item

The outlook for UK exports

ITEM Club Special Report

February 2011

Executive Summary

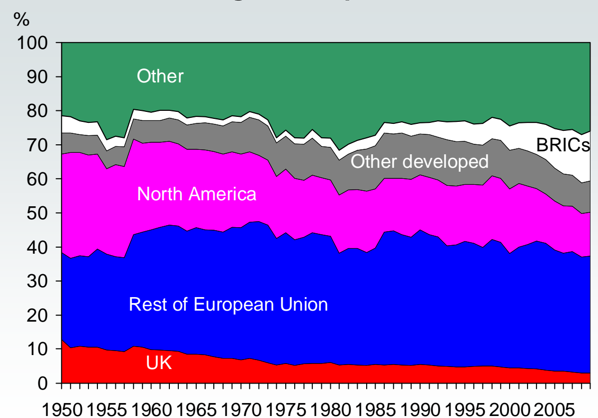
- The UK has consistently lost share of global exports since the Second World War, with the export performance in the decade prior to the financial crisis being particularly disappointing. We attribute the poor performance of the past ten years to a combination of a lack of penetration of emerging markets, in particular the BRIC countries, and a loss of competitiveness brought about by a persistently overvalued pound. However, future prospects look more encouraging. Though it lags behind many of its competitors in the developed world, the UK has made some encouraging progress in re-orientating its exports towards emerging markets in recent years. Furthermore, the gain in competitiveness delivered by the steep devaluation of the pound over the past three years will also help UK exporters to gain market share in more traditional markets such as the EU and the US.
- The past ten years have seen a marked divergence in the fortunes of goods and services exports. Goods exports have disappointed, having been hampered by poor competitiveness arising from increased competition from emerging markets and an overvalued pound. However, services exports have continued to grow strongly, led by financial services and computer & information services.
- UK exporters have been slow to adjust to the rapid growth of the BRICs, but there have been more encouraging signs over the past year. The weakness of the domestic economy will force UK firms to look abroad in order to grow their businesses. However, the outlook for most developed markets is subdued so the UK will need to continue to re-orient its exports towards the BRIC economies if it is to achieve strong export growth. Rising standards of living and an expanding middle class in the BRICs provide a good opportunity for this to happen, with the demands of these economies becoming more closely aligned to the goods and services in which the UK can demonstrate a comparative advantage.
- Competitiveness is also a key factor and the German experience of the past decade emphasises the importance of competitiveness in helping to penetrate the BRIC markets. While we think it unlikely that the UK can replicate the German success in the short term, due to the need for stronger productivity growth which is only likely to occur through structural reform in education and in encouraging investment, the UK should receive a significant boost from the weakness of the pound. This will support exports to the BRICs and also help gain market share in developed economies.
- However, this forecast is not without its risks, the main one being the potential for unfavourable exchange rate movements to damage competitiveness. Over the longer term, therefore, policy should be focused on supporting competitiveness through closing the productivity gap to Germany. The government also has an important part to play in facilitating the re-orientation of exports towards emerging markets by helping to break down regulatory barriers through developing strong relationships with the governments of the major emerging economies.

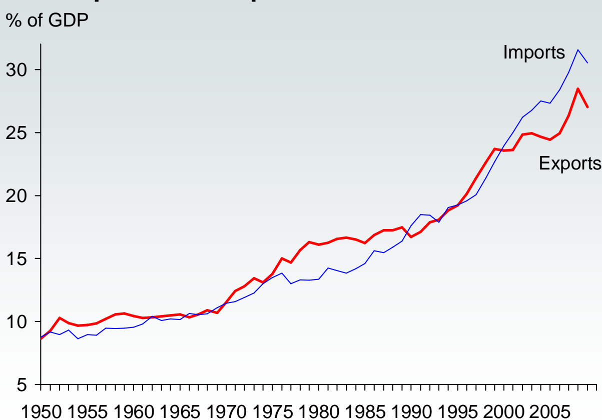
Introduction

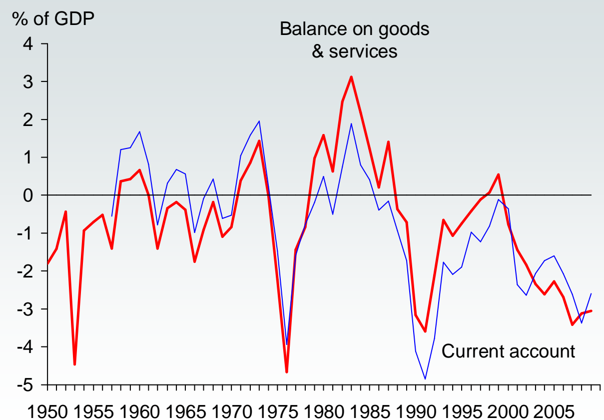
Over the past thirty years net trade has largely been a drag on UK economic growth, with rapid growth in home demand sucking in large amounts of imports, while exports have failed to keep pace. However, with the consumer and government sectors likely to be in retrenchment mode for several years, there is now a renewed focus on exports as a key source of growth for the UK economy. This Special Report looks at the UK's recent export performance and analyses how the type of export and the typical trading partner have evolved over time. The report then moves on to discuss how these trends are likely to develop in the future, asking whether UK exports really do have the ability to drive growth over the next decade.

The UK has lost share in global exports over the past sixty years

Over the past sixty years the UK has progressively lost share in global exports. In 1950, in the aftermath of the Second World War, the UK accounted for more than 10% of global exports, yet by 2009 that share had declined to just under 3%. The decline has generally been steady, halted only by the success of North Sea oil in the 1970s, but it has accelerated over the past decade, partly because of the underperformance of the UK export sector but also due to the emergence of the BRIC[1] countries as major players in the global economy. The UK is not alone amongst the developed economies[2] in seeing its share of global exports decline – the share accounted for by the developed economies has fallen from 73% in 1950 to 59% in 2009 – though the UK's decline has been more rapid than for most other major economies.







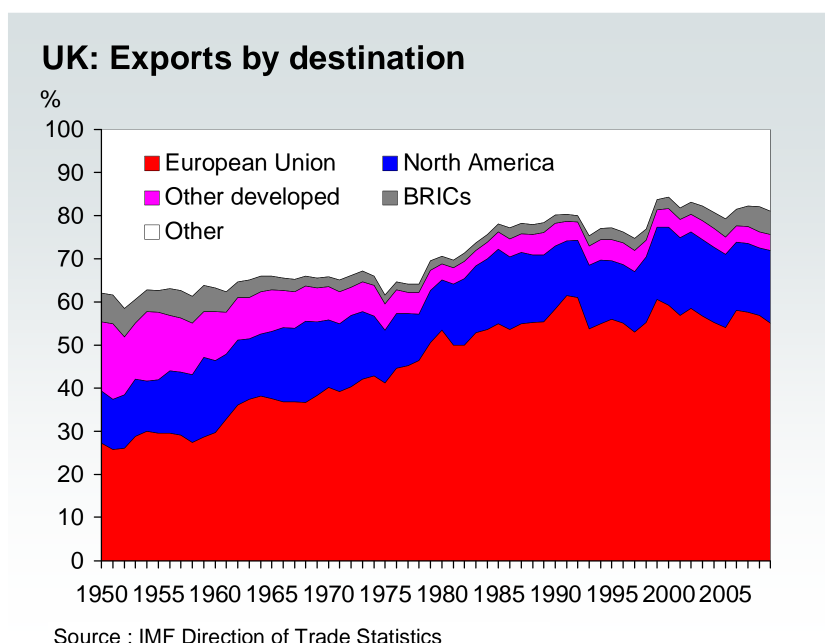
[1] *BRIC – Brazil, Russia, India and China*

[2] *Developed economies are defined in this report as: European Union, North America, Japan, Korea, Australia and New Zealand*

The period of relative export underperformance over the last decade coincided with a booming home economy in which consumer demand was the key driver. This sucked in large amounts of imports, opening up a wide and persistent deficit on trade in goods and services (3.1% of GDP in 2009) and on the current account (2.6% of GDP in 2009).

