Stay productive in uncertain times

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BvA: How do we respond to uncertainties that crises create? Are they holding us back in investing, hiring and innovating? Or can crises make us more agile and resilient, perhaps even more creative and inventive? And what might that mean for productivity? We are going to find out. Welcome to Productivity Puzzles.

[Music 0:00:20– 0:00:36].

BvA: Hello and welcome to the 14th episode of Productivity Puzzles, your podcast series on productivity, brought to you by the Productivity Institute and sponsored by Capita. I'm Bart van Ark and I'm the professor of productivity studies at the University of Manchester and I'm the director of the Productivity Institute, our UK-wide research body on all things productivity, in the UK and beyond.

Welcome again to Productivity Puzzles and nice to have you back. Productivity Puzzles has now had as many as 6000 downloads, so if you're among those liking this series, please do so by promoting it on your social media.

Today we will talk, perhaps not surprisingly, about crises and more specifically about the uncertainties that crises create for the economy, for businesses and for workers. As one crisis seems to follow another these days, the question arises whether there is any respite for us to recover before the next one knocks on our door. After struggling in the aftermath of the financial crisis, by the end of the past decade many businesses were beginning to see the benefits of new technologies, innovations to tackle the weak productivity performance we had seen for more than a decade.

Then we were hit by the pandemic in 2020, which set us back again, at least temporarily. And just as we began to hope that the economic fallout of the pandemic – including higher prices and supply chain disruptions – might just be temporary, we're being hit by one of the worst geopolitical crises of the past 75 years. As much as we all hope we can get past the worst of this war, sooner rather later, it could affect global political and economic stability for decades to come. Big topics for which we need great minds. And here we are again today with three panellists to take us through the main questions on how uncertainty impacts on productivity and what we can do to respond.

First, I welcome Jagjit Chadha, who is director of the National Institute of Economic and Social Research, where he oversees a wide range of research, including monetary outlooks and quarterly forecasts of the UK and the global economy. The National Institute was one of the first to come up with an early assessment of the potential impacts of the Ukraine crisis on the economy and Jagjit is also our theme lead of the Productivity Institute's research on macroeconomic policy and trends and is a member of its leadership team. Jagjit, good to see you.

JC: Thank you for having me on, Bart, it's an absolute pleasure, as usual.

BvA: Rain Newton-Smith is the chief economist of the Confederation of British Industry, where she and her team provide business leaders with advice on the UK economic outlook and global risks. And among other things CBI is helping to develop the economic policy response to the COVID-19 pandemic and to the war in Ukraine. Rain has previously worked for forecasting groups including Oxford Economics, the Bank of England and the IMF. Rain, thank you for joining us today.

RN-S: I'm delighted to be here with you, Bart, and everyone.

BvA: And finally, Paul Mizen is a professor of monetary economics and director of the Centre for Finance, Credit and Macroeconomics at the University of Nottingham, where he studies the interaction between monetary policy, investment, real activity, resilience to shocks, and productivity. Paul is also involved with the decision-maker panel at the Bank of England, where every month they survey almost 10,000 CEOs and CFOs on economic uncertainty and the effects of major shock. Paul, great to have you on this panel today with us.

PM: Thank you, Bart, it's great to join you.

BvA: Good, well a lot to talk about. So let's start, perhaps, with acknowledging that what we're talking about here today cannot compare with the personal harm that people in the Ukraine are experiencing, losing their homes, their communities and even their lives, as we have seen in recent days. We need to continue to give our support to help our neighbours and friends in need. But we also need to manage what it means for our own livelihoods. Because, for sure, the combination of the COVID-19 pandemic and the renewed level of geopolitical uncertainty – which are two massive shocks – will upset our economies, our businesses, our jobs and living standards.

So I think we need to start with taking the temperature a bit. What's happening to us right now and how are we weathering this storm in the short term?

So Rain, as you talk to businesses so much…I think I have already seen two communications from CBI on the impact of the crisis, including one just two weeks ago. So, can you summarise some of your key pointers on, for example, the impact of energy prices, trade, inflation, interest rates, whatever you think is important at this point to address?

RN-S: Yeah, absolutely Bart. And maybe just for starting with the humanitarian consequences, because I think, you know, the businesses that I speak to have absolutely been focused on what they can do to support humanitarian efforts and actually we've been coordinating with businesses, with the Ukrainian Embassy on some very practical measures in terms of getting food supplies to people who need them in Ukraine.

So I think that's, sort of, where businesses have been first and foremost. And of course, it's a reminder of what an interconnected world… You know, many businesses have staff here in the UK with families in the Ukraine and elsewhere. So, as you said, I think that's where everyone's head has been immediately.

And then of course thinking how we can implement sanctions as effectively as possible, and we've been helping to, sort of, signpost businesses to where they can get more information on that.

