



# Economics Weekly

8 February 2010

## Recovery in UK exports holds key to future growth

Despite the 25% fall in sterling's trade-weighted exchange rate, the UK trade deficit remains stubbornly wide

Although the exchange rate has fallen, export prices remain elevated, as companies have sought to rebuild profit margins, thereby raising the sterling price of their goods, rather than gain market share

This implies that the trade balance may not post the improvement that is essential if the UK is to enjoy strong and sustained growth over the medium term

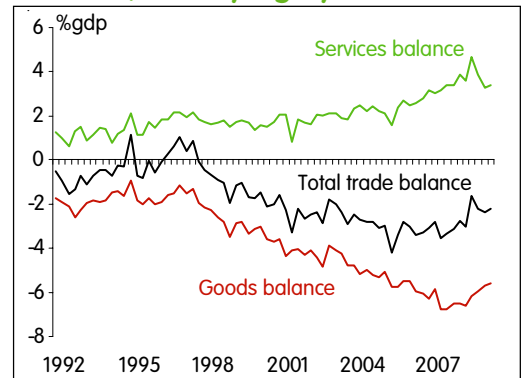
The sharp fall in sterling over the past three years and the nascent signs of recovery in the global economy provide an opportunity for growth that the UK cannot afford to miss. With the household and corporate sectors weighed down by high levels of indebtedness, and the public sector about to embark on a substantial fiscal squeeze, the prospect of a meaningful recovery in domestic demand over the coming years is, we believe, limited. Instead, to achieve a reasonably strong and sustained rate of growth means it is not only desirable, but essential, that the UK rebalances away from debt-driven domestic demand towards net exports. The competitive boost provided by the fall in sterling, and the steady recovery in global demand, provide this opportunity.

Since peaking in January 2007, sterling's trade-weighted index has fallen by around twenty-five percent. While the trade-weighted exchange rate has recovered a little over the past year, the overall decline over the past three years represents the largest correction in the exchange rate since the UK withdrew from the ERM in the early 1990s. As chart a shows, the decline in sterling has been most acute against the yen, with GBP/YEN having dropped by around almost 70% over this period. Nonetheless, against the US dollar, euro, Swiss franc, and a host of emerging market currencies, sterling has also fallen sharply.

To the extent that a fall in the exchange rate raises import prices and lowers export prices, one might expect the fall in sterling to be associated with a marked improvement in the UK's trade position (the difference between the amount we export and import, in current prices). But, as chart b shows, the improvement in the UK's trade balance in recent years has been relatively modest.

Since early 2007, the UK's total trade deficit in goods and services as a proportion of gdp has improved by

Chart b: The UK's trade deficit has narrowed, but only slightly



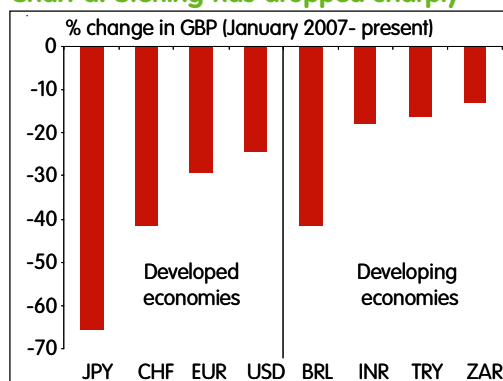
just over 1 percentage point (pp) to 2.2%, driven by a reduction in the visible (goods) trade deficit. While the current trade deficit is not out of line with the experience of the last decade, it remains troubling that the UK export sector has not yet responded more strongly to the fall in the exchange rate, particularly given the fragile backdrop to domestic demand. This is particularly so, as a large part of the improvement in the UK's trade deficit has been the result of a sharp fall in imports, reflecting weak demand conditions at home. This source of improvement cannot be sustained indefinitely, and a meaningful recovery in the UK's export performance will be required if the trade balance is ultimately to move back into surplus territory - as it did briefly in the mid-1990s, following sterling's exit from the ERM.

