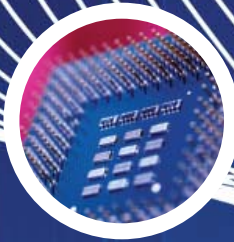


The ERA Foundation



The Sustainability of the UK Economy in an
Era of Declining Productive Capability

4th Report - February 2010

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Introduction

There can be no doubt that manufacturing, and productive industry in the broadest sense, must play a critical role in any rebuilding of the UK economy. The UK has benefited from a strong manufacturing base in the past and can again become a major world player if a more fertile environment well-matched to the needs of manufacturing industry is established.

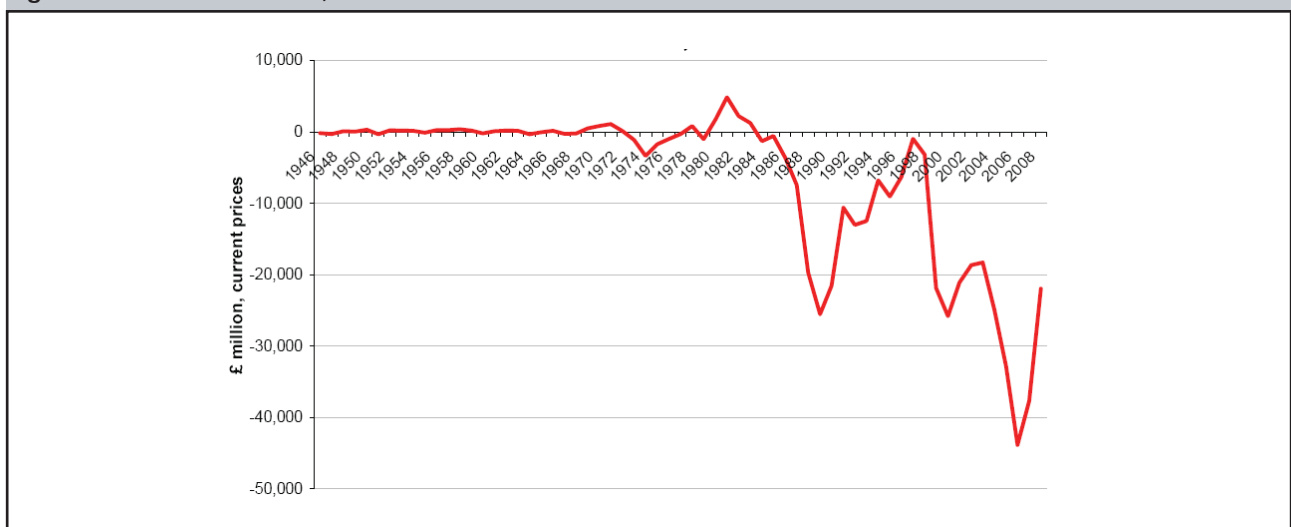
The recovery of the financial services sector following the recession is important, but the nation can no longer be dependent on expectations of that sector's continued growth and resilience – or be held hostage to its excesses. The growth of other business services, particularly those referred to as 'knowledge-intensive', is also welcome, but their scale is insufficient to be a substitute for manufacturing for the foreseeable future. A return to a balanced economy with productive industry at its heart is the only realistic option if the UK is to prosper in an increasingly competitive world.

Background

Successive Governments over the past 25 years have been committed to developing and maintaining a favourable environment for financial services. This was pursued to the extent that there was a widespread belief emanating from the Government downwards that the UK was entering a "post-industrial era" with an economy based upon financial and business services. In this model, which has been explicit for over twenty years, a declining manufacturing industry was deemed to be relatively unimportant by policy makers and little was done to either recognise or react to the decline. Under the Conservative Governments of Thatcher and Major, manufacturing declined from 25% to 22% of the economy; this has accelerated rapidly under the Blair and Brown administrations and has now reduced to 12% of GDP. Germany, Japan, China, Italy, Korea, Singapore, India and others have been happy to fill the void. From the fourth largest manufacturing nation in the world we have now sunk to seventh (behind US, China, Japan, Germany, Italy and France) and are on our way to an exit from the top ten within a decade on current projections.

The recent global financial crisis has distorted the economic trends but the myth of the post-industrial society can be clearly illustrated in the UK Trade Balance and the impact upon the Balance of Payments in the period prior to 2008. See Figure 1. Although the Balance of Trade has recovered somewhat over the past year as a consequence of the recession, the position for manufacturing remains dire (see Figure 2).

