Green Paper

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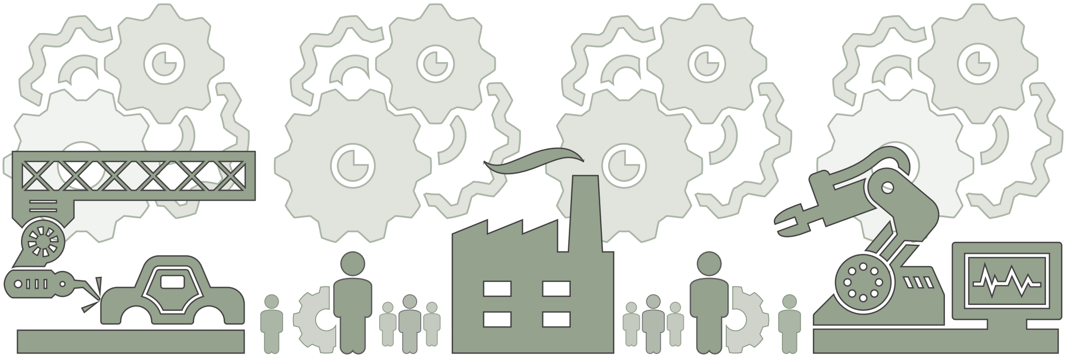
Make or Break

Why Britain needs a manufacturing resurgence and how we can help it to take place

Phillip Blond & Edward Douglas



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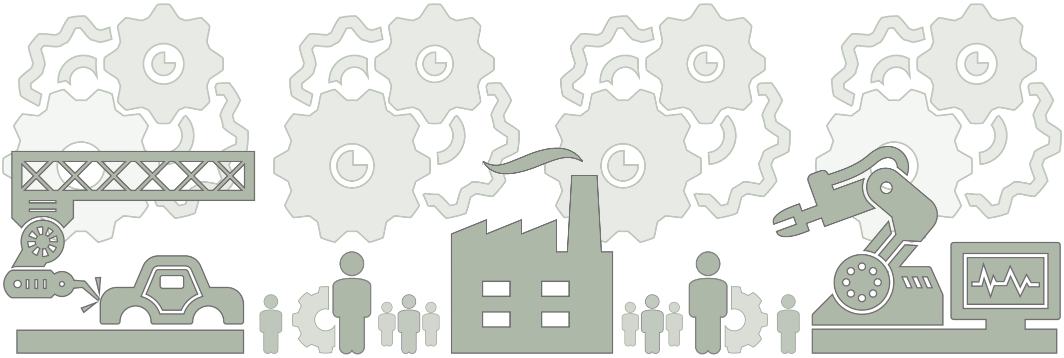


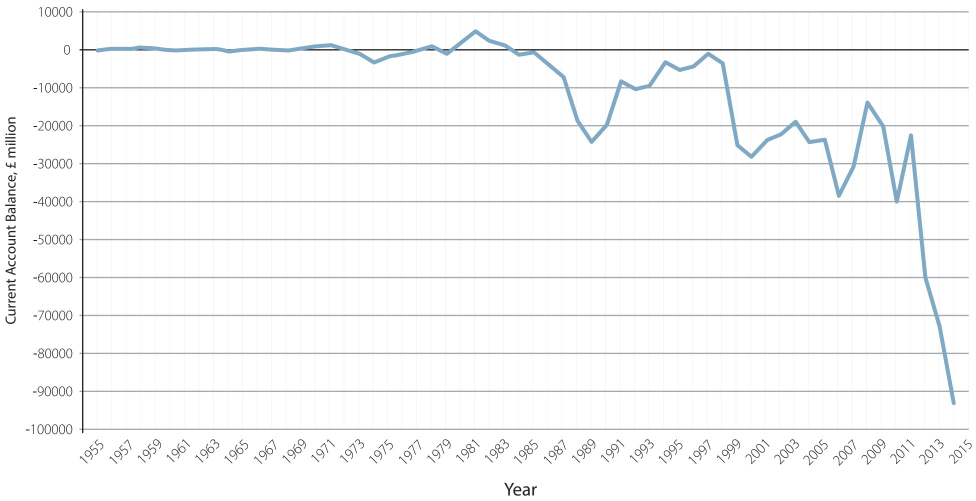
Introduction

This paper sets out how Britain can better help manufacturing contribute to UK-wide economic prosperity, productivity and opportunity. In recent years, the nature of capital and investment inflows into the UK and their impact on the exchange rate have been ignored by policy-makers trying to create an environment that helps manufacturing to grow. We seek here to address that omission and suggest that through boosting productive investment inflows we can better support leading British manufacturers and the creation and domestication of the SME supply chains that support them.

The British economy has returned to sustained growth. In the third quarter of 2015, GDP increased for the 11th consecutive month, public sector borrowing was down £7.5 billion on the same period last year, and the employment rate was up 0.3%.[1] But productivity growth has declined by 0.8% per annum since the 2008 financial crisis,[2] public confidence in the economy is mixed[3] and regional economic disparities are growing.[4] So despite clear grounds for optimism, we remain some way off a return to the economic good times. Among the reasons for this is that certain underlying issues in the economy remain unaddressed.

If we want stronger, sustained economic growth we need to address the three trends that have defined the British economy of the last 40 years. The UK has been prone to external deficits and crises;[5] manufacturing has increasingly given way to services;[6] and the current account deficit has grown substantially – as Figure 1 shows, last year's current account deficit of £92.9 billion was a peacetime record.[7] This is an escalating problem: the trade deficit in the third quarter of 2015 alone almost doubled to £14.2 billion, knocking 1.5% off economic growth in the same period.[8] The recent collapse of the British steel industry is but the latest chapter in the story of Britain's post-1945 manufacturing economy.

