HOUSE OF LORDS

Library Note

Debate on 5 July: The International Competitiveness of UK Industry, Exporting to Global Markets and Attracting Inward Investment

This Library Note provides background reading for the debate to be held on Thursday 5 July:

"The international competitiveness of UK industry, its success in attracting inward investment and exporting to global markets, and its role in strengthening the United Kingdom's economy and in job creation"

It considers the most recently published economic data indicating the competitiveness of UK industry, focusing in particular on recent figures for UK exports and foreign inward investment. It also examines the debate about the role UK companies might play in ensuring an economic recovery by the targeting of new markets for trade and inward investment, and the debate as to whether the Government should pursue a more activist industrial strategy.

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1. Introduction

This Note considers the most recently published economic data indicating the competitiveness of UK industry, focusing in particular on recent figures for UK exports and foreign inward investment. It also examines the debate about the role UK companies might play in ensuring an economic recovery by the targeting of new markets for trade and inward investment, and the debate as to whether the Government should pursue a more activist industrial strategy.

An examination of the UK Government's growth strategy is provided by the House of Lords Library Note, *Economic Growth Strategy* (LLN 2012/025, June 2012).

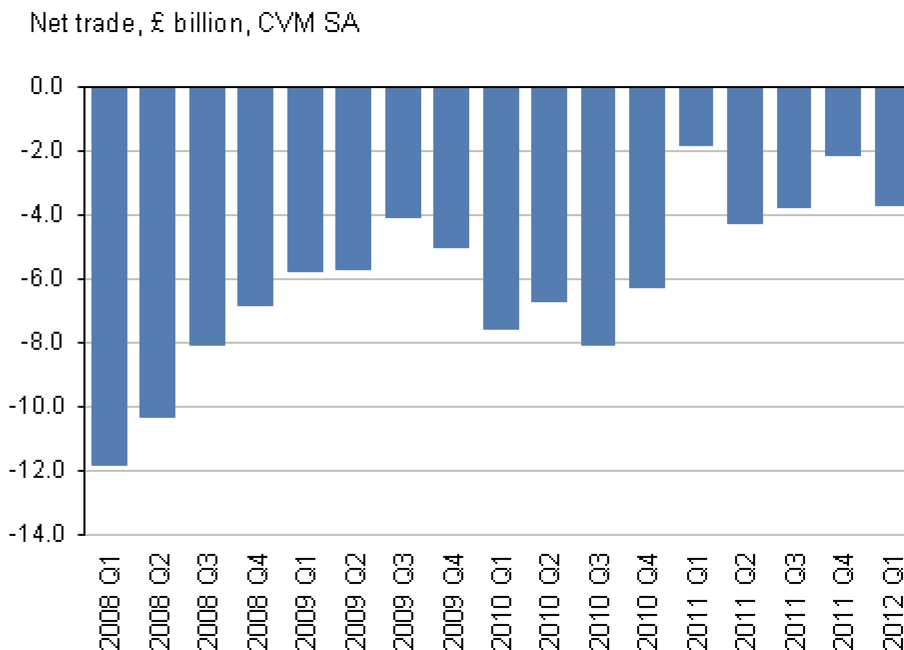
2. Official UK Figures for Exports and Foreign Direct Investment

2.1 Exports

The Office for National Statistics (ONS) reported in their *Quarterly National Accounts, Q1 2012* (June 2012) that exports in goods increased by 0.3 percent while exports of services fell by 4.5 percent in the first quarter of 2012. However, the size of the trade gap grew over the same period. The deficit in net trade was £3.7 billion in the first quarter of 2012, compared with a deficit in net trade of £2.2 billion in the last quarter of 2011.