So why has the UK's trade position not improved more sharply? Part of the reason may be that the competitive boost has occurred against the currencies of those countries which undertake relatively little trade with the UK (see chart c). For example, UK exports to Japan, Switzerland and Brazil account for only 4% of total exports.

However, against the currencies of our largest trading partners - the major euro zone countries and the US - the drop in the exchange rate has still been substantial. Against the euro and US dollar, sterling has dropped by around 25-30% since early 2007 - far more than it has against many of the developing economy currencies. It seems that rather than increasing market share, therefore, UK exporters have used the opportunity of the weaker exchange rate to rebuild profit margins. Indeed, over the past three years, export prices have risen by almost 25% (see chart d).

The UK's terms of trade is the ratio of its export prices to its import prices. As such, it measures how many units of imports the UK can buy with one unit of exports.

Chart a: Sterling has dropped sharply



### Editorial comments to:

Trevor Williams  
Chief Economist  
Lloyds TSB Corporate  
Markets  
Economic Research  
10 Gresham Street  
London, EC2V 7AE  
Tel: +44 (0)20 7158 1748

## 2010 calendar of central bank meetings

### European ECB (1.00%)

4 March, 8 April, 6 May, 10 June

### US FOMC (0-0.25%)

16 March, 28 April, 23 June

### UK MPC (0.50%)

4 February, 4 March, 8 April, 6 May, 10 June

## Rolling calendar of UK data releases and events

Trade balance (09/02)  
Industrial production (10/02)  
BoE Inflation Report (10/02)  
CPI inflation (16/02)  
BoE MPC minutes (17/02)  
Labour market stats (17/02)  
Public finances (18/02)  
M4 money supply (18/02)  
Retail sales (19/02)

## Rolling calendar of US data releases and events

Trade balance (10/02)  
Retail sales (11/02)  
TIC capital flows (16/02)  
Housing starts (17/02)  
Industrial production (17/02)  
FOMC minutes (17/02)  
Producer prices (18/02)  
Consumer prices (19/02)  
Consumer conf (23/02)

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

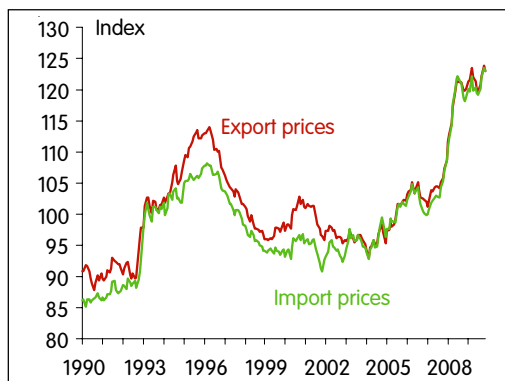
## Chart c: The UK's largest export markets



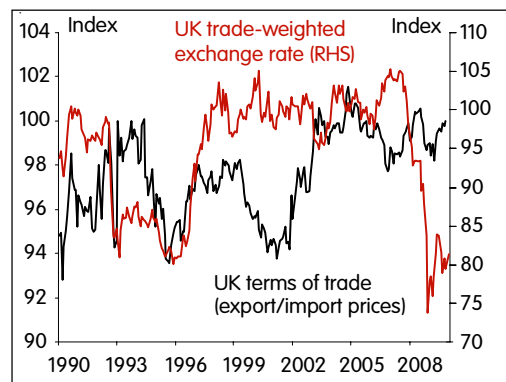
Other things being equal, a fall in the exchange rate might be expected to lead to a deterioration (i.e. fall) in the UK's terms of trade, as import prices rise and export prices fall (and vice versa). As chart d shows, however, the UK's terms of trade has actually improved slightly over the past three years. In other words UK export prices have risen relative to import prices, despite the fall in sterling's exchange rate over this period. The improvement in the terms of trade, it seems, has limited the recovery in UK export volumes.

The experience of the past three years contrasts with the experience of the UK in the early 1990s, when export volumes responded more aggressively to the fall in the exchange rate. Indeed, it was the boost to UK net trade during this period that was instrumental in raising real incomes and bringing the UK out of recession. It remains to be seen whether the same will occur this time around. It may not if export prices do not fall.

