



Economics Weekly

7 June 2010

Can the UK export its way to growth?

Only by maximising the opportunity it currently has to boost net trade may the UK have a good chance of stronger, more balanced growth in the years ahead

High levels of indebtedness, credit constraints and forthcoming fiscal austerity raise the likelihood that UK domestic demand will remain relatively weak over the next few years. As such, it raises the question of where UK economic growth will come from. Hence, it is important the UK maximises the opportunity it currently has to boost net trade through a weak exchange rate and low wage inflation.

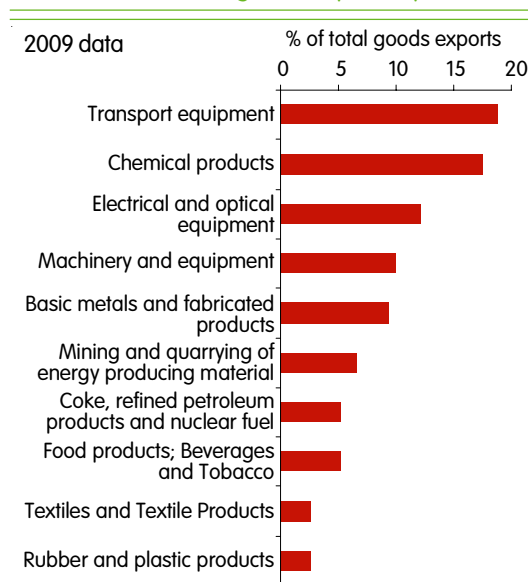
The fall in the exchange rate and the decline in relative unit labour costs provide a window of opportunity for the UK to boost its export performance

The challenge is a huge one, but not beyond the UK's capability. Over the past forty years, the UK's share of global trade has fallen from 6.1% to 2.8%. The decline has run in tandem with the relative decline of the UK manufacturing sector, which now accounts for just 13 per cent of UK national output compared with over 30 per cent in 1970. These declines, however, paint an unduly pessimistic picture of the UK's trade performance. The UK is still the world's fifth largest overall exporter - after the US, Germany, China and Japan - and the world's tenth largest exporter of merchandise goods. The decline in the UK's share of global trade has largely been due to the rapid growth of the developing world. Faced with a lack of infrastructure to support domestic growth, many of these economies have relied, in their infancy, on net exports to grow national income - China and Russia being two clear examples.

To capitalise on this opportunity, it is imperative that the UK continues to invest in those high-value added industries in which it has a comparative advantage.

Similarly, the relative decline in UK manufacturing is mostly just that, reflecting the sharp growth in UK services industries, particularly those in which the UK has a comparative advantage, notably financial, and business services. Nevertheless, the UK manufacturing

Chart a: Share of UK goods exports by sector

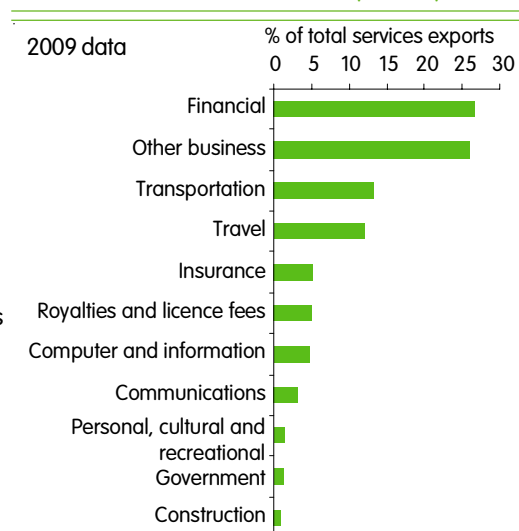


sector has also been through its own transformation. The inability of traditional industries to compete on price with lower cost overseas producers has forced UK manufacturers to become more innovative and more entrepreneurial, focusing on those industries and products in which it has a comparative advantage. The rapid growth of the UK's higher valued added industries, such as bioscience, engineering and chemicals has been clear evidence of this trend.

Aided by growth in these industries, the UK manufacturing sector has continued to expand. Contrary to conventional wisdom, the volume of UK manufacturing output is over 10% higher than it was in the early 1970s. Moreover, while the UK manufacturing sector accounts for a relatively small share of UK GDP at 13%, the share of total UK trade accounted for by merchandise goods is far higher, at 60%. Again, it has been those manufacturers that have focused on the production of high valued added products, where the UK's comparative advantage lies, that have benefited most from an improvement in overseas demand - see chart a.

