



Perspectives by Ruth Lea

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Manufacturing industry: a brighter future?

Introduction

It may seem perverse to speculate about a brighter future for manufacturing industry when the evidence shows that the sector is suffering disproportionately during this recession. In the first quarter of 2009, whilst GDP tumbled 1.9% in the quarter to be 4.1% lower than a year earlier, manufacturing output had fallen 5.5% to be 13.1% down on the previous year. Moreover, the economies that are especially sensitive to the growth in world trade manufactures are experiencing some of the worst declines during this recession.¹ Germany's GDP fell a worse-than-expected 3.8% in the first quarter of 2009, to give a quite staggering 6.7% year-on-year drop.

But this state of affairs will not persist and, even though we broadly concur with the Governor of the Bank of England's recent cautionary comments about the recovery when he said that the "healing" of the economy would "take some time",² growth will return in the UK and, generally, in the world economy.

The drivers of growth in Britain, however, must surely be different from the debt-fuelled growth of recent years. Given the horrendous public sector deficits, growth of the public sector must be constrained as we have argued on many occasions.³ The public spending splurges of the early 21st century simply cannot go on. And consumer spending, which has grown faster in recent years than GDP as a whole stimulated by increasing personal indebtedness, will surely "under-perform" the rest of the economy as the economy recovers.

So growth is likely to be focused on an improving external sector, where the lower pound should help to boost Britain's exports of goods and services and constrain imports. (Given the likelihood of low interest rates for some time it is reasonable to assume that the pound will stay weak.) One of the beneficiaries of this scenario should be manufacturing industry, especially those parts of manufacturing industry where Britain has traditional exporting strengths such as aerospace and pharmaceuticals. But other services, such as business consultancy and tourism should do well – though the financial services earnings are expected to shrink.

The need to rebalance the economy

An improved performance on the external account is long overdue as Britain has been running considerable current account deficits since the late 1990s. Indeed an overall, wholesale rebalancing of the British economy is long overdue. In summary: the public sector must be cut back, consumption should be curtailed and the country needs to be much more mindful of “living within its means”. The current imbalances of the economy, which have grown up over the last decade of economic mismanagement, are quite simply unsustainable.

The manufacturing sector, a major player in Britain’s overseas current account transactions, should have a major part to play in this rebalancing act. Our manufacturing trade performance has been relatively poor in recent years, partly hindered by the strong pound. A stronger performance from manufacturing should therefore not only be expected, as implied already, it is necessary.

Manufacturing and Britain’s balance of payments

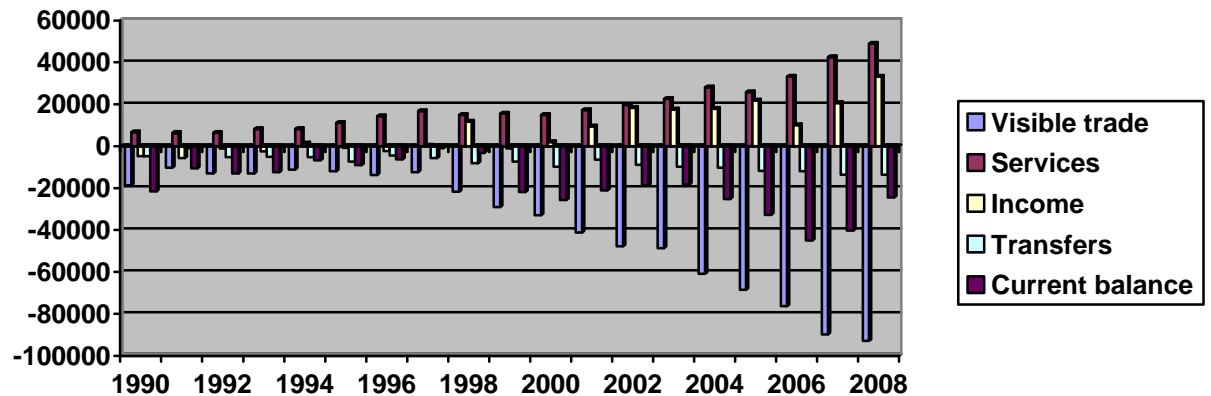
It is sometimes asserted that “Britain doesn’t make things”. But Britain is still the 6th largest manufacturing nation after the USA, China, Japan, Germany and Italy, and has a larger manufacturing sector than France.⁴

And Britain is still a major exporter of goods, most of which derive from the manufacturing sector. Indeed Britain is the 6th largest exporter of goods after Germany, the US, China, Japan and France.⁵ But, having said that, even a cursory look at the balance of payments data shows there has been a rapidly deteriorating situation in Britain’s overseas trading position in recent years. Imports growth has easily outstripped exports growth, reflecting the rapid growth of consumption and deteriorating competitiveness.

