26 February 2010

The Rt Hon Alistair Darling Esq MP
Chancellor of the Exchequer
HM Treasury
1 Horseguards Road
London SW1A 2HQ

Dear Chancellor

Re: Engineering and Machinery Alliance Budget Submission

I write further to my letter of October 19th on behalf of the now 11 trade associations in our Alliance in the run-up to your Budget Statement. (The Engineering and Machinery Alliance now represents some 1600 firms with approximately £8 billion in sales).

The issues we highlighted ahead of your Pre Budget Report are still of concern.

But first may I say that we applaud the steadying hand you have brought to the challenging macro economic environment, underlining the need to tackle the public deficit while at the same time giving the country time to pull itself out of recession so that it steels itself for the tightening that must inevitably follow, We also appreciate the measures you introduced to underpin demand (e.g. the car and boiler scrappage schemes) and to provide firms some of the extra flexibility they need in managing their cash flow (e.g. HMRC negotiated payment holidays).

Productivity and value added
I believe it is common ground between us that there can be no real economic revival, no rebalancing of the economy without manufacturing playing a bigger role. In previous submissions we have shown how UK manufacturing productivity has been exemplary, but also how while French and German manufacturers for example have grown their output and the wealth it generates by a quarter with (nearly) the same number of employees, in the UK we have maintained output while reducing the numbers employed by a quarter and have therefore added less value to the economy directly and through exports (see table below).

	Year	**Germany**	**France**	**UK**
Gross Value Added manufacturing industry	2007	€494.0	€220.7	£150.5
Constant 2000 prices (billions)	1997	€390.5	€174.4	£141.7
Difference GVA manufacturing growth *(10 years)*		**+27%**	**+23%**	**+6%**
Numbers employed in manufacturing	2005*	7,515	3,325	3,299
Full time equivalents (thousands)	1997*	8,098	3,634	4,520
Difference numbers employed *(8 years)*		**-7%**	**-9%**	**-27%**
Manufacturing Value Added	2005*	€70.0	€68.0	£51.7
Per employee (thousands)	1997*	€53.9	€51.4	£37.3
Difference GVA per employee growth *(8 years)*		**+30%**	**+32%**	**+39%**
Goods exports	2007	€975.2	€400.0	£209.9
Constant 2000 prices (billions)	1997	€457.3	€255.4	£160.6
Difference in growth of goods exports *(10 years)*		**+113%**	**+57%**	**+31%**

Source: AMECO (EU Commission ECFIN Database)
* Note: 8 year span due to lack of UK data for 2006 - 2007

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In sum, greater productivity does not necessarily lead to greater value added for the economy. The missing ingredient is investment.

Investment

The decline in orders for manufacturing goods has brought about its own decline in demand for new manufacturing capability. The danger is that too many firms are not investing ahead of the eventual upturn for lack of confidence.

In our October submission we showed how UK manufacturing investment has declined per company by some 30%. Although reversing this trend will require a change of culture which will of course extend well beyond current concerns, this requirement must inform policy.

	1997	**2007**
Companies	169,663	149,101
Total investment £ millions	20,314	12,002
Average per manufacturing company £	120,000	81,000

Source: Annual Business Inquiry 16 June 2009

Unfortunately matters are not clear cut. And competing in a globalised industry we see other challenges rising.

First, one of the lessons from previous recessions is that left to its own devices, manufacturing investment is likely to remain weak for some time (four years according to an EEF study) because when demand builds it initially takes up the slack that's still left in the system.

Second, but at the same time, manufacturing technology life cycles are getting shorter.

As producers of the capital plant manufacturers use we know that we have to innovate and upgrade our machines every two to three years. For some it is a continuous process. (For an extreme example look at autosport. Their 'machines' are revolutionised every year and upgraded every week between races.)

Companies supplying into innovative or high value added markets have to keep investing to innovate and upgrade performance in plant and skills. If they don't they fail. And where they fail they threaten the supply chain that depends on them all the way up to the original equipment manufacturer (OEM).

So banks must step up as partners to facilitate investment not just with the OEMs but with these crucial supply chain link SMEs, even with the economy finely balanced. Without that investment UK firms and the supply chains that depend on them will be lagging competitors who are installing the latest equipment now.

Current state of trade

In January, responding to our Monthly Business Monitor (which reflects performance this month with the preceding) firms gave their most bullish business performance returns so far (see attachment 1). Five companies reported increases in inquiries for every faller. Two firms reported increased sales for every one recording a decline. It was also the first month where exports have really shown strong increases, which is important in our sector as we are 70+% export.

