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John Mills  
**Institute for  
Prosperity**

# The Road to Recovery

Reviving Manufacturing after Coronavirus

John Mills



## THE COVID-19 REVIEW

How Britain responded to the Coronavirus

Part Three

# The Road to Recovery



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Reviving Manufacturing after  
Coronavirus

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Prosperity**

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# Contents

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Author	vii
Summary	ix
Introduction	1
1. Investment: generating economic growth	4
2. The cost base: costing manufacturing operations	7
3. Deindustrialisation	9
4. Borrowing and lending	12
5. New challenges	15
6. Recovery prospects	20
7. Remedies: reindustrialisation and boosting manufacturing	23
8. Globalisation	28
9. Faster growth	31
10. Countering the objections to a competitive exchange rate	34
Conclusions	44
Notes	50



# Author

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John Mills is an entrepreneur and economist with a life-long political background in the Labour Party, leading him to becoming its largest individual donor. He graduated in Philosophy, Politics and Economics from Merton College, Oxford, in 1961. He is currently Chairman of John Mills Limited (JML), a consumer goods company specialising in selling products requiring audio-visual promotion at the point of sale, based in the UK but with sales throughout the world. He was Member of Camden Council, specialising in Housing and Finance, almost continuously from 1971 to 2006, with a break during the late 1980s when he was Deputy Chairman of the London Docklands Development Corporation. He was a Parliamentary candidate twice in 1974 and for the European Parliament in 1979.

John has been Secretary of the Labour Euro-Safeguards Campaign since 1975 and the Labour Economic Policy Group since 1985. He has also been a committee member of the Economic Research Council since 1997 and is now its Vice-Chairman. During the period running up to the June 2016 referendum he was Chair of The People's Pledge, Co-Chairman of Business for Britain, Chair of Labour for a Referendum, Chair and then Vice Chair of Vote Leave and Chair of Labour Leave, which became independent of Vote Leave two months before the referendum.



John is the author of numerous pamphlets and articles and he is a frequent commentator on radio and television. He is founder of The Pound Campaign which regularly produces bulletins advocating that economic policy should be far more focused on the exchange rate than it has been for many decades, arguing that an over-valued pound has been largely responsible for UK deindustrialisation and our seriously unbalanced economy. He is the author or joint author of thirteen books, these being: *Growth and Welfare: A New Policy for Britain* (Martin Robertson and Barnes and Noble, 1972); *Monetarism or Prosperity* (with Bryan Gould and Shaun Stewart; Macmillan 1982); *Tackling Britain's False Economy* (Macmillan 1997); *Europe's Economic Dilemma* (Macmillan 1998); *America's Soluble Problems* (Macmillan 1999); *Managing the World Economy* (Palgrave Macmillan 2000); *A Critical History of Economics* (Palgrave Macmillan 2002 and Beijing Commercial Press 2006); *Exchange Rate Alignments* (Palgrave Macmillan, 2012); *Call to Action* (with Bryan Gould, Ebury Publishing 2015); *The Real Sterling Crisis* (with Roger Bootle, Civitas 2016); *Britain's Achilles Heel – Our Uncompetitive Pound* (Civitas 2017); *Economic Growth Post Brexit* (Bite-Sized Books 2019) and; *Left Behind: Why voters deserted social democracy – and how to win them back* (Civitas 2019).

# Summary

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This report argues that, as a result of misguided policy decisions over a long period, the UK economy is poorly positioned to recover from the Covid-19 pandemic, partly because it is so unbalanced and partly because our underlying growth rate is so low. The proportion of our GDP which we invest in our future is far below the world average and we do not spend money on the right projects. We have deindustrialised to a greater extent than any other advanced economy, with dire consequences for regional balance, good steady job prospects and increases in productivity which are much easier to secure in manufacturing than in services. Deindustrialisation has also left us with too little to sell to the rest of the world, as a result of which we suffer from chronic balance of payments deficits which in turn are directly responsible for us both getting deeper and deeper in debt and losing control over more and more swathes of our economy. Meanwhile both regional, intergenerational and socio-economic measures of inequality have all widened.

The root cause of all these problems is over-reliance on services at the expense of manufacturing. For many years we have run our economy with a relatively high exchange rate. This suits services, which are not particularly price-sensitive and where we have natural advantages in our language, our geography, our legal system, our universities and our skilled labour force. Too strong a pound, however, is lethal

for siting new manufacturing facilities in the UK. It has made it impossible to invest in the mechanisation, technology and power which are the keys to the successful restructuring and expansion of our economy. We are going to need very badly a stronger industrial base as we recover from the coronavirus pandemic and prepare to shoulder other heavy cost pressures over the coming decade from climate change, health expenditure, social care, pensions and training needs. Without a much stronger manufacturing base than we have now, we will not avoid UK living standards being lower in 2030 than they were in 2019 or even 2007.

A strong pound may be popular with the City, with importers, with those who value highly their cheap holidays abroad and low prices in our stores but the cost is low growth, overstrained public services and stagnant incomes. The real choice we have in front of us is between export- and investment-led growth or import- and debt-led stagnation.

# Introduction

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The coronavirus pandemic has harshly exposed us all to how vulnerable we have become to disruption to our way of life and our economy. Eventually, nevertheless, all the indications are that we will find a way of emerging from lockdown, and economic recovery will get under way. What can we say, however, about the form this may take? How long is it likely to be before we get back to the GDP level we achieved in 2019 – and what is the prognosis beyond this point? What is going to happen to productivity and living standards over not only the next two or three years but during the coming decade? Where are we going to be with globalisation? Should we be more self-sufficient, or should we continue to depend on China to produce so much of what we buy in our stores – let alone the personal protective equipment, test kits and ventilators which the NHS has needed to deal with Covid-19?

This report suggests that we are not in good shape to negotiate the next few years as a result of a variety of policies we have chosen to adopt which have left us much more vulnerable than we should be. Over the last few years, we have certainly had some successes. Inflation and unemployment have been low. Government borrowing has been much reduced. On the other hand, we have allowed investment in the UK to fall to far too low a percentage of GDP and we have failed to put resources into the most

fruitful projects. We have deindustrialised more than any other comparable country, with dire consequences for jobs, regional balance, productivity and our ability to pay our way in the world. We have borrowed too much and sold too many assets to pay for a standard of living which we have not been earning. We have allowed our country to become dangerously unequal in terms not only of income and wealth but in life chances too. Furthermore, we have done all this at a time when climate change, health care, training and social care costs are all ballooning upwards. The result is that most of the rest of the world – particularly China and other countries along the Pacific rim – are likely to do much better than we are over the next few years. What is this going to do to our status in the world and the esteem in which our politicians, our political systems and our institutions are held?

Is it inevitable that we continue along this depressing trajectory? This pamphlet argues that it is not. There are entirely feasible ways of ensuring that we do much better than this, but only with a radical rethink of our priorities. Essentially, we need to rebalance our economy, particularly around manufacturing and investment. It is true that we do well internationally on the export of services, but not well enough to offset deficits on our net income from abroad, transfers and raw materials. We cannot afford to continue with an overall balance of payments deficit of nearly £100bn a year – not far short of 5% of our GDP<sup>1</sup> – and the only way of overcoming this problem is for us to stop having a £100bn<sup>2</sup> annual deficit on manufactured goods. There is no other feasible way of closing this gap.

To make this possible, we need to get manufacturing as a percentage of our GDP back from its current 10% to somewhere around 15%. And we need to do this for other

## INTRODUCTION

reasons too: to provide better job opportunities outside London, to enable us to take advantage of the productivity improvements which are so much easier to achieve in manufacturing than they are in services and to make ourselves more self-sufficient and financially stable. Our aim should be to get our underlying growth rate up from the 1.4%<sup>3</sup> per annum which it has averaged over the past decade to around the 3.5%<sup>4</sup> world average – an increase of as much as a couple of per cent every year. This report is about how this might be done.

# 1.

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## **Investment: generating economic growth**

The starting point is to recognise the special role which certain categories of investment have in generating economic growth. A key insight is that almost all public sector investment – in roads, rail, schools, hospitals, public buildings and housing – however desirable from a social standpoint, produces overall returns to the economy which are little more than the interest costs needed to finance them. They therefore contribute little or nothing to economic growth. The same is true of much private sector investment too – in office blocks, shopping malls, projects such as new restaurants and IT systems to support banks and other financial services. The narrow range of investment projects which do produce much higher rates of return are clustered round mechanisation, technology and power. Think of a combine harvester replacing a scythe or a large truck being used instead of a wheelbarrow or a new machine which produces twice the output of the one it replaces with the same inputs. It is investments of these types whose total – or social – rate of return to the economy (including higher wages, greater profitability, better and cheaper products and a stronger tax base) which – as can easily be deduced from Table 1.1 below – are very much higher than the lower return investment which is also included. To achieve the

averages shown, high-powered investment must often produce returns as high as 50% or more per annum.

