

UK ECONOMICS FOCUS

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Editors: Roger Bootle and Jonathan Loynes

Can the UK make the most of the lower pound?

- Concerns have been expressed that the UK's export-dependent sectors, most notably manufacturing, no longer have the key ingredients necessary to make the most of the boost to their competitiveness from the fall in the pound. **But we still think that the best medium-term hope for the UK economy lies in a mini-revival of the manufacturing sector and a period of net export-driven growth.**
- It has been argued that UK manufacturers no longer have the know-how, skilled labour or capital necessary to boost production. However, we disagree for several reasons. **First, the UK has, on the whole, only stopped producing things which require relatively little expertise.** In contrast, it has continued to expand production in high-tech areas like aerospace and electricals.
- Second, manufacturers need not necessarily be hamstrung by a shortage of skilled labour. **Skilled workers can be redeployed from other sectors, particularly financial services, or imported.**
- Lastly, capacity constraints do not look like a serious obstacle. **Manufacturers have a lot of spare capacity, including factories lying idle.** By the time this has been used up, the credit crunch should have thawed, making it easier for firms to borrow to invest. Even if firms still find it hard to get credit, the boost to profits from the lower pound should leave firms with higher retained earnings to invest.
- That doesn't mean that manufacturing's share of the economy won't fall further during this recession. It may drop to just 11% of GDP, from 12% last year. **However, we think that over the following five years or so, it could rise to around 13% of GDP.**
- At the same time, net trade should make a significant contribution to GDP growth, especially given that manufacturing is not the only area of the economy set to benefit from the drop in the pound. Exports of tourism services, as well as transport and IT services, should rise significantly. **Eliminating the trade in goods and services deficit would boost GDP by about 3.2%, spread over several years.**
- With the world economy so weak, a decent contribution to overall GDP growth from net trade looks unlikely this year, or perhaps even next year. **But further ahead, the external and manufacturing sectors could play a starring role in the post-recession economy.**

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Can the UK make the most of the lower pound?

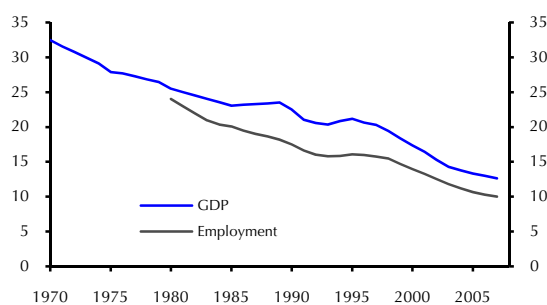
Any previous hopes that the UK's external sector would help to offset, rather than exacerbate, the recession have been well and truly dashed. Exports have been falling as heavily as imports, preventing any significant improvement in the trade position. And output in the particularly export-dependent manufacturing sector has plummeted.

More importantly, though, people have started to question whether net trade can provide a boost to growth further ahead, once global demand has recovered. **Of particular concern is whether the manufacturing sector has simply shrunk too much to be able to make the most of the lower pound.** In this *Focus*, we take a closer look at whether or not it is wise to rely on the exporting sectors, and manufacturing especially, to return the UK to healthy rates of economic growth.

Manufacturing's current state

Chart 1 illustrates the sheer scale of the relative decline in UK manufacturing over the past few decades. The sector's share of nominal GDP fell from over 30% in the early 1970s to just 12.6% in 2007 (the latest data available). The recession looks likely to take this share even lower, to just 11% or so. Meanwhile, manufacturing's share of employment has fallen from 25% in 1980 to 10% now.

CHART 1: MANUFACTURING (AS A % OF GDP & EMP.)

