Economics
UK

UK exports

Can do better, must do better

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- **Despite a sharp sterling depreciation in 2008, UK trade has disappointed**
- **Stagnating productivity and a reliance on financial services partly explain this**
- **The UK economy must rebalance internally by raising productivity, and externally by exporting to new markets**

After a depreciation of around 25% in trade-weighted sterling following the global financial crisis, it was hoped that trade could help the UK return to strong and sustainable growth. But after several years of disappointing net export performance and general economic stagnation, rebalancing the UK economy has fallen down the agenda in a dash for growth of any kind.

In 2012, the current account deficit was the largest on record and net trade subtracted from GDP growth. The main drag was from services exports – and financial services in particular – which are also a relatively large share of exports.

However, this is part of a long-term trend – the UK has not run a trade surplus since 1997. This gap between exports and imports must be paid for by borrowing from abroad. Large deficits cannot be sustained indefinitely. The UK can do better, and must do better.

Rebalancing will not be easy. It will require an improvement from the currently dismal rate of productivity growth, which has eroded some of the gains from a lower exchange rate. Addressing the lack of manufacturing capacity and skilled labour also takes time. Tight credit conditions, especially to exporting SMEs, may have delayed the rebalancing process.

There is hope though. UK trade data have improved in recent months, and the return to growth in the euro area is further reason to be relatively more optimistic. The UK also has some highly-competitive manufacturing industries, and is still the second largest exporter of services in the world. Finally, as emerging market economies develop, they should also rebalance towards greater consumption of goods and services in which the UK is stronger. We think, therefore, that the UK will do better.

Contents

Summary

- After the global financial crisis and subsequent sterling depreciation, the hope was that exports would drive a recovery
- Several years of stagnation later, rebalancing seems to be off the agenda: policymakers will take growth wherever they can get it
- But the need to rebalance growth, both internally and externally, hasn't gone away

Is the UK selling the wrong things at the wrong prices to the wrong places?

"We're in a global race today and that means an hour of reckoning for countries like ours. Sink or swim. Do or decline." Those are the words of the UK Prime Minister, David Cameron, in a speech in October 2012. In it he promised to link Britain to the fastest-growing parts of the world in order to win the "global race".

But far from pulling ahead, the UK's trade performance post-crisis has been disappointing. Despite a sharp depreciation in the trade-weighted exchange rate of over 25% during 2008, net exports have been relatively weak, and actually subtracted from GDP growth in 2012.

UK exporters should have had a boost to their competitiveness from the sharp depreciation of sterling back in 2008. Goods exports didn't do so badly, but weak growth in services exports meant the UK's overall trade performance disappointed. Compared with other countries, UK financial services account for a large proportion of services exports. Financial services suffered a particularly significant global demand shock from which they have yet to recover fully.

No quick fixes

In part this reflects cyclical factors, such as the collapse in demand during the Great Recession of 2007/08, especially in the euro area, the UK's largest trading partner. And although we focus on exports in this survey, the resilience of imports is also puzzling. Despite sterling depreciation and weak domestic demand, which might have been associated with lower imports, import growth has outpaced domestic demand for the past three years. The UK seems unwilling or unable to kick its import habit and use domestic alternatives.

Mr Cameron is surely right about the potential benefits of exporting to faster-growing countries, but it is not straightforward either. We see three main bottlenecks currently holding back UK exporters. These are 1) a shortage of spare capacity in manufacturing, limiting firms' ability to increase supply to meet demand 2) lack of skilled labour able to move between sectors, and 3) tight credit conditions, especially to smaller, credit-constrained exporters. Policies to unblock these bottlenecks in labour and credit markets could include infrastructure investment, better training and education, and careful monitoring and easing of credit conditions to SMEs.

Held back by weak productivity

Even if these issues are addressed, UK firms' competitiveness will not transform overnight. On an aggregate level, the UK's "competitiveness" problem is related to a more general productivity problem.

Productivity growth in the UK has been dire since the recovery from the 2008 recession. This has eroded some of the gains in competitiveness from lower sterling. Again, at least part of this is cyclical in nature and should be reversed as demand recovers. However, we think this weakness in productivity growth also reflects some fundamental structural issues within the UK economy. Addressing the structural issues will be neither quick nor simple.

Can do better, must do better

Although equipping the workforce with the right skills is important, existing strengths may become more valuable as faster-growing economies develop.

The UK is still competitive in many in many high-skilled services sectors as well as manufacturing industries such as cars and pharmaceuticals. That means UK exporters are potentially well-positioned. As emerging markets undergo their own rebalancing from investment and export-led growth towards greater consumption, they will also demand relatively more services and consumer goods, and less raw materials and investment goods.

Export growth opportunities have therefore not disappeared, and could be even greater in the future. If the UK can do more to improve its weak productivity, then it will have gone a long way to improve conditions for exporters to succeed. We are not in a race except against ourselves.

Predicament

- After the 2007-08 financial crisis and recession, it was hoped that net exports could offset weakness in domestic demand
- Sterling fell sharply after the financial crisis, but the UK's trade deficit remained large and was 3.8% of GDP in 2012
- Rebalancing has moved down the agenda in a dash for growth of any sort, but the need for rebalancing has not disappeared

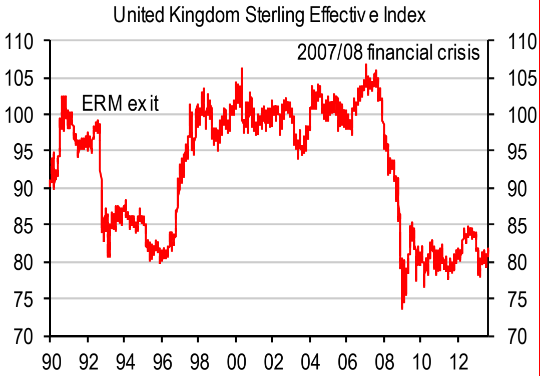
Will net trade drive growth?

Sterling saw a sharp 25% depreciation following the 2007-08 financial crisis (chart 1). Although it is impossible to say what might have happened had the depreciation not occurred, it did little to improve the UK's trade balance over the subsequent years. Net exports made a positive contribution to GDP growth after the depreciation, but that was mainly due to falling imports. Although a weaker currency may take time to take effect, disappointingly, net trade was a negative drag on GDP in 2012, several years after the depreciation.

The puzzle then, is why the trade deficit remains so large when both domestic demand and sterling are weak. In large part, we think the answer lies in the structure of the UK economy. The UK has not run a trade surplus in goods since the early 1980s. Goods exports were held back by a shortage of skilled labour in manufacturing, while the weakness in services mainly reflects lower financial services exports, demand for which has fallen since the financial crisis (chart 2).

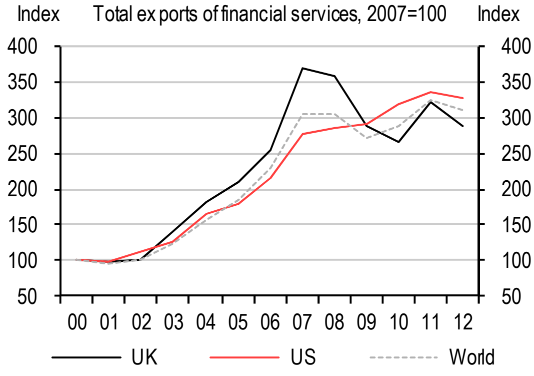
Fixing these problems will not be quick or easy, requiring a fundamental rebalancing of the UK economy – and global demand to hold up.

1. Sterling depreciation in 2008 was even larger than when the UK left the exchange rate mechanism in 1992



Source: Bank of England

2. UK financial services export growth was hit relatively heavily after the financial crisis, and has yet to recover



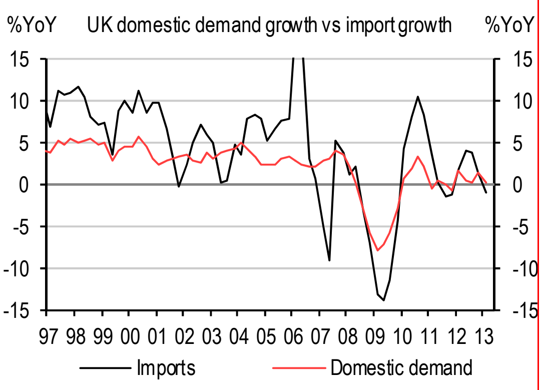
Source: WTO, HSBC

The J-curve hypothesis

In the short-run, the current account deficit can actually widen initially after a fall in the exchange rate, due to the so-called "J-curve" effect. This is because currency depreciation immediately makes imports more expensive. But import and export volumes do not change in the short run because consumers take time to change spending habits and firms are tied to contracts. The total value of imports will therefore rise immediately after the depreciation, while revenues from UK exports will not change, causing a deterioration in the current account.