**Table 1.1: Gross investment, social rates of return and growth rates for selected countries and periods**

Country	Period	Gross Investment as a % of GDP	Average Social Rate of Return	Average Growth Rate
UK	1934-1941	14%	37%	5.6%
USA	1939-1944	7%	144%	10.1%
Japan	1953-1970	29%	35%	10.1%
China	2002-2012	37%	25%	9.1%
Korea	2005-2016	30%	12%	3.5%
Singapore	2005-2016	26%	20%	5.3%
UK	2005-2016	17%	8%	1.4%
World	2005-2016	26%	14%	3.5%

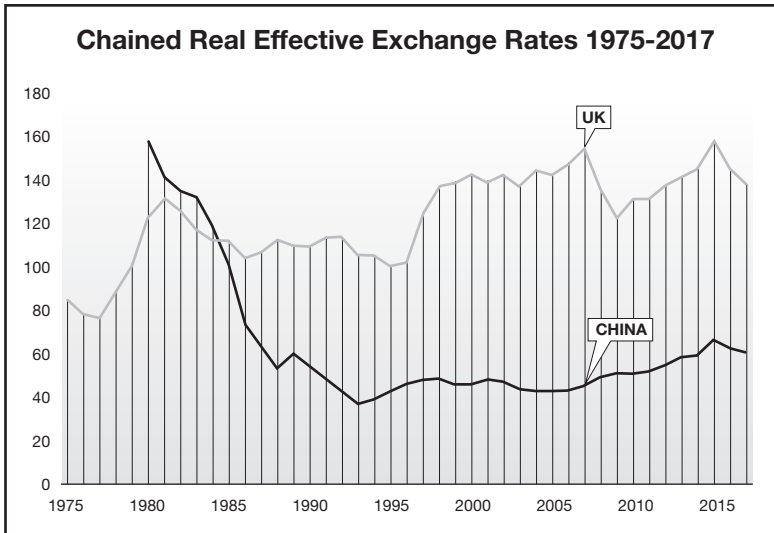
**Note:** The Gross Investment figure for the USA for the period 1939 to 1944 covers private investment only, so the average Social Rate of Return for the US economy as a whole must have been lower than 164%.

**Source:** The Social Rate of Return is calculated as the ratio between total investment and total increase in GDP over a long enough period – around ten years – to iron out fluctuations (Data from *International Monetary Statistics Yearbooks*, Washington D: IMF and *100 Years of Economic Statistics* by Thelma Liesner).

The problem with the UK economy is that not only do we invest in our future a much smaller proportion of our GDP – just under 17%<sup>5</sup> – than the world average of 26%<sup>6</sup>, but we invest very low amounts (gross) in the most high powered variety – down from 3.6% of GDP in 2008 to 2.9% in 2018<sup>7</sup> – and now almost nothing net of depreciation.<sup>8</sup> This is why productivity in the UK is virtually static, living standards are stagnant and our growth rate has been so low. Table 1.1 displays the proportion of GDP devoted to investment, and the average social rate of return achieved by it, for various periods and countries, showing clearly how poor the UK's recent performance has been.



Figure 1.1



**Sources:** International Financial Statistics Yearbooks, Washington DC, IMF, 2000 edition: pages 344 and 345 for China and 980 and 981 for the UK; 2010 edition: page 229 for China and 744 for the UK; 2018 edition: page 279 for China and 1055 for the UK. Based in all cases on Relative Unit Labour Costs.

And there is a clear explanation as to why this has happened. Most manufacturing output – especially the medium- and low-tech variety – is very price sensitive internationally and the key problem for the UK is that the exchange rate has been too high for most manufactured output to be competitive. The graph above in Figure 1.1. shows what has happened to sterling’s competitiveness vis à vis China since the late 1970s when, even then, UK manufacturing was none too internationally competitive. It has been a combination of very high interest rates and tight money in the 1980s followed by the liberalisation and encouragement of capital imports in the 2000s which between them pushed up the sterling exchange rate to something like double the mid-1970s level by the late 2000s, and which has been directly responsible for the collapse of most UK industry.

## 2.

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### **The cost base: costing manufacturing operations**

Why is the exchange rate so critical for competitiveness? It is because it determines the rate at which any country's cost base is charged out to the rest of the world. The cost base is made up of all the costs involved in production which are incurred in the domestic currency – sterling of course in our case. Typically for manufacturing operations, about 30% of all costs are for machinery, raw materials and components, for which there are world prices, and around 70% are determined in the local currency.<sup>9</sup> These domestic costs include direct labour charges, management salaries, all overhead costs, interest, taxation and profit.

Now look at what happened to the UK competitiveness when the exchange rate rose about 70%, as the graph in Figure 1.1 shows, between 1977 and 1981. Measured in international currency – say US dollars – the costs of machinery, raw materials and components stay the same, but the cost base whose total charges have to be recovered on export markets rises by 70%. The upward pressure on export prices – and corresponding increase in the attraction of imports – is then 70% (the increase in the exchange rate) times another 70% (the proportion of total costs incurred in sterling), which comes to almost exactly 50%.

No wonder that, as the exchange rate climbed during

the last 40 years, so much of UK industry collapsed, as the statistics all too clearly show. The proportion of UK GDP coming from manufacturing plummeted from almost one third as late as 1970 to barely 10% now.<sup>10</sup> Our share of world exports of manufactures, which was 25% in 1950 has now fallen to less than 2%, a more than 90% ratio reduction.<sup>11</sup> Our share of total world trade fell from 10.7% in 1950 to 7.1% in 1970 and by 2019 was 2.5%.<sup>12</sup> Of course some companies survived and prospered – those with exceptionally good management, those with niches which were difficult to attack, high tech companies with skill sets and experience which were hard to replicate – but most failed to do so. The vast majority of UK medium- and low-tech companies subject to international competition succumbed.

# 3.

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## Deindustrialisation

Does it really matter? Can't we survive and prosper on services, where our international trading record is much better? We have an export surplus on services of over £100bn per annum.<sup>13</sup> Welcome though this achievement is, however, it is not enough. Services are too difficult to sell overseas in sufficient quantity for us rely on them to pay our way, and a very weak manufacturing base has a multiplicity of other adverse consequences.

First, as Table 3.1 shows, with a massive deficit on manufactured goods, we cannot pay our way in the world. The only realistic way in which we can rectify this situation is for us to avoid the constant balance of payments problem, financed by too much borrowing from abroad and the net sale of UK assets, and to sell more goods. Services will never fill the gap. Total UK net capital receipts since 2000 – used to buy shares in existing companies, bonds and property assets and excluding direct investment in productive assets such as plant and machinery – have totalled over £trn.<sup>14</sup> No wonder that we have lost control over swathes of our economy.

Second, deindustrialisation has led to very substantial regional disparities, leaving large areas of the country with far too little to sell to the rest of the world to pay their way. In 2017, Gross Value Added (GVA) per head of the population was £48k in London compared to only £20k each in Wales

and the North East.<sup>15</sup> Over the last decade, real incomes have more or less held their own in London but they have fallen in real terms in the North East by 9% and by 10% in Wales<sup>16</sup>, so the gap is widening. While the UK has an annual balance of payments deficit of close to £100bn per annum, Greater London Authority (GLA) data shows that London has a surplus of a least £50bn.<sup>17</sup> This means that everywhere outside London is operating on average with a deficit of £150bn – roughly 10% of the non-London UK GDP.<sup>18</sup> If this is the average and some places – Oxford, Cambridge, Manchester and Bristol for example – are clearly doing reasonably well, other towns and cities must be doing even worse. No wonder that many areas of the country are so heavily dependent on subsidies and transfers from London. It would be far better if manufacturing industries could be re-established in these areas, so that they could pay their own way as used to be the case. Until the 1920s, the North of England was richer than the South.<sup>19</sup>

Third, there is a quality of jobs issue which has become more and more dominant as services have become a larger and larger component of the UK's economy. Services tend to produce a mixture of high quality, high productivity, stable and relatively high earning jobs at one end of the spectrum and much lower productivity, less secure, and worse paid employment at the other. Manufacturing is much better than services at producing satisfying jobs to help to plug this gap.

Fourth, as we have seen, it is much easier to secure productivity increases in manufacturing than it is in services because it is particularly in light industry where most investment of the most productive categories takes place. Table 3.2 provides some examples of economies showing how strong the correlation is between growth rates in GDP

per head and the proportion of GDP devoted to investment and manufacturing.