The destination of our exports has changed markedly....

The destination of UK exports has changed markedly over the past sixty years. In the aftermath of the Second World War the relative importance of the UK's trading partners were as much influenced by long-term colonial links as by geographical proximity. In 1950, 12% of UK exports went to Australia, while New Zealand, India and Canada combined to account for just under 15%. Over time the Commonwealth has significantly declined in importance to UK exports, particularly since the UK joined the European Union in 1973. Prior to that, around 40% of UK exports went to European Union countries, but in recent years that proportion has risen as high as 60%. At the same time the UK has become more reliant on exports to other developed economies, such as the US and Japan, such that developed economies now account for 75% of UK exports. One group of countries that UK exporters have largely struggled to penetrate to date is the BRICs. Despite some progress in recent years, just 5% of UK exports go to the BRIC economies, which compares unfavourably with BRIC shares of 10.6% for Germany and 11.1% for the US.

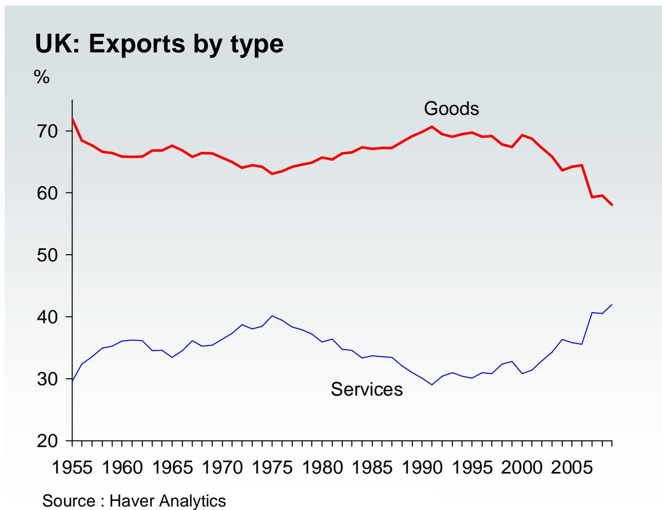


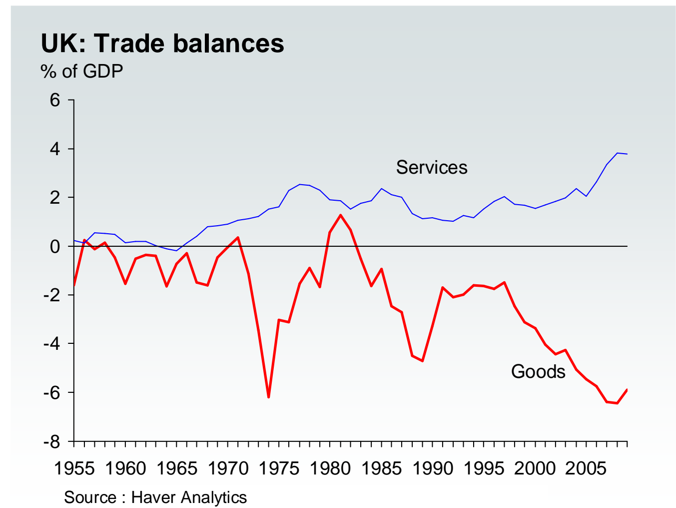
Source : IMF Direction of Trade Statistics

...and there has been an increasing shift from goods towards services

The composition of UK exports has also evolved, with a progressive increase in the importance of services exports, at the expense of manufactured goods. In the past two decades, the share of total exports accounted for by the services sector has increased from 30% in 1990 to 41% in 2009, with services exports having grown by 9% a year in value terms over that period. Indeed, in dollar terms the UK is now the second largest exporter of services, behind the US. The UK has excelled across a wide range of services activities, but the strongest performers have been computer & information services, which has grown by 24% a year in value terms since 1990, insurance services (17% a year) and financial services (14% a year). In the case of all of these sectors there is evidence of rapid growth in demand across the world over the past two decades, but in each case the UK has succeeded in outperforming

global trends. In the case of financial services and insurance this can be directly linked to the development of a financial and business services 'cluster' based around the City of London. The capital has been successful in attracting highly skilled labour and strong capital flows into its financial services sector. Allied with a relatively 'light touch' regulatory regime, the natural benefits of language and time-zone, and high-class support services in fields such as IT, legal services and accountancy, the UK has become a global leader in financial service provision. The UK now hosts the world's largest foreign exchange market, with a daily turnover of 34% of the global total, as well as being the world's most important market for over-the-counter derivatives, with 43% of global trades[3].



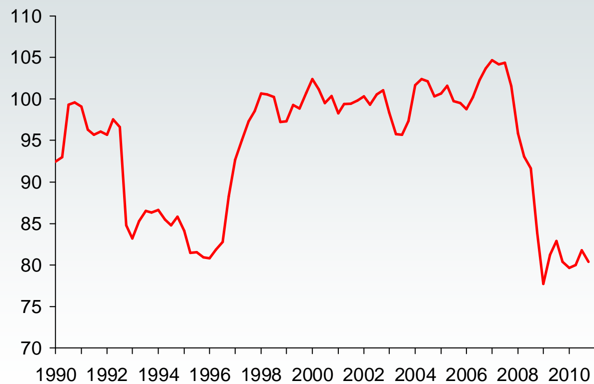


Equivalently, the contribution of goods exports to total exports has been falling – from 70% in 1990 to 59% in 2009. The UK runs a relatively large deficit in the trade of goods compared to other OECD countries and it has worsened significantly since 1990. A loss of competitiveness appears to be behind the relative decline in UK goods exports, with the reasons for this loss of competitiveness being two-fold. The first factor has been the increase in competition from emerging economies, in particular the BRICs, where costs of production are significantly lower. This has drawn production of certain goods away from the UK towards emerging markets, largely those goods where labour accounts for a high proportion of costs and where a combination of mass-production techniques and low-skilled labour can be employed. The second factor was a persistently overvalued exchange rate from the mid-1990s onwards. Between the beginning of 1996 and early-1998, the pound appreciated by 25% on a trade-weighted basis and it largely held that level until the financial crisis began in late-2007. Sectors requiring significant amounts of commodity inputs derived modest benefit from this appreciation in terms of the impact on their dollar-denominated input costs. However, the appreciation against the dollar was much lower at 7.5%, so the net effect was a significant loss of competitiveness. With wage settlements in UK manufacturing continuing to grow at around 4% a year in the decade from 1996 onwards, we estimate that by the time that the financial crisis hit in 2007, UK manufacturing unit labour costs had risen by 52% relative to competitor countries.

