Cabinet Office
The Strategy Unit

BIS | Department for Business Innovation & Skills

How can the UK achieve sustainable economic growth in the future?

Introductory presentation by the Strategy Unit & the Department for Business, Innovation and Skills

HANDOUT PACK

This presentation introduced a seminar on 23rd September 2009 at the Cabinet Office, Admiralty Arch.

THIS IS A DISCUSSION PACK. IT IS NOT A STATEMENT OF GOVERNMENT POLICY

This presentation analyses patterns in sector growth performance across the UK and identifies future prospects

This presentation:

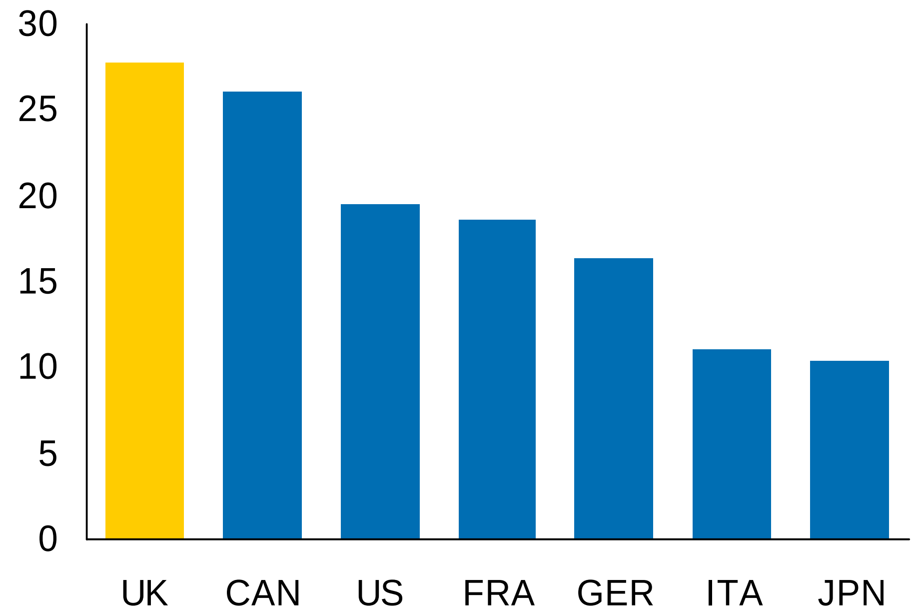
- Examines, briefly, how the UK as a whole has performed
- Touches on the current downturn and the possible rebalancing required for sustainability
- Focuses on the drivers of productivity, to boost growth in the longer term
- Uses sector analysis to unpick where growth has come from in the last decade
- Highlights that different parts of the economy have grown for different reasons
- And presents some indicators suggestive of the future prospects for different sectors

The UK has seen strong economic growth over the last decade

Between 1997 and 2007 the UK outperformed most of its closest competitors…

- Real GDP grew at an average rate of 3% per year
  - *Compared to the US (3%), France (2.3%) and Germany (1.5%)*
- Real output per worker grew at an average rate of 2.2% per year
  - *Compared to the US (2%), France (1.8%) and Germany (1.7%)*
- The UK saw the fastest GDP per capita growth of the G7 economies
- Despite this, there still exists a labour productivity level gap with key competitors, notably the U.S.

Percentage increase in real GDP per capita, G7 countries, 1997-2007



But recent events have highlighted that stable growth will require a more balanced demand side

Growth became unbalanced...

- Households consumed an increasing share of their income
- And accumulated large amounts of debt
- Overall the UK has been spending more than it earns
- Led to a rising current account deficit
- Major contributors to this deficit were household and government sectors
- Overall, increasing amount of national income went into consumption and investment in housing