Year	Goods Balance	Services Balance	Trade Balance	Net Income	Net Transfers	Balance of Payments
2007	-88.1	57.4	-30.7	-7.3	-13.4	-51.4
2008	-89.9	55.7	-34.2	-14.7	-13.6	-62.5
2009	-84.5	59.6	-24.8	-11.5	-15.2	-51.6
2010	-95.0	63.0	-32.0	1.1	-19.9	-50.8
2011	-96.0	81.0	-15.0	6.6	-20.8	-29.2
2012	-105.0	84.9	-20.1	-17.8	-20.9	-58.8
2013	-117.8	95.1	-22.8	-36.3	-25.7	-84.8
2014	-121.1	95.1	-26.0	-38.0	-23.9	-87.9
2015	-117.7	91.2	-26.5	-43.9	-23.7	-94.0
2016	-134.2	101.9	-32.3	-47.9	-23.7	-104.0
2017	-135.9	110.8	-25.1	-24.7	-22.5	-72.3
2018	-139.4	109.6	-29.8	-27.5	-25.6	-82.9
2019	-129.7	103.8	-25.9	-30.3	-27.5	-83.8

Source: Time Series Dataset. London: ONS, March 2020

	China	Korea	Singapore	Germany	Holland	USA	UK
Growth in GDP 2006-2016	136%	39%	59%	19%	9%	14%	2%
Growth in Population 2006/16	5.6%	3.9%	21.9%	0.5%	3.3%	8.2%	8.2%
Growth in GDP per head 2006/16	124%	33%	30%	19%	6%	5%	3%
Manufacturing as a % of GDP	29%	29%	20%	23%	12%	12%	10%
Investment as a % of GDP	45%	29%	27%	19%	19%	20%	17%

Sources: Various tables in *International Monetary Statistics Yearbook 2017*. Washington DC: IMF, 2017. Manufacturing data from the World Bank website. This data relates to 2016 as does the IMF data on investment as a percentage of GDP.

# 4.

## Borrowing and lending

It is an accounting identity that, within any economy, all surpluses have to be exactly matched by deficits, with the same equivalence applying to borrowing and lending. The crucial implications of these relationships on management of the economy and particularly on government borrowing, however, appear much too often to have been lost from sight.

**Table 4.1: UK net lending (+) and net borrowing (-) by sector in £bn**

Year	Public Sector	Corporations	Households	Rest of the World	Totals
2008	-81.8	-17.0	38.2	62.2	1.6
2009	-156.0	16.3	88.6	51.3	0.2
2010	-148.7	1.9	95.4	51.5	0.2
2011	-124.6	23.9	70.2	30.0	-0.5
2012	-139.7	10.3	69.3	59.3	-0.8
2013	-98.5	-41.1	52.9	86.0	-0.6
2014	-103.5	-48.0	61.9	89.9	0.3
2015	-88.0	-81.9	72.0	96.0	-1.8
2016	-66.8	-73.5	32.6	105.7	-2.0
2017	-50.9	-27.6	4.0	73.9	-0.6
2018	-47.6	-41.4	6.5	85.4	2.9
2019	-46.1	-52.0	7.1	84.6	-6.4

**Source:** Time Series data supporting ONS Quarterly National Accounts 2019 Q4. London: ONS, March 2020. Figures for 2018 and 2019 are still being reconciled by ONS and the net totals will also be at or very close to zero when this process is complete.

Table 4.1 shows UK borrowing and lending during the last few years by the government, the corporate sector, households and receipts from abroad. What immediately stands out is the extent to which the public sector has been a borrower every year while the rest of the world has been a lender. It is no accident that this has happened. With purchasing power being siphoned out of the UK's economy year after year by its balance of payments deficits, the government has had no alternative but to spend more than its income, otherwise there would have been a shortage of demand which would have plunged the economy into a recession. The key implication, however, is that the level of government borrowing is not primarily the outcome of decisions about taxation and spending, as is often supposed. Instead, it is the size of the balance of payments deficit which drives government borrowing, because the balance of payments deficit has to be roughly the same as the figure for lending from abroad.

But surely it must be the case that, if governments raise taxation or cut spending, this will reduce the government deficit. Not necessarily so. Instead, the main impact of such actions is likely to be to depress the economy, reducing the government's tax revenues and increasing its spending on benefits, leaving its deficit close to where it was before. As Table 4.1 shows, the government deficit cannot come down unless there are compensating changes elsewhere in the economy. So if the balance of payments deficit stays the same as it was previously, there is no reason why corporate or household borrowing and lending should allow the government's deficit to come down.

The key implication is that austerity policies designed to reduce government borrowing are almost entirely misplaced. If the objective is to reduce the government's



deficit, by far the most efficacious way to do this is to bring down the balance of payments deficit. This is why countries such as Germany, which have large export surpluses, have not had the government borrowing problems which have dogged us.

## 5.

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### **New challenges**

Most people in the UK may not have had much, if any, real income increases during the past ten years, net of inflation, but only a relatively small – although important – minority have suffered from significant falls in their living standards.<sup>20</sup> This may be about to change not only because of coronavirus but also because we may now be moving into a period when almost everyone in the UK is going to suffer from falling disposable incomes for other reasons. This is because a number of very expensive problems are going to hit us over the coming years. With estimates as to what might reasonably be expected to cost every year, in each case as percentage of GDP, these can be summarised as follows:

#### **Climate change – 3% of GDP**

There are no very reliable estimates as to how expensive it is going to be both to combat and to mitigate the costs of climate change, but some suggestions have been made. In 2019, the Treasury produced a preliminary ball-park figure for the UK of £1trn spread over the period between now and 2050.<sup>21</sup> The Committee on Climate Change, which advises the government, recently put the cost at £50bn a year while the Department for Business, Energy and Industrial Strategy believes it will cost more, with an estimate of £70bn a year.

These costs include those which will be incurred directly by the public sector and those impacting businesses and private individuals.<sup>22</sup>

Public sector expenditure is going to have to be incurred both on measures such as combating rising sea levels and flooding, as well as subsidising research and development on ways of mitigating the effects of climate change. In the private sector, a combination of carbon taxes and tough regulation is going sharply to put up costs of everything from travel to home heating, from food to most manufactured goods, especially if the goals of reducing carbon emissions by 50% by 2030 and to net zero by 2050 are really going to be treated as serious targets. It seems likely that the £70bn a year estimate may be more realistic than the £50bn one; £70bn a year is about 3% of GDP.

### **Healthcare – 2% of GDP**

Public spending on healthcare in the UK was 2% of GDP in 1947 and no more than 4% by 1970. It fluctuated around 5% in the 1980s and 1990s, and then rose to a peak of 7.65% in 2010, before falling back to 7.1% in 2020. Between 1997 and 2010, spending in real terms doubled, since when it has risen much more slowly.<sup>23</sup> The strain on the NHS from the resulting tight budget constraints at a time when the population is growing, ageing and suffering from new threats such as the current pandemic, while the costs of many treatments are rapidly rising, is all too apparent from media reports.

Total healthcare costs, including those in the private sector, were running in 2019 in the UK at 9.8% of GDP, which is close to but slightly below the 10.1% average for comparable countries elsewhere.<sup>24</sup> It is notoriously difficult to increase overall productivity significantly in very

heavily service sector organisations like the health service where about 45% of total costs are on wages and salaries<sup>25</sup> and where there is little scope for employing investment with high rates of return to increase output per hour. As a result of all these factors, it is difficult to see how total healthcare costs in the UK are going to avoid rising as a percentage of GDP over the next decade by perhaps 2% – from 10% to 12%.

### **Education and training – 1% of GDP**

Expenditure on education and training fell from 4.9% of GDP in 2012/13 to 4.1% by 2017/18<sup>26</sup>, a trend that very clearly needs to be reversed if we are going to be able to compete in the world. Despite these cuts, the UK still spends about the international average percentage of GDP on primary and secondary education and UK PISA test results have recently improved as we moved up in 2018 compared to 2015 from 22nd to 14th on reading, from 15th to 14th on science, and to 18th from 27th on maths.<sup>27</sup>

Our really big failing is on tertiary education and training on which we spend no more than 0.5% of our GDP, which is much less than most other developed countries and well below the OECD average.<sup>28</sup> We therefore badly need to spend at least another 1% of GDP over and above where we are now, on education generally but particularly on training.

### **Social care and our ageing population – up to 2% of GDP**

Despite our rising population, the total amount spent in the UK by local authorities on social care peaked at just under £20bn in 2009 and by 2017 it had fallen to £17.5bn, a fall of more than 10%.<sup>29</sup> Over the same period, the number of people receiving domiciliary care funded by local authorities fell by 20%.<sup>30</sup> Just to get back to the level per head achieved in 2009,

we need to spend at least an additional £5bn on social care – but probably twice this amount – just to satisfy even the most pressing demands.

But over the next decade these requirements are going to increase as our older population continues to rise, and the number of people entitled to pensions goes up in relation to the working population from 280 per 1,000 in 2016 to an estimated 375 by 2040, a ratio increase of just under 35%.<sup>31</sup>

In 1997, state pension payments amounted to 3.6% of GDP and by 2016 this figure had risen to 4.6%. This ratio seems certain to go on increasing as a result of a combination of the rising number of pensioners in the population. This, combined with the need for social care of an acceptable standard, looks likely to add at least an additional 1% to the pressure on GDP over the next ten years and possibly another 1% by 2040.

If these figures are correct, they imply that anything up to about 8% of UK GDP is going to be absorbed over the coming years by increased costs which will have to come out of the population's otherwise disposable income. As about 80% of UK GDP is accounted for by consumption,<sup>32</sup> there is a threat of a 10% reduction in living standards unless the growth rate in the economy can be increased to offset the additional costs which will have to be borne.

