

# CHAPTER 4

## THE RELATIVE DECLINE OF THE UK MANUFACTURING SECTOR

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### Introduction

The analysis in Chapter 1 of this *Review* suggests that if traditional policy instruments are relied on it will become increasingly difficult to secure full employment with a satisfactory balance-of-payments position. In this chapter we examine the long-term decline of the UK manufacturing sector relative to that of its main competitors, which is the main cause of the macro-economic problem. The manufacturing sector plays a key role in securing a satisfactory balance-of-payments position because it not only accounts for a large proportion of our exports but must also supply the bulk of the home market with manufactured goods which would otherwise have to be imported. Moreover it is the manufacturing sector to which we look as the main source of technical progress, economies of scale, increasing output per man and economic growth. The performance of this sector therefore impinges more than any other on the achievement of the general economic objectives of full employment, a satisfactory balance of payments and rising living standards. Any strategy for achieving these objectives in the future must prove itself capable of reversing the relative decline of UK manufacturing industries. An alternative strategy concentrating on the promotion of net exports of the service sector is unlikely to be an adequate substitute, although more exports from all sectors are needed.<sup>1</sup>

The poor performance of the UK manufacturing sector manifests itself in two main ways – a growing lack of competitiveness in foreign trade, and slow growth of industrial capacity. These two aspects are inextricably bound up together and reinforce each other. A growing lack of competitiveness embracing not only (and perhaps not even mainly) relative prices, but also quality differences, design characteristics, delivery dates and after-sales service, both contributes to and results from relatively slow growth of industrial capacity.

This chapter presents empirical evidence to show that the problem is a real and serious one and considers alternative diagnoses of the nature and causes of the relative decline of the UK manufacturing sector. We then examine the minimum requirements of a policy package capable of slowing down and reversing the decline, and review the main alternative policies which have been proposed to this end.

<sup>1</sup>Much of the strength in the invisible account accrues from such items as interest, profits and dividends, rather than from the export of services. The contribution of services to export earnings is less than half the contribution of manufactures and the balance of trade surplus on services is also about half that in manufactures. In the absence of a strong manufacturing sector it is difficult to see how the net export of services such as shipping, air transport, banking, insurance and tourism could expand by the required amount.

### Measures of the relative decline of the UK manufacturing sector

Direct measures of competitiveness in foreign trade and of growth of industrial capacity are difficult to find. Most indicators are likely to reflect both.

Competitiveness can perhaps best be measured in terms of its effects on the volume of exports and imports. It will be shown that, relative to other industrial countries, UK exports have steadily lost ground and that the downward movement in export share has continued in spite of nominal improvements in UK costs relative to competitors. It will also be shown that the penetration of imported manufactured goods into the UK domestic market has accelerated since 1969 relative to import penetration in other industrial countries, after allowing for differences in growth rates. Moreover, there is no reason to think that import penetration has yet reached the point of saturation.

As an indicator of capacity, investment in UK manufacturing industries is shown to be historically low relative to that in other industrial countries; from 1970 onwards it actually fell in absolute terms.

#### *Export shares of the UK and major competitors*

Table 4.1 shows the share of each of the six major industrial countries in exports to the other five in selected time periods.

- (a) 1963–7 – a period of fixed exchange rates
- (b) 1967–70 – post UK devaluation with fixed exchange rates
- (c) 1970–4 – flexible exchange rates with UK joining the EEC.

**Table 4.1 Share of each of six major industrial countries in exports to each other.**

	1963	1967	1970	1974
UK	14.4	12.0	10.1	9.7
Germany	23.6	24.9	23.6	25.0
France	14.3	13.7	14.6	16.1
Italy	10.5	12.8	12.6	11.4
USA	28.7	25.4	24.8	23.7
Japan	8.3	11.2	14.3	14.1

Note: The figures are based on data published in the IMF *Direction of trade manual*, converted to constant 1970 prices in dollar terms using implicit price deflators obtained from OTS values and volumes data and WEP (75) 43 export prices (all commodities) \$ terms.