[3] *"The City UK: The World's leading International Financial Centre", UK Trade and Investment, City of London Corporation, Think London, and International Financial Services London, August 2008*

UK: Sterling effective exchange rate

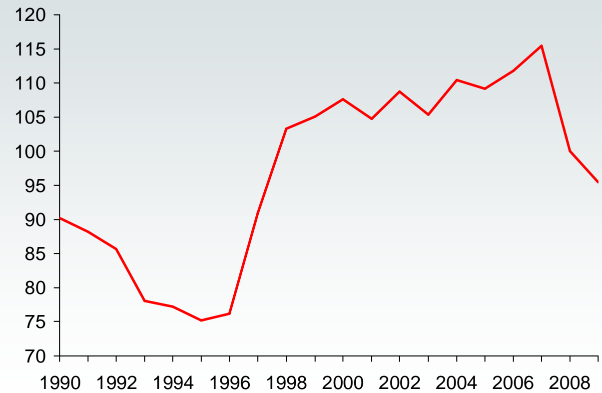
£EER (Jan 2005=100)



Source : Haver Analytics

UK: Relative unit labour costs

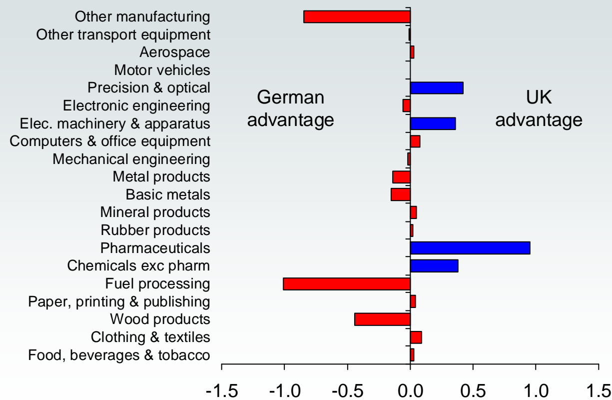
2008=100



Source : ITEM Club/Haver Analytics

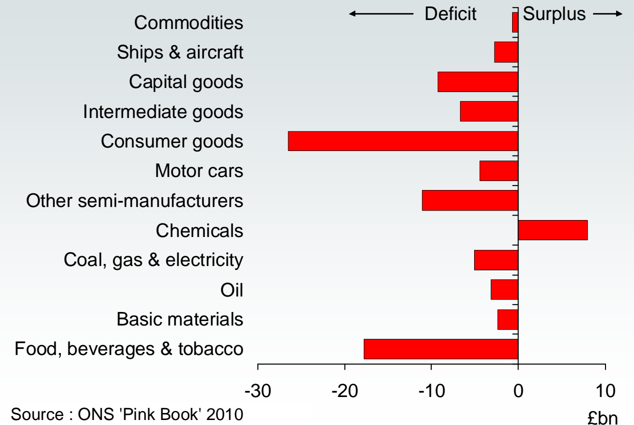
However, in spite of the massive deterioration in competitiveness, the UK has managed to retain a comparative advantage in a small number of goods exports sectors. Comparative advantage can be measured in a number of ways. One definition is that the opportunity cost of producing an item is less than another nation's opportunity cost of producing that item; this can be defined as being where productivity in an industry is high relative to other industries in that country. Comparing the UK with Germany in this way (see chart below left), suggests that the UK continues to hold a comparative advantage in a number of 'high-tech' manufacturing sectors such as pharmaceuticals, precision & optical instruments and chemicals. Alternatively, comparative advantage can be indicated by a sector running a trade surplus (see chart below right); the chemicals sector also performs strongly on this measure, although all other goods sectors have run deficits in recent years.

Comparative advantage: UK vs. Germany



Source : OECD STAN, ITEM Club

UK: Goods balance by sector (2009)



Source : ONS 'Pink Book' 2010

The UK's low exposure to emergers has dampened the export recovery...

The collapse in world trade following the onset of the financial crisis caused UK export volumes to drop sharply – between 2008Q2 and 2009Q2 exports fell by 12.9% in volume terms with both goods (-16.7%) and services (-7.1%) trade plunging. However, with the financial crisis causing flows of capital into the UK to dry up, sterling depreciated by around 25% between 2007 and 2009, thus boosting UK export competitiveness and providing a cushion against the plunge in world trade. This meant that the UK's decline in exports was actually much smaller than most other

developed economies, including industrial powerhouses Germany (-18% decline from peak-to-trough) and Japan (-37%).

Nevertheless, the UK has not benefitted from the subsequent rebound in world trade to as great a degree as most of its competitors. While none of the developed economies have seen exports regain pre-recession levels, growth in countries such as Germany (21% in volume terms from the cyclical trough), US (16%) and France (13%) has been significantly stronger than the UK (8%). This partly reflects the UK's greater exposure to services exports than elsewhere, given that exports of services continued to fall until the middle of 2010.

However, the UK's underperformance in the recovery phase is also a reflection of the fact that UK exports are poorly orientated and our econometric analysis of historic UK export performance identifies growth in demand export markets as being the key driver of UK export performance. The share of UK exports accounted for by developed economies is significantly greater than their share of the world economy and these areas are also recovering much more slowly than emerging markets. The table below compares the shares of UK exports going to different parts of the world in 2009 with their share of world GDP, as calculated by the IMF, using both US$ and PPP weights. The use of dollar rather than PPP exchange rates gives a bigger weight to the advanced economies, but the picture is similar. The BRICs now make up 16 to 23% of the world economy depending upon their exchange rate weight, but take only 5% of UK exports. We do relatively well in terms of exports to OPEC countries. However, nearly 50% of our exports go to our partners in the EU who make up just over 21-28% of world GDP. In total, 80% of our exports go to the advanced industrial economies of the OECD area, compared with a GDP share of just 54-69% – and falling.

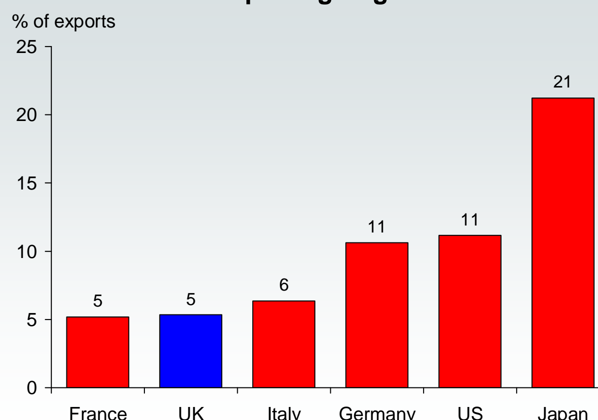
UK exports and world markets in 2009

	Share of UK exports (%)	Share of World GDP (%)	
		Using $ exchange rates	Using PPP* exchange rates
Attributed to:			
EU	48.7	28.4	21.2
North America	19.1	26.3	23.1
Other OECD	12.6	14.3	9.6
Advanced	**80.4**	**68.9**	**53.9**
Brazil	0.6	2.7	2.9
Russia	1.1	2.1	3.0
India	1.2	2.1	5.1
China	2.0	8.6	12.6
BRICs	**4.9**	**15.6**	**23.5**
Oil exporters	3.8	3.4	4.9
Rest of the World	10.9	12.0	17.7

**PPP = Purchasing Power Parity*

Source: IMF: International Financial Statistics, ONS: The Pink Book 2010

In terms of the BRICs, the driving force of the global recovery, the UK's market penetration measures up particularly poorly against most other developed countries. Just 5% of UK exports went to the BRIC countries in 2009, a share comparable to France but less than half of that of Germany or the US, and less than a quarter of the share of Japanese exports. Notably, the UK does not just compare unfavourably in terms of exports of goods (see first table below), an area in which we have noted that the UK has struggled in recent years, but it also lags Germany in terms of the level of services (see second table below) exported to the BRIC economies[4], despite the UK exporting a higher value of services to the world as a whole than Germany does.