It has been argued by some people<sup>33</sup> that this paints too gloomy a picture and that increased expenditure on climate change, health care, education, training, social care and pensions will add to GDP rather than reduce it. This may be much too optimistic. More probably, any additional expenditure on these headings will have to be offset by exactly corresponding increases in taxes or prices to pay for them. Total GDP will therefore not increase but stay the same

while the total resources are shifted out of consumption and into paying for the new cost pressures.

What can be done to offset this problem? The answer is that we need to get the economy to grow faster, as it adjusts to the new requirements laid upon it. Increased cost pressures of, say, 8% of GDP over 10 years, equates to 0.8% per annum.

## 6.

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### Recovery prospects

Looking ahead, although exact projections are impossible, the general shape of recovery from coronavirus and the orders of magnitude involved seem to be along broadly predictable lines. The ultimate aim has to be the development of a vaccine which will provide immunity, but this seems unlikely to materialise in mass quantities before late 2020 at the earliest and quite possibly not until 2021.<sup>34</sup> In the meantime, there will be overwhelming pressure to keep the death toll down to a tolerably low a level – and at least within the NHS’s capacity to cope – consistent with trying to control the damage to the economy, which has both material and health implications of its own.

If, as seems to be the case, it is correct that only a single or low double figure percentage of the population in the UK – and in most other countries – have caught the virus, without a vaccine we will be a long way from having naturally achieved herd immunity. This requires some 60% of the population to be immune either naturally or because they have had the disease – provided that this does give immunity which appears not to be certain.<sup>35</sup> The risk of too many deaths is generally perceived to be too high to allow herd immunity to be developed by allowing Covid-19 to spread unchecked. The only realistic alternative then to keeping lockdowns in place until a vaccine is widely available is to

increase the amount of testing sufficiently for carriers to be identified and quarantined quickly and accurately enough for the risks of raising lockdowns to be worth taking.

Albeit with a potentially substantial cost in terms of intrusion on personal liberties, experience from countries such as China and South Korea suggests that policies along these lines have a reasonably good chance of success. If they were to be implemented from the middle of the summer 2020, there appears to be a realistic prospect – but no certainty because of the risk of another peak – of us being back to something closer to normal life by the end of 2020, with or without a vaccine, albeit with the economy still operating at well below its 2019 level. Of course, these projections may well turn out to be wrong – either too optimistic or too pessimistic, or of the wrong shape altogether – but they provide some kind of plausible case from which to start estimating the scale of the recovery problems which governments in the UK and elsewhere will have to face.

The key immediate problem may be the diminished capacity of the economy to meet the pent-up demand which is likely to be placed upon it as current restrictions which make spending difficult are lifted. Some projections have suggested a ‘V-shaped’ depression with a rapid recovery, while others have been much more cautious.<sup>36</sup> To provide some ideas of possible orders of magnitude, taking an optimistic view, if GDP in 2020 Q2 is the same as in 2019 Q4 for the public sector and half of the private sector, but down by something close to 60% in the remaining half of the private sector, overall GDP will have fallen between 2019 Q4 and 2020 Q2 by about 20%. If it recovers to minus 10% in 2020 Q3 and to minus 5% in 2020 Q4, this would give us a year-on-year reduction between 2019 and 2020 of around 10%. In the absence of any further radical changes



in economic policy to accelerate the process of restoring lost economic growth, it may then take another two or three years for GDP to get back to the level seen in 2019. This, however, may turn out to be a “best case” scenario. There have been estimates that the 2020 Q2 drop in GDP may be as high as 35%.<sup>37</sup> If these pessimistic projections turn out to be right, it will inevitably take much longer for UK GDP to get back to its 2019 level.

If the economy follows this more pessimistic trajectory over the next few years, combined with mounting cost pressures from climate change, education and training, health care and our ageing population, the impact on disposable incomes is going to be very heavily adverse. It may well be that we will be facing another lost decade of stagnant or (more probably) falling real living standards – combined with more long years of public sector austerity – for the bulk of the population from the beginning of 2020 to 2030. Can we do better than that? This pamphlet argues that we can.

## 7.

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### **Remedies: reindustrialisation and boosting manufacturing**

The key to an alternative policy aimed at getting the economy to perform much better is to get the sustainable underlying growth rate up by a significant amount. The target proposed in this pamphlet is an increase of about 2% per annum above current expectations once the main recovery from Covid-19 has taken place. This would bring our growth rate up to an average of around 3.5% per annum instead of the 1.4% average we have seen recently.<sup>38</sup> This would then enable us to pay for the impact of Covid-19 and the other cost pressures which we know are going to hit us over the next few years by creating new output rather than by squeezing down incomes. We need to do this through a combination of rebalancing the economy and increasing its productive capacity.

How would this be done? The key to grasping how to achieve this objective is to appreciate the crucial role of investment and, in particular, its most productive categories, in generating economic growth. As we have seen, the total proportion of our GDP which the UK invests in its future is far lower than the world average. Even more important, however, is the fact that investment in mechanisation, technology and power – the key drivers which have made possible the vast majority of the increase in living standards

which the Industrial Revolution unleashed – now appears to be no greater in the UK than the depreciation charged on existing assets.<sup>39</sup> It is because the UK has such low net expenditure on these crucial categories of investment that we have such a poor record on productivity, while we tolerate stagnant real wages and low economic growth.

Why has this happened? It is because the natural home for most of the categories of investment which generate high economic growth is in the highly competitive internationally traded sector of the economy made up mostly of light manufacturing industry. Because its ownership is very largely in the private sector, reasonable prospects of profitability are key to investment on the scale required. It is because the cost base in the UK has been charged out internationally through the exchange rate for many decades at too high a rate for this criterion to be met, that investment on anything like the scale required has simply not materialised.

Evidence that this is the case is all too clear from the statistics. It is in medium- and low-tech manufacturing, where the scope for productivity increases is as high as it is anywhere else, that the UK has seen the largest reductions. Services may be able to live with an exchange rate of \$1.50 to the pound – bolstered by the benefits they receive from our geography, our language, our legal system, our universities and the skills of some of our labour force – but an exchange rate at this level is lethal for manufacturing. What UK export success stories there are have been achieved by companies such as Rolls Royce and BAE, where price competition is limited in a way which seldom applies to medium- and low-tech exports. Tellingly, a study in 2011 showed that 27% of UK manufactured exports were high-tech, whereas in Germany only 17% of a much higher total were in this

category. 38% of UK manufactured exports were medium-tech compared to 51% in Germany.<sup>40</sup>

As we have seen, on average about 30% of the cost make up for manufactured goods for exports comes from machinery, raw materials and components, for which there are generally world prices. All the remaining costs – for direct labour, salaries, overheads, interest charges, taxation and profit are incurred in the domestic currency – sterling of course in the UK's case – and the rate at which they are charged out to export markets is directly a function of the exchange rate. If we are ever to rebalance our economy by at least a reasonable measure of reindustrialisation, it has to be profitable to site new manufacturing capacity in the UK rather than elsewhere. This is why we need an exchange rate low enough for this vital condition to be fulfilled.

Reindustrialisation is not only needed because it is much easier to secure productivity increases in manufacturing than in services, and thus to increase overall growth; it is also vital to rebalance the economy between its regions. As we have seen, there are huge disparities in productivity, measured as Gross Value Added (GVA) per person per year between different areas of the UK. Much of this has to do with the fact that large areas of the UK simply do not have enough to sell to the rest of the world to pay their way, for which deindustrialisation is very largely responsible, and this has to change.

The resulting deficits are the mirror image of the support they get in the form of grants and transfers from central government to stop the disparities in living standards between London and the regions becoming unbearably large. The solution to the problem is not trying to reverse austerity with larger and larger transfers to the poorest regions of our economy, which central government is bound

to have problems affording. It is to provide the regions with an environment in which they can generate enough income for themselves to pay their way in the world. Services will never fill this gap. Reindustrialisation, with all the prospect it brings of stable high productivity jobs, is a much better way ahead.

A much lower exchange rate and a larger manufacturing sector is also the solution to our balance of payments problem. The UK has recently exported an average of about £270bn<sup>41</sup> worth of manufactured goods a year – around 45% of our total exports – even though manufacturing accounts for only 10% of GDP compared to about 20% in Germany, Switzerland and Singapore and an even higher ratio – almost 30% – in China.<sup>42</sup> If raising the proportion of GDP coming from manufacturing by 50% to 15% generated a corresponding increase in exports, allowing for an import content of, say, 30%, the annual first order improvement to the UK's balance of payments position would be about £270bn times a 50% increase in exports times 70% to allow for import content, which comes to just under £100bn. We would then no longer need to sell assets or to borrow from abroad year after year to sustain a standard of living which we are not earning. Furthermore, if we largely or completely got rid of our balance of payments deficit, for the reasons set out in chapter 4, we would no longer have to fight a constant battle to get government borrowing down.

Would a strategy along these lines help to mitigate inequality? Perhaps, although whether it would actually do so depends largely on political rather than economic choices. Reindustrialisation would certainly help reduce regional inequalities below what they would otherwise be. The recovery from Covid-19 may well generate tax and asset valuation changes which will do something

to reduce income and wealth inequalities. Millennials may get a better deal if the economy grows faster and investment, particularly in housing, goes up on the back of improved overall performance by the economy. Faster economic growth would certainly provide opportunities for generating greater equality, whether or not they are taken.