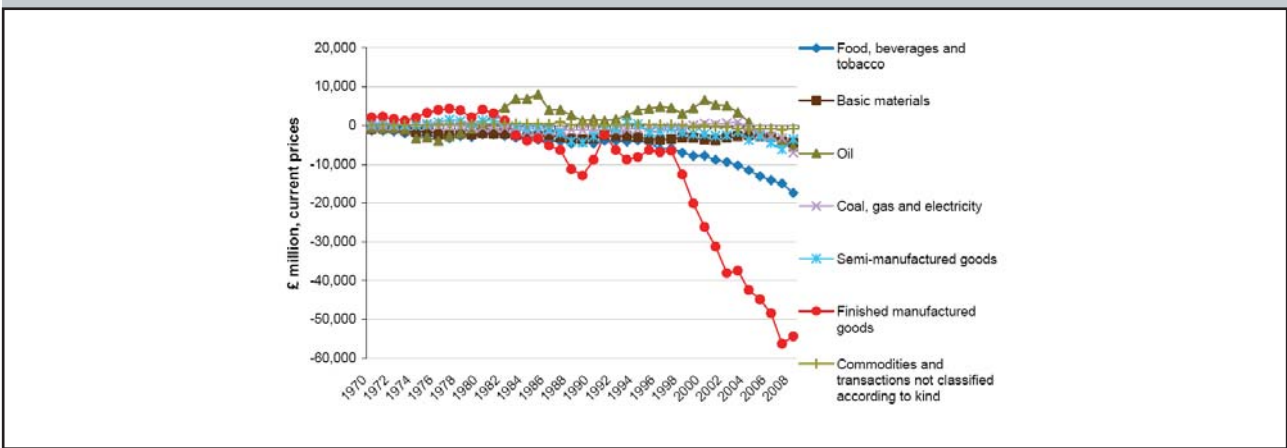
Figure 1: Balance of Trade, 1946 - 2008



The seriousness of the situation has been highlighted in a series of investigative reports commissioned by the ERA Foundation from Oxford Innovation, and available in a compilation from the ERA Foundation as "*The Sustainability of the UK Economy in an Era of Declining Productive Capability.*" – http://www.erafoundation.org/docs/ERAF_report_oct2009.pdf. (Figures 1 to 4 in this report are from that earlier compilation report, but are updated here for the past two years to include the effect of the recession.)

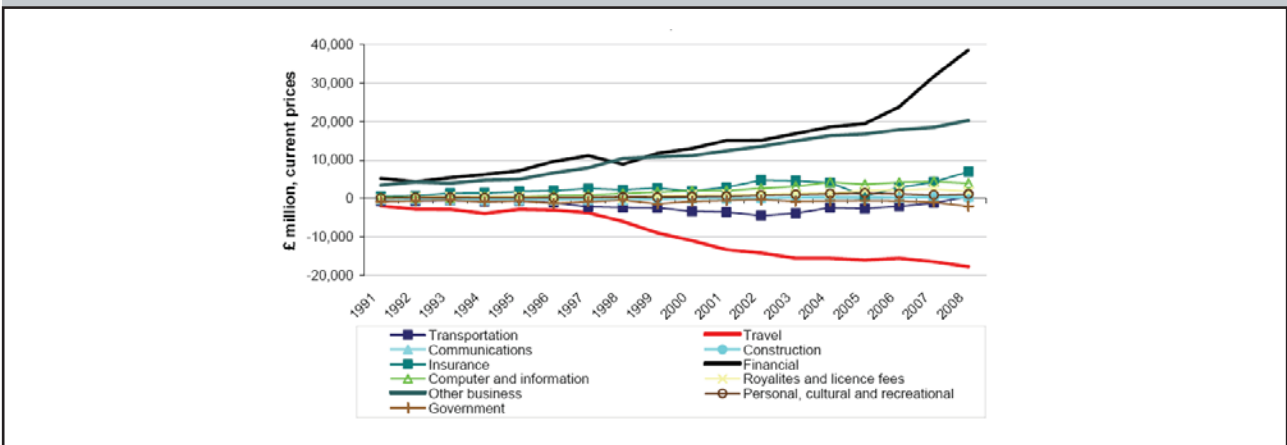
The huge cumulative deficit in the balance of trade over the past decade has been driven primarily by the massive and growing deficit in trade of manufactured goods; the effect has been dramatic (see Figure 2). Whilst the recession has halted the decline, manufacturing has not yet benefitted markedly from the market-driven devaluation of Sterling – certainly not to the same extent as it did in 1993 after the UK's forced withdrawal from the Exchange Rate Mechanism. The decline of the industrial base, particularly in the non-military sector, is likely to be a significant factor in this weak recovery.

