CSJ The Centre for Social Justice

John Mills Institute for Prosperity

CSJ DISCUSSIONS

The Road to Prosperity

Why enhancing Britain's manufacturing base is essential for levelling up Britain

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Report by **John Mills**

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About the Author

John Mills is a businessman, economist and author who has long been involved in political affairs. He is also the founder, Chairman and majority shareholder of JML, the global consumer goods company which sells high-volume consumer products in the UK and 85 countries worldwide.

John started his career selling household goods door-to-door as a student in 1959. After two years national service in the Royal Navy, a six-month spell at Unilever and a series of other business ventures, John founded JML from his basement in Camden in 1986. Under his stewardship, JML has become a global multi-channel retailer selling over 15 million products a year. Today, JML is one of Britain's most successful exporting businesses employing over 250 people. The success of the company has helped put a JML product in more than 7 out of 10 homes in the UK.

John Mills has been a Labour Party supporter, donor, and activist for over 50 years. As an economist, his main interests are the relatively poor performance of western economies compared with those in the East and the UK's relationship with the EU. For many years, John was a senior Labour elected member of Camden Council, the London Borough's Association and the Association of Metropolitan Authorities. In the late 1980s, he was deputy chairman of the London Dockland Development Corporation.

John was formerly the Chairman and then Deputy Chairman of Vote Leave, Co-chair of Business for Britain, and the founder of Labour Leave, all campaigning for Brexit during the run-up to the June 2016 EU referendum.

Today, he is now joint-chair and treasurer of the Foundation for Independence. He is also the Vice-Chairman of the Economic Research Council and founder of Labour Future and The John Mills Institute for Prosperity, all concerned in different ways with the UK's economic and political prospects.

A committed and well-respected advocate for growth and enterprise, John Mills is an accomplished writer and has published over 12 books over the last 40 years on a range of political and economic issues.

Having appeared on all major UK broadcasters including Radio 4's The Today Programme and BBC's Question Time, John remains a go-to commentator and analyst on issues relating to the UK economy, exchange rate policy and Britain's withdrawal from the European Union.

In 2018, he founded the John Mills Charitable Trust, which supports organisations active in economic and political research, as well as other worthy causes. He is a supporter of the mental health charity SANE. John lives and works in London.

About the John Mills Institute for Prosperity

The John Mills Institute for Prosperity is a cross-party research initiative that seeks to provide policymakers of today and tomorrow with new, innovative, and fresh ideas to increase levels of prosperity and growth.

By working with policy stakeholders, legislators, business and industry leaders, trade union representatives, economists, commentators, regional leaders and the public, the Institute for Prosperity aims to bring policymakers together to effect change and find new solutions to Britain's economic problems.

About the Centre for Social Justice

Established in 2004, the Centre for Social Justice is an independent think-tank that studies the root causes of Britain's social problems and addresses them by recommending practical, workable policy interventions. The CSJ's vision is to give people in the UK who are experiencing the worst multiple disadvantages and injustice every possible opportunity to reach their full potential.

The majority of the CSJ's work is organised around five "pathways to poverty", first identified in our groundbreaking 2007 report Breakthrough Britain. These are: educational failure; family breakdown; economic dependency and worklessness; addiction to drugs and alcohol; and severe personal debt.

Since its inception, the CSJ has changed the landscape of our political discourse by putting social justice at the heart of British politics. This has led to a transformation in government thinking and policy. For instance, in March 2013, the CSJ report It Happens Here shone a light on the horrific reality of human trafficking and modern slavery in the UK. As a direct result of this report, the Government passed the Modern Slavery Act 2015, one of the first pieces of legislation in the world to address slavery and trafficking in the 21st century.

Our research is informed by experts including prominent academics, practitioners and policy-makers. We also draw upon our CSJ Alliance, a unique group of charities, social enterprises and other grass-roots organisations that have a proven track-record of reversing social breakdown across the UK. The social challenges facing Britain remain serious.

In 2022 and beyond, we will continue to advance the cause of social justice so that more people can continue to fulfil their potential.

In this new Discussions paper, economist and businessman John Mills makes the case that only a revolution in manufacturing supported by macroeconomic change can deliver the change needed to meet the challenge of levelling up.