However, it has been more than four years since the sterling depreciation. One reason for the long duration of the J-curve may be that heightened uncertainty means firms do not want to invest in expanding into new overseas markets, or compete with imports in domestic markets. For example, firms may worry about the sustainability of growth prospects, as well as whether the sterling depreciation is sustained. Import growth has also been relatively robust despite weak growth in domestic demand (chart 3). Finally, the sharp tightening in credit conditions during the credit crunch may have delayed the reallocation of resources. The expected increase in export volumes could therefore be taking more time than usual.

3. Import growth strong relative to weak domestic demand



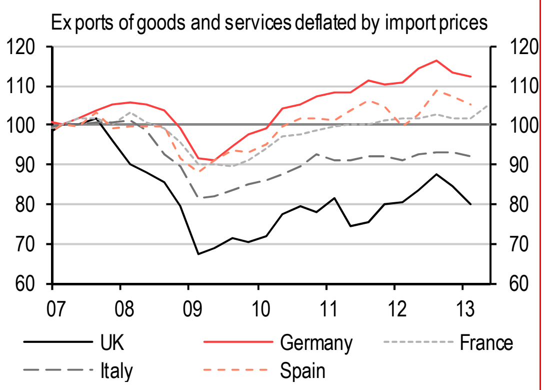
Source: ONS, HSBC

Currency depreciation not a panacea

If a country can only increase exports through lower export prices (either through lower margins or continual depreciation of its currency), then the gains from increasing net trade will eventually be offset by a fall in purchasing power – a deterioration in the **terms of trade** in the economic jargon, expressed as export prices divided by import prices.

A fall in the terms of trade may mean UK exports are more "competitive", but that is not necessarily a positive on an aggregate level. After all, the only reason for a country to engage in international trade is not to export, but so that it can pay for imports of goods and services that it cannot (or should not) produce. So the real test is how much the UK can buy in imports with what it earns from exports.

4. Purchasing power of UK exports has deteriorated



Source: Eurostat, HSBC

As chart 4 shows, the level of UK exports, in terms of how much in imports that it can buy, suffered a large negative shock as a result of the sterling depreciation, and there has been little in terms of higher export/lower import volumes to offset the price effect. But as we explain below, the UK's terms of trade have remained remarkably stable despite the currency depreciation. That implies exporters are maintaining margins rather than lowering prices to drive volume growth.

Wrong prices?

- The UK's terms of trade (export prices divided by import prices) have remained remarkably stable
- A sharp sterling depreciation in 2007-08 helped UK firms' competitiveness – but mainly for goods it seems
- On an aggregate level, the UK's competitiveness problem is mainly a low productivity growth problem

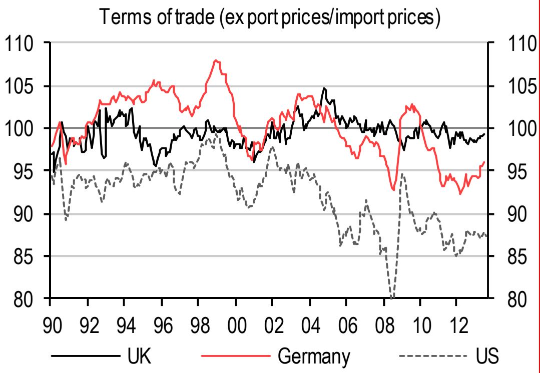
Were exports too expensive?

UK import and export prices have tracked each other very closely, so the UK's terms of trade (export prices divided by import prices) has been remarkably stable given the large currency depreciation (chart 5). By contrast, German and American export prices rose by less than their import prices, implying that exporters in those countries allowed their margins to fall by not passing on the costs of any given increase in import prices. So despite the sterling depreciation, UK export prices are still higher. Something has offset part of the expected gain from depreciation.

Could exporters afford to cut prices?

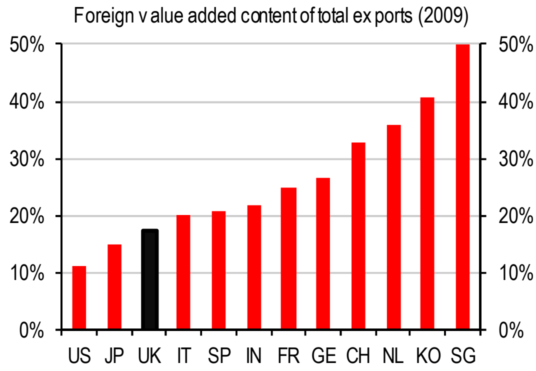
One problem with a falling exchange rate is that import costs for UK firms will increase, potentially reducing exporters' ability to lower export prices. What matters is how much imported inputs firms use per unit of exports. But the data show that UK exports do not appear to be particularly import-intensive (chart 6). Exporters in other countries require a higher proportion of imports per unit of exports. UK firms could in theory have lowered export prices and become more price-competitive when the pound depreciates. So why did they not?

5. Export relative to import prices have risen by less in Germany and the US compared to the UK



Source: Thomson Reuters Datastream, HSBC

6. UK import content of exports not particularly high



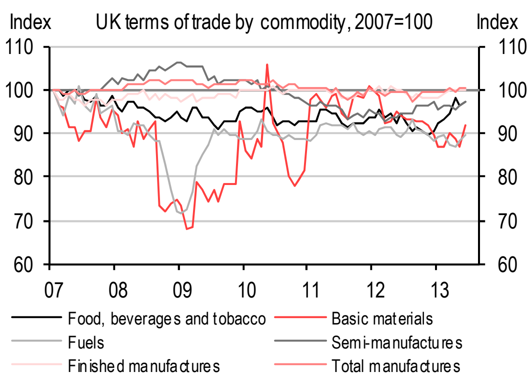
Source: WTO, OECD

Sacrificing volumes for margins?

If exporters have pricing power, then their selling prices may not respond much to currency depreciation. This could happen if UK exporters were specialised in niche markets or had strong brands i.e. difficult-to-replicate competitive advantages. If so, the usual assumption that higher margins are competed away might not hold.

The UK does have some strong brands, such as in cars and luxury goods. Other sectors may also have monopoly pricing power such as with patented pharmaceuticals. This is also much more likely to be true of manufactured goods compared with relatively standardised commodities such as fuels and basic materials. That would explain why those goods saw a much larger terms of trade deterioration than manufactured goods (chart 7).

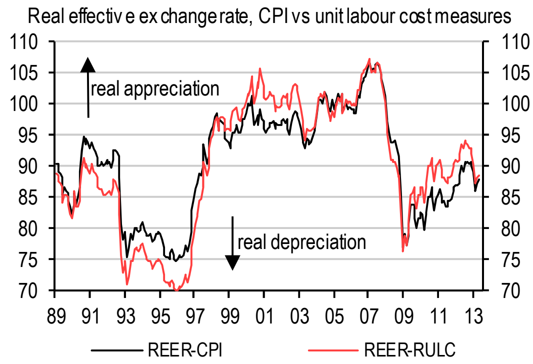
7. UK terms of trade sticky for manufactured goods



Source: ONS, HSBC

However, some of the gains from the 2008 sterling depreciation have been eroded away by low productivity growth. Up until recently, the real effective exchange rate (REER) on a real unit labour costs basis had risen by more since 2009 than the REER based on inflation (chart 8). Reduced international "competitiveness" is therefore just the other side of the low-productivity coin.

8. Exchange rate based on real unit labour costs have risen

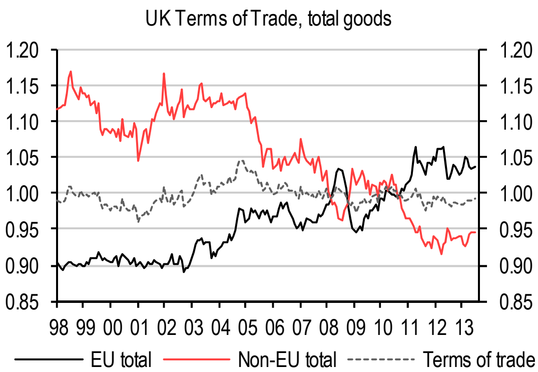


Source: IMF, HSBC

Different prices for different markets

The stability in the overall terms of trade masks some interesting differences. UK export prices (excluding oil and erratics) to non-EU countries did not increase by as much as import prices in recent years i.e. the UK's terms of trade with non-EU countries fell (chart 9).