Chart 1 shows that the current account was almost in balance in 1997.⁶ A modest deficit in visible trade (goods) of £12.3bn was almost totally offset by healthy surpluses on services and in investment income. But by 2008 the visible trade (goods) deficit was dreadful, soaring to nearly £93bn. The transfers deficit (including transfers with the EU) had also increased. The current account deficit, however, was helped by large surpluses generated by services and in investment income, boosted by the dramatic weakening of the currency.

But, whatever the moderating and mitigating circumstances, large current account deficits are ultimately unsustainable. They need to be financed. Such financing inevitably increases Britain’s overseas liabilities and the servicing costs inevitably increase the current account deficit. This cannot be sustained indefinitely. The country has to “live within its means”. Britain experienced this happy state of affairs in 1997, but increasingly not so since.

Chart 1 Current account of the Balance of Payments, balances, £m, 1990-2008

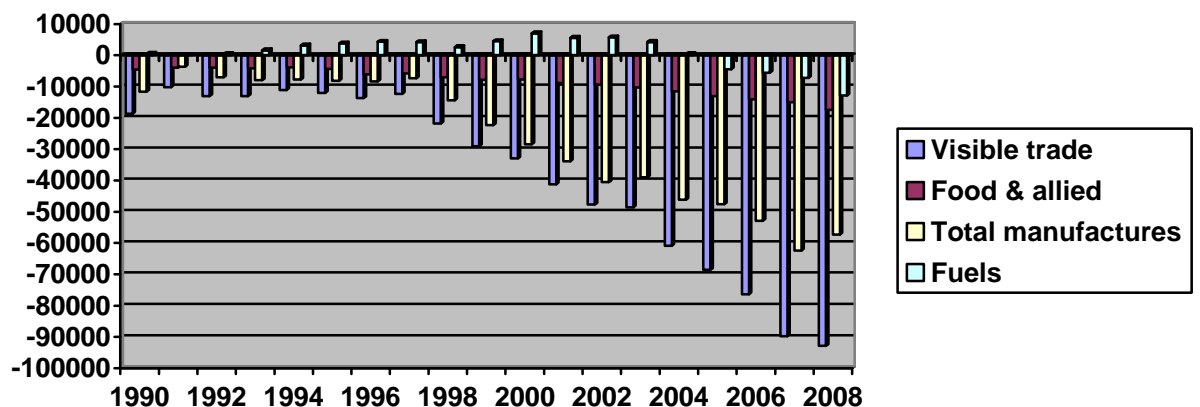


Sources: ONS, *United Kingdom Balance of Payments Pink Book*, 2008 edition and ONS database.

Chart 2 provides a breakdown of the visible trade balances. Visible trade data are classified according to the Standard International Trade Classification (SITC), the broad categories of which are: food, beverages & tobacco; basic materials; fuels; total manufactures (semi-manufactures and finished manufactures); and “unspecified”.⁷

Three broad observations on Britain’s visible trade performance over the last two decades can be made. The first is that the balance for “total manufactures” deteriorated dramatically from the mid 1990s to 2007, only to moderate in 2008 reflecting the onset of recession. The second is that the balance “food, beverages and tobacco” has worsened significantly and steadily over the last two decades. And the third is that the balance on “fuels” turned negative in 2005 and is now deteriorating very quickly as the supply of indigenous oil and natural gas reserves wind down. The bonanza from the North Sea is fading and this is yet another challenge that will have to be faced by Britain’s policy-makers.

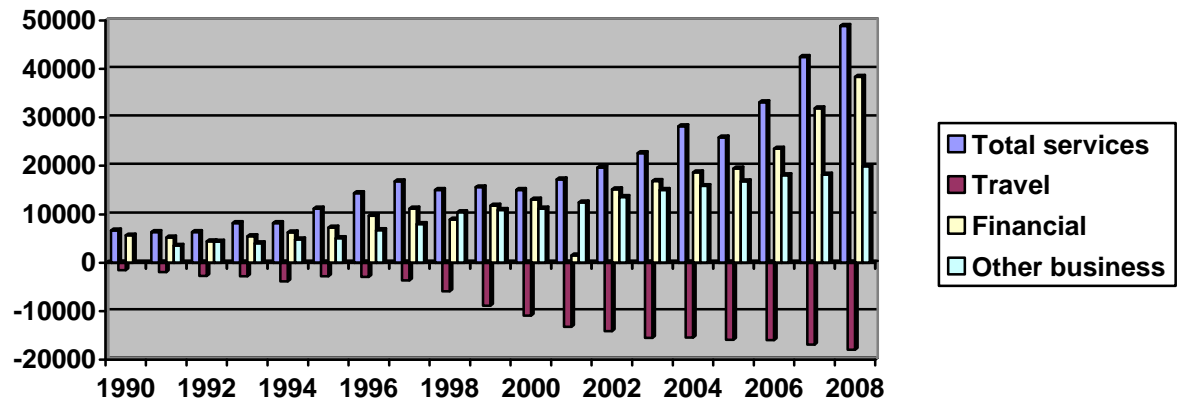
Chart 2 Selected components of the visible trade balance, £m, 1990-2008



Source: ONS database. Trade in “basic materials” and “unspecified” items are omitted from the chart.