## 8.

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# Globalisation

It is a key belief among most economists and the wider public that free trade, liberalisation and globalisation are forces for good. There may well be resulting losers, but their losses are easily outstripped among those who benefit. There is clearly a correlation between the time when trade was progressively liberalised over past decades and the alleviation of a large amount of poverty in the world. It is also evident that international competition spurs the dissemination of better practices and the opportunity for the most efficient to capture market share to the benefit of consumers.

While there are, therefore, clearly advantages to be secured from globalisation, trends which manifested themselves well before the advent of the coronavirus have shown that perceptions about its net benefits are not by any means universally shared – and with some good reasons. There is little doubt that unmanageable competition from the Far East has deeply destabilised and undermined the opportunities for large sections of the labour forces in western countries. As globalisation has intensified over the past four decades, the growth rate particularly in the developed world has not accelerated. On the contrary, it has fallen from an average of about 4% per annum between 1950 and 1975 to 3% between 1975 and 2000 then to no more than 2% for the last 20 years.<sup>43</sup> Part of the problem has been

that some countries, particularly in the East, have secured disproportionately large shares of world manufacturing and the trade surpluses which tend to go with them. Meanwhile countries such as the UK and the USA, with exchange rates which are too high for much of their manufacturing industries to cope with, have accumulated large deficits and their growth rates have dwindled.

There is also a deeper problem. How much benefit does the world really receive in terms of better value from their imports than if they relied on domestic production? Detailed quantitative research, whose results do not appear to have been seriously challenged, has indicated that they may be perhaps surprisingly small. Subject to various conditions about the extent of competition, they are calculated for the world economy to be equivalent to about 2.5% of world GDP.<sup>44</sup> With imports representing close to 30% of world GDP<sup>45</sup>, this equates to the average additional benefit being received from all imports over all home production as being a little over  $8\% - 2.5\%$  divided by 30%. Furthermore, this is a benefit in relation to world GDP which has a constant static ratio to total world output unlike a growth rate of, say, 2.5% per annum which cumulates up every year.

The figure of 2.5% is evidently not very high in this context. Especially in these circumstances, what can be done to secure the benefits of international trade without its costs being outweighed by negative factors? Part of the solution must be to get manufacturing more evenly spread across the world, reducing the scope for imbalances and trade with little real net benefit. Does it really make sense, for example, for about 80% of UK car manufacturing being for export while about the same proportion of all cars purchased by UK residents are imported?<sup>46</sup> The real drivers of economic growth are investment especially in mechanisation,



technology and power. Trade may spread the consequent increases in productivity and security of supply if it is reasonably well balanced. If it is not, it may well lead to worse overall performance: a point which may well have been exemplified by the UK's inability to produce in sufficient volume such relatively simple items as ventilators, testing facilities and personal protective equipment to combat the coronavirus.

## 9.

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### Faster growth

There are two essential conditions to be fulfilled to enable the UK to get its economy rebalanced and to induce investment and export-led expansion which will increase its growth rate to somewhere near the world average. The most critical of all is to get the exchange rate down – and to keep it there – at a level which makes it profitable to invest in a reasonably wide spread of internationally traded manufacturing in the UK. The second is to ensure that the resources – particularly the finance – required to enable the UK economy to acquire greater manufacturing capacity are available.

It is relatively easy to calculate from what we know of the price sensitivity – or more precisely the price elasticities of demand for exports and imports – what exchange rate would be needed to make a wide spread of medium- and low-tech manufacturing viable again in the UK. With an elasticity of 0.8 for exports and 1.0 for imports, it is about  $£1.00 = \$1.00$  or  $€0.85$ , or some 20% lower than the approximately  $\$1.25$  and  $€1.10$  prevailing at the beginning of June 2020.<sup>47</sup>

What would need to be done to get the exchange rate down to this level? The most important requirement would be for the government to announce that this was its objective and that, once achieved, it would be its settled intention to keep the parity at its new competitive level. The Bank of

England would need to be marshalled to support this policy by selling sterling, if necessary, to keep the rate where it needed to be. Since all current account deficits have to be exactly matched by capital imports, downward pressure on sterling could be achieved by using public interest tests on takeovers of UK companies from abroad and tax penalties on the acquisition of property assets by foreign interests. Bearing in mind the scale of the UK's current account deficit, getting the UK economy into a more competitive condition is hardly likely to be perceived by the markets as pushing the economy in fundamentally the wrong direction.

The second major requirement for making sure that a competitive environment actually delivers the investment and export-led recovery we need is to ensure that manufacturing industry has access on favourable and plentiful terms to the finance needed to make it happen. There is ample evidence in the UK that banks are reluctant to lend to manufacturing industry. Unfortunately, this sector of the economy's poor record shows that a good deal of this scepticism may be justified by experience, at least judged by the banks' assessments of risk, taken from their own perspective. Lending decisions which may be prudent case by case for banks do not, however, add up to a strategy which necessarily make sense for the economy as a whole. This is because the total returns to the wider economy, especially on the most productive forms of investment, vastly exceed the private returns to banks. Bank lending to industry therefore needs to be firmly guided and possibly underwritten by the state, as indeed has been done to support companies generally during the current coronavirus pandemic. Concentration should not, however, be on propping up existing companies which are short of liquidity but should be primarily targeted at encouraging

manufacturing investment across the board. The experience of Japan during its period of recovery from World War II and its subsequent meteoric rise, when exactly this sort of targeted lending was a major component of the policies then pursued, shows what can be done.

These policies are not new ones in world terms. They are very much those employed by successful economies everywhere to sustain their manufacturing sectors and their export performances. A recent example, showing that they are achievable, was provided – again by Japan – whose authorities deliberately brought down the value of the yen by about a third between June 2015 and August 2016<sup>48</sup> by employing almost exactly the suite of policies recommended here for the UK – and for the same reasons. The problem entailed in getting sterling down to a competitive level is not technical. It is the very widespread and almost unthinking view in the UK among politicians, the civil service, the commentariat, the academic world, think tanks and public opinion, that a strong currency is an advantage. So, it may be in the short term for the City, for importers, for those who enjoy cheap holidays abroad and low prices for imported goods in our stores. Unfortunately, however, too strong a currency and restricted lending to industry have also entailed the UK having much too weak a manufacturing sector, unable to pay its way in the world, with low productivity increases, stagnant or falling real incomes, little or no growth, relative international decline and a deeply unsettled social and political future. And this is before we start dealing with the impact of Covid-19 on the economy and how to get it to recover.

# 10.

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## **Countering the objections to a competitive exchange rate**

Many people, even if they were persuaded by the logic of the case for a more competitive exchange rate for sterling which has been presented in this pamphlet, might well be inclined to shy away from trying to implement it because of deeply held suspicions that such a policy would neither be achievable nor would it work even if it could be put into practice. What are these contentions and how can they be countered?

There are six main arguments that are regularly advanced to support these concerns. They are, first, that devaluation always produces extra inflation which may negate in part or in full any gains in competitiveness; second, that devaluation is impossible to combine with an open economy; third, that, if we did devalue, we would run the risk of being met by retaliation which would undermine its potential benefit; fourth, that reducing sterling's parity would make us all poorer; fifth, that we have tried devaluation in the past and it does not work; and sixth, that the UK is no good at manufacturing and that our economy would not therefore respond positively to a lower exchange rate. None of these allegations stand up to close scrutiny and a central part of the case put forward in this pamphlet is to understand why this is so.

### **Devaluation and inflation**

The contention that devaluation always produces a rise in inflation is true in so far as it applies to goods and services which are imported. Price rises here are inevitable and a necessary part of switching demand from foreign to domestic suppliers. It does not, however, follow that the price level generally will rise more quickly than it would have done without a devaluation, and a wealth of evidence from the dozens of devaluations which have occurred among relatively rich and diversified economies such as ours in recent decades shows that in fact lower parities sometimes produce a little more inflation, sometimes a bit less, but most of the time little if any change. This may seem a very surprising result to many people, but this is unequivocally what the statistics show. Looking at recent examples, when the UK left the Exchange Rate Mechanism in 1992, sterling fell by trade-weighted 15%<sup>49</sup>, but inflation fell from 5.9% in 1991 to 1.6% in 1993.<sup>50</sup> When sterling dropped from about \$2.00 to the pound in 2007 to \$1.50 in 2009, a drop of 25%, the rate of inflation barely flickered<sup>51</sup>, and what increase there was in 2011 was very largely driven by an increase in commodity prices, which fell away as soon as supply caught up with demand again.<sup>52</sup>

The reason why these are common outcomes is that, while higher import prices push up the price level, many factors to do with a lower parity tend to bring it down. Market interest rates tend to be lower after a devaluation, and so do tax rates. Production runs become longer, bringing down average costs. Investment, especially in the most productive parts of the economy, tends to rise significantly, increasing output per head, reducing costs and producing a wage climate more conducive to keeping income increases in line with productivity growth. Furthermore, as domestic

supplies of goods and services become more competitive with those from abroad, demand switches to local sources, negating the need to pay higher import prices even if foreign suppliers reduce their prices to try to retain market share.