9. Stark divergence in terms of trade with EU and non-EU



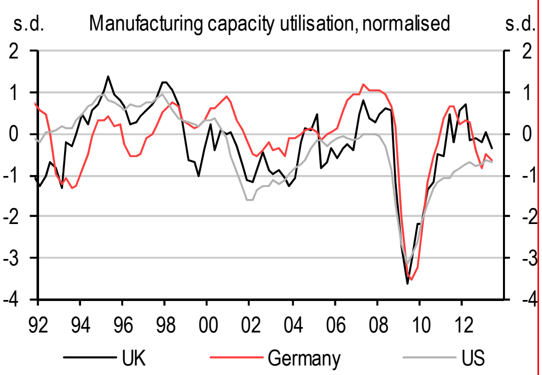
Source: ONS, HSBC

UK exporters to non-EU markets cut margins, but firms exporting to the EU chose higher margins instead of lower prices and higher volumes. This is consistent with the difference in performance of EU and non-EU export volumes. Of course, recession and austerity in much of the euro area certainly depressed demand. But it is not just a demand story. There are also considerable supply-side issues holding back UK exports.

Lack of capacity

We think another explanation could be that UK exporters were physically unable to increase output to match demand. Before the 2007/08 financial crisis, the UK had a lot of capacity in manufacturing (chart 10). However, the sector has been operating at above or close to normal levels of capacity utilisation compared with firms in the EU and the US, suggesting supply-side problems.

10. UK capacity utilisation has been consistently higher



Source: OECD, HSBC

This is rather odd given that manufacturing output is still almost 10% below its January 2008 peak. Either firms have mothballed capacity and so do not report it in surveys, or the recession has caused a massive destruction of supply capacity. Either way, this lack of capacity to increase manufacturing production could have contributed to the weakness in UK exports. Low spare capacity also works on the import side of the balance of payments: if domestic firms cannot increase output easily, then the potential for import-substitution is reduced.

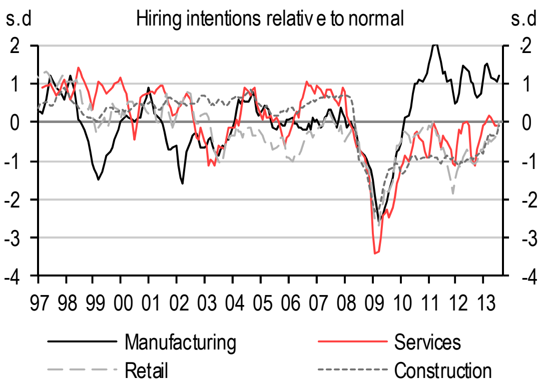
Unfortunately, this is a structural supply issue, and not something that can be rectified immediately. Investment (which in the UK was relatively low before the recession and fell even lower afterwards) takes time to come online. And retraining labour could prove even more costly and time-consuming than replacing capital.

Rebalancing skills takes time

Aside from a lack of capacity within firms, certain industries may have also lacked the skills to rebalance. For example, manufacturing jobs fell from 25% of total jobs in the 1970s to just 8% today. This was offset by growth in services sector jobs including in non-traded sectors such as government, real estate, construction etc. This trend naturally takes time to reverse, and may require a substantial cultural shift as well.

In theory, trade should have no effect on the total number of jobs in an economy – economies return to full employment in the long run as wages adjust. Since the international movement of labour is much less free than for goods or capital (more's the pity) any jobs created in an exporting sector must mean a job lost in a non-exporting sector.

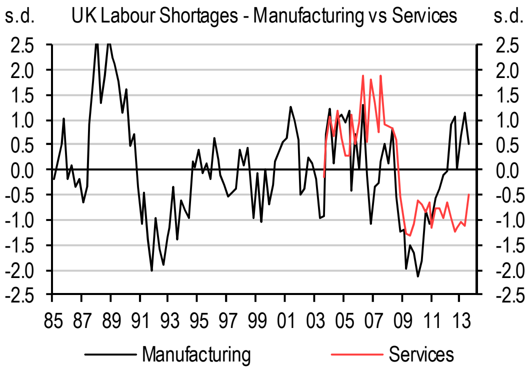
11. Manufacturing firms were desperate to hire...



Source: DG-ECFIN, HSBC

However, labour market rigidities can cause labour shortages in one sector and unemployment in another in the short-run. UK goods exports were on a path similar to that of Germany's between 2010 and 2011 but then tailed off, while German exports continued to grow (see Appendix 1). Manufacturing firms were still keen to hire during that period, suggesting that there was some recovery in demand (chart 11), but shortages in manufacturing were more acute in the past two years than they were before the crisis (chart 12).

12. ...but skilled labour shortages were a constraint



Source: DG-ECFIN, HSBC

Since a trough at the end of 2009, the total number of jobs in the UK economy is now higher by 973,000, while manufacturing has only gained a net total of 4,000 jobs over the same period. But again, as output is so far below its pre-crisis peak, we are back to the productivity puzzle.

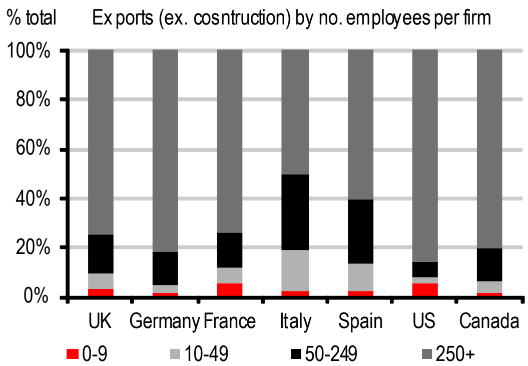
Perhaps, this reflects a more fundamental lack in the UK of the necessary skills to work in an economy open to international competition and technological disruption. Rebalancing will require retraining of current workers and more students choosing STEM subjects (science, technology, engineering, maths) rather than, say, Economics. And if manufacturing doesn't work out, the skills and knowledge from STEM degrees are always highly transferrable (and highly-valued in, say, financial services).

Do UK SMEs export too little?

The argument goes that large firms can relocate production overseas to save transport costs and so UK firms are internationalising through foreign direct investment. The UK then earns income from abroad rather than through higher exports.

However, the data show that UK SMEs actually account for a relatively high proportion of total exports (especially for an island economy) compared with Germany and the US (chart 13). Furthermore, countries with a higher proportion of exports from large companies also tend to export more in absolute terms. That should make sense considering that large firms have greater economies of scale and scope, which give them an advantage when competing in international markets. Still, it is worth asking whether SMEs could have exported more, and if not, why not.

13. More SME exporters does not mean more exports

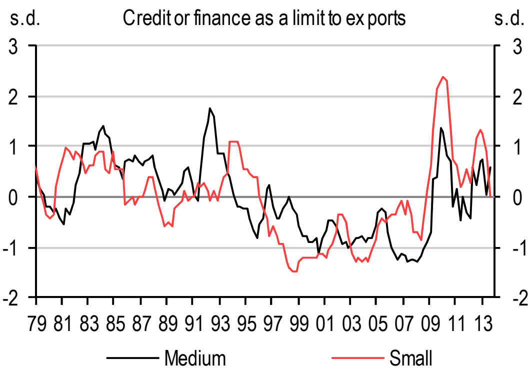


Source: OECD, HSBC

What might be holding SMEs back?

Credit conditions tightened significantly for SMEs during the credit crunch and have not eased by as much as it has for large firms since the recovery. Apart from hampering demand and slowing down the reallocation of resources in general, tight credit conditions seemed to affect small exporters disproportionately. Credit was a more significant factor in limiting their export potential (chart 14).

14. Small exporters were more credit-constrained



Source: CBI, HSBC

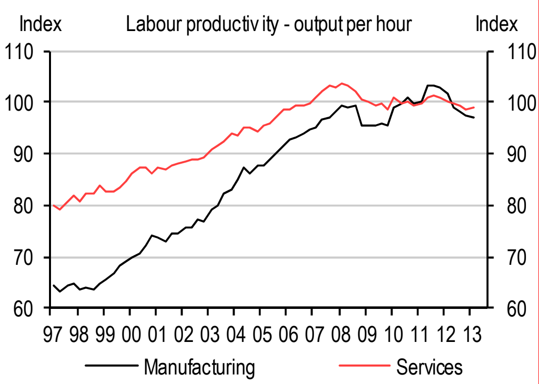
Productivity is destiny

In the long run, domestic productivity growth is the main driver of long-term economic growth, regardless of how much the UK trades. Higher productivity growth is good in and of itself, regardless of whether it benefits exporters or not (though there is no reason why it should not). Similarly, higher productivity growth in other countries should increase incomes and create a larger market for UK exports.

