The UK must recognise its enduring economic strengths

A decade of stagnant living standards, weak productivity and low investment combined with a coming decade of major change – driven by Covid-19, Brexit and the need for accelerated action on Net Zero – mean that it is crucial for the UK to renew its economic strategy. ***Josh De Lyon, Ralf Martin, Juliana Oliveira-Cunha, Arjun Shah, Krishan Shah, Gregory Thwaites,*** *and* ***Anna Valero*** *argue that the UK is a services-exporting superpower, but it is not narrowly focused on finance and has strengths outside the service sector, for example in clean technologies and pharmaceuticals. A renewed economic strategy cannot ignore the UK's history and current endowments: it needs to build on these areas of strength and protect them from new risks.*

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The UK was the fourth-largest exporter in the Organisation for Economic Cooperation and Development (OECD) in 2019 (behind Japan, Germany, and US), and the fifth largest in the world (also behind China), exporting nearly $900 billion worth of goods and services. But within this we have a very large specialisation in services: we exported $418 billion worth of services in 2019, the second highest in the world. At just over 45 per cent of total exports, the UK's services share is roughly twice that of the OECD average, and 1.8 times the global share. This is a far larger share than any country of a comparable size: among large rich economies, the US, France, and Spain also specialise in services, but to a far lesser extent, with roughly a third of their exports being services. In contrast, Japan, Germany, and Korea specialise successively more strongly in goods, with services amounting to less than a fifth of their exports.

Within this services specialism, the UK has a well-known, strong advantage in financial services, insurance, and other business services, exporting more than double the global average share ($230 billion across these three services categories). However, financial services have been falling as a share of exports – from 12 per cent in 2009 to 9 per cent in 2019. And the UK is also a strong exporter in other services, such as personal, cultural, and recreational services (including education), where our export share is one-fifth larger than the global average (totalling $5.7 billion in 2019). The UK earns a lot from charges for intellectual property (such as royalties to broadcast UK-produced TV shows abroad), and has strengths when it comes to exporting in a number of goods categories. A larger-than-average share of our exports are in aircraft, art, beverages, and pharmaceuticals. There are clearly some goods where the UK has real relative strengths: it is not a services one-trick pony. The UK's single biggest relative weaknesses is in electrical machinery and equipment, where the share in our exports is around half the global share.

Taken together, these specialisms are relatively varied. On a range of statistical measures, the breadth of the UK's trade mix is average by the standards of medium-sized industrialised countries, meaning that the UK is not particularly concentrated, nor diversified, in its exports. We are slightly more specialised than France or Germany, but less specialised than Japan, and much less specialised than small but rich countries like Switzerland and Ireland. The UK's pattern of specialism is therefore not unusually narrow or idiosyncratic. However, while the absolute size of UK exports in 2019 was only slightly smaller than other rich countries in relation to both the size of the economy (i.e. openness) and to imports (i.e. the trade balance), UK exports substantially underperformed those of our international peers' in 2020-21.

Our focus on services is not to blame for the UK's economic stagnation

Statistical analysis suggests that there are several broad types of exporting countries based on their revealed patterns of specialisation: one group comprises manufacturing-heavy countries, including Germany and several East Asian economies, and there is also a services-intensive group that includes the UK, France, the United States and Singapore. All of the latter three countries have higher GDP per capita than the UK, suggesting that a services focus can be consistent with higher levels of productivity and income than the UK has been able to achieve.

Moreover, while UK exports grew moderately slowly in the decade to 2019, at an average rate of 3.3 per cent per year (in dollar terms) — similar to the 3.1 per cent growth enjoyed by Germany but much slower than the 4.8 per cent for the US — none of this underperformance was due to the UK's product mix. It is the case that in 2009 the UK was specialised in products that, on average, saw relatively strong worldwide growth in exports in the ten years that followed, meaning product mix explains none of the 1.5-percentage-point shortfall in growth in UK exports when compared to the US over this period. The gap is therefore instead explained by the UK losing share in the markets in which it exports. Both these factors suggest that the UK's specialisation in services does not of itself explain the shortfall in productivity and incomes relative to the international frontier, nor the recent stagnation in its productivity growth.

A new economic strategy must recognise that economic specialisms have tended to develop slowly

Most developed countries, including the UK, have not changed their specialisms much over the course of recent decades. For example, the UK's strength in services was present in 1980, before the rapid deindustrialisation of its economy was complete, although it did increase significantly in the late-1990s, peaking around the time of the financial crisis. Of the top 10 products in which the UK was most specialised in 1989, seven were also in our top 10 in 2019, and the top two then – financial services and beverages – are still the top two now.

More broadly, comparative advantage in most product categories has not tended to change much over time: internationally, we find that a country's revealed comparative advantage (RCA) in a product ten or even thirty years ago has generally been a good predictor of that country's RCA today. The extent of this 'persistence' in the UK is similar to other advanced economies. Large swings from goods to services or vice versa are rare: among countries comparable to the UK – i.e., high-income OECD countries who did not undergo a post-communist transition – since 1980, only Finland and Norway have experienced a change of a magnitude sufficient to move the UK from being a services specialist to a country that exports goods and services in the same proportions as the rest of the world.

A renewed economic strategy cannot ignore the UK's history and current endowments: it needs to build on these areas of strength and protect them from new risks. Key areas of long-standing UK specialisation rely on a highly educated and innovative workforce, and international openness to talent and ideas. In the case of finance and business services, the UK's specialisation reflects London's role as an international financial centre. The UK's creative strengths can be traced to cultural openness, high quality creative education and – in media – the important role that public service broadcasting has in shaping the market. Pharmaceuticals, as part of the wider life sciences sector, draws on and contributes to the UK's strong science base. But although an economy's strengths are persistent, they are not immutable. For example, we show that it would only be a 'short hop' from the UK's current mix of goods specialisation to several other product areas in which the UK could grow its exports, including products across several machinery and pharmaceuticals categories. Patenting activity of UK-resident inventors also highlights areas in which the UK's advantages could grow. The UK is innovative in chemistry and the associated fields of pharmaceuticals and biotechnology. Although these fields saw relatively weak growth in global patenting activity in the decade to 2015, they are widely recognised to be growth areas of the future. The UK also has a promising strength in patents relating to clean technology, where further growth is anticipated due to international commitments to Net Zero. A successful economic strategy needs to capitalise on these new areas of high growth opportunity, while building on existing strengths.

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Notes:

- *This blog post is an edited excerpt from the executive summary of Enduring strengths: Analysing the UK's current and potential economic strengths, and what they mean for its economic strategy, at the start of the decisive decade, The Economy 2030 Inquiry, April 2022, by the Resolution Foundation and LSE's Centre for Economic Performance (CEP). The inquiry is funded by the Nuffield Foundation.*
- *The post represents the views of its author(s), not the position of LSE Business Review or the London School of Economics.*

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