For the period 1963–74 the UK share of exports to the industrial countries fell by almost a third. This contrasts sharply with the experience of other countries, except the USA whose share fell half as much as that of the UK. The fall in the UK share, although less marked in recent years, continued after the sterling devaluation of 1967 and the downward float of the

**Table 4.2** The change in each industrial country's export share of the group as a whole compared with changes in each country's export price competitiveness relative to the group as a whole

	UK	USA	France	Germany	Italy	Japan
<i>1963-7</i>						
A (absolute change in export share)	-2.4	-3.3	-0.6	+1.3	+2.3	+2.9
B (change in export price of manufactures relative to those of the group as a whole)	+4.5	+4.0	+1.9	-1.2	-7.0	-5.7
<i>1967-70</i>						
A	-1.9	-0.6	+1.3	-1.3	-0.2	+3.1
B	+0.7	-0.1	-5.9	+3.5	-1.0	-0.1
<i>1970-4</i>						
A	-0.4	-1.1	+1.5	+1.4	-1.2	-0.2
B	-3.0	-13.4	+3.1	+8.6	-2.8	+14.2

Note: The data for 'B' rows are an index (1970 = 100) of export prices of manufactures in dollar terms. Each country's index is expressed as a ratio of the index for the group as

a whole. The figures show the change in percentage points in this ratio in each time period.

early 1970s. Likewise Germany's export share remained buoyant in the 1970s in spite of upward revaluations of the Mark.

More detailed analysis of each of these countries' exports into individual third markets revealed that the UK share fell in almost all of them between 1963 and 1974 (in many cases the share was more than halved) and that there was a clear tendency for the UK export performance to be relatively weaker in rapidly growing markets.

Table 4.2 shows that in the period 1963-7, and also from 1967 to 1970, changes in export share (row A) moved broadly in line with changes in price competitiveness (row B), in the sense that *a priori* expectations of opposite signs (i.e. the export share rising when relative export prices fall) are largely fulfilled.

The same cannot be said for the period 1970 to 1974. Germany, France and Japan held or increased their export share in spite of having experienced a relative rise in manufactured export prices, whereas the UK, the USA and Italy all suffered a decline in export share during a period in which their manufactured export prices fell significantly relative to their major industrial trading competitors. There is no presumption here that price elasticities on imports and exports are either low or declining - indeed these are quantified and found to be substantial in this *Review*. The implication must be that the impact of price elasticities has been more than offset by other factors working in the opposite direction.

#### Import penetration

Table 4.3 shows, for selected industrial countries, the degree to which manufactured imports have penetrated the home market.

An earlier study<sup>2</sup> covering the period 1963 to 1970 showed that the level and the increase in import penetration of manufactured goods into the UK domestic

market was not significantly greater than in many industrial countries. Table 4.3 shows that from 1969 to 1974 there has been an increase in import shares in all countries except Germany. However, it has accelerated particularly rapidly in the UK, where the percentage share of imports has increased by almost two-thirds, compared with Italy at about one-third, the USA at 27%, and France and Japan at about one-fifth.

**Table 4.3** Import penetration of manufactured goods into the UK and other selected industrial countries 1969-74

Country	Manufactured imports as a percentage of the domestic market*		
	1969	1974	% change 1969-74
United Kingdom	10.2	16.7	63.7
Germany	13.4	11.8	-11.9
Italy	15.2	20.1	32.2
France	12.1	14.3	18.2
United States	3.7	4.7	27.0
Japan	3.1†	3.7	19.4

Source: United Nations, *The growth of world industry*, Vol. 1 and OECD, *Foreign trade statistics*.

\*  $\frac{M}{V - X + M} 100$  where

M = Imports of manufactures at 1970 constant \$ prices.