However, keep in mind that this is off the bottom of the recession, where the sector is on average 30-35% down on where it was in November 2008.

On access to finance, although firms said overwhelmingly that conditions hadn't changed, over a fifth still say investment financing is more difficult to come by. (We continue to work with the British Bankers Association and some of its members on this issue. We are still receiving reports of very poor banking behaviour. When a firm pays a rearrangement fee for their overdraft at the end of 2009 only to be told recently that it will be withdrawn in June this year the bank (RBS yet again) and insists they go for invoice financing it leaves the customer with a spiralling cash flow problem if they should have the slightest downturn in their fortunes and it can also have a knock-on impact on their ability to export -- see below under cash flow.)

With these sorts of practical pressures adding to the uncertainties that are in any case there in the market, we cannot say whether the January improvement is solid. That is why we are keen that you don't withdraw the under-pinning measures too quickly. However, we are cautiously more optimistic than we were nine months ago.

Our companies' priorities are still to find (new) customers (mostly overseas), maintain cash flow and access finance on internationally competitive terms.

We therefore continue to prioritise action in those areas.

Finding new customers
Trade Credit Insurance
UK exporters, particularly SMEs need a far more flexible system of coverage, particularly if they are to penetrate new, dynamic markets as well as the traditional ones. Following Treasury pressure, ECGD's offer has been so scaled back as to be ineffective for most of our members needs. Indeed for many SMEs the Trade Credit Insurance Top Up scheme stopped at the frontier and so excluded exports.

Bank guarantees for customer deposits paid on orders placed with UK companies
In mechanical engineering it is standard practice for a customer to pay a 30% deposit to confirm their order. It happens all over Europe and in the USA. In return for the deposit, the customer expects to receive a guarantee, normally from a bank, that they will receive the machine they have ordered or their money back.

Whereas French, German and US banks provide the guarantee for a small (sometimes no) charge, UK banks often deduct the deposit from the company's overdraft at the bank, so that the manufacturer is no better off for having received the deposit. There's no benefit to company cash flow.

Apparently such difficulties do not arise in other countries, because they run a 'Bond Support Scheme' with government backing, so that any orders where the deposit may be too big to be handled by the usual channels, can be covered competitively.

Following Treasury pressure UKTI is charging SMEs unreasonably for certain services
Here's an example. "This week I came across an extraordinary paradox from UKTI the organisation that is there to assist small UK companies to do business overseas. I was invited on a trade mission to the US to meet some senior officials in NASA. To my amazement when I enquired the details I found we are to be charged for the introductions being provided. I quote "The British consulate offices in Washington and Los Angeles will charge a fee for making the connections within NASA and the prime contractors, taking care of logistics and for aspects of mission organisation that will be passed onto mission delegates. We have agreed with the consulate offices on a per company charge of £480 + VAT for the mission." For me this comes on top of recently having to pay the Consulate in Taiwan £500 to validate an electronic signature on a UK Export Licence – because the new electronic signature had not been agreed with the countries to which it applied. Our customer, the Taiwanese Government wouldn't believe the signature."

Cash flow
We have already mentioned some areas where a change of practice would enable exporters to make proper use of the deposits they receive with their orders as working capital. And more

flexibility in trade credit would also improve cash flow for SMEs using invoice financing, which banks refuse to pay on exports unless there is a guarantee.
Other areas:

- a technical amendment to accounting standard FRS 5 so that firms servicing Just-in-Time contracts aren't subject to the huge increase in Corporation Tax liability when work in progress and stocks are grossed up and added to sales.
- maintain pressure on the banks to fulfil the undertakings they gave as part of the rescue package they received, e.g. to lend an extra £40 billion to SMEs.

Investment
If the UK is to maintain its push for a more broadly balanced economy, then investment is surely fundamental. Already there is a danger of sliding back into the era of the two speed economy, as the banks come roaring out of recession at the expense of the wider economy and with the benefit of public backing.

Reluctantly we have come to the conclusion that UK manufacturing SMEs are unlikely to have as supportive a relationship with their banks as similar sized firms enjoy in Germany and France or the USA.

In our October letter we included evidence from a Gallup survey commissioned by the EU Commission and the European Central Bank. It showed UK SMEs being squeezed far harder than their counterparts in France and Germany in particular (see attachment 2).