But then, as you say, I think businesses have been turning to what's in front of them. How does it affect the UK economy; how does it affect their own operations? And, you know, it's absolutely about the impact on energy prices, on inflation, here in the UK. And I think the big challenge is it exacerbates a lot of the challenges that had really started to accelerate from the beginning of the year. So, while the UK economy is growing, we're seeing much, much higher inflation. And the higher energy costs that we're seeing – as we saw very recently with the energy price cap – it's having a real impact on households and their incomes in real terms. So I think there's a real sense that this is going to make the living standards squeeze harder, and particularly harder for low income households.

And now, you know, as the OBR and others… And I'm sure Jagjit will talk extensively about, you know, the outlook for inflation being well over eight per cent this year. But I think also, just in terms of some of the commodity exposure that we have, lots of people are… You know, we've suddenly become experts on some of the things that Ukraine and Russia export. So of course in Russia's case, people have been thinking about oil and gas and our dependencies there, which is, you know, particularly more so for Europe, who have a higher proportion of gas from Russia. But I think, you know, Russia and Ukraine together are 25 per cent of exports of wheat, they're really important in sunflower oils and also around fertilisers. And so, certainly from the farming community, there's a sense that we will see higher food price inflation.

And now businesses are also thinking through to wider supply chains. You know, an increase in transport and shipping costs. Because I think a lot of these supply chains were quite strained anyway, as we recovered from COVID. So it's, sort of, the confluence of those two shocks that I think makes it a much more challenging environment. And of course, more broadly, while we see higher inflation over the longer term, you know, this will have an impact on our growth and our productivity. So I think there's a real focus from business and policy-makers that we need to build confidence. We need to get the drivers of long-term productivity happening now: investment, ideas, innovation and skills. That's how we will make our economy more resilient and lead to rising living standards in the long-term.

BvA: Yes, as we will discuss in a bit, I mean, productivity is very much about long-term issues but, you know, when these crises happen it suddenly becomes a short-term challenge and there can actually be big impacts on short-term productivity. But we'll get back to that later. You already referred to Jagjit and, Jagjit, I'd like you to speak next a little bit. Because, as we mentioned earlier, the National Institute was quite early with some early estimates and pointers, again, to just, sort of, give an idea what this might mean for the growth of the economy and growth of inflation that Rain already pointed to. But I also heard you say recently, when you spoke to the Parliamentary Committee of the Treasury Committee at parliament, that you actually said this would significantly raise the risk of recession. So if that's the case, how worried should we be about recession right now and what would that mean for businesses at this point in time?

JC: Well, recession is just a manifestation of lower growth than we anticipated. I think the OBR numbers that we saw the week before last now look optimistic, when you take into account an elevated set of energy and oil prices as well as further disruptions to supply chains. So the economy is very likely to show little signs of growth in the second half of this year and be, to coin a phrase, bumping along the bottom for most of next year. Where it is fortunate that we've just about recovered the level of activity we saw prior to COVID, I'm afraid the economy doesn't show any great signs of adaptability or flexibility, again. And I say again, because I've been director of the National Institute for six years next month. In some sense, six years have flown by but in some sense those six years have almost been like Groundhog Day, where it's been crisis after crisis after crisis.

One word that you haven't mentioned – probably wisely, because it does lead to some issues on either side – is Brexit. We had a number of years where we didn't quite know how it was going to happen, whether it was going to happen and the terms under which it would happen. And I know Paul and Rain have looked at these questions. And that is something that has definitely elevated uncertainty, both for firms domestically and for those exposed to international trade. We see a large amount of trade compression related to Brexit. But then, following Brexit, we've talked about COVID and now we have this war in place. That's three crises in six years. That's almost the same average as the English cricket team. It's a fairly large number of crises.

But what I want to say is I think – and this relates to your point about productivity in the long run – these crises continually expose the risks that have been built up during normal times. We're more sensitive to a shock in energy prices because we don't have inventories. We are more sensitive to a disruption in supply chains because of the just-in-time approach that we have in the UK. We're more sensitive to a withdrawal of labour in certain industries, either following Brexit of following COVID, because we haven't necessarily got the wide range of educational endowments across the country for domestically-trained people to step into those roles. And that leaves firms often short of the workers that they have.

So what we find is, because we're not thinking about the long run, time and time again, when these crises come along we're more sensitive to them than we would otherwise be. Meaning we're then returning to what I've called often crass demand management. And I don't for a minute argue that Treasury or Bank of England are crass, but what I mean is they have to do what they can. And what they do is what they can do with fiscal policy and what they can do with monetary policy.

But it doesn't really provide an enduring substitute for the lack of long-term planning or an adaptable and flexible supply side, which is where your institute and the work that we're doing there really comes in. We need focus on the long run and not be continually dragged back into short-run crisis management. It is the British failure, it seems to me. It's something that has gone on since at least the 1970s. Crisis after crisis, managed in the very short run with limited room for manoeuvre, because we're penned in by previously awful policy decisions.

