Eastern Europe. The impact on certain regions, in terms of jobs, growth and social dislocation, have been profound.

Stoke-on-Trent certainly knows all about the impact. The recent history of the ceramics sector is surely one of the paradigm stories of off-shoring and globalisation. Of course the story is a little more complex than that – from the sudden and significant costs imposed on the sector by the 1957 Clean Air Act to the high interest and exchange rates of the 1980s, government policy has regularly weakened the sector. Cultural changes in consumption patterns, in terms of in-house dining and take-away meals, undermined demand. And a wave of acquisitions and stock-market flotation weakened competition and encouraged the short-termism often associated with the worst excesses of the shareholder return model. Yet the impact of increased global competition and the lure of cheaper labour and energy costs abroad, was undoubtedly an enormous factor in the decisions taken by iconic brands such as Waterford Wedgwood Royal Doulton's (WWRD) to move offshore (in WWRD's case, to Indonesia).

Unfortunately, this decision did them little good. Mismanagement and the dilution of their quality, in production and branding, saw them go to the wall. As a recent and excellent Policy Studies paper points out 'premium priced table and giftware have long traded on the heritage of the highly crafted, hand-made and/or hand-decorated pieces. Moreover, the long-standing credibility of the 'made in Staffordshire' back-stamp is undermined if Staffordshire branded products are mass-produced in the Far East'.[1]

But now the off-shoring orthodoxy too may be shifting. In a recently published piece of research by General Electric, 27 per cent of UK manufacturing businesses said that the past year had seen increased purchases of domestically manufactured products. Only 13 per cent were buying less. The kilns, boosted by a string of events from the Queen's Diamond Jubilee and the Royal Wedding to the Olympics, are firing once more. High quality brands such as Aynsley and, most obviously, Emma Bridgewater have carved out their niches by playing on the heritage of the Potteries tradition. Portmerion, owner of the Spode and Royal Doulton brands, is currently posting record profits. And, perhaps as a lesson in the short-termism of off-shoring, the hotel and tableware firms that

1 Jose-Luis Hervas-Oliver, Ian Jackson & Philip R.Tomlinson (2011), 'May the Ovens Never Grow Cold. Policy Studies. 32:4 p383.

always maintained production in the area – Steelite, Dudson and Churchill – are booming. With Sterling's (relative) weakness and China beginning to be affected by rising labour, energy and transport costs, the emerging trend is one of companies looking to move production back to the UK; 'of re-shoring'. The question now is how, in the Potteries and elsewhere, we sustain this?

The first step is to guard against complacency. It is still far too early to trumpet encouraging developments as a fully-fledged manufacturing renaissance. Some commentators point out that depreciation by roughly 25 per cent in the value of Sterling between 2008 and 2010 should have generated far more export growth. Others suggest that the growth figures are misleading as they do not capture just how low our manufacturing base had sunk. And whilst we may no longer export more to Ireland than to the BRIC countries combined, we do still export more to Belgium and Luxembourg than China. That, in the context of possible European stagnation, is not a particularly encouraging statistic.

The second and undoubtedly the most important step, is to tackle our skills problem. Arguably, with youth unemployment at over 20 per cent and the risk of creating a 'lost generation' all too real, this is the biggest challenge we face as a nation and we should approach it with all the vigour of a national emergency. But we need to be absolutely honest about the scale of this challenge. There can be no return to the days when you left school with no qualifications on the Friday and went to work in a factory on a Monday. The days of manufacturing being able to provide a steady supply of low-skilled jobs are over – not just here but across the world as new technologies begin to move us away from the 'River Rogue' model of mass production. The future of manufacturing is emphatically high skill. However, I do still believe that if we get our policy right on skills, apprenticeships and 'on the job' vocational training, manufacturing offers far more scope for post-education social mobility than the service sector.

But the skills challenge is even more important for a reason that perfectly captures the importance of re-shoring. As advocates, we must make our case for manufacturing on solid grounds. We must not fetishise our re-industrialisation in the same way that some ideologues did deindustrialisation. And in my opinion, the strongest argument for boosting manufacturing is its remarkable capacity to drive productivity growth through innovation.

Again this requires a certain honesty about jobs. Technological innovation has at times been bad news for the overall size of the productive labour force. More for less has sometimes meant fewer jobs. Nevertheless, it is our capacity to produce innovation that can give us the competitive edge and encourage companies to re-shore, particularly in sectors where the source of innovation is embedded within the manufacturing process. This is because when the innovation stems from the process itself it becomes harder to separate manufacturing from the R&D. A competitive edge in process-led manufacturing R&D helps to build resilience to off-shoring and encourage re-shoring. This is heartening: in many key UK sectors, in automotives, ceramics, energy, textiles, chemicals and metals, it is precisely this kind of process innovation that is stepping up. Maintaining this strength will be absolutely fundamental to growing our competitiveness.

However, it only reinforces the centrality of skills. Ultimately innovation, new ideas, products and opportunities, come from people. To encourage firms to re-shore our labour force must become our biggest asset. We must think hard about how to create profitable link-ups between manufacturers, businesses and our world-class higher education sector. Continued pressure upon larger manufacturers to see sustaining the skills supply chain as a social responsibility as well as an operational necessity would also help.

But we should also look further afield to understand how to unlock the benefits of horizontal collaboration. For example, in our ceramics sector, Staffordshire University is very strong in art and design and we have a world-class research institute at CERAM. However, when compared with some of our competitors, in Bologna Italy and Castellon Spain, the effectiveness of our link-ups on the technological and engineering side of things could be improved. Growing specialised clusters of success, such as the Cambridge Hi-tech cluster, where supply chains, human resources and institutions work together as an 'industrial commons', creating and reinforcing innovative capabilities, is the surest way to attract companies back to the UK.

But all this requires investment in infrastructure, R&D and new technologies. The government could do a lot more with capital allowances to encourage firms to invest in new technology or plant improvements that could dramatically improve their competitiveness and capacity for growth. And specifically on infrastructure we need more attempts to rebalance the significant regional disparities in investment. For decades Whitehall has pursued a strategy that has actively favoured London and the South East. We are used to hearing how former manufacturing heartlands in the North and Midlands have become over-reliant on the public sector for economic growth. But what is all too frequently forgotten is just how much London and the South East are locked into a dependency on state infrastructure spending, masking the true cost of doing business in the capital. Latest figures show that the South East region absorbs over 87 per cent of capital spending on transport with £27.3 billion committed to London alone. This comes at the cost of other parts of the UK. A more sustainable manufacturing economy requires this imbalance to be addressed.

Finally, we must return to costs. Companies must be able to see a degree of certainty and constituency in the projected cost of doing business in the UK. In many respects this is less about the sum total and more about the knowledge that costs will stay roughly the same in the long-term, enabling companies to plan five, ten or fifteen years into the future. Therefore a strategic direction, an explicit, joined-up UK industrial strategy becomes even more important and lends current government discussions about energy security even more urgency.

The immediate benefits of bringing production home are self-evident. More manufacturing activity means an increase in local employment and a greater diversity of local economic activity. This in turn leads to more resilient communities. And there is almost a snowball effect to re-industrialisation, a 'virtuous circle' that can transform the local skills environment, attracts higher skilled young employment to the area which then becomes a reason for future investment in itself.

If we can continue to attract companies to re-shore then we can radically transform our communities, laying down the foundation for future resilience and long-term prosperity. It will be the job of this cross-party group to push for that commitment and hold successive governments to account for it.

11

A Strategic Role for Government

Lord Mandelson

Government cannot do everything. This may seem an unusual place from which to start a discussion about how government can rebalance the economy, but when considering industrial policy it is important, always, to stress that there are a number of things that governments do not do very well. One such thing is long-term strategic thinking, which is precisely what is required by such a sustained project as rebalancing the entire structure of a nation's economy. We cannot rebalance overnight – that much is obvious. And yet, it is also clear that the level of consistency, stability and predictability in policy needed to underpin a strategic change in direction will have to span periods of time when different parties are in government. Continuity between government policy and strategy is vitally important and it is not something this country has traditionally excelled at. We have in government, as is increasingly the case in business, a mentality that is obsessed with the short-term, fixated by tactics over strategy and immediate gain over long-term value. Therefore, it is important to note the fundamental importance of cross-party collaboration on such projects.

A historical view

Taking a historical perspective, it is obviously not the case that this country has never had a dedicated government policy focusing on manufacturing and industry. Yet despite worthy, intelligent attempts by the governments in the 1970s to 'pick winners', the all too often result was that the losers ended up picking the government. That view is well established.

It is less fashionable to say anything about positive industrial intervention in the 1980s. And yet the seeds of many of the current success stories in British manufacturing – aerospace, biotech, pharmaceuticals, Japanese inward investment in the car industry (started in the late 1970s but ramped up in the 80s) were sown in this decade. Frequently, these successes are downplayed, portrayed as a grudging exception against the government of the time's overall approach to the economy. Nevertheless, despite all the unnecessary and extremely damaging anti-manufacturing rhetoric of the 1980s, they happened.

In the latter half of the 1980s we had the Big Bang reforms and the embrace of financial services, itself an industrial policy of sorts. There was absolutely nothing wrong with the close relationship between government and financial services – it has generated considerable wealth and employment in our country. The problem came when the relationship turned into a mindless infatuation. That is when the well documented mistakes began to be made.

But the truth is alongside all this we have had, under successive governments, a drip-drip of numerous 'pea-shooter' initiatives, haphazardly scattered across different sectors, and with little strategic direction. This has been the real colour of government action in relation to manufacturing and industry in the last twenty years. Generally speaking, these 'pea-shooter' initiatives all share certain characteristics: they are sub-scaled, under-financed, unambitious announcements that do not even intend to change a great deal and, in practice, often end up changing even less. Not only are such actions utterly pointless; they discredit intervention itself, limiting a government's strategic arsenal. Resisting the temptation to partake in these kinds of initiatives should be the starting point of a modern, twenty-first century industrial policy.

Strengthening Competitiveness

To strengthen the competitiveness of British manufacturing, we need to focus public-private efforts on four important points.

First, we have to recognise that knowledge should become the be-all and end-all of our manufacturing strategy. Knowledge, and the innovation and specialisation that it drives, provides us with our competitive 'USP', giving us the ability to enter global production networks and supply chains. Along with skills, it is what gives us our comparative advantage. This commitment to knowledge, and its application throughout the economy, should be reflected in everything that the government does. Whether it be the Hauser Technology Transfer Institutes, the Queen Elizabeth

Engineering Prize, the Technology Strategy Board, or investment in the science budget, we must be rigorous in backing and investing in knowledge.

On skills, our approach has been inconsistent. We have begun to make an important effort to recognise and support the development of skills. But we need to do much more to support the development of advanced, modernised apprenticeships – a project that the last government began and the coalition is continuing. A modern, transferable and internationally competitive skills base requires the status of the apprenticeship system to be raised, standing alongside our already globally competitive university system. In order to achieve this, it will need to be far better rooted in the schools system than it currently is.

Second, we have to recalibrate the dominant financial model in this country so that it supports capital raising and investment in the real economy, especially in the SME range of businesses. This is not simple. There is wide recognition of the problems of delivering start-up and growth capital for small and medium business: the business community knows it, the government knows it and the banks also know it. But as others have noted, it is difficult for banks to provide this whilst at the same time complying with new capital threshold rules and deleveraging from the hangover of the 2008 crash. The government should look into using the extraordinarily low borrowing cost available at the moment to help provide a flow of professionally managed, underlined, seed investment to businesses that need longer investment time frames than a purely profit-maximising commercial bank can provide. For example, I find the concept of the Green Investment Bank attractive, although there are a variety of other models that could also be followed.

More too can be done to increase general capital intensity. There has been much discussion about the respective merits of capital allowances against a general reduction in corporation tax. I do not believe that we should allow our corporation tax levels to become uncompetitive, but that is hardly the case currently. Therefore, I am in favour of increased capital allowances as a way of encouraging capital intensity. This, along with providing a vehicle that provides patient long-term finance to SME businesses, are the priorities for recalibrating our finance sector.

Third, we need to continue to encourage and enhance the case for targeted government lending that supports, whether in relation to specific technologies or sectors, ‘game-changing investments’ which can radically improve our future competitiveness. The market is smart when it comes to the aggregation of our economy. But it can be exceedingly stupid in isolated cases, such as, for example, the case of Sheffield Forgemasters. That case involved serious investment in a technology that would have provided us with capacity in a crucial part of the supply chain, giving us a new capability in large-scale civil and nuclear construction. There was probably only one other forge with a press of that size in Europe, so there would have been immediate competitiveness benefits. The commercial banks would not provide a loan because the loan in question was actually bigger than the company’s entire balance sheet. It fell foul of every single tick box in the system of risk assessment that banks undertake. Intervening was not a case of government blithely signing the cheques; such was the caution that my department actually took six months to decide to press ahead with the loan. And £80 million, in the grand scheme of government business, is a small price to pay for the competitive benefits it would have generated. Moreover, it was a loan that we would certainly have recovered. In isolated cases such as this, the market is unable or unwilling to find the solution. But government can take a wider, more long-term view than commercial institutions, particularly in the post-crash economic condition.

The fourth point concerns the proper role of government in the economy, and its ability to take strategic decisions that connect to the bigger picture. Germany, the Netherlands, and on a good day France, all have government cultures that look across a range of sectors and technologies, with the ability to place their weight behind important potential developments. They take a bigger view than we are in the habit of doing in the UK. Partly this is because taking the bigger view requires individual departments of government to co-ordinate, to take decisions in unison. To say the least, this is one of our perennial weaknesses. The case for the Department of Business, Innovation and Skills as a dedicated department for the micro-economy has proven itself, but we need to inculcate and train a body of civil servants with the skills and political backing to advise government on how to calculate risks. Civil servants, in the main, are not encouraged or trained to assess commercial risk or to contribute to quite major financial decisions. We need to get a cadre of such people deployed in Whitehall who can fill this administrative gap in the government machinery.

However, it is people, and Ministers too, who must have the ability and the political courage to say no as well as yes. Ministers come under huge pressure from backbenchers and constituency members who have their own pet projects, spun in the language of being vital for the strategic national economic interest. But it is absolutely vital, if governments are going to play a more active role in industrial policy, that Ministers have the courage to say no. There should also be a comprehensive system of checks and balances, experts standing outside of government who monitor and verify that intervention is sensible. The job of government, in other words, is not to replace the private sector, but sometimes to take the point of view that the private sector, banks and financial markets, for whatever reason 'can't or won't'. When this inability damages the national economic interest, government should look to intervene.

Bolstering British

A few more minor points. First, we must be careful how we define manufacturing. Our industrial policy and our definition of manufacturing should not be steeped in nostalgia. Manu-services and the creative light industries are equally important and should certainly form part of our exports agenda. It is about Adele as well as Airbus, as it were.[1]

Second, we simply have to learn more from our competitors overseas, particularly from countries such as Singapore, South Korea, even China, where a more intelligent mix of public and private sector enterprise gives such countries a huge competitive advantage.

Finally, supply chains. One of the main focuses of our industrial policy, even a measurement of its success, is bringing home supply chain work to this country. This, obviously, does not mean

1 See Pat McFadden, *Making Things*, Policy Network, London, May 2012, pp.12-13.

shutting our borders to trade or taking protectionist measures to enforce production at home rather than overseas. We need, not so much to 'buy British' but to 'bolster British'. This should become a keynote for the government's overall approach.

Perhaps it is important to add, in the current climate, that this is not about retreating from Europe, where our best markets, our biggest sources of investment and some of our most important strategic alliances remain. It is about taking a fresh view, a more creative, balanced and specialist view of how we are going to pay our way in the world in the twenty-first century global economy. Markets will suggest where this is going to be far better than governments. But that does not mean that governments should simply stand back and abstain, or stop thinking and reacting intelligently to what markets tell them. Sometimes this may involve doing a lot less of what governments have done, historically or otherwise. But at other times it will involve making smart strategic interventions into the economy. Particularly when the task we face, rebalancing the economy, requires such sustained, long-term strategic action.

12

Strategies for Rebalancing

David Bailey

The US leads the way

Reading recent copies of the Financial Times, or listening to the arguments of certain economists, gives the increasing impression that industrial policy is back on the policy agenda in the United States. And, of late, the National Economic Council has been talking the language of industrial policy activism. Yet the truth is, unlike here, industrial policy was never off the agenda in the US. It is fair to say that both the UK and the US are generally perceived as pursuing similar liberal economic models, but when you compare the tools that (industrial) policy makers on either side have in their respective arsenals, the difference is marked.

Whether it be the Pentagon's procurement policy (in particular through the Defence Procurement Acquisition Program), the Department of Census, or other parts of the federal government, the US's industrial policy has been crucial in developing many new technologies that we now take for granted.

Furthermore, within the US, there is a culture that allows companies to experiment at government expense whilst they go through the process of reducing costs and developing a commercial market. When they are ready to go to market, the government stands aside.

There is also the Small Business Administration, a state-run bank that supports small companies unable to get support from the banking system or access other more traditional methods of finance (the supply of which is already far more diversified than in the UK). Indeed, much of the venture capital industry that has proven so beneficial to innovative US start-ups was in fact stimulated by sustained federal government activity between the 1950s and 1970s. Tax credits for research and development (R&D) are more generous and there is a far more generous system of capital allowances than here in the UK.

Finally, there is also the Committee on Foreign Investment in the US (CFIUS), which scrutinises high-tech foreign takeovers in order to ensure that they will not have a detrimental impact on the R&D base in America.