## Chart d: The improvement in the terms of trade has limited the recovery in exports



## Chart e: The fall in the pound has not been reflected in the UK's terms of trade



However, the lags between exchange rate movements impacting on trade volumes can be substantial. Companies, for example, may be locked in to multi-year fixed price contracts; they may be wary about lowering their export prices for fear that the decline in the exchange rate could be short-lived, and/or they may need to widen margins to help protect their balance sheets.

Notwithstanding the above, we are hopeful that the UK will respond to the opportunities that arise from the fall in sterling and the signs of global economic recovery. Indeed, the marked improvement in the export orders balances of the latest CBI SME Trends and manufacturing PMI surveys provide grounds for optimism. According to the January PMI survey, manufacturing export orders are currently at their highest level since this data were collected in 1996.

Although the share of manufacturing in gdp has fallen markedly over the past thirty years, there remain many industries, in both the goods and services sectors, in which the UK has a comparative advantage - chemicals, business & financial services, engineering and biosciences, to name but a few. If the UK is emerge from the downturn with a stronger and more stable economy over the medium to longer term, it is essential that this rebalancing away from domestic consumption towards net exports occurs.

**Adam Chester**  
Senior UK Macroeconomist

### Customer sales

#### Andrew Willett

+44 (0)20 7158 1616  
andrew.willett@lloydstsb.co.uk

#### Kathryn Ball

+44 (0)20 7158 1672  
kathryn.ball@lloydstsb.co.uk

### Credit Distribution

#### Martin Bates

+44 (0)20 7158 1983  
martin.bates@lloydstsb.co.uk

### Commercial sales

#### Matt Lawrence

+44 (0)20 7158 1661  
matthew.lawrence@lloydsbanking.com

### Wealth product sales

#### Andrew Evans

+44 (0)20 7158 1691  
andrew.evans@lloydstsb.co.uk

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## Weekly economic data preview

8 February 2010

### BoE MPC to provide further detail behind decision to halt QE

- Following on from last week's decision by the MPC to halt its programme of quantitative easing, attention will shift to the detail of its quarterly Inflation Report (published on Wednesday), which would have been a key input into the MPC's deliberations. Key themes arising from the statement accompanying the policy decision announcement was that the Committee thought recent monetary policy initiatives would continue to "impart a substantial monetary stimulus" to the economy, although it acknowledged that should the recovery falter, it could restart the programme of asset purchases. We expect the detail of the Inflation Report to strike the same tone and show that the MPC is very much in "wait and see" mode. On dataflow, the BRC retail report is released on Tuesday. The January CBI retail report was downbeat, with the VAT rise and inclement weather negatively impacting activity. Our forecast for a two percentage point fall in the annual rate of BRC total sales growth (to 4%) is also a reflection of these factors. We expect the headline trade balance (also Tuesday) to be unchanged at £6.7bn, while industrial production data (Wednesday) are expected to post a 0.3% decline in December. That would be consistent with the sectoral output data within the ONS's preliminary GDP estimate released last month, which showed that the industrial sector grew 0.1% over Q4.
- Financial markets will be closed in the US on Monday for the Presidents' Day holiday. Although there are no major economic releases on Tuesday, the sale of \$40bn of 3yr notes by the Treasury will be closely watched. Given the recent weakness of global equities, we expect to see strong appetite from investors. The main data highlight this week is provided by the January retail sales figures on Thursday, which will provide an early pointer for consumer spending and growth prospects in the first quarter. We look for a modest gain of 0.3% in headline retail sales and excluding autos of 0.5%, rebounding after surprise falls in December. It is worth highlighting though that the monthly data are notoriously volatile. The University of Michigan consumer sentiment index, published on Friday, is expected to show a further modest gain in February, reflective of the improving labour market. We expect the headline index to breach the 75 level for the first time since January 2008. However, after the news of a further fall in non-farm payrolls last month, focus will also be on the latest initial jobless claims data on Thursday, particularly following the surprise gain seen last week. We look for a sharp fall to 445K in the week to February 6, from 480k previously. The other major release in the US this week is the December trade balance on Wednesday. We look for a modest narrowing in the trade deficit to \$36bn, from \$36.4bn, on stronger exports. The data will also be used to refine estimates of US Q4 2009 GDP growth.
- At the recent ECB's press conference, Jean-Claude Trichet was noticeably more upbeat on the subject of Greece and the efforts being made to repair its public finances. So there was more than a touch of irony when stock and bond markets registered significant falls shortly afterwards, apparently on the back of concerns over contagion effects from the euro-zone periphery. As far as the spread of 10-year government bond yields over equivalent bunds is concerned, Portugal and Spain have also moved into the limelight. Preliminary Q4 GDP releases feature strongly in this week's euro-zone economics data calendar. At the aggregate euro area level, we look for an outturn of +0.4% quarter-on-quarter, yielding an annual rate of -1.9%. National data from Germany, France and Italy are published on the same day, Friday. Broadly speaking, exports and inventories remain the key drivers of euro-zone economic activity, although these components clearly do not guarantee seamless recovery. Other economic releases include December industrial production figures for the euro-zone (along with national data for Germany, France and Italy).