BvA: Paul, let's get you in the discussion, because you've actually been very involved in tracking some of…almost real-time responses from businesses, both on Brexit and on the COVID pandemic, with the decision-maker panel at the Bank of England.

PM: Thanks, Bart. So I think I'm picking up on a few things that Rain and Jagjit have already said. You know, a key important feature of which businesses are affected is exposure. And I think that was something Rain mentioned. You know, some businesses were very exposed to the Brexit shock and different businesses were exposed to the COVID shock and now we're seeing Ukraine. And of course, because energy affects everything, most businesses are affected in some ways but some are very affected and others less so. So I think exposure is a key issue. And, apart from the tightness in energy markets and commodity markets and the increased prices that we see there, there's tightness in the labour market too, and that's feeding through to companies. And this is all affecting their costs and being passed through to prices.

BvA: What I find interesting about some of your work is that you're also talking about, sort of, the way that firms respond to uncertainties has a couple of different moments, right? They don't respond in the same way at every point in time. Can you explain it a little and can you also see if we're seeing that again now with the Ukraine crisis, that there are these different types of responses that are emerging over time?

PM: In terms of…you talked about moments and… So this is, I suppose, a technical term for the distribution of effects. And we can think about there being a negative effect, which we've already mentioned in terms of the impact on sales, the impact on employment that comes from these very adverse shocks that we've seen in quick succession. But also there is an increase in the spread of the distribution which shows the, kind of, increased uncertainty. And there are some firms that are more firmly lodged in the bottom tail and have had a very adverse effect.

So we can think about, for example, accommodation and food and recreational services during COVID, which were massively affected by the circumstances of that particular shock. And now there are other types of firms, in different sectors, that are impacted by the Ukraine situation. So we do see these effects.

There are also some winners. There are some firms up in the upper tail that are benefiting: firms that have sold their goods and services online have done better than those that were reliant on bricks and mortar locations. But that's just one way in which we can observe the varied effects through the moments as we might call them, shifting the distribution and also changing its shape.

BvA: Yeah. So we've now touched on this term, uncertainty, many times and we may have to unpack this a little bit more. Because, you know, it's a bit of a black box, what uncertainty exactly is and I think trying to understand a little bit would help. And Jagjit, maybe I can come back to you here first. So, sort of, what different types of uncertainty should be distinguished? How should we think about these different types?

JC: Well the classical distinction, in economics, between risk and uncertainty. So we have certain risks that we might face and a firm that is able to do so would want to put in measures to mitigate against the risks that they can see. What we're specifically talking about when we think about firms delaying investment or reducing foreign direct investment, both are stories that we've seen quite prominently over the last four or five years – and I'm sure Rain and Paul can provide more accurate representation of the data there – it's really that firms are really unsure about the revenues that they might have.

So when they're planning into the future, they're saying to themselves, look, what kind of revenue performance will I see? Well I won't know it exactly but I know it has some form of distribution. It may be lower or higher. And when they try to take a view as to what that revenue is, in the face of uncertainty, not knowing exactly what it is, if the firm is risk-averse – so if it prefers certainty to uncertainty – then it will reduce the level of its investment compared to what it might otherwise do. In a sense, because that income stream is not certain, the value it places on it is less than it would otherwise be. Because the value it places on it is less than it would otherwise be, the amount of money it has to service any debts that might accrue in response to that level of investment would be less than it would otherwise be. So the firm takes on less debt and is less likely to invest.

So there's a number of things we need to see there in order to have a relationship between uncertainty and firm behaviour. First is they don't like risk. Second that the measurable level of risk is high – or uncertainty, I should say, forgive me – uncertainty.

And there's all kinds of measures. Paul has been involved in that: in measuring firms' subjective views of their level of uncertainty. But also that the firms themselves cannot directly offset that risk by being able to access the money in some other form. So if they're not heavily cash-rich, typically, as the results say, if a firm has a lot of debt, it's not cash-rich. If it's a small firm, one that hasn't got a long-lived reputation so it can go to sources of finance. These are all the kinds of firms, going back to Paul's point about distribution, that are most affected by uncertainty. And also firms that predominantly work in one market, other than those that have a portfolio of interests across different markets and in different areas, again, might be able to deal with risk or uncertainty in a different form.

So I think that's the kind of story we have in our mind when we talk about uncertainty. Those sets of characteristics that ultimately lead to firms deferring or delaying investment in a way that materially matters.

And just one final point. We can see that matters because, as we come out of the crisis, the COVID crisis, and enter the next one, we can see that, despite the fact GDP and employment are broadly back to where they were prior to the crisis, the level of business investment is still far below where it was prior to the crisis. And that's on the back of three or four years of underperformance as well, during the Brexit exit process. And that's on the back of 40 years of under-investment from the public sector. Public sector hasn't met its target of three per cent of GDP, on average, since 1979. The average has been around one and a half per cent. So the level of public capital we have employed is also very low. And I think that probably also interacts with private investment.

Again, Paul and Rain will be probably better placed to give you chapter and verse on that. But I think there are a lot of problems here in terms of where firms are and the level of physical capital that they have access to.