Source : IMF Direction of Trade Statistics

Cross-country comparison of goods exports (2009)					
Value of goods exports ($US billion)					
	Origin of Exports				
	UK	Germany	France	Italy	US
Destination of exports					
Brazil	2.7	10.2	3.6	3.8	26.2
China	8.0	52.2	11.0	9.2	69.6
India	4.5	11.3	3.4	3.8	16.5
Russia	3.5	28.8	7.0	9.0	5.4
BRICs	**18.7**	**102.5**	**25.0**	**25.8**	**117.6**
European Union	194.6	696.3	298.1	233.9	221.3
North America	58.1	82.7	30.7	26.7	204.7
Other	81.8	239.2	130.3	120.5	513.4
Total	**353.4**	**1120.7**	**484.1**	**407.0**	**1057.1**

Source: IMF Direction of Trade Statistics

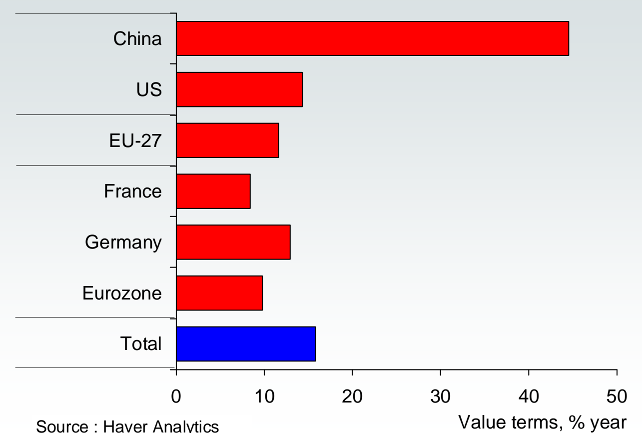
Cross-country comparison of services exports (2008)					
Value of services exports ($US billion)					
	Origin of Exports				
	UK	Germany	France	Italy	US
Destination of exports					
Brazil	1.0	2.0	1.4	1.0	12.3
China	4.5	5.8	5.8	0.7	15.9
India	3.2	2.0	1.1	0.5	10.6
Russia	3.7	2.8	1.5	1.4	1.9
BRICs	**12.3**	**12.7**	**9.7**	**3.5**	**40.7**
European Union	114.7	129.5	80.5	78.6	198.4
North America	66.0	34.1	24.5	11.1	70.5
Other	93.9	68.9	48.9	26.2	240.1
Total	**285.9**	**246.2**	**163.6**	**119.3**	**549.6**

Source: OECD

[4] *If Hong Kong is treated as being part of the BRICs then UK services exports to the BRICs are slightly higher than Germany's*

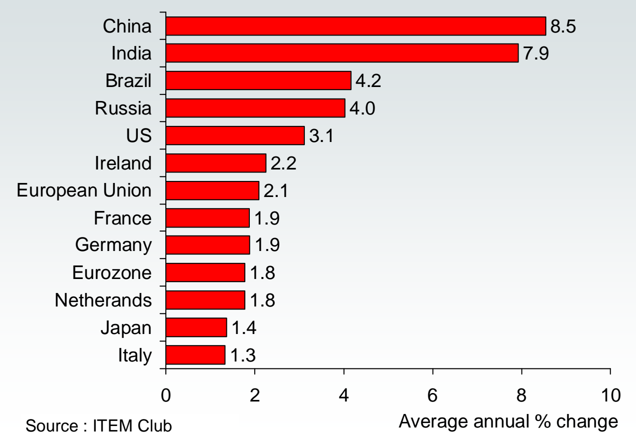
...though encouraging progress is beginning to be made

However, there are some encouraging signs that, having been left behind over the past decade, UK exporters are belatedly beginning to catch up. The latest monthly statistics for goods trade reported that in the three months to November 2010, UK goods exports to China had risen by 44.6% in value terms compared with the same period a year earlier. That China accounts for only 2% of UK exports while the European Union – which saw export growth of 11.6% over the same period – accounts for almost 50%, explains the UK's poor relative export performance. However, the are signs that things are moving in the right direction, particularly given that UK exports to China rose faster than Chinese imports, suggesting that the UK has gained market share.



The key objective for UK exporters over the next decade will be to continue the progress that they have made over the past year. With the consumer and government sectors attempting to battle against high levels of indebtedness, the recovery in UK domestic demand is likely to be weak. This will act as a powerful incentive for UK firms to look overseas if they are to continue to grow their business. The large – and rising – share of GDP accounted for by exports shows that firms are already thinking in this way and we expect this trend to continue over the next ten years.

However, many other developed economies face similar domestic challenges to the UK over the coming decade. This means that many of the UK's traditional export markets are likely to see much slower economic growth over the coming decade than over the ten years leading up to the financial crisis, with the Eurozone expected to grow by less than 2% a year over the period to 2020. In contrast, prospects for the emerging markets look very good. The BRIC countries, in particular, will be characterised by continued strong growth in population and a slower increase in dependency ratios than in the developed world, even accounting for the implications of the Chinese one-child policy. We also expect these emerging markets to gradually implement structural reforms aimed at reducing the high levels of corporate and household saving and boosting consumption. With the BRIC countries exhibiting neither the high household nor government indebtedness of the developed world, we expect the Chinese economy to grow by 8.5% a year from 2010-2020, with India close behind at 7.9% a year. This two-speed global economy will, therefore, force UK firms to increasingly look to emerging markets in order to continue to grow their businesses.



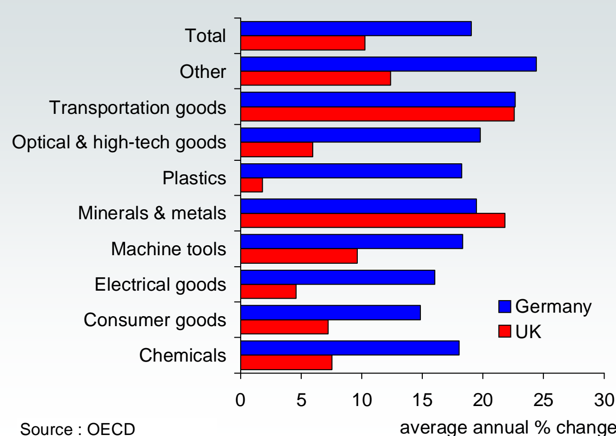
An added dimension, however, is that the weakness of consumer and government demand in their domestic markets will also force other developed economies to place a significant emphasis on exports as a source of growth, thus increasing the level of competition that UK exporters will face in penetrating emerging markets. The recent

Competing for Growth[5] survey carried out by Ernst & Young suggests that this process is already well underway, with 47% of respondents from emerging markets reporting increased market competitiveness from existing players from developed markets and 53% reporting increased competition from the entry of new players from developed markets.