X = Exports of manufactures at 1970 constant \$ prices.

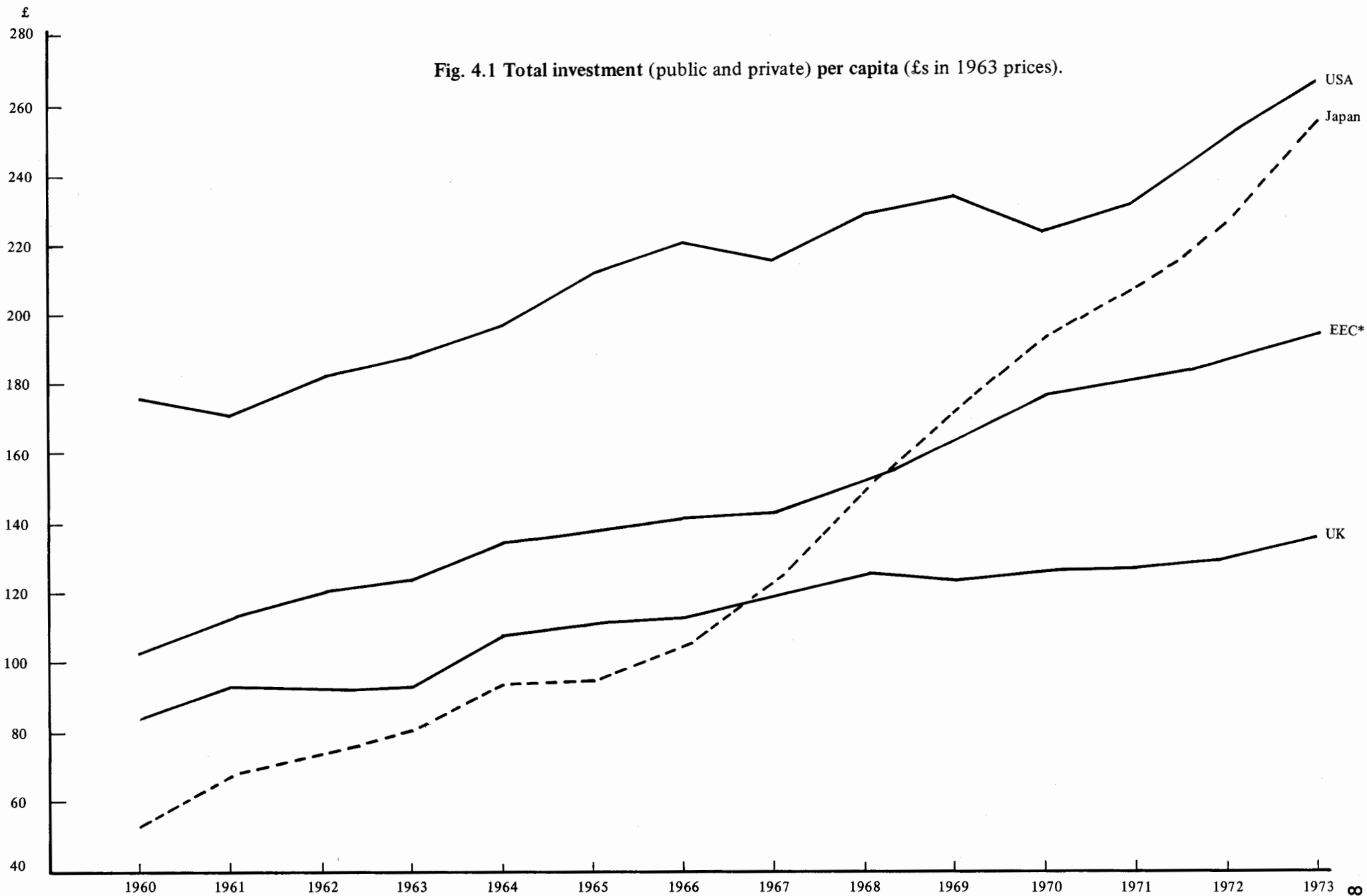
V = Value of gross output at 1970 constant \$ prices.