Foreword

In 2019 the Conservatives were elected with a majority of 80 based on two key promises: delivery of the people's vote to leave the European Union in 2016, and the pledge to "level up" those parts of this country that for too long felt that the political class had left them behind. While there is an electoral imperative for the Conservatives – shared by the Labour Party - to address the needs of those voters, without whom electoral victory will not be possible, the moral imperative to make Britain a more inclusive economy – and a fairer society – is even greater.

The Prime Minister himself has rightly attributed the root cause of our regional disparities – among the largest in the industrialised world – to our enormous productivity gap. This causes slow and unequal growth, stunted wages and frozen living standards. While London has accelerated away, every other UK region is less productive than the national average, and in relative terms has fallen further and further behind. the average London worker earns 164 per cent of the average worker in Blackpool and is 280 per cent more productive. In some parts of Britain, there has been almost no meaningful growth at all since 2008.

In this CSJ Discussions paper, published jointly with the John Mills Institute for Prosperity, economist John Mills argues that the goals of levelling up and tackling regional inequality can only be achieved by rebooting and reinvigorating Britain's embattled manufacturing sector. While Britain was once the "workshop of the world", manufacturing has declined as a proportion of our national income from 30 to just 9 per cent. Without a strong manufacturing base, Mills argues, it will not be possible to achieve the levels of growth necessary to level up the country, or to reduce the deep disparities between our regions.

He makes the case that manufacturing has the potential to generate the growth needed to close the North-South divide in a way that low-skilled services sectors can't. He also claims that jobs in manufacturing tend to provide better salaries, more job stability, opportunities for progression and job satisfaction than many of the low-paid, low-skilled jobs on which many regions have come to rely.

Some may argue that advanced economic deindustrialise inevitably, or that UK industry is simply uncompetitive in a globalised world. But Mills provides powerful counter-examples to this trend, notably Germany and Japan. And UK exporters are not, he argues, inherently uncompetitive. Rather they are hobbled by a huge obstacle beyond their control: the exchange rate.

This obstacle has nothing to do with the efficiency, effectiveness or the inherent competitiveness of our industries, and everything to do with the international strength of sterling pricing British companies out of the market. The Government must take action, he says, to mitigate this destructive macroeconomic barrier. Moreover, as manufacturing declines as a major part of our economy it loses esteem, sucking talent and ambition away from our industries and industrial regions.

The Centre for Social Justice is a think tank committed to improving the lives of the poorest in our society. In our own previous reports, *The Great British Breakthrough* (2017), *The Future of Work* (2017 & 2018), and *Poverty, Productivity and Place (*2018), we have exposed the role of geography in determining – and, in some cases, limiting – people's futures and potential.

This experience of place-based decline all too often precipitates a downward spiral of other social ills, from mental health problems and poor education to low pay, unemployment, rising addiction and family breakdown. The American opioid crisis, which has been clearly correlated with the closure of hard industries in the Rust Belt, is a stark example of this.

Stagnant growth, weak wages and low-quality jobs mean lost potential and dashed opportunity, but also place huge demands on our welfare state. Forty per cent of Universal Credit claimants are currently in work: better jobs would allow more parts of the UK to become genuinely self-sustaining, rather than relying on subsidies and welfare. Tragically, many UK regions have come nearly to an economic standstill during periods in which welfare has simultaneously been cut. For more people to be able to stand on their own two feet there is a clear case that our grossly unbalanced economy needs to change.

The CSJ is embarking on its own major report on the UK manufacturing sector, looking at the macroeconomic issues highlighted here by Mills, but also looking at skills, training, apprenticeships, regional incentives, opportunities for devolved decision-making, the use of procurement to stimulate underperforming regions and options for greater partnership between government and industry in delivering better quality jobs. It is hoped that this work will shape and inform UK public policy thinking, and persuade government to place manufacturing at the heart of levelling up. This Discussions paper marks a first step in reintroducing the role of manufacturing into the debate on how to reinvigorate all UK regions.

We believe passionately in the value of work, but also that work should be productive and dignified. British workers of all backgrounds should have access to good jobs, wherever they happen to be born. If we are to take the scale of the levelling up challenge seriously, our goal must be that the dignity of work is something that's available to all.

Gavin Rice, Policy Director
Centre for Social Justice

Introduction

This report is a contribution to the debate about UK economic policy. It has been produced jointly by the Centre for Social Justice (CSJ) and the John Mills Institute for Prosperity (JMI). The CSJ has a particular interest in improving the well-being and job prospects of the most disadvantaged. JMI's primary focus is on getting the economy to grow faster and in a more balanced way. Both parties to this report, therefore, have a substantial overlapping common interest in policies to increase productivity, in making the levelling up agenda successful, in reviving manufacturing if this is the best way to do this, and in generating more prosperity to make everyone better off.