Figure 2: Trade in Goods, 1970 - 2008



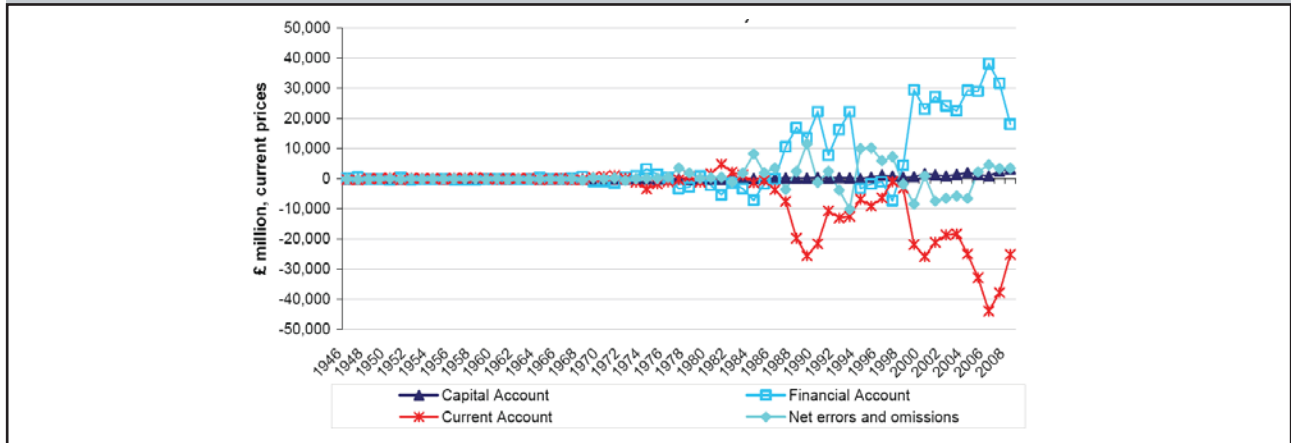
It is notable from Figure 3 that over the past decade, and in contrast to widespread claims to the contrary, the deficit in manufacturing has not been compensated for by the growth in financial and business services. The surplus on Other Business Services has been almost entirely offset by the deficit on overseas travel. With a deficit in the trade of manufactured goods still at £55 billion per year, and a deficit in food and beverages of almost £20 billion per year, the overall picture of the past twelve years is that of a nation consuming more goods than it is able to pay for by trade and earnings from abroad.

Figure 3: Trade in Services, 1991 - 2008



The resulting deficit in the balance of payments has been financed primarily by the sale of debt and equity assets; to the tune of £40 billion in 2007 alone. Without this capital inflow the UK would not have been able to finance the deficit in the current account, which, although reducing with the onset of recession, remains stubbornly in negative territory. See Figure 4.

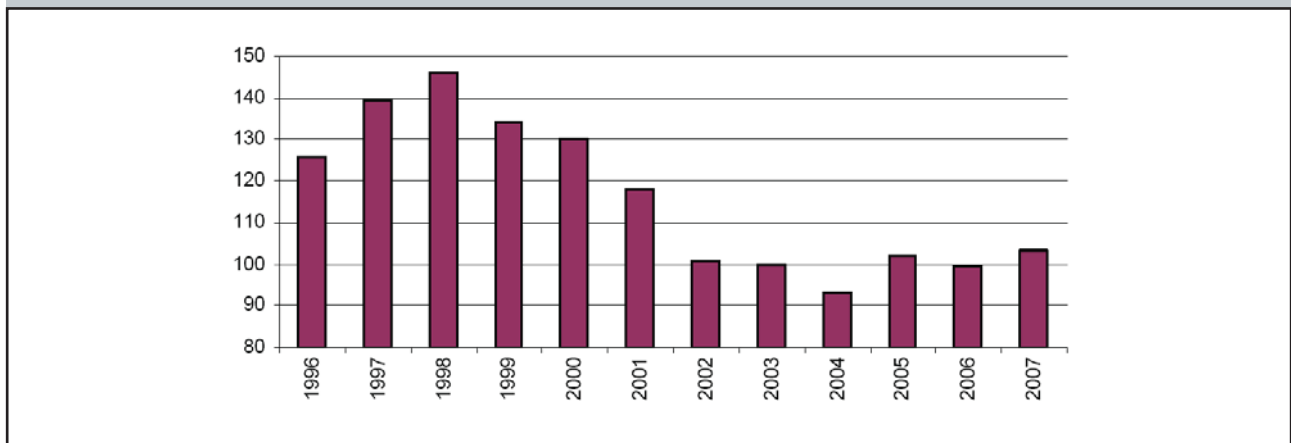
Figure 4: Financing the deficit - financial, capital and current account balance, 1946 - 2008