† 1970 share.

This conclusion is supported in Table 4.4, which shows a marked acceleration in the penetration of manufactured imports into the UK market after 1970.

Yet, as Table 4.3 shows, import penetration into the UK by 1974 had still not reached the level experienced in Italy. This might be indicative of a situation in

<sup>2</sup>T. F. Cripps and R. Tarling, *Cumulative causation in the growth of manufacturing industries*, DAE mimeo, 1975.



\*The original six members.

**Table 4.4 Manufacturing import penetration in the UK, 1960-75**

Change in the % share of manufactured imports in domestic sales		
1960-5	1965-70	1970-5
+1.0	+3.0	+5.6

Sources: *National income and expenditure*, 1970 input-output table and *Overseas trade statistics*.

which import penetration into the UK market could go on rising. Certainly there are no *a priori* reasons for thinking that the limit to import penetration has been reached and in the absence of more effective policies aimed at revitalising the manufacturing sector further import penetration is likely to take place.

*Investment*

Fig. 4.1 shows *total* investment per capita in real terms for the UK, the original six members of the EEC, Japan and the USA. By 1973 investment per head in Japan and the USA was about 80% higher than in the UK and in the EEC it was 40% higher than in the UK. All three groups were gaining relatively to the UK, particularly after 1970.

But the main concern is with *manufacturing* investment, where the UK performance is particularly

**Table 4.5 Gross domestic fixed capital formation per 1000 operatives in manufacturing industries (£'000 at 1963 prices)**

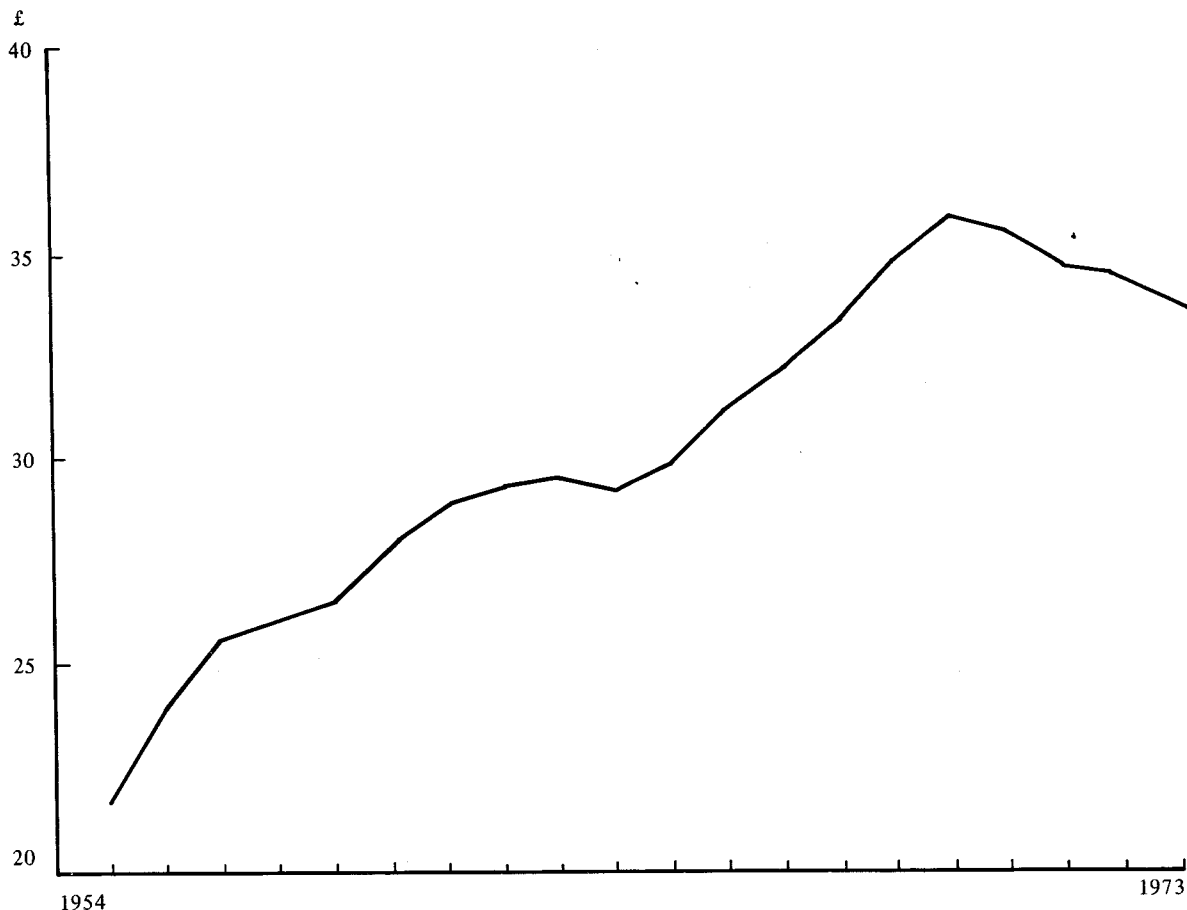
Average for period	Japan	Germany	UK
1963-7	301	306	207
1968-71	597	380	262