Germany provides a good example of how to penetrate BRIC markets

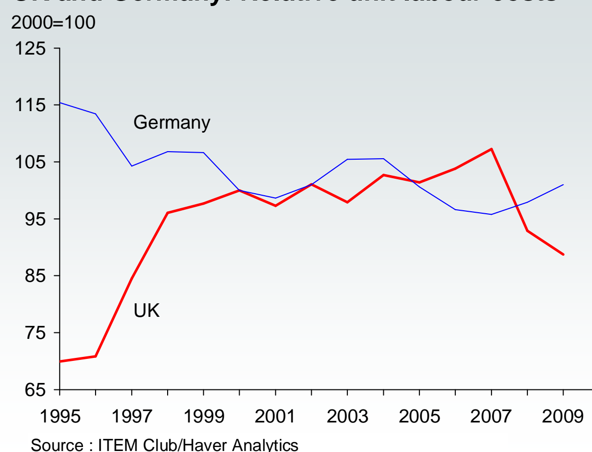
We have demonstrated that, to date, UK exporters have been relatively unsuccessful in penetrating emerging markets, particularly the BRICs. However, the experience of other developed countries demonstrates that it can be done and that experience can provide a good template to follow. Over the period since 2000 Germany has increased the share of its exports which go to the BRICs from 4.5% to 10.6%. This has mainly come through the goods side, where German exports to the BRIC countries rose by 19% a year in value terms between 2000 and 2009, compared with UK growth of just 10.3% a year. The German success has been broad-based – the nine broad sectors that we have identified all grew by 15% a year or more over that period – and so does not suggest that Germany has exploited advantages in any specific sectors. Indeed, in the cases of minerals & metals and transportation goods, the UK achieved similar rates of growth over the period.

UK & Germany: Exports to BRICs (2000-09)



Source : OECD

UK and Germany: Relative unit labour costs



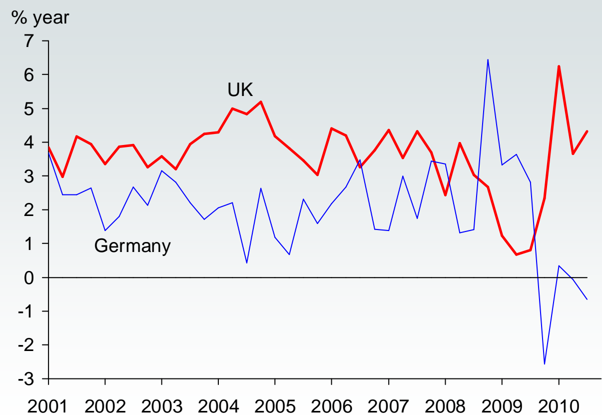
Source : ITEM Club/Haver Analytics

Instead, it would appear that the German success can largely be attributed to its stronger competitiveness. We have already identified the significant decline in UK competitiveness in the period up until 2007, partly due to a persistently overvalued exchange rate. In contrast, Germany enjoyed a significant decline in relative unit labour costs[6] between the mid-1990s and the onset of the financial crisis (15% between 1996 and 2007) which was arrested only in the period immediately after the introduction of the euro. Indeed, strong German competitiveness cannot be attributed to favourable exchange rate movements; arguably the relative strength of the euro has actually hindered German competitiveness since 2000. Instead it appears to be a function of tight cost control and strong productivity growth. Throughout the course of the past two decades German manufacturers have achieved both much stronger levels of, and growth in, labour productivity than the UK, yet manufacturing wages have grown, on average, 1.5 percentage points a year faster in the UK. Part of the earnings differential can be attributed to higher rates of inflation in the UK,

[5] *'Competing for growth - Winning in the new economy'. Study carried out by Ernst & Young with support from the Economist Intelligence Unit (EIU) between 1 September and 15 October 2010.*

[6] *Relative unit labour costs are defined as the unit labour costs of a given economy relative to its competitors in domestic and foreign markets. This is based upon the series published by the OECD.*

with the UK CPI averaging 2.1% a year between 2000 and 2010 and the EU harmonised rate of German inflation rising by 1.6% a year. However, the lower growth in German wages also suggests that its labour market displays greater flexibility than it is often given credit for. This is partly because German manufacturing is heavily unionised and its trade unions have prioritised job preservation over large pay increases for a number of years. German wage settlements have further been suppressed by the threat of plants being relocated to the newer members of the EU in Eastern Europe.



Numerous studies have been undertaken to investigate the causes of weak UK productivity growth, with most concluding that the underperformance of UK manufacturing was due to two key factors. Firstly, low levels of skills amongst the workforce, with the German 'dual system' of vocational training widely recognised as promoting higher skill levels. For example, a study by Roper and Hofmann (1993)[7] examined 20 plants in four manufacturing sectors in Northern Ireland and Germany and found that labour productivity in the Northern Irish plants averaged only 60% of the German level. The second factor was German superiority in the areas of innovation and research and development. UK business spending on research and development is low by international standards – OECD data for 2007 reported that UK business spending on R&D was 1.1% of GDP, compared with 1.8% in Germany – and while most other countries have increased their spending over the past decade, in the UK it has declined as a proportion of GDP.

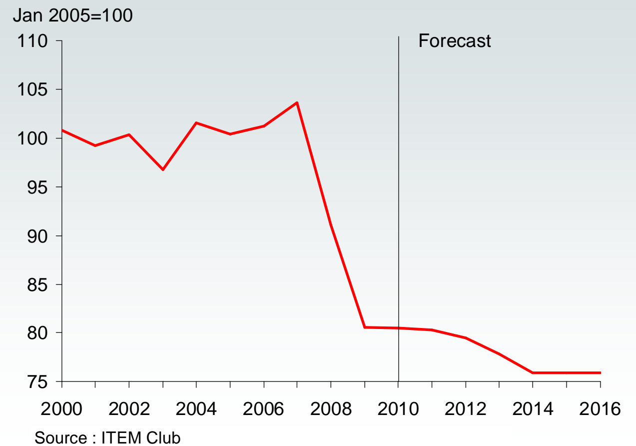
A weak pound can provide the boost to UK competitiveness

The German experience emphasises the importance of competitiveness in penetrating the BRIC markets. But our econometric analysis suggests that, after the strength of market demand, competitiveness is the second most important factor in determining export performance across all markets and for both goods and services. While there is much potential for the UK to follow the German lead and seek to boost its competitiveness through productivity enhancements, this would very much be a long-term process, achievable only through structural reform of the education system and improving the incentives for firms to invest in research and development.