Figure 1: UK Current account balance since 1955

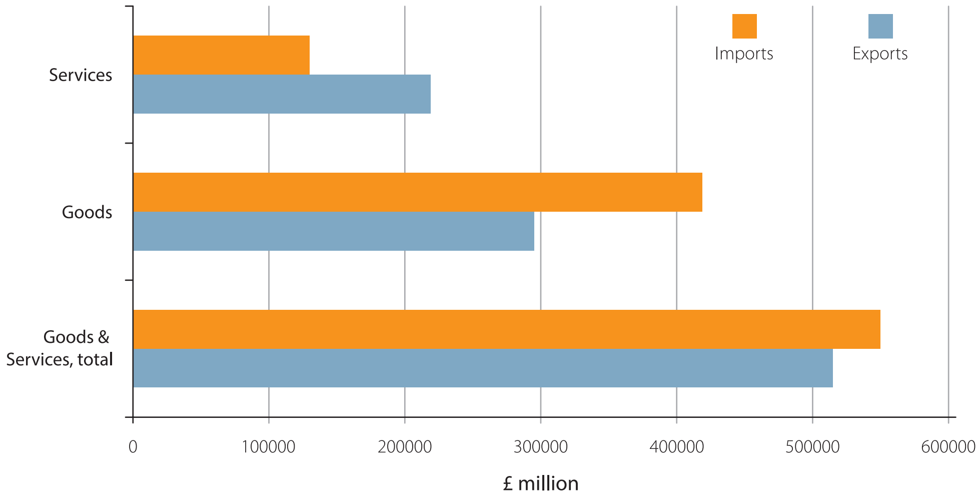


Source: OECD

These trends are linked: the relative decline of manufacturing has in part led to our record current account deficit, as despite the welcome success of our services industry, this service expansion has been unable to export enough to cover the deficit in trade in goods – as Figure 2 (*overleaf*) demonstrates.[9] This is not surprising: globally, the ratio of service to goods exports is only 24.7%.[10] In short, globally speaking people export four times more goods than services, as most services remain quite local, limited by language and dictated by national regulation and domestic standards, so past a certain point it becomes difficult to fully globalise services. That said, the UK has done extremely well, in a smaller part of the global export market: service exports, in which the UK is a dominant player. The UK figure for service to goods exports is 74.4%, so our proportion of service to goods exports is roughly three times higher than the global average.[11] What this means is that our service export performance is very high and it is not clear (beyond the removal of immigration limits on universities) how much more realistically it could improve. And given the potential of a Brexit it could easily suffer a significant shock.

So if we want to close the trade deficit it seems apparent we need at least in some measure a much stronger export performance in goods to redress the balance. And if our goods are good enough to export they will in all likelihood be good enough to buy domestically and so reduce imports. This double benefit of manufacturing in terms of the deficit has also itself been oddly overlooked. However, we are not yet in such a place and the size of our

Figure 2: UK Balance of Trade, 2014



Source: Office for National Statistics

goods trade deficit has increased our reliance on external financing to cover the current account shortfall. Our growing dependence on external capital and investment inflows has increased our exposure to economic risk, the sustainability of which is at best unclear – a danger which is increasingly recognised by both commentators and politicians.[12] [13] [14] [15]

As suggested earlier there are many ways to help manufacturing that have been rightly discussed and examined at length. We know about skills, training and finance. We know about supply chains and the need for a far greater supply density of them for our leading tier of manufacturers, we know about the small and medium sized enterprises we have lost in those firms that used to supply, for example automotive manufacture, and the ones we risk losing in say aerospace. But important as they are these issues are not the subject of our paper. Rather we would like to look at two interrelated and in policy terms largely overlooked factors – the nature of capital inflows and the importance of the exchange rate, and understanding both are crucial if we are to grasp how we can achieve stronger and more balanced economic growth.

The first factor is the nature of capital inflows. As the International Monetary Fund has recently recognised, inflows can be classed broadly as productive or unproductive.[16] Productive inflows increase the productive capacity of the economy and ultimately boost output in the short and long-term; unproductive inflows – such as the purchase of gilts, assets or luxury London property as a 'safe haven' investment – do neither. Instead, returns flow out of the UK, perpetuating the current account deficit without boosting Britain's economic performance.[17] A good example of this is the Chinese Investment Corporation (CIC)'s purchase of substantial stakes in Thames Water and Heathrow Airport.[18] Whilst we acknowledge that investors will often upgrade the capital stock of the companies they buy, the returns on these purchases (often national assets) will flow out of the UK, increasing the current account deficit but not necessarily increasing the productive capacity of the economy.

The second factor is the exchange rate, which has a direct impact on the cost competitiveness of British manufacturing exports.[19] The crisis that has beset the UK steel industry – caused partly by the high pound-euro exchange rate – has made this painfully clear. Although not the only factor (energy prices being perhaps the most damaging) behind the industry's struggles, the high value of sterling has not helped UK firms such as Tata Steel sustain their competitiveness when faced with subsidised Chinese steel. [20]

What is often neglected is the role capital inflows play in putting upward pressure on the pound. As the pound appreciates – and over the last seven years it has continued to gain in value against the euro (the currency of our largest export market) – the ability of British manufacturing to compete globally is diminished, thereby increasing further our trade in goods deficit and perpetuating the vicious cycle.[21] [22]

Even if services growth and external financing could together plug the current account deficit, and even if we discount the risk of an increased reliance on capital inflows, this would be demonstrably undesirable because of manufacturing's importance to the sectoral and geographical rebalancing of the UK. To understand why, we need to examine the links manufacturing has with productivity, the performance of the services sector, and the economic health of the UK's regions.

First, productivity growth is essential to any growing economy – and manufacturing remains a vital source of productivity growth.[23] Since 1948, productivity growth in manufacturing has averaged 2.8%, compared with only 1.5% in the services sector.[24] If the Government is to achieve the goals set out in its Productivity Plan, manufacturing will have a significant role to play.[25] Moreover, academic studies have repeatedly shown the benefits to GVA (Gross Value Added) and national economic growth in both developed and developing countries of foreign direct investment (FDI) in manufacturing compared with other sectors.[26] [27]

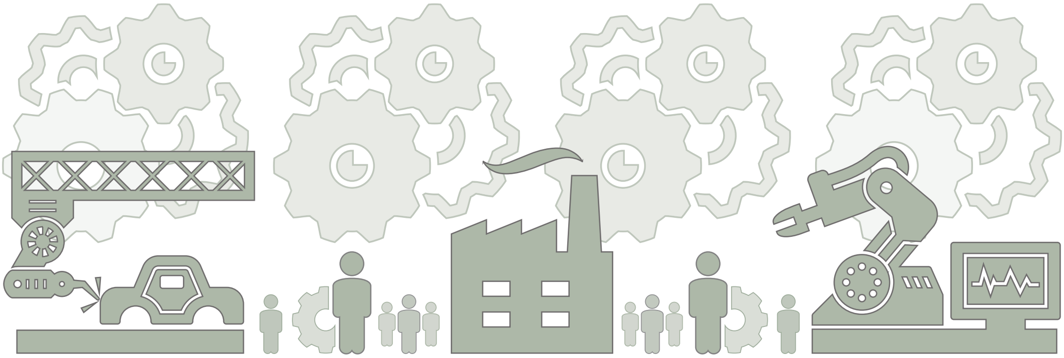
Secondly, manufacturing plays an important role in sustaining a range of services industries through its large spill-over effects. Manufacturing has a much larger multiplier effect on the rest of the economy than services: anything that is manufactured has to be financed, insured, transported, warehoused and ultimately sold and maintained. Many more service activities, and therefore domestic service sector employment, are derived from goods production than the other way around.[28] That is why manufacturing increases the consumption of services.[29]

Third, the health of our goods export economy is directly linked to the wider prosperity and vitality of Britain. Manufacturing accounts for a substantial proportion (30%) of the 8.7 million British jobs in sectors which produce goods for export. While 2.3% of total employment in London is in manufacturing, in regions such as Yorkshire and Humber (11.1%) and the East Midlands (12.1%) that figure is substantially higher. Similarly, the sector is a key contributor to regional GDP outside London (where it makes up 9.7% of GDP) – such as in Wales (28.4%) and the West Midlands (24.5%). Manufacturing is disproportionately important to regional economies and employment, and productivity growth in the sector means it brings higher wages and gains in livings standards.