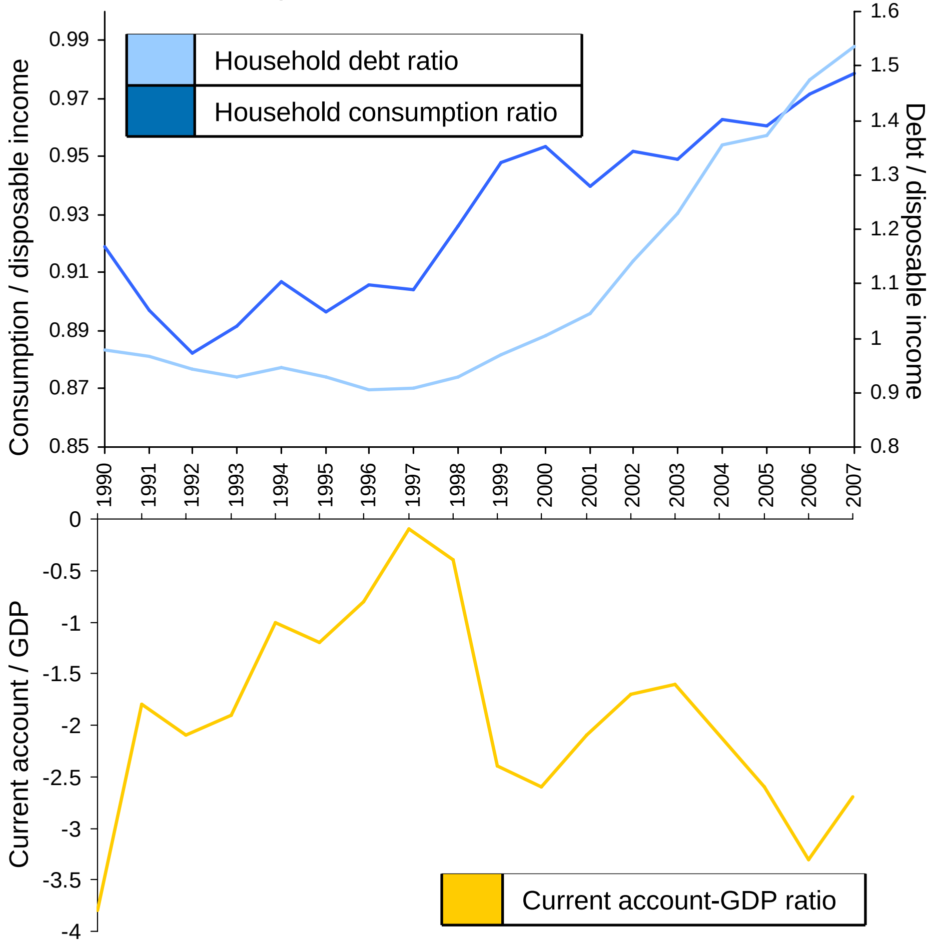
Sustainability requires changes...

- Households will need to rebalance portfolios, saving more
- For higher savings to be compatible with sustainable recovery, investment and net exports need to rise
- But with more attention to the long run growth drivers

– *What is the right amount of rebalancing?*

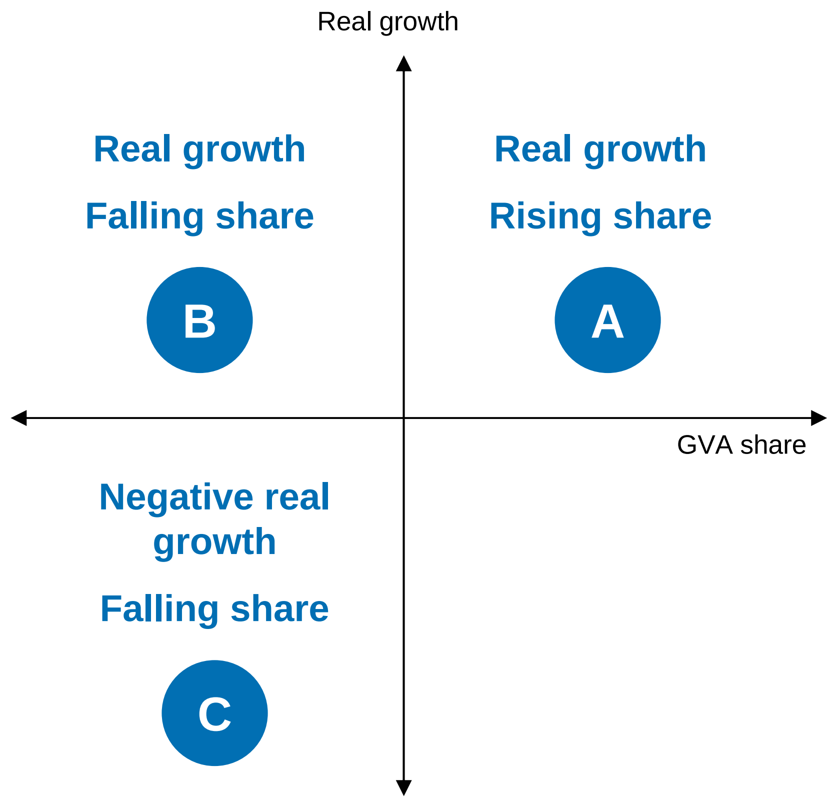
– *What is the appropriate speed to encourage this?*