Unfortunately, it is well-known that UK productivity growth has been very weak in the current recovery[1]. This is the real source of the UK's loss of international "competitiveness".

If the current period of weak productivity growth is only cyclical, then perhaps export "competitiveness" will improve rapidly when productivity recovers. However, the weakness in productivity growth trend has persisted for over half a decade now (chart 15), and looks increasingly like a structural problem. As manufacturing is much more export-orientated than services, this fall in productivity has a doubly negative effect on UK exports.

15. UK productivity has gone into reverse



Source: ONS

Are workers misallocated to the wrong sectors?

Will switching workers to manufacturing cure the UK's export malaise? After all, the level of manufacturing productivity still compares well to most services sub-sectors in terms of GVA/job (table 16). The main laggards are in the services industries – especially those that are non-traded (suggesting that productivity may actually increase with trade due to greater competition).

16. Gross value added per job (constant prices)

Sector (SIC07 classification)	GVA per job (Constant GBP)	Workforce jobs ('000s)
Mining & Quarrying inc. oil & gas	81.78	69
Real estate	66.18	511
Electricity & Gas	34.50	120
Finance & Insurance	26.50	1,149
Water & Sewerage	21.05	203
Information & communications	17.08	1,320
Other Services	14.57	814
Manufacturing	13.08	2,614
Public admin & defence	10.26	1,576
Services Total	10.01	26,933
Professional & Scientific	9.93	2,559
Construction	9.69	1,994
Transport & Storage	9.28	1,564
Education	7.77	2,767
Admin & support	6.93	2,574
Health & Social work	6.64	4,145
Agriculture	6.27	363
Arts, Entertainment & Recreation	6.12	876
Accommodation & food service	4.42	2,050
Wholesale, Retail & Motors	1.38	4,952

Source: ONS, HSBC
NB: Services sectors are in red

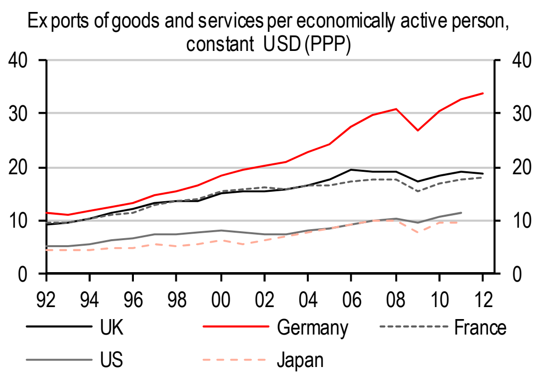
It would be dangerous to over-simplify however. There are significant differences even within manufacturing itself, such as between high- and low-tech manufacturing for example. In general, the sectors with highest productivity are capital-intensive. With services accounting for 78% of the UK economy (even though most services are not traded), it could be argued that overall GDP growth might be more effectively increased by policies that improve productivity growth in services. The case for "manufacturing primacy" is far from clear-cut. A more fundamental solution would be to increase the skills of the labour force, and invest to increase the size of the capital stock.

[1] We have written extensively on the UK's productivity puzzle and its implications. See *Carnival to Carnage?*, 15 August 2013; *Still Paying for Past Excesses*, 14 January 2013; *The Opposite of a Miracle*, 27 February 2012

Conclusion

Countries are not the same as companies. On an aggregate level, UK workers are actually fairly good "exporters": the UK exports a relatively high amount of goods and services per economically active population (chart 17).

17. UK exports per capita are actually fairly high



Source: OECD, HSBC

The UK's export propensity is also relatively high – it is Germany that looks like the anomaly (chart 18). But that means the vast majority of economic output still consumed internally, so any nominal depreciation of the currency should have less influence on living standards than may be commonly assumed. It is certainly less important in the long-run than productivity growth.

18. UK exports a relatively high share of its output

Source: World Bank

Nevertheless, poor productivity growth almost certainly means that some firms or industries have become less competitive in the global market. This is natural, given that labour productivity, allocation of capital, natural resources and even consumer tastes are not constant, but it does mean the UK economy needs to rebalance given the sharp shock to those factors that determine the structure of trade.

This is will involve difficult but necessary adjustments to what we think are long-term structural issues. The UK's export performance since 2008 has understandably received a great deal of attention. However, we also think the problems were evident in the years before the financial crisis. We find that UK companies have perhaps exported less than they should have, given the growth in their export markets. As we explore in the next two sections, this was due to a combination of high exposure to slow-growing export markets and a less-than-optimal product mix.

Wrong places?

- Around half of UK exports still go to the EU, where growth has been relatively slow
- Compared with other major exporters, the UK trades relatively little with fast-growing emerging markets
- Trade flows tend to self-adjust – richer countries demand more imports – but the process takes time

External demand slowdown regional, not global

Global trade growth has slowed since the 2007/08 financial crisis. In the decade to 2007, world trade volumes grew by an average of 6.8% y-o-y. Since 2008, the rate of growth has fallen to 2.7%.

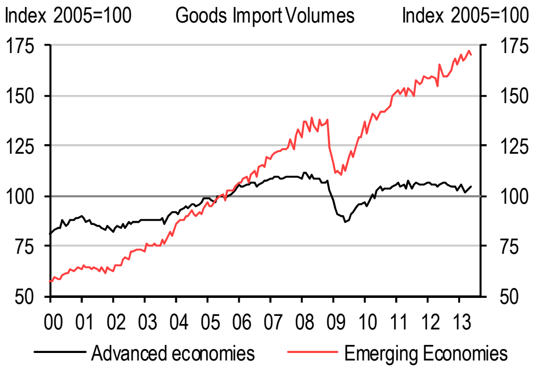
However, this has mostly been a developed country phenomenon. Emerging economies saw a sharper fall in imports in 2008. But demand has since rebounded strongly (chart 19). It seems obvious that if the UK wants to improve its trade balance, it needs to shift the source of demand for its exports more towards emerging markets.

Is external demand rebalancing?

Unfortunately, the pace at which the UK has shifted its relatively low export share to developing countries has been slow (chart 20). And "developing countries" is a large umbrella for a very diverse collection of economies.

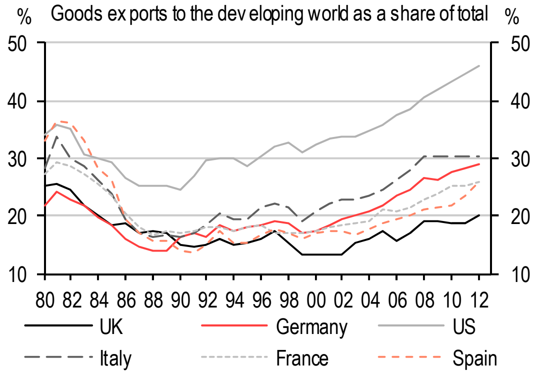
For example, Asia ex. Japan import volumes have grown by an average of 9.1% annually since 1992, compared with 6.8% for Africa & Middle East. Although the difference seems small, it means the level of imports of Asia ex. Japan is now six times higher compared with 20 years ago – for Africa & Middle East it is 3.7 times.

19. Emerging market imports have rebounded impressively



Source: CPB

20. But the UK's share of exports to emerging markets is low



Source: IMF, HSBC

Not making the most of Asian growth

Other countries, especially Germany, seemed to have re-orientated exports towards Asia, while the UK has lagged behind. The UK's average annual growth rate of exports to developing Asian economies has been consistently lower than for many other developed economies in the last three decades (table 21). In part, this may reflect the nature of import demand in Asia (e.g. more capital goods and commodities), as we explain in a later section.

21. Average growth of goods exports to developing Asia

%YoY	UK	Germany	France	Italy	US	Japan
83-92	7.2	11.5	11.6	14.4	7.8	10.1
93-02	4.2	8.2	4.2	8.6	8.3	8.1
03-12	11.4	16.0	15.0	12.1	13.6	13.1

Source: IMF, HSBC

So where does the UK export to?

On a country-by-country basis, the majority of UK exports still go to developed markets, and especially to European countries. But perhaps the most striking thing is the stability of trade direction – the rankings of the UK's top export markets have barely changed over the past decade, with the exception of China steadily moving up in the rankings (table 22).