For all these reasons, the plain fact is that neither theory nor historical experience, based on a wide range of individual cases, show evidence of devaluations having any systematic effect on increasing inflation above what it probably would have been anyway. Still less does either theory or practice show that competitive gains from a devaluation tend rapidly to be eroded by higher inflation, although this is a central tenet of monetarist thinking, which perhaps explains why so many people believe it to be the case even though it is not. On the contrary, the longer-term evidence very firmly indicates that economies which have strongly competitive international pricing tend to perform better and better as talent and highly productive investment is attracted to those sectors of the economy most likely to produce rising productivity and increasing competitiveness. This is the environment into which a considerably lower parity needs to draw the UK economy.

### **Changing the exchange rate in an open economy**

Next, it is frequently contended that the parity of sterling is determined by market forces over which the authorities have little control, so that any policy to change the exchange rate in any direction is bound to fail. Again, historical experience indicates that this proposition cannot be correct, as Japan has recently shown. Further back, the Plaza Accord, negotiated in 1985, produced a massive change in parities among the major trading nations of the world at the time, causing the dollar, for example, to fall against the yen by just over 50% between 1985 and 1987.<sup>53</sup>

It is of course true that market forces have a major influence on exchange rate parities, but it does not follow from this that the authorities cannot influence the factors which determine what market outcomes are. If the UK pursues policies which make it very easy for foreign interests to buy British assets, for example, this will exert a strong upward pressure on sterling's parity. If the Bank of England raises interest rates, this will also push sterling higher. If the Bank evidently wants to help to keep the parity of the pound up by buying sterling and selling dollars, this will have a correspondingly strengthening impact on sterling.

Sooner or later, the parlous state of our balance of payments is also likely to be a major factor. Up to now, the ability of the UK to finance its increasing deficit by selling assets has kept the markets confident that the rate at which sterling is trading on the foreign exchanges is sustainable. It is far from clear that this confidence will continue indefinitely for two main reasons. One is that it may become increasingly difficult to find enough to sell in future if more safeguards relating to the sale of UK assets are put in place, thus making it more difficult to keep the exchange rate as high as it is at the moment.

The second is that every £100bn annual deficit, financed by selling assets with an average gross return of the order of 3%<sup>54</sup>, adds another £3bn to the underlying deficit every year, as we forfeit the returns we would have had from the assets had we not sold them. The laws of economic gravity can be ignored for a long time but as Herbert Stein had it – incidentally with balance of payments deficits as a prime example – “Trends that can't continue, won't.”<sup>55</sup> It may, therefore, very well be the case that in the foreseeable future there will be a change in market sentiment which will bring sterling down to a lower parity with or without the



assistance of the authorities. The fall in the value of sterling following the EU referendum in June 2016 and its further fall during the coronavirus crisis has already shown this happening, although the fall from \$1.45 to \$1.20 or \$1.25 is unfortunately still not enough to precipitate a large-scale industrial revival.

### **Retaliation**

If the UK were to devalue by a sufficient amount to enable the economy to reindustrialise to a point where we could pay our way in the world – is it likely that there would be retaliation from other countries which would negate any benefits in the form of increased competitiveness which the devaluation had secured?

In the first place, it depends on the position from which the devaluing country starts. The curse of foreign payment imbalances starts not with countries like the UK, with massive deficits, but with countries such as Germany, Switzerland and the Netherlands with huge surpluses – in the mid-2010s almost 8% of GDP in Germany and the Netherlands and 15% for Switzerland.<sup>56</sup> These surpluses have to be matched by deficits somewhere else in the world economy. Unfortunately, surplus countries are never under any immediate pressure to reduce the beggar-thy-neighbour impact of their surpluses by revaluing their currencies and this leaves economies such as ours, carrying big deficits, with no alternative but devaluation to get the situation under control. There is thus a very strong principled case for countries such as the UK to make for getting sterling to a more competitive level.

In terms of practicalities, the UK has a number of advantages which other countries do not share. We are not in the EU's Single Currency, membership of which would

clearly preclude the UK from doing anything about our exchange rate. We still have our own central bank and control over our own interest rate and monetary policy. Sterling is not a major world reserve currency like the dollar, making it much easier for us to alter our exchange rate without there being very significant international consequences. The fact that our share of world trade is now so low – at 2.5% in 2017<sup>57</sup> – means that what happens to sterling has relatively little impact on the rest of the world.

As to recent evidence, the quite major changes in the parity of sterling when the UK left the ERM in 1992 – a trade weighted drop of 15%<sup>58</sup> – and the fall in the rate for sterling against the dollar between 2007 and 2009 – about 25%<sup>59</sup> – as well as the post-EU referendum drop in sterling's parity and the most recent one triggered by the coronavirus crisis, all engendered no retaliation. All were evidently seen by other countries – the markets and the authorities – as being exchange rate adjustments which were clearly warranted by the state of the UK economy. Against the background of our currently ballooning foreign exchange deficit, there is no reason why the same could not be made to happen again. If the manifest imbalances in the UK economy are clearly associated with an unsustainably high exchange rate this should also enable us to overcome any objections from our G7 partners, with whom we have jointly agreed not to indulge in unwarranted competitive devaluations.

### **Sterling and living standards**

It is frequently argued that a devaluation must make us all poorer. This argument tends to take two forms, one of which is manifestly incorrect while the other can relatively easily be countered.

The first is that if we reduced the value of the pound by,

say, 20%, in world currency terms, we would make ourselves 20% worse off and we would therefore genuinely be poorer by this amount. The fallacy with this argument is that, while it might be well founded if we did all our shopping in international currencies such as dollars, this is not what UK residents do except perhaps when they go on holiday. UK citizens pay for almost everything they buy in sterling and it is therefore GDP measured in sterling, not in dollars, which counts. This is reflected in the way in which international accounting is done and this explains why IMF figures do not generally show falls in GDP when countries devalue. On the contrary, they almost invariably show the growth rate rising and GDP increasing in consequence. Since living standards closely approximate to GDP per head, especially over time, if the economy is increasing in size and the population does not change from what it would have been anyway, GDP per head and thus living standards must, as a matter of logic, go up rather than down.

The second potentially more substantial argument is that, if we are going to increase our net trade balance to a point where we are not enjoying a standard of living far beyond what we are earning – as we are at the moment – living standards will have to suffer. Relatively speaking, this has to be correct. If we produce more for export, too, there will be less for the home market. Furthermore, if, to get the economy to grow faster, we have to spend a considerably higher proportion of our GDP than we do at the moment on investment, there will again have to be a corresponding reduction in consumption as a percentage of GDP. The crucial question then is whether the economy can be made to grow fast enough to enable both the shift towards exports and investment to be accommodated without living standards falling – and indeed preferably rising. Careful

calculations show that this would be possible – provided that a high enough proportion of increased investment goes to the most productive parts of the economy, mostly manufacturing. It can be done.<sup>60</sup>

### **Past devaluations**

Sterling may be too strong now for the good of our manufacturing base, but there is a powerful case to be made that this is no new phenomenon. Controversies over banking prudence and the link between sterling and gold, combined with the dominance of financial interests over those of industry, all stretch back to the beginning of the nineteenth century. Ever since industrialisation in the UK really got under way, too high an exchange rate has almost always hobbled British industry. Although we initially showed the way to industrialisation, other countries have overtaken us as their manufacturing bases have become stronger and their more competitive currencies have allowed them to secure better net trade advantages.

As these other countries, by looking after their manufacturing industries, have invested more heavily in the future than we have, their output per head has grown more rapidly than ours, their wage climates have been better and their inflation rates have been lower. As an extreme example, in Switzerland, between 1970 and 2010, the price level rose by 88%. In the UK, it increased by 780%. The average annual Swiss inflation rate over these 40 years was 1.6% while in the UK it was 5.6%.<sup>61</sup> It was against this kind of background that from time to time the over-valuation of sterling became so obvious that either the markets or the authorities or both tolerated, engineered or encouraged the parity for sterling to fall. Perhaps it is worth reiterating the often-forgotten fact that sterling's fall by about 25% in 1931 – after near

stagnation during the 1920s – enabled the UK economy to have its fastest peacetime spurt of growth ever during the middle of the 1930s – over 4% per annum cumulatively for the four years between 1933 and 1937, and faster still as we moved into full-scale war mobilisation.<sup>62</sup>

When World War II ended and the continent began to recover from wartime devastation, it soon became apparent that the UK had no chance of maintaining the pre-war dollar parity of \$4.03 to the pound, and sterling was devalued in 1949 to \$2.80.<sup>63</sup> Higher than average inflation in the UK than elsewhere and underinvestment in export industries resulted in steady trade deterioration in the 1950s and 1960s, culminating in the pound being devalued in 1967 from \$2.80 to \$2.40.<sup>64</sup> Once currencies started to fluctuate against each other in the 1970s, following the break-up of the Bretton Woods fixed parity system in 1971<sup>65</sup>, rapidly rising prices combined with high interest rates kept sterling much too strong. This was especially so early in the 1980s and later in that decade as the UK entered the Exchange Rate Mechanism, which we left in 1992 with a devaluation of about 15% against all currencies<sup>66</sup>, to escape from a sharp economic downturn. After showing some signs of recovery, the UK economy then became more and more unbalanced as assets sales, starting in the late 1990s on a scale unparalleled anywhere else, pushed sterling up to completely unsustainably high levels in the 2000s, reaching \$2.11 at its peak in November 2007.<sup>67</sup> Its value fell between 2007 and 2009 – still by not nearly enough – since when it has climbed back a bit and then fallen to roughly where we were in 2009 (after the EU referendum and the start of the coronavirus crisis). Meanwhile, in the East, over past decades, exactly the opposite policies were followed as they massively devalued.