Manufacturing is not just desirable but is also necessary to Northern economies because the success of London's services sector cannot be easily replicated elsewhere. The economic success of the capital can be directly attributed to its cluster of professional skills, technological innovations, and a dense concentration of global trading companies.[30] These agglomeration effects have sustained the huge success of the financial services industry, which accounts for 18.6% of London's GVA – comparable to the importance of manufacturing to Northern regions.

Northern regions do however have similar advantages in manufacturing industries, retaining the skills reservoirs needed for a manufacturing renaissance.[31] The success of large manufacturers such as Jaguar Land Rover, Nissan and Bombardier present the opportunity to build back supply chains in the UK and move away from the replication of low value industries that has rendered desolate many of our former industrial towns and cities.[32]

In this paper, we set out how a new focus from policy-makers on capital inflows and the exchange rate can in addition to the more conventional approaches better address the barriers that prevent the flourishing of our manufacturing sector and a true rebalancing of the economy.



1. At the Mercy of Capital Flows

The economy is increasingly reliant on external financing. As cost competitiveness has deteriorated sharply, the downturn in the balance of trade and net income from abroad has been startling.

Sterling has been trending upwards in trade-weighted terms since early 2013, unwinding more than half of its post-financial crisis decline. Britain's external deficit is now a record for peacetime, -5.5% of GDP notably exceeding those associated with successive sterling crises of the 1950s (-2.3% of GDP) and 1960s (-2.6%), the IMF crisis of 1976 (-4.3%), and the ERM debacle of the early 1990s (-4.9%).[33]

What we have also seen is a substantial inflow of capital from abroad. And a large current account deficit has to be financed by capital inflow. But at the same time, a large inflow of capital for reasons unrelated to financing the current account (for example, an inflow of foreign capital into London property seeking safe haven investment) can push the currency up, creating a vicious circle.

In short the problem is this: heavy inflows of unproductive investment reduce a country's export competitiveness, bringing about a current account deficit which must be financed by further capital inflows. Policy-makers should differentiate on the basis of the wider impacts of different capital flows: between unproductive investment that simply generates *wealth*, such as foreign takeovers that can see profits flow out of the country; and productive investment that generates *worth*, such as investment in machinery or skills, which bring with them substantial wider benefits. For too long, governments have pursued policies to attract inward investment that fail to properly discern the impact of different types of capital flows. Of course some investments are an inevitable mixture of both, some would be wholly advantageous and some would be best avoided. All that we are asking is that regulators develop the ability and conceptuality to judge where on the scale of productive or unproductive investment certain foreign inflows might lie. Such a framework would be a considerable advance and its effective deployment in terms of setting incentives and disincentives would be a great development.

Beyond its overall magnitude, financing a current account deficit depends on the credibility of a country's macroeconomic policy framework, and its continuing openness to trade and investment. So far, in the UK's case, these conditions for comfortable external financing have been met. It is vital that this continues – international confidence can be painfully fickle.

The evidence suggests that what makes a country vulnerable to a sudden loss of confidence is excessive reliance on short-term funding, particularly short-term bank funding, to finance a current account deficit.[34] As demonstrated by the economy's long history of sterling crises, this is something to which the UK has historically been prone.

So far, the nature of the capital flows financing the external deficit does not suggest a particular exposure beyond their absolute size. Moreover, the UK's short-term liabilities, particular its short-term loan liabilities, have declined since the global financial crisis. Most of the recent inflows have been longer-term in nature, and there has been a high proportion of foreign direct investment and equity-related inflows.

Experience also shows that net capital inflows are more likely to be a risk to financial stability if they are associated with rapid domestic credit growth. Present levels of UK credit growth are however currently relatively modest.[35]

The currency composition of a country's external balance sheet matters too. In the event of a loss of confidence and a fall in the exchange rate, firms and financial institutions that have borrowed in foreign currency to finance assets denominated in domestic currency can incur heavy losses. However, the UK is currently in the opposite position: a greater share of external liabilities is denominated in sterling than in external currencies.[36]

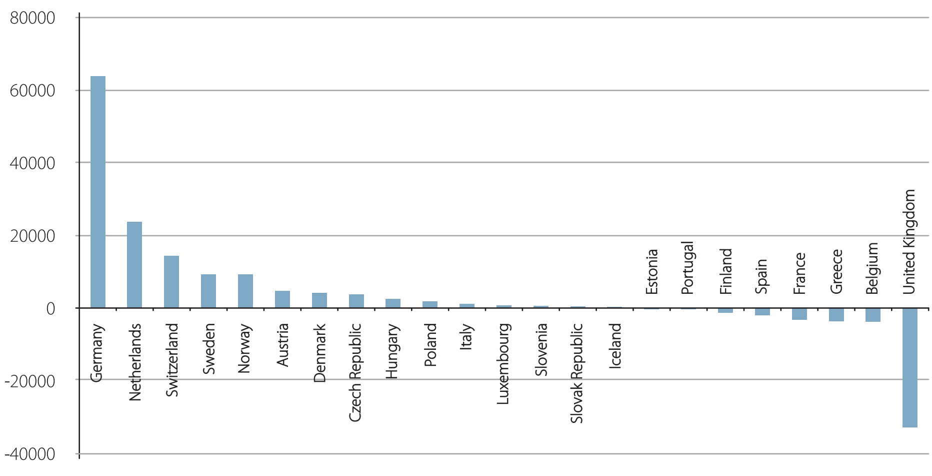
There are, then, reasons to be reassured in the immediate term. Beyond that, however, the unprecedented scale of the UK's external deficit must be viewed as a major source of potential instability and concern. Moreover, the strength of sterling which accompanies these developments is exerting a worrying effect on the structure of the economy.