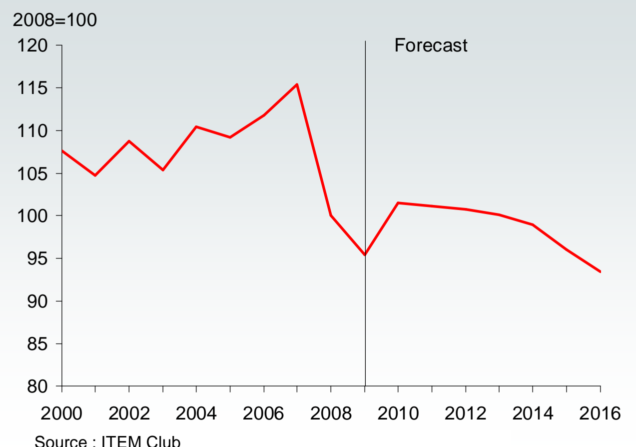
However, in the short-term, favourable exchange rate movements should provide UK competitiveness with a significant boost. Sterling fell by 25% on a trade-weighted basis between mid-2007 and early-2009 and has remained broadly stable over the period since. Just as the strength of sterling significantly damaged UK competitiveness in the second half of the 1990s by driving up relative unit labour costs, the opposite effect is being seen now; we estimate that relative UK unit wage costs declined by 17% between 2007 and 2009.

[7] *Roper S. and Hofmann H (1993) Training, Skills and Company Competitiveness. A Comparison of Matched Plants in Northern Ireland and Germany. NIERC Research Series*

Furthermore, we expect sterling to remain weak. Prior to the financial crisis sterling had been supported by a strong domestic market, plus strong capital inflows from the east as high rates of saving in Asia combined with strong borrowing trends, and therefore demand for capital, in the UK. However, the domestic market is likely to remain weak for a prolonged period, while the climate for borrowing has deteriorated significantly and, with households and governments likely to be in retrenchment mode for some time to come, we are unlikely to see capital inflows return to pre-crisis levels. In addition, despite the current high levels of inflation, we expect the Bank of England to maintain a very loose monetary policy stance for a prolonged period in order to offset the dampening effects on growth and inflation of the most aggressive fiscal retrenchment for a generation. We expect Bank Rate to remain at 0.5% until well into next year and it is likely to be at least four of five years until it has returned to a neutral rate of between 4 and 5%. Though we would expect the Federal Reserve and the European Central Bank to also tighten gradually, this monetary policy climate is more likely to push sterling further down, rather than up. Furthermore, with signs that the Chinese authorities are willing to permit a managed appreciation of the renminbi, we expect sterling to weaken against BRIC currencies too. It might take a little time for exporters to be assured that the drop in the real exchange rate will be locked in, given that in previous instances it has swiftly been reversed, either by a rise in the nominal exchange rate – as it was from 1995-99 – or by rapid wage growth, as it was from 1967-70. However, once producers are happy that this will be the case, it will also give them the confidence to invest in areas such as export delivery networks and sales and marketing.



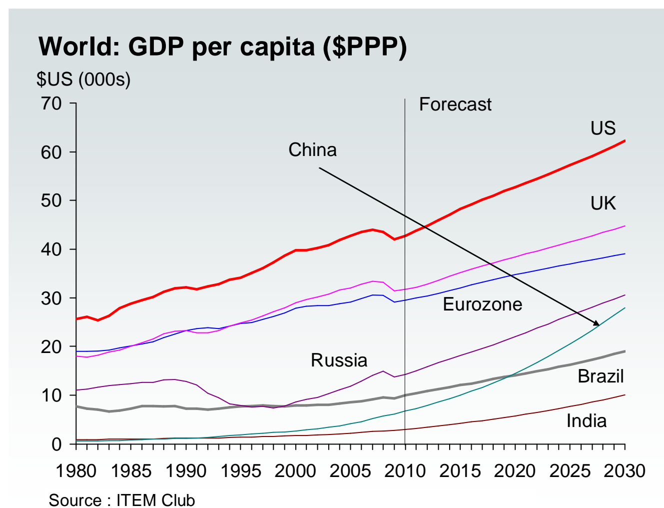
For some producers the weakness of sterling has been a double-edged sword, with the boost to competitiveness mitigated by the impact on their costs from sharp rises in dollar-denominated commodity prices. In the short-term this is likely to dampen the gains in competitiveness. However, in our view the recent rises in commodity prices can be attributed to a combination of weather effects – for commodities such as food and cotton – surging demand from emerging markets and market speculation, and we view each of these as being temporary factors. Assuming that this year's harvests are successful we should see food and cotton prices stabilise, while tighter monetary policy will cause emerging markets to throttle back. As such, any threat to competitiveness from rising input costs is likely to prove short-lived and we expect relative unit wage costs to continue to fall over the coming years.

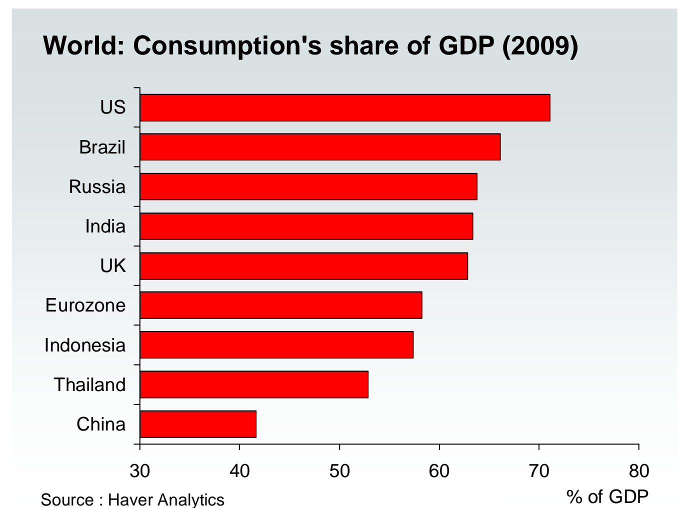


The needs of the BRIC markets are becoming increasingly aligned with sources of UK export strength...

We have established that one of the reasons that the UK has struggled to penetrate emerging markets, yet Germany has thrived, is because of relative cost competitiveness. It could be argued that this impact has been more intense because of the nature of the goods that emerging markets have typically imported, concentrating on more generic manufactured goods which can be produced in many countries, making cost the overriding factor. There has also been a concentration on capital goods, imported to support the growing manufacturing capability of emerging economies, an area in which Germany traditionally excels but where the UK performs less well. However, there are signs that the consumption patterns of emerging markets are beginning to evolve, a process which we anticipate will bring the requirements of these countries more closely into line with the areas in which UK exporters excel.

In particular, there is evidence of much stronger consumer demand from the BRICs as standards of living rapidly improve. This can be demonstrated by the recent strength of passenger car sales in China, which grew by 192% between 2007 and 2010. As the BRIC economies continue to achieve rapid economic growth, household incomes will continue to grow and we expect nominal household income growth to average 14% a year in the BRICs over the period to 2020. With levels of household indebtedness very low and consumer spending accounting for a very low share of GDP in China in particular, there is plenty of scope for a robust increase in consumer demand over the coming decade.





Furthermore, there is evidence that the profile and behaviours of BRIC economies are changing. Currently only 30% of the Indian population and 43% of the Chinese population live in urban centres – compared with rates of 82% in the US and 90% in the UK – but urbanisation is increasing rapidly. Similarly, there is a rapidly expanding middle class in these economies, who are increasingly looking to spend on goods and services more traditionally associated with consumers in the developed world, as demonstrated by the steep upward trend in rates of car ownership in China.