Households consumed ever more of their income and the economy as a whole borrowed from abroad



On the production side of the economy, identifying sector differences helps us understand the sources of growth in the UK

- In rebalancing the UK economy, it's important that growth is accompanied by increases in productive capacity, not from demand
- Requires renewed focus on the supply side determinants of productivity growth
- Examining the production side of the economy allows us to see where growth has come from in the past
- How can we measure which sectors have grown?
- Consider **two simple measures** of sector growth:
  - **Real gross value added growth**
  - **Change in sector's share in aggregate gross value added**
- This gives us **three quadrants** of interest:
  - *A. Growing in real terms and as a share of the economy*
  - *B. Growing in real terms but falling as a share of the economy*
  - *C. Contracting in real terms and as a share of the economy*
- For each of these quadrants we use a number of measures to understand the patterns of growth within the group



(A) The UK's fastest growers saw large investments in ICT and strong total factor productivity growth

- All these sectors have grown in real terms and as a share of the economy
- Even within this group, strong differences, particular between leading three and the rest:

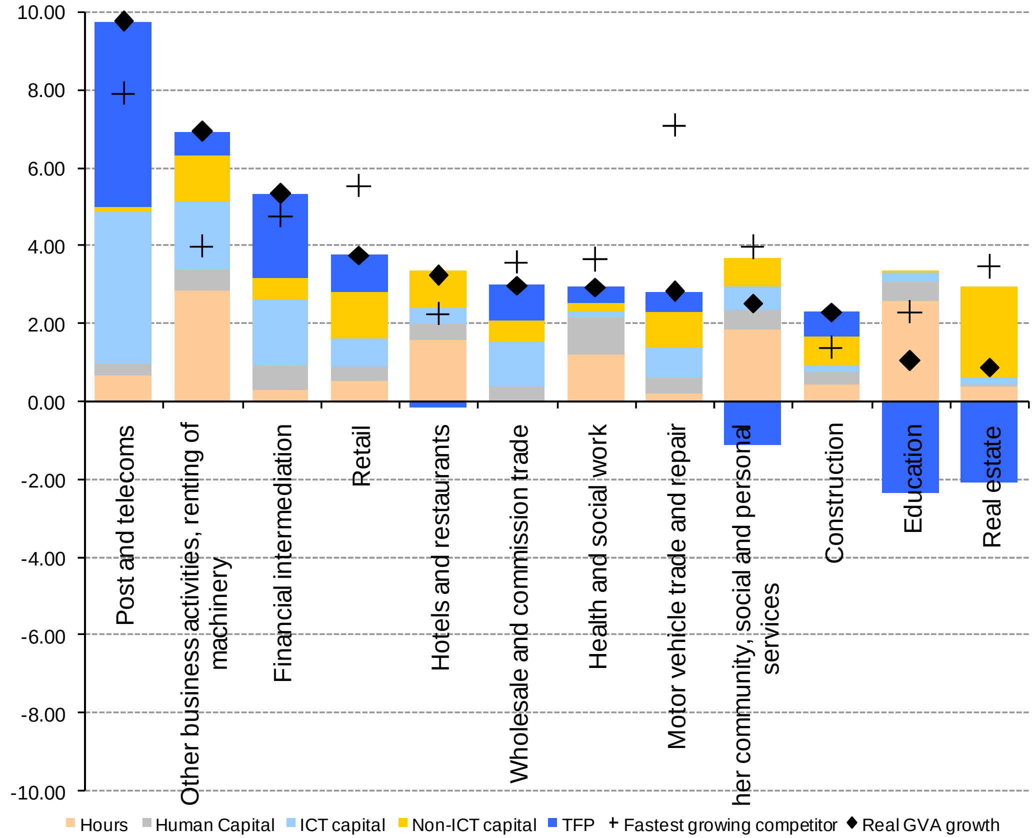
Leading 3 performers (tradable services)