A closer look at the current account

The UK's record current account deficit has we suggest been largely caused by the historically high deficits in manufactured goods and foreign income. By contrast, as previously noted the services balance is in record surplus. The trade deficit in 2014 was £35.2 billion, and has been relatively persistent over the last 15 years or so.[37]

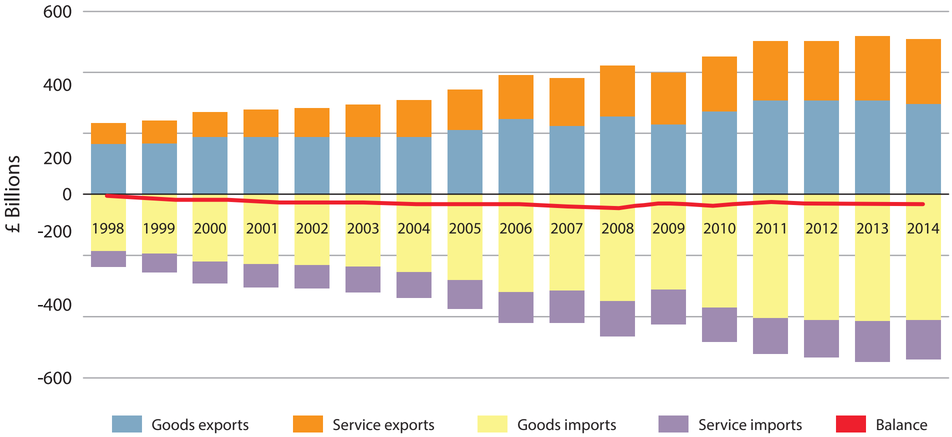
> It is hardly surprising that the tradable goods sector is struggling. Inflation, especially since 2010, has been consistently faster than that of our main trading partners – France, Germany, the EU as a whole, and the US. The UK's international cost competitiveness, as measured by relative unit labour costs, has deteriorated by over 10% since 2010.[38]

Figure 3: Current Account Balance, 2015 Q1 – European Countries



Source: OECD

Figure 4: British exports and imports of goods and services at current market prices



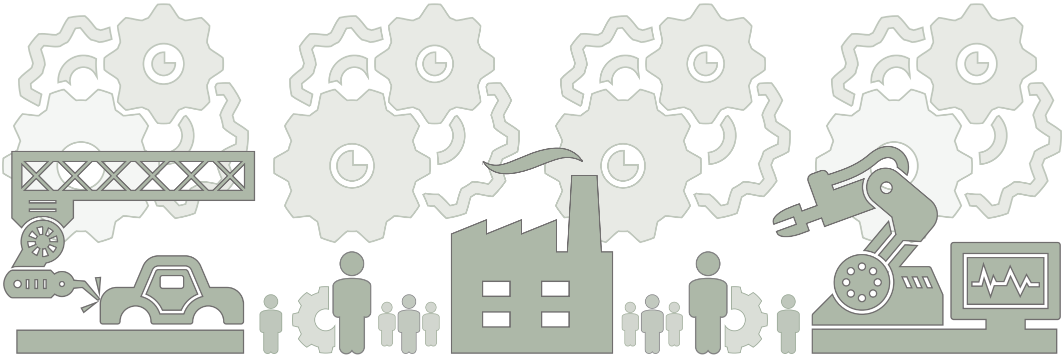
Source: Office for National Statistics

The result? UK export growth is not keeping up even with the current modest rate of expansion of our export markets: since 2010, UK inflation-adjusted exports of goods and services has grown by 6.7 percentage points less than the imports of our principal trading partners. In other words, our partners are sourcing their imports from countries other than the UK.

The decline in our net income from abroad has also been startling. The balance was consistently in comfortable surplus as recently as the middle of the previous decade, but the red ink in 2014 amounted to 4% of UK GDP. This is largely because of falling income from investments in Europe.

The weakening of net investment returns is expected by the Office for Budgetary Responsibility (OBR) to unwind as the global – particularly the European – economies recover and a number of one-off negative factors dissipate.

But there is a real risk that this process disappoints and proves incomplete, especially given the potential consequences of EU fracture following both the unprecedented immigration surge and the recent terror attacks in Paris. The concern in the wake of the global financial crisis is that the deterioration in the investment income balance will – like the economy's growth potential – prove structural.[39]



2. The Relative Importance of Industry and Services

Manufacturing has higher productivity growth than the service industry and a strong ripple effect on the rest of the economy. It is also disproportionately important to the economies of the Midlands and the North. Manufacturing is therefore vital if we want a high wage, high growth, balanced British economy.

Prosperity over the course of history has typically been associated with industrial innovation and expertise, particularly in manufacturing. The great economic powers have long tended to be those that controlled the bulk of industrial production and manufacturing technology. Frontier technology and innovation have also tended to emerge from manufacturing.

As noted in the introduction technological advances, fuelled by investment in manufacturing equipment, can lead to significant productivity gains. Productivity, directly linked to higher wages, is the single most important determinant of average living standards. Crucially, productivity has a habit of growing more rapidly in the manufacturing sector than elsewhere in an economy.[40] Since 1948, manufacturing productivity has grown by an average of 2.8% per annum - compared with only 1.5% in services.[41] There are many reasons for this. One is that higher levels of innovation and investment in machinery – which in manufacturing is three times higher than the sector's output share of the economy – meaning manufacturers can achieve productivity gains difficult to replicate in services on a big scale.[42]

Domestic manufacturing also has large spill-over effects on the rest of the economy. Input-output data reveal that manufacturing exerts a much larger multiplier effect on the rest of the economy than does the services sector: anything that is manufactured has to be financed, insured, transported, warehoused, and then ultimately sold and maintained. Accordingly, many more service activities, and therefore much domestic service sector employment, are derived from manufactured goods production than the other way around.

In principle, a society's appetite for manufactured products does not have to be met by production at home: manufactured goods can of course be imported. In that case the income to pay for these goods has to be earned by exporting services to the rest of the world; and to the extent that the service-exporting sector is highly productive, high living standards can result for all.

However, it is unrealistic – practically, politically and socially – for an entire large, sophisticated economy to thrive by exporting only services while importing its goods. There are two reasons for this. The first is that, while services generate a large balance of trade surplus, this is not close to being sufficient to make up the goods deficit.[43] The second reason is that the success of London's services sector simply cannot be easily replicated elsewhere. The prosperity of the capital can be directly attributed to its cluster of professional skills, technological innovations, and a dense concentration of global trading companies.[44] These agglomeration effects have sustained the huge success of the financial services industry, which accounts for 18.6% of London's GVA – comparable to the importance of manufacturing to Northern regions. Northern regions do however have similar advantages in manufacturing industries, retaining the skills reservoirs needed for a manufacturing renaissance.[45] The success of large manufacturing primes such as Jaguar Land Rover, Nissan and Bombardier present the opportunity to build back supply chains in the UK and move away from the replication of low value industries that has left behind many of our former industrial towns and cities.[46]

Moreover, our European Union (EU) membership is disproportionately important to our services exports. This is because market access for services within the EU is more secure than under the World Trade Organisation (WTO) regime, under which market access for goods is better guaranteed than it is for services. But our continuing membership of the European Union (EU) is in question, and with it our access to the large and growing European service sector. Our dependence on services exports should therefore be a particular cause for concern.