The reality is that the UK's exchange rate has been much too strong to allow our industrial base to flourish as it could have done for almost all of the last two centuries. The devaluations that have taken place have made the situation rather better than it otherwise would have been, but they have invariably been too little and too late.

### **Devaluation and the UK response**

Finally, it is argued that the UK has no bent for manufacturing and that, even if industry was presented with a much more favourable competitive environment, it would not respond. While it is true that a wide swathe particularly of low- and medium-tech manufacturing is uneconomic in the UK at present, and does not therefore attract investment, there is no evidence whatever that, if more favourable conditions prevailed, UK entrepreneurs would not be just as good as those everywhere else in the world at taking advantage of the new opportunities which would then open up.

Evidence for this proposition comes from a wide variety of sources. Perhaps the most obvious is to consider how implausible it is that the nation which was the very birthplace of the Industrial Revolution should be incapable of running manufacturing operations successfully, given a reasonably favourable environment. Nor is there the slightest evidence that the UK lacks entrepreneurial people who would be willing to try their hands at making money out of making and selling, if the right opportunities were there. The problem with the UK, as a manufacturing environment, is that these conditions simply do not exist at the moment, because the cost base is too high and entrepreneurs rightly shun investing in ventures which they can see from the beginning have poor prospects of being profitable and successful.

# Conclusions

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In the face of all the evidence, it is impossible to believe that the policies we have pursued over a long period have not hugely disadvantaged UK manufacturing industry. Nearly all of our internationally-traded low- and medium-tech manufacturing has been driven out of business and there is insufficient high-tech industry – also subject to long term threat – to fill the gap. The result is that our economy has been left deeply unbalanced, unable to pay its way in the world, with too much borrowing and with mounting regional, inter-generational and socio-economic inequality. On top of this, we are now faced with the need to recover from what looks certain to be far the largest downturn in the economy since the 1930s depression when the Covid-19 crisis eventually recedes.

It may be that we shall attempt to achieve this recovery along broadly familiar lines, with the pound much too high for manufacturing to flourish. We will then have far too low a share of the world's manufacturing capacity to enable us to benefit much – if at all – from its unique capacity to raise productivity, and to secure enough growth in output to meet all the challenges which we are going to have to deal with over the next few years. The risk then is that real incomes are significantly squeezed down, as public services remain under mounting pressure, and disposable incomes fall.

The message in this pamphlet is that we ought to be

## CONCLUSIONS

able to do much better than this. Very few major policy initiatives are risk free, however, and this is true of going for a competitive exchange rate and export- and investment-led growth to create the resources necessary for us to be able to face the coming decade with reasonable confidence. The real risks with the strategy proposed are, however, relatively easy to identify and to quantify. There are three of them which are key to successful implementation.

Year of Devaluation	Overall devaluation percentage	Inflation previous year	Inflation devaluation year	Inflation devaluation year +1	Inflation devaluation year +2	Inflation devaluation year +3
1931	25%	-1.7%	-10.1%	-9.9%	-6.6%	+5.5%
1949	31%	5.1%	2.4%	2.7%	9.9%	6.3%
1967	16%	3.9%	2.7%	4.8%	5.4%	6.3%
1992	15%	5.9%	3.7%	1.6%	2.5%	3.4%
2008	22%	2.3%	3.6%	2.2%	3.3%	4.5%
2016	9%	0.1%	1.3%	2.6%	2.4%	1.9%

**Sources:** *One Hundred Years of Economic Statistics* by Thelma Liesner. London: Facts on File and the Economist, 1989, and successive editions of *International Statistics Yearbook*. Washington DC, IMF. Combined with data from the Office for National Statistics and <https://inflationdata.com>.

The first concerns whether there is any unusual risk to be expected from inflation if the cost pressures from recovery from Covid-19 are combined with the inflationary impact on import prices from a lower pound. The answer is that the risk of significant price rises as a result of a depreciated pound on its own are limited, as Table C.1 shows. There certainly is a risk of inflation going up if demand exceeds the capacity of the economy to supply as a result of the damage done to it by the lockdown period, but this threat will be there whether or not there is a lower pound. Is there a risk that a combination of both a lower pound and recovery from



the coronavirus together would make the risk cumulatively greater? Realistically, there has to be some risk here, but it does not look very great in relation to the benefits which ought to be secured. If – probably at worst – there is an increase in inflation of 1% or 2% as a price for increasing the growth rate by around 2%, it seems likely that most people would certainly think this a price worth paying.

The second issue is whether we can rely on the sensitivity of exports and imports to a much lower exchange rate being sufficiently large to generate enough new demand for exports, constraint on import volumes and sufficient incentive to increase investment to make the policy work. This is potentially a matter of legitimate concern because some recent evidence suggests that the UK economy is a good deal less responsive to increased price competitiveness than it may have been in the past.<sup>68</sup>

Certainly, figures from the past indicate that the UK economy's elasticities of demand for imports and exports were easily high enough to make a competitive exchange rate policy work. Table C.2 shows the result of a major study carried out by the IMF covering the early 2000s and there is a ready explanation for why the elasticities may now be lower. This is that the high value for the pound especially over recent decades has run all the most price sensitive parts of our economy – medium- and low-tech manufacturing – out of business, leaving high-tech and services which are well known to be much less price sensitive as an ever increasing proportion of our foreign trade.

If the export and import elasticities are measuring the responsiveness of the UK economy to more competitive prices only in terms of how much additional output can be squeezed out of existing production capacity, it is not surprising that they should be fairly low. The objective of the

## CONCLUSIONS

**Table C.2: Elasticity of demand for exports and imports 2001-2004 (estimates produced by the IMF and published in 2010)**

	Export Long Run	Import Long Run	Total
Australia	0.70	1.61	2.31
Austria	1.20	0.88	2.08
Belgium	2.10	0.56	2.66
Canada	1.32	0.83	2.15
Czech Republic	0.82	1.20	2.02
Denmark	1.27	0.78	2.05
Finland	1.23	0.01	1.24
France	1.14	1.03	2.17
Germany	2.51	0.10	2.61
Greece	1.13	1.11	2.24
Hungary	0.88	0.83	1.71
Iceland	0.91	1.46	2.37
Ireland	0.84	0.34	1.18
Italy	0.99	0.97	1.96
Japan	1.72	0.75	2.47
Korea	1.02	0.21	1.23
Luxembourg	2.65	2.63	5.28
Netherlands	1.04	0.73	1.77
New Zealand	1.01	0.94	1.95
Norway	0.33	1.61	1.94
Portugal	1.65	1.46	3.11
lovakia	0.84	0.83	1.67
Spain	1.08	1.33	2.41
Sweden	1.84	0.04	1.88
Switzerland	1.27	0.78	2.05
United States	1.77	1.52	3.29
United Kingdom	1.37	1.68	3.05
Mean	1.28	0.97	2.25
Median	1.14	0.88	2.02

**Sources:** Export Supply Elasticities Table 2, page 21, and Import Demand Elasticities Table 1, page 15 in *A Method for Calculating Export Supply and Import Demand Elasticities* by Stephen Tokarick. Washington DC: IMF Working Paper WP/10/180, published 2010. N.B. Signs have been reversed for Imports in the table above for the sake of clarity.

competitive exchange rate policy set out in this pamphlet, however, is much broader and less short-term than this. It is to make it worthwhile siting new manufacturing capacity in the UK rather than elsewhere, thus producing a quantum leap in the UK's exporting potential and its import saving capability. This is what is needed to bring the elasticities back to where they ought to be.

Caution is still required, however, and this is why the calculations about the impact of a lower exchange rate in this pamphlet have been based on elasticities of 0.8 for exports and 1.0 for imports, which are considerably lower respectively than the 1.37 and 1.68 of the IMF report. These lower elasticities still easily fulfil the widely accepted criterion for a lower exchange rate producing an improved trade position – the Marshall Lerner Condition – which is that the sum of the import and export elasticities (ignoring their sign) is more than unity. Given a commitment by the government to maintain a sufficiently competitive exchange rate to make a substantial measure of reindustrialisation profitable in the UK, the risk of an inadequate elasticity response therefore looks low.