The UK is still a rich country by world standards, but it is suffering from lower and lower economic growth, compared with many other economies, particularly many in the Far East. Once the recovery from Covid-19 has taken place, UK growth is projected by the Bank of England and the Office for Budget Responsibility, both of whom have been over-optimistic in the past, to average well under 2% per annum[1]. There is a massive difference in prosperity and living standards between those in London and the rest of the country. Unemployment is low and the proportion of the total population in work is at an all-time high, but far too many people are in low productivity, insecure jobs, struggling to make ends meet. This is all happening at a time when we have a number of very expensive claims on GDP which we are going to have to meet over the next few years. Dealing with climate change may well cost 3% of GDP; rising health care costs another 2%; social care and increased expenditure on pensions a further 2%; and restoring the past decade's cuts to training budgets another 1% - about 8% of GDP in total. Most of these costs are going to fall on the public sector, pushing up government expenditure at a time when the country's ability and willingness to pay considerably higher taxes may be strictly limited.

The thesis in this report is that all these problems would be much more manageable if the economy was performing better – growing faster and doing so with less regional inequality. The need to respond to these challengers has not, of course, been lost on policy makers in either the recent or more distant past. Endless studies have been carried out on the UK's productivity slow down. Dealing with the North-South divide and finding ways of improving prospects in the UK's left behind towns and cities – and the countryside which surrounds them – has now moved to the top of the policy agenda. The issue raised in this report, however, is whether the focus of nearly all this work has been on the real root cause of the UK's mediocre growth and massive inequality problem or whether too much effort has gone into researching supply side solutions rather focusing on the demand side of the productivity challenge.

More specifically, the conventional approach to considering why the UK economy has been growing so slowly and why there are such imbalances has been to focus almost entirely – to the exclusion of wider matters - on supply side factors. These include improving education and training, upgrading the country's infrastructure, encouraging companies to invest by giving them tax breaks and easier access to finance, providing guidance to companies with weak productivity records to catch up with those doing better and promoting more R & D. All these approaches are valuable, and they all help a bit. The question is whether they work well enough, even if they are all done together, to make any real difference to the performance of the economy. Will they be adequately effective in the absence of policies to complement them which make it possible to substantially increase demand without overheating the economy and generating unmanageable inflation or balance of payments problems?

This gap cannot be bridged by the current policy approach. Supply side remedies on their own do too little to make sufficient difference. We estimate that, in relatively slow growing economies such as ours, successful implementation of the whole of the supply side agenda is capable of contributing no more than about a 0.5% increase in GDP per annum. In much faster growing economies, there may be a 1% supply side contribution, but no more. This is because it is not supply-side inputs which provide most economic growth. Rather, economic growth is driven largely by physical investment, and in particular by certain categories of investment which are capable of producing much higher rates of return than the average.

This distinction between categories of physical investment with high or low total – or social – rates of return is crucially important. Most physical investment is never expected to contribute much to economic growth and is not undertaken with this goal in mind. This is true of nearly all public sector projects – in road, rail, schools, hospitals, public buildings and housing. It also applies to a substantial proportion of private sector investment - in office blocks, shopping malls, projects such as new restaurants and IT systems – and again housing. The high return categories of investment, which are mostly found in the private sector, cluster round mechanisation, the application of technology and the use of power. Think of a combine harvester replacing a scythe, a computer instead of a slide-rule, a 44 ton truck compared to a wheel barrow or a new machine which produces twice the output of one it replaces with the same inputs.

It was the discovery and development of these kinds of high-return investment opportunities which made the Industrial Revolution possible. Whereas most investment produces a return to the whole economy roughly equal to the interest payable on its funding - around 5% per annum on average - these high-powered types of investment can produce much higher returns. They can typically be as much as 50% or more per annum, taking account of the fact that their high increased productivity generates not only a recompense for whoever funded the investment but also provides increased value added to fund higher wages, greater profitability, a stronger tax base, and often better and cheaper products. How do we know that total returns of 50% or more are achievable? The answer is that there is no other way of accounting for the very rapid increases in GDP produced, for example, by Japan for decades after 1945 and by the Chinese since China rejoined the world economy trading system around 1980.