Over the coming decade we expect consumer spending growth to average 13.5% a year in value terms in the BRIC countries. We expect this strong growth, combined with rising living standards and the rapid expansion of the middle class, to result in a significant acceleration in demand for goods such as electrical goods, optical & high-tech goods and cars. These factors will also continue the strong growth in the demand for services imports from these economies seen in recent years – UK exports of services to China rose by 79% in value terms between 2005 and

2008, with exports to India rising by 54% over the same period. The parts of the services sector that we expect to benefit the most are financial and insurance services, with rising standards of living creating additional demand for financial planning and investment services, as well as IT and communication services, as the internet revolution experienced by western economies over the past decade spreads to emerging markets.

The consumer-related growth sectors identified here dovetail well with the areas in which UK exporters have demonstrated comparative advantage. On the goods side, the UK demonstrates a particularly strong comparative advantage in the production of high-tech optical equipment, while in services the UK has consistently achieved large surpluses on trade in financial and insurance services. Furthermore, research by the Gerson Lehrman Group[8] finds that consumer-facing sectors in the BRICs are more suited to the European way of business than American-style "mass market" brands. In contrast they do note the success of luxury brands, where there is already evidence of significant market penetration.

In addition to the consumer-related opportunities, the development of the BRICs is also likely to create additional demand for business-to-business services, such as legal and accountancy services, another area where the UK has considerable expertise. Overall, the development of the BRIC economies is likely to create significant additional demand across a range of goods and services in which the UK has demonstrated strength and we expect this to be a key source of export growth for UK firms over the coming decade.

...and barriers to entering emerging markets appear to be easing

The oft-cited constraint to growing trade with emerging markets is barriers to entry, ranging from issues involved with establishing delivery networks to cultural differences and regulatory constraints. Often these vary significantly from one sector to another and in certain sectors they are likely to remain a significant bar to increasing export growth; the most obvious example of this is the defence sector, where many governments are unwilling to deal with foreign contractors.

However, there is a wealth of evidence suggesting that barriers to entry are easing across most other markets. This partly reflects the increase in BRIC ownership of companies based in the developed world, with the influence of foreign ownership having enabled companies to gain greater insight into the business practices and culture of these markets and better prepare strategies to enter these markets effectively. There is also evidence of firms looking to create alliances with businesses based in emerging markets to smooth the entry into new markets; the Ernst & Young *Competing for Growth* survey reported that 43% of firms had made alliances with other organisations to accelerate market entry in the pursuit of increased sales.

In an article for the Portland Business Journal[9], Aginsky Consulting Group, a market entry advisory firm, reported evidence of the benefits of a local presence to represent a firm's goods and services and to also reinforce credibility in local markets. The creation of alliances with companies in emerging markets is also one way that firms have sought to achieve this, but there is also evidence of UK firms investing heavily in their own delivery networks in emerging markets, with Foreign Direct Investment (FDI) in China and India having increased substantially over the past decade. Indeed, with UK firms having run up significant financial surpluses over the past few years, they now have the resources to commit to investing in new delivery networks and we expect this combination of funding and

[8] *'BRIC markets are very dissimilar opportunities', Gerson Lehrman Group, 29 April 2008*

[9] *"When it comes to exporting goods, there's gold in the BRICs"; Alexander Aginsky of Aginsky Consulting Group writing in the Portland Business Journal, 17 September 2010*

the opportunities offered by rapidly expanding markets, to underpin sustained strong growth in UK investment in emerging markets over the coming decade.

Anecdotal evidence suggests that some progress has been made in terms of breaking down regulatory barriers, though it is very much a gradual process. We expect this process to continue, particularly in areas of the services sector where emerging economies struggle to provide the quality of service required without assistance from abroad. However, this is a factor governing UK export performance over which UK firms will have little influence; much depends upon the will of local governments to open their markets to foreign firms. The UK government also has an important role to play here in developing relationships with governments in emerging markets and lobbying for regulatory barriers to be broken down. In this respect the recent trade delegation to China, led by high-ranking members of the coalition government, is an encouraging sign, though it is only the first step and the government has plenty more work to do in this area.

A re-orientation of exports and improved competitiveness will drive a strong performance over the next decade

Though its lags behind many of its competitors in the developed world, the UK has made some encouraging progress in penetrating emerging markets in recent years, and we see a continuation of this success as being the key factor behind a robust export performance over the coming decade. However, the gain in competitiveness delivered by the steep devaluation of the pound over the past three years will also help UK exporters to gain market share in more traditional markets such as the EU and the US.

Our forecast shows exports of goods growing by 8.7% a year in value terms between 2010 and 2020, with services exports rising by 8.4% a year. In both cases the strongest growth is forecast to come from trade with the BRIC countries, in particular India and China, where GDP growth is expected to be strongest and where the most potential exists for improvements in living standards to be reflected in increased demand for the types of good and service in which the UK holds a comparative advantage. Our forecasts for the developed world emphasise the importance of competitiveness, with exports to the EU and the US forecast to grow at more than twice the rate of the decade leading up to the financial crisis, despite less favourable trends in economic growth.

In terms of goods exports, we forecast the strongest growth in electrical goods and optical & high-tech goods. This is principally due to the expectation of strong growth in demand from emerging markets, allied to the UK's comparative advantage in producing these goods. However, there is also evidence that export performance in these sectors is responsive to improvements in competitiveness.

On the services side, the financial services sector is expected to make the largest contribution to export growth. However, while demand from emerging markets is expected to grow strongly, the legacy of the financial crisis is likely to mean weaker growth for financial services in developed economies. We also attribute a proportion of the services export success of the past decade to benefits gained from structural changes and, with these unlikely to be repeated, most services sectors are expected to achieve slower – albeit still robust – growth in the future.

Growth in UK goods exports by destination Value terms, average annual % change			
	1998-2008	2008-2010	2010-2020
European Union	3.1	2.2	7.6
of which:			
Germany	1.3	4.2	7.6
France	-0.9	8.5	8.2
Italy	-0.8	5.5	6.2
Ireland	4.7	-2.2	6.0
Netherlands	-0.8	9.8	7.4
United States	2.6	3.4	9.1
Other developed economies	1.3	6.8	8.0
Developed economies total	2.9	2.7	7.9
BRICs	11.8	5.4	11.8
of which:			
China	16.9	19.7	11.8
India	9.5	5.1	14.1
Russia	14.5	-10.3	9.3
Brazil	3.6	-3.0	9.7
Rest of the world	3.2	3.1	9.2
Goods total	**3.3**	**3.0**	**8.7**

Source: ITEM Club

Growth in UK services exports by destination Value terms, average annual % change			
	2004-2008	2008-2010	2010-2020
European Union	13.6	-8.1	8.0
of which:			
Germany	13.9	-7.5	7.7
France	11.6	-7.3	7.3
Italy	11.0	-9.6	6.3
Ireland	12.0	-11.5	6.6
Netherlands	10.7	-4.7	7.6
United States	12.9	-7.8	8.2
Other developed economies	10.7	-6.3	7.7
Developed economies total	13.1	-7.9	8.1
BRICs	22.8	-3.0	11.5
of which:			
China	13.9	3.9	14.5
India	23.2	-1.5	12.7
Russia	34.1	-10.3	5.7
Brazil	18.2	-1.9	11.4
Rest of the world	14.9	-7.1	8.4
Services total	**14.2**	**-7.4**	**8.4**