As mentioned above, a truly dreadful performance in visible trade has been partly offset by good performances in services and in investment income. Chart 3 shows the growth in net services income in recent years. Most categories of services are net overseas earners; the exceptions are travel, transportation and government services. The big earners have been financial services, which will be hit this year by the financial crisis, and “other” business services (including legal advice, management consultancy, advertising and engineering consultancy).⁸

Chart 3 Selected services, balances, £m, 1990-2008



Source: ONS database.

But even with the strong services performance, and mindful of the problems in the financial sector, a stronger performance by manufacturing exports will surely have to be part of the solution for correcting the current account imbalance. The declining fortunes of North Sea oil clearly strengthen the need.

Crystal ball gazing: a brighter future for manufacturing?

Roger Bootle recently discussed a scenario of how the economy may change over the next decade. He concluded that “manufacturing’s share of the economy could temporarily grow from 11% to 13% or even 15%. In contrast the financial sector’s share could shrink from 8% to more like 5%”.⁹

Charts 4a and 4b show the current breakdown of GDP by industry in 2007, compared with Roger Bootle’s projected breakdown in 2020. The main “winners” over this period are business services as well as manufacturing and the main “losers” are public services as well as the financial services.

Chart 4a Breakdown of GDP in 2007 (% of total)

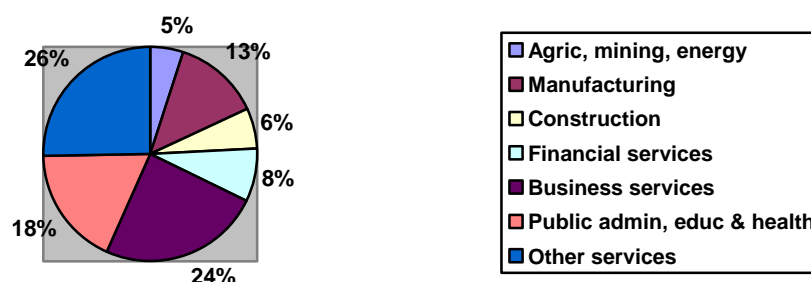
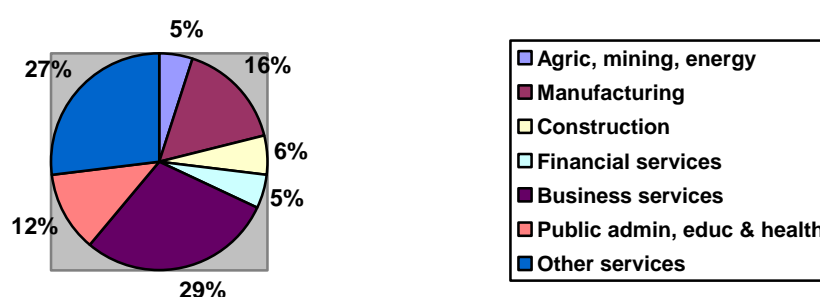


Chart 4b Breakdown of GDP in 2020 (% of total)



Source: Roger Bootle, *Economic Review: After the storm*, second quarter 2009, April 2009, Deloitte, available from www.deloitte.com. Other services comprises: distribution, hotels & restaurants, transport & communications, “other”.

These are, of course, projections. But they are useful ones as they focus on some key developments and issues that will be of relevance to the British economy once this recession is through. The economy’s structure will have to change and manufacturing, so long a neglected sector and a shrinking share of GDP, should benefit.

References

1. World Trade Organization, “WTO sees 9% global trade decline in 2009 as recession strikes”, 23 March 2009. This would be the biggest drop in trade since World War II.
2. Bank of England, Inflation Report press conference, opening remarks by the Governor, 13 May 2009, available from www.bankofengland.co.uk.
3. Ruth Lea, “Budget preview: time for the scalpel”, Arbuthnot Banking Group Perspective, 20 April 2009.
4. BERR and the DIUS, *Manufacturing: new challenges, new opportunities*, September 2008.
5. IMF, *Balance of Payments Statistics, Yearbook 2007*.
6. Current account = Visible trade (goods) + Invisible trade. Invisible trade = Services + Income (mainly investment income) + Transfers.

7. The SITC categories do not totally mirror the Standard Industrial Classification (SIC), which is used for industrial classifications. In particular, some goods produced by manufacturing industry are included in the SITC categories of food, beverages & tobacco, basic materials and fuels. In other words, goods produced by manufacturing industry are not only included in the SITC category of “total manufactures” but also in the other main categories as well.
8. Other net earners include communications, construction, insurance, computer & information technology and royalties & license fees.
9. Roger Bootle, *Economic Review: After the storm*, second quarter 2009, April 2009, Deloitte, available from www.deloitte.com.

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