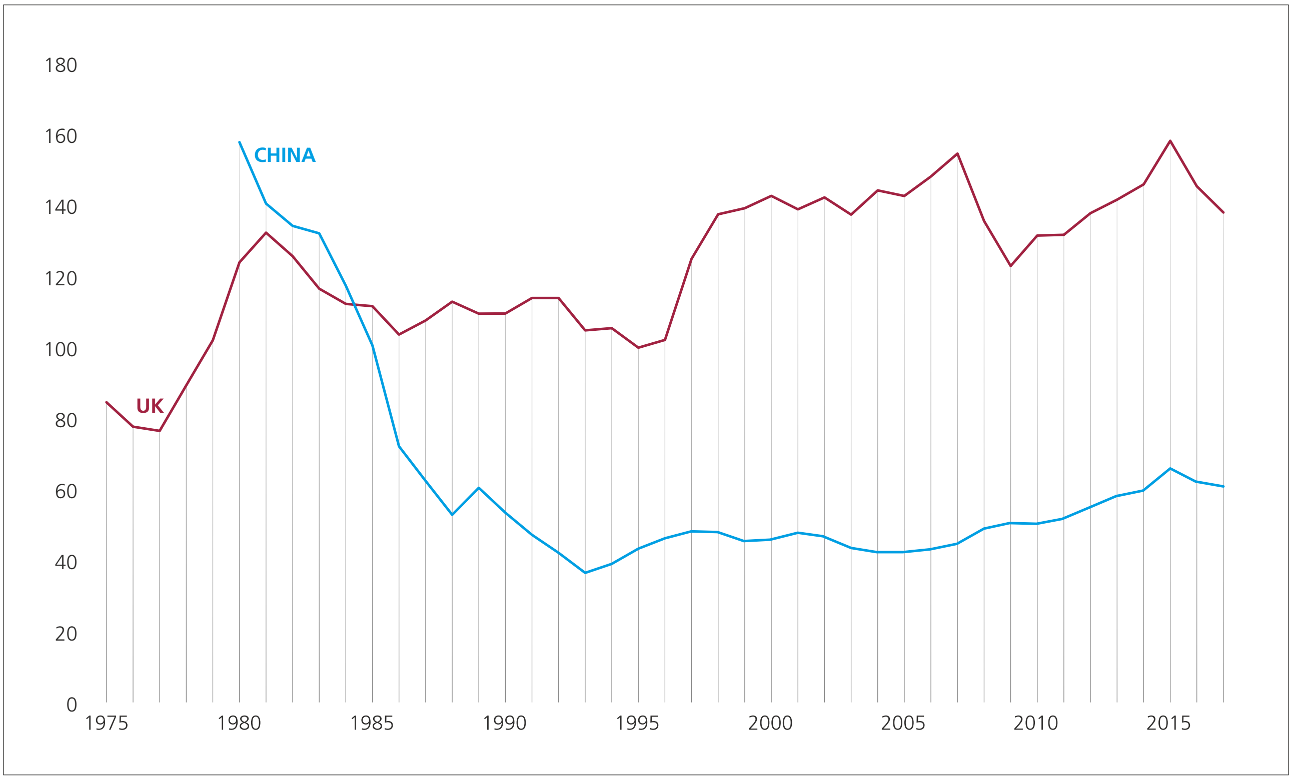
A critically important feature about investments in mechanisation, technology and power, however, is that they tend to be found in the internationally traded, highly competitive privately owned light industrial sector, where profitability is key. To ensure that investment of the high growth orientated type is generated in sufficient quantities, the economy has to be able to sell its manufactured output into the world market at competitive prices. This is what produces the export-led growth which makes investment profitable enough to make sure that it materialises on a sufficient scale, thus generating greater productivity, rising GDP and increasing living standards.

Judged by this criterion, the UK has done extremely poorly. Our lack of competitiveness is shown all too vividly by the extent to which we have lost share of world trade steadily since the end of World War II. By some measures, as much as 25% of world manufactured exports came from UK factories in 1950.[2] The ratio is now less than 2%.[3] Even as late as 1970, almost a third of UK GDP, where a large proportion of the most productive investment is to be found, came from manufacturing.[4] Now it is about 9% and still drifting downwards.[5] The reality is that no economy can grow as fast as the world average if it is losing share of world trade and no developed and diversified economy can grow reasonably rapidly - let alone in a balanced way - unless it has a prosperous manufacturing sector. The root problem with productivity in the UK is that our economy enjoys neither of these key requirements, and this has much to do with the left behind areas of the UK and the levelling up problem.