Moreover, the regional imbalances generated by a services-dominated economy should be cause for alarm. As Figure 5 (*opposite*) shows, goods exports make a disproportionately large contribution to the economic health of the North East, East Midlands, East, Wales and West Midlands.[47]

> The health of our goods export economy is directly linked to the wider prosperity and vitality of Britain. 21 per cent of British jobs – 8.7 million – are in sectors which produce at least some goods for export. Of these, manufacturing's 2.6 million workers make up 30 per cent of those in exporting sectors.[48]

Manufacturing jobs make up only 2.3% of total employment in London and 5.8% in the South East; this is a significantly lower proportion than the rest of the country, particularly Yorkshire & Humber (11.1%), East Midlands (12.1%), West Midlands (11.3%), Wales (10.6%) and Northern

Figure 5: Goods exports' share of regional gross domestic product (per cent), 2013

Source: Her Majesty's Revenue and Customs, Office for National Statistics and Capital Economics

Ireland (10.1%).[49] The point here is not just about job numbers, it is about the nature of that employment. As we have shown, productivity growth in manufacturing means the sector brings higher wages and ultimately gains in living standards. This provides a base upon which to build – from which government can launch a short to medium-term rebalancing of the economy if it takes the right actions.

What is clear from this is that a more diverse economy, with more balanced exports, offers not only useful insurance but the prospect of inclusive economic growth too. An export economy increasingly reliant on services will deepen regional inequalities, reduce living standards outside London and the South East and condemn the regions to being globalisation losers. To mitigate these risks, policy-makers need a renewed focus on supporting manufacturing exports.

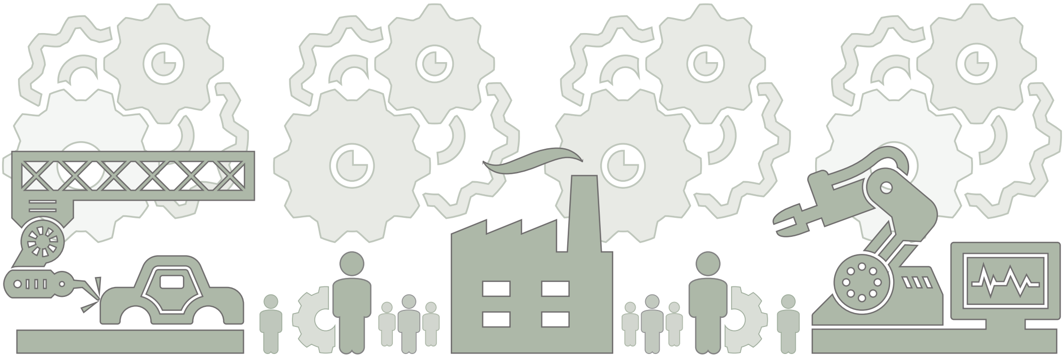
A lack of balance

We have seen that the UK economy is becoming increasingly unbalanced – externally, sectorally and geographically – and is vulnerable in two respects:

- The current account deficit is the biggest it has ever been, and is being financed by large, growing and potentially unstable currency inflows from abroad; and
- The economy as a whole, and to an even greater extent its exports, have become increasingly concentrated on services.

Each of these developments needs to be addressed. The compound risk is of the two happening more or less together. This would expose the UK to particular threat at a time when our EU membership – and with it our trade arrangements with our principal trading partners – is at stake.

Germany's economic strength – its Europe-leading merchandise export performance is reflected in its record current account surplus and high manufacturing wages – indicates the potential we have yet to realise.[50 51] The euro exchange rate has had a significant role to play in this. The continuing depreciation of the euro against the dollar and the pound helped the German current account surplus reach €215.3 billion last year – outstripping even China.[52] How can UK export performance similarly thrive? It is to this issue we now turn.



3. Longer-term Structural Remedies

A weaker pound is the best option in the short-term, but managing a lower currency is not straightforward. Structural policy offers long-term solutions. First on the list should be better support for SMEs in the manufacturing sector.

Over the longer term, the UK's international competitiveness and the relative health and size of individual sectors of the economy can be addressed by structural policies. These range from reduced labour taxes, to increased spending on education and research and development, to infrastructure improvements, and the development of a more sympathetic regulatory environment for business.

One particularly fertile area is the small company and, to an even greater extent in Britain, the mid-market company sector which has considerable potential to export more.

Britain's production industries compete internationally largely on the basis of quality competition, a catch-all term which includes innovation alongside quality.[53] There is a growing recognition that smaller and new firms are central to this, driving innovation and productivity in the manufacturing sector and its supply chain.

But that is not the only reason manufacturing SMEs are important. On average, albeit by a small margin, expanding manufacturing SMEs create more jobs than knowledge-intensive business services (KIBS) SMEs. Over the 2011-2014 period, each expanding SME operating in KIBS created on average 6.6 jobs in cities, while manufacturing firms created 6.9 jobs.[54] The difference in job creation is even greater outside cities. The other side to this is, however, that there are more expanding KIBS firms and more job losses in manufacturing. With better support services for manufacturing SMEs we can build on these clear potential employment gains and reduce job losses.

A quick survey of the success of German *Mittelstand* firms – SMEs with annual revenues up to €50 million and with up to 500 employees – demonstrates this potential. In 2011, the German *Mittelstand* included more than 99% of German firms and contributed almost 52% of total economic output for the nation.[55] In the UK, Chancellor of the Exchequer George Osborne has championed the *Mittelstand* model as a way for UK SMEs to become more competitive.[56] So far, however, efforts to internationalise UK SMEs have sadly fallen flat.

A survey of the various possibilities suggests that to realise this potential, the Government should adopt a holistic, Government-sponsored approach.[57] Such an approach should:

- Embrace the entire supply chain;
- Be adopted in consultation with key stakeholders, including HM Treasury, BIS, the British Business Bank, UK Export Finance, and UKTI;
- Prioritise regulation that facilitates new economic activity rather than unwarrantedly controls or limits existing activity;
- Encourage the synergistic clustering of small and medium-sized firms;
- Encourage an export culture and raise international ambition through briefings, better education, improved teaching of modern languages and better advisory services; and
- Examine the range of existing policies and best practice from around the world.

It would also be beneficial to broaden the funding options beyond the traditional banking sector, especially for young and fast-growing firms, and promoting greater access to venture capital, mezzanine finance, private placements and SME securitisations.

This could be further encouraged by addressing the legal, regulatory and tax constraints for SMEs, investors and supporting institutions, while also promoting better information collection and dissemination and a single, uniform rating system of smaller firms.

Finally, the ability of SMEs to enter, and to thrive in, external markets is dictated to a significant degree by the level and volatility of the exchange rate.[58] Fluctuations in the level of sterling affect the profitability of selling overseas, yet smaller companies often have little or no expertise in drafting contracts to protect against foreign exchange risk. Neither do they typically have much knowledge of how to hedge risk through forward contracts and other derivative products that the Chief Financial Officers of larger firms can fall back on.