The longer-term trend in net trade is shown in the following graph:

Net trade, £ billion, Chained Volume Measure, Seasonally Adjusted



(Source: ONS, *Quarterly National Accounts, Q1 2012*, 28 June 2012, p 8)

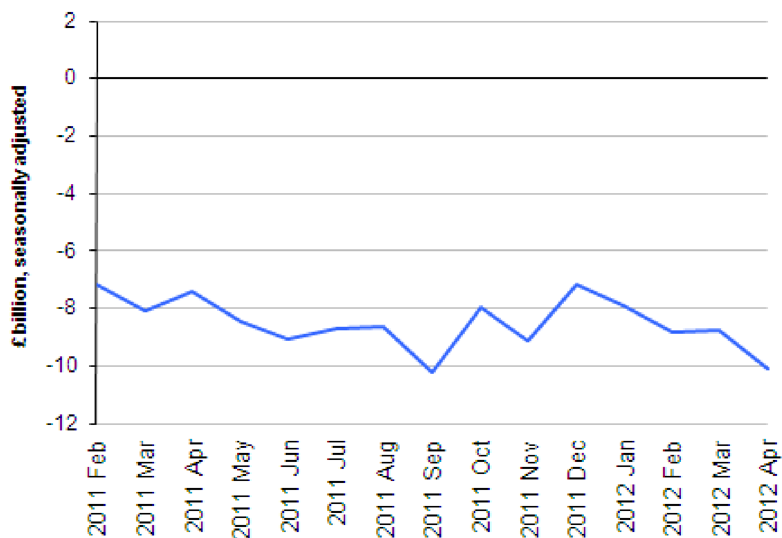
The month by month changes to the balance of trade provides a more challenging outlook of the health of UK trade. A sharp increase in the UK's balance of trade deficit

and a sharp drop in exports of goods took place in April 2012. The ONS's *UK Trade, April 2012* (June 2012) reported:

> The UK's deficit in the trade in goods and services increased to £4.4 billion in April, up £1.5 billion from £3.0 billion in March. The UK's surplus in the trade in services was estimated at £5.7 billion in April, down £0.1 billion compared with March. Exports of services rose by £0.1 billion (0.8 percent) to £15.6 billion and imports of services rose by £0.2 billion (2.3 percent) to £9.9 billion.
>
> The UK's deficit in the trade in goods increased by £1.4 billion to £10.1 billion in April compared with March. Exports of goods fell by £2.2 billion (8.6 percent), from £26.1 billion in March to £23.8 billion in April. Imports of goods fell by £0.9 billion (2.5 percent) from £34.8 billion in March to £33.9 billion in April.
>
> (ONS website, *UK Trade, April 2012—Statistical Bulletin*, 15 June 2012)

The trend in the UK's balance of trade in goods is indicated in the following graph:

Balance of UK Trade in Goods, April 2012



(Source: ONS website, *UK Trade, April 2012—Statistical Bulletin*, 15 June 2012, p 3)

The ONS reported that lower exports in the following commodities had been the driving factor in this fall in total exports of goods:

- Chemicals exports were down £0.8 billion to EU countries including Germany, and non-EU countries including the US (particularly in pharmaceuticals).
- Exports of cars were down £0.5 billion particularly to non-EU countries, including the US, China and Russia.
- Exports of precious stones were down £0.2 billion to EU countries including Belgium, and non-EU countries including India.
- Exports of ships were down £0.2 billion to non-EU countries.

(ibid, p 4)

Reacting to the larger than expected increase in the trade deficit, Chief Economist at the British Chambers of Commerce (BCC), David Kern, commented:

> The importance of one month's figures should not be exaggerated as longer-term comparisons show that exports have been flat over the past year. This proves that our exporters are facing major challenges, especially given the increased problems in the eurozone and weaknesses in the global economy. In our recent forecast we predicted export volumes of goods and services to grow by a modest 2.6 percent this year. But on the basis of the figures published so far, it is likely the outcome will be weaker.
>
> The government's deficit cutting measures will continue to put pressure on the domestic economy, which means that a lasting UK recovery will depend highly on increased exports, replacing imports with goods produced at home and increased business investment. The global environment will continue to pose serious challenges for our exporters at a time when they are trying to maintain their positions in international markets. British exporters have major untapped potential but the government should do more to help them overcome the obstacles facing them. Our businesses do not want handouts, but they need to see action which allows them to compete with overseas competitors.
>
> (BCC website, 'BCC: Government Must do More to Help UK Exporters', press release, 15 June 2012)

A longer-term overview of changes to UK trade, including changes in the balance of trade, the changing markets for UK goods exports, and how the UK has ranked as a goods exporter, is provided in the House of Commons Library Standard Note *UK Trade Statistics* (SN06211, March 2012).