Moreover, these interventionist economic tools are all seen as normal in America. In contrast, one suspects that were similar tools introduced in the UK, they would be seen as extraordinary or drastic. So perhaps we should be thankful that we are even beginning this conversation. Yet, if the US is the model to emulate, then we have a lot of catching up to do – in the last recession, or the earlier part of this recession if you prefer, 15 per cent of our manufacturing output was lost. To recover that ground, we need urgent action now.

The challenges faced: exports, finance and skills

The rebalancing theme has been discussed for some time now. In 2010 I conducted a survey alongside Deloitte, which asked manufacturers what support they would need to rebuild and contribute to a rebalanced economy. Three key needs were identified: support to develop the capability to grow exports; access to finance; and access to skilled labour. These three areas remain the biggest challenges today.

The 2007 crash wiped off 7.4 per cent of our total economic output. And yet unemployment has not risen anywhere near as much as one would expect, given that loss of output. During the crash companies, particularly in manufacturing, made an almost universal collective decision that holding onto their skilled workers was the right thing to do. Different shift patterns, reduced hours, and more flexible arrangements were all preferred to outright redundancies. This is important when we consider manufacturing's ability to help drive job creation. Because if companies hoarded staff to preserve capacity during the recession, then by the same token they cannot create huge numbers of jobs as we recover. Hence there is a strong case that due to this latent underemployment, the private sector's ability to create new jobs has been grossly overestimated, particularly in manufacturing.

During 2010-2011 manufacturing delivered some impressive figures. It started exporting, it started to take on new workers and growth in 2010 was twice the growth in the broader economy.

But these headline figures were deceptive.

First, it started from such a low base that the percentage growth figures exaggerated the overall strength of the sector.

Second, there was a restocking boost: manufacturers ran down their stocks during the recession then began to restock from 2010 onwards. This was a temporary phenomenon.

Third, manufacturing was boosted, in this period, by the depreciation of Sterling. Between 2008 and 2010 Sterling depreciated by about 25 per cent. This is now being unwound, slightly, but that depreciation certainly helped manufacturing's competitiveness. And yet despite this period of depreciation, exports did not grow as much as anticipated. Partly this was because there is a natural lag as the new conditions 'worked through' the system. And partly it was because our manufacturers were exporting to the 'wrong' places. We may have got rid of that millstone statistic, the comparison between exports to Ireland and the BRIC countries, but we do still export more to Belgium and Luxembourg than we do to China – a pretty telling statistic. To grow the sector, it is imperative that we look to export to different markets, not just the BRICs, but to other expanding economies, such as Indonesia and Turkey. Some companies such as Jaguar Land Rover and JCB are leading the way with this; however we need to do more to support them. Part of the problem overlaps with the wider problem of access to finance, with companies often having the capability to win export orders, yet unable to access the necessary short-term finance to deliver on them.

Finally, on depreciation, it is important to note that we are only just emerging from a sustained period of exchange rate overvaluation, which had priced us out of certain export markets. The depreciation only really brought us back down to a 'decent' equilibrium level. This is not enough. You probably need a significant period of undervaluation to allow companies the time and help to get back into lost export markets – not that we should undervalue our exchange rate. But we must at least acknowledge that there is a significant hidden cost of getting back into export markets that have been lost and that firms therefore need help.

The need for targeted government intervention

Beyond 2011, we saw the bounce-back of manufacturing slow.

PMI figures were in decline, dropping to less than 50 per cent, until eventually the sector began to act as a drag on growth, actually contracting. Currently, export orders are dropping at their fastest rate for three years. Of course the sector-by-sector picture is more complex. Some sectors, notably automotive, are growing strongly, whilst others are going into reverse. Generally, there are three main reasons why this is happening. The first two are tied to the wider macroeconomic picture: a stagnant domestic economy and Eurozone uncertainty. These conditions are deeply troubling because if we do, for whatever reason, enter a sustained period of depressed demand in the economy, then there is a very real danger that we could lose growth capacity permanently. This is why generating growth and investment now is so important, and why we now require an aggressively active industrial policy. Indeed, even the third problem, the financial situation, in terms of businesses being able to access finance, can also be improved with the right sort of intervention.

Again a comparison with the US and the activity of the Obama administration is helpful. Obama improved capital allowances for companies to invest in plants and equipment. Apart from in specific Enterprise Zones, the government here has actually reduced capital allowances in order to fund a general reduction in corporation tax. Whilst tax reductions are always welcome for businesses, this was perhaps the wrong choice for the economy overall. The government should follow the US example and create enhanced capital allowances to incentivise investment.

However, even with corporation tax the government could perhaps improve its focus. For example, it could introduce further reductions for manufacturers who increase output above a trend rate of growth, or which increase value added. The point being that if the government do decide, eventually, to go for a 'Plan B', with increased supply-side measures and tax cuts, then they should be targeted on sectors and companies that have the ability to increase output and contribute to rebalancing the economy. Another such measure that should certainly be considered is a National Insurance holiday, which could be targeted at companies in manufacturing and business services that export, take on workers – especially young workers – or who create high quality, long-term apprenticeships. Furthermore, targeting such intervention on the areas that require improvement will also provide businesses with a clear indication of the government's vision for a rebalanced economy.

On R&D, the above the line tax credit for large firms, announced in the Autumn Statement in 2011, is certainly welcome. But there is a long way to go if we are to incentivise R&D, particularly in high-tech sectors, as successfully as they do in the US. And we should look at ways in which we can further exploit the European Commission's relaxation of the rules on export credit guarantees in 2008, a move which enables government to periodically intervene in order to provide short-term finance for exporters when the market will not supply it. This could at least resolve one of the many problems surrounding the issue of finance.

It is impossible to underestimate how critical the issue of finance is. Everyone is aware of the problems small businesses face in trying to gain access to capital. In fairness to the banks, they are under an immense amount of pressure to rebuild their capital base in the wake of the 2008 crash and making micro-loans to small companies, particularly in manufacturing, has never been a particularly profitable revenue stream anyway. This is damaging because firms are capable of winning orders, but are incapable of delivering on them because their financial needs make them ineligible for support from the banks. For example, they might be operating in a sector that banks deems too risky or are unprepared to invest in, or they might need a tailored repayment structure over a longer period of time that the bank is unable to provide. Financing tooling in manufacturing – especially the auto industry – is a particular problem area. With the market unable to provide the right solutions, it is clear that we need something else. Credit-easing is a start, but my preference is for a small business investment bank or a vehicle that can provide direct assistance to small companies.

Building effective supply chains

Such a financial vehicle would be particularly important in the context of building up our supply chains. For example, the government's intervention to support the Vauxhall Plant at Ellesmere Port was a strong example of government action, backed by workers and unions, doing everything possible to present an attractive offer to General Motors. Yet when you look at the supply chain surrounding the manufacturing operation at Ellesmere Port, only 25 per cent of the components are sourced from UK firms. JCB provide another example: 96 per cent of parts in JCB's diggers were manufactured in the UK in the late 1970s. Today the figure is under 40 per cent. It is not enough to simply support the growth of manufacturing; we also need to think about rebuilding the capacity of our fractured supply chains. Part of this is about ensuring that smaller companies can actually compete with the bigger players to win orders. In this respect, there is enhanced scope for the Manufacturing Advisory Service to play a role delivering that competitiveness for smaller firms.

Finally, the last challenge of the three identified is how to help firms access skilled workers. Jaguar Land Rover are building a new engine plant in the West Midlands, which is obviously great news. They offer excellent wages, flexible terms and conditions and plan to recruit thousands of workers. Inevitably those workers are going to be sourced from the existing supply chain within the local manufacturing economy – that is where the skills lie. But this presents a challenge: how do we backfill? How do we make sure that exciting new investments such as this do not actually hollow out the local supply chain and that there are enough skilled people to replenish the extra capacity? Our overall industrial strategy must not just be about getting new engine plants; it must also investigate how to maximise the spill-over for local economies, minimising the amount of components and workers that need to be sourced from abroad. The starting point must surely be an intelligent and dedicated supply chain policy. The Advanced Manufacturing Supply Chain Initiative is a start, but £125 million is nowhere near enough: multiply that figure by ten and we could start to take on the serious work needed to restore our fractured supply chains.

We can also learn valuable lessons from our competitors. Germany, with its KfW investment bank and its healthy industrial economy, is the obvious example. But I also think that we need to re-examine hostile takeover legislation. The paradigm example is Kraft's takeover of Cadbury in 2009. Not only did the UK lose ownership of an iconic brand but, on balance, the impact on the UK's economy was negative. After all, Cadbury was an incredibly well-run company that, at the time, was outperforming Kraft. Of course you don't want to go too far and introduce regulation that would scare off inward investment. But a strengthening of existing legislation is certainly needed. For example, reforms such as raising the bar from 50 per cent to 60 per cent of shares required to trigger a takeover, or placing a minimum criterion of 12 months of ownership for shareholders to vote in takeover situations; would be welcome reforms. Taken together they would have probably saved Cadbury, a company which would then have been able to continue with its long-term investment. The point being that very often, such takeovers do not have the best long-term interests of the business at heart.

The regional dimension

Finally it is important to acknowledge that the rebalancing agenda should also have a regional aspect. Our economy is heavily balanced towards certain regions, namely the South East. Boosting manufacturing should help to rebalance this as often it is less prosperous regions, in particular the North and Midlands, which, being more reliant on manufacturing in the past, have the most to offer in terms of existing supply chains and skills. In this context the decision to shut the Regional Development Agencies (RDAs) was surely rushed. Some of their former activity has, rightly, been displaced to the local level with the LEPs, although there are certainly some major issues concerning their capacity. Other elements of their activity, however, have been moved up a level to Whitehall and central government. This move towards a top-down industrial policy is regrettable as ultimately the RDAs were better placed to make the right judgement calls on local investment.

However, even worse, some of the RDAs' activity has disappeared altogether, such as elements of cluster policy, for example. In the West Midlands, the RDA played a pivotal role in preparing the local supply chain for the collapse of MG Rover, helping suppliers to serve other companies and diversify into other markets. The automotive sector in the region is harvesting the fruits of this important work now.

And this also ties in with the broader debate about industrial policy. As Dani Rodrik, the Professor of Political Economy at the

Harvard Kennedy School, might put it there is always a role for industrial policy where there are 'information deficiencies' in the economy. What this means is that those suppliers supplying components for MG Rover were simply working so hard on fulfilling their orders that they did not have the capacity to see where else they could operate. It took the RDA to come knocking on the door and say, 'Look, this company is not going to go bust tomorrow, but you need to think about other markets and different industries. Here are a few. Some of those companies even diversified out of the automotive sector altogether, serving medical technology companies or aerospace.

Therefore when thinking about rebalancing the economy and upgrading our supply chain, we must not forget the importance of the regional dimension or underestimate the capacity of regional institutions to deliver transformation in the wider economy.

13

Rebalancing Through Export-led Manufacturing

Terry Scuoler

For some time now politicians and economists of all stripes have daubed themselves in the rhetoric of 'rebalancing our economy'. However, before answering the question 'why rebalance?' it is helpful to briefly state what exactly it is we mean. EEF would define it as a return to broader-based sustainable growth, with business investment and trade making a larger on-going positive contribution to growth in manufacturing innovation, and accompanied by a reversal of the UK's net trade balance. Clearly, this requires a move away from the previous growth model underpinned by debt-fuelled consumer spending, the inflation of the housing market and rapid increases in government spending. A more sustainable economy would have two features that this current balance lacks.

Firstly, an answer to the crucial question of how the UK pays its way in the world, a question which ultimately relates back to the current account trade deficit. Secondly, and perhaps even more importantly, it would have far more resilience to the economic shocks – inflation spikes, commodity price volatility and financial mini-crises that can threaten future growth.

One thing, however, needs to be made absolutely clear: despite all the hackneyed and contentious appeals to 'go for growth', the challenge we currently face is not just about growth, or at least not when by 'growth' we mean the crude measurement of aggregate GDP. A sustainable economy needs sustainable growth; growth that generates wealth in a way that aligns to how we want to develop as a nation. It should be export-led and well-balanced in terms of where the wealth is created. This means we must be far more discriminating about the type of growth we seek to generate – overly-relying on financial services again will not help to build the economic resilience we need, nor will it reduce the trade deficit.

It is my strong belief that manufacturing generates the sort of growth we need. The case for manufacturing has previously been well made but it is worth re-iterating. In 2010 the sector contributed £205 billion of exports – around 55 per cent of the UK total. There is also manufacturing's remarkable capacity to generate productivity growth through innovation, a feature which sets it apart from other sectors. If we therefore accept the principle that our recovery should be export-led, it would seem obvious that manufacturing must play a significant role.

Manufacturing: our strengths

The obvious starting point for determining how we might bring about a manufacturing renaissance is a realistic appraisal of our current strengths and weaknesses as a manufacturing nation. It is clear that there are already a number of export-intensive sectors in which the UK is already very strong, such as aerospace, automotive and pharmaceuticals. These sectors were underpinning a steady revival in our manufacturing economy throughout 2011 before the uncertainty surrounding the Eurozone began to affect global confidence. Aside from the obvious success stories, such as Jaguar Land Rover and Rolls Royce, we also have a raft of innovative niche companies which provide a range of smaller-scale bespoke solutions. Manufacturers such as Buhler Sortex and Chas A Blatchford and Sons and many more are focusing on a range of innovations to improve competitiveness and extend their process ownership and control. Clearly there is no off-the-peg model for all businesses, but certainly this innovation-led approach to improving competitiveness has proven to be a fruitful path to growth. Quality and innovation are areas in which we can and should be confident of competing against the rest of the world.

Absolutely vital to this success, however, is the ability to penetrate new markets beyond the EU. This goes far beyond the current Eurozone woes. Without diversifying to take advantage of expanding developing markets, we will not be able to rebalance the economy sufficiently. Trade with other EU countries still accounts for roughly 50 per cent of total exports, but that means that 50 per cent of our exports now go beyond the EU – a figure which would have been unthinkable even a few years ago. In 2011, for example, exports to Russia, India and China last year were up 43.1 per cent, 44.9 per cent and 43.1 per cent respectively.

Of course, our penetration of the BRIC markets is starting from a relatively low base, and we must maintain a slight cynicism about large statistical improvements. But that old, oft-ventured statistic that we export more to Ireland than to all the BRIC countries combined has long been inaccurate – since the second quarter of 2010. The rate of improvement in exporting to these nations, as well as to other emerging markets such as Turkey, Eastern Europe and the Middle East, offers considerable optimism about what we can achieve in the future.

Another reason for optimism is the tremendous step forward we have seen recently in terms of labour relations between employers, employees, and their trade union representatives. There is now a better understanding and a sharper focus on our mutual interests than perhaps there has been in the past. I would also suggest that the quality of leadership, the men and women who run our businesses, has improved markedly in the last couple of decades – and I include our trade union colleagues in the broader category of improved leadership. It is no coincidence that as this leadership has improved we have seen concurrent improvements in our productivity. We may still have some way to go in terms of closing the productivity gap with some of our competitors, and with the US in particular, but we have made significant inroads compared to the situation just a few decades ago when the gap was limiting the nation's economic capacity.

Manufacturing: our weaknesses

Our industrial make up does have some key weaknesses and it would be foolish not to recognise them. There are also areas where our competitiveness needs to improve.

In truth we simply do not have enough world-class global companies based within in the UK. This is important as it is these firms that surely hold the key to anchoring supply chains, embedding job creation and stimulating local manufacturing ecologies through research and collaboration.

Our record at turning our innovative niche companies into competitive mid-sized companies of £500 million turnover and 500 employees or above is poor, and we compare poorly to our competitor nations. We need to work out why our companies seem unable to traverse beyond the challenging growth process and put in place measures to counteract this problem. Without such companies, creating long-term sustainable supply chains is difficult. Even worse, when such companies leave the UK, it causes existing supply chains to erode. EEF's recent research however does point towards a measurable trend of businesses moving in the opposite direction and choosing to relocate in the UK, driven by concerns about overseas supply chain disruption. Furthermore, the majority of businesses have long told us that, all other factors being equal, they would prefer to use domestic suppliers. In EEF's supply chain report of June this year, 'Be Prepared: Monitoring Supply Chains; Maximising Resilience', we found that two-fifths of companies were bringing some production back in-house and one quarter had increased their use of local suppliers – this is progress.

Barriers and action

Another legitimate question concerns the barriers limiting competitiveness, wealth generation and economic rebalancing. There are no insurmountable or inherent barriers for a great trading nation such as ours with a history of innovation, save, that is, for a poverty of ambition. We need to celebrate and encourage success, not demean it. And we must focus, as a culture, on the aspects of innovation that we need most to encourage innovative overseas businesses to locate to the UK, as well as growing our own. Above all, we must go beyond the British culture of 'make do and mend' – it simply will not wash in a global competitive environment. We need to challenge ourselves to become better and to drive for constant change.

This requires action from both government and the private sector. For manufacturers and investors, long-term strategy is critical. To compete, we need to increase our focus on knowledge, capability and innovation; we need up-skilling of our labour force to invest in increasing productivity. It also requires the courage to invest in the face of countercyclical economic trends. The best business leaders have always known and demonstrated that there are opportunities even in an economic downturn.

In terms of government action, we firstly need an acknowledgement that government is the shaper of market conditions. Governments, both past and present, have tended to suggest that intervention is only required when markets fail. There are a variety of tools available to government that can be used to help grow markets, including regulation, procurement, tax and investment incentives. Businesses need confidence to invest. But more importantly, and before government starts tinkering with those levers haphazardly, we need a clear and unambiguous plan for growth and rebalancing. Without being overly critical of the coalition government, one cannot help but feel that if they had shown the same forensic attitude to rebalancing and growth, as they have towards reducing the fiscal deficit, we might be in a better economic situation than we now find ourselves.

