



HM TREASURY

**dti**

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# Productivity in the UK 5: Benchmarking UK productivity performance

A consultation on productivity indicators

March 2004

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## INVESTMENT ENVIRONMENT

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**3.7** It is widely understood that volatility in the macro-economy tends to lead to lower investment rates as businesses demand greater expected returns from their investments. OECD research supports this, finding that high inflation tends to dampen businesses' incentives to invest, while highly volatile prices tend to lead to a shifting of resources away from riskier projects.<sup>3</sup> It is these riskier projects, with potentially high returns, which can deliver high economic and productive benefits. 'Hurdle rates' are one way of capturing how the macroeconomic environment impacts on investment decisions.

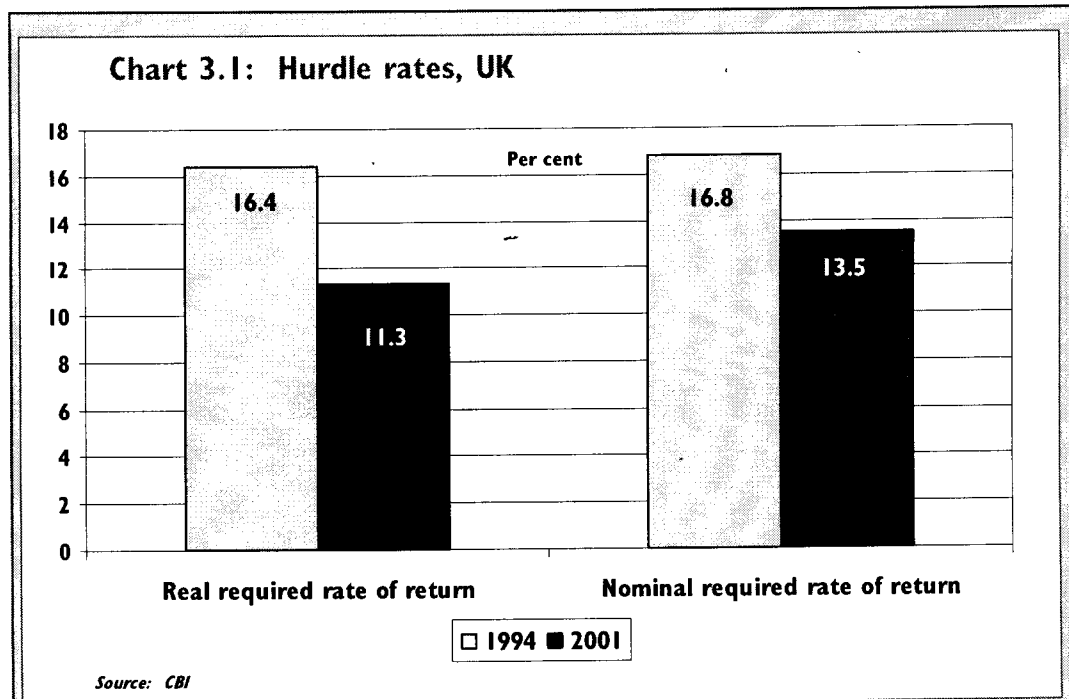
### Hurdle rates

**3.8** Hurdle rates refer to the expected rate of return firms require on their investment for the project to proceed. Firms use an array of methods to make this calculation. During periods of greater demand and inflation certainty, the hurdle rate would be expected to fall. The opposite would be expected in a more volatile environment. When hurdle rates are low, more investment proposals are likely to be realised.

**3.9** The Confederation of British Industry (CBI) has conducted two surveys in the UK investigating hurdle rates (1994 and 2001). The 2001 CBI survey notes that hurdle rates are only one among a number of factors that influence business investment decisions, and that firms may use different methodologies for estimating their required rate of return.<sup>5</sup> It is also worth highlighting that the survey primarily covers the manufacturing sector. Nevertheless, the measure can point towards improving or deteriorating business perceptions of the macroeconomic climate and the resultant effect on their investment decisions. There may thus be value in monitoring this measure if it is produced regularly.

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<sup>5</sup> Godden (2001)



#### Definition and methodology

The 2001 survey targeted finance directors primarily within the UK manufacturing industry to ascertain the type of assessment they use to determine whether to proceed with an investment project. Those using quantitative assessments were asked about the methods used, and the rates of return (or length of payback period) they look for. Firms may use one or more of these types of assessment.

Normal Industrial Trends Survey procedures were used to weight the results, to take into account the size of each firm responding, and to reflect the importance of their sub-sector to manufacturing as a whole. The results should therefore be read as percentages of the weighted response. The survey size was 337 in 2001 and 438 in 1994.

**UK performance** **3.10** The results from the CBI's survey show that for firms using a nominal required rate of return, the required return fell between 1994 and 2001, which is consistent with falling inflation expectations. More interestingly, for those using a real required rate of return, the rate they required also fell during the period, suggesting that there has been an improvement in business' perceptions of the investment climate over and above a mere inflation effect

**Alternative indicators** **3.11** An alternative approach could be to look at variation in macroeconomic variables directly. Complications that would need to be overcome to do this include identifying which macroeconomic variable(s) to focus on, and how to gauge uncertainty. For instance the DTI's Productivity and Competitiveness Indicators 2003 considered volatility in GDP growth, exchange rate movements, inflation and short-term interest rates over a period of 10 years.

Question 3.2: Do you agree that hurdle rates (the rate of return required for an investment project to proceed) are the best available indicator of the investment environment? If not, what alternative would you suggest?