22: Top UK export destinations, goods and services

Position	2002	% total	2012	% total
1	US	18.2%	US	16.6%
2	Germany	10.6%	Germany	8.8%
3	France	8.9%	Netherlands	7.0%
4	Ireland	7.1%	France	6.1%
5	Netherlands	6.7%	Ireland	5.5%
6	Belgium	4.5%	Belgium	3.5%
7	Italy	4.1%	Switzerland	3.3%
8	Spain	4.0%	Spain	2.9%
9	Japan	2.7%	China	2.8%
10	Switzerland	2.6%	Italy	2.8%

Source: ONS, HSBC

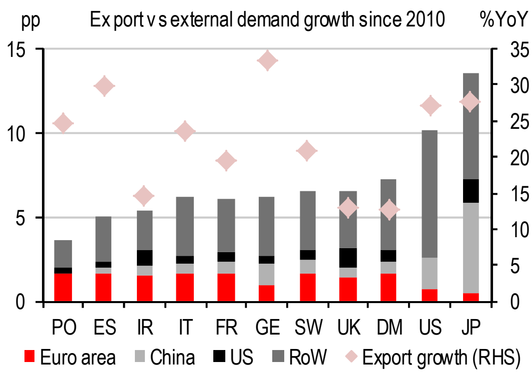
NB: A significant proportion of exports to the Netherlands would be re-exported

Distances still matter: the costs of transporting goods exports – 61% of total exports – are not trivial, and it should not be surprising that the top export destinations are also some of the closest.

UK export market growth not to blame

Growth in UK exports should reflect two things: demand from trading partners and relative prices. According to a recent Bank of England analysis, the UK's export destinations have actually grown slightly faster than those of Germany, France and Italy's since 2009 (chart 23). So an unusual weakness in demand cannot be blamed for the disappointing trade performance.

23. UK export market growth not to blame



Source: Bank of England

Notes: bars represent contributions to annual world GDP since 2010 from a country's export market, weighted by share of that country's exports to that market

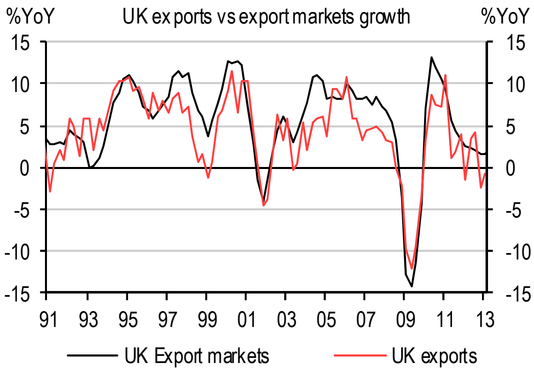
UK exports lagged its export markets

UK exports growing more slowly than overall growth in its export market is not a new phenomenon. The UK's export performance had already been lagging growth in external demand before the 2007/08 crisis (chart 24). That suggests the explanation could be more structural in nature, e.g. if UK exporters could not produce enough supply to meet demand, or produced too many uncompetitive goods or services.

By contrast, German exporters have been growing their market share. Not only has German export growth been stronger than growth in its export markets since the recession, it had over-performed pre-crisis as well (chart 25). Effectively, that also means Germany has been gaining market share.

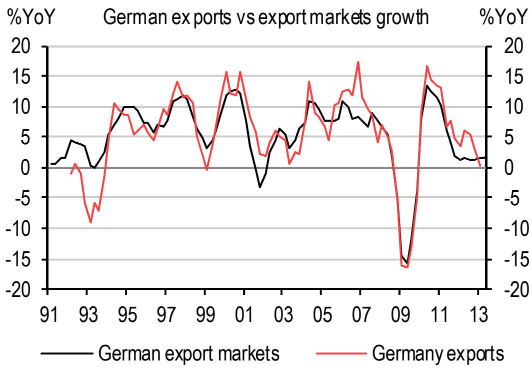
Comparisons of export performance:

24. UK exports underperformed growth in its export markets



Source: OECD, HSBC

25. German exporters were gaining market share



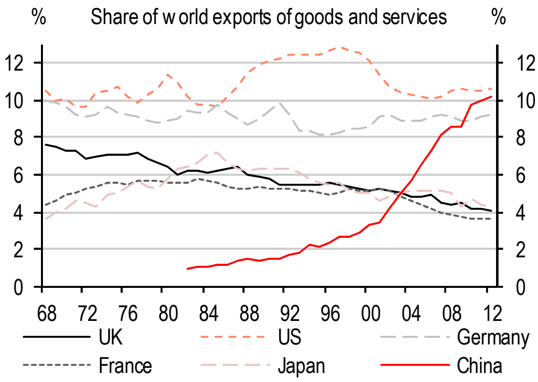
Source: OECD, HSBC

UK export market share decline consistent with long-term trend

Loss of export market share did not just happen post-crisis – it has been a trend for the best part of half a century, at least. The recent fall also does not look especially rapid compared with the long-term trend (chart 26).

The UK's relative decline as an exporter should not be unsurprising though, because emerging markets will eventually catch up and start to reach their potential as exporting nations. It is also worth remembering that the UK still exports roughly the same proportion of GDP as China does, and the UK's real exports per capita is relatively high.

26. UK share of world exports has been on steady decline



Source: OECD, HSBC

The UK's declining share of world exports is partly due to the structural shift from manufacturing (which exports a high proportion of output) to services (which neither exports as much, nor face as much import competition). This shift is not necessarily bad. But the current low productivity in services – both the levels of value added and in growth rates – is not positive for the UK's long-term prospects. And since many services are non-traded, companies in these sectors can only gain market share at the expense of other domestic firms, making no difference to the trade balance. Productivity is still destiny.

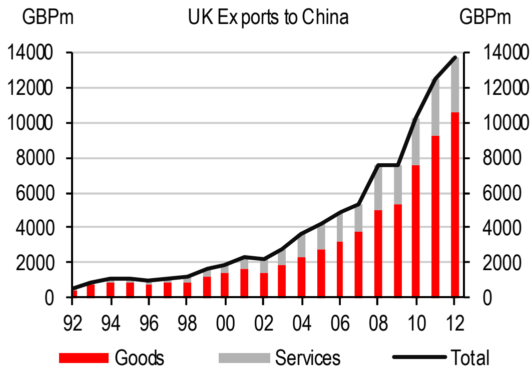
Conclusion

Rebalancing external demand to faster-growing economies takes time, but there are signs that it is happening. The UK's visible trade deficit with non-EU countries has narrowed recently and is now smaller than its deficit with the EU. And though the UK may keep exporting relatively heavily to Europe and relatively little to fast-growing emerging markets in the short run, its main export destinations did not grow especially slowly compared with those of other major European economies during the recovery. Instead, the UK's export problems stem partly from the supply-side constraints we explored in the previous section, and the nature of what the UK exports, as we discuss in detail in the next section.

Box: UK exports to China

China is the UK's 7th largest goods export partner, and 13th largest for services. Goods still account for the majority of exports to China, although the share of services has grown steadily (chart 27).

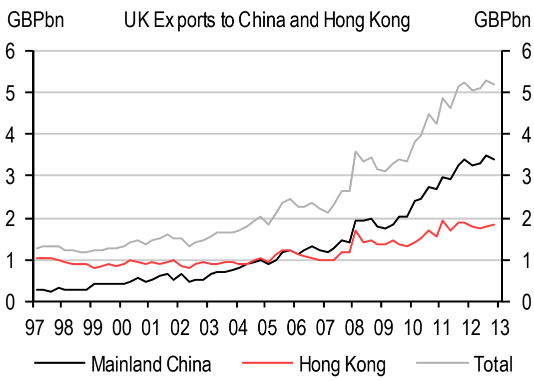
27. UK exports mainly goods to China, but services rising



Source: ONS, HSBC

It should be noted that the data do not include exports to Hong Kong that are then re-exported to China. It is difficult to split out what proportion of UK exports to Hong Kong is re-exported to mainland China (as well as other countries in Asia), but it is reasonable to assume a large proportion of UK goods exports to Hong Kong are actually destined for China. Nevertheless, the level of UK exports to the mainland has grown more rapidly in recent years (chart 28).

28. Exports to mainland China overtook those to Hong Kong

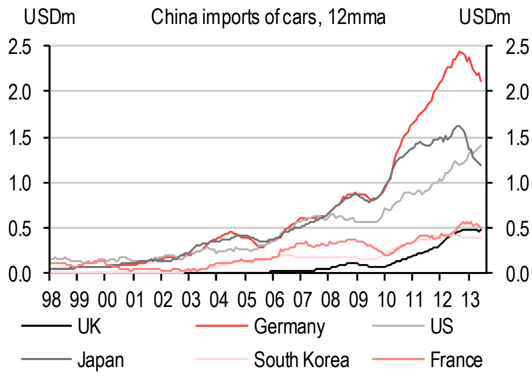


Source: ONS

What does China import?