Manufacturing does matter – even at its current level it provides half of all UK exports, three quarters of all business Research & Development and employs nearly 3 million people. Fundamentally manufacturing provides the major source of real wealth generation and represents the best hope for the UK to re-establish a stable economy.

The need for manufacturing to play a leading role in bringing about financial recovery is emphasized by the fact that alternative drivers for real growth are not up to the task. Consumers' spending will be restrained as households recover from the credit bulge of the pre-2007 years. Tax increases will almost certainly hit households hard as the Government seeks to repair public sector deficits. Public spending, after a period of rapid expansion, must also be restrained severely and this will surely act as a drag on growth. With the running down of North Sea gas and oil and a growing deficit in energy, Britain will be increasingly dependent upon growth in the manufacturing sector and its exporting and import-substituting capacity to balance the economy. To seek a return to the debt-driven economy prior to the financial crisis, so clearly depicted in the Trade figures above, cannot be a realistic option. The lack of industrial investment over the past decade (see figure 5) is symptomatic of the failure to recognise manufacture as a key element of the economy.

Figure 5: Manufacturing Investment (Index 2003 = 100)



In their recent paper "*Prospects for the UK Balance of Payments*" the Cambridge economists Coutts and Rowthorn have predicted, using conservative assumptions, that the current account deficit will increase from 2% of Gross Domestic Product in 2009 to almost 5% by 2020. They make the point that empirical evidence indicates that a deficit of this magnitude is not sustainable and, if unchecked, will lead to a painful adjustment involving lost output and higher unemployment. Their paper calls for industrial and other policies to improve UK trade performance, including services but above all in manufacturing.

Fortunately what remains of the UK's manufacturing capability is of good quality and the nation still has a strong science and engineering base on which to build. Just as Governments over the past quarter century have worked to create an environment which has been beneficial to the particular needs of financial services, they must now establish an appropriate environment in which manufacturing can thrive. A balanced economy, in which manufacturing can flourish alongside financial and business services, can be achieved but it will require strong consistent leadership from Government at the highest level.

Government has very recently launched a number 'initiatives' in various aspects of manufacturing and technology. Although specific initiatives will have their place, the primary need is for an environment in which most, if not all, of the parameters needed for a flourishing industrial base are optimized to encourage the investment in, and profitable operation of, productive industry. The ERA Foundation has used the analogy of a greenhouse to illustrate the situation. In essence, when too many of the plants in the greenhouse are withering it is time to examine the greenhouse and not the individual plants. The key parameters of our national manufacturing "greenhouse" can be identified and, with the future prosperity of the nation at stake, Government must take the lead in a campaign to optimize them to the greatest degree possible.

The "Greenhouse" Parameters

Working with other similarly concerned bodies, the ERA Foundation established a list of parameters which were considered to be influential in shaping a healthy environment for manufacturing. (See Annex 1.) The list is not necessarily exhaustive; nonetheless, to test the parameters and provide some initial prioritization, it was circulated as a simple questionnaire to one hundred knowledgeable industrialists and policy makers who were invited to add further parameters if these were felt to be important. Thirty-six responses were received and a final list of 31 parameters compiled; these are organized in the priority order shown below. In addition the ERA Foundation commissioned a report from Oxford Innovation on the subject of "*The Environment for Successful Productive Industry*" (Oxford Innovation, July 2009, available from the ERA Foundation).