Source: ITEM Club

Growth in UK goods & services exports by destination
Value terms, average annual % change

	2004-2008	2008-2010	2010-2020
European Union	8.0	-1.6	7.8
of which:			
Germany	7.8	0.1	7.6
France	2.3	2.4	7.9
Italy	4.8	-0.2	6.2
Ireland	8.4	-5.4	6.2
Netherlands	6.2	2.0	7.5
United States	8.3	-3.1	8.6
Other developed economies	6.9	-0.8	7.8
Developed economies total	8.0	-1.9	8.0
BRICs	20.6	2.2	11.7
of which:			
China	16.5	14.4	12.7
India	17.1	2.4	13.6
Russia	30.6	-10.3	7.8
Brazil	19.0	-2.6	10.3
Rest of the world	10.2	-1.9	8.8
Goods & services total	**9.3**	**-1.8**	**8.5**

Source: ITEM Club

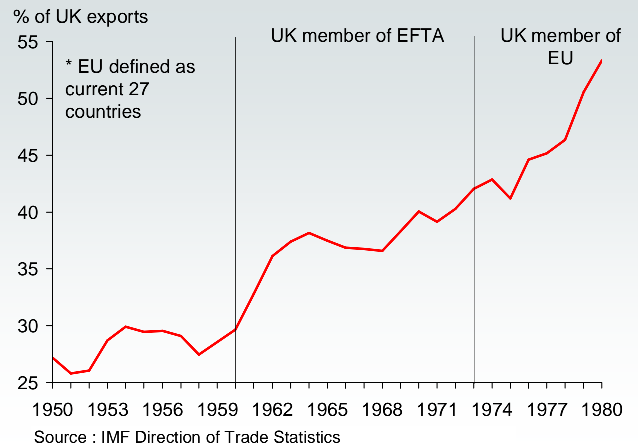
UK export growth by sector
Value terms, average annual % change

	1998-2008	2008-2010	2010-2020
Goods			
Chemicals	10.7	-5.3	8.6
Consumer goods	1.6	5.4	6.4
Electrical goods	-2.1	9.9	11.6
Machine tools	-1.0	11.3	8.6
Minerals & metals	6.3	-1.8	9.0
Plastics	2.3	8.9	6.6
Optical & high-tech goods	1.6	5.0	10.4
Transportation goods	1.1	7.2	8.3
Other	2.5	8.2	7.6
Goods total	**3.3**	**3.0**	**8.7**
Services			
Transportation	9.1	-8.3	7.6
Travel	6.0	-9.6	6.5
Communication services	16.7	-6.2	9.2
Construction services	16.0	-4.7	9.5
Insurance services	13.7	-7.1	8.6
Financial services	17.9	-5.2	9.9
Computer & information services	17.5	-7.9	7.6
Royalties & licence fees	8.4	-10.3	5.6
Other business services	12.3	-7.2	8.5
Personal, cultural & recreational services	12.0	-9.5	6.1
Government services	9.2	-9.4	6.3
Services total	**11.8**	**-7.4**	**8.4**

Source: ITEM Club

Such a shift in export performance would not be unprecedented...

Our forecast implies significant structural shifts, driven by changes in export orientation and cost competitiveness. However, such changes would not be unprecedented for the UK. The changes required here echo the transformation that the UK underwent in the 1960s when the poor economic performance of the Commonwealth and the UK's old colonies necessitated a reappraisal of UK export policy. In that instance, the focus shifted towards Europe which, at the time, was a rapidly growing market. While the location of this market made the change easier, there were still substantial language, cultural and political barriers to overcome. This was also the period before the UK joined the European Economic Community (EEC) and so the UK was hindered by trade barriers to non-EFTA[10] countries. The net result was an increase in the share of UK exports going to what is now the European Union from 30% in 1960 to 40% in 1970. The increase in the BRICs' share implied by our forecast is significantly lower over the coming decade.



...and could provide assistance for the government's regional policy

Policymakers and economists alike have long discussed the benefits of rebalancing the UK economy, and an improvement in export performance, along the lines of our forecast, would suggest a move towards greater balance. It could also yield benefits in terms of UK regional policy. Our forecasts show sustained strength across a number of goods sectors, which would represent a significant improvement on the performance of the previous cycle and implies that the persistent long-term decline of the UK manufacturing sector could be arrested. Different areas of the UK have developed distinct sectoral specialities and with manufacturing heavily orientated towards northern England and the Midlands, a stronger manufacturing performance should provide a significant boost to these regions. This would provide a useful counterbalance to the drag from lower government spending, which we expect to hit these regions harder because of their comparatively larger public sectors. Nevertheless, the south of England also stands to benefit from stronger export growth, particularly London from its successful financial services sector.

Conclusion

The UK has consistently lost share of global exports since the Second World War, with the export performance in the decade prior to the financial crisis being particularly disappointing. We attribute the poor performance of the past ten years to a combination of a lack of penetration of emerging markets, in particular the BRIC countries, and a loss of competitiveness brought about by a persistently overvalued pound. Export growth has recovered since the recession, though the relative lack of exposure to emerging markets means that the UK has underperformed relative to its competitors in the developed world.

However, there have been signs of encouragement, with exports to the BRICs growing rapidly over the past year from this low base and there is evidence that UK firms are more actively looking to penetrate emerging markets. In

[10] *EFTA - European Free Trade Association. Members in this period were Austria, Denmark, Norway, Portugal, Sweden, Switzerland and the United Kingdom, with Finland being an Associate Member*

our view, the weakness of domestic markets and markets elsewhere in the developed world, plus the opportunities offered by the BRICs, will drive UK firms to further increase their export activity in these markets. Furthermore, rising standards of living and an expanding middle class in the BRICs should provide a substantial boost to demand for goods and services in which the UK can demonstrate a comparative advantage. With competitiveness boosted by the recent steep devaluation of the pound, there is also potential for UK exporters to gain market share in the developed world.

The forecast is not without its risks, the main one being the potential for unfavourable exchange rate movements to damage competitiveness; with the UK's poor relative record on productivity allowing little scope to bolster competitiveness in the way that Germany has over the past decade, at least in the short term, a strengthening of the pound would dampen export growth. Over the longer term, however, policy should be focused on closing the productivity gap to Germany, through improving skill levels and incentives for investment, as the UK should not be in a position where it needs to rely on favourable exchange rate movements to support competitiveness. The government also has an important part to play in facilitating the re-orientation of exports towards emerging markets. We have assumed that progress is slow in breaking down regulatory barriers, but there is the potential for more rapid improvements were the government to be successful in developing strong relationships with the governments of the major emerging economies.

In addition to boosting economic growth in the country as a whole, a strong export-led recovery could also yield benefits in terms of UK regional policy. Our forecasts show sustained strength across a number of goods sectors, implying that the persistent long-term decline of the UK manufacturing sector could be arrested. With manufacturing heavily orientated towards northern England and the Midlands, a stronger manufacturing performance would provide a useful counterbalance to the drag from lower government spending, which we expect to hit these regions harder because of their larger public sectors. Nevertheless, the south of England also stands to benefit from stronger export growth, particularly London from its successful financial services sector.