Source: OECD statistics.

disappointing. Table 4.5 compares investment per operative in manufacturing in two periods - 1963-7 and 1968-71 - for the UK, Germany and Japan.

In Germany investment per operative has remained about 50% higher than in the UK over both periods. In Japan it was 50% higher in the first period but more than double that for the UK in the second period.

Manufacturing investment in the UK, expressed as a share of total investment, fell from 27% in 1956/7 to 19% in 1975. When real manufacturing investment per capita in the UK is examined over the past 20 years in the form of a four-year moving average, 1971 to 1975 is the first period of any length in which investment in manufacturing was in actual decline (see Fig. 4.2).



**Fig. 4.2. UK manufacturing investment per head of population, four year moving average (using data from 1952 to 1975, £s at 1970 prices).**

### Alternative explanations of the relative decline of the UK manufacturing sector

Views on the nature and causes of the problem fall into three main groups:

#### (1) *The UK economy 'prices itself' out of world markets*

This view stems from traditional international trade theory and maintains that there has been a persistent tendency for wages and industrial costs to rise relative to those in other countries and that this has made British products uncompetitive in export markets. The main requirement for a solution is therefore to secure an improvement in competitiveness by a downward adjustment of UK relative prices.

While not denying that relative prices are a contributory factor, the thesis that they are all-important is not convincing, particularly in view of the UK experience over the last decade. From 1967 onwards there is evidence that the tendency for UK costs to rise more rapidly than those of our main competitors has been more than offset by a depreciation of the exchange rate, thus maintaining export prices at a 'competitive' level over the last 8 years (see Table 4.6). Yet the UK net balance of trade in manufactured goods was lower between 1973 and 1975 than at any other time in the post-war period. This further supports the view that the benefits of devaluation have been offset by other adverse factors.

**Table 4.6 UK balance of trade and relative prices of manufactured goods, 1963-75**

Year	UK balance of trade in manufactures (£m at 1970 prices)	Index of UK relative price competitiveness
1963	2357	101.3
1964	2084	101.9
1965	2332	105.2
1966	2273	106.6
1967	1846	105.8
1968	2138	99.7
1969	2659	98.7
1970	2256	100.0
1971	2481	100.9
1972	1662	99.3
1973	1478	92.2
1974	1613	90.5
1975	2172	n.a.

Source: *Overseas trade statistics*.