Of course, there are certain things that China demands more than others. Car exports would be one that the UK seems happy to oblige with - a third of total UK exports to China are vehicles. There is still room for improvement though –the UK's share is still some way below Germany, Japan and the US (chart 29).

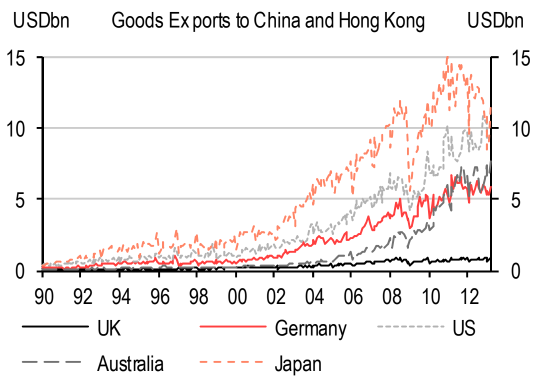
29. German, Japanese and US car imports still most popular



Source: China Customs

However, not all sources of comparative advantage are replicable. Take Australia, for instance, whose exports to China have seen a stratospheric rise due to commodities (chart 30). The UK simply does not have the natural resource endowments to compete with that. We examine which sectors it does specialise in in the next section.

30. The UK remains low in China's top import sources



Source: IMF, HSBC

Wrong things?

- Countries specialise according to their differences, and the UK had tended to specialise in services exports
- The financial crisis has unsurprisingly hit financial services exports, but there are success stories too, such as cars
- There will be opportunities for both services and goods exports to grow as emerging markets become richer

Services-bias in exports

International trade works via comparative advantage: countries specialise and trade to take advantage of their differences. For decades the UK has had a relative advantage in exporting services, and thus exported a higher proportion of services than other exporters (chart 31).

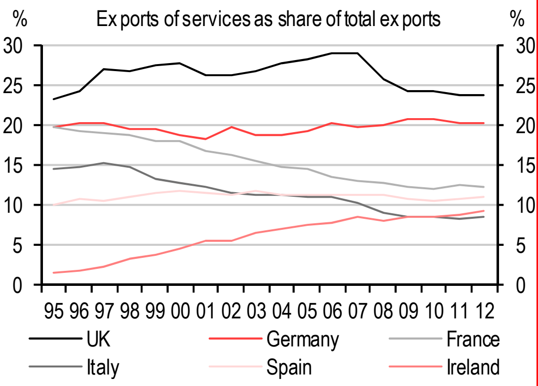
Specialising in services means the UK is more reliant on developed markets. Emerging markets on the other hand tend to demand more investment goods, and the UK performed dismally in capital goods exports, defined as goods used in the production of other goods (chart 32).

2007/08 crisis hit financial exports…

Even though countries such as Germany benefited hugely from exporting capital goods to fast-growing economies, the UK's focus on services served it well in the decade before the financial crisis. But since the 2008 crisis, services exports have barely grown, which largely reflects a fall in exports of financial services.

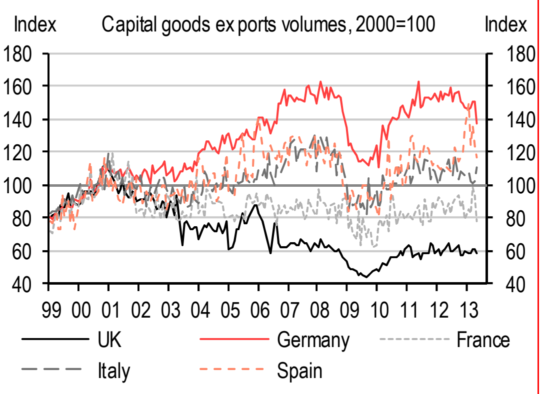
This has been compounded by the dominance of financial services. Compared with other countries, the UK exports a larger proportion of finance and insurance services as proportion of total commercial services exports (chart 33).

31. UK exports a relatively high proportion in services



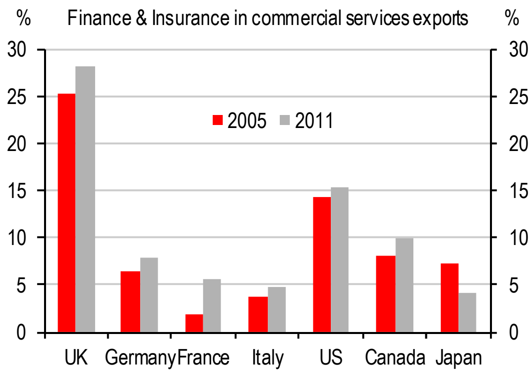
Source: Eurostat

32. UK capital goods exports compared very poorly



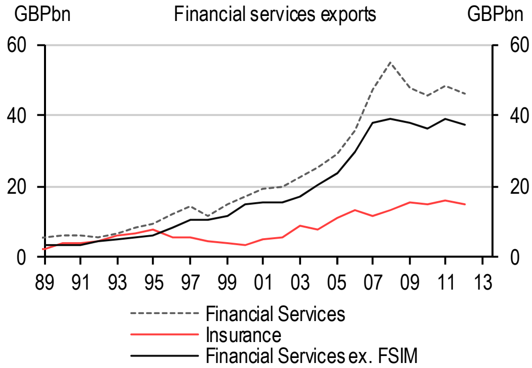
Source: Eurostat

33. Finance and insurance dominate UK services exports



Source: World Bank

34. Financial services exports ex. FISIM have fallen by less



Source: ONS

There was a significant contraction in global demand for the UK's financial services exports in the post-crisis world. It seems likely that at least part of that shock will persist for some time yet, so some rebalancing of the UK economy away from financial services might be warranted.

So far however, there has been little sign of this. While the UK economy finally appears to be recovering, reliance on the services sector has actually increased. For policymakers, the rebalancing, much-hyped in 2010-11, has been replaced by a dash for any kind of growth.

…although measurement difficulties complicate analysis

Measuring the value of financial services is difficult. Services such as intermediation and transaction processing are not explicitly charged for. So a large proportion of financial sector services are measured indirectly using proxies.

Around 20% of UK financial services exports are "financial intermediation services indirectly measured" (FISIM). There are concerns that FISIM is poorly measured. If it is excluded, UK financial services exports have not actually fallen far below pre-crisis levels (chart 34). So measurement errors could have exaggerated the observed fall in financial services exports.

Others' rebalancing are opportunities

The outlook for UK financial services exports is also far from bleak. London is still a vital financial centre, and the UK does not just have a comparative advantage in financial services, but an absolute advantage, not least because of its position spanning across both Asian and American time-zones.

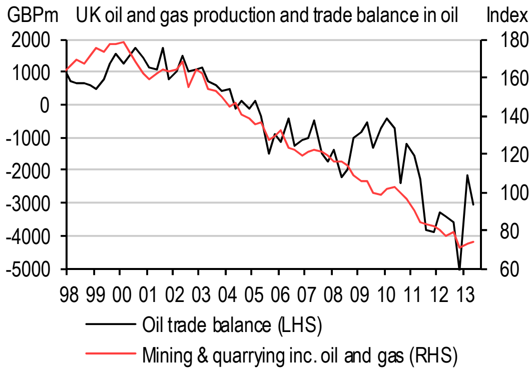
Trade is also dynamic and not static, and the UK is not the only economy that needs to rebalance. Emerging economies tend to consume more as they get richer, presenting new opportunities for UK exporters. For example, if China rebalances away from investment and toward consumption, one would expect a relative fall in its demand for commodities and capital goods, and a rise in demand for consumer goods and services.

Hope for manufacturing

Decline is sometimes inevitable…

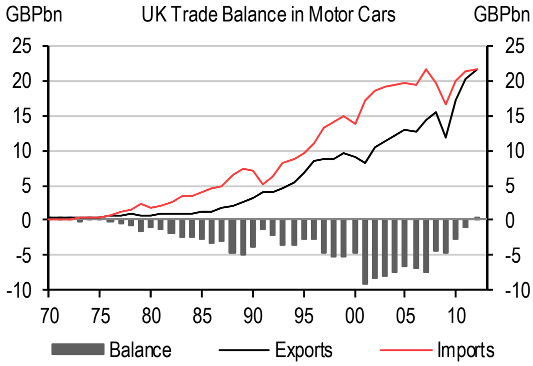
Longer-term prospects for some UK exports look less favourable. The UK's oil industry – a key reason behind the UK's swing from trade surplus to deficit since 1997 – is experiencing a steady and structural decline (chart 35). Peak oil extraction was in 2000 and over the past few years, the trade deficit in crude oil has accounted for around a fifth of the UK's total trade deficit.