- Had strong growth, particularly associated with effective investment in ICT capital (strong additional TFP growth)
- Grew faster than US, French and German counterparts
- As well as having strong trade performance

Other sectors (primarily non-tradable services)

- Labour input accounting for a stronger proportion of growth in a number of sectors (hotels/rest, health, personal services, education).
- Often low skilled and TFP level gap with the US
- If relative prices had been held at 1997 levels, many of these would have had a falling share

Growth accounting decomposition, sectors growing in real terms and as a share, 1996-2005



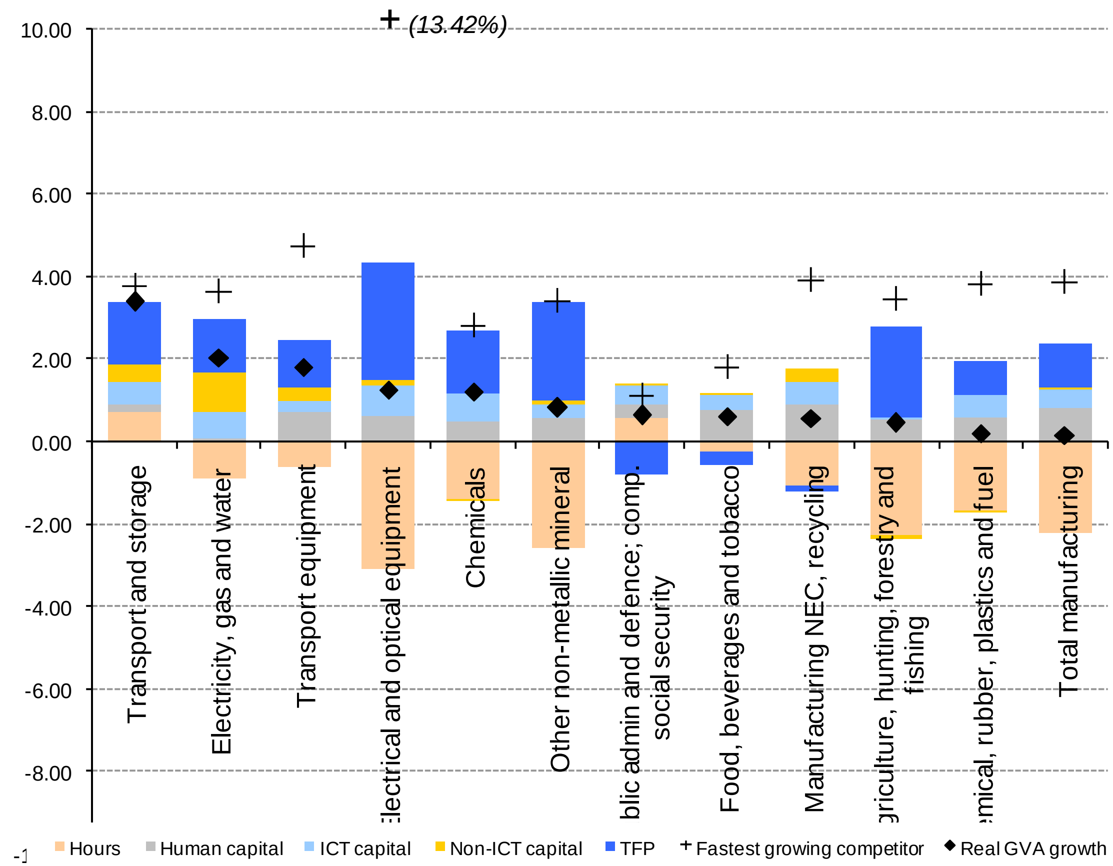
(B) Growing sectors with a falling share often exhibit strong total factor productivity growth, but lag behind our competitors

- All these sectors have grown in real terms but fallen as a share of the economy
- Many of these sectors invested in ICT and skills and saw additional strong TFP growth
- But output grew slowly, consistent with falling employment
- Consistent with productivity growth leading to falling prices, leading to labour savings
- If prices were held constant at 1997 levels, many of these sectors would have seen a rising share
- All these sectors lagged competitors in terms of growth

– *Does lagging performance suggest a failure compete well in global markets?*

– *How do we improve performance?*

Growth accounting decomposition, sectors with real GVA growth but a falling share (1996-2005)