The Cost Base

Why have UK prices for manufactured goods produced by UK factories been uncompetitive enough to cause our share of world manufactured exports to fall by over 90% over the last seventy years? Why has manufacturing as a percentage of UK GDP gone down from around 30% even as late as 1970 to less than 10% now?[6] It is not because of the costs of raw materials, machinery or components are higher in the UK than they are elsewhere. There are world prices for all these manufacturing input costs, which typically make up about 30% of manufacturing costs on average and in world currency terms they are more or less the same everywhere.[7] The crucial distinction is in the rate at which all the other costs involved in manufacturing in the UK are charged out in export prices. These are all the charges which are paid for in the domestic currency – sterling, of course, in our case. These include wages and salaries, almost all overhead costs, interest charges and taxation, all making up the remaining 70% of total manufacturing costs, once the 30% for machinery, raw materials and components is excluded. Whether these domestically incurred costs are charged out as export prices which are competitive or not then depends partly on how efficient UK manufacturing is compared to elsewhere and partly on the exchange rate, which is used to translate domestic prices into those offered to world markets. The UK problem is that UK manufacturing has for a long time - but especially during the last 40 years - not been efficient and cost-effective enough to warrant the exchange rate which has been used to charge out its export costs.

Chained Real Effective Exchange Rates 1975-2017



Sources: International Financial Statistics Yearbooks. Washington DC, IMF. 2000 edition: pages 344 & 345 for China and 980 & 981 for the UK; 2010 edition: page 299 for China and 744 for the UK; 2018 edition: page 279 for China and 1055 for the UKBased in all cases on Relative Unit Labour Costs

It is no coincidence that these problems have become much more acute since the 1970s and 1980s. This was when the breakdown of the Bretton Woods post-war international world trading settlement led to stagflation. The western world was confronted with serious inflationary problems, which led to very high interest rates and tight money policies being implemented to get inflation down. Price increases did subside but, in the process, sky high interest rates meant that sterling hugely strengthened as little attention was paid by the authorities to the impact of these new policies on competitiveness. Sterling rose from an index number of 76.4 in 1977 131.8 in 1973, an increase of 73% as, over the same period, the Chinese re-entered the world market.[8] Following this, China then devalued the yuan/renminbi by about 70% between 1979 and 1995[9].[10] Many other countries on the Pacific Rim followed suit after the 1997 Asian financial crisis.[11]

A brief review of the maths involved shows how enormous the impact of these exchange rate changes was. Suppose that our export prices were 100 in 1977. By 1981, with currency appreciation of 73%, they were 30 (for machinery, components and raw materials) plus 70 (covering all domestic costs) x 173% (the currency appreciation). 30 + (70 x 1.73) equals about 140. Between 1979 and 1995, on the other hand, Chinese export costs fell by half. If they were 100 in 1980, by1995 they were 70 (again the costs of machinery, components and raw materials) plus 70 (covering all domestic costs) x 30% (reflecting the reduction in charged out costs as a result of the currency devaluation). 70 + (70 x 0.30) equals about 50. This meant that the Chinese could manufacture almost anything at half the previous price without any margin sacrifice. No wonder that manufacturing still makes up almost 30% of Chinese GDP while in our case it has fallen to around 9% - and still drifting down.[12] No wonder the world's manufacturing capacity shifted on a massive scale from West to East, emasculating ours in the process.

Manufacturing

A crucial theme in this report is that any advanced economy such as the UK needs a reasonably strong manufacturing base for at least five reasons. These are:

Productivity

Because, for all the reasons given above, productivity is much easier to increase in manufacturing than it is in services, the growth rate of the economy depends heavily on manufacturing to provide the heavy lifting. It is in this sector of the economy that most of the investment in technology, mechanisation and the use of power takes place. This is why fast-growing countries such as China and India – and much richer ones such as Singapore - tend to have a considerably higher proportion of their GDP coming from manufacturing than relatively slow growing economies, such as the UK and the USA, which depend exceptionally heavily on services. It is no coincidence that the average proportion of GDP coming from manufacturing in the slow-growing West is about 15% but about 25% in the East.[13] Nor is it surprising, that, on the back of these figures, the proportion of GDP spent on investment rather than consumption is about 40% in the Far East and around 20% in the much slower growing West.[14]

