LSE Business Breakfast: Thoughts on Rebalancing

John Van Reenen, Professor of Economics and Director of Centre of Economic Performance

December 11th 2010

1. Summary

What is rebalancing & How to facilitate it?

What has been Recent UK performance?

Where are we in strengths & weaknesses?

What should we do?

What are the key questions?

2. Introduction

2.1 What is Rebalancing?

Within Private Sector: The UK is "overweight" in finance and construction & underweight in manufacturing, high VA services? [2007: 15% of GDP in financial & professional services cf to 11% EU-15 average; 12% in manufacturing compared to 18% in EU-15, MGI 2010]

> **Example of Talent misallocation from Sir John Harvey-Jones**, former chairman of ICI (at that time the largest manufacturing company in Britain; Jan 1995), *"When I was chairman of ICI all the advisers that we used, advisers mark you, were all paid more than I was, be they the auditors, be they the merchant banks, be they the City solicitors. Now I ask you, in realistic national terms, who is likely to have the biggest impact on the fate of the bloody country?"*

Between Public and private sector: too large. Extreme austerity discussion – problem isn't direction but speed of change. Can lead to premature capital of human and fixed capital.

Geographical: half of all growth in last decade in Greater London & neighboring regions

2.2 How to get more rebalancing?

- State is a bad judge compared to market, but can facilitate (or damage) creative destruction

- Essentially role of the state is to help can the environment right to foster productivity & growth. A lot of this is to do with providing key inputs – infrastructure, skills, safety, etc.

- Much will happen "naturally". **Example of Financial services regulation**
    i. Too big to fail (contagion within and between). Bail out creates moral hazard problem and excess risk at all levels

ii. Solutions

   a. **Better regulation** (Basel capital requirements, closer supervision; living wills, etc.)
   b. **Structural changes** (Reducing incentives/ability to be large & create systematic risk so less need to bail out; Vickers, Myners)
   c. **Payment systems.** Factoid: top 10% increased their share of wage bill from 27 to 30% 1998-2008. Most of this was top 1% and ¾ of this was bankers' bonuses. Bad incentives & public outrage. Transparency a market friendly solution (Walker). Unlikely to cause max exodus. Win-win policy.

3. Recent UK Performance

- Too much doom and gloom about last 15 years
- Productivity is key indicator (GDP per hour or per worker). Why? High wages.
- In 1995 UK GDP per hour was 10% less than EU-15 average we have now bridged that gap (e.g. GDP/worker higher than Germany).
    - This is related to (i) increase of college % from 15% to 27% 1997-2010; (ii) increase in R&D/GDP post 2003 after a 20 year decline; (iii) competition policy
- Contribution of sectors to productivity growth of 23% between 1995-2005: (i) 6% manufacturing (1/4); (ii) 5% prof and financial services
- Jobs market (high rate of employment in 2007; better performance of unemployment than previous downturns)
- But still ~15% gap with the US. This means we could take Friday afternoons down the pub.

4. Where are we?

4.1 Strengths (building strengths in areas of growth)

- Universities (2nd in G8 after US, best in per $ spend). Research and International students,
- Bio-sciences (2 top pharma firms HQ'd in UK)
- Creative sectors
- English language

4.2 Weaknesses

- Management – McKinsey/LSE work (competition, skills, family firms)
- Skills (e.g. low/intermediate)
- Retail (e.g. planning)
- Public sector productivity – health, education

5. How to support?

- Don't intervene too much: our liberalized labour and product markets is a strength
- Innovation : R&D tax credit, patent box

- Skills – university issues (overseas student permits; subsidy for non-STEM); apprentices, EMA.
- Tax – Mirrlees, Structure more than level (e.g. treatment of debt; move to tax land and consumption rather than labour)
- Regional policy – enable mobility; regional pay
- “industrial policy” – green growth

6. <u>Questions</u>

- What is state’s role in enabling growth
- What to do if extreme austerity goes wrong?
- University finance
- Management
- Technology
- Finance

7. <u>Conclusions</u>

No easy answer

Rebalancing mainly from private sector but state can facilitate by

i. Getting environment right
ii. Sector specific interventions
iii. Regulating smartly (e.g. finance and pay)