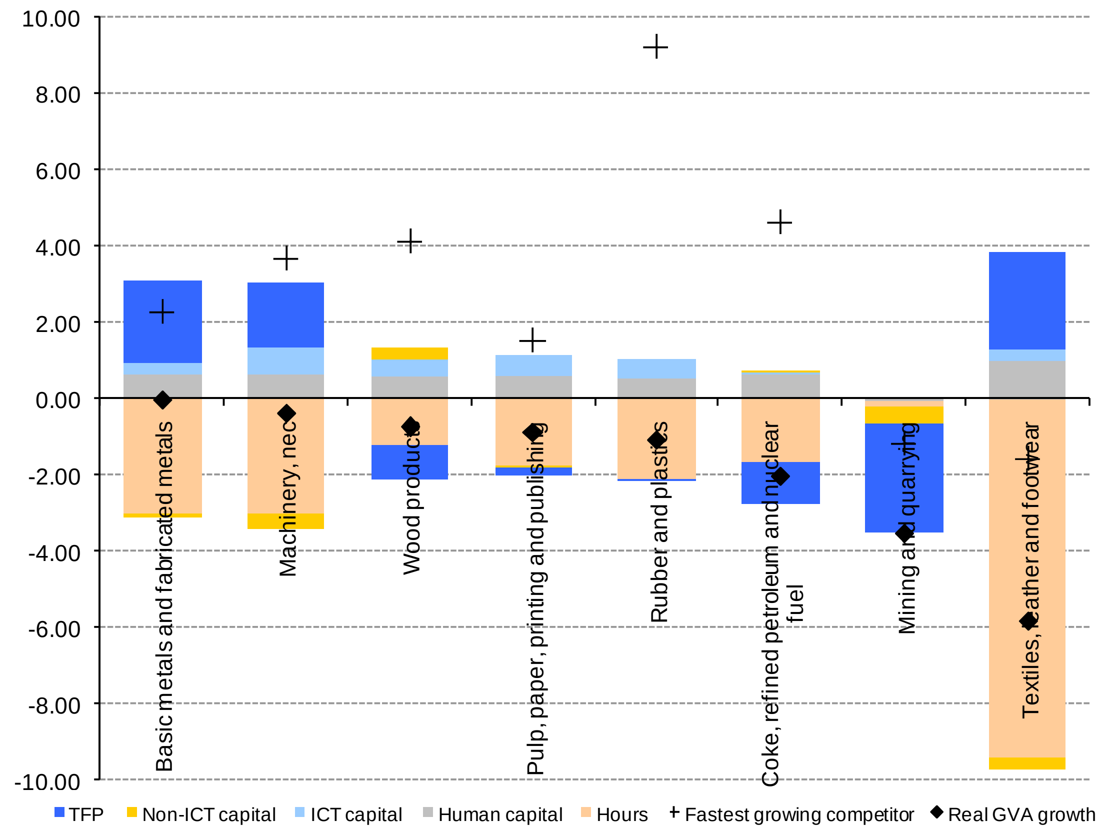


(C) Sectors with falling output and shares have seen big falls in employment, often without much investment or productivity growth

- All these sectors have falling real GVA and are contracting as a share of the economy
- Widespread labour shedding
- Little or no ICT investment, unlike the previous group
- Sectors are those where low-wage competition is strong

– *What should government's approach be for these sectors?*

Growth accounting decomposition, falling real GVA and share (1996-2005)



In summary, the UK has quite a diverse economy, with many success stories

- **Overall**
  - There has been widespread up-skilling
  - With good investment in ICT capital
  - Many service sectors and high tech manufacturing performed well

- **But there is a lot of diversity**
  - Group A sectors show a lot of variation, with several of the service sectors lacking productivity growth, relying on employment growth
  - Group B sectors have mostly seen growth associated with TFP, while their overall growth has been pulled down by labour shedding
  - Group C sectors mostly appear in decline; falling shares and real GVA without productivity growth