But what should such a plan contain? Certainly, some key performance metrics should be introduced to measure progress and foster accountability.

More broadly, its thrust should be to enable and encourage more products and services to be brought to market, encourage more globally focused businesses to invest in the UK, help expand those businesses with high-growth potential already here, lower the overall cost of business and create a more productive and flexible labour market. In terms of specific problems within the market as it is currently functioning, access to finance, in particular for SMEs, is a major problem which urgently requires action both in terms of support and supply. Loosening up planning restrictions and reducing the cost of business regulation would also help.

More specifically, in terms of policy, the government's priorities should lie in incentivising and unlocking investment through incremental 100 per cent capital allowances, improving the supply of finance at the right cost and terms and conditions by increasing competition in, and reducing over-reliance on, the banking sector, making our skills system simpler with the customer rather than the provider in the driving seat and ensuring that it delivers on its commitments to invest in our infrastructure.

Conclusion

Notwithstanding the progress that has been made and clear reasons for optimism it is inevitable that ever-increasing global competition will continue to present the UK manufacturing sector with challenges to maintaining growth and expanding market share.

The only option open to us, and it is a compelling one, is to relentlessly drive for enhanced technological development, increased competitiveness, and an ever-more skilled workforce, and deliver the investment to secure them.

14

Reconstructing the Economy through New Forms of Manufacturing-Service Innovation: The Cambridge Technology Cluster Example

Elizabeth Garnsey

Why do we need manufacturing? And, more specifically, why do we need highly innovative manufacturing firms at a local and regional level? There are five basic reasons.

First, manufacturing is the key export sector of the economy, helping us to pay our way in the world.

Second, such firms tend to be major customers, providing demand for wider supply chains. When a manufacturing firm closes or moves off-shore, there tends to be a knock-on effect in the service sector, with many firms going out of business.

Third, they are locally embedded. Unlike, for example, the highly centralised financial services sector, they provide jobs at all levels, from unskilled manual to highly skilled professional work. And, as they are local, they provide a regional resource base and an innovation foundation for the whole country. It is this reason in particular that highlights the central importance of manufacturing to the rebalancing agenda.

Fourth, they are a key part of the 'knowledge economy'. Over 50 per cent of private sector research and development (R&D) is conducted by manufacturing firms. Design and R&D for innovation is therefore closely linked to the manufacturing sector, and if manufacturing migrates, design and R&D often migrate with them. We cannot rely on our economy continuing to be more advanced than those of emerging economies; priority must be given to education and training in order to foster a healthy innovation ecology within the UK.

Finally, there are massive opportunities for UK plc in manufacturing at the moment. In the 1980s, prospects opened up for the financial services sector following the Big Bang reforms. Today, opportunity structures have moved in favour of innovations for a greener economy and there are new production and service business models that can offer exciting new opportunities for UK-based businesses.

The National Picture

For all the talk of the decline of the UK's manufacturing, statistics show that decline has been relative not absolute. In terms of output, the sector increased steadily for over fifty years, until 2007 and the subsequent crash (**Fig. 1**). Indisputable, however, is the size of the trade deficit (**Fig. 2**). Beginning in the early 1980s, this has steadily built up over time. This is particularly troubling as, following the massive devaluation of the pound since 2007, we would have expected the trade gap to have closed significantly, as assumed in the economics textbooks. But the gap has persisted and currently stands at a record £4.3 billion. This would suggest that the manufacturing base has been eroded to such an extent that it could not take advantage of the new currency levels. This could be indicative of a dangerous lack of resilience across the sector.

Learning Lessons from the Cambridge example

At the national level, innovation is the key to revitalising manufacturing. However, ultimately, innovation is a local phenomenon. Cambridge and the success of its hi-tech cluster and science spin-outs can serve as an exemplar, showing how locally embedded innovation is capable not only of rebalancing an economy, but completely reconstructing it, transforming what was originally a traditional service economy. Now 40,000 jobs in the region can be found in technology sectors such as telecommunication, electrical engineering, IT hardware, IT software, R&D, biotech and instrumentation (**Fig. 3**). Of course there are historically unique factors in Cambridge's case, most obviously the presence of a world-leading university in the area. Nevertheless Cambridge offers important lessons that other regions can apply to their own situation.

The first lesson is that, in order to understand the nature of innovation and how it works, we need to understand the places where innovation occurs. Manufacturing jobs in Cambridgeshire declined at a slower rate than the national average, despite the fact that traditional manufacturing firms, such as Cambridge Instruments, Pye and Phillips suffered the same consolidation, acquisition and closure patterns as occurred elsewhere (**Fig. 4**). The reason why manufacturing jobs held up better in Cambridge is that new manufacturing activities arose and new sources of innovation were found. However, the dichotomy between 'manufacturing' and 'service' jobs is a crude one. Many companies do not sit comfortably in either category. They may, more accurately, be labelled something like 'manu-services'.

For example, how do you categorise the software sector? Certainly software is a product. It is not a manufactured product in the traditional sense of the word, but the software companies in the Cambridge area have to test their products and face scale-up problems as their customer base expands. These are problems of a different order from those facing service companies. Moreover there are companies like ARM (Advanced RISC Machines) which cannot easily be categorised. Most of us have chips designed by ARM in our mobile phones. But they are not, in fact, a manufacturing company, and instead are a design and customer support company. Or consider Technology Partnership, a design consultancy firm which helps customers design innovative products, but possesses a production facility that manufactures prototypes and short runs of the products it helps customers to design. It is a service company that engages in manufacturing processes. Perhaps the best known example of this manufacturing service model is Rolls Royce, hardly a low-profile company. And yet the crude dichotomy between the manufacturing and service sectors is still being perpetuated. In the emerging manufacturing services sector there are expanding opportunities for many types of activity and business model.

The Cambridge tech firms are also very active exporters. About 50 per cent of UK exports are from manufacturing, while around 20 per cent of services are non-exportable in the economy as a whole. But 60-70 per cent of many Cambridge tech firms' revenues come from overseas. This global dimension is matched by localism. The skilled local labour market is a critical resource. The Cambridge tech clusters started from the local science base, with scientists-cum-entrepreneurs recognising international demand for technologies that could be based on their research. As the cluster evolved beyond this early phase, with companies spinning out of other companies in a multi-generational process of learning and diffusion, the phenomenon took on a global dimension. Cambridge-based inkjet printing products are sold all over the world but the firms have many local suppliers. Global exports can thus help to build local supply chains.

There are also the well documented benefits of horizontal collaboration that come with clusters. When Domino Printing Sciences decided it no longer wanted to do its own testing, it gave its testing equipment to Hansatech, 50 miles away in Kings Lynn, which enabled Hansatech to take over the provision of testing services to other inkjet printing firms, thus improving the capability of the whole cluster. The cluster model often involves a combination of manufacturing and service innovations.

The Cambridge firms have also shown considerable resilience. For example, though the tech sector globally was damaged by the US tech crash of 2000, comparisons with Silicon Valley show that the Cambridge cluster firms were less affected by the crash and, proportionately, recovered quicker, both in terms of absolute numbers (**Fig. 5**) and when these are shown in relative terms (**Fig. 6**)[1]. Thus another lesson we can learn from Cambridge is about resilience. This has to do with continually building on the skills base that has arisen in the area by applying it to emerging opportunities in new sectors. For example, computer hardware production emerged as a result of having scientists in the area using computers, but their skills were also relevant to software development, now a major sector in the area. Similarly computer aided design, which was pioneered in Cambridge, led to geographic information systems and now GIS and GPS are also to be found in the area. As inkjet printing has matured it has become recognised that it is not just an advanced printing technique, but actually a generic deposition technique that can be used for the deposition

1 Adjusting figures to reflect appropriately the discrepancy in size of the respective clusters – with Silicon Valley 35 times the size of the Cambridge Cluster.

of valuable materials and is now being used to develop the plastic electronic sector in the area. This rapid mobilisation of skills to realise new opportunities gives the cluster its resilience, and relies on a strong skills base and innovative sectors that are highly adaptive.

As regards Cambridge's relationship with venture capital, funds were drawn to the area with the emergence of biopharm, and into other sectors following the technology boom of the new millennium, but the reduced availability of VC in the area following the downturn also had a positive impact on Cambridge firms in some respects, in accelerating the spread of ingenious businesses models with an emphasis on efficiency and frugality. This had antecedents in the case of a successful firm like ARM, which did not have the funds to set up a foundry to manufacture silicon chips, but it did have the expertise and imagination to develop an unusual licensing business model.

Resilience

The financial crash has affected Cambridge to a lesser extent than elsewhere in the UK, but its effects are serious in the implications they have for renewal. Some firms in emerging sectors have managed to demonstrate resilience following the 2008 financial crash, as Cambridge tech firms did earlier after the US tech crash – one example being opto-electronics, which has added around 200 jobs to the cluster between 2008 and 2010 (**Fig. 7**). However, despite these encouraging signs, overall the financial crisis has had a damaging impact on Cambridge tech firms. The number of jobs is down by four per cent and the number of firms down eight per cent (**Fig. 8**). This decline in start-ups and micro firms in the Cambridge area is a matter of concern because these firms represent the pool of talent from which the future leaders of the industry will be drawn. Cambridge technology firms have also been affected by the stark decline in bank lending nationally, which has done so much to choke off a recovery from 2008 (**Fig. 9**).

The hope is that the resilience and innovative capacity of the cluster can again insulate it from the worst effects of the recession. But given the lack of capital and the credit squeeze, resilience has its limitations. Relatively few anchor firms have grown up in the area, resulting in a lack of the larger-scale global firms that can more easily withstand a long-drawn-out recession and help protect the local supply chain. Another issue is that the most innovative firms in the area, those with the best prospects, tend to be systematically acquired in foreign takeovers. Had what are now major US innovators – Google, Microsoft, Apple – been acquired at an early stage in their development, they would never have become the innovative industry leaders that they are today. A number of larger independent firms in the area have been particularly important as anchor firms and have been expanding throughout the downturn. The persistent acquisition of the most promising emergent innovators in the Cambridge area may be linked to the relative scarcity of locally founded large and independent firms and has implications for the criteria used to judge the impact on competitiveness of mergers and acquisitions.

Silicon Roundabout won't save us…

The Cambridge example of technology firms generated by a university is not unique. Imperial College and other universities also produce many spin-out firms, and Oxford is arguably more impressive in terms of the number and size of its manufacturing spin-outs, some of which have built on management skills in the local automotive sector. (Cambridge has a considerable lead over Oxford when it comes to patents filed in the area, often used as an index of innovativeness of a locality.) Clearly, there is an opportunity to spread this model – other areas with high quality research universities also have the potential to incubate innovative manufacturing-service clusters producing products and services for which there is international demand. An important new development involves firms like Eight19, which are beginning to look for routes to market in emerging markets, in this case in the demand in Africa for affordable solar power.

However, when it comes to the overall task of rebalancing the economy, technology clusters around universities are important but only part of the agenda. In 1991, Florida and Kenney wrote a book called *Silicon Valley and Route 128 Won't Save Us*. Twenty years later, it is clear that they were not altogether mistaken. The US economy has been in trouble despite the Silicon Valley innovators, as manufacturing has declined and reliance on imports increased overall. And if it is true of Silicon Valley, then it is certainly true of our smaller tech clusters in the UK. We therefore need a far more radical reconstruction of the economy.

There are many issues that need to be resolved before we can even begin this task. Our fragmented supply chains and the dependence on large foreign corporations are the two problems that stand out, problems that have been recognised and deplored. One of the most frustrating aspects of long-term UK industrial policy is that solutions are attempted by one government and then reversed on the next swing of the electoral pendulum. To remedy the imbalances in our economy, we need new institutions that are capable of building long-term capability. The most urgent need is a bank for industry, or many such banks, which are not subject to current short-term commercial pressures. Entrepreneurs in Cambridge have been trying to set up a new commercial bank, to which they have given a nickname of 'the Boring Bank' because it intends to support local firms with 'boring' but essential commercial services. The latest such initiative is to create a providential society that could provide loans without being subject to the restrictions that make it hard to set up a new bank. Regional institutions are also needed in recognition of the fact that innovation is a local and regional phenomenon. This could encompass the setting up of regional chambers of commerce such as they have on the European continent. The new Local Enterprise Partnerships are too numerous and too short-term in focus to fulfil this function and they cannot take up the lost capacity resulting from the end of the Regional Development Agencies (RDAs).

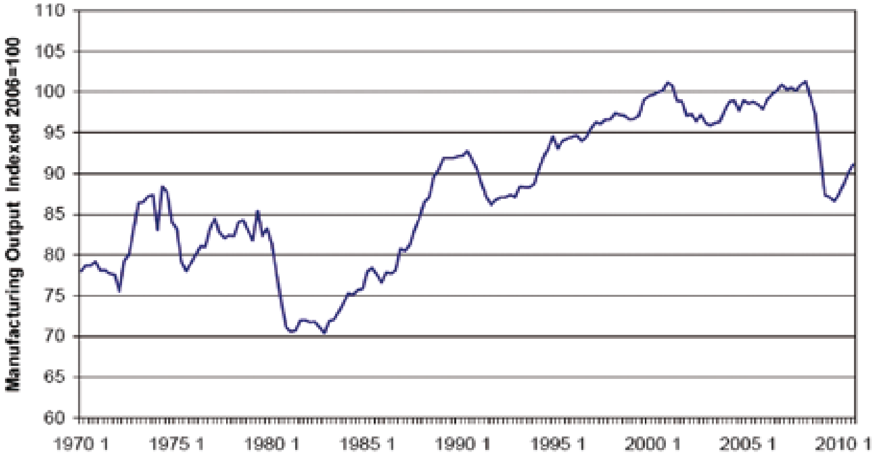
The regional road to reconstruction

Indeed, devolving power away from Whitehall and a reduction of the top-down centralised approach to economic policy is needed, with regional bodies and institutions that build up knowledge of the strengths and weaknesses of their area over time. There is a vibrant civic culture in this country, which resides mainly in cities (which themselves are underused as a spatial level for policy). For example, like many cities, Cambridge has active local environmental and social enterprise movements, with many environmental innovators, green enterprises, and low tech as well as high tech innovators.

Genuine rebalancing requires not only policy input but creative experiments to change lifestyle and consumption. Transition Cambridge, for example, is a movement for resilient cities, focused on building resilience from the grass roots up. There are new hybrids – technology companies with a social mission like Diagnostics for the Real World – and companies like Eight19, developing its solar technologies for Africa. There are social enterprises, looking to become self-reliant with commercial arms. There are NGOs with expertise in emerging economies which could be shared with businesses wanting to produce affordable products for the emerging markets. These movements and their adherents would point out that social and environmental progress has not kept up with GDP growth. Indeed, it is not aligned with GDP growth. If we compare indicators of GDP growth and indicators of social wellbeing, we see that during the growth period before the financial crisis, social wellbeing was actually falling as GDP rose. Yet despite this disconnection, GDP growth persists as the measurement by which policy decisions are calibrated, in contrast with metrics like those developed by the New Economic Foundation, whose Measure of Domestic Progress (MDP) includes social and environmental indicators. For genuine rebalancing, it is precisely the connections between growth and social and environmental improvements that need to be addressed (**Fig. 10**).

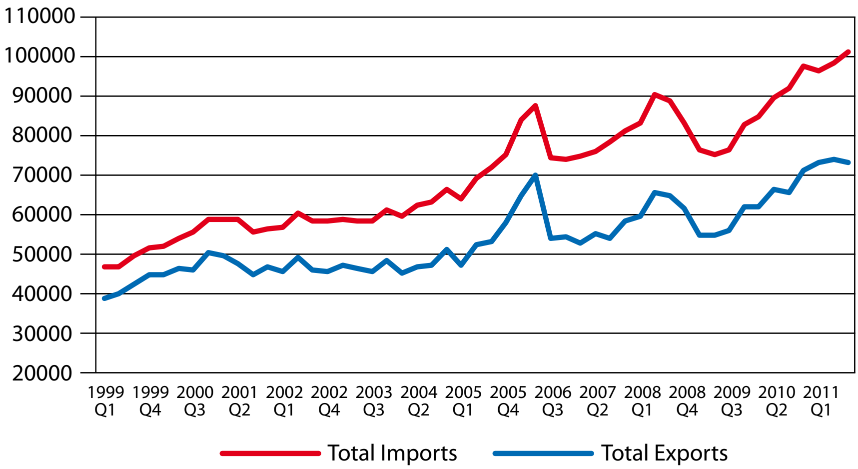
Indeed, it has been argued that rebalancing is a metaphor that makes the challenge ahead seem simpler than it actually is. Given the state of manufacturing at the moment, reconstruction might be a better metaphor. Whether you believe in rebalancing or reconstruction, there is a definite need for environmental and social issues to be introduced into the debate on growth in the UK. That reconstruction begins with local and regional innovation.