Nevertheless, the UK continues to run a sizeable merchandise goods deficit - i.e. we import more than export. However, this is not the case for services, where the UK runs a significant net surplus. Not surprisingly, exports have risen in those services sectors in which the UK has particular expertise. Together, financial, business and legal services - account for over 60% of the UK's total service sector exports, and 25% of the

Chart b: Share of UK services exports by sector



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2010 calendar of central bank meetings

European ECB (1.00%)
10 June, 8 July, 5 August, 2 September

US FOMC (0-0.25%)
23 June, 10 August, 21 September

UK MPC (0.50%)
10 June, 8 July, 5 August, 9 September

Rolling calendar of UK data releases and events

Trade balance (9/6)
Producer prices (11/6)
Industrial output (11/6)
NIESR GDP (11/6)
Consumer prices (15/6)
Retail prices (15/6)

Rolling calendar of US data releases and events

Trade balance (10/6)
Retail sales (11/6)
Uni of Michigan conf (11/6)
TIC capital flows (15/6)
Producer prices (16/6)
Housing starts (16/6)

Rolling calendar of Emerging Markets data releases and events

Brazil GDP (8/6)
Brazil CPI (9/6)
Selic rate decision (9/6)
Mexico CPI (9/6)
China CPI (11/6)
Russia GDP (11-15/6)

* All charts are sourced to Lloyds TSB Corporate Markets Economic Research, Bloomberg and Thomson Datastream

Chart c: Fall in unit labour costs has led to a marked improvement in UK competitiveness

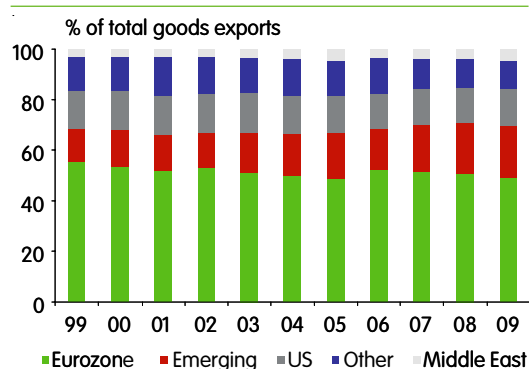


UK's overall overseas trade - see chart b. It is important that the regulatory, tax and infrastructure remain conducive to continued growth in these areas. The challenges posed by the fallout from the financial crisis pose a clear risk in this regard.

Notwithstanding these challenges, we believe the UK now has a window of opportunity to significantly grow its exports, whether it is in merchandise goods or services. The decline in the UK's nominal exchange rate has imparted a competitive boost to UK industry. Since peaking in mid-2007, sterling has dropped by 30% against the US dollar, by 20% against the euro and by 45% against the Japanese yen.

The improvement in competitiveness is starker when viewed in real terms. Allowing for the relative movement in consumer prices and unit labour costs, the UK is currently one of the most competitive economies in the OECD. Based on relative unit labour costs, the UK currently ranks well above Germany, France, Canada, Japan and the US in terms of its competitiveness - see chart c. The improvement in the UK's relative competitiveness against the Eurozone has been particularly marked. This is especially important as the euro-zone is by the far the UK's largest trading partner, accounting for over 50% of UK exports. Given the economic challenges facing the single currency area, however, it is questionable whether UK companies will be able to significantly increase their exports to this market.

Chart d: The share of UK goods exports to the emerging world has risen, but not by enough



It is essential therefore that the UK broadens its export base away from its over-reliance on Europe. While this is a daunting challenge, there are cautious grounds for optimism that it can do so. Over the past few years, the UK has started to target more actively the growing markets of Asia. Since 2000, the proportion of UK goods exports destined for the emerging markets has risen from 14% to 20%. By contrast, the UK's share of exports to the Euro-zone has declined by 5 percentage points over the past decade - see chart d.