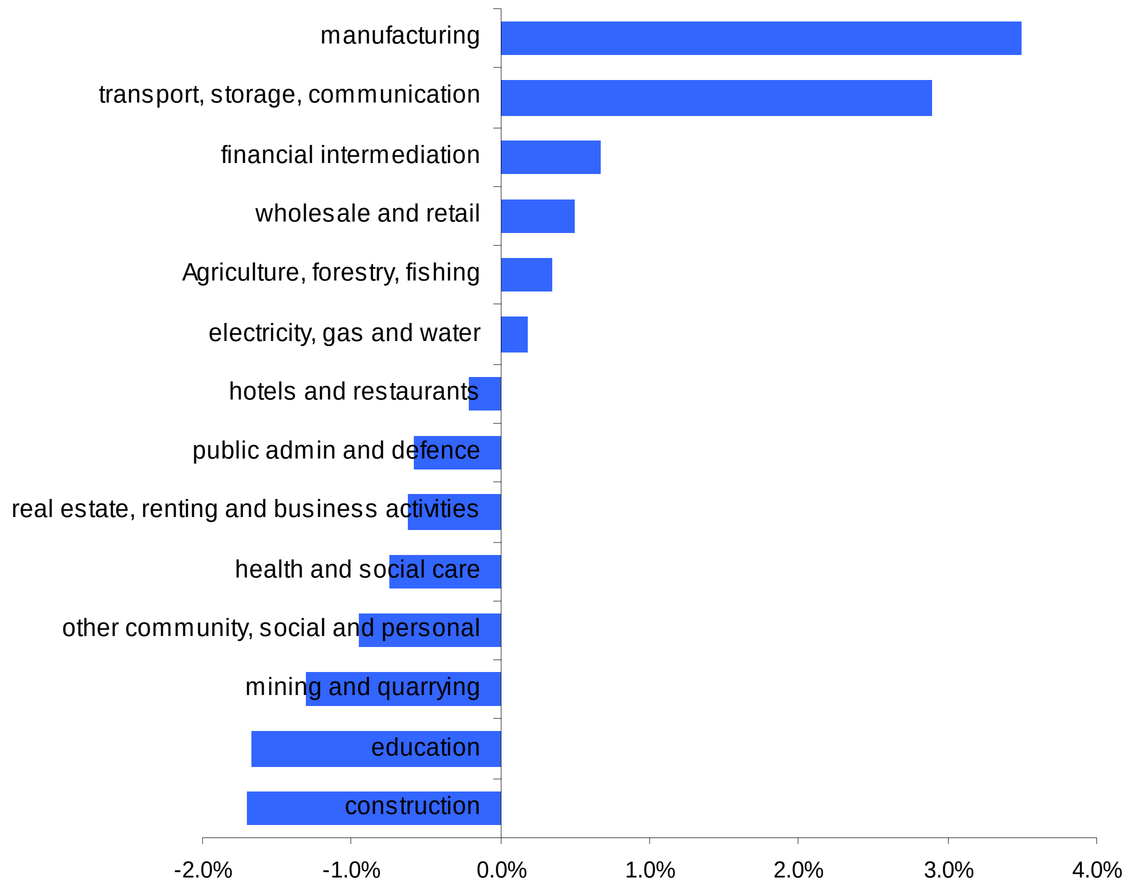
- **Looking into the crystal ball…**
  - Using three particular lenses – relative price/productivity growth, comparative advantage, and future demand – we can attempt to understand whether these growth patterns will continue

An interpretation of this focuses on changes in relative prices, which are likely to be important for future GVA and employment shares

- **Baumol effect**: Less scope for productivity growth in some industries raises relative costs/prices and lead to increasing shares of GVA
- If relative prices from 1997 had held constant until 2007 manufacturing, transport/comms would have **up to** 3% higher share of the economy (price effect may have reduced this)
- Technological development and off-shoring/global competition will continue to impact on relative prices.
- *Interestingly, Baumol (1985) draws the distinction between:*

1. 'Stagnant personal services' – quality reflects labour time expended; lack of standardisation reduces scope for productivity growth
2. Progressive impersonal services – e.g. telecoms.