Figure 1: UK Manufacturing Output 2006=100



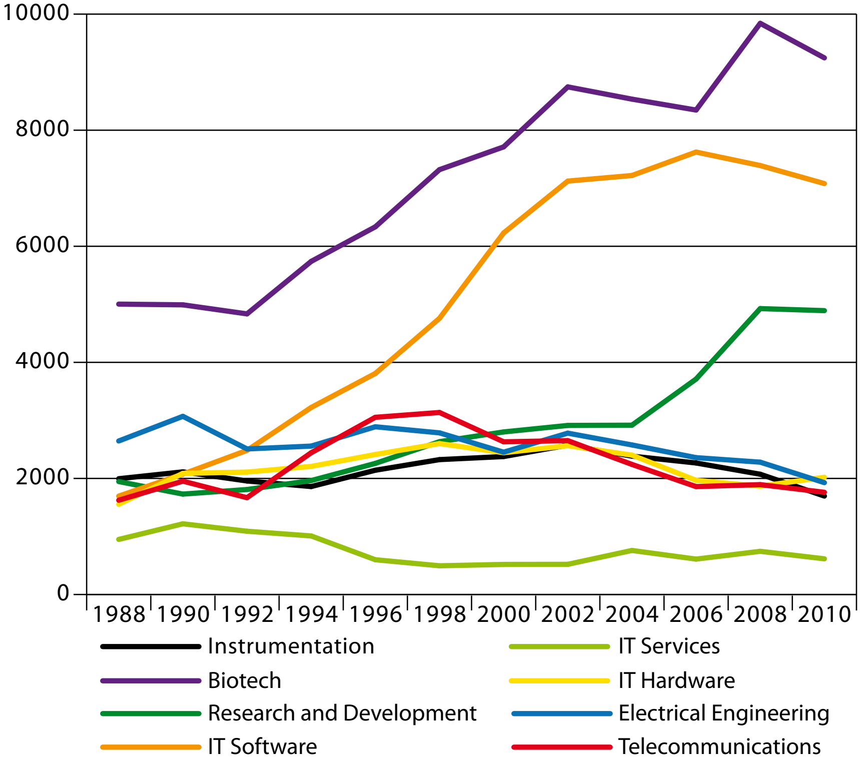
Source: BIS Advanced Manufacturing Growth Review

Figure 2: UK imports & exports (£m)



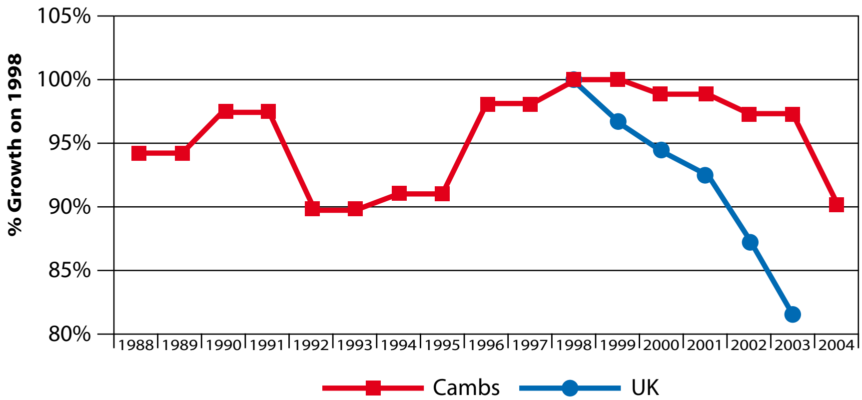
Source: Office of National Statistics 2011

Figure 3: Employment in Technology Based Firms in the Cambridge area 1988-2010



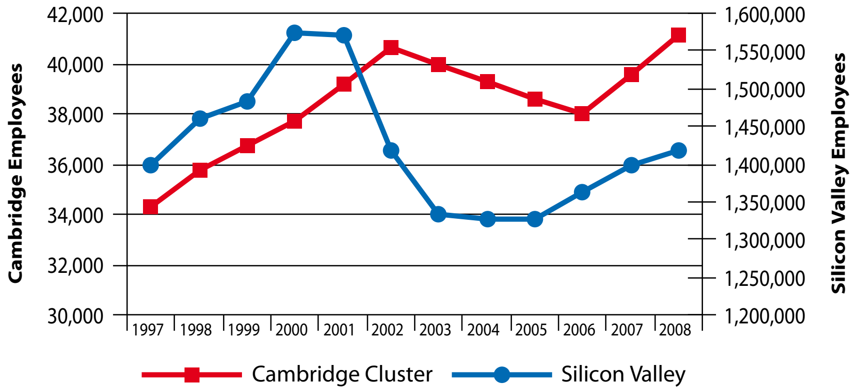
Source Mohr and Garnsey, 2011, The Cambridge High Tech Cluster Facing the Downturn, www.ifm.eng.cam.ac.uk

Figure 4: Change in Manufacturing Jobs Cambs and UK, 1998=100



Source: IfM unpublished study 2005

Figure 5: Changes in Tech Employee Numbers, Cambridge Tech Cluster and Silicon Valley



Source: Vivian Mohr & Elizabeth Garnsey, 2011, How do High-Growth Firms Grow? Evidence from Cambridge, UK, CTM Working Papers, IfM 2011/04, August 2011 http://www.ifm.eng.cam.ac.uk/ctm/publications/w_papers/

Figure 6: Relative Changes in Tech Employee Numbers, Cambridge Tech Cluster and Silicon Valley

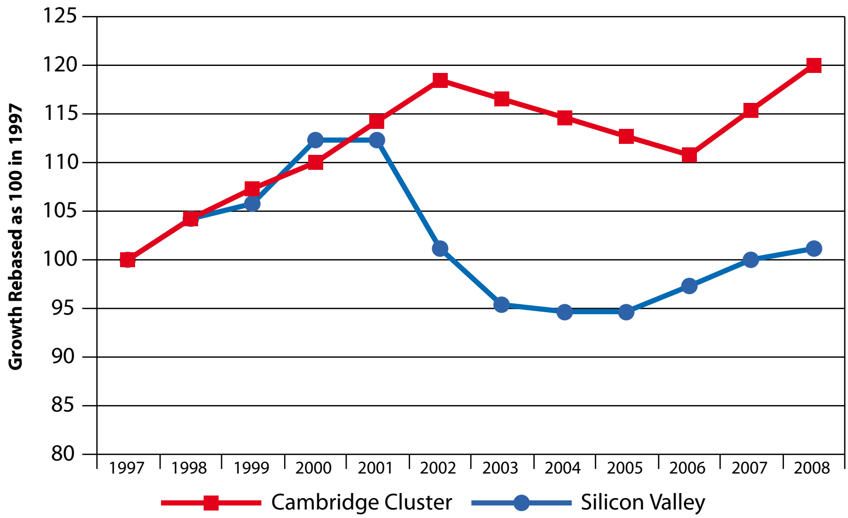
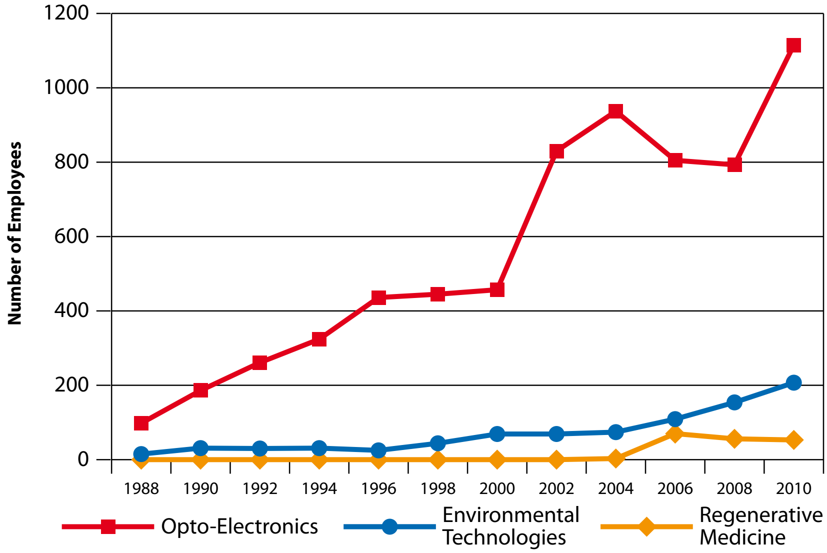
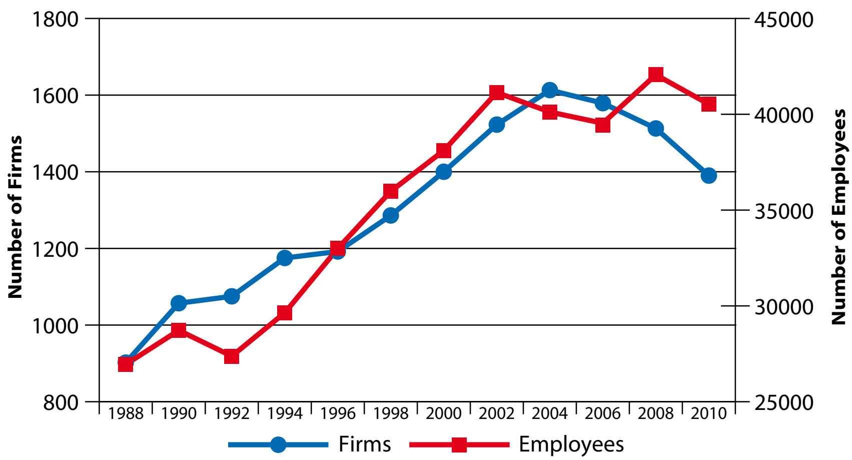


Figure 7: Jobs in Three Emerging Cambs Sectors



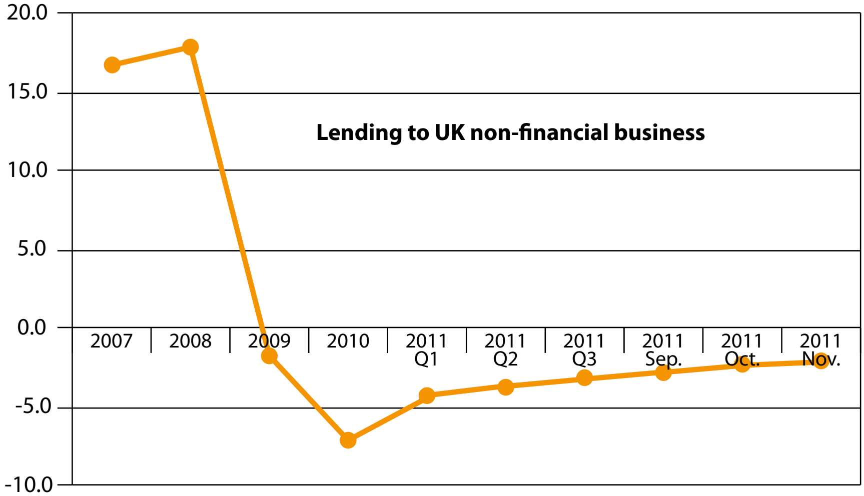
Source: Mohr and Garnsey 2011, http://www.ifm.eng.cam.ac.uk/ctm/publications/w_papers/

Figure 8: Tech Jobs and Firms, Cambs



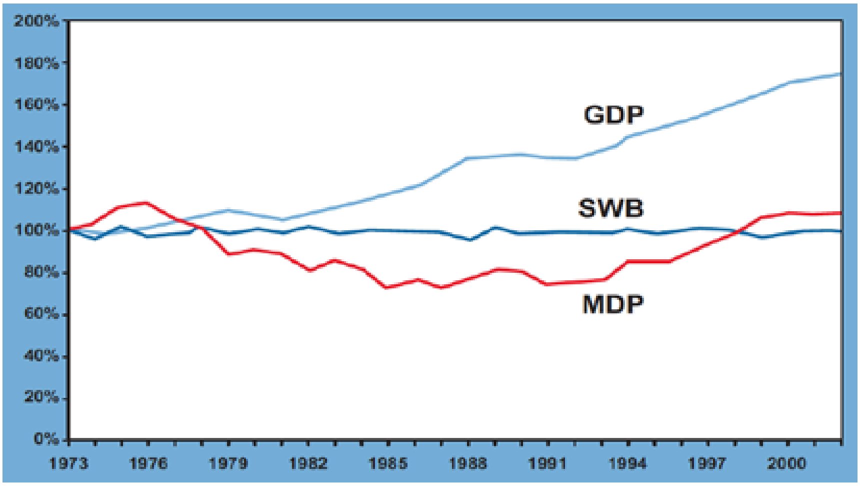
Source: Mohr and Garnsey 2011, http://www.ifm.eng.cam.ac.uk/ctm/publications/w_papers/

Figure 9: Twelve-month growth rate (per cent)



Source: Bank of England Dec 2011

Figure 10: Indicators of UK Gross Domestic Product, Social Well Being and Measure of Domestic Progress



GDP – Gross Domestic Product; SWB – Social Well Being; MDP – Measure of Domestic Progress – social and environmental. Source: New Economic Foundation

PART 4

Balancing the Current Account: Generating Export Led Growth

15

Engaging India: Reconnecting through Trade and Investment

Jo Johnson MP

Achieving growth

Coming into office in 2010, David Cameron noted in his first speech on the economy as Prime Minister that Britain had long suffered from twin deficits: a structural budget deficit and a longstanding trade deficit.

On the first of these, progress has been rapid and effective and is underpinning the UK's ability to borrow 10-year money in the capital markets at well under two per cent. The UK's budget deficit has been reduced by 25 per cent in the first two years of this government, from 11.1 per cent in March 2010 to 8.3 per cent in March 2012. The current structural budget deficit is forecast by the independent Office for Budget Responsibility to fall to 2.9 per cent by March 2015.[1] The backdrop to the second of these goals, reversing the trade deficit, is even more challenging. A trade deficit is a symptom of a lack of international competitiveness and the UK has run one every year since 1984, and in all but six years since 1900.

A surplus in its trade in services (seen in every year since 1966) has traditionally failed to compensate for a deficit shown in the UK's trade in goods. The last time the UK registered a fleeting surplus on its trade in goods was in 1982, but only thanks to North Sea oil. In 2010, the current account deficit was £48.6 billion, equivalent to -3.3 per cent of GDP, not far off the 1989 record of -4.9 per cent. In 2011, it shrank a little, to £29 billion, or 1.9 per cent of GDP.

The UK has steadily lost share in global exports over the past 60

1 Office of Budget Responsibility, Economic and Fiscal Outlook, March 2012, p13.

years. This is partly due to the emergence of competitive low-cost exporters from the developing world, epitomised by China, which has been pursuing an aggressively mercantilist approach and keeping its exchange rate down through huge foreign currency intervention. But it is also due to ferocious competition from developed world structural surplus countries, such as Germany and Japan.

While developed economies' share of global goods exports has fallen from about 75 per cent in 1950 to just under 60 per cent, the decline in the UK's share has been sharper, from 10 per cent to under three per cent.[2]

In a two-speed world, there is nothing to dictate that Britain must stay in the slow lane of economic recovery, but it must recognise that it is facing the wrong way and must better position itself to take full advantage of the booming emerging markets that will account for the bulk of global growth over the next few years. The Prime Minister has repeatedly urged British business to take advantage of growth in the world economy that was 'not in the Eurozone, but in huge modern cities from Bogotá to Istanbul', where 'people [were] hungry for the skills and services Britain is best at'.[3] Other senior ministers have also repeatedly urged businesses to lift their horizons. George Osborne, the chancellor, has said that 'an enterprising Britain is one that sees a world with a resurgent China, a booming India, a thriving Brazil and understands that it is an opportunity not a threat'.[4]

Although by instinct suspicious of the Heseltinian tradition of herding businessmen onto aeroplanes bound for faraway countries, Messrs Cameron and Osborne have consistently led from the front what has been a concerted cross-government effort to boost Britain's commercial diplomacy. The creation of a new UK Trade and Investment (UKTI) cabinet sub-committee, chaired by Lord Green, previously Group Chairman of HSBC, was an early and welcome indication of resolve in this respect.

The urgency of this reorientation has if anything increased over

2 Ernst & Young, The outlook for UK exports: ITEM Club Special Report, February 2011 (see p2) (refers to IMF, Direction of Trade Statistics database).

3 David Cameron, Speech at BFI, 10 November 2011.

4 George Osborne, Speech at British Business Leaders' Lunch, in Davos, 28 January 2011.

the last two years. With the Eurozone economy yet to emerge convincingly from recession, UK exporters are likely to struggle in a market that accounts for 45 per cent of all external trade. Overall UK export performance is still to a great extent determined by demand in the Eurozone (and in other OECD markets accounting for a further quarter of the UK's trade).

No one is suggesting UK businesses should seek to export less to the rich European countries that form the world's most important trading area, with a GDP of about €12,000 billion and a population of 500 million. Indeed, the UK has to continue pushing for the completion of the single market. Eliminating significant non-tariff trade barriers could increase our trade with other EU members by up to 45 per cent, according to the Department for Business, Innovation and Skills, and boost per capita incomes by seven per cent.[5]

The UK and Europe have to work on boosting internal and external trade in tandem. In order to re-invigorate domestic European demand, countries such as Spain and Italy will have to continue in their efforts to reform their public and private sectors, and EU members will have to genuinely commit to liberalising the single market. At the same time, in order to take full advantage of growth in developing countries, the EU has to push for Free Trade Agreements (FTA) with countries outside the EU that will help unlock their markets to European firms.

Ultimately, while it is demand in emerging countries that has the greatest potential to drive forward UK, European and global growth, re-orienting existing UK trade towards higher growth markets will take longer than a political cycle. Our trading relationships have been shaped by distance, market size and cultural, linguistic and historical ties and the EU will continue to be the UK's biggest market (albeit a slow-growth one) for at least a decade. Over the last decade, the rate of growth of exports to EU countries has been roughly half that to non-EU countries. A breakdown of goods exports by destination shows that the fastest growth has been to Australasia and parts of South East Asia, such

5 Department for Business, Innovation and Skills; BIS ECONOMICS PAPER NO. 11; The economic consequences for the UK and the EU of completing the Single Market; February 2011.

as South Korea and Indonesia. Even though annual growth in exports to some countries has at times exceeded 100 per cent, the fact that the export share was initially so low means that many countries remain relatively trivial trade partners in absolute terms.