2.2 Foreign Direct Investment

The estimates for the flow of inward investment to the UK are published by the ONS. The ONS noted that 2010 was a relatively quiet year for Foreign Direct Investment (FDI) involving UK companies, with both outward and inward flows of investment at their smallest for several years:

- Net flows of direct investment abroad by UK companies fell to £23.4 billion in 2010, their lowest value since 1996.
- Flows of inward investment by foreign companies to the UK also fell during 2010, decreasing to £32.8 billion, the smallest inflow since 2004.
- The overall level of inward direct investment in the UK at the end of 2010 was £731.6 billion, the highest level on record.
- Earnings from investment in the UK by overseas companies also increased in 2010, up to £37.5 billion.

> (ONS website, 'Foreign Direct Investment involving UK companies, 2010 Release', 8 December 2011)

The ONS *Business Monitor MA4: 2010 Release* (February 2012) provided the following industrial analysis of inward FDI flows to the UK in 2010 and how they have changed since 2009:

> The largest decrease in the UK's inward FDI flows in 2010 was from Europe, where it fell from £32.1 billion in 2009 to £1.8 billion in 2010, the lowest value since comparable records began in 1988.
>
> The rise in the overall investment position at the end of 2010 was primarily driven by an increase in the value of UK equity held by foreign companies, from £579.5 billion in 2009 to £643.6 billion in 2010. This was partially offset by a decrease in net levels of debt due to foreign parent companies and head offices from £91.8 billion in 2009 to £78.3 billion in 2010.
>
> (ONS, *Business Monitor MA4: 2010 Release*, February 2012, p 56 and p 67)

The breakdown of inward FDI flow between the three broad industry classifications of services, manufacturing and resources for 2010 was as follows:

- Services fell to £16.6 billion, down 58 percent compared with £39.9 billion in 2009.
- Manufacturing rose to £15.7 billion up 20 percent compared with £13.1 billion in 2009.
- Resources rose to £0.5 billion compared with a net disinvestment £4.0 billion in 2009.

(ibid, p 58)

The ONS also identified the five sectors which accounted for 90 percent of FDI inflows to the UK in 2010, and provided an analysis of how the amounts have changed since 2009:

- Food products, with £9.5 billion (compared with £0.5 billion in 2009)
- Information and communication, with £7.8 billion (compared with £1.2 billion in 2009)
- Financial services, with £7.5 billion (compared with £20.8 billion in 2009)
- Transportation and storage, with £2.5 billion (compared with a disinvestment of £4.0 billion in 2009)
- Computer electronic and optical products, with £2.3 billion (compared with a disinvestment of £0.7 billion in 2009)

(ibid, p 58)

For more information on FDI, the House of Commons Library have produced a Standard Note *Foreign Direct Investment (FDI)* (SN01828, March 2012) which sets out recent trends in FDI for the UK and the world.

3. Office for Budget Responsibility (OBR)

In their forecasts for the UK economy, the OBR has considered the key factors which contribute towards the level of UK gross domestic product (GDP). The OBR have stated that they believe that a future UK recovery would be supported "primarily by growth in business investment and net trade" (OBR, *Economic and Fiscal Outlook—November 2011*, November 2011, p 9).

In both their March 2012 and November 2011 forecasts, the OBR have been pessimistic as to the growth of business investments, believing that balance sheets were weaker than official statistics suggested.

The OBR stated in their March 2012 forecast that they expected UK exports to continue to be supported by the depreciation of sterling which began in 2007 (OBR, *Economic and Fiscal Outlook—March 2012*, March 2012, p 68). However, the OBR had revised down their prediction for growth in world trade both in their March 2012 and November 2011 forecasts. Their March 2012 forecast for the world economy was growth of 4.1 percent in 2012 and 6.4 percent in 2013. They predicted that this lower than expected growth in the world economy would damage UK exports. They also stressed that it was difficult to draw firm conclusions on the momentum of growth in UK exports on account of the erratic nature of short-run movements in trade data which are prone to large revisions.