BvA: Chapter and verse. So Rain, you have the chapter.

RN-S: Thanks so much Bart. I guess if I'm distinguishing one of the challenges that businesses are facing at the moment, you know, we talked initially about that squeeze on the cost of living and thinking about that in terms of households. But obviously businesses themselves are dealing with higher energy costs and I think one, you know, section of firms is thinking about small businesses in an energy-intensive sector. That's where there's, sort of, challenge they're facing at the moment.

So you might be, you know, a manufacturer producing more sustainable packaging. That takes a lot of energy actually, currently, to produce. And so you will be facing higher energy costs. So I think there's certainly a role for policy and thinking about access to finance for those SMEs to, sort of, help them in the transition. And I think that is something that's on the minds of policy-makers. But particularly in a world of higher inflation and higher interest rates, I think that access to finance for SMEs…

And I think to this wider point about business investment being crucial, we know that, you know, across the G7 countries the UK has had one of the lowest rates of business investment as a share of GDP almost for the last three decades. And so… And obviously some of the uncertainty we've seen in recent times is undoubtedly not helping, but there are policy things that are in our control, that we can look at. And one of the things the Treasury has looked at is the super-deduction, right? Looking at capital incentives to get businesses investing.

But what businesses will be saying now is that super-deduction is only available for another year but businesses, when they make investment decisions, they are taking them now for the next ten years. So they need to know what sort of incentive we will have in 2023, now. And it is something the Treasury is looking at but I think businesses, you know, they want to have that certainty.

And then I think the final area which… And this was absolutely true during COVID and has continued to be true during an energy crisis, is that businesses are saying look, we need to be accelerating our move to a net zero economy. We need to be thinking about things like energy efficiency in our homes, in our businesses, and we need the government to set out more of the policy certainty around how we will retrofit our homes, for example, how we will have to develop hydrogen, which might be a solution for transport, or potentially in heat in homes.

There are ways in which the government can set out revenue streams associated with newer, green technologies and it's something that, you know, businesses will really be looking for more detail from government. It's a constant refrain we get, that policy-makers need to be taking some of the action, so they get the policy certainty and so businesses themselves can get behind and invest in some of these green technologies.

BvA: It's so complex, right? On the one hand you want the government and policy to really set out this kind of longer-term focus, which is so important for productivity, but then at the same time you get these crises coming along that, sort of, continuously interact with these long-term policy commitments. So it is quite an art for policy-makers to be consistent, you know, to stay focused on the longer-term and at the same time manage these short-term interactions. So that is really tough. But, Paul, what are your additional thoughts on what Jagjit and Rain have been saying? So adding the verses to the chapter.

PM: Well uncertainty certainly is the killer for investment. I mean, firms don't invest when there's more uncertainty. They wait and see what's going to happen and stall their new investments until there's greater clarity. So it's undoubtedly the case that with the three, sort of, major shocks that we've had in the last few years, that uncertainty has been a great deal higher than it has been before that period. And as a result, the investment has been lower. You can see it in the comparison with other G7 countries. You can see the impact effects of COVID on investment: particularly strong but quite short-lived.

So we'll see how things develop from there. In terms of what the government can do, I think it's really… I mean, there have been some successes. I think the furlough scheme did prevent the separation of employees and employers to some degree, by providing some insulation to the businesses from keeping those employees employed, rather than letting them go. And that's been a welcome step but a very costly step. It's much more difficult to know quite how government can do the same thing for investment. I think that is a much more challenging decision from a policy perspective.

Super-deduction helps but it's very focused on a very narrow part of investment – essentially, tangible investment. And I think it would be well worth the government looking at intangible investment and the areas where investment takes place in very productive companies to see if that could also be encouraged to try to offset some of the effects of uncertainty. I think also the fact that they've maintained, for some years, the annual investment allowance at a very generous rate - £1million – for some time. That's been a welcome development as well. But it's a challenge to deal with that uncertainty around investment.

BvA: Jagjit?

JC: Paul's right: uncertainty, by its very nature, is very hard to offset. But I think there are three direct areas the government could work on here, over the medium term. And of course, what I'm about to say is nothing new. I've already mentioned public investment. If the government was clear about a path to public investment over the medium to long run – 10, 15, 20 years – where that three per cent of public investment would take place, that provides some clarity and a framework for private investors in whatever part of the country. If we know where it's going and it's going to be there year after year, that does provide some reduction in the level of uncertainty that any particular private firm is having to face. If it knows that in Warrington, or in Stoke, there will be a level of investment that's going to continue over the expected lifetime of that firm, in my view that makes a difference.

We haven't got those kinds of commitments. Unfortunately, our fiscal episodes in this country are extremely short run. We don't know what's going to happen next. It's almost as though the chancellor, whoever he is or whoever she may be in the future, just stands up and says I'll do what I can to make the newspapers the next day, rather than thinking about the long run.