Implied change in 2007 share if prices remained at 1997 levels



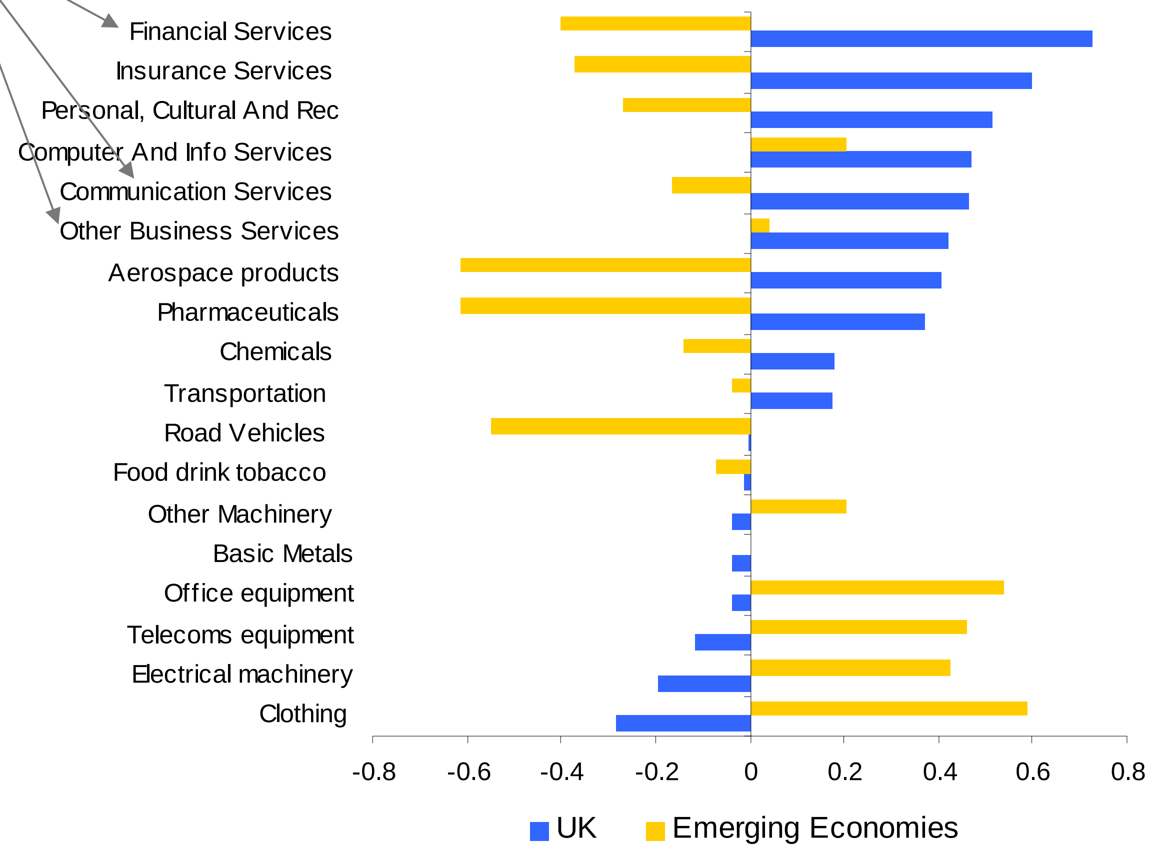
Many sectors are well placed for the future, the UK's strengths are largely distinct from those of the developing economies

- UK's top 3 growth performers (group A) have distinct comparative advantages
- Comparatives advantages largely in tradable services and some high end manufacturing
- UK has benefited from being specialised in higher skilled and innovative manufacturing and service sectors
- Sectors where competition from low-wage economies is weakest
- Likely to continue to offer greatest scope for UK companies in global markets