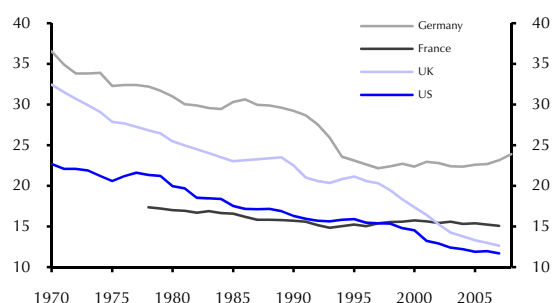


Source – Thomson Datastream

This trend is not, of course, peculiar to the UK. As Chart 2 shows, manufacturing has also declined as

a share of GDP in most other developed economies. While these data suggest that UK's manufacturing share is still smaller than in France and Germany, it is a touch higher than in the US. And alternative data from the IMF suggest that it is a bit bigger than in France as well.

CHART 2: MANUFACTURING (AS A % OF GDP)



Source – Thomson Datastream & Capital Economics

Nonetheless, this decline has prompted concerns that the UK no longer has an adequate “manufacturing base” to work with. Once manufacturing capacity is lost, it is argued, it is lost for good. In order to assess whether this argument has any truth, we look in turn at the three essential ingredients for manufacturing success - know-how, skilled labour and capital.

The UK still has the expertise

Starting with know-how, has the UK lost the capability required for a mini-revival in manufacturing? The short answer is no.

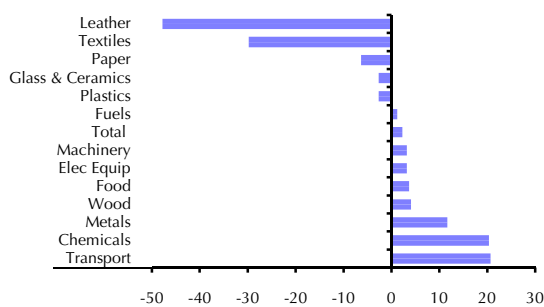
The key point is that the manufacturing capacity lost by the UK has primarily been in low-technology, low-skilled sectors. **In other words, the UK has only stopped producing those things which do not require much know-how anyway.** And it could presumably get back some of these if it made economic sense, given that it was predominantly countries which rely on a large pool of unskilled labour that took them from the UK in the first place. Even if the UK does not start to produce entire goods from start to finish, it can

easily play a greater role in the production process. For example, the drop in sterling could increase the usage of UK-produced components in cars produced both domestically and abroad.

In contrast, the UK has been increasing its production of the high-tech, high-expertise areas of production. (See *UK Economics Focus*, “Has manufacturing really reinvented itself?” 22nd January 2008.) A recent report by the Work Foundation showed that high to medium technology output now accounts for around half of manufacturing production.

Indeed, the UK is now one of the leading producers of chemicals, aircraft, electrical and optical equipment and “green” technologies (such as electric cars), with output in these areas having expanded by up to 20% between 2000 and 2007. (See Chart 3.) Manufacturers have also diversified into providing services (e.g. maintenance contracts) alongside their manufactured goods. And spending on research and development by the manufacturing sector rose at an average annual rate between 2004 and 2007 of 6%.

CHART 3: % CHANGE IN OUTPUT IN MANUFACTURING SUB-SECTORS (2000 – 2007)

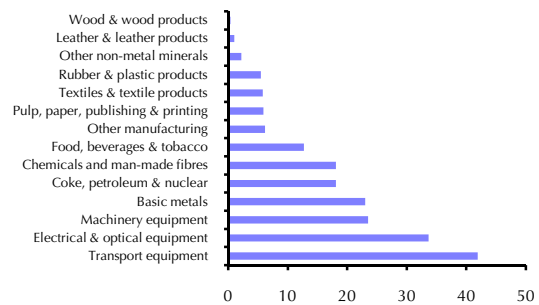


Source – Thomson Datastream

To claim that UK manufacturers have lost their expertise therefore seems wide of the mark. **On the contrary, they seem well-placed to continue to play to their exporting strengths.** As Chart 4 shows, the bulk of manufacturing exports are in high-tech areas such as transport (33% of which is aerospace and 12% engine parts) and electrical

and optical equipment (27% of which is medical and precision instruments).