The second point is we've got a UK investment bank but, unfortunately, it's tiny. Its capital at the moment, or the amount of money it's looking to allocate, is around one per cent of GDP. It's not large enough at the moment to address the significant physical capital shortfalls in the country. It's not, for example, enough to replace what we've lost through the European Investment Bank, where we were very good at the UK in attracting money there. And of course, that's very, very important. I wish the UKIB very well, but at the moment it's not sufficiently ambitious or well enough resourced to deal with the gaps that are there.

And finally the question is, do we have a domestic financial sector. I'm not talking about the global financial sector, all those bits in the City of London, but do we have a domestic financial sector that is able to support SMEs in raising finance through banks or through other forms in the way that they need, and over a longer tenure than is typically the case. Can a small- or medium-sized enterprise, or a growing one, or even a larger one, raise money over anything more than a couple of years? The answer is, generally not.

And I think that is another part of what could be done to offset uncertainty. Remember I said right at the beginning, if you're sufficiently liquid, if you've got sufficient access to cash, you can offset a lot of uncertainty. I'm afraid in these dimensions there's just not enough being done at the moment. And I would call upon this government and successive governments to address these questions.

BvA: So we have a lot on the table here and I want to even deep dive a little bit more or perhaps zoom in a little bit more on what the significance is for businesses is at this point in time, with all this uncertainty and the policy mess that we're talking about. But before we do that, let's take a short break to hear what else is happening at the Productivity Institute – and stay with us.

[Music playing 0:28:35– 0:28:42].

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BvA: Welcome back to my discussion with Rain Newton-Smith, Paul Mizen and Jagjit Chadha on how uncertainty impacts on economic and business behaviours and what that all might mean for productivity. Well, before the break we already talked about a lot of things. We talked a lot about what uncertainty really meant from a productivity perspective, what kinds of channels we need to look at. Investment, we talked about a lot. We talked about the, kind of, policy environment.

But, Rain, I really want to go back a little bit to the urgency of the moment, if you like. You know, with these rising prices at this point in time, companies have essentially three options right now, right? I mean, they can either pass on price increases to the customer, if possible. They can reduce costs per unit of output, which either means cost efficiency or productivity gains – that's where productivity comes in – or they diversify to other markets where they can grow. What do you see happening right now?

RN-S: I mean, I think in general it is too early to say because, you know, businesses are really in the throes of this crisis. And I think, you know, the experience of each business is probably more heterogeneous this time than during COVID. A terrible economists' word but essentially if you think during COVID that sense of we're all in this together, it was happening to all countries at the same time and all businesses. So, you know, there was a more…it was happening at the same time. Whereas now I think what you're seeing is if you're an energy-intensive business where you're really…fuel cost is a big part of your overall costs, you know, you're much harder hit now than, I think, some of the business and professional services. So I think that's one of the things that comes across.

But I think what we do hear from across businesses is that we need to have, you know… They want to see the Chancellor and policy-makers act early to get ahead of weaker business confidence. I think there's a real sense that this recovery in the UK is very fragile. And so I think anything that can be done to help smaller businesses, particularly, deal with energy costs… And the government have their COVID loan schemes that are still running. There's a way of using that scheme and just extending it, so that you can really help businesses to get access to lending, to help their way through this crisis.

And then I think the second thing is just really getting on with things that are under their control and making the big decisions that help to crowd in some of the private sector investment we want to see. And, you know, whether that's being quicker to approve offshore wind farms… You know, businesses will have said, you know, it takes eight years in the UK versus other countries, where it can take four years. So, you know, there are things we can do to, kind of, improve investment now. And making some of those…setting out a roadmap for capital incentives and getting on with it now would make a real difference.

But I suppose the other thing I'd weave in is almost thinking back on the last crisis, we did some really interesting work with the London School of Economics, surveying businesses about digital adoption that they made during the crisis. And what we found is that, you know, 60 per cent of businesses in that first lockdown adopted a new digital technology or a management practice and we re-ran that and found that it's continuing. You now, that digital adoption I think has continued.

So there's a… Even in a crisis it can be a window to more digital adoption. And also product innovation. It's hard to know exactly what the innovation will come out of this latest crisis but, you know, creating that ecosystem where it's easy for businesses to innovate, to come up with new ideas and adopt digital technologies we know leads to a more resilient economy.

BvA: So you talked about, you know, the potential for extending these lending schemes that the government implemented during COVID. Are you saying that because it helps businesses to keep their heads above the water and to survive or do you also think that these schemes really help companies to make these investments in digital and everything else that, sort of, keeps them productive in the longer term?

RN-S: I mean, I think it's both but it's almost, you know, that second one that has the more power and potential, right? I mean, the trick is you don't want to keep businesses going that, in the long run, aren't going to be viable. You really want that lending to be available for businesses that are facing a short-term liquidity problem but over the long term are solvent. But we know from that work that we did around innovation, actually access to finance was one of the barriers that a lot of smaller businesses in particular talked about, in terms of being able to adopt a digital technology or an innovation. So I think having that access to finance is really important. And whether that's working with the British Business Bank or others and just making sure we have something that is there over the long term and not just to be used during a crisis.