Their March 2012 report also identified evidence of divergence in the outlook for EU and non-EU trade:

> The Deloitte CFO survey for the fourth quarter of 2011 indicated that foreign-facing firms appear less pessimistic than domestic-facing firms, recording higher risk appetite and a more expansionary outlook. More recently, the CBI services sector survey for the first quarter of 2012 reported that the value of business with EU markets declined over the past three months with a further decline expected, but the value of business with non-EU firms has increased. These survey readings are supported by the ONS monthly trade release for January which showed that while core goods exports to the EU have fallen 2.9 percent since last August, core exports to non-EU destinations have increased by 13.3 percent (excluding oil and erratics).
>
> (ibid, p 88)

4. Bank of England

The Bank of England's *Inflation Report—May 2012* (May 2012) stated that one of the key risks to the UK economy was the slowing of global demand in the second half of 2011 as a result of the weakening of growth in the euro-area. Euro-area GDP contracted by 0.3 percent in the fourth quarter of 2011 (p 22). While exports of UK goods rose by 0.8 percent in the fourth quarter of 2011, this was accompanied by a fall in services exports over the year. The overall trade balance remained in deficit in the same period:

> [The] deficit, alongside other factors such as low national saving, indicates a need for the UK economy to rebalance away from domestic demand towards net exports. The depreciation of sterling between mid-2007 and the end of 2008 should aid that process, by continuing to support UK net trade and the current account over the medium term.
>
> (ibid, p 23)

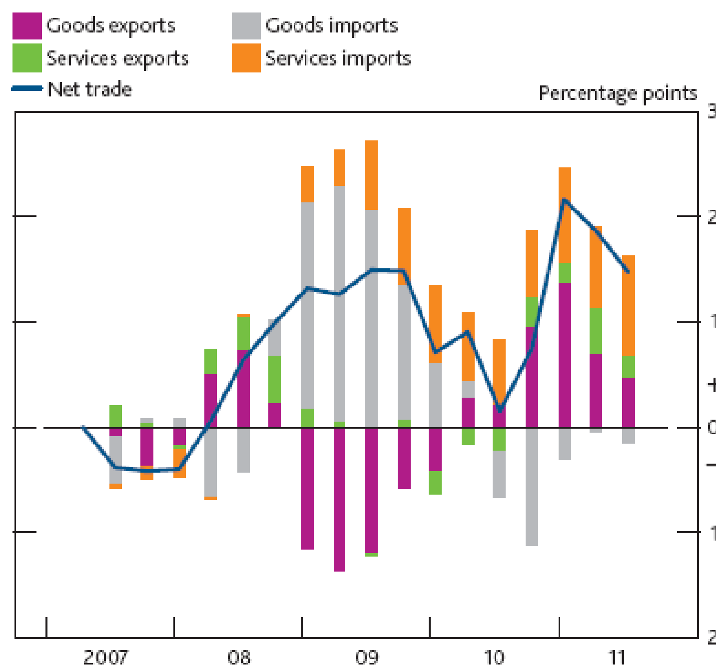
The Bank of England added a similar warning to the one given by the OBR suggesting that the pattern of growth may prove erratic as trade data is prone to revision.

The Bank of England's *Quarterly Bulletin* provided a possible explanation for why there had been stronger growth in UK exports of goods than exports of services. The *Quarterly Bulletin 2011 Q4* (December 2011) included a research report entitled 'Understanding

recent developments in UK external trade'. The report identified the shift towards UK exports and away from imports since the 2008 recession as a result of the exchange rate and the relative weakness of the pound. It also stated that financial services exports appear to have suffered from the financial crisis, resulting in a fall in the UK's share of the services export market. The report suggested that this was consistent with services exports being less sensitive to movements in the exchange rate.

Changes in goods exports and services exports since 2007 are indicated in the following graph:

Cumulative Changes in Net Trade and its Components as a Share of GDP Since 2007



Sources: ONS and Bank calculations.

(a) Imports are inverted, since they detract from GDP.