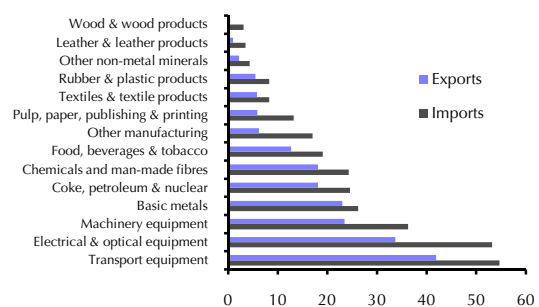
CHART 4: UK GOODS EXPORTS (£BN IN 2008)



Source – Thomson Datastream

What’s more, this expertise should also leave the UK manufacturing sector well-positioned to start producing more of the goods that are currently imported. **After all, the immediate hopes for a net trade boost lie just as much, if not more, on import substitution as on higher exports.** Chart 5 (which also shows the breakdown of goods imports to the UK) shows that the bulk of imports are in those areas where manufacturers have been most successful in terms of both output and exports.

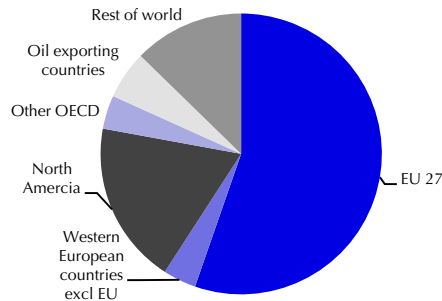
CHART 5: UK GOODS EXPORTS & IMPORTS (£BN IN 2008)



Source – Thomson Datastream

Of course, even with the drop in sterling, the UK is never going to become cost-competitive against countries such as China. But most of the UK’s imports in fact come from Europe. (See Chart 6.) And following the pound’s fall, there is no reason why the UK cannot compete on costs with its European neighbours.

CHART 6: UK IMPORTS BY AREA OF ORIGIN (% OF TOTAL)



Source – Thomson Datastream

We therefore do not see why a lack of expertise should hamper the future of the manufacturing sector. The UK has continued to develop its expertise in high-tech sectors, even as the overall manufacturing sector has declined.

Skilled labour should not be a problem

Even if the expertise exists, the sector will still need more people with the education and skills to be able to apply that know-how to actual production. And traditionally, a lack of skilled labour has been a key factor holding back the sector.

However, we do not think that a lack of skilled labour is an insurmountable obstacle, for at least four reasons. **First, many areas of production can increase output without any extra skilled labour at all.** It might just be a case of increasing the number of unskilled workers operating production lines.

Second, many workers, both skilled and unskilled, are not being fully utilised anyway at the moment. Large parts of manufacturing have put their workforces on reduced hours.

Third, there is considerable scope for skilled workers in other sectors of the economy to be redeployed to the manufacturing sector. The most obvious example is financial services, given that a revamped bonus culture and tighter regulation is likely to hamper the growth and attractiveness of the sector for years to come. As a result, there should be a flow of new science and engineering graduates who would previously have been funnelled into the City, entering industry instead.

And fourth, if it needs to, there is no reason why the UK cannot import skilled labour from abroad.

After all, it has been doing so in great numbers in financial and business services, so why not manufacturing? Admittedly, the UK is tightening up on immigration restrictions. However, the new points based system means that exceptions will be made for sectors where the UK is short of skilled labour. And as the manufacturing sector begins to grow more rapidly, it may feel better placed to offer more competitive salaries to attract skilled workers from overseas.

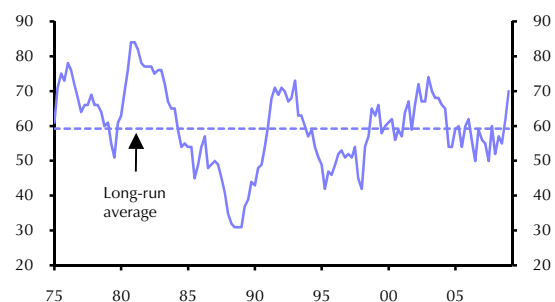
And there is plenty of spare capacity

Lastly, what about capital? The problems firms are currently facing in accessing finance means that, in theory, this could be the biggest barrier to manufacturing rebuilding itself. But even here, there are ways around the problem.