George Johns (UK Macroeconomist), Jeavon Loyal, (Senior Global Macroeconomist, Mark Miller (Global Macroeconomist)

Chart 1: MPC's November Inflation Report projection on unchanged Bank Rate at £200bn of asset purchases

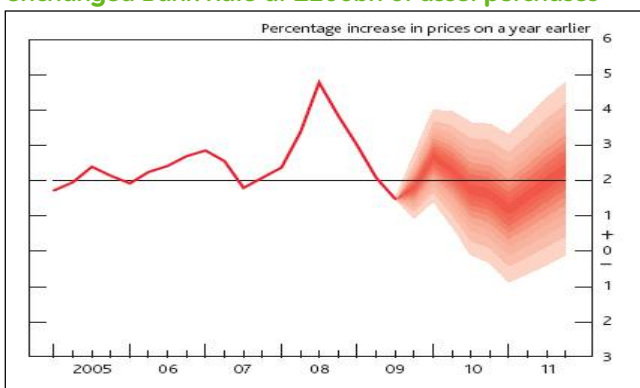
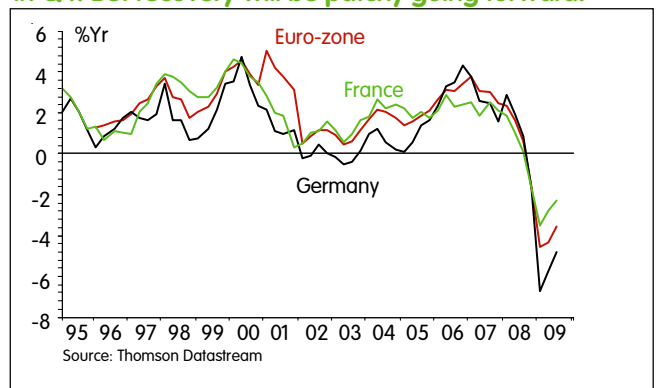


Chart 2: Euro-zone GDP is likely to continue improving in Q4. But recovery will be patchy going forward.