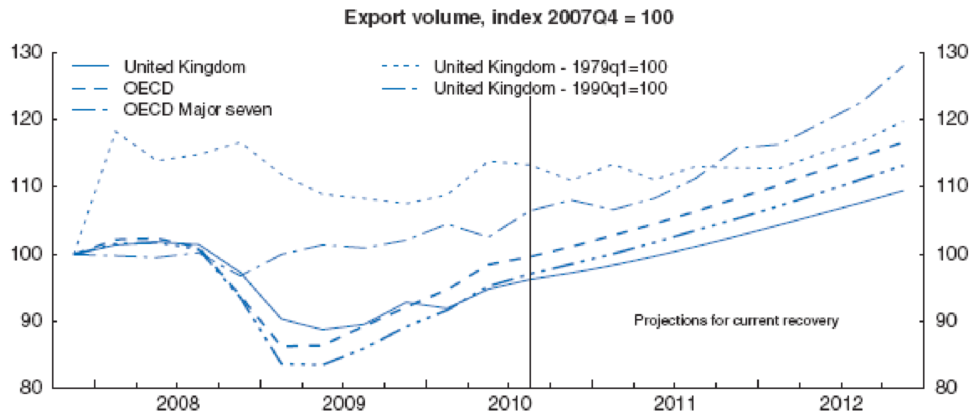
(Source: Bank of England, 'Understanding Recent Developments in UK External Trade', 2011, p 303)

5. Comparative Figures: How Competitive is the UK in Exports and in Attracting Foreign Investment?

The OECD characterised the recovery of UK exports after the 2008 downturn as disappointing compared both to other OECD countries and previous recessions, despite the advantage to UK exports due to the weakness of sterling. The OECD argued that the depreciation of sterling by 20 percent since late 2007 had had a reduced effect on export prices because of faster rising labour costs in manufacturing in the UK. (OECD, *OECD Economic Surveys: United Kingdom 2011*, March 2011, pp 23–5).

A comparison of the volume of UK exports against those of other OECD states is provided in the following graph:

Export Performance Prices and Costs

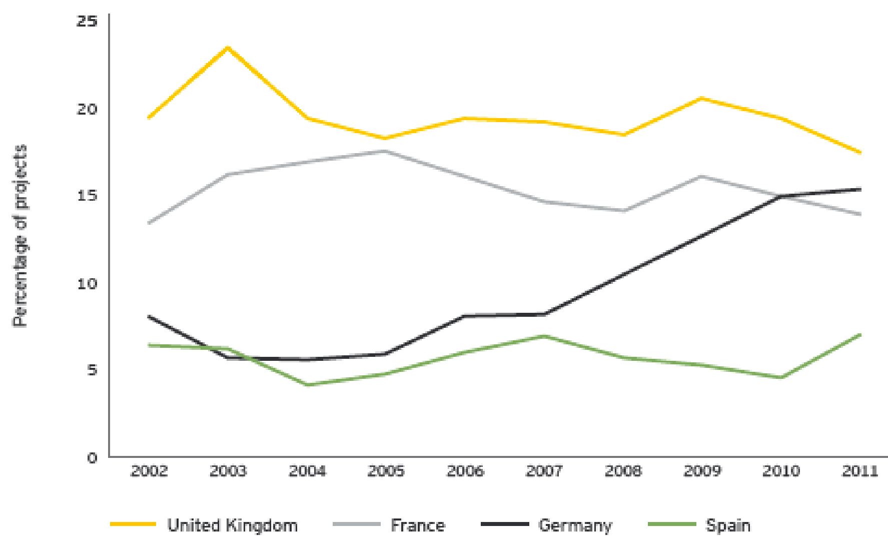


(Source: OECD, *OECD Economic Surveys*, March 2011, p 24)

Ernst & Young's *Staying Ahead of the Game—Ernst & Young's 2012 Attractiveness Survey: UK* (June 2012) stated that the UK remained in the lead in attracting European FDI. However, the report noted that the UK's lead was under threat with Germany's share of FDI rising for the fifth year in a row, a decline in the number of UK investment projects and a decline in the UK's relative market share. The report identified Germany's success as in part due to its success in attracting Chinese FDI, winning twice as many projects as the UK from China in 2011 (p 4).