– *Are these our 'natural' comparative advantages?*

– *Can new comparative advantages be created?*

Revealed comparative advantage: UK versus developing economies

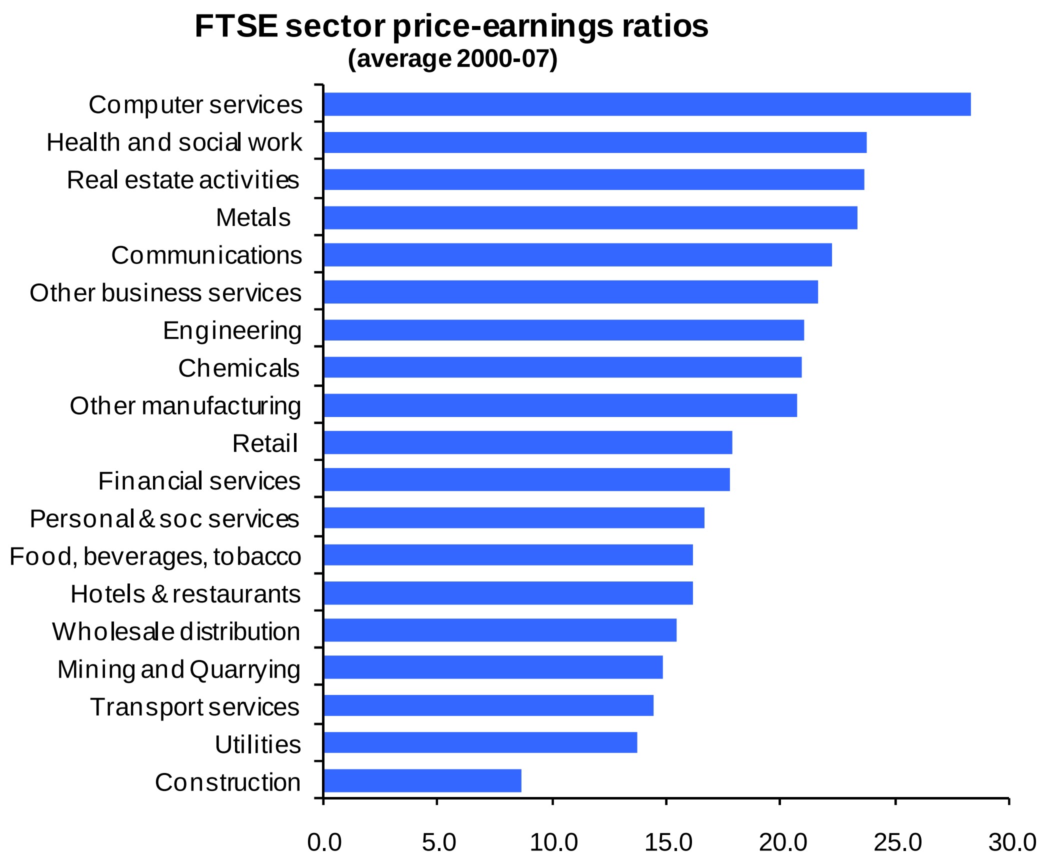


And many sectors stand to benefit from changing patterns of demand in the world and at home

NINJ identified a selection of changes which present important opportunities:

- **Growing global prosperity**
  - Demand from rich countries and BRIC middle class supports consumer parts of our high skill economy, e.g. high tech goods and tradable services
- **Environmental standards and move to a low carbon economy**
  - Creates a host of new green services and technologies
  - On green services carbon price infrastructure creates opportunities around carbon finance for group A
  - On green technology, new wind, wave and carbon capture and storage (CCS) technologies provide new opportunities for advanced manufacturing, often group B sectors
- **Ageing population**
  - Demand for higher quality healthcare plays to our strengths in pharmaceuticals and life sciences
  - Increasing demand for low skill services, such as social care, P/E ratio might reflects this
  - But may draw in workers from higher productivity sectors, so improving productivity in these sectors vital
- **New technologies**
  - E.g. new ICT technologies allow further unbundling of supply chains, new access to foreign markets
  - New technologies could accelerate decline in some B and C sectors; but may open up new niche markets

These trends are reflected in market expectations of possible growth sectors



- Some overlap with previous strong performers
  - strongly growing services (group A)
  - manufacturing with strong productive growth
- Also good prospects for a few of the UK's slower growing, low productivity sectors:
  - e.g. health and social work
  - expected to do well – perhaps reflecting expectations of rising demand
- Other slow growing services have more average prospects
  - e.g. hotels and restaurants, wholesale

Conclusions

- Rebalancing overall demand is likely to be important for sustainable growth
  - *What is the right amount of rebalancing?*
  - *What is the appropriate speed to encourage this?*
- Focus on the drivers of productivity growth, and different parts of the economy have grown for different reason
- UK's strongest growing sectors have been in tradable services (with strong ICT investment and TFP growth)
  - *What policy lessons can we learn from the successful sectors for other sectors?*
  - *To what extent should we focus on widening the range of UK manufacturing strengths, creating new areas of comparative advantage?*
  - *How is the changing nature of low-wage competition likely to impact on UK sector prospects?*
- Likely to see a continuing rise in the share of employment in non-tradable services, often lacking strong productivity growth
  - *What can we do to raise productivity (growth and levels) in these sectors?*
  - *What is the right balance between focussing on capturing international market share in tradable sectors and improving productivity in low productivity, non-tradable services?*