35. There has been a structural decline in UK oil production



Source: ONS

36. Turnaround in UK's cars trade balance was impressive



Source: ONS, HSBC

…but car industry shows things can be turned around

Other UK export sectors are also losing international market share because of weak productivity growth and emerging market competition. But there will always be some good or service that the UK can export, and one of the recent success stories is the turnaround in car exports. The UK is now running its first trade surplus in cars since 1975 (chart 36). Of course, it took decades of painful industrial restructuring and labour market reforms, but at least it shows that industries thought extinct can turn around.

It also shows that it is not only services where the UK has a comparative advantage. The UK specialises in other high-end manufacturing as well, such aerospace, chemicals and pharmaceuticals. But the revival in the motor industry is particularly impressive.

During the dark days of the UK's domestically-owned motor industry in the 1980s, the idea that the car manufacturing industry would again become a success story would have been laughable. Even BMW could not turn around Rover's fortunes in the 1990s, reportedly referring to it as "the English patient". It is no wonder that car export growth was weak at the start of the century, especially compared with Germany.

While some famous British historical marques have been lost, other such as Mini, Jaguar and Land Rover have thrived under foreign ownership. The industry has bounced back particularly strongly since the end of the recession, and this has been driven by exports. Over 80% of vehicles manufactured in the UK are exported, and cars are now the UK's fourth biggest goods export.

The sector has also managed to re-orientate external demand: the share of exports to China increased from 1.4% in 2008 to 8.1% in 2012. And emerging market demand is still growing at a staggering pace: in 2011 the value of car imports grew by 41.6% y-o-y in China, 43.2% in Brazil, and 63.2% in Russia.

The turnaround was due to a combination of better management, much improved labour relations, greater investment and a shift up the value chain. Moreover, it shows that there is nothing inherent that means the UK cannot succeed in manufacturing. Although its strength in services will remain – and long-term prospects are decent as emerging markets grow richer – a rebalancing towards manufacturing in the meantime, particularly at the higher-end, could lead to a more sustained improvement in the UK's trade balance.

Some final conclusions

The current account is simply the difference between domestic savings and investment: an economy wishing to invest more than it saves must run a current account deficit, and to finance this it must borrow. This is an inescapable accounting identity. Although the current account is not a perfect indicator of economic strength or weakness, countries with persistently large deficits will eventually have to run surpluses in the future. The alternative, depressing domestic consumption in order to raise the savings rate, is much more painful.

In the post-crisis world, the UK must also adjust so that it can pay its way. After three years of economic stagnation in the UK, talk of rebalancing in the UK has receded in the current dash for growth. That does not change the fact that such large trade deficits are unsustainable.

In theory, the solution to improving UK trade is simple: it needs to export more to the faster growing areas of the world. In practice, this will not be straightforward. For one thing, everyone knows the solution and struggling Western economies are all trying to export to emerging markets. With everyone trying to do the same thing, the marketplace will be crowded.

Trade flows are dynamic, not static, and the UK could be well-positioned

That is no reason to despair however. Trade offers more than enough opportunities for it to be mutually beneficial. While UK cannot be complacent about its own rebalancing, emerging markets are rebalancing as well. As emerging markets develop, they may naturally have a higher demand for some of the things the UK specialises in, for example financial services. Currently, banking systems remain relatively protected in many parts of the world. This could change in future.

Also, as emerging economies become more innovative and more dependent on services, demand for legal and other business services could rise. And as their citizens get richer and older, so do exports of leisure (e.g. tourism), financial services (savings and investment) and healthcare (pharmaceuticals is another recent UK success story). It is not unreasonable to imagine China following the precedent set by Japan, and becoming a nation of consumers, tourists, pensioners and investors.

Networks of people important too

To capitalise on emerging market opportunities fully, however, UK exporters will need to be even better at selling. We highlighted some structural issues related to shortages of capacity, labour and credit. But a change of mind-set could be required as well. In large parts of the world a business relationship is hugely important. The right product at the right price is still crucial, but people are less likely to buy anything from you until they have established that you are the sort of person they can to business with. This is probably the case in Japan, China, India, in fact most of Asia and the majority of Africa. If we add parts of southern and Eastern Europe to this list, it is clear that it comprises the majority of the global economy.

Tear down these walls

If the UK can do more to improve its domestic productivity, then it will have gone a long way to improve conditions for exporters to succeed. But there is always the risk that instead of addressing the more fundamental issues, we see protectionism or mercantilist policies instead.

Policymakers have mostly stayed away from increasing tariffs after the Great Recession. But there also are all kinds of hard-to-detect non-tariff barriers to trade such as subsidies, discriminatory regulations against foreign firms, or nationalistic government procurement.

Firms "export" just about everything they produce – their own employees typically account for a tiny percentage of sales – so firms have to "export" almost all of its output while other firms try to do the same. If a firm becomes more efficient, it can gain market share at the expense of its competitors.

But countries are different: international trade is not a zero-sum game. Domestic productivity growth leads to higher output and consumption. Productivity growth in other countries increases their incomes and creates a larger market for UK exports.

Protectionism would make most people worse off. That includes domestic producers as well as consumers, who are prevented from buying the best goods at the lowest prices. International competition is also a positive force, increasing the incentives for firms to innovate and improve efficiency. Industries shielded from foreign competition tend to decline in the long run, as the sorry history of "national champions" has proved. Finally, the risk of setting off mutually-destructive trade wars is real and must be avoided.

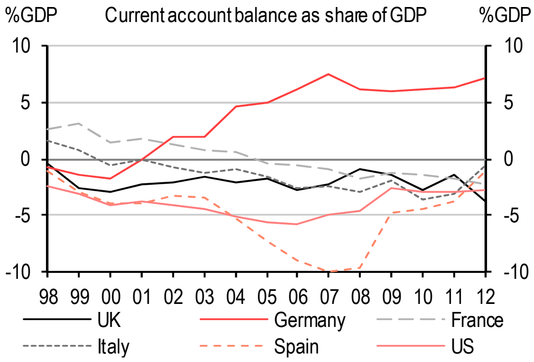
Encouragingly, there are also a number of free-trade agreements under discussion, namely the Transatlantic Trade Partnership (between the US and the EU) and the Trans-Pacific Partnership (between the US and 11 Asian countries, although China, South Korea and India have not joined talks for the moment). While not a first-best solution (that would be a unilateral reduction in trade barriers), a regional free-trade agreement covering as large a part of the global economy as the US and the EU (almost half of world GDP) is probably better than nothing.

Britain's gift to the world

The UK was the architect of free trade in both theory and practice back in the 19^{th} century. It is no coincidence that this period is often considered a golden age. Britain accounted for around a third total world manufactured goods exports before the First World War. Of course, its share will not return to anywhere close to that level, but the global market is also much bigger now, so the potential gains are massive. The UK can do better, and must do better. We believe it will do better.