We therefore support the idea of an Infrastructure and Industrial Investment Bank. This would change perceptions about the UK as a place to run a manufacturing business.

We welcomed the introduction of 100% capital allowances in 2008. However, the cap at £50,000 is far too low for manufacturing. Recognising that the downturn also puts pressure on the public finances, we recommend that the cap be raised to £250,000 immediately to encourage firms to kick-start investment.

Ultimately the cap should be raised to £500,000 to encourage investment in more substantial, leading edge equipment and eligibility should be extended to companies with a maximum turnover of £50 million. At this level you will capture those firms that have significant global potential but are still constrained by access to finance from competing with the really big international companies.

Yours sincerely

Martin Walder
Chairman
Engineering and Machinery Alliance

cc Rt Hon Lord Mandelson – Secretary of State -- BIS
Ian Pearson MP – Economic Secretary – HMT
Ian Lucas MP – Minister for Business -- BIS
Marie-Anne Mackenzie/Brian Greenwood/Sandy Grom -- BIS
Katherine Green/Karen O'Brien – HMT
Member associations

Engineering and Machinery Alliance

Attachment 1

Business Monitor for January 2010 (126 responses)
Change on previous month % responses (exporters 65% of sample)

Note: No December survey due to holiday period and other seasonal business interruptions

1 Prospects/Inquiries	**UP**		**SAME**		**DOWN**		**UP/DOWN Difference**	
	UK	***Export***	***UK***	***Export***	***UK***	***Export***	***UK***	***Export***
January 2009	15	13	24	47	61	40	-46	-27
February	22	23	38	54	40	23	-18	0
March	28	22	33	50	39	28	-11	-6
April	31	28	26	28	43	44	-12	-16
May	24	12	47	50	29	38	-1	-26
June	33	19	44	54	23	27	+10	-8
July	33	14	48	55	19	31	+14	-17
August	28	13	36	51	36	36	-8	-23
September	46	33	38	55	16	12	+30	+21
October	41	37	42	42	17	21	+24	+16
November	52	33	37	50	11	17	+41	+16
December	No survey							
January 2010	**58**	**42**	**33**	**49**	**9**	**9**	**+49**	**+33**

2 Order intake	**UP**		**SAME**		**DOWN**		**UP/DOWN Difference**	
	UK	***Export***	***UK***	**Export**	**UK**	***Export***	**UK**	**Export**
January 2009	18	20	20	32	62	48	-44	-28
February	18	21	31	29	51	50	-33	-29
March	11	18	28	42	61	40	-50	-22
April	21	30	23	33	56	37	-37	-7
May	20	5	35	46	45	49	-25	-44
June	39	19	28	49	33	32	+6	-13
July	37	22	26	42	37	36	0	-14
August	33	22	23	41	44	37	-11	-15
September	51	34	26	43	23	23	+28	+11
October	40	23	43	56	17	21	+23	+2
November	34	22	39	44	27	34	+7	-12
December	No survey							
January 2010	**47**	**47**	**30**	**39**	**23**	**14**	**+24**	**+33**

3 Jobs in the UK	**UP**	**SAME**	**DOWN**	**UP – DOWN**
January 2009	9	59	32	-23
February	0	67	33	-33
March	0	74	26	-26
April	2	65	33	-31
May	8	66	26	-18
June	8	71	21	-13
July	12	61	27	-15
August	8	70	22	-14
September	11	75	14	-3
October	19	56	25	-6
November	9	80	11	-2
December	No survey			
January 2010	**15**	**75**	**10**	**+5**

4 Investment	Investment stopped	Plans deferred	Developing projects	Investing in all areas	Investing in staff	Other
January 2009	10	28	40	6	8	8
February	27	31	17	4	17	4
March	31	22	25	10	6	6
April	28	28	32	5	2	5
May*	22	28	35	6	4	6
June	25	34	22	9	9	1
July	22	30	35	6	4	3
August	30	19	26	11	5	9
September	12	22	30	20	12	4
October	25	17	29	8	17	4
November	10	27	30	3	25	5
December	No survey					
January 2010	**11**	**13**	**32**	**17**	**22**	**5**

Note:

- *** over 100% due to rounding**
- **choice of statements in full:**
  1. **All investment activity stopped**
  2. **Investment plans deferred**
  3. **Developing projects but not committing to them**
  4. **Investing in staff development and training but capital investment**
  5. **Investing in all areas of the business**
  6. **Other**