For a start, in the near-term, firms won't actually need any extra capital.

They will be able to increase output using their existing resources (assuming that the capital has not become obsolete in the more high-tech and fast-moving areas of manufacturing). A huge amount of spare capacity is building up in the manufacturing sector, as evidenced by the mothballing of plants and factory shutdowns. Simply fully utilising existing machinery and equipment will allow output to expand significantly from its current levels. Chart 7 shows the CBI's net balance of firms operating below spare capacity is close to 70%.

CHART 7: CBI % NET BALANCE OF FIRMS OPERATING BELOW SPARE CAPACITY



Source – Thomson Datastream

Admittedly, the availability of working capital – and, in particular, the availability of trade credit insurance – might still present a problem in the short-term. However, the CBI’s *Access to Finance* survey suggests that this is a much bigger problem for small, than for large, firms. And firms should now be helped by the Government’s new top-up insurance scheme announced in the Budget.

Of course, firms’ spare capacity will be used up eventually. Then there are two key questions. **First, will firms be willing to commit funds to invest? And second, will they have the cash to do so?**

Firms might be reluctant to invest if they think that the drop in the pound will be reversed at some point. They might also hesitate if they think that the long-term prospects for the industry are still pretty poor. However, the exchange rate does not look massively out of kilter with the economic fundamentals – what was odd was the *previous* high level of the pound. Responding to the lower level of the exchange rate is therefore the entirely appropriate thing for manufacturers to do.

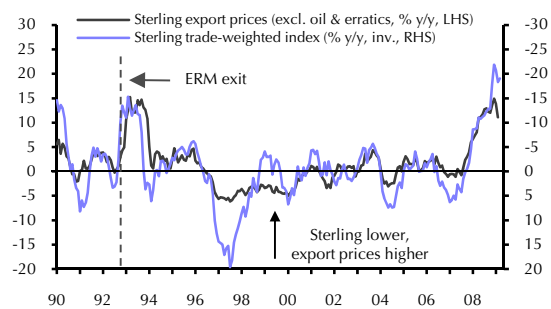
Meanwhile, it’s true that any rise in manufacturing’s share of GDP is unlikely to continue beyond the medium-term. Industry is set to remain in long-term relative decline, reflecting both the increasing reach of globalisation and the fact that as we get richer, we tend to spend more on services than on goods. But that doesn’t mean that the *level* of output will decline in the future. **And, of course, a mini-revival in manufacturing’s share in the economy will leave the *level* of output permanently higher.** Investment in plant and machinery will therefore still be worthwhile.

Whether manufacturers will have the funds to invest is another matter. But by the point that firms’ spare capacity has been exhausted, the credit crunch should have thawed considerably, allowing firms to borrow to invest. In any case, manufacturers have so far been fairly sanguine about the impact of the availability of finance on investment. The net balance of manufacturers reporting availability of external finance to be a

constraint on investment was a relatively low +15 in Q1’s CBI Industrial Trends survey (although this may be because firms do not want to invest for other reasons and so have not tried to get credit).

Lastly, even if credit conditions *are* still acting as a constraint on investment, firms should soon have higher retained earnings to fall back on, resulting from the boost to their profit margins from the drop in the pound. Exporters have pushed up their sterling prices as the pound has fallen, thus foregoing an increase in their market share, but enjoying a boost to their profitability. (See Chart 8.)