The third issue is whether it is realistic to assume that the overall or social rate of return on a substantial proportion of the new investment in mechanisation, technology and power, with most of it going into manufacturing industry, would be high enough. Would it be sufficient to make a shift towards both more investment and a better trade balance possible at the same time as paying for rising social and environmental costs, avoiding a severe squeeze on disposable incomes and finding the resource for increased investment? The evidence from Table 1.1 indicates that this condition is also one which could be met. Both Japan and China have had long periods in their histories – matched by

## CONCLUSIONS

the USA and even to some extent the UK for shorter periods during the build-up to World War II – when returns on the required scale were achieved. We need to replicate them again, using the same determination and foresight to break ranks with the past as the government did in the UK when coronavirus struck, only this time to build the economy up rather than drastically to reduce its output.

So, there are some risks with a competitive exchange rate strategy even though they look containable. And these risks need to be weighed up against those entailed by not adopting this kind of strategy. The risks are then a prolonged and slow recovery from Covid-19, accompanied by increasing cost pressures while the UK economy becomes even more unbalanced, its growth rate falters, and living standards decline, probably quite steeply. The risks involved in this scenario economically, socially, politically and internationally are clearly very substantial. This is why recognising the need to make the UK economy more competitive, and taking the necessary action to make it happen, may be a much safer course of action than ploughing into another decade of import- and debt-led stagnation.

# Notes

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- 1 See Table 1.1.
- 2 ONS code HBOP divided by ABMZ.
- 3 ONS codes ELBH and ELBI
- 4 Page 75 IN *International Financial Statistics 2018*; Washington DC, IMF, 2018
- 5 Ibid page 81
- 6 Ibid
- 7 ONS code DLWO
- 8 Page 1059 in *International Statistics Yearbook 2018*. Washington DC: IMF 2018.
- 9 Page 7 in *Economic Review, March 2014*. London: ONS, 2014.
- 10 Calculations based on ONS codes AQBNI and YBEX. London: ONS, March 2020
- 11 Export value tables in successive editions of *International Financial Statistics Yearbooks*; Washington DC: IMF.
- 12 Ibid
- 13 Code IKBD. London: ONS, March 2020
- 14 Data from Section 8 of the 2019 Pink Book. London: ONS, 2019
- 15 ONS NUTS Data. London: ONS 2018
- 16 Calculated from ONS NUTS data
- 17 Table 4.1 in GLA London Input-Output tables, Working Paper 97
- 18 UK GDP, measured by ONS code ABMI, was £2.09trn in 2019. London, according to Google data, accounts for approximately a quarter of UK GDP.
- 19 Poverty and wealth across Britain 1968 to 2005. ERF website and *North and South* by David Smith
- 20 ONS Wage Data. London: ONS, 2019
- 21 Statement by Philip Hammond as Chancellor of the Exchequer
- 22 Official statements on departmental websites.
- 23 [www.kingsfund.org.uk](http://www.kingsfund.org.uk) website
- 24 [www.oecd/health](http://www.oecd/health)

## NOTES

- 25 [www.kingsfund.org.uk](http://www.kingsfund.org.uk) website
- 26 [www.gov.uk/education/training](http://www.gov.uk/education/training) and skills
- 27 [bbc.co.uk/news/education](http://bbc.co.uk/news/education) 50663833
- 28 [www.oecd/training](http://www.oecd/training)
- 29 Google website entry on Social Care
- 30 [www.ukhca.co.uk](http://www.ukhca.co.uk) website
- 31 ONS national population projections
- 32 Page 84 in *International Financial Statistics 2018* gives a figure of 84%. Washington DC:IMF 2018
- 33 This was an argument advanced by Rebecca Long-Bailey
- 34 Media reports in early April 2020
- 35 Reports from SAGE – the UK’s Scientific Advisory Group for Emergencies
- 36 Office for Budget Responsibility report early April 2020
- 37 Statement by the Chancellor of the Exchequer in early April 2020
- 38 ABMI Time Series data. London: ONS
- 39 While ONS code DLWO, covering investment in Other Machinery and Equipment has fallen from 4% of GDP in 2008 to 2.9% in 2018, overall depreciation as a percentage of GDP has risen over the same period from 11.8% to 12.7%
- 40 Data provided by the Centre for Progressive Capitalism
- 41 ONS codes BOPO and BOPP
- 42 World Bank database.
- 43 GDP Volume Growth tables in successive editions of *International Financial Statistics Yearbook*. Washington DC: IMF
- 44 *Trade Theory with Numbers: Quantifying the Consequences of Globalization* by Arnaud Costinot and André Rodriguez-Clare. Handbook of Economics, Vol 4, 2014
- 45 World Bank statistics
- 46 Society of Motor Manufacturers and Traders statistics.
- 47 Detailed calculations showing how these figures are reached can be found in *Call To Action* by John Mills and Bryan Gould. London: Penguin Random House, 2015
- 48 Google entry on the USD YEN exchange rate
- 49 Ibid, page 981
- 50 Ibid, page 125
- 51 Page 66 in *International Financial Statistics Yearbook 2014*. Washington DC: IMF, 2014
- 52 Ibid, pages 89 to 91
- 53 Wikipedia entry on the Plaza Accord

- 54 Pages 826 and 827 in *International Financial Statistics Yearbook 2017* shows a net return on UK investments abroad averaging 2%.of their capital value over the period 2007 to 2016
- 55 Wikipedia entry on Herbert Stein.
- 56 Country tables in *International Financial Statistics Yearbook 2016*. Washington DC: IMF, 2016
- 57 Ibid 2018, Exports FOB Table.
- 58 Page 981 in *International Financial Statics Yearbook 2000*. Washington DC: IMF, 2000
- 59 [www.xe.com](http://www.xe.com) website
- 60 *CALL TO ACTION: Britain's economic problems and how they can be solved* by John Mills and Bryan Gould: London: Ebury Publishing, 2015 contains the necessary calculations
- 61 Producer Prices/Wholesale Prices 1970 to 1999, pages 120 and 121 in *International Financial Statistics Yearbook 2000; Prices: Home and Imported Goods for Switzerland, 1999 to 2010*, page 696 and prices for manufacturing output for the UK, page 742 in *International Financial Statistics Yearbook 2011*. Washington DC: IMF, 2012
- 62 Table UK1 in *Economic Statistics 1900-1983* by Thelma Liesner. London: *The Economist*, 1985
- 63 Ibid, Table UK.15
- 64 Ibid
- 65 Wikipedia entry on Bretton Woods
- 66 Page 981 in *International Financial Statics Yearbook 2000*. Washington DC: IMF, 2000
- 67 [www.poundssterling.com](http://www.poundssterling.com)
- 68 For example, a recent paper by Francesco Aiello, Graziella Bonanno and Alessia Via of the European Trade Study Group finds that “the long run level of exports appears to be unrelated to the real exchange rate for the UK”. Quoted in an article by Lord Skidelsky in *The Guardian* on 21st October 2016

# The Covid-19 Review

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There will be plenty of official inquiries into the Covid-19 pandemic and the British Government's response to it. This series of reports is intended to help those sitting on these inquiries, as well as the public, MPs, peers and experts, to ask the right questions.

To ensure proper accountability and independent scrutiny, these reports are inspired by the need respectfully to examine some of the roots and handling of the crisis and how we can best prepare for future outbreaks.

The authors do not doubt the huge efforts of all involved in addressing the pandemic, from the frontline medical staff, to all those in care homes and the ancillary services, through to our political leaders. Nor do we doubt that, throughout the crisis, they acted with the best of motives.

But there are clearly alternative approaches and different national rates of success in responding to Covid-19. What is important is that we learn the right lessons from this outbreak so that, next time, it really will be different.





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## THE COVID-19 REVIEW

How Britain responded to the Coronavirus

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The global economy may well take much longer to recover fully from the shock caused by the coronavirus crisis than many initially expected – and hoped. With business closures and lockdowns forecast to throw the world into the deepest recession since the 1930s Great Depression, John Mills, the UK entrepreneur and economist with a life-long political background in the Labour Party, suggests that the UK economy will be faced with a number of disadvantages which will make recovery especially difficult.

In this report, John Mills sets out why, as result of unwise policy decisions taken over a long period, the UK economy will be poorly positioned to recover from the Covid-19 pandemic. Our economy is unbalanced and the underlying growth rate is low. The proportion of our GDP which we invest in the future is far below the world average and what money we do spend is not on the right projects. We have deindustrialised to a greater extent than any other advanced economy, with dire consequences for regional balance, good steady job prospects, increases in productivity and our ability to pay our way in the world.

The root cause of our problems is over-reliance on services at the expense of manufacturing. For many years we have run our economy with a relatively high exchange rate which suits the City and our service economy but too strong a pound has been lethal for siting manufacturing facilities in the UK. It has made it impossible to invest sufficiently in the categories of investment which really drive productivity, particularly mechanisation, technology and power.

To achieve a successful recovery from the pandemic, we desperately need a stronger industrial base both to rebalance our economy and to enable us – without decimating most people's disposable incomes – both to recover from Covid-19 and to pay for the mounting costs of climate change, health and social care, pensions and training. Without a much stronger manufacturing base, we run a major risk that UK living standards will be lower in 2030 than they were in 2019 or even 2007. The real choice we now have in front of us is between export- and investment-led growth or import- and debt-led stagnation.

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