#### (2) *The 'crowding out' hypothesis*

Proponents of this view maintain that British industry has failed to prosper because it has been 'crowded out' or robbed of resources by rapid expansion of the public sector. Industry is said to be crowded out in any or all of three ways – that it is deprived of labour, unable to obtain finance or over-taxed.

On the first, there is little evidence to suggest that the labour supply constraint facing the manufacturing sector has been binding<sup>3</sup> or that it has become more marked in recent years than in (say) the 1950s. Indeed, the evidence would suggest the opposite – namely that from 1966 UK manufacturers have been releasing labour almost continuously onto a labour

<sup>3</sup>Except in the short-term sense that a sudden boom (e.g. 1972-3) found employers caught short after prior run-down of their labour forces.

market under less pressure than occurred in the 1950s. Many of our industrial conurbations are located in regions in which the labour market throughout the post-war period has been depressed by the standards of industrial countries generally.

Secondly, there has been increasing concern over the ability of companies to obtain the financial resources necessary to undertake investment in new plant and machinery. This concern has been fostered by a squeeze on internally generated funds as a source of finance for firms, which became particularly acute in the period of accelerating inflation in the 1970s as a consequence of very rapid stock appreciation. Although firms in the UK have traditionally relied on internal sources of funds for new capital investment, external sources of finance are potentially available for profitable projects. The main problem seems to lie in the terms under which external finance is available (mainly fixed-interest), but this is a function of the structure of the capital market itself and is quite unrelated to the size of public sector borrowing.

Thirdly, while adequate profits are a necessary condition for investment, the view that profit margins have been squeezed by increases in company taxation to such an extent as to reduce investment is not convincing. On the contrary the evidence shows that the effective company tax rate (after allowing for investment grants and allowances) has fallen sharply in post-war years, preventing any substantial decrease in net profit margins, at least until the early 1970s. The slow growth of demand, shortages of liquidity and a declining real rate of return on capital have presented a much greater threat to investment than increases in corporation tax.

#### (3) *Cumulative causation*

In many respects the theory of cumulative causation offers the most convincing explanation of the long-run relative decline of the UK manufacturing sector. Briefly the main argument is that the growth in productivity of the industrial sector in Britain has in post-war years consistently failed to match that of our major competitors. This low growth in productivity is both a cause and consequence of a lack of competitiveness in world markets, and a slow rate of growth of domestic demand, arising from the need to correct persistent balance-of-payments problems (made more difficult in the 1950s and 1960s by adherence to fixed exchange rates and in the 1970s by the increasing failure of exchange rate adjustments to maintain export shares in anything but the short term). The slow rate of growth of both domestic and foreign demand has in turn been associated with a low rate of investment by the manufacturing sector and a low rate of expansion of productive capacity relative to other industrial countries. Low levels of investment imply a relatively slow rate of adaptation by industry to technical progress, particularly in growth industries, to changing demand and innovation in product ranges and to the need to modernise whole production and marketing processes.

Thus the vicious circle having been established in the UK for a decade or two, unimpeded competitive forces result not in improved efficiency and productivity but rather in a reinforcement of the process of cumulative decline to the benefit of more prosperous

trading rivals, whose growth of productivity and efficiency is higher. The longer the process goes on the more difficult it is for governments to reverse it by policy intervention. Frustration with the declining economic performance also adds to the difficulties of government, industry and trade unions in reaching agreement, even though all would like to see an acceleration in the rate of growth of productivity and output.

By contrast rapidly growing economies experience a 'virtuous' circle of cumulative expansion. Gains in market shares enable such countries to secure fast growth of demand while maintaining a favourable balance of trade. Rapid growth of the domestic market then ensures fast growth of domestic industries and rapid improvement in productivity – which in turn leads to further gains in market shares.

**Minimum requirements for a solution and policy options**  
The minimum requirements for a substantial relative improvement in UK industrial performance are:

- (i) alleviation of the balance-of-payments constraint over the medium term;
- (ii) substantial growth in industrial capacity, implying higher rates of investment;
- (iii) a high and, if possible, steady growth of demand together with greater confidence that it can be sustained.