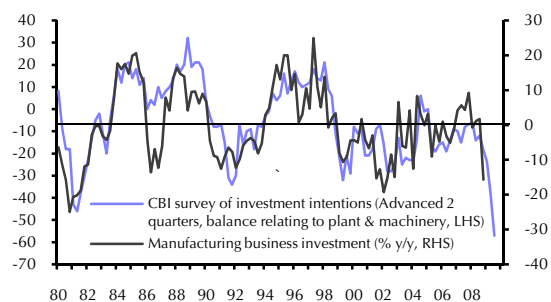
CHART 8: STERLING & EXPORT PRICES



Source – Thomson Datastream

Of course, building capital takes time. Again, though, firms have years before their spare capacity is exhausted and so have ample time to get the ball in motion for the creation of new capacity. In any case, Chart 9 suggests that the time lag between changes in investment intentions and actual investment is as short as six months.

CHART 9: MANUFACTURING INVESTMENT



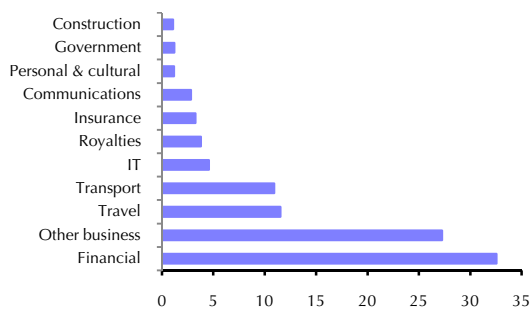
Source – Thomson Datastream

Drop in the pound will boost services

We therefore think that there is plenty of potential for the manufacturing sector to benefit from the drop in the pound. **What's more, there is no reason why a revival of net exports must involve manufacturing exclusively.**

Admittedly, there is limited scope for growth in the biggest area of services exports – financial services. These account for one third of overall services exports. (See Chart 10.) But other areas of services should be able to exploit the fall in the pound.

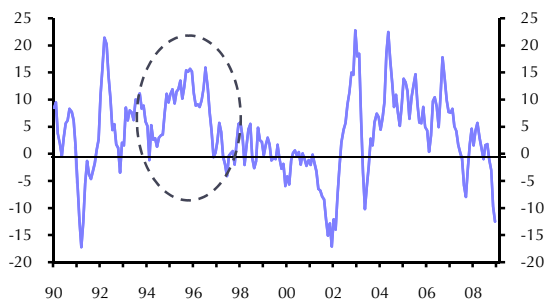
CHART 10: BREAKDOWN OF SERVICES EXPORTS (AS A % OF TOTAL)



Source – Thomson Datastream

The most obvious example is the tourism sector, which accounts for 11.5% of services exports. The number of visitors to the UK rose at double digit annual rates following the 1992 sterling depreciation. (See Chart 11.) IT services, business services (such as law or management consultancy) and transport (such as freight or air travel) should also benefit from a boost to their competitiveness.

CHART 11: OVERSEAS VISITORS TO THE UK (% Y/Y)



Source – Thomson Datastream

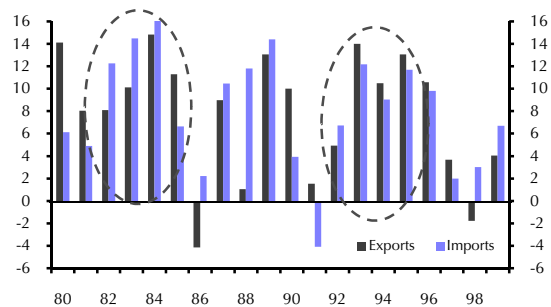
As with manufacturing, the drop in the pound should also help UK firms to start providing some of the services that are currently imported from abroad, also helping to improve the net trade position. Again, tourism is a prime example, with the lower pound likely to encourage more UK residents to holiday in the UK, rather than abroad.

The potential net trade boost

So what might the net trade picture look like once the near-term drag from falling global demand has eased? The obvious blueprint is the mid 1990s experience, given that a similar drop in the pound was seen after the exit from the Exchange Rate Mechanism in September 1992. The early 1980s also saw a substantial 32% fall in the pound, but the drop took place gradually over almost 6 years.