Ernst & Young illustrated these recent changes in the market share of FDI with the following graph:

European FDI Market Share of the Top Four Recipients



(Source: Ernst & Young, *Staying Ahead of the Game*, 2012, p 7)

6. Government Policy

The role of exports and foreign investment in a UK recovery is a key part of the policy debate between the Government and the Opposition over the means of ensuring economic growth for the UK economy. The Chancellor of the Exchequer, George Osborne, in his *2012 Budget* (March 2012) stated that an economic recovery would take place on the following basis:

> Increasing exports and investment, as companies capitalise on global opportunities, will support more sustainable growth in the medium term. Lower government spending will release resources from the public sector for use by the private sector. Through this process, the economy will rebalance and become more resilient and competitive. As global conditions normalise, private sector investment and UK exports will be further supported by the Government's tax and supply-side reforms (as set out in the 2012 Budget).
>
> (p 13)

He stated in the 2012 Budget that it was the Government's ambition to more than double annual UK exports to £1 trillion by 2020 (ibid, p 43). Measures included in the 2012 Budget to encourage exports and inward investment were:

- The expansion of the overseas role of UK Export Finance to enable it to develop finance packages that could help UK exporters secure opportunities identified through UK Trade and Investment's High Value Opportunities programme.

- Help to secure temporary private sector office space overseas for new UK exporters in high growth countries where such services are difficult to obtain.

- Continue to increase UK Export Finance's regional presence in the UK to support small and medium sized businesses seeking trade finance.

(ibid, p 43)

The Government stated in its *Plan for Growth* that the rebalancing of the economy by encouraging growth in UK exports and FDI was one of its four priorities for action. The other priorities included reforms to the tax system, measures intended to make the UK a more attractive place to start a business and measures intended to create a more educated and a more flexible workforce (HM Treasury and the Department for Business, Innovation and Skills, *The Plan for Growth*, March 2011).

The Government's growth strategy has been criticised by the Shadow Chancellor, Ed Balls, on the grounds that it had not delivered growth, did not offer enough to promote business investment and had not offered any solution to high levels of unemployment (HC *Hansard*, 22 March 2012, cols 957–63).

More information on the Government's growth strategy and a summary of recent reaction and comment is provided in the House of Lords Library Note, *Economic Growth Strategy* (LLN 2012/025, June 2012).

7. Business and Trade Union Comment

The CBI and Ernst & Young report *Winning Overseas: Boosting Business Export Performance* (November 2011) argued that the UK has lost ground in its share of exports and has failed to compete on a level footing with some of the UK's closest competitors (ibid, p 4). The report argued that the UK's relative decline in exports was the result of a mismatch between the goods and services the UK sold and those demanded by high growth economies (ibid, p 5). It identified five sectors with the largest potential for tapping into demand from high growth economies: construction services; electrical goods; optical and high-tech goods; financial services; communication services. It projected that the combined impact of successful growth in these areas could contribute an extra £20 billion to UK GDP by 2020 (ibid, p 6). The report advocated an exports strategy from the Government to achieve this.

The EEF's *Executive Survey 2012* (January 2012) reported that nearly half of the manufacturing firms in their survey had said that increasing demand for products in emerging markets would be an area of growth for them in 2012. Under a half of firms stated that an increasing demand for services in new markets would be an area for growth. Companies in machinery and electrical and optical sectors showed particular interest in the opportunities posed by expanding into emerging markets. The report stated that this growing interest was a reflection of weaker forecasts for domestic growth and the continuing problems in the eurozone (EEF website, *Executive Survey 2012—Executive Summary*, online version accessed 28 June 2012, p 5).

The TUC advocated in their report *German Lessons: Developing Industrial Policy in the UK* (January 2012) that the Government should take more action to strengthen the manufacturing sector thus enabling it to play a larger role in the UK economy, which would be essential in securing growth. While it welcomed the Government's recognition of the importance of manufacturing, the TUC advocated a more activist industrial strategy with the need for political decisions to support certain sectors. The TUC also urged caution in copying Germany's recent dependency on exports:

> Germany experienced strong growth in 2011, partly driven by exports to Asia. But this is a non-traditional market for Germany and is not expected to continue. Indeed, whilst the German government forecasts growth of 2.9 percent in 2011, it expects growth of just 1 percent in 2012 and, according to Germany's leading economic institutes, it will narrowly avoid a technical recession, defined as two negative quarters of economic growth, over the coming winter. This is due to struggling economies among some German export markets and underlines the case for boosting domestic consumption in Germany to balance its success in exports.
>
> ... It is a widely held view among economic commentators that Germany must modify its export-led model, being prepared to import more and to boost domestic demand (and therefore the wages of German workers). The economic stability that this export-led model has delivered for Germany is clear for all to see, but it has come at a price, both to German workers and to the wider global economy.
>
> (TUC, *German Lessons: Developing Industrial Policy in the UK*, January 2012, p 12 and p 24)

8. Think Tanks and Blogs

Senior Research Fellow at the Institute for Public Policy Research (IPPR), Kayte Lawton, writing in the *New Statesman*, argued that the Government should do more to enable UK companies to expand and innovate, and that not enough was being done to support UK small and medium sized enterprises. She contended that one of the lessons that the UK should learn from northern European countries was that of encouraging innovation by offering better opportunities to the workforce:

> Countries like Germany, Finland, Norway and Australia have stolen a march on the UK by experimenting with different ways of supporting businesses to raise their game. Employers are supported to invest in new ways of working, access finance and develop new products, as well as to develop a well-skilled workforce. In one example in Finland, a local catering service was helped to restructure its business so that catering assistants took on a role in planning meals, budgeting and purchasing ingredients. Procurement costs fell and productivity improved, and the ability to use new skills raised motivation among staff. A simple training programme divorced from the need to reorganise the production process is unlikely to have delivered the same results.
>
> (*New Statesman* website, 'Supporting Business: Let's Follow Northern Europe', 17 April 2012)

Philip Booth, Editorial and Programme Director at the Institute of Economic Affairs (IEA), warned that reducing the trade deficit had to be done by reducing the UK's levels of borrowing. He stated that the cost of exports and imports were determined by the UK's real interest rates which were affected by the level of private saving and government borrowing rather than by monetary policy:

> We are buying goods from China today and promising to pay for them, not in exports today, but in exports tomorrow. These trends can be reversed. It would help if the Government cut its borrowing and did not discourage saving. Elsewhere, as the Japanese population continues to age, they will become net dis-savers, and so on. Of course, Chinese households are saving as if there is no tomorrow (or, perhaps, as if there is no today…). The export of capital lowers the Chinese exchange rate and is the counterpart of the net export of goods and services which are produced but not consumed.
>
> (IEA website, 'A Policy for a Lower Exchange Rate will not Boost Economic Growth', 28 June 2012)

In *The Entrepreneurial State* (June 2011) published by Demos, Mariana Mazzucato argued that the belief that the size of the public sector must be kept in check to prevent it becoming a drag on entrepreneurship and innovation had been damaging to the economy, and that successful economies resulted from government doing more than just creating the right conditions for growth:

> The state can be far more proactive in spurring industrial innovation at the forefront of knowledge than is currently understood by policy makers. Just as developing nations can successfully plan to catch up with Western nations, so any state can spur the development of technological solutions and/or the furtherance of practical knowledge in a given sector simply by catalysing a networked economy to engage in multiple innovations.
>
> (Demos, *The Entrepreneurial State*, June 2011, p 71)

Simon Less, Senior Consultant on Regulatory Policy at Policy Exchange, has advocated the encouragement of new low carbon innovations and technologies as a means of improving overall levels of growth, exports and employment in the UK. However, he criticised the Government's current policy on green growth as it involved heavily subsidising selected green industrial sectors:

> Successful export sectors are based on comparative advantage. The Government argues that it can create UK comparative advantage in relation to offshore wind, and other marine renewables, through the use of large subsidies, coupled with the UK's North Sea oil and gas engineering expertise and the potential for large-scale deployment on the UK continental shelf. The Government also believes that, having created comparative advantage, that there will be a large world market in marine renewables that the UK will be in a good position to export into. The Government is gambling £10 billion on these beliefs. It is very far from clear that this gamble will pay off.
>
> (Policy Exchange website, 'We Need to Focus on Growth and Being Greener—Not 'Green Growth'', 3 April 2012)

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