These new emerging markets are therefore unlikely to be any quick fix for growth within the term of this parliament because the base of our economic engagement is still too small to make any noticeable difference to the overall picture. There are some striking figures that illustrate this point. India's share of UK exports, for example, remains well under two per cent, notwithstanding volume growth of around 40 per cent in 2011. In total, the four BRICs (Brazil, Russia, India, China) accounted for current account credits worth £31.3 billion in 2010 or 5.1 per cent of the £615 billion total.

China accounted for about 1.9 per cent of total UK current account credits in 2010, India and Russia for between 1.2-1.3 per cent each, and Brazil for 0.75 per cent. Exports to Ireland of £20 billion in 2010 exceeded the combined value of exports to India and China (£19.4 billion). That is an improvement on the previous year, when the UK notched up more credits on the current account with Ireland (£28.7 billion) than it did with the four BRICs, Indonesia and Mexico combined.

It is noteworthy that other developed countries have re-oriented their export profiles more effectively than Britain has done, raising doubts about whether we are keeping pace with our EU partners in promoting British commercial interests in the emerging economies. The proportion of Germany's goods exports going to the BRIC countries, which are showing strong demand for its capital goods at this stage in their development, is more than twice ours, having more than doubled from 4.5 per cent in 2000 to 10.6 per cent in 2009.

Furthermore, it is worth noting that the UK ran a big current account deficit with the BRICs of about £21 billion in 2010 (up from £17 billion in 2009), which represents an increasing drag on UK growth. This is principally because of the UK's current account deficit with China, which, at £20.9 billion (up from £17 billion in 2009), is the largest of any individual country. The UK ran a small current account deficit of £1.3 billion with India (down from £1.5 billion in 2009), and modest surpluses with Brazil and Russia.

It is of course essential that the UK becomes more engaged with these markets, as they will be the principal sources of global growth over the next five years, with China and India likely, notwithstanding slowing growth rates, to develop into economies that eventually are the size of those of the US and EU today. But it will also be important to change the terms of trade, so that the UK ceases to run substantial current account deficits with China and India.

This will not be easy. Penetrating difficult and distant markets will be a marathon, not a sprint. But government can have an important part to play in encouraging new firms to export, in facilitating the re-orientation of existing exporters towards emerging markets, and in breaking down non-tariff barriers and other regulatory hurdles to trade. There is much to be done, but the work undertaken in the first two and a half years of the coalition government has been impressive.

The organisational overhaul of UKTI, the restructuring of the Export Credit Guarantee Department and the Foreign and Commonwealth Office's decision to create 30 new posts in India and 50 new positions in China, roughly a seven per cent increase in each mission's manpower, at a time of severe budgetary restraint, all underline the seriousness of the coalition's intent to boost its commercial diplomacy in BRIC countries.

India as a case study of UK engagement with the BRICs

India and the UK are re-connecting at an unprecedented rate, forging a partnership of equals that is no longer overshadowed by their colonial history. The coalition has stated its determination to forge a 'new special relationship', an ambition that is finding an echo in India as it prepares to play a bigger role on the global stage. With respect to India, the urgency underlying the new approach is more than justified. The UK has been rapidly slipping down the rankings of India's trading partners over the last decade. In 1999, Britain was India's fourth most important source of imports, according to official figures collected by India's Commerce Ministry. By 2011, it was its twenty-first.[6]

Many of the countries that have overtaken the UK in the

6 Source: Ministry of Commerce, Government of India.

rankings of India's trade partners are energy-rich ones in a position to supply India with oil and coal. But that is not the whole picture. Germany has made phenomenal progress in penetrating the Indian market and is now easily the largest goods exporter to India among the EU27. It is meeting a massive demand for the capital goods needed to plug India's various infrastructural deficits. It is not alone in outstripping the UK: even Belgium exported more goods to India than Britain in 2011.

That is not to say the absolute growth in UK–India trade is unimpressive: UK goods exports jumped 40 per cent and services exports by 23 per cent in 2011, taking the total value of UK exports in goods and services to £8.06 billion, up from £6.25 billion in 2010.

At this rate of growth, Britain is on track to meet its target of doubling 2010 levels of trade with India by 2015, a significant achievement. But there is no doubt that other countries are out-trading the UK and that we are losing market share in many sectors.

While the volume growth has improved, the quality of UK exports to India remains questionable. Non-ferrous metals, non-metallic mineral manufactures, metalliferous ores and metal scrap seem to account for a considerable proportion of the export basket. Such commodities are hardly high value-added or particularly reflective of the areas in which the UK economy is potentially competitive. This is an area of concern.

Part of the explanation for this relative under-performance vis-à-vis Germany and others is that the Indian market has been relatively closed in the areas where the UK economy is competitive and open in others where Britain is weaker. Although there are encouraging signs that this might change, following a long-awaited announcement of liberalising measures made in September 2012, Britain's services exporters have historically encountered major obstacles to effective market entry in India.[7]

7 Finance Minister Palaniappan Chidamabaram announced on September 14, 2012 a range of liberalising measures that included federal-level approval of foreign direct investment (up to 51 per cent ownership) in multi-brand retail; permission for foreign companies to purchase stakes of up to 49 per cent in Indian airlines; and a repetition of promises to raise the FDI-ceiling in the insurance sector to 49 per cent from 26 per cent.

India's near $500 billion retail sector, for example, has been completely closed to investment by foreign supermarket groups, even though allowing in the likes of Tesco and Sainsbury's (not to mention Wal-Mart and Carrefour) would simultaneously raise farmer incomes and lower food prices for consumers. Food price inflation has been running at high levels for many years to the extent that a kilo of onions in Tesco is now cheaper than a kilo of onions in Bombay.[8]

Financial services liberalisation has also proceeded at a glacial pace. Foreign banks continue to find it difficult to open up branches across India and their cause has not been aided by the financial crisis, which left India largely unscathed and reinforced what was already a very conservative mindset at the Reserve Bank of India.

UK hopes of achieving its market access goals in financial services have also suffered with respect to the insurance sector, where Foreign Direct Investment (FDI) in the insurance sector remains capped at 26 per cent. Even though the Indian government first promised nearly a decade ago to lift this ownership restriction, the legislative logjam in the Indian parliament, paralysed by a spate of corruption scandals, has been a longstanding obstacle to reform.

The Indian economy is much more open in sectors where the UK's competitive advantage is less obvious, notably in infrastructure, capital goods, project engineering and manufactured products. This pattern has played particularly favourably to the strengths of countries such as Germany that have larger and more competitive manufacturing sectors. Machinery and vehicles and other manufactured goods account for almost 80 per cent of EU27 exports to India.

That said, the UK has also let some opportunities to increase its market share of Indian merchandise goods imports slip. Potentially game-changing deals have been lost, with the Eurofighter consortium's failure to secure the Indian Ministry of Defence order for 126 multi-role combat aircraft, the most noteworthy recent

8 A kilogram of loose red onions (class 2) in Tesco bought online costs £0.95. A kilogram of onions in a market in Mumbai can cost between Rs60-80 and on occasion more. See 'No onion distribution through ration shops', Times of India, 22 December 2010 (http://articles.timesofindia.indiatimes.com/2010-12-22/mumbai/28255848_1_onion-prices-onion-crop-onion-stock).

example. Valued at over $10 billion, this would at a stroke have embedded British firms in key supply chains in India.

Getting the EU–India Free Trade Agreement right

The Eurofighter example shows the tension between the EU as a union of competitors on the one hand and as a union of countries with a common interest in gaining more favourable market access to rapidly developing markets on the other. It is in the latter capacity that the EU launched FTA negotiations with India in June 2007.

After 11 full rounds, they are now in a phase where negotiators meet in smaller more targeted clusters rather than full rounds. This entails expert level intercessionals, chief negotiator meetings and exchanges at Director General level. Following the EU–India Summit on 10 February 2012 in Delhi, negotiations are at an intense phase but there is a limited political window of opportunity and a formidable amount of work still to be done on important issues, particularly with respect to the overall ambition of the services package.

If agreement can be reached, the prize is great. An extended FTA, according to an analysis conducted for the European Commission in May 2009, could see India gain €4.9 billion in the short run and €17.7 billion in the long run and the EU gain €4.4 billion in the short run and €1.6 billion in the long run. It would therefore bolster further what is an already strong EU–India trade relationship.[9]

The EU is already India's largest trading partner accounting for just over €100 billion in trade in goods and services in 2011, up sharply from approximately €86 billion in 2010. The EU accounted for 19 per cent of India's total exports and 14 per cent of India's total imports in 2010. Although the EU is still a more important trading partner for India than India is for the EU, this dynamic is changing.

India ranked eighth in the list of the EU's main trading partners in 2010, up from 15th in 2002. India accounts for 2.6 per cent of EU's total exports and 2.2 per cent of the EU's total imports.

9 European Commission, Trade Sustainability Impact Assessment for the FTA between the EU and the Republic of India, May 2009.

There is still much potential for trade growth on both sides, and the completion of an ambitious FTA – unlike the modest and un-ambitious FTA that Japan concluded with India in February 2011 – would be a significant enabling factor.

Estimates vary as to the value potentially to be created from such an FTA. Britain alone believes the UK could see a trade boost of upwards of £300m a year, and potentially more, depending on how ambitious the deal is and on the time-frame adopted for the phasing in of the most important liberalising measures. But the overall picture is that an FTA would help underpin the EU's position as the number one supplier of goods and services to India at a time when its grip on that position is under considerable competitive pressure from countries such as China, South Korea and the UAE.

The FTA is a way to give the EU an advantage against the competition by providing its businesses with access to an important Indian market on a preferential basis (as WTO rules provide for a carve-out from requirements to multilateralise for bilateral FTAs that cover substantially all trade).

The EU–India Summit on 10 February 2012 reaffirmed both sides' commitment to the early conclusion of an 'ambitious and balanced package'. From the UK perspective, negotiations for an FTA are an ideal opportunity for Britain to improve the terms of its trade relations with the subcontinent. The UK remains committed to the multilateral trading system, but in the absence of progress on Doha, is also supportive of broad and ambitious FTAs that open markets and boost trade and jobs.

Concluding the EU–India FTA is a priority for Britain, but certainly not at any price. While it is helpful to aim to have a final text ready for ratification (a process which will itself take at least a further 15-18 months) by the end of 2012, it is essential that the opportunity for an ambitious agreement, covering not just goods, but also services and investment, is not wasted.

The leverage that the negotiation of an FTA provides, offers the best chance that the UK will have for some time to make progress towards longstanding goals of British commercial diplomacy.

The difficulty is that progress on the aspects of the FTA that are of most interest to the UK has been extremely slow. On the goods side of the negotiation, most of the pieces are now in place, even if the EU still expects India to show some movement on cars and wines and spirits, which attract import duties of 150 per cent, in return for concessions on the export of garments and textiles from India to the EU.

On the services side, however, there is little to show for six years of talks. The EU only received an Indian offer of any sort in March 2012. This exchange of offers on services was of course a welcome development in itself, as it was a sign of progress and gives member states a chance to comment for the first time. As much of the services offer fell so woefully short of UK expectations, however, it in fact raised many more questions than it answered, not least as to the likelihood of an ambitious agreement being achievable by the end of 2012.

The unsatisfactory nature of the negotiation should not have been surprising, given India's general defensive posture in the WTO and track-record of crafting 'trade light' FTAs, pursued more for foreign policy than commercial reasons. Indeed, India is reckoned to have the worst-quality FTAs among major Asian FTA players.[10]

It is unlikely that the negotiation will succeed in meeting the timetable envisaged as, in a number of important specific respects, the UK, and it is far from alone in this respect, clearly needs India to move much further than may be politically deliverable in New Delhi. Although the recent announcement of unilateral liberalisation in the retail, aviation and insurance sectors is encouraging, significant obstacles remain.

There is still a significant risk that the EU–India FTA will be taken hostage by domestic Indian coalition politics and that, like the Doha Round of multilateral trade talks, it will die a lingering death. A 'deep-integration' FTA with India is regarded as 'next to impossible'.

A central problem is that the United Progress Alliance (UPA) government in New Delhi has failed to secure broad buy-in for reform, as the proceeds of growth, notwithstanding substantial subsidy programmes theoretically aimed at low-income groups, have so far been unevenly shared. Systemic corruption, which hits the

10 Indian Trade Policy after the Crisis, Razeen Sally, p2, ECIPE Occasional Paper, No. 4/2011

poor hardest and fuels their sense of unfairness, has worsened this problem and strengthened the hand of those opposed to reform.

The announcement of a new wave of reforms made in September 2012 is a recognition that India was failing to put in place the conditions to allow the economy to regain and sustain the near double digit growth rates of the 2005-2008 period. It also reflected concern that India could lose the confidence of international investors, demonstrated by Standard & Poor's decision in April 2012 to announce a 'negative outlook' on the country's BBB- investment rating and criticism that the global economic crisis has thus far 'induced marginal protectionist backsliding rather than further liberalisation'.[11]

The proposed reforms represent the UPA 2 government's perhaps last attempt to salvage its reputation as a steward of the 'India story' and to make the most of the very limited political space it had available to it, following disappointing setbacks in battleground state elections in Uttar Pradesh in March 2012 and ahead of national elections in 2014.

P. Chidambaram's return to the finance ministry in 2012 has been well received by international investors and by members of the Indian strategic community, to some extent allaying concerns that India risked falling into a 'middle income trap', like a number of former emerging market darlings which failed to sustain turbo-charged growth-rates for more than a few years.[12]

Seven crucial issues in the EU–India FTA negotiations

There are seven areas in the EU–India FTA negotiation which will decide its future. These are set out below.

Mode 4

London is reluctant to make further concessions in relation to India's most important request in the services negotiation, which relates to the 'temporary movement' of services professionals

11 Ibid, p9.

12 Nonalignment 2.0: A Foreign and Strategic Policy for India in the Twenty-First Century, Centre for Policy Research. Sunil Khilnani, Rajiv Kumar, Pratap Bhanu Mehta, Lt. Gen. (Retd.) Prakash Menon, Nandan Nilekani, Srinath Raghavan, Shyam Saran, Siddharth Varadarajan

under the so-called Mode 4 provisions of the General Agreement on Trade in Services. This covers the movement of natural persons. The size of the UK's services sector means that London's stance in relation to Mode 4 is of critical importance and will be a key factor in whether an ambitious trade deal can be concluded this year.

Given the need to balance Mode 4 offers with the annual limit on non-EU immigration sought by the coalition government, however, the UK is expected to be unlikely to offer a more generous settlement in any bilateral trade negotiation than it has already made as part of the Doha negotiations. It will not be possible for the UK to make commitments in the FTA which are incompatible with the government's efforts to reform the immigration system. The first major change to reduce immigration into the UK took effect in April 2012, when the UK Government's new annual immigration limit came into force.

This, along with radical changes introduced to the student route and plans to tackle permanent settlement, is intended to cause net migration to fall back down to the tens of thousands. Under the annual limit, employers will be able to bring only 20,700 people from outside the EU to work in skilled professions under Tier 2 (General) of the points-based system. A further 1,000 visas will be made available to people of 'exceptional talent', to ensure that Britain remains open to the brightest and the best. Those earning a salary of £150,000 or more will not be subject to the limit.

The Intra Company Transfer route (ICT), which is not part of the annual limit and is of particular importance to Indian information technology service providers, will also be changed in 3 ways:

- The job will have to be in an occupation on the graduate occupation list;
- Only those earning £40,000 or more will be able to stay for more than a year; they will be given permission to stay for three years, with the possibility of extending for a further two years, and
- Those earning between £24,000 and £40,000 will be allowed to come to the UK for no longer than 12 months, at which point they must leave the UK and will not be able to re-apply for 12 months.

Banking

Little progress has been made on the Reserve Bank of India's roadmap for liberalisation since the onset of the financial crisis. This undoubtedly made financial sector reform less easy to achieve politically, strengthened the hand of conservatives within the Indian regulatory establishment and provided a pretext for a continuation of a variety of protectionist practices.

There is, in particular, an urgent need for clarity over the RBI's subsidiarisation plans for foreign banks. UK banks such as Standard Chartered, HSBC, Barclays and RBS need to have it confirmed that foreign banks converting to subsidiaries will receive 'national treatment', just as Indian banks such as ICICI do in the UK, which is now home to nearly 30 Indian financial services firms.

Branch licensing restrictions prevent UK and other foreign banks from expanding in wealthier areas unless they meet quotas for lending to priority sectors and open branches in rural areas. The UK is pushing for these lending restrictions to be eased as and when banks convert to subsidiaries (at present they operate as branches of their UK operations).

The UK accounts for half of all foreign bank branches in India, but that is in large part because British banks have been in the country longer than many others and have in some cases stuck with a difficult market through thick and thin. For example, the Chartered Bank, a forerunner of what would become Standard Chartered, opened its first overseas branch in Kolkata in 1858.

A financial sector which is dominated by state-owned banks and Indian private sector banks – foreign banks account for about two per cent of the Indian market – is struggling to provide the capital required to meet India's massive infrastructure requirements. Poor physical infrastructure – particularly in roads, ports, and power – is one of the principal bottlenecks for continued Indian growth.

Financial liberalisation would significantly help India meet its infrastructure needs, which exceed the capacity of the domestic banking system. The government estimates a financing gap of over $310 billion over the next five years alone. India's savings rate is high, at over 30 per cent of GDP, but is not harnessed effectively into productive investments because the banking system is repressed and capital markets are under-developed.

Pensions and Insurance

Lifting the caps on FDIs in the insurance sector would provide a further source of funds for investment in Indian infrastructure. British institutions such as the Prudential and Standard Life, which are minority partners in market-leading private sector insurers, are potential sources of long-term funds for investment in infrastructure.