Chart 12 shows the annual growth rate of exports and imports of goods and services, in value terms. Exports grew at stonking rates – by 11% p.a. on average between 1982 and 1985 and by 10% between 1993 and 1997. But imports grew quickly too – in fact, *more* quickly in the early 1980s.

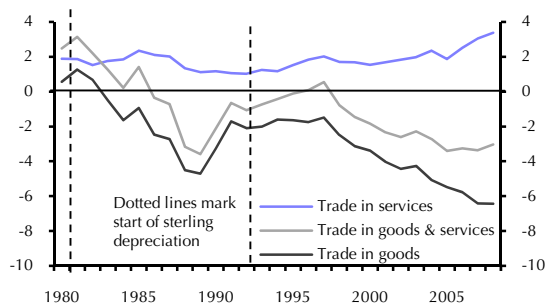
CHART 12: GOODS & SERVICES EXPORTS & IMPORTS (VALUES, % Y/Y)



Source – Thomson Datastream

The impact on the trade balance was therefore far from spectacular (and in fact in the early 1980s the deficit actually *deteriorated*). Nonetheless, between 1992 and 1995, the trade in goods deficit narrowed from £2.1bn to £1.6bn. The total goods and services balance turned from a deficit of 1.1% in 1992 to a surplus of 0.5% by 1997. (See Chart 13.) A similar experience this time would see the overall trade deficit narrow by about 1.5% of GDP.

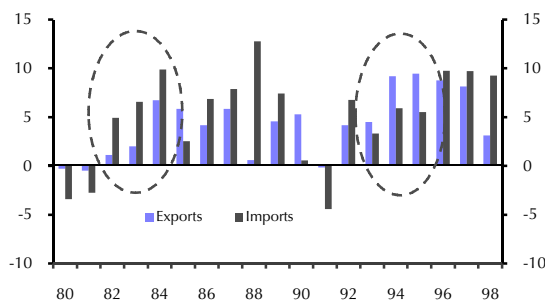
CHART 13: GOODS & SERVICES TRADE BALANCES (AS A % OF GDP)



Source – Thomson Datastream

What’s more, the reduction in the trade deficit of around 1.5% of GDP in the early 1990s had an even bigger impact on *real* GDP growth. As Chart 14 shows, in *volume* terms, export growth outpaced import growth more convincingly. Import volumes grew by 5% p.a. on average between 1993 and 1997, while exports grew by almost 8%.

CHART 14: GOODS & SERVICES EXPORTS & IMPORTS (VOLUMES, % Y/Y)



Source – Thomson Datastream

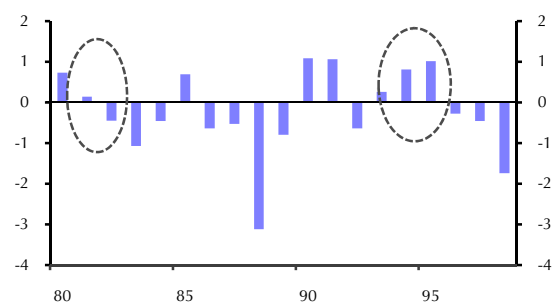
By 1995, net trade was therefore contributing some 1% to annual GDP growth. (See Chart 15.) The cumulative contribution over the three years from 1993 to 1995 together was 2%.

What’s more, the improvement in the trade deficit and net trade could be even bigger this time.

Admittedly, it is hard to see exports growing much more quickly than they did in the early 1990s. But imports could well be weaker. After all, real consumer spending grew by a fairly robust 2.4%

p.a. on average between 1993 and 1995. But the medium-term outlook for spending looks much weaker now, given that a prolonged period of deleveraging is likely. Note that every 1% reduction in the annual growth rate of imports increases the net trade contribution to annual GDP growth by 0.3 percentage points.