BvA: Yeah. So, Paul, I'm sure that the decision-maker panel, that I said earlier is a kind of monthly survey that you do with CEO and CFOs also had a lot to say about how companies were responding to these schemes, right, and whether they did help them to invest and to try to get a focus on the, sort of, longer-term challenges that they had ahead of them.

PM: Absolutely. The decision-maker panel has certainly been asking questions about this but also another piece of work that I've been involved with, with the Office for National Statistics, is the Management and Expectations Survey, which has definitely reinforced the points that Rain has just made.

So for example we found that the better managed firms, the firms that were implementing better management practices pre-COVID and pre-Ukraine, were in a better position to forecast better and therefore to understand the changing environment they were in. More likely to innovate and adopt new practices, not just in management but actually new technology, new ways of working, new processes and products. And thereby to pivot in the face of the shock. So these businesses were able to adapt to their circumstances much more readily than others. And I think this is the key, that these firms have got the edge.

Now, what can the government do about that? I think in the medium term some of the policies to encourage businesses to learn from the best-managed firms – Help to Grow, Be the Business – these are all good schemes to try to spread that knowledge and encourage best practice. I think that would be an enormously worthwhile undertaking. The real challenge, however, is that many of the firms that would really benefit from learning these practices seem somewhat reluctant, maybe just too busy and firefighting at the moment to be able to take them up. And it's really creating the right environment in which they would be able to learn from these really better-performing firms, better-managed firms, to be able to be more resilient, more resourceful, better able to pivot to future shocks.

BvA: So, Jagjit, from a very high level, what kind of advice would you give to policy makers to create an environment that is a bit more predictable, a little bit more easy to navigate, for businesses to see what's coming down the pipe for them?

JC: Thank you, Bart, that's a very good question. If I could just break it up a little bit. I mean, you started off by asking how firms will deal with the current conjunction. I think, you know, we need to understand these are incredibly difficult times. We started off showing solidarity with Ukraine and the difficult times they're under. But also for anyone running a firm at the moment, they've had two years of uncertainty as to respect to the revenues that they might raise but also their labour inputs, you know. Whether people can come to work, whether they're unwell, whether they're caring for someone who's unwell, whether their children are unwell.

And we haven't got to the end of that yet. All kinds of firms of various sizes don't know, at the start of every day, how many people are going to turn up for work. That's an incredibly difficult situation for any firm to have to deal with and I suspect that's going to continue for some time to come.

One way to think about this is we're re-engaging with the new world of work. That five-day into the office pattern has been, probably permanently, broken. But I also think every firm will have its own optimal structure in the way that it should be spending its time. Some firms may be able to get by just fine remotely, from here to the end of time, but some will need those interactions, particularly to deal with problematic issues as they come up.

Productivity, I think, is helped, working remotely, if it's a well-understood problem. You can just go away and get on with it. But the more complex and difficult the problem, the more you need to put heads together to try and understand what to do. That's the point at which we need to come back together.

So point number one is that I think firms are still dealing with the ragged edge of COVID. And, as you say, we're adding to that a large increase in cost pressures and firms will absolutely have to deal with that in one of two ways. For firms that have an inelastic demand for their goods and services, they will have no other choice than to raise the prices of their final output. They'll want to hold onto their staff. They'll have to pay the wages to try and support them. They have families to look after. And they will seek to put up their prices. But for firms for whom output is hugely competitive – so if they work in the more tradeable sectors – it's going to be more difficult for them to push up prices.

But that's where, maybe, some of the good news might come in, that Rain was talking about, and Paul, where maybe those firms can find some extra cost savings or productivity gains. They can say to themselves what more can we do if we want to hold onto particular tradeable markets or, indeed, extend our influence in them and create a bridgehead? And they may be able to find further productivity gains, particularly if they can harness the digital economy or digital framework. So there's a possibility there.

But in all of that, given the inflationary shock, the high level point is that the Bank of England must put up interest rates. We can't have a situation where we lose control of price stability. At current market estimates, interest rates are going to go to something like one and a half per cent in a year or so, but inflation will still be above two per cent. That means negative real interest rates. And the problem there is not so much whether that stabilises inflation or not, but it doesn't help sort out the zombie firm problem.

An interesting paper from colleagues at the Bank for International Settlements, who are looking at the secular increase in zombie firms – and I'll define what they are in a minute – but it's gone up from something like two to four per cent of the stock of firms to something like 15 to 20 per cent over the last generation or so.

And a zombie firm is typically a firm that has low levels of investment, a low market value relative to its book value, low levels of training, in terms of what it does for its staff, and essentially is not an innovative and highly productive firm. Typically these are firms that would otherwise have gone under but have not done so, because the interest that they have to pay on their debt is very low. Meaning they can continue to be less than fully productive and meet their debt payments.