**8 - 12 February 2010**

Country	Time	Event	Actual	Consensus	Forecast	Previous	
<b>Mon 8th</b>							
	13:15	CA	Housing starts (Jan)		179.0K	180.0K	174.5K
<b>Tue 9th</b>							
	00:01	UK	BRC retail sales monitor (Jan)		n/a	n/a	n/a
	00:01	UK	RICS house price balance (Jan)		27%	25%	30%
	07:00	GE	Trade balance (Dec)		14.6B	n/a	17.4B
	07:00	GE	CPI - EU harmonised (Jan F)		-0.7% (0.7%)	-0.7% (0.7%)	-0.7% (0.7%)
	09:30	UK	Visible trade balance gbp/mn (Dec)		-£6,700	-£6,700	-£6,784
	09:30	UK	Trade balance non eu gbp/mn (Dec)		-£3,100	n/a	-£3,032
	15:00	US	Wholesale inventories (Dec)		0.5%	0.5%	1.5%
	23:50	JN	Machine orders (Dec)		7.5% (-10.8%)	7.0% (-11.3%)	-11.3% (-20.5%)
	23:50	JN	Domestic CGPI (Jan)		0.1% (-2.3%)	0.1% (-2.3%)	0.1% (-3.9%)
<b>Wed 10th</b>							
	07:45	FR	Industrial production (Dec)		0.5% (-1.6%)	0.3% (-1.9%)	1.1% (-3.8%)
	09:30	UK	Industrial production (Dec)		0.2% (-4.1%)	-0.3% (-4.6%)	0.4% (-6.0%)
	09:30	UK	Manufacturing production (Dec)		0.3% (-3.0%)	0.3% (-3.0%)	0.0% (-5.4%)
	13:30	CA	Int'l merchandise trade (Dec)		-0.2B	-0.1B	-0.3B
	13:30	US	Trade balance (Dec)		-\$35.5B	-\$36.0B	-\$36.4B
	15:00	UK	NIESR gdp estimate (Jan)		n/a	n/a	0.3%
	19:00	US	Monthly budget statement (Jan)		-\$70.0B	-\$60.0B	-\$63.5B
<b>Thu 11th</b>							
	00:30	AU	Employment change (Jan)		15.0K	22.0K	35.2K
	00:30	AU	Unemployment rate (Jan)		5.6%	5.6%	5.5%
	02:00	CH	Consumer price index (Jan)		(2.2%)	(2.2%)	(1.9%)
	13:30	US	Advance retail sales (Jan)		0.3%	0.3%	-0.3%
	13:30	US	Retail sales less autos (Jan)		0.4%	0.5%	-0.2%
	13:30	US	Initial jobless claims (Feb-06)		456K	445K	480K
	15:00	US	Business inventories (Dec)		0.4%	0.4%	0.4%

**8 - 12 February 2010**

Country	Time	Event	Actual	Consensus	Forecast	Previous
<b>Fri 12th</b>						
	07:00	GE	Gdp s.a. (Q4 P)	0.2% (-2.2%)	0.2% (-2.2%)	0.7% (-4.8%)
	07:45	FR	Gdp (Q4 P)	0.5% (-0.3%)	0.3% (-0.5%)	0.3% (-2.3%)
	10:00	EC	Euro-zone ind. prod. Sa (Dec)	0.1% (-1.7%)	0.0% (-1.8%)	1.0% (-7.1%)
	10:00	EC	Euro-zone gdp s.a. (Q4)	0.3% (-1.9%)	0.4% (-1.9%)	0.4% (-4.0%)
	14:55	US	U. of Michigan confidence (Feb P)	74.8	75.3	74.4

**Key events of the week**

**Mon 8th** CA Bank of Canada Deputy Governor Duguay speaks in Lewis in Quebec (17:45)

**Tue 9th** UK DMO to auction £2bn of 4.5% gilts due 2034 (10:30)

US Treasury to sell \$40bn of 3-Year notes (18:00)

**Wed 10th** EC Germany to sell €5bn of 10-Year bonds (10:15)

US Fed member Tarullo speaks in Washington (14:30), Treasury to Sell \$25bn of 10-Year notes (18:00), Fed's Plosser speaks in Philadelphia on Financial Crisis (17:45)

UK Bank of England releases its Quarterly Inflation Report (10:30)

**Thu 11th** UK DMO to sell £900mn of 1.875% index linked gilts due 2022 (10:30)

US Treasury to sell \$16bn of 30-Year Bonds (18:00)

EC ECB Publishes (Feb). Monthly Report (09:00)

CA Bank of Canada David Wolf & OMERS Ted Carmichael in Toronto (16:45)

**Fri 12th** EC ECB's Nowotny speaks in Vienna (08:00)

Source: Bloomberg

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