Looking ahead, we are optimistic that the UK can improve its export performance. To date, companies have seemingly held back from passing on the fall in the exchange rate through lower prices, preferring instead to bolster their profit margins as they seek to repair their balance sheets. Over time, however, we suspect the fall in the exchange rate, in both nominal and real terms, will start to have a more pronounced impact on the UK's export performance. Such a strategic shift is likely to be aided by policy, with the new coalition government indicating that it also believes the opportunity for growth lies in an expansion of exports, particularly to emerging Asia. To capitalise on this opportunity, however, it is imperative that the UK continues to invest in those high-value added industries in which it has a comparative advantage.

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Weekly economic data preview

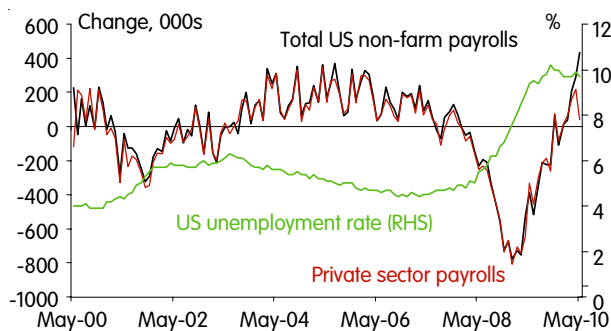
7 June 2010

Markets await Bernanke and Trichet

- The euro remains under selling pressure, falling below \$1.20 for the first time since March 2006 and dipping to a record low versus the Swiss franc last Friday. Global equities also saw further declines, while 'safe haven' flows pushed government bond yields lower. News that US private sector payrolls rose by just 41k in May (total payrolls rose by 431k, boosted by census workers) reinforced this price action. The overarching theme in European markets is that the recent €750bn rescue package has failed to sufficiently assuage investor concerns and further initiatives from policymakers cannot be discounted. However, what markets really want is action on reducing high government deficits and debt. But meaningful progress is unlikely to be achieved quickly - implying that volatile market conditions may persist for some time yet. Data releases this week are likely to take a back seat to events this week, with Thursday's ECB press conference and Fed Chairman Bernanke's testimony on the economy at the House Budget Committee on Wednesday providing key highlights.
- In the UK, we look for the Bank of England to leave Bank Rate on hold at 0.5% and maintain the size of its asset purchase programme at £200bn. In its May Inflation Report, risks to the Bank's GDP growth projection were skewed to the downside, consistent with the idea that the Bank is open to the idea of re-starting asset purchases if required. In terms of economic data, this week sees the release of April industrial production figures, where we look for an increase of 0.4% m/m. This will provide an early guide to Q2 GDP (where the preliminary estimate is published on 23 July).
- Economic data flow in the euro-zone is limited this week, so attention turns to Thursday's ECB Governing Council meeting. Here, we look for the key refinancing rate to stay on hold at 1%, although the 'bigger picture' of euro-zone (in)stability continues to concern financial markets. We note that Jean-Claude Trichet was silent on the subject of euro-zone government bond purchases at May's ECB press conference, before undertaking such purchases only two working days later. Mr. Trichet could thus be faced with tough questions on the ECB's communication strategy and possibly its wider credibility. In addition, the ECB will publish its latest staff economic projections. Back in March, the ECB's forecast range stood at 0.4%-1.2% for this year and 0.5%-2.5% for 2011. It is not clear that any meaningful revisions are imminent in this week's projections, with the drag from recent financial market volatility broadly offsetting a still robust export performance from the "core" countries.
- There are a host of Fed speakers this week, headed by Chairman Bernanke at the House Budget Committee on Wednesday. After the softer-than-expected payrolls report last Friday, their views on the economic outlook may provide important insights on the potential nature and timing of exit strategies. The Fed's Beige Book is also published on Wednesday. The main data highlights this week are provided by retail sales on Friday, which we expect to post an eighth straight gain in May (+0.2%) and the trade figures on Thursday, which we predict to show a slight widening in the deficit to \$42bn in May.
- In other news, New Zealand is expected to join a select group of G-20 countries and raise its policy rate to 2.25% from 2%. Among the downpour of data from Brazil this week, three key releases are expected to confirm that growth remains brisk. Real GDP is forecast to have grown 2.9% in Q1 from Q4 2009. But high inflation outturns and tightening capacity constraints are likely to see the Brazilian central bank tighten interest rates by 75 basis points at its meeting on Wednesday, bringing the target interest rate to 10.25%. Key inflation and trade data from China are also due this week.