As the cost to the financial services sector of offering support does not depend on the size of the company, the market at present does not provide sufficient foreign exchange support to SMEs. What is needed in addition to SME financing is an exchange rate support structure financed by UK Export Finance (UKEF).[59] Hedging mechanisms cannot alone make exporting profitable but they can overcome a key barrier to market entry.

The welcome recent announcement by the Government around the devolution of business rate powers will potentially allow city authorities to offer support to manufacturing SMEs. As further powers are devolved in the next wave of city devo deals, there is a real opportunity for cities, Local Enterprise Partnerships, UKEF and UKTI regional offices to work together to improve access to existing export support services and fill gaps in the market.

Case Study: Sheffield Manufacturing District

Building on a historical manufacturing sector specialising in heavy steel, Sheffield City Region is working with the cluster of companies in the Sheffield-Rotherham corridor to develop an Innovation District model to boost economic growth and productivity. This place-based approach to the manufacturing ecosystem will focus on supporting existing businesses as well as growing and attracting new businesses. With greater powers and control over strategic planning and business rate retention, Sheffield City Region can bring together essential infrastructure needs through investments in premises and transport as well as greater integration of existing business support and skills development.

Plans for a Sheffield Manufacturing District are primarily focused on improving knowledge-based assets and boosting the export potential of advanced manufacturing. However, the benefits of co-location and idea-sharing are a means through which all manufacturing activity can be supported, encouraged and accelerated. It presents a wider opportunity for supply chain development across the whole manufacturing industry driven by innovation, research and development in software, data, robotics and other technologies. This concentration of activity can lead to greater spill-out of new manufacturing businesses, products and production.

What is missing is export support to help greater internationalisation of Sheffield's manufacturers, who could benefit substantially if this was delivered alongside other business support through the City Region and tailored to the specific needs of the industries within the Manufacturing District.

Such a support system offers multiple benefits. Helping manufacturing SMEs and mid-sized firms to grow their exports holds out the possibility of a reduced current account deficit; strong employment growth; a solution to the UK's productivity puzzle; and substantial regional economic growth outside London and the South East.

Sterling and the immediate issue

Such structural policy changes take some considerable time to bear fruit, however. In the short-term there is a strong case for encouraging a weaker pound. This would deliver a more immediate and recognisable improvement in competitiveness.[60]

Case Study: Tata Steel

In October 2015 Tata, which owns the remnants of British Steel, announced its decision to stop production of steel plates – resulting in 1200 job losses. 900 of these were in Scunthorpe, another 270 in Scotland. Plate mills in Scunthorpe, Motherwell and Clydebridge, in Cambuslang, have been mothballed.

Although the dumping of steel onto European markets by subsidised Chinese producers has been cited as the trigger, the company has blamed the pound-euro exchange rate as a key factor behind the current crisis. With most of Tata's exports going to mainland Europe, the high value of sterling against the euro has led to a 20% loss of price competitiveness against Chinese steel – an effective export premium on British steel.[63]

The inclusion of plant machinery in the UK business rates regime – which sets us apart from our European competitors – has also added to Tata's cost base. Moreover, investment can be penalised under the current system, with changes to plant footprint or machinery upgrades resulting in higher business rates.

The current strength of sterling should not necessarily be seen as a positive reflection of the UK economy's performance. Sterling's strength is at least as much a result of economic problems in the UK's principal trading partners, particularly in continental Europe.

There would be many consequences of a depreciated pound, including for the distribution of income.[61] Most importantly, estimates suggest that the demand for British manufactured exports and imports is sufficiently elastic – that is, price sensitive – for a lower pound to have a net benefit.[62]

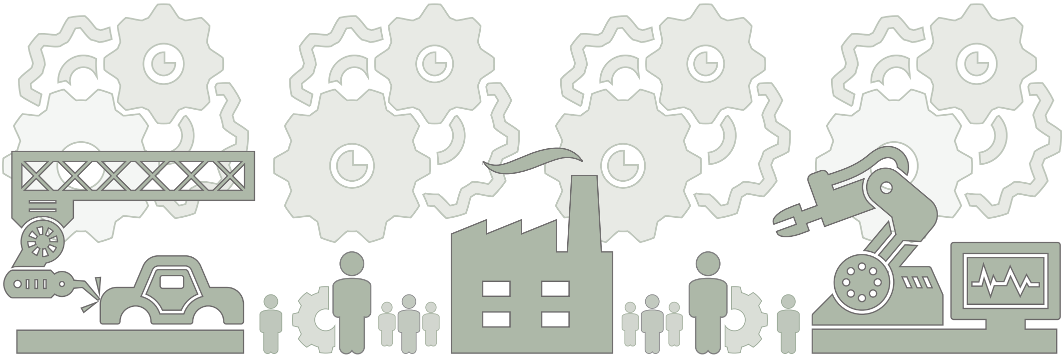
A weaker pound – provided it was sustained and the competitiveness gains not inflated away – would therefore alter the sectoral balance of the economy away from its heavy dependence on services, towards increased manufacturing output. This would bring us more in line with other major high per capita income countries.

UK governments in recent years have kept away from any significant hint of explicit industrial planning, preferring that – within a sympathetic structural policy framework – resource allocation be left essentially to market forces. But the market alone cannot decide the appropriate, risk-minimising division between services and manufactures. That is a function of the exchange rate, and the exchange rate is to some extent a function of government policy – or at least should be.

That is not to say that the exchange rate can be managed with any degree of precision.[64] This is particularly so when there are other policy priorities too, such as an inflation target, high and stable employment, or a prescribed path for the public finances. Such objectives can prove inconsistent with a particular exchange rate that might be desirable from the point of view of the external balance.

But in the current environment, reported inflation is of little concern, inflation expectations are well-anchored, employment is reasonably full, and the budget deficit and public debt ratio are being addressed. There is also little indication that the authorities' other policy goals are a binding constraint on exchange rate adjustment. Indeed, it could be argued that the prevailing policy mix of historically-low interest rates and programmed fiscal consolidation is already broadly consistent with a more competitive exchange rate.

Moreover, a less-strong pound would also provide much needed impetus to private sector investment – not least because, as other industrial economies are finding out, recent technological developments including information technologies and 'robotisation' are now making it more feasible to bring a number of manufacturing activities back on-shore.



4. Recommendations

We are at a critical point for British manufacturing, and with it the long-term economic security and prosperity of the UK and its regions. There is an urgent need for action to:

- Strengthen the exports of goods as well as services
- Facilitate the conditions for small and mid-market manufacturing companies to export more.

We acknowledge and accept the long term factors that are also needed to improve UK manufacturing and export these have been amply and expertly discussed elsewhere, from education and skills to bespoke investment and the right regulatory environment – we uphold all these approaches.