In the old-fashioned world, in old-fashioned money, pounds, shillings and pence, these firms would have disappeared and their capital, their resources and their labour would have been allocated to new firms that may have had new, innovative ideas. That kind of churn has not happened to the extent to which it has done so in the past. So one hope is that as interest rates start to climb, which is the right thing to happen, we're going to prevent this secular increase in zombie firms and possibly reverse it.

But for that to happen we certainly need more imaginative fiscal policy, which is where the final part of your question came in. I think I hinted at the answer a little bit earlier on. We've been much more about fiscal policy, in terms of the headlines that the Chancellor gets on the next day, rather than thinking about the long run.

And we and others have argued for a long time that we need an annual state of the economy analysis: more statements as to where the economy has gone relative to some notion of where we want it to get to. There's absolutely no point in defining fiscal policy in terms of the level of the deficit or the level of debt. We need to be much more courageous and say okay, you want to level up? What level of income does that mean for the north-west relative to London, in 2030? How far are we going to get along the line by the end of this parliament? And what do we have to introduce in terms of policy to bring that about? And we need assessment of those kinds of policies. And also a lot more counterfactuals and normative analysis.

And I think that process, of addressing wellbeing in the economy, will be better addressed by a full-scale assessment of where we are in terms of a state of the economy address that would happen every year, at a set time, so that we could assess the results across the board and have a proper discussion around them. We just don't have that in this country.

BvA: Yeah. I want to give each of you a final word, but I hope that in your final word you try to address something that troubles me, and that is the issue of inequality. You know, on the one hand you raise the issue of zombie firms and that in a way this, kind of, crisis basically might ultimately help us to get rid of some of those zombie firms. And on the one hand we say okay, that's good for productivity.

But on the other hand, we have this issue that this long tail isn't, sort of, coming along. Paul addressed the issue of management practices and that we need to diffuse technologies better and that we can learn from each other. But I do worry about the fact that this, sort of, subsequent range of crises that we've been seeing in the past decade are creating that wider inequality between workers, between firms, between regions. So that's just one thing that I hope each of you will, in your final comment, say something about, whatever else you want to say. And, Rain, I'd like to start with you here.

RN-S: Thanks, Bart. So I absolutely agree with what Jagjit was saying, that we need to have something that steps back and really looks at the, sort of, state of the economy and what we can do. And I'd go further and say, you know, that you get leading thinkers then saying what can we do to really drive growth and productivity now. And there are many things that fiscal policy can do but there's so much we can do, even in the delivery of infrastructure, that we have committed to, that could really make a difference to growth now.

And I think, you know, related to that it is really thinking about that growth and productivity being central to, you know, higher living standards and addressing inequality. And I'd put at the heart of that – and something Jagjit touched on but I would take it further – is really thinking about a skills revolution. We've talked a lot about investment in capital and in innovation, which is hugely important, but we know in the UK we have a huge deficit in how much we invest in people. And we really need to have much more of a skills revolution.

And if you look at the tools that we've used in terms of policy to increase investment in training, by businesses or government, it, you know, it's been through the Apprenticeship Levy, which does… And the apprenticeship model, which has a lot of merits, you know. I don't think anyone's undervaluing proper apprenticeships. But when you think about how much the economy in the world is changing, it does feel like it's something that's stuck in the past.

And you can see it in the numbers, right? Apprenticeships have gone down over the course of that policy. And when you think about the skills we need for the future, you know, how do you install an air source heat pump, helping electricians understand how to do that, helping in a business and professional services company… You know, people knowing how to measure their Scope 1 and Scope 2 emissions or, you know, just thinking to digital technologies and adoption. That talks to a much more flexible, modular…taking a course for six weeks, three months, you know, and that fitting into a modern lifestyle.

And so I think that's my hope for the future as well, that we really have a proper, sort of, skills revolution in this country. And that's got to happen from businesses working with government, with the best academics, right, on how you really implement that properly.

BvA: Paul?

PM: Thanks, Bart. So I think what we've learnt from the three major shocks that we've experienced – and we're still not through with them. They're still in many ways still impacting us. What we've learnt is that different sectors have had very diverse experiences and these sectors, the ones that have benefited from the shocks in some way and those that have been really adversely affected, are located in different places and therefore the geographic location of these shocks has been evident from the result of the locations where the firms are that have been impacted.

And I think this is something that has led to a lot of geographic inequality and within different sectors across the income spectrum there's been quite a lot of inequality in terms of which particular workers have been most affected as well.

There is some reallocation that is taking place. That's the good news. This has happened much more in sales than it has in employment, however. So I think the process of reallocation between industries and between firms within industries has got to continue.