All three requirements are closely related. A high and steady growth of demand could not be secured unless the balance-of-payments constraint was alleviated and a high rate of growth of industrial capacity had already been achieved. But normally a higher rate of investment is contingent on a high and steady growth of demand. Moreover the balance of payments is a major constraint on securing both a high rate of growth of demand and higher rates of investment. The only way out of the vicious circle is to take new initiatives with respect to the balance of payments and investment. In each case there are two possible types of policy action, one relying on improving the working of the price mechanism, the other on more direct intervention and control.

For the balance of payments the main policy options which are not mutually exclusive are further significant devaluation of the exchange rate combined with effective wage restraint, import controls and fiscal incentives to encourage exports. Each would require to be effective for a long period, of ten years or more, to at first slow down and then reverse the relative decline. Devaluation and wage restraint, if sustained, would help manufactured exports, and thereafter demand, profits and investment. But on the evidence of the last decade this policy option would work slowly and with the inflationary impact via higher import prices it is very doubtful whether it can be sustained on a large enough scale for a sufficiently long period. Import controls should help the balance of payments directly, but the effect in the longer term would depend on the degree and timing of any retaliation on the part of foreign competitors. Controls on finished and semi-finished manufactures for consumer markets would have to be on a very significant scale indeed to have the desired effect and would only permit fast growth if associated with very substantial increases in manufacturing capacity. Finally, measures

specifically aimed at reducing the taxation of export profits, to bring it more into line with that of many of our industrial competitors, could also be considered.

To accelerate the growth in industrial capacity there are two main types of policy option – fiscal incentives and more selective direct public intervention. Investment incentives as operated in the past have been costly and ineffective at the national level (although much more effective at the regional level), but there are reasons for thinking that a major restructuring of these incentives towards a more selective incremental system could improve their effectiveness. Under such an incremental system investment incentives would be available at generous rates only *at the margin*. Firms would be expected to finance out of their own resources (with the help of existing tax allowances) a base level of investment equal in real terms to (say) the average achieved over the past five years. Thereafter firms could raise investment by a further amount (more or less in particular industries) and this marginal investment would be financed by generous investment inducements. Such a scheme would remove one important element of risk from companies investing ahead of demand.

More direct government intervention in the industrial sector is far from being a new phenomenon. One large manufacturing industry, steel, was nationalised in the 1960s and physical controls such as IDC machinery have been operated since 1948. Moreover serious attempts at improving the growth performance of manufacturing industry via indicative planning were made at the time of the National Plan in 1964 and have to some extent continued through the NEDO machinery. None of these have been sufficiently effective to halt or reverse the relative decline in UK manufacturing industry. For this approach to succeed it would have to be much more comprehensive and thorough than hitherto, combining several types of intervention. Direct public investment would be needed, at a minimum, to revitalise the weakest firms and industries (as recent events in the car and ship-building industries have proved). Planning at the level of individual firms (such as under the proposed machinery of planning agreements), backed by selective government assistance, would be needed to implement sectoral or national strategies of the kind which have hitherto been discussed through NEDO machinery.

The economic outcome of adopting any one of these policy options must be a matter of some speculation. In principle each one could make a contribution to the solution of the economic problem, but all may to some degree be 'unacceptable' on non-economic grounds at the present time. There must be some doubt as to whether it is now too late to tackle the problem effectively if only one of the policy options is to be adopted in isolation. An effective release from the vicious circle of cumulative decline may require a combination of some or all possible policy options to be applied. In formulating a viable industrial strategy the important point is that *ad hoc* and piecemeal intervention of a micro-economic kind will be to little or no avail, if at the same time concerted and sustained action to remove the macro-economic obstacles to more rapid industrial development is not also taken.