But we believe other overlooked measures can also help. To this end we recommend the following initiatives:

1. Treasury and BIS Ministers should talk the pound down. As our research shows, the exchange rate of a currency is determined by many factors.[65] One of these is the attitude of policymakers. Given the high costs associated with direct interventions such as quantitative easing, indirect intervention is often a better alternative.

Ministers and other senior policy-makers should take a consistent, well thought-through line in major public statements on the current account deficit and the sterling exchange rate. In particular:

- The Governor of the Bank of England, who has already started to draw attention to the matter of the current account deficit, should be joined in this by other senior policy-makers.
- It is important that it be led from the top, and in particular that the Prime Minister, the Chancellor of the Exchequer, and the Foreign Secretary all 'sing from the same song-sheet'.

- Such efforts will be more powerful if they are supported by commentary from other 'points of light' throughout society, including industry leaders, senior trade unionists, and well-regarded independent economists.

There is always a risk of a currency decline becoming destabilising, leading to significantly above-target inflation, a fall in real incomes, and necessitating an abrupt tightening of monetary policy. But those risks currently seem small, especially when compared with the risk of the UK economy becoming progressively more and more unable to redress future balance of payments issues because of an unhelpfully lopsided economic structure.

2. The Government should place a new importance on the UK economy's structure and UK competitiveness. A return to explicit industrial policy or indicative planning would be a misstep: given the UK's experience with such policies, few today would advocate that. But a serious public debate about the external deficit, and the respective roles of the so-called production industries on the one hand and the services sector (and particularly financial services) on the other, should be encouraged. The discussion should be framed within the rubric of minimising future risk.

- **HM Treasury should publish a discussion paper, in collaboration with other key government departments, on the UK's economy's structure.** It could thereafter usefully become a matter for public debate.

- **The UK Government should publish an annual report on UK competitiveness.** Longer term, discussion of the issue could be informed by the publishing of an annual report on UK competitiveness that would highlight the main areas of strength and weakness, and discuss potential policy initiatives to address major shortcomings. The European Commission already does this for each of its member states, but it receives little publicity and tends to get lost in the flood of information emerging from Brussels. The UK Government should release its own report around the time of the budget, where the Chancellor could draw attention to its conclusions.

It would be easy, even tempting, to dismiss such discussion as empty rhetoric. But intelligent, sustainable private-sector investment decisions perforce have to be taken in the light of a view about the future. The better, the more logical, the more informed, and the more certain that view is, the more likely it is not only that investment decisions will be sound, but also that the business sector will feel sufficiently confident to invest on an scale appropriate for a growing and prosperous future.

3. HM Treasury should encourage investment into productive areas of the economy and discourage investment into unproductive areas. Monetary inflows into the UK can be constructive, or they can be unhelpful. Long-term fixed investment bringing in more productive capacity, new technologies, better organisational and managerial practices and skills that are in short supply, is an example of the former. Inflows of ill-gotten money seeking safe haven purchases of real estate, and which in the process unhelpfully push up sterling, are an example of the latter. Hence, there is a case for policymakers to:

- **A) Discourage currency inflows that do not finance investment that increases the UK's productive potential**; and, particularly, discourage inflows motivated only by the desire to take advantage of the UK for speculative or safe haven reasons.

- HM Treasury should work out such policies in the light of a detailed analysis of various types of currency inflow, particularly post 2008. And such policy initiatives would have to be taken in full recognition of the UK's international treaty and other obligations.

  > **The Government should consider extending the new 3% Stamp Duty surcharge on Buy to Let to all first time properties bought by foreign buyers.** It will be difficult and complex to ascertain if foreign buyers own property elsewhere but it would be a safe assumption that they do. Hence the 'second home penalty' should in all fairness apply to them on their first purchases in the UK. In addition, to further penalise safe haven investment, consideration should be given to further extending the Stamp Duty charge on expensive homes bought by foreign buyers. There is currently a blanket 12% charge on all properties sold for more than £1.5 million. For example, a new 15% rate for properties in the £2 million and over purchase price band bought by foreign buyers would avoid additional complexity in the tax system, narrowly targeting safe haven and speculative investments. The Government has already from this year extended Capital Gains Tax to foreign-owned properties. The extent of this levy could at least in theory be raised but that risks adding further complexity to the structure of Capital Gains Tax.

  > **Now incentives should also exist alongside penalties** – for foreigners who wish to invest in Britain, which of course we should welcome, we have failed to provide them with a better investment choice and vehicle than residential housing. This must change. We could for instance count their homes as if they were first purchases by UK citizens and therefore free of Capital Gains Tax and the Stamp Duty surcharge if they invested a comparable sum in British SMEs – perhaps through an attractive recognised local authority investment vehicle (the creation of which ResPublica has argued for in devolved settlements to UK cities). This creation of an incentive would lead to various user friendly schemes that could function so as to attract foreign investors to not just invest 'unproductively' in British homes but to invest productively in British industry.

- **B) Encourage currency inflows that boost productivity and help UK manufacturing compete with low-wage economies.**

  > The starting point to encourage constructive investment is to ensure that the UK offers an internationally-competitive, transparent and relatively-stable system of corporate taxation.

  > Beyond this, the question is where and how best to employ more specific incentives such as temporary tax holidays, and accelerated investment allowances on plant and equipment spending, or on associated training and research and development outlays.

> With economic growth increasingly concentrated in urban areas, devolution of responsibility for business support to cities will be constructive. Enabling a new approach to inward investment will allow cities to work better together to forge a portfolio of connected destinations for foreign direct investment in particular industries, and foster 'smart specialisation'.[66]

> **Funded by the new property tax, Government should introduce a fiscal incentive to invest in devolved area investment funds**, such as the Merseyside Single Investment Fund proposed by Liverpool's Combined Authority.[67] Leveraging foreign investment at a time of significant devolution could mean substantial gains for the UK's productive capacity.

> **Local authorities should use new business rate powers to offer discounts to manufacturing firms investing in new machinery or equipment**. A new, locally-led system of business rate relief linked to productive investment would support local productivity, create high wage employment and spur local economic growth. It would also help to offset rates of depreciation of factory assets – a key overhead for manufacturing firms.

It has, at last, become recognised that investment in infrastructure, including importantly publicly-provided infrastructure, can be as essential as purely private sector investment in fostering national productivity and output growth. **In that context, the recently-announced National Infrastructure Commission, with its remit to plan, co-ordinate, and deliver investment of that kind should play a major constructive role in this.**

4. The Government should work with local government to develop mechanisms to help more small and mid-market companies to enter export markets. Just as there are many reasons – from the cultural to the geographic, from the financial to the historical – for the mediocre export performance of UK small and particularly mid-market companies, so are there many policies already in place to redress the situation.[68]

But three areas are in need of further attention: financing; foreign exchange contracts and hedging, and making better use of the policies that already exist.