And I think this is where policy can come in, to encourage good practice and investment by the very best firms in technology and training, to improve their prospects. This will lead to some further reallocation, I think, in employment and higher productivities again. We are seeing, actually, firms indicating that they're prepared to divert their investment away from certain areas, towards technology training, software, IT and so on, and that these will benefit those industries where that takes place. I think also the fact that there's more working from home means that, really, these benefits then get spread much more widely, geographically. The whole footprint of any industry is now much larger than it would have been, say, five years ago when, essentially, we all had to be within commuting distance of the main office. I think that's another factor that's going to transform the UK.

So hopefully these will all impact on inequality in a positive way and lead to higher productivity.

BvA: Yeah. I think the point that you make, very importantly, is that the regional effects of this can be quite important and therefore I think also collaboration between industries and governments at a local and regional level is at least as important in these kinds of crises as at the national level. Jagjit, the last couple of words are yours to see if you can wrap this up. So much we've discussed here and such a rich issue, but yeah, I wonder what you have to say also about this point of inequality and how we can deal with that?

JC: Thank you, Bart. Also, if I may thank Rain and Paul; I've really enjoyed listening to you both. I want to start with one observation and that is Western economies have gone through a productivity decline relative to the rest of the world in the last 20 years or so, particularly after the financial crisis. Productivity and prosperity go hand-in-hand. They're two words that mean the same thing, essentially. If we want to be more prosperous, we need to be more productive, as an economy.

Within that, the body of evidence that we're seeing suggests that the UK has done worse than most of our trading partners. Now, I'm not saying we're the worst but it doesn't look like we're anywhere near the middle and it doesn't look like we're anywhere near the top. You know, we're in the bottom performing advanced economies in that. So you've got two things going on. Our performance vis-à-vis the rest of the world has deteriorated as a set of advanced countries. And within that set of advanced countries, the UK has done worse than them.

There are a number of reasons for that, that we have touched upon, and some that we haven't. But that relative decline has become incredibly obvious to us, for those of us who travel and talk to people in other parts of the world. And it's ultimately a question for our body politic: which way are we going to go? Are we going to go further down the route of crass populism, trying to appeal to small fractions of the population and the political system will just deliver results that benefit just them, which will not solve the inequality problem that you're talking about? Or will we have the courage to reform and rebuild and think about the infrastructures that we need, the education requirements that Rain was talking about and the support for small firms that Paul is intimately involved in, that ultimately are going to be costly? They'll be costly to current sets of zombie firms, they'll be costly to the kinds of people who may have to finance those types of innovations.

And I'm afraid that is the only way we're going to end up with an economy in which things don't continue to fall apart. And, indeed, this morning I was talking to a policy-maker about how we might offset the trend towards a form of populism that just leads to a further deterioration in this country's performance and we found ourselves reminding ourselves of Cicero, which goes something along the lines of: I've always been of the opinion that unpopularity earned by doing what is right is not unpopularity at all, but glory. And I'm afraid we need policy-makers who want to pursue glory rather than popularity. And that means thinking about the long run, doing the right things and projecting a much stronger economy, and one that isn't continually pinned in by the crisis, that we've been observing time and time again over the last few years.

I live in hope, but not expectation.

BvA: Yeah, it's so interesting that throughout this discussion, which really, you know, when we started to think about this podcast we thought about the uncertainty of the current crisis and the way that business and companies are responding to this, but I think all three of you are continuously talking about you can't just see this in isolation. You have to understand this is part of a longer-term commitment that policy and actually the whole of civil society is making to economic development and growth and equality and issues like that.

So Rain Newton-Smith, Paul Mizen, Jagjit Chadha, thank you so much for joining us for this conversation and indeed we hope to see you again on this podcast, Productivity Puzzles, soon.

JC: Thank you, Bart.

RN-S: Thank you.

PM: Thank you, Bart.

[Music 0:53:15– 0:53:22].

BvA: I’m very much looking forward to our next episode of Productivity Puzzles, which will be a discussion on a new book from two authors closely involved with the Productivity Institute. The book has the ambitious title Restarting the Future, and the subtitle How to Fix the Intangible Economy. In this book, Jonathan Haskel, who’s professor at Imperial College Business School and external member of the Monetary Policy Committee of the Bank of England and a member of the Productivity Institute, and Stian Westlake, who’s chief executive of the Royal Statistical Society and a member of our Productivity Commission, they argue that our failure to adapt policies and institutions to what already is largely an intangible economy, is what we need to focus on. This is a huge issue for productivity in the modern economy that we want to discuss with them.

And for this discussion we will also be joined by Diane Coyle of Cambridge University, who leads TPI’s knowledge capital theme. You can sign up for the entire Productivity Puzzles series through your favourite platform to make sure you also don’t miss out any future episodes. If you’d like to find out more about upcoming shows or any work by the Productivity Institute, please visit our website at productivity.ac.uk or follow us on Twitter and LinkedIn. Productivity Puzzles was brought to you by the Productivity Institute and sponsored by Capita and this was me, again, Bart van Ark, at the Productivity Institute. Thanks for listening and stay productive.

[Music 0:54:46– 0:55:18]

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