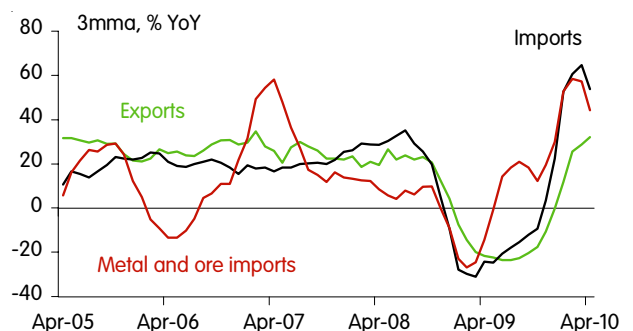
Jeavon Lolay, Mark Miller and Sian Fenner

Has the US labour market come to its 'census'?



Source: Thomson Datastream

External trade data from China may weigh on commodity prices





7 - 11 June

Country	Time	Event	Actual	Consensus	Forecast	Previous
Mon 7						
GE	11:00	Factory orders (Apr)		-0.2% (25.2%)	0.2% (25.6%)	5.0% (26.1%)
US	20:00	Consumer credit (Apr)		\$0.0bn	\$0.0bn	\$2.0bn
Tue 8						
UK	00:01	BRC retail sales monitor (May)				
JN	00:50	Current account (Apr)		¥1424.1B	¥1300.0B	¥1773.1B
JN	00:50	Trade balance (Apr)		¥871.9B	¥830.0B	¥1074.7B
JN	06:00	Leading index CI (Apr P)		102.5	102.5	102.7
JN	06:00	Coincident index CI (Apr P)		102.5	102.5	101.5
GE	07:00	Trade balance (Apr)		17.0bn	n/a	17.2bn
GE	11:00	Industrial production (Apr)		0.7% (12.3%)	1.0% (12.6%)	4.0% (8.6%)
BZ	13:00	GDP (Q1)		2.6% (8.5%)	2.9% (8.5%)	2.0% (4.3%)
CA	13:15	Housing starts (May)		205.0K	n/a	200.7K
Wed 9						
JN	00:50	Machine orders (Apr)		1.7% (7.3%)	1.0% (6.6%)	5.4% (1.2%)
UK	09:30	Visible trade balance (£/mn) (Apr)		-£7,000	-£6,900	-£7,522
UK	09:30	Trade balance non-eu £/mn (Apr)		-£3,900	-£3,700	-£4,103
UK	09:30	Total trade balance (£/mn) (Apr)		-£3,350	-£3,200	-£3,683
BZ	13:00	CPI Inflation (May)		0.4% (5.2%)	0.5% (5.2%)	0.6% (5.3%)
US	15:00	Wholesale inventories (Apr)		0.7%	0.5%	0.4%
MX	15:00	Consumer prices (May)		-0.5% (4.1%)	-0.5% (4.1%)	-0.3% (4.3%)
NZ	22:00	RBNZ official cash rate		2.75%	2.75%	2.50%
BZ		SELIC target interest rate		10.25%	10.25%	9.50%
RU		Weekly CPI (Jun-7)		n/a	n/a	0.1%
Thu 10						
JN	00:50	GDP annualised (Q1) F		4.2%	4.2%	4.9%
JN	00:50	GDP deflator (Q1) F		-3.0%	-3.0%	-3.0%
JN	00:50	Domestic CGPI (May)		0.1% (0.3%)	0.1% (0.3%)	0.4% (-0.2%)
SK	02:00	South Korea official bank rate		2.00%	2.00%	2.00%
AU	02:30	Employment change (May)		20.0K	24.0K	33.7K
AU	02:30	Unemployment rate (May)		5.4%	5.4%	5.4%
GE	07:00	CPI - EU harmonised (May) F		0.1% (1.2%)	0.1% (1.2%)	0.1% (1.2%)
FR	07:45	Manufacturing production (Apr)		0.3% (7.0%)	n/a	0.8% (6.7%)
FR	07:45	Industrial production (Apr)		0.0% (6.6%)	0.0%	1.00% (6.20%)
UK	12:00	BoE announces rates		0.50%	0.50%	0.50%
EC	12:45	ECB announces interest rates		1.00%	1.00%	1.00%
CA	13:30	Int'l merchandise trade (Apr)		0.7B	0.7B	0.3B
US	13:30	Trade balance (Apr)		-\$41.0B	-\$42.0B	-\$40.4B
US	13:30	Initial jobless claims (w/e Jun-5)		447K	445K	453K
US	19:00	Monthly budget statement (May)		-\$140.0B	-\$150.0B	-\$82.7B
CH		Imports (May)		(44.4%)	(44.4%)	(49.7%)
CH		Exports (May)		(32.0%)	(32.0%)	(30.5%)
CH		Money supply - M2 (May)		(21.0%)	(21.0%)	(21.5%)
Fri 11						
CH	03:00	CPI (May)		(3.0%)	(3.1%)	(2.8%)
FR	07:45	CPI - EU harmonised (May)		0.1% (1.9%)	0.1% (1.9%)	0.3% (1.9%)
UK	09:30	PPI input (May)		-0.8% (10.8%)	-0.6% (11.2%)	0.6% (13.1%)
UK	09:30	PPI output (May)		0.5% (5.8%)	0.4% (5.7%)	1.4% (5.7%)