Financing. While bank lending will remain the dominant source of funding for some time, it has already become necessary to develop a diverse and competitive funding environment. It is appropriate to focus on potentially-key funding markets, including venture capital, mezzanine finance, private placements, and SME securitisation. There is a particular need to:

- Develop seed, start-up, and early- and later-stage venture capital markets;
- Promote the use of more mezzanine finance to help fill the current gap in growth capital for SMEs;
- Improve access to the private placement market for mid-sized companies;
- Unlock access to institutional investment through securitisation of SME loans; and
- Increase competition among finance providers.

Foreign exchange support. SME financial officers are necessarily generalists and cannot hope to match the experience and expertise in treasury and foreign exchange management enjoyed by larger companies. Meanwhile, the high street banks typically provide these services only to SMEs at some considerable cost. Moves to devolve business support and further responsibility for UKTI export advice services are welcome, but the Government risks missing a trick if exchange rate support is not provided.

UK Export Finance should conduct a consultation into the provision of exchange rate support locally and nationally. It should examine:

- Provision of more structured advice on how best to draft contracts that involve a foreign exchange component.
- Help for SMEs to find alternative, cheaper, but reliable sources of foreign exchange hedging advice in the private sector.
- SME access to hedging products and other privately-provided exchange rate services.

As part of this review it should consider the potential impacts of introducing new support to ensure existing services, such as those provided by the British Chambers of Commerce, are not crowded out or duplicated by any new public sector provision.

We propose UKEF, UKTI regional offices, LEPs, Growth Hubs and local authorities work together to meet needs identified by this consultation through new 'export hubs' which will bring together existing support schemes alongside new financing and foreign exchange hedging initiatives. Integrating export support in this way would allow it to be delivered in a more bespoke, place-based way than at present.

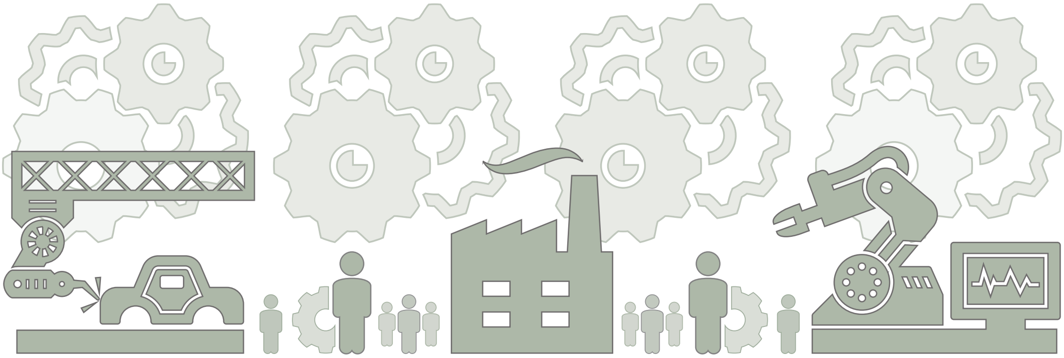
Streamlining existing policies. Many policies and schemes are already directed at supporting UK SMEs, including those wishing to export. But awareness of what is on offer is lacking, not least because of the sheer number of schemes, and frequent name changes. Online information is poor. And not surprisingly, take-up is low. Investigations have revealed a strong case to:

- **Create a well-constructed 'one-stop-shop' gov.uk website that is properly accessible and user-friendly, underpinned by a clear and logical structure and framework.** Root-and-branch rationalisation will be required to establish and maintain usability. This site should:

  > Emulate 'best-in-class' websites of the US, Sweden, and particularly Australia;

  > Be kept in the government sector: non-government, private sector sites are generally viewed as commercially skewed, and hence with scepticism.

For too long, issues like the nature of capital inflows and the exchange rate have been neglected by policymakers. A new focus on the exchange rate – with measures to improve the UK's cost competitiveness, encourage productive inward investment and discourage unproductive capital flows – will help to tackle the current account deficit and secure the future prosperity of the whole of the United Kingdom. A vitalised manufacturing sector supported in this way will boost UK productivity, create real wealth in the economy and secure high wage employment opportunities outside London and the South East. So the choice is clear – do we make or break?



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ResPublica Green Papers

ResPublica Green Papers are pithy yet powerful publications which communicate a single idea or thesis in public policy, supported by a highly persuasive argument. The purpose of these short, provocative pieces is to spark a debate and generate public-wide interest in our punchy recommendations. We hope that this publication will do just this.

Prosperity Programme

The UK has some of the highest levels of wealth concentration in the developed world. It has an economy where most mature markets are dominated by a small number of players and the barriers to entry are far too high. It is not an exaggeration to suggest that in many areas, from energy to banking to groceries, the UK has a monopolistic rentier rather than a market economy – a system in which certain individuals or small groups gain market dominance and excessive returns through anti-competitive practices. This conspires against innovation and is detrimental to the small and emergent businesses that generate growth and spread prosperity. Added to this, our education system, by specialising too early and often in the wrong areas, fails to produce students with fully rounded skill-sets. We are simply not equipping our future workforce with the means to safeguard our, and their, economic future. This is one reason why the real value of wages in proportion to growth in GDP continues to stagnate or fall. Our long-term productivity dilemma is a function of market capture and the effective de-skilling of the population.

We believe that shared prosperity cannot be achieved by simply tweaking the market. Britain needs significant demand and supply-side transformation, with new visionary institutions re-ordering our economy. We need long-term solutions that give power over wealth and assets, not simply handouts, to ordinary people. Central to this process of economic empowerment is an ethical, practical and adaptable education that gives people the skills to build their own businesses, or develop their own talents, rather than a conveyor belt to a service industry of low wage and less return.

New financial institutions to promote small business lending are required, and this involves smaller, more specialised and decentralised banks that can deliver advice as well as capital. We wish to explore ways in which all financial transactions can be linked to a wider social purpose and profit, which itself needs a transformation of the legal framework within which economic transactions take place. We believe that the future lies in the shaping of a genuinely social market which would be in consequence a genuinely free and open market. Internalising externalities and creating a level economic playing field in terms of tax paid and monopolies recognised and challenged, remains beyond the scope of contemporary governments to deliver. Such a vision requires new concepts. The viable transformative solutions lie beyond the purview of the current visions of both left and right in the UK.

This paper sets out how Britain can better help manufacturing contribute to UK-wide economic prosperity, productivity and opportunity. In recent years, the nature of capital and investment inflows into the UK and their impact on the exchange rate have been ignored by policy-makers trying to create an environment that helps manufacturing to grow.

We seek here to address that omission and suggest that through boosting productive investment inflows we can better support leading British manufacturers and the creation and domestication of the SME supply chains that support them.

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