The UK, along with a number of other countries, notably the US, has been pushing successive Indian governments to honour a commitment made to lift the FDI cap in the insurance sector to 49 per cent from the present level of 26 per cent. Progress with the Pensions Bill is similarly slow-moving as these liberalising steps are dependent on legislative changes that are controversial in India.

Although the government said in September 2012 that it would move the Insurance Laws (Amendment) Bill 2008 and The Pension Fund Regulatory and Development Authority (PFRDA) Bill 2011 during the budget session, few are betting on rapid progress in a political environment in which the Indian government is hunkering down ahead of a general election in 2014 and unlikely to expend political capital on liberalising reforms.

Legal and professional services

Foreign lawyers in India are banned outright from setting up offices in India, and even domestic firms are heavily restricted. They cannot grow in size to beyond 20 partners each and they cannot incorporate, advertise or tie up with companies outside their profession.

Numerous studies have recommended that India's legal profession be opened if only to rebalance the market, which derives 90 per cent of its revenue from litigation and is small compared with the size of the economy. But many Indian lawyers, a good number of whom also sit in parliament, have fiercely opposed the entry of their foreign rivals, arguing they are not prepared for competition from global firms and that corporatisation will destroy the values of the local industry.

Britain is the EU country keenest on deregulation, although it is certainly not alone, because London is home to some of the world's largest and most international law firms, including Clifford Chance, Linklaters, Freshfields Bruckhaus Deringer and Allen & Overy.

The passage of the Limited Liabilities Partnership (LLP) Act should make it easier to pass the legislation needed to open up the sector. It is estimated that liberalisation of the sector could boost the Indian economy by $2-3 billion a year.

The LLP Act also marked an important step forward for the international accountancy profession, which has faced similar obstacles in opening up the Indian market. Firms such as KPMG are not allowed to use their own brands in the Indian market. There is a need also for independent regulation of the sector. Indian chartered accountant firms are regulated by the Institute of Chartered Accountants of India under provisions of the Chartered Accountants Act (1949). The requirement for the rotation of corporate auditors in the Companies Act (2011) and pressure from international investors for higher standards of corporate governance and for the adoption of international accounting standards have reinforced pressure from the EU for the liberalisation of the accountancy industry in India.

Retail

Failure to open up the retail sector to multi-brand retailers such as Tesco, Wal-Mart and Carrefour had long been emblematic of the government's waning energy. Steps to move ahead with liberalisation announced in September 2012 are therefore highly significant, underlining the extent to which Prime Minister Manmohan Singh had seen the opening of this sector as a way to cement his legacy and continue the economic reforms he supervised as finance minister in the 1990s. A more efficient retail sector is likely to boost employment and better connect farmers to urban markets.

Indian critics of FDI, however, fear the loss of neighbourhood stores and a restriction in consumer choice. The decision to press ahead with the reform, which had been put on hold after it was initially floated as a proposal in November 2011, has encountered stiff opposition from the BJP, which has a strong Poujadiste tradition and considerable support from small traders. It has also imperilled the electoral arithmetic of the UPA coalition, with the defection of its second largest constituent party, the All India Trinamool Congress, led by Mamata Banerjee.

Investor protection

The investment chapter of the EU–India FTA negotiations has barely been opened. The delay reflects in part the fact that the European Commission only in January 2011 requested the expansion of its negotiating mandate to include investor protections. EU Member States have Bilateral Investment Treaties (BITs) with very high levels of investor protection, which India wants to repeal in the event that there is an over-arching investment chapter in the FTA.

This reflects less a desire to avoid duplication than the wish to tighten up bilateral treaties that India regards as excessively open-ended. India is concerned by the trend for companies to have recourse to international arbitration under these bilateral treaties, which were signed in the 1980s and 1990s at a time when India was a largely closed economy and attracted little FDI. The UK–India Agreement for the Promotion and Protection of Investments, for example, dates to March 1994. BITs contain important protections against state interference with investments of investors from the other state. These include the obligation to provide full compensation in the event of expropriation, but also other protections, including protection against arbitrary, discriminatory and unfair treatment.

The retrospective changes to Indian tax law announced in the March 2012 Budget, which affect Vodafone and many other companies, makes it likely that the investment chapter of the negotiation will be one of the hardest to close as such arbitrary action reinforces the demand for strong investor protection. There would appear to be good grounds for arguing that the imposition of a retrospective tax would constitute unfair treatment in breach of a BIT. Given that work has not even started, this is a considerable hurdle to the signature of an FTA by the end of 2012.

Clearly, there must be a balance between not exposing a resource-constrained Indian state to costly arbitration and India's need, as a country running a substantial and widening current account deficit, now equal to around four per cent of GDP, to attract healthy flows of FDI. The two-way flow of investment between India and the UK has been strong. There have been some sizeable mergers and acquisitions, notably the Tata Group's acquisition of Corus and Jaguar Land Rover, which, strikingly, has made Tata the largest single employer in the UK manufacturing sector.

There is more Indian investment in the UK than in all other EU countries combined. Vodafone's purchase of Hutch Essar, the mobile operator, and BP's partnership with Reliance Industries, India's foremost oil, gas and petrochemicals group, were major ventures in the other direction. But, in general, notwithstanding the significance of these big tie-ups, both countries acknowledge that the potential for more intensive economic co-operation remains to a great extent untapped and will remain so until key liberalising reforms are undertaken by the Indian government.

Human rights and democracy

Indian objections to the inclusion of a standard 'human rights and democracy' clause in the proposed FTA have the potential to re-emerge as a serious stumbling block. This clause, which is likely to be discussed in the end-game of the negotiations, could be a deal-breaker for India.

Making human rights observance an 'essential element' and a condition of trade terms and development aid gives the EU the ultimate right to suspend all or part of an agreement if a partner country does not fulfil its human rights obligations. New Delhi argues that the 'essential elements' clause conflicts with India's longstanding position that economic agreements should not be 'contaminated' by political riders. It suspects that such clauses provide protectionist cover and is unlikely to give ground.

Since a decision by the EU Council in 1995, which was re-affirmed in 2008, the European Commission has systematically included this 'essential elements' clause in bilateral trade and co-operation agreements. It now applies to agreements with more than 120 countries. The FTA is therefore caught between an irresistible force and an immoveable object.

The Commission has triggered an intense debate among the EU's member states by pushing for an apparent exception for India, on the grounds that a 1994 EU–India co-operation agreement covers human rights questions.[13]

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13 1994 Cooperation Agreement between the European Community and the Republic of India on partnership and development,http://www.europarl.europa.eu/meetdocs/2004_2009/documents/fd/dsaa11102004_002/dsaa11102004_002en.pdf

Given how much both countries can potentially gain from the FTA, the Commission argues that the FTA should leave more political considerations for other agreements. Feeling is equally strong in sections of the European Parliament on the need for consistency across FTAs. India is a member of the United Nations Human Rights Council, but ranks low, according to the Asian Human Rights Commission, among the international community in terms of the ratification of international conventions and covenants.

The benefits to India

For all India's bubbling self-confidence, the reality is that it is barely a lower-middle income economy, with a nominal per capita income little above a thousand dollars and with more than 300 million Indians living in absolute poverty. It faces a huge challenge in generating the jobs necessary to absorb the rising numbers of entrants to the country's workforce. To meet global expectations and to achieve its development targets, India will have to focus on a few critical drivers, with which the UK can help in material ways.

The first is to abandon the notion that a demographic dividend will materialise mechanically from its vast young population and accept the hard reality that it will have to be earned, via a human resources and skills revolution. The second is to jettison the myth that the economy and the private sector can continue to grow 'despite the government'. The third is to overcome energy shortages and to provide sufficient capacity, preferably from renewable sources, to meet the needs of its fast-growing economy. The fourth is to make agricultural modernisation and the boosting of income levels of those engaged in agriculture a priority. Fifth, and last, India should recognise that its breakneck urbanisation has hitherto been largely unplanned and that this has to be urgently rectified.

India is making often astonishing progress, but its rise is not yet a done deal. It faces many potential futures, not all of them rosy, and cannot be complacent. As the authors of an influential recent essay on New Delhi's strategic policy have noted, India has a 'limited window of opportunity in which to seize [its] chances' and if it is 'to avoid the "middle income trap" that has afflicted many other societies where growth rates experienced rapid acceleration only to peter out, then it will have to move decisively and rapidly across a range of fronts'.[14]

As the UK is still the seventh-largest economy in the world and one of the most open, it should be an attractive partner to India.

Its capabilities in education and skills development; in farm-to-fork cold chain management and retailing; in banking, infrastructure finance and insurance; in pharmaceuticals and life sciences; and in urban planning, architecture and design, to name just a few promising sectors, are directly relevant to India's most pressing needs. It is in India's interests, as much as Britain's, for the two countries to engage more intensively and to become more inter-dependent than they are at present.

Five ways to expand UK–India trade and investment

The UK can strengthen an already strong economic relationship by focusing on a few core areas where it needs revitalising.

Maximise UK influence in the EU

First, as trade is an exclusive EU competence, the coalition must maximize Britain's influence in Brussels so that the Commission reflects UK interests to the greatest extent possible in the negotiations over the long-awaited EU-India Free Trade Agreement. A comprehensive FTA that addresses considerable remaining tariff and non-tariff barriers, particularly on the services side, could deliver significant economic benefits as well as helping to reduce poverty in India. The coalition, on a bilateral basis, through the on-going Economic and Financial Dialogue and other mechanisms, must also continue to encourage further liberalisation of Indian markets, particularly for financial and professional services and for goods, including wines and spirits, defence, chemicals and automotive parts. The conclusion of an ambitious FTA (and, of course, of the Doha Round, in which India is a key player) would make it more likely that the UK will achieve its objective of doubling trade with India by 2015.

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14 Nonalignment 2.0: A Foreign and Strategic Policy for India in the Twenty-First Century, Centre for Policy Research. Sunil Khilnani, Rajiv Kumar, Pratap Bhanu Mehta, Lt. Gen. (Retd.), Prakash Menon, Nandan Nilekani, Srinath Raghavan, Shyam Saran, Siddharth Varadarajan

Business first

Second, the coalition must encourage businesses to rise to the challenge of exporting to a country rightly seen as 'difficult'. India never scores highly in surveys measuring the ease of doing business. In the World Bank's 2011 survey of 183 countries, India ranked 134th, behind Brazil (127th), Russia (123rd) and China (79th).

In terms of enforcing contracts through the court system, a critical attribute of any market economy, India scores appallingly, coming 182nd of 183 countries. The World Bank estimates going to court to enforce a contract involves 46 procedures, takes an average of 1,420 days and consumes 40 per cent of the value of any claim. Obstacles such as this explain why surveys consistently show that UK firms are wary of pro-actively seeking out business opportunities in these priority markets.

Smaller and innovative firms have in the past experienced disproportionate barriers to exporting to India. Recent surveys show that only 23 per cent of UK SMEs export, compared to an EU average of 25 per cent, a shortfall of 100,000 firms that could deliver a potential £30 billion to the UK economy if they rise to the challenge. This is a legitimate area for vigorous government intervention, and the drive to reform both UKTI and the Export Credits Guarantee Department, renamed UK Export Finance, is welcome.

Take up of UK Export Finance (formerly ECGD) products aimed at SMEs has in the past been disappointing, with the UK's official export financing arm underperforming comparable bodies such as France's Coface and Germany's Hermes. The ECGD's chief executive, Patrick Crawford, is now explicitly targeting 'the many small exporters who have never heard of us' and it will be important for that organisation to be held to account for its progress in this respect.

Connectivity

Third, we must overhaul connectivity to the big emerging markets. While London has excellent direct connections to its traditional business partners, it lags behind European competitors in serving the BRICs.

London has 215 departures a week to New York, for example, but only 31 a week to two destinations in mainland China (compared to 64 to three such cities from Paris Charles de Gaulle and 56 to four such cities from Frankfurt). UK–India air traffic has trebled in the last five years, due to the liberalisation of the UK–India market, but this rate of growth will be hard to sustain given the UK's historic failure to make long-term provision for runway capacity in the South East. This will be a major brake on our ability to capitalize on the commercial opportunities presented by growth in India, as well as other fast-growing emerging markets, and is expected to cost the UK economy up to £14 billion over the next decade.

Runway utilisation at Heathrow is operating at 98.5 per cent, compared to 70 per cent to 75 per cent at other big European airports, such as Paris Charles de Gaulle, Amsterdam and Frankfurt. This is causing delays and reliability problems that are damaging Britain's attractiveness, and restricts London's ability to expand to new markets without sacrificing existing ones. Jakarta, Osaka, Caracas and Bogotá have all been removed from Heathrow's destination boards in recent years, while Lima, Manila, Panama City and Guangzhou have never been available. They are all served by London's three main rivals. All options for expanding hub capacity for London are controversial but all options need to be urgently considered, including the construction of a new hub airport in the Thames Estuary.

Aid

Fourth, we need to overhaul an anachronistic donor-recipient aid relationship, which risks trapping Britain in some outdated attitudes towards its former colony. After a decade in which the UK sharply increased its aid to India to make it the Department for International Development (DfID)'s single largest country programme, the tide is now turning. Under Andrew Mitchell and Justine Greening's leadership between 2010 and 2012, DfID has been rapidly downscaling its cash commitments to India, while shifting the focus to technical assistance.

India is now emerging as an aid power in its own right, as demonstrated in July 2011 by New Delhi's announcement that it intended to set up its own $11 billion development agency. A new era of partnership in international development is emerging and

Britain and India have an opportunity to be in the vanguard of this process, working together, as equal partners, to reduce poverty in other developing countries.

Talent

Fifth, we must embrace global talent, which is in superabundance in India, not put up bureaucratic barriers to it. Britain has a strong base on which to build. It is the preferred launch-pad for Indian firms hoping to conquer European markets, with more companies headquartered here than in all other EU Member States combined. London has an unrivalled place in the hearts of the Indian wealth-generating class. Le tout Delhi is in London in June, drawn by the mild climate, Wimbledon and the cultural activities the British capital has to offer. It still remains the preferred place for the affluent to buy their first home outside India.

But links between students, especially through universities, are not as strong as they could be. Indeed, British universities attract more people from China than they do from India, despite our stronger historical and cultural links with the subcontinent. A 2010 British Council report based on market research confirmed a widely-held belief that 'students tend to choose a country first before choosing a university, meaning that it is crucial to build a national brand showing the UK as a safe and exciting place to study, offering a rich life experience and enhanced career prospects'.

Students invest in British education both to improve their job prospects back in their home country and to find post-study work in the UK. If the UK signals that it is no longer 'open for business', students will quickly choose countries they think are, such as Australia, Canada and the US. Australia is especially keen to earn its slice of the market: in October 2011, its government announced sweeping reforms to liberalise its student visa system. Britain is in danger of being seen to be moving in the opposite direction.

The UK is right to be debating how best to account for students in immigration statistics. Tapping top-flight student talent globally will not just mean the UK gains in terms of innovation, research and a broader science and skills base. Greater exchange of students now will mean stronger relationships later. The UK cannot afford to lose touch with the next generation of opinion-formers, let 'Britishness' become a currency of depreciating value for a more

Americanised elite, or allow Britain to recede further as a cultural reference point.

Conclusion

The emergence of new powers in the east and south has led to a sensible shift in the UK's focus from the Euro–Atlantic world towards a more multi-polar world. Progress in forging an 'enhanced partnership' with India over the last two years has been significant and welcome. The 40 per cent growth in trade in 2011 is emblematic of this renewed vigour in the relationship, but there is much more to be done. It is a concern that the UK is in some quarters seen as a country of diminishing relevance in India, as indicated by a leading research institute in Delhi recently ranking India's strategic partnership with Britain as less significant than the one with France in terms of its historical significance and potential for the future.[15]

This reflects a worrying disconnect between perceptions of what Britain offers and the reality of the UK as a friendly country with relevant capabilities, not just in financial services, but across a wide spectrum of India's needs as a developing economy and emerging global power. It also mirrors a broader disenchantment in New Delhi with the idea that the EU, as a plural, composite and democratic polity of 27 nations and 500 million people, can provide any kind of positive reference point for India as it builds up its own national power as a huge multi-lingual, multicultural state with a federal form of government and constructs its own continent-sized internal market. Mired in the Eurozone crisis, the EU as a whole is at risk of being seen as an agglomeration of declining countries rendered rudderless by baroque decision-making processes, a deepening democratic deficit and lack of political solidarity between member states.[16]

Unless Europe puts itself back on a growth path, by undertaking structural reform and completing the single market, it will lose its appeal as a strategic partner for India and the UK will lose its value

15 India's Strategic Partners: A Comparative Assessment, Foundation for National Security Research, November 2011.

16 Chinese and Indian views of Europe since the crisis: New perspectives from the emerging Asian giants , Karine Lisbonne-de Vergeron, Konrad Adenauer Stiftung and the Global Policy Institute, 2011

as a bridgehead to Europe. Equally, there is awareness among reformers in New Delhi that India still faces a broad range of potential futures, not all of them happy, and that further economic reform is the key to prosperity for many tens of millions. Over the 20 years since the onset of the reform era, India has benefited hugely from liberalisation, but a second wave of reforms, whether linked to an EU–India FTA or not, is long overdue. The choices India makes in the coming years, while it still has a chance of reaping a demographic dividend from its young and growing workforce, will set the parameters of its potential for decades to come.