7 - 11 June

Country	Time	Event	Actual	Consensus	Forecast	Previous
UK	09:30	PPI output core (May)		0.5% (4.8%)	0.3% (4.5%)	1.1% (4.4%)
UK	09:30	Industrial production (Apr)		0.4% (2.3%)	0.4% (2.4%)	2.0% (2.0%)
UK	09:30	Manufacturing production (Apr)		0.5% (3.9%)	0.5% (4.0%)	2.3% (3.3%)
US	13:30	Advance retail sales (May)		0.2%	0.2%	0.4%
US	13:30	Retail sales less autos (May)		0.1%	0.2%	0.4%
US	14:55	University of Michigan confidence (Jun) P		75.0	75.0	73.6
US	15:00	Business inventories (Apr)		0.6%	0.3%	0.4%
UK	15:00	Niesr gdp estimate (May)		n/a	n/a	0.5%

Key events of the week

Mon 7	US	NY Fed's Potter speaks at conference in Connecticut (13:00), Fed's Yellen gives welcome remarks at Asia conference (22:00)
	EC	Euro-Area finance ministers hold meeting in Luxembourg (16:00)
Tue 8	EC	ECB's Trichet speaks at IIF conference in Vienna (8-10 Jun)
	UK	DMO to auction £1.1bn of 1.25% index linked bonds due 2027 (10:30)
	US	Bernanke interviewed by Sam Donaldson in Washington (00:45), Fed's Duke speaks to Bankers in Florida (13:25), Fed's Evans speaks in Chicago on Economic Outlook (14:10), Treasury to sell \$36bn of 3-year notes (18:00)
Wed 9	EC	Germany to sell €6bn of 2-yr notes (10:15) , Germany to sell €1bn of index-linked notes (11:00)
	UK	DMO to auction £3.75bn of 3.75% gilts due 2020 (10:30)
	US	Fed's Hoenig speaks at Agricultural Symposium in Kansas city (00:00), Fed's Bernanke testifies to the House Budget Committee (15:00), NY Fed's Sack speaks to Economists in New York (17:00), Treasury to sell \$21bn of 10-year notes (18:00), Fed releases Beige Book economic report (19:00), Fed's Bernanke speaks at Richmond fed employment conference (21:00)
Thu 10	EC	Austria's WIFO reports final quarterly economic statistics (07:40), ECB announces interest rate decision in Frankfurt (12:45), Trichet speaks at ECB monthly news conference (13:30)
	UK	Bank of England monetary policy committee decision (12:00)
	US	Treasury to sell \$13bn of 30-year bonds (18:00)
Fri 11	UK	Bank of England releases its quarterly Inflation Attitudes survey (09:30)
	US	Fed's plosser speaks on Economic Outlook in Pennsylvania (13:20), Fed's Kocherlakota speaks in Minneapolis on Economy (17:00)

Source: Bloomberg

NB: Data in brackets denote YoY. Market consensus estimates are taken the preceding Friday.