Despite the limited scale of this survey, the combined responses do provide firm indication of the items of concern. Only two of the parameters received a substantial 'low priority or irrelevant' vote. The parameters which scored highest as either 'urgent action for an incoming Government' or as 'needing optimization' are shown below. The 'optimization' of parameters, substantial and developmental in some cases, should be undertaken with a view to tilting the playing field in favour of UK industry and manufacture and thereby creating the conditions for growth rather than decline. Such optimizations must include the provision of a fertile environment for profitable investment and this demands attention to a variety of taxes. In optimizing any of these parameters the need to maintain a sensible degree of stability is critical if long term investments are to be encouraged.

It should be noted that the recent devaluation of Sterling and the onset of low interest rates have removed two major issues for manufacturers; therefore they do not appear in the 'urgent action' list. However, it is clear that these are key parameters and there is a long term need for Government to manage them with manufacturing in mind, and, in particular, to reduce volatility to the greatest degree possible.

Parameters identified as requiring urgent action:

- *A long term, well publicized, Government commitment to manufacturing.*
- *Competitive energy supply and costs.*
- *Availability of technical skills (non-professional).*
- *Encouragement especially of the young towards industry and manufacture.*

Parameters requiring review and optimization:

- *Government procurement policies and practices.*
- *Investment tax incentives.*
- *Capital depreciation relief.*
- *Research & Development Tax credits.*
- *Corporation tax.*
- *Business start-up support.*
- *Deregulation (and reduction of bureaucracy).*
- *Direct Government grants for specific industrial initiatives.*
- *Availability of engineers and other professional skills.*
- *Encouragement for Academic/Industry collaboration.*
- *Maintaining the science base.*
- *Regional Development and the role of the RDAs.*
- *Infrastructure (transport and communications including broadband).*
- *Venture capital tax incentives.*
- *Bank for Industry.*
- *Accommodation costs/business rates.*

Parameters judged to be in reasonable shape at the present time:

- *Foreign exchange rate.*
- *Interest rates.*
- *Labour costs.*
- *Flexibility of labour laws.*
- *Capital Gains tax.*
- *Capital controls.*
- *Intellectual property protection.*

Parameters considered of low priority or irrelevant to manufacturing:

- *Competition policy.*
- *Foreign takeovers.*

The Key Parameters and an Industrial Policy

It is not our intention to discuss at length the individual "greenhouse" parameters within this report, since there is informed comment available in the open literature on all of them. These parameters are intended as an input to a broad review of manufacturing industry and the means of improving its prospects and performance in the UK. Clearly such a review will have to take into account affordability and other political constraints. Nevertheless, to enhance the environment for manufacture in the UK, the optimization of these parameters in a coordinated way deserves the highest priority and preferably should be implemented within a cohesive industrial policy. The UK's declining manufacturing capabilities can only be addressed effectively by an integrated approach, led from the highest level of Government. The fact that UK Governments have not been successful in implementing industrial policies in the past should be a stimulus for getting it right this time rather than for accepting defeat and retiring from the contest.

The need for urgent action is illustrated by the Office of National Statistics data for 2008 shown in Table 1 (from the paper by Coutts and Rowthorn).

Table 1: Main Items in the UK Current Account Balance of Payments 2008 (£ millions)

	Credits	Debits	Balance	%GDP
Surplus Items				
Financial services & insurance	60,864	15,282	45,582	3.2
Other knowledge-intensive services	66,955	38,944	28,011	1.9
Investment income	262,671	235,025	27,646	1.9
Deficit Items				
Manufactures	193,601	251,449	-57,848	-4.0
Energy (oil, coal, electricity, gas etc)	35,386	47,841	-12,455	-0.9
Food, beverages and tobacco	13,719	31,099	-17,380	-1.2
Basic materials	6,625	11,014	-4,389	-0.3
Transport and travel	40,478	57,632	-17,154	-1.2
Government services	2,102	4,062	-1,960	-0.1
Current transfers	15,422	29,032	-13,610	-0.9
Items not elsewhere specified	2,803	4,314	-1,511	-0.1
Current Account	700,626	725,694	-25,068	-1.7

Source: *UK Balance of Payments Pink Book 2009*, ONS; table 1.2, 2.1, 3.1.

The table shows the main items in the UK Current Account Balance of Payments for the year 2008. Despite the large devaluation of Sterling, it can be seen that the trade deficit in manufactures remains stubbornly at £58 billion per annum. While there are surpluses derived from Financial and Knowledge Intensive Services and Investment Income, these are not large enough to offset the deficit from manufactures and the other deficit items and the net effect is a negative balance of £25 billion. Coutts and Rowthorn's prediction for the future indicates a reduction in the deficit in manufactured goods under the influence of the devaluation and the recession but then a resumption of the downward trend.