Acknowledgments
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Closing the Trade Gap

Sir Alan Rudge

A particularly strong negative trend in the UK's balance of trade became increasingly evident from 1998, which was the last time the UK was close to achieving a trade balance. Since then the deficit worsened progressively at the rate of about 20 per cent per year until disrupted by the effects of the banking crash in 2008. The crash reduced the trade deficit temporarily but added substantially to our national debt. Since 1998, the UK's trade deficit in goods has grown to approximately £100 billion per year. This has been only partially offset by a surplus in services and investment income and the net position is a deficit of the order of £40 billion per year. To put this in perspective, the defence budget is less than £40 billion per year.

Throughout this period the balance of payments deficit has been financed primarily by the sale of debt and assets. Annual interest payments are now in the order of £50 billion per annum. The bulk of the UK's gold reserves are long gone, and more than 2000 UK companies were sold into foreign ownership in the last decade. In many sectors the large enterprises, those with more than a thousand employees, are now predominantly foreign-owned, and this includes manufacture, mining utilities and transport. In manufacturing, more than 60 per cent of large companies are foreign-owned and controlled. The UK is home to 228 large manufacturing companies by that definition, and only 93 are UK-owned. While there are some excellent examples of foreign investment, there are equal tales of plant closures and job losses. One of the key characteristics is the lack of interest in export markets. Most of these companies are not acquired by international groups to sell their products to China. They are acquired to manufacture and sell locally. This is one of the reasons why government has trouble in exciting their interest in foreign markets.

The overall picture of the UK is one of a nation living above its means. It is consuming more goods and services than it is able to pay for by trade and earnings abroad. This is a nation which has been borrowing and selling assets to finance consumption, rather than to invest in productive wealth creation. This is not a sustainable economy, and it is not a very comfortable starting point for the coalition government. Substantial action must be taken to avoid serious economic decline. The ONS Trade and Payments data provides an indication of the main issues and it is clear that to maintain the current standard of living in the UK, the problems within manufacturing need to be resolved.

Since 1998 the trade deficit in finished manufactured goods grew steadily, reaching £60 billion per annum in 2008. It is currently hovering around this level; the negative trend is likely to be re-established unless some action is taken. There needs to be a government campaign to close the trade gap. Manufacturing in the UK has declined from 22 per cent of the nation's gross domestic product to 11 per cent since 1998. From being the fourth largest manufacturing nation in the early 1990s and sixth three years ago, the UK is now ninth, and if current trends continue will be out of the top ten within this decade. In terms of investment, for example in machine tools, the UK rates twenty-seventh in the world. The high exchange rate has had a gradual effect on profits which has affected companies' ability to invest. If companies can't invest in capital equipment for the future they have nothing to build upon.

Despite this decline in terms of investment, however, the frequently repeated mantra that the UK is a post-industrial nation is dangerous nonsense. Manufacturing still provides nearly half of all the UK's exports, and three quarters of the nation's R&D. It is hard to see how to maintain the current standard of living without it. If the UK is not an industrial nation, then what does define it?

The following options, or a combination of these options, are available to close the trade gap and restore the current account without continuing the practise of increasing debt and selling assets. One, increase manufacturing exports by 10 per cent and substitute manufactured imports by 10 per cent. Two, increase financial services' exports by 100 per cent. Three, increase all the other knowledge-based businesses' exports by 150 per cent.

To implement a strategy based primarily on massive increases in exportable financial or knowledge-based services, even if they were feasible or desirable, would result in a very unbalanced economy. In terms of scale alone, a 20 per cent growth in manufacturing would seem to be a far more realistic objective and deserves some priority.

In 2008 the ERA Foundation started a series of studies on the sustainability of the UK economy in an era of declining productivity. The first three reports identified the problem based on the ONS data and the fourth report provides a framework for the way forward, defining a core objective of an industrial strategy. To use an analogy: If some of the plants die in a greenhouse, examine the plants. If all the plants are withering in a greenhouse, examine the greenhouse. The ERA Foundation considered the latter was closer to the truth for UK manufacturing and by means of surveys and interviews with knowledgeable industrialists, it established a list of 31 parameters which influence the environment for manufacturing investment and operations in the UK. The intention was that in the process of establishing an industrial policy, government could work down this list and attempt to optimise as many of the parameters as possible in favour of productive industry. The report was used to lobby the then government and both opposition parties. The message that manufacturing matters has achieved a higher profile with the new government. Some of the identified parameters have been given attention but not necessarily at the right scale or within the integrated industrial strategy that the ERA Foundation found to be necessary.

If there is to be a re-growth in productive industry in the UK then small and medium-sized enterprises, the SME sector, is a key element. It provides half of the UK's total GDP, has been very poorly served by the UK banking system and has received far too little attention from government. The decision by the coalition government to reduce the capital allowances for small and medium-sized companies has only made matters worse. In Germany, by contrast, SMEs can offset capital investment against tax. Germany also displays a work ethic that values engineering and manufacturing alongside relatively good access to funding with its network of savings banks providing around half of all Germany's investment in industry. There may be lessons to be learned from there.

The UK must make it easier for SMEs to raise funds for investment to keep their costs low. This cannot be just a few small changes around the edges – bold steps towards change must be taken. SMEs need to have much improved access to funding. The SME sector has quite different problems from those of the large manufacturers and this has to be understood and dealt with appropriately. The ERA Foundation has produced a report supporting the case for a bank for industry to attack the lack of finance, one of the key barriers to growth of the sector. The regeneration of the UK's manufacturing base is a huge but not insurmountable challenge. It will not occur with a few political initiatives, or the complacent hope that it will all come right in the end, although that is a position that has been adopted by some economists. As a minimum it requires commitment and leadership from the top, a national industrial strategy with the highest priority, headed up by a minister with Cabinet rank. There needs to be an industrial strategy with objectives that recognise the different requirements of the small and medium-sized sector and the large companies.

Government's first responsibility is to establish a fertile environment for manufacturing investment and operations. This should not be coloured by political objectives or social engineering or ill-conceived legislation such as the 2008 Climate Change Act, which is hugely damaging to industry. It is particularly relevant to the small and medium-sized sector, which requires no government advice on picking winners. It would have been impossible for a government to predict bicycles would be a source of a sensible, international business. Individual, innovative ideas will come from the SMEs, which are largely UK-owned and controlled.

Government and politicians cannot decide what is going to be successful and what is not. The first objective of government should be to create an environment where it is attractive to both invest and operate manufacturing businesses in the UK. Government should create the fertile environment and leave the choice to the entrepreneurs.

Secondly, the government should work closely with the larger companies in industry to select key sectors both requiring and worthy of more direct support. The national interest should be a major factor. This will directly affect the larger companies but it will also affect their supply chains, so picking the right sectors is very important.

Finally, the government should instigate an independent review of the UK's policy of an open economy, and the positives and negatives of this to the nation as a whole, rather than only the benefits accruing to the City. The UK is the only country in the world to have permitted such a policy. Two-thirds of all the foreign direct investment over the last decade has been to acquire UK companies rather than for new greenfield investment. The UK must beware of a move away from an industrial economy, or even a service economy, towards a servant economy where it only provides labour for other nation's industries. There needs to be a long term view – the drive to deliver short-term shareholder value has been very damaging for UK industry, leading to break-ups and sell-offs. These issues merit some urgent attention.

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Promoting the Engineering Profession

Will Butler-Adams

There is good will within the coalition to balance the economy but it is no good balancing the economy if those people who are going to do the balancing don't approach this from the perspective of the UK's education system. Alongside my role at Brompton, I am a trustee of the Education and Employers Taskforce, a charity which goes into schools to try to inspire the next generation. I am particularly interested in manufacturing and engineering and I have been to quite a few schools with the charity. There is a monstrous misunderstanding of what engineering and manufacturing are in the UK, and there is an absolute misunderstanding of what it is to be an engineer.

Perhaps it doesn't help that I turn up on a bicycle in a pair of shorts, but the belief is that an engineer is somebody who comes to your house to fix your tap. If this misunderstanding endures, young people will not go into the engineering profession. They may be excited about it, but they will be discouraged by their parents or their teachers, due to a lack of understanding of the industry. Parents will encourage their children to become doctors or lawyers or maybe even bankers.

At the moment manufacturing is failing to attract the best brains to build businesses for the future. Children have to make the choice to go into engineering at an early stage in their education – as early as when they make their GCSE choices. This is different to many other professions – classics graduates can go into law or finance, but engineers need to plan for their future careers much earlier on in their education. The cleverest people I knew through my school and university years became bankers, doctors and lawyers. They all disappeared off into other professions. Only two of us from my engineering degree course at Newcastle University are practicing engineers. The UK needs to encourage more children to go into engineering, to stay in engineering, to set up businesses and take risks, to build up our manufacturing for the future.

In Germany, I would be introduced as Engineer Butler-Adams. Engineering has a totally different aura around it there, and that needs to be mirrored here. The government should regulate the use of the term 'engineer', so that it only refers to qualified professionals. This will help to elevate the status of an engineer to that of a solicitor or doctor and would attract more students into the profession.

There has been a propensity in the government, through enthusiastic misunderstanding, to believe that the way to rebalance the economy is through cutting-edge technology – nanotechnology, pioneering development or developing the next iPad. This must be applauded, but engineering takes a long time. These technologies take years to develop before they become commercially viable. What the government is overlooking are the thousands of SMEs running well below their operational capability. There are many businesses which are manufacturing with less than 20 staff in the UK and are still in existence after the recent recession. These companies may have gone through a succession from inspired founders to the toolmaker who managed to get enough money together to buy the business. These businesses often don't even have AutoCAD, which is a basic piece of equipment. Recently, we were visited at Brompton's factory by a man who has taken over his father's plastic injection mould company. He employs fourteen people, has introduced CAD but his company does not have a rapid model-making machine. It would be an obvious addition for his company to make, but requires a capital injection. There is so much potential in the UK for improving the efficiency of what is already being done well. GrowthAccelerator, a £200 million programme delivering growth support for England's most ambitious small businesses, has the potential to help in this area.

It is important to highlight the great things that are going on in British engineering. One in four Ford engines are made in the UK and Triumph are selling more motorcycles in the US than Harley Davidson. It is possible for the UK to export more. The UK is innovative, has a good reputation and exports popular products in expanding markets such as Asia. It must focus on its strengths. There are many examples of businesses succeeding and doing what other businesses could be doing. Talented risk-takers need to be encouraged to build businesses and become household names. Manufacturing growth can be restored – there is so much potential to change the state of manufacturing in the UK. The solutions are there to be found. The politicians need to understand which direction to take.

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An Economist's Perspective

David Tinsley

The UK is among the top ten of the largest trading nations in the world and is the third biggest exporter of services in the world behind the US and Germany, which is impressive considering it has a population of 60 million in a world of seven billion.

Even during the recession and the subsequent recovery that has petered out, net trade contributed two percentage points to the level of GDP which went some way to offsetting the overall 4.4 per cent drop in the level of GDP over that period. Exports are up three per cent and imports are down. There are challenges and the UK could do better, but the export sector in the broader sense, the net trade sector, is making an important contribution. Before the recession export growth was consistent, averaging around four per cent for goods and around 4.8 per cent for goods and services. Since the recession and the subsequent recovery, the average growth rate is down at around 0.7 per cent.

The data reveals where the weakness lies. When considering the two episodes of an abrupt falling exchange rate, after the UK exited the ERM and the 2007/2008 exchange rate depreciation, the performance of the level of goods exports is broadly similar. When the UK dropped out of the ERM, goods exports after twelve quarters were up 24 per cent. Twelve quarters following 2009, after the 2007 to 2008 depreciation, goods exports are up 19.5 per cent. Some of this represents a rebound from a large fall in 2008, but given the weakness in global demand over the last few years, the UK's share of goods exports has responded at least as well as might have been expected after an exchange rate depreciation.

The overall performance, however, is somewhat limited. The drop has been in financial services exports, which are about 33 per cent of total services exports. Financial services exports have fallen 20 per cent since 2008. A key consideration for the outlook and the future of UK exports overall is whether financial services exports can be made good in their own right or whether the hole has to be filled by other means if there is a structural shift down in the level of financial services exports. It is worth noting that outside of the financial services, the UK has many creative and knowledge-based scientific industries that can add a great deal to exports.

Around 47 per cent of UK goods go to the Eurozone, but when service exports are factored in, the figure for the EU is down to 40 per cent. A breakdown by country shows that the US is still the UK's single biggest trading partner at 13.3 per cent of exports, followed by Germany at 10.9 per cent. Some of the peripheral European companies that are experiencing the most violent financial market tension are still relatively small in terms of UK export share – for example Spain at 3.2 per cent and Greece at 0.4 per cent.

The UK exports for many other markets, however, are disappointing. The UK exports 3.1 per cent of total exports to China, which makes up 19 per cent of the global population. China and India jointly make up just over 35 per cent of the total world population, yet jointly only take five per cent of the UK's total exports. There is an opportunity for the UK as these markets mature and their per capita GDP rises, but there will be challenges in exporting to these markets for linguistic, cultural and regulatory reasons. The UK must not ignore its existing markets, particularly the United States, whose economy is expected to be growing at a reasonable rate in two or three years' time. It is important to do more in terms of directing trade to the BRICs, but the UK must not be seduced into thinking it can't do more close to home, where there are long-standing trading ties in place.

Understanding the UK's marked difference in export performance across various countries and sectors is the first part of making good policy in terms of addressing them. For example, although relatively little is presently exported to Brazil over all, the UK forms 13 per cent of Brazilian imports of printed materials. The UK does well in terms of pharmaceutical exports to the US, but Germany and France do substantially better in terms of exports to Mexico, just south of the US border. The UK tends to do well when exporting to higher GDP markets but performs less well in some of the lower GDP markets. The UK could expand its exports to Latin America. The region has seen an increase in GDP and the UK should be taking advantage of Latin America's close geographical location to the US, where it is already exporting successfully.

Small and medium-sized enterprises are very important. Over two-thirds of trade growth, according to some studies, has come from new firms entering markets rather than existing firms expanding exports. According to some studies, 23 per cent of SMEs export goods, while a large proportion either don't export at all or export a relatively small number of products. There is certainly scope in terms of generating export-led growth to improve upon some of those records. Exports can be improved at the extensive margin and the intensive margin. The extensive margin is persuading or helping firms to export; the intensive margin is persuading or helping firms which already do export, to export more. Those two different characteristics will not necessarily require the same policy response, and it could be argued that given the fixed costs of entering markets, there may be a bigger role for policy on the extensive margin than the intensive margin.

In a time of austerity, policy needs to be realistic. It is worth focusing on firms that don't export at all. Large corporates can largely take care of themselves and buy in services from others, so government should focus on the small and medium-sized enterprises and the extensive margin. Government needs to do what it is responsible for. The Doha trade round needs to be up and running again and the interests of the UK need to be represented in the EU. The government has to run sensible macroeconomic policy, as many of those gains from the small one percentage point fall in the corporate tax rate could be wiped out by careless macroeconomic policy that leads to exchange rate volatility. Much more needs to be done in terms of making credit available to smaller companies to generate some of this export-led growth.

It is arguable that the growth of the financial services sector contributed to the appreciation of the exchange rate in the late 1990s and that this put a squeeze on manufacturing. It also saw a move among graduates from engineering to banking. Government-backed incentive structures may now be needed to encourage these graduates back into manufacturing and engineering.

There is no doubt that the next few years are going to be difficult and that under any scenario the Eurozone is going to grow slowly. The US recovery is more firmly entrenched but nonetheless sporadic and it is going to take time for exporters to make progress in new markets. However, there is a role for policy to play, and it can make a difference. The Bank of England and the Treasury can help exporters by expanding credit to small and medium-sized businesses and by preparing the infrastructure for successful growth for the future. There is no need for excessive pessimism about the UK's ability to improve its export margins.

PART 5

Rebalancing the Boardroom: Diversity and Remuneration

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Improving Diversity in the Boardroom: The Experience of the 30% Club

Helena Morrissey

Nobody now disputes, at least not openly, the importance of improving female representation in the boardroom. Nevertheless, the last few years have seen a remarkable sea-change in attitudes about how we should achieve this task.

Perhaps it would be instructive to start at the beginning of the 30% Club story. We formed in November 2010 with the simple aim of trying to increase the number of women in the boardrooms of the UK's top companies.

The germ of the idea came six months earlier, in May 2012, after I attended a meeting about the annual Female FTSE report by the Cranfield School of Management. That report revealed that only 12 per cent of FTSE directors were women and it became clear that not enough was being done to get women in the boardroom. It was also clear that what was required as a response was a serious, concerted effort made from within the business community. One of the obvious benefits of the push being spearheaded by a non-commercial organisation, was that it could be trusted to provide a safe, non-commercially threatening space from which to co-ordinate sector-wide activity. So with just seven founding members – all chairmen of major companies – the 30% Club was born. In just a short space of time we have grown substantially, with 53 chairmen now signed up to the Club, over half of which are chairmen of FTSE 100 companies.

Aside from promoting the positive benefits of boardroom diversity more broadly, our target is, obviously, for women to make up 30 per cent of corporate board members. And, dealing with the numbers first, we have made significant progress towards this headline figure. This year Boardwatch, the professional boards forum that monitors the appointment of women to UK boards, reported that 44 per cent of new non-executive director appointments in the FTSE 100 were being offered to women. Clearly this is a huge improvement on 2010 levels, when only 13 per cent of those appointments went to women. Even last year the figure was only 30 per cent.

All the figures are moving in the right direction, which reflects a deeper change as to how the problem is viewed amongst leading chairmen. In short, the diversity 'problem' has been legitimised and there is an improved understanding of the benefits of diversity. We no longer need to justify the importance of the campaign to chairmen who dispute or dismiss the need for action. Indeed, the question we routinely face is no longer 'why is this important' but rather 'how do we actually achieve change?'