Levelling Up

The fundamental problem faced by the areas of the UK which have been left behind is that deindustrialisation has left them with far too little to sell to the rest of the world for them to be able to pay their way. There is a massive gulf between the gross value added (GVA) per head of the population in London and elsewhere in the country. In 2017 GVA per head in London averaged £49k while in Wales and the North-East it was £20k – well under half the London figure.[15] Some idea of the scale of the transfers from London to the regions, to stop living standards becoming unmanageably unequal, is provided by national accounts. These show the UK with a national balance of payments deficit recently nudging up to £100bn a year while Greater London Authority data shows London with a surplus of at least £50bn.[16][17] This means that everywhere outside London is operating with a deficit - made good mainly by transfers from London – of around £150bn on GDP outside London of around £1.5trn – a 10% deficiency. We know that some cities, such as Oxford, Cambridge, Manchester, and Bristol are doing reasonably well, but this means that other areas are doing even worse.

The only way to restore prosperity to the regions is to provide them with opportunities to produce and sell goods and services on a sufficient scale to stop the gulf between London and the rest of the country widening - and hopefully to start to close it. How is this to be done? It is very hard to see the provision of more services filling the gap. Perhaps something can be done by increasing tourism, although this is clearly not a universal panacea. Some cities have greatly benefited from providing a home for universities, but it seems unlikely that this provision can be expanded much more than it has been already. The only realistic alternative is the re-establishment of manufacturing on a large enough scale to provide the prosperity which will never be made available any other way.

Job Quality

More manufacturing employment is also needed to improve the average quality of available jobs available in the work force. In 2019, 7.8% of those in work in manufacturing in the UK produced 9.7% of the total value added, indicating that productivity was about a quarter higher in manufacturing than on average in all the rest of the economy.[18] Manufacturing jobs also tend to be more satisfying and – in the right conditions – more stable. Too many of the jobs in the "left behind" areas of the country are low productivity, low skilled. This situation will never change until better more productive employment opportunities are made to materialise.

International

There is also a crucial international angle to manufacturing. A striking feature of our national balance of payments accounts is the huge deficit we have every year on manufactures – peaking at just over £100bn in 2017[19]. The UK used to be the workshop of the world with a healthy annual surplus of manufactured exports, but since the 1980s we have had a growing deficit. Our services have thrived– with an export surplus equivalent to around 5% of GDP - but this is not enough to fil the gap. Part of the problem is that services are much more difficult, on average, to sell into foreign markets than goods. Over 80% of our GDP is made up of services compared with less than 10% from manufacturing, but each of these two sectors contributes about the same amount to our export total - about 45% each with the remaining balance in commodities.[20]

Security

Perhaps no single event recently highlighted the weakness of the UK manufacturing base more vividly than its inability to produce more than a fraction of the PPE needed to deal with Covid -19. There is now a much more widely felt need to improve our security by being able to make more of what we need ourselves. These sentiments are reinforced by two other factors. One is recognition of the contribution which shipping makes to world pollution. Another is increasing scepticism about whether international trade really brings in train as much benefit as is often claimed if much of it is the exchange of similar goods. A recent report suggests that the total benefit from international trade is no more than the equivalent of about 2.5% of world GDP.[21] No doubt total foreign trade will go on having a significant ratio to world GDP, but it seems unlikely to grow faster than this in the future, as it has done during most of the past 40 years[22]. It may well even decline.

Note on Services

Services make up well over 80% of UK GDP and exports of services make up a higher proportion of GDP than in any other comparable country, generating a UK surplus of services exports over imports of over £100bn per annum.[23][24] The UK has number of key natural advantages in services – our language, our geography, our legal system, our universities, and the skills of our labour force to name just a few. Services are not very price sensitive compared to manufacturing and in the UK they can evidently compete successfully in international markets with an exchange rate of around \$1.50 to £1.00.

Their dominance means that services have a heavy influence over people's perception of what the overall exchange rate ought to be. Unfortunately, \$1.50 = £1.00 is lethal for manufacturing which has none of the natural advantages enjoyed by services, but which is vital for the balanced health of our economy. Services are vitally important to the UK economy, but they are too difficult to export to close the balance of payments gap; they tend to be concentrated in big cities which are already doing relatively well; and they have an environment where productivity increases are notoriously difficult to secure. This is why running the economy with an exchange rate to suit services rather than manufacturing condemns us to sluggish, unprofitable manufacturing exports, inadequate levels of investment, slow growth, stagnant real incomes, and to the deeply unbalanced economy from which we suffer.