5 Capital availability	More Difficult		About the same		Easier	
	Working	***Investment***	***Working***	***Investment***	***Working***	***Investment***
January 2009	48	58	52	42	0	0
February	39	40	61	60	0	0
March	37	41	61	59	2	0
April	41	36	59	64	0	0
May	22	24	76	76	2	0
June	25	33	75	66	0	1
July	22	23	78	77	0	0
August	33	30	63	68	4	2
September	14	21	79	76	7	3
October	25	21	69	75	6	4
November	18	25	80	73	2	2
December	No survey					
January 2010	**14**	**23**	**80**	**74**	**6**	**3**

Most active sectors (% firms responding to this question): automotive (28%); food, beverage and food processing (19%); healthcare, pharmaceutical and medical (17%), aerospace and defence (17%) and oil, gas and renewables (11%).

Least active sectors (% firms responding to this question): automotive and motor sport (27%), construction and yellow goods (18%), pharmaceutical, medical and toiletries (18%).

Engineering and Machinery Alliance

Attachment 2

UK – EU comparisons on access to finance and associated costs
In June and July Gallup Organisation carried out some research for the EU Commission and the European Central Bank on companies' access to finance across the EU27+ others.

Eurobarometer's *Access to Finance Report* (published in September) covers many industries (60%) such as manufacturing, construction, distributive trades and logistics as well as services (40%) for business and individuals with a particular focus on SMEs which accounted for over 92% of all responses.

As the following extracts testify, the report indicates that banks play a more central role as supportive business partners in Germany, France and Italy than they do in the UK, where firms use a greater variety of sources placing perhaps a greater demand on cash flow.

Survey results

1. Compared to companies in Germany, France and Italy, use of trade credit has been far more popular in the UK. (Note this refers to 'trade credit', the period between delivery and when payment must be made for the goods, not 'trade credit insurance'.) On the other hand, a far smaller proportion of UK firms accessed a bank loan in the first two quarters.

Used over the last 6 months:	**UK**	**Germany**	**France**	**Italy**
Bank loan	19	28	26	32
Internal funds	60	67	50	39
Grants, subsidised loans	9	7	10	16
Bank overdraft	36	30	31	38
Trade credit	35	5	9	10
Leasing, hire purchase, factoring	18	33	14	19

2. Banks are more involved in providing loans to business in other countries than in the UK.

Provider of most recent loan over the last 2 years:	**UK**	**Germany**	**France**	**Italy**
Bank	72	86	94	94
Private individual	14	9	1	3
Other (micro finance, government etc)	14	5	5	3

3. While over half UK firms say that the cost of financing (other than interest rates) has increased in the last six months, half of French and German firms say that the cost has remained unchanged. And in Germany more than one in eight say charges have fallen.

Charges other than interest rates in last 6 months:	**UK**	**Germany**	**France**	**Italy**
Increased	53	17	37	46
Unchanged	33	58	48	35
Decreased	7	13	3	8

4. While half of firms in all four countries say that the size of their loans remained unchanged over the last six months, far more UK firms report decreases in the amounts they could borrow than in the other three countries.

Available size of loan over the last 6 months:	**UK**	**Germany**	**France**	**Italy**
Increased	10	24	14	20
Unchanged	52	54	54	55
Decreased	30	16	18	11

5. UK firms are equally likely to use a loan as working capital or for fixed investment, whereas fixed investment dominates French, German and even Italian use. Also far more UK companies use loans to help finance R&D or training.

Use of most recent loan (over last 2 years):	UK	Germany	France	Italy
Working capital	**57**	**44**	**20**	**35**
Fixed investment	**50**	**60**	**69**	**42**
R&D	**13**	**8**	**6**	**9**
Training	**10**	**2**	**1**	**2**

Conclusions

1. UK suppliers may have had more pressure on their cash flow than their competitors in France Germany and Italy. Standard payment terms are much shorter for example in Germany.
2. Banks are much more closely involved with their business clients, with bank loans far more prevalent in the other three countries than in the UK.
3. French and German companies are more likely to be benefiting from financing terms that have been maintained at pre-crisis levels. Terms for UK and Italian firms are much more likely to have got tougher.
4. One of the key changes for UK companies was the cut in the amount they could borrow. German, French and Italian firms were not hit to the same degree.
5. Loans in Germany, France and Italy are more likely to go on fixed investment, where the plant can be used to pay off the loan. UK companies are more likely to spend it on running the business, with more than two in ten using it for R&D and training.