Nevertheless, it is notable from Table 1 that manufacturing exports are still three times as large as those from financial services or all of the other knowledge intensive services combined. Coutts and Rowthorn make the point that a 10% rise in manufactured exports, combined with a similar fall in manufactured imports, would generate a £45 billion improvement in the balance of payments, which is equal to the total UK net earnings from financial services and insurance or more than 1.5 times that contributed by all other services. Investment income is the other large factor in Table 1. However, this is a highly volatile item and the net income from investment was inflated in 2007-8 by the huge losses of foreign banks operating in London. Coutts and Rowthorn predict that the surplus derived from investment income will fall back to about half the current level.

Conclusions

The past decade could be considered as a large scale experiment with policies and practices in which the UK turned its back on its industrial past and adopted a new approach with its economy firmly based upon financial and knowledge-intensive services. The experiment in a post-industrial Britain has been successful only in the sense that it has clearly demonstrated that this is not a feasible path for the nation. Neglect of manufacturing as Britain's principal economic engine and ignoring its decline has resulted in a seriously unbalanced economy. While financial services and knowledge-based services represent important elements of the UK's economy, they are not a substitute for manufacture. Services, financial, knowledge-intensive, or otherwise, do not exist in a vacuum; they all benefit from the presence of a strong industrial base. If that base is no longer present in the UK, then it should be no surprise that these services apply their knowledge to enhance overseas manufacture and wealth creation. In this case the net benefit to the UK is much reduced as the trade figures above clearly demonstrate.

Industrial power is an essential requirement for the UK if it is to maintain its standing in the world and to protect its freedoms.

With the added fiscal burden imposed by the banking crisis the choice for the UK is quite stark. Either the nation undergoes a period of austerity to restore the economy to the pre-crisis condition, which is itself unsustainable, or the unavoidable period of austerity is combined with a major drive to restore the UK's industrial engine with manufacturing at its core. If the latter is accepted as the only realistic approach then the formation of an industrial policy becomes essential and the greenhouse parameters proposed above could provide a useful input to the process.

The challenge is huge but the UK still has the capabilities necessary to enhance and grow its industrial base, from its scientific excellence and its ability to educate and train the population in the necessary skills, through its existing manufacturing expertise to the financial and knowledge-intensive supporting services. The environment for manufacture and investment in industry requires attention, but above all there is the need for leadership from Government to establish the framework, implement the necessary environmental enhancements and lead and encourage the return to a more balanced economy and culture.

References

"The Sustainability of the UK Economy in an Era of Declining Productive Capability." – see - http://www.erafoundation.org/docs/ERAF_report_oct2009.pdf.

"The Environment for Successful Productive Industry" (Oxford Innovation, July 2009, available from the ERA Foundation).

K. Coutts and R. Rowthorn, *'Prospects for the UK Balance of Payments'*. Centre for Business Research, University of Cambridge. Working Paper 394, December 2009.

Acknowledgements

We wish to thank the numerous senior industrialists, policy makers and opinion formers who have met with us and shared their views. We wish to acknowledge the collaboration of the Royal Academy of Engineering and Civitas in this work. We received useful additional information from Christopher Simpson.

Annex: Factors influencing the environment for manufacturing industry

A long-term high-level Government commitment to manufacturing.
A competitive exchange rate.
Low interest rates.
Lower corporation tax.
Capital depreciation tax relief.
Taxation of dividends.
Capital gains tax on companies (cf. property etc).
R&D tax credits.
Direct government grants.
De-regulation/ Better regulation.
Intellectual Property protection.
Skills – professional.
Skills – technical.
Energy costs.
Accommodation costs (including business rates).
Capital controls – including FDI.
Competition policy – mergers and acquisitions.
Foreign takeovers of UK companies.
Role of Regional Development Agencies.
Labour costs.
Flexible labour laws.
Bank for Industry.
Infrastructure – transport, communications, broadband.
Government procurement.
Tax incentives for investment.
Business start-up support.
Venture capital funding and tax incentives.
Science research base.
Academic-industrial collaboration.
Encouraging the young to consider working in industry.
Culture – recognizing and broadcasting the critical contribution of manufacturing to the future of the UK.

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