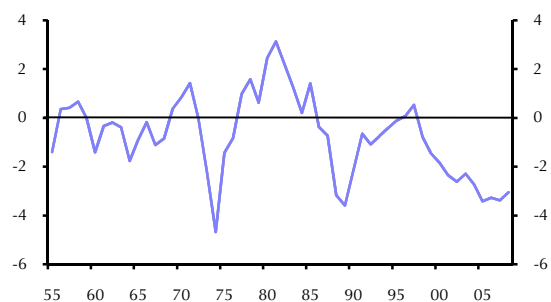
CHART 15: NET TRADE CONTRIBUTION TO ANNUAL GDP GROWTH (%)



Source – Thomson Datastream

Of course, net trade cannot continue to boost GDP growth indefinitely. As Chart 16 shows, the trade in goods and services balance has very rarely been in surplus. Nonetheless, just eliminating the deficit would give a cumulative boost to GDP of around 3.2%, spread over perhaps 4 or 5 years.

CHART 16: TRADE IN GOODS & SERVICES BALANCE (AS A % OF GDP)



Source – Thomson Datastream

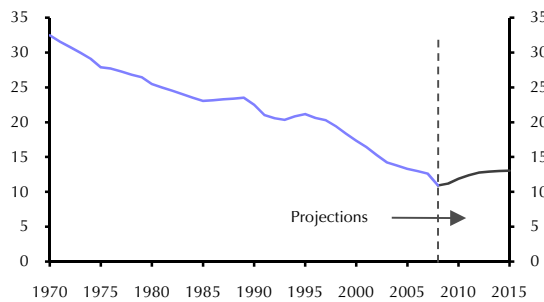
Manufacturing to reach 13% of GDP?

So what does all of this mean for the size of the manufacturing sector? Of course, not all of the rise in net exports will be due to manufacturing – services will play a key role too. Nonetheless, in its

strongest year of the early 1990s, 1994, manufacturing output rose at an annual rate of 4.7%. And between 1993 and 1995, manufacturing's share of the economy edged up by a percentage point or so, from 20.4% to 21.2%.

We expect to see something similar this time round, with manufacturing's share of GDP rising from a likely low-point this year or next of 11% to around 12% or 13% by 2015 or so. (See Chart 17.) The former would require average annual growth rates of manufacturing output of around 5.5%, while the latter would require growth of around 7.5% (both assuming a period of sub-trend growth in the overall economy in the near-term and above-trend growth further ahead).

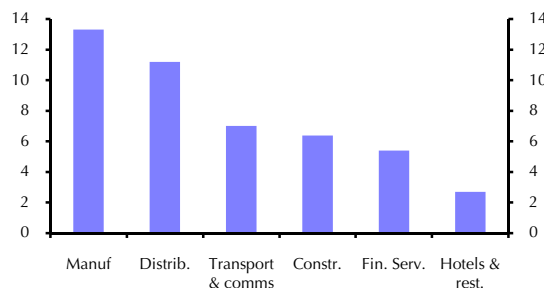
CHART 17: MANUFACTURING (AS A % OF NOMINAL GDP)



Source – Thomson Datastream

This would offset some of the hole left by the likely drop in the financial sector's share of the economy. By 2015, manufacturing could be close to three times the size of financial services. (See Chart 18.)

CHART 18: PROJECTED SECTOR % SHARES OF GDP IN 2015



Source – Thomson Datastream

Conclusions

From the end of boom and bust, to the infallibility of the banking system, a number of assumptions about the UK economy have been blown out of the water by recent events. The inevitable decline of UK manufacturing could be another one.

Of course, there is no escaping a further sharp contraction in both manufacturing output and export volumes over the next few months at least. Thereafter, however, we think that manufacturers could be in an excellent position to drive the economy forward.

As we explained in our latest *UK Quarterly Review*, this recovery in manufacturing will clearly have knock-on implications on everything from the regional picture of the UK to the productivity performance of the UK. (See "The next decade," vol. 2 2009.) **The face of the UK economy is set to change significantly over the next decade and a mini-revival in the manufacturing sector will play a key role in this.**