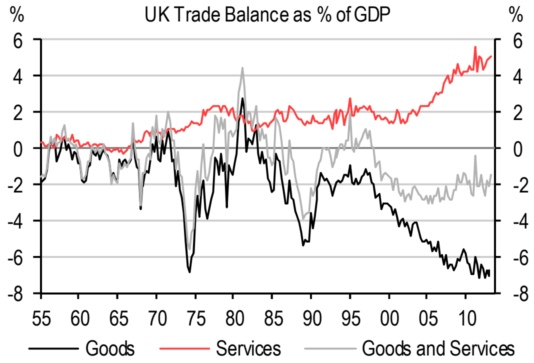
Appendix 1: Cross-country comparisons

Current account balance: UK now bottom of the pack



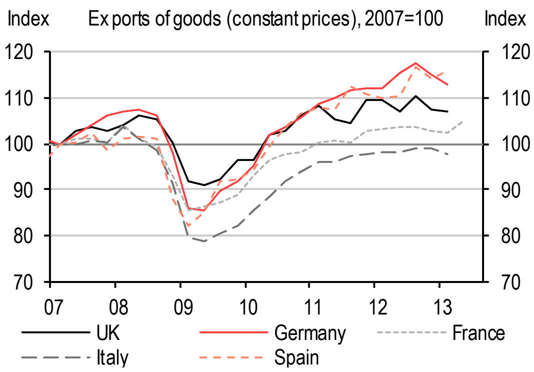
Source: OECD

The deficit is driven by goods, partially offset by services



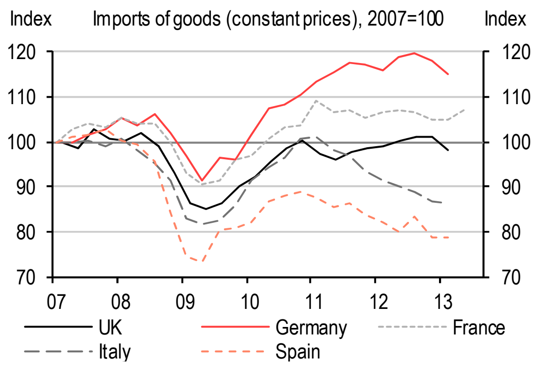
Source: ONS

Goods exports have grown, but not outperformed



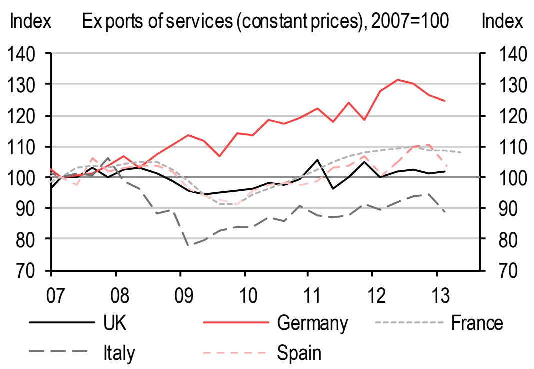
Source: Eurostat, HSBC

UK imports of goods back to pre-crisis levels



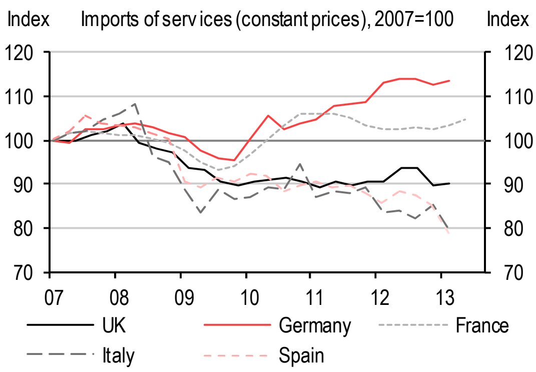
Source: Eurostat, HSBC

Exports of services have barely grown in six years



Source: Eurostat, HSBC

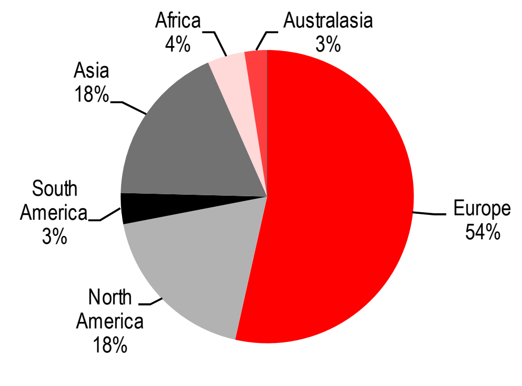
Although imports of services have fallen since the crisis



Source: Eurostat, HSBC

Appendix 2: UK exports by destination

Goods and services exports: UK exports mainly to Europe

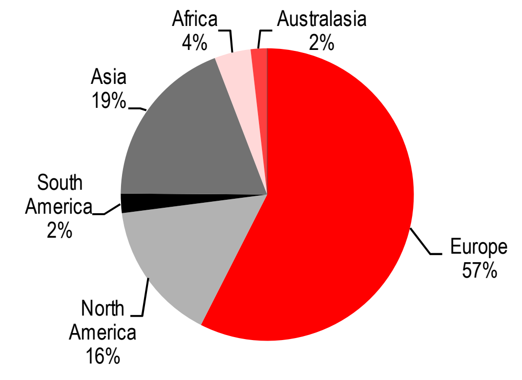


Source: ONS, HSBC

Share of total exports to Europe has fallen in past decade

Source: ONS, HSBC

Goods exports: overwhelmingly to Europe

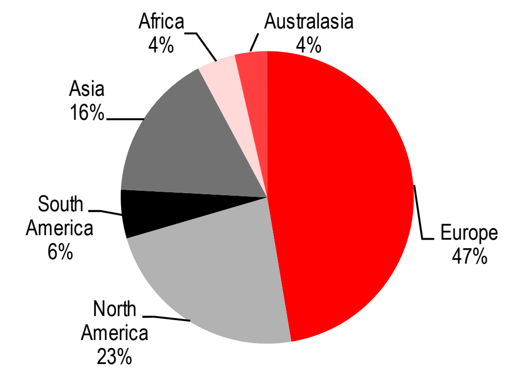


Source: ONS, HSBC

Share of goods exports have shifted from Europe to Asia

Source: ONS, HSBC

Services exports: slightly more diversified



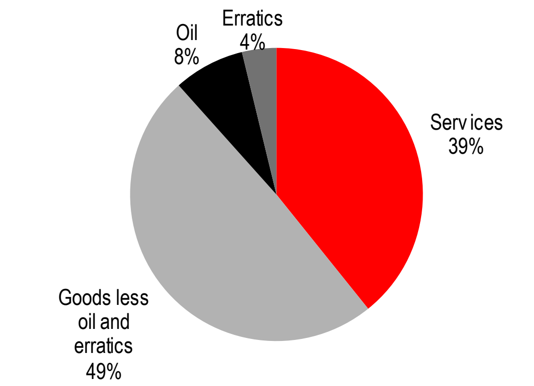
Source: ONS, HSBC

Services exports rebalancing a bit more slowly

Source: ONS, HSBC

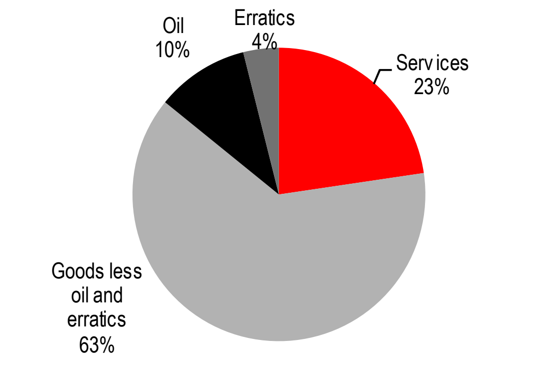
Appendix 3: UK trade by product groups

Majority of UK exports are still goods



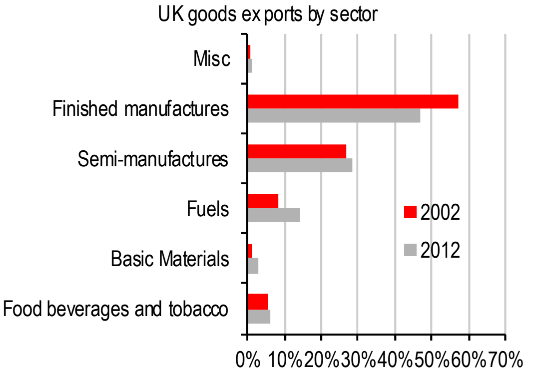
Source: ONS, HSBC

The UK imports a lot more in goods than services



Source: ONS, HSBC

UK goods exports are mainly finished manufactured goods

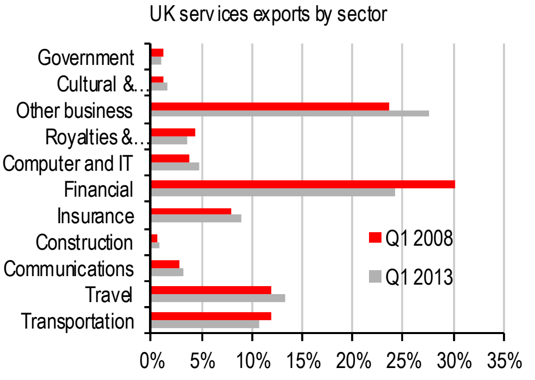


Source: ONS, HSBC

Share of finished goods imports increased; fallen for fuels

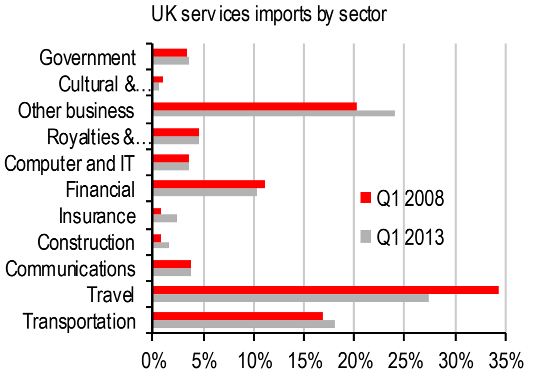
Source: ONS, HSBC

Services exports are intensive in financial services



Source: ONS, HSBC

UK imports proportionally more travel and transport services



Source: ONS, HSBC

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Disclosure appendix

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