With legitimacy firmly established, delivering this has now become our key challenge. Discussion about improving the gender balance in boardrooms tends to be dominated by one issue: quotas. The 30% Club seeks to achieve change by working with companies to find long-term practical solutions to the problem. This does not involve the setting of prescriptive targets or compulsory quotas.

There are a number of reasons for adopting this approach. First, there is a feeling that quotas can be a hindrance to genuine engagement with the issue. Without this engagement, it is not difficult to imagine scenarios where companies would concentrate on ticking the right boxes, achieving a 25 per cent or 30 per cent quota, but would carry on in exactly the same manner in terms of their attitude and culture. Cosmetic change is not good enough: companies will only tackle the deeper issues, such as business culture and practices, without quotas. Put simply, they need to believe that the work is good and necessary for their businesses and that it is the right thing to do, not something that they are only doing because they have been told to do so.

Furthermore, quotas would be ineffective in solving the gender imbalance because, arguably, it is not structural barriers that limit women's progression within the executive sector. The correct frameworks, in terms of rules, are already in place. What we are dealing with is a much broader set of issues, involving sociology and business culture.

Therefore, there is much to commend in the government's current approach, which strikes the right balance between keeping the spotlight on the issue and not being too heavy-handed with prescriptive regulation. Both Theresa May [Secretary of State for Women & Equalities] and Vince Cable [Secretary of State for Business, Innovation and Skills] advocated a strong business-led approach at a recent 30% Club event, held to celebrate reaching 50 chairmen signing up to our programme. However, both also hinted at the possibility of a more sanctions-orientated approach if sufficient progress is not made. This is important; whilst in an ideal world people would be convinced for business or even moral reasons, having strong government support always acts as a catalyst for change.

Yet the business-led approach remains the best one. Whilst so much of the work that needs to be done concerns attitudes within the sector, the only effective approach to driving change is an internal one. For example, a current 30% Club initiative is attempting to try and increase the number of prominent and successful women within companies that are prepared to put themselves forward as role models for younger women within the wider sector. In the past this is something that has proved problematic, with many women reluctant to take on the issue of gender within the sector themselves. There are a number of reasons why this might occur, (not least the pressures of the day job!) however the main one is fear of being seen to play the 'women's card'. Women are understandably scared to put themselves at risk of further marginalisation. Indeed, this is precisely how I felt myself when I first became a Chief Executive. Ultimately, we need to make women, particularly in leadership roles, feel more comfortable with the responsibility of being a role model for younger women within the sector, particularly when this concerns the ever important issue of managing work and family commitments. There are encouraging signs that this is beginning to change, again a positive effect of the increased legitimacy. Nevertheless, it remains an area where improvement is necessary. This example also demonstrates the strength of the business-led approach and the limitations of prescription from outside – how could these subtler points be tackled from outside the sector?

Another point that this example raises is that the importance of increasing the supply of senior female talent is not one that can be fixed overnight. You cannot artificially create a female role model who, for example, is a CFO or a senior trader in a bank as they will not command the respect of less senior women within the company without having actually stayed the course and worked their way up from the bottom themselves. Tokenism is of no help – respect and 'role model status' must be earned (something which is surely true of the internal politics of all companies!).

The 30% Club started as an initiative addressing the numbers of women on the board. But sustainable, meaningful change, the sort of change that can contribute to a more balanced economy, requires more. It is not just about the people at the top and the boardroom. We recognise that we must make an effort to support women when they begin their careers – something that companies should be dedicated to doing themselves, of course. The professional services firms, lawyers and accountants experience particular difficulties in sustaining their pipelines. The high attrition rate, of women leaving the sector, is well known. There are often more than 50 per cent of women at entry level, but only 10 to 15 per cent go on to become partners, whether it be in legal services, finance, accounting or consultancy. If anything this imbalance is more damaging than the lack of diversity at executive level and therefore it presents a massive challenge for all of us, albeit one that these firms are now openly starting to address.

Ultimately, the main message is one of hope. There is now a far greater appreciation that women deserve to have a seat at the table and need to be listened to. And this is not being done begrudgingly but because the diversity of perspectives women can provide are valued. Of course it is regrettable that the importance of these perspectives is only just being acknowledged by many companies. Indeed, often the staunchest supporters of the 30% Club are those who were originally the most reluctant! I vividly remember one chairman assuring me that this campaign was not, in any way, for him. Six months later he contacted me of his own volition and joined up. His volte-face was grounded in his own experience from when his real estate company embarked upon a joint venture in China. As befits the macho culture stereotype, the entirely male company board were eager to seal the deal as quickly as possible. However, the one woman on the board piped up just as they were about to sign, suggesting that she was deeply concerned about one particular aspect about the venture. After taking extra time out to re-read the contract, they realised she was absolutely right. Had the chairman followed the macho groupthink, single-minded in its desire to get the win, then the obvious defect in the contract would have been missed and he would have signed a flawed deal.

Slowly but surely, the benefits to business of having different perspectives and experiences in the boardroom are permeating throughout the sector. Perhaps the financial crisis has had an impact. Companies are recognising that the world is a completely different place to five years ago. There have been a series of cataclysmic revelations indicating that boards have not overseen executive management teams effectively enough – the LIBOR scandal is just the latest of long list. Lord Davies' recommendations and the 30% Club's work have focused initially on gender. Yet there is an opportunity to act as a catalyst for a broader debate about the overall effectiveness of our boardrooms. We should not gloss over the difficulties that women and other minorities continue to face on a daily basis, but there is a palpable will to change things in many businesses. What is important is that political mud-slinging and the popular backlash generated by the recession, certainly against the financial sector, does not work against the positive desire to change from within the sector – because it could. Many people will recoil from the idea of helping the banks. Yet we need to look forward as a country and ask questions such as 'what does an effective board look like?', 'how is an efficient management team structure?', 'what business culture do we need to embed?', and 'how should businesses function in today's financial climate?'. Government has a role to play in making sure that this conversation takes place and does not get drowned out by populist anger or wider criticisms of our economic model.

Finally, it is important to stress that, in terms of gender roles, we remain a generation in transition. The traditional model, with a stay at home mother and a father that provided for his family through work, led to the existing culture of business and working practices being centred on male cultural tendencies. However, with the help of modern technological advances, future generations can and will work very differently. This gives us the opportunity to completely rethink a lot of the practices that adhere to a rather rigid system – the 'old boys' network'. We should welcome the different opinions and different perspectives that will help us to make the right decision for the future.

Ultimately, you cannot legislate for behaviour that, in an ethical sense, is either wrong or right in terms of how our banks and businesses operate. But we can improve the wider business environment. The recession and its far reaching consequences in terms of cultural impact, means that we are effectively pushing at an open door. It is vital that we seize this moment and work together, pragmatically, to create a better, more balanced business sector.

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'Marzipan Managers', Diversity and Productivity

Julia Hobsbawm

Clearly boardroom diversity is an issue that has received a tremendous amount of coverage in recent weeks and months. When you have a seismic moment in the UK economy such as LIBOR, and in one of our key industries of comparative advantage, to have no woman even mentioned as a potential candidate to take on the senior executive role and repair the damage within the sector seems extraordinary. For these reasons, perhaps it is understandable that the headlines focus on the top, the senior executives and directors.

Yet, perhaps it is unhelpful to always view the issue of diversity through this prism. We need to focus, not just on the boardroom, but on the entire workforce and arguably the extensive focus we place on leadership itself is misguided, as it leads to a 'bottleneck' approach which only addresses the most visible aspect of the underlying problem. Furthermore, whilst, to quote the best-selling book *Half the Sky*, it is important that we continually consider half the population in terms of gender, inequalities in the boardroom, workplace and in senior management are about much more than just gender. They are also profoundly about class and race; and unless we rebalance comprehensively and holistically, we are only going to create a partial, one-sided and ultimately myopic solution.

We live in a county that is still associated with, if not outright dominated by, 'the old boys' network'. Therefore the establishment including parliament itself, in which networks are formed by an elite group of schools and institutions, is justifiably dogged by such accusations. Unless we see a big and, frankly, unlikely shift in the way the country is structured, the solution must be to extend and change the manner in which the networks operate. Britain's old boys' network historically created a narrow elite, an Establishment from the same schools and same networks which is no longer fit for purpose. We need social and intellectual plurality to get social and professional mobility.

The motivation for this is simple: productivity. This is about making the UK economy rebalanced, more effective and more productive. The Department for Business, Innovation and Skills routinely publish papers, including one only seven months ago in association with the London School of Economics, on the constraints placed upon developing UK management practice and its impact on productivity levels. These reports point out what we already know about UK productivity levels – that they are 'distinctly mid-table by international standards for developed countries'.[1] We are behind France, we are behind Germany and of course we are way behind the USA.

The only way to change this is to look at skills and education, which are absolutely critical and paramount to changing our productivity dynamic. As that same paper points out: 'there is a strong correlation between better management practice measures of a manager and worker education.'[2] Put simply, better management produces better outcomes. This is where the cultural change, which we all prefer over the legislative big stick, becomes important as it seems to me to be a statement of the obvious that a motivated, engaged, included, happy worker is a more productive worker. In contrast, somebody who is isolated, marginalised, placed under the stress of having to develop sharp elbows just to survive whilst they are worrying about childcare, or someone who feels that they belong to a voiceless minority within the workplace, is simply not going to be as motivated or productive as they can be. Workers need to be brought into the existing networks within businesses and feel that they are supported as valued members of the organisation.

In many ways, if the government recognised this, then the issue becomes in some senses far more simple than it is complicated, as they too need to become part of this network of inclusion. It

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1 Leadership and Management in the UK: The Key to sustainable Growth.' BIS. London. July 2012. http://www.bis.gov.uk/assets/biscore/further-education-skills/docs/l/12-923-leadership-management-key-to-sustainable-growth-evidence

2 Ibid.

needs to simplify the content of web pages around networks and business communities, and actually focus on personalising and professionalising the working relationship government has with business. The communication between government and business can be radically improved. In my personal experience, in over twenty years the only direct communication I have had with government as a director of a business – other than accompanying Helena Morrissey and the Prime Minister to talk at the Northern Futures Summit – is an invitation to a 'VAT open day'. Which itself is rather bizarre as I hope most businesses know how to pay VAT! And yet government does not appear to engage actively or meaningfully in any of the communication activities being introduced within the business sector. There is a solid base of empirical evidence demonstrating their effectiveness. Despite this, techniques in metrics, in terms of social capital, social network analysis, the well-being agenda, all of which aim to get people to connect and communicate directly to share information and knowledge, are largely ignored. Such techniques are relatively inexpensive to implement, but they require a completely different 'joined-up' mind-set across Whitehall.

You cannot run a business or a country unless you are open to what is happening outside it. In the private sector, a lot of research and effort has been devoted to a complete reorganisation of focus around gender. For example, McKinsey have made an enormous commitment through their oft-cited studies and similarly PricewaterhouseCoopers in America. If the government and businesses in this country are outward-looking, they can work together and use this research which has been initiated in the private sector. There is no reason why this cannot be replicated in what they call 'networking circles'. In other words, you can information-share between like-minded people with common goals and 'match-fund' people in like-minded communities.

In summary then, the first step to improving diversity across the workforce is to eschew the idea that leadership is the be all and end all. The engine of economic productivity is not just the leadership; it is far more the workforce. Specifically, it is the group I call the 'marzipan manager' – stuck below the leadership icing. This group really is stuck; in meetings, on email, behind a wall of paperwork. They are denied the kind of mobile knowledge networking those above enjoy. No-one is helping them navigate, curating what they need to know and who they need to know and devising systems which focus them on the most productive thing they could be: engaged, interested and stimulated. Deny the 'Marzipan Manager' the oxygen of outside connections and the power of ideas, and they do what anyone does in silo or a bunker: they react as if to a threat, not so much burning out but tuning out. Managers are the engine of economic delivery so we need to focus far more on improving their lot. The opening up and the devolving of networking opportunities, hoarded by leadership, to this class of manager, would stimulate ideas and improve wellbeing and productivity. This can have an enormous impact on delivering an improved, flexible and more imaginative corporate culture. So whilst clearly we cannot side-step the hard-core issues about equal pay, respect and childcare, if we really want to improve the condition of women at work, we need to turn Britain into less a 'nation of shopkeepers' and more a 'nation of networkers'. Only then will we be able to begin to take on the Americans at the productivity game.

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Executive Remuneration and Diversity

Jan Hall

Over the last decade, particularly in the last two years, there has been a noticeable increase in the willingness of boards to appoint women members. In this more positive climate, the old structural 'glass ceiling' barriers to a woman's success and a more diverse boardroom are, if not eradicated, certainly far less prevalent than before.

The main challenge now is supply and contribution. The new positive climate has meant that boards have become more open to appointing women who are perhaps more junior or less experienced than male candidates, but who nonetheless are extremely effective boardroom performers. However, the real issue is the lack of women already in top executive roles in business, in financial services and the professions. Importantly, the UK is well ahead of other European countries in this regard and we can certainly expect a multiplier effect – as more women land the top roles and gain more experience, the female talent pool increases, so women are more likely to land the best boardroom appointments. Yet, currently, the pool of women available for board level or equivalent roles remains regrettably small. Sadly, this is true for all organisations of a significant size, encompassing companies and professional services firms more generally. Therefore, the real challenge now is about increasing supply.

Addressing this crucial issue is far from simple and may well require more imaginative solutions than have previously been suggested or are currently in operation. However, it is important that the correct balance is struck and that we avoid simply introducing new layers of regulation and bureaucracy. Although it is clear that this is a hugely important challenge, it is essential that companies, particularly smaller businesses, are not burdened with further legislation in this area.

In terms of fairly remunerated boardrooms, we need to be clear about the distinction between executive and non-executive directors. I do not believe that non-executive directors are paid too much. Many non-executives work extremely long hours for comparatively low fees and this has been especially true over the last few years. In terms of executive remuneration, robust structures are already in place. The problem arises when overly demanding executives' compensation and remuneration packages are not restrained by their boards. From a recruitment perspective, one reason that UK executives aggressively pursue better remuneration packages is due to comparisons with equivalent executives in other businesses. This is particularly true for businesses headquartered outside of the UK, especially in the USA where pay is not linked to performance in the same way that it is here. It is also the case for businesses held by private equity companies where the risk to reward ratio is different, but where they still deliver significantly higher rewards than those received by executives in publically quoted companies. Similarly, the impact of the arguably excessive rewards in listed financial services organisations being so much higher than the rewards for equivalent level and skilled individuals in other sectors as a driver for increased executive pay, should not be underestimated.

The 'simple' structural solution to remuneration would be for companies and governments, all around the world, to harmonise their tax regimes and approaches to pay. Ultimately, though it may seem fairer, unilateral action on pay would be self-defeating in terms of its overall economic impact. For example, for financial services in public companies, the regulation around the risk-reward ratio, where there are huge personal upsides and the minimal personal downsides that have huge social ramifications, seems wholly inappropriate. However, at a time when the UK economy is struggling and companies have to excel to succeed in highly competitive global markets, we must not disadvantage our companies relative to their global competitors.

Understandably, there is some interest around transparency and the disclosure of executive pay as a way of putting the brakes on. However, this too may have counter-intuitive results. Research shows that as countries make companies publish the way their top executives are rewarded, pay actually increases. Of course the motivation for such action is nearly always to make pay come down, or reduce income inequality, but people should not be surprised if pay increases because at the top level, for many, the amount an executive earns functions more as a score card than as an absolute.

It is not the proper role of government to dictate who sits on company boards. However, encouraging companies to adopt sensible guidelines, as has been done, with the combined code for companies, is always helpful. There is a global dimension too – our government should be actively lobbying other governments around the world to contain remuneration and reverse the last twenty years' acceleration of the gap between the highest and lowest paid members of society. Working together on a global stage to simplify tax and, ideally, to eliminate evasion is also of vital importance. A functioning global economy requires good global governance – or at least co-operation. It is essential however, that the US takes the leading role in meeting this challenge.

Returning to diversity, as a leading executive search firm, the JCA Group contributed to the drafting of the new Voluntary Code of Conduct for Executive Search Firms. The approach adopted was to capture best practice from across the sector, in the hope that it would be shared by the industry as a whole. The appointment of increasing numbers of women onto the top boards is not proof of its success, but it certainly shows that things are moving in the right direction. However, ultimately, as search firms, we do not appoint people onto boards. We respond to clear briefs determined by our clients and we only give them the best possible choice of candidates. Over the last eighteen months in particular we have seen chairmen and boards giving a greater priority to appointing female directors. The search firms who drew up the Code are totally committed to helping clients appoint talented women to our boards.

Because things are already moving in the right direction, government legislation would be unhelpful. The main priority right now is for our companies to be performing at peak productivity, for the good of the UK economy. Companies need to be able to appoint the best senior executives into the key roles free from restriction. Furthermore, perhaps the 'elephant in the room', which needs far more consideration, is the lazy assumption that all women actually want such roles. Many women actively choose not take on these very senior roles as they are often incredibly demanding and do not facilitate a healthy work-life balance. The drop-off rate for senior female executives is very high. In terms of my own experience , when I had my son, I deliberately chose to become a headhunter so that I could avoid the extensive travel and inflexible working hours that came with the executive director role I had at the time and which the role, not unreasonably, required. Of course there is a role for government in encouraging companies to do all they can to help women progress in organisations and for improving the structure of society to allow this, through addressing improving issues such as childcare provision.

Legislation that interferes in the internal affairs of companies is emphatically not the correct way to overcome this challenge.