How to make the economy grow

What do we need to do to avoid these outcomes? A key part of the answer is straightforward. We need to run our economy with an exchange rate which primarily suits manufacturing rather than services. We need have the pound at a level which makes it profitable to invest in new manufacturing capacity in the UK rather than elsewhere. We need our manufactured exports to be priced at levels, which mean that we no longer continue to lose share of world trade. We need to get manufacturing – with most new capacity sited in our erstwhile industrial areas but now focused on the industries of the twenty first century - rising from under 10% of GDP to probably about 15%. We do not need to attain the 20% or so achieved by countries such as Germany, Switzerland and Singapore, because we have such a strong services export record, but we do need substantially more than 10% of GDP coming from manufacturing to achieve anything like a balanced economy.

Will a lower exchange rate by itself achieve higher performance we need? No. It is a necessary but not, on its own, a sufficient condition. We need a balanced approach between the demand component from a competitive exchange rate and all the supply side responses required to make increased demand fructify. Both are equally important. The crucial take from this report, however, is that getting the exchange rate right is not something which can be tacked on to an agenda dominated by supply side issues. On the contrary, new-found competitiveness is a fundamental building block for underpinning the achievement of a revived and rebalanced economy. Without demand side improvements in place, supply side reform on its own will fail to lift economic performance by anything like the amount required.

There is another crucial advantage to having a much lower exchange rate. It stimulates investment and growth but does not require subsidies from the public purse. The main driver for increasing GDP comes from increased investment opportunities driven by much enhanced profitability, not subventions from the tax-payer. At a time when the tax take in the UK is at a peak and when incomes are already being severely squeezed, this is a huge benefit. Trying to get industry to expand when the only way to try to make this happen is by subsidising it is bound, in the end, to fail. Providing private investors and entrepreneurs with relatively easy ways of making money has been the key to strong economic growth ever since the Industrial Revolution began to get under way.

How to get the exchange rate down

How much lower would the sterling exchange rate have to be to make UK manufacturing competitive? Econometric analysis indicates that, to get the UK economy to grow, say, 2% faster per annum than would otherwise have been the case, the rate would have to be of the order of £1.00 = $1.00 or around €0.85. This is a reduction of about a quarter from its current levels of approximately $1.36 and €1.20 as of the start of 2022.[25]

How would such a reduction be achieved? The UK authorities would not have to do something which has never been tried before. Instead, they would have to pursue the same policies as many other countries do to maintain their currencies at competitive levels.

We would need government to take a lead by declaring its determination to ensure that in future the country's manufactured exports were competitively price – not excessively so but sufficiently to ensure that our economy was no longer stagnating. We would need to curtail capital imports, particularly the sale of UK assets by imposing the sort of public interest tests on take-overs which are commonplace throughout the rest of the world. We could establish a wealth fund to sell sterling assets and to buy those priced in foreign currencies – using countries as diverse as Norway and China as examples. We could use the tax system to make it less attractive for foreign interests to own UK assets, perhaps by implementing a withholding tax to provide the kind of incentive required. We would need to ensure that the Bank of England used its financial leverage to get sterling to its new competitive level and to keep it there. Using these sorts of approaches, Japan brought the value of the yen down by about a third between 2013 and 2015.[26] Germany has had what is effectively a competitive exchange rate policy throughout the period since 1945. China has made no bones about pursuing a highly price advantageous policy since 1980. Why can't we do the same? The reasons why for many decades – arguably stretching back to the nineteenth century – the UK has hobbled itself with too strong a pound, and has been reluctant to change from doing so, fall into three broad categories. They are doubts as to whether such a policy would work if it were put into practice; second, concerns about whether, even if it could be successfully implemented, it would really be right to promote faster economic growth; and third worries about whether it would be feasible to implement it in practice in the real world. We consider each of these reasons for concern in turn.

Objections in Principle

There are six well known perceptions and points of view which lead people to oppose a weaker pound policy. These are:

Inflation

There are understandable – but largely misplaced - concerns about inflation. It is true that import prices are bound to go up if the pound goes down. It does not follow from this, however, that inflation as a whole will increase, although it is widely believed that this will happen. This is not what the statistical record shows. Sometimes, as the value of the currency on the foreign exchanges goes down, prices do riser faster than and sometimes more slowly than before but generally they follow much the same trends as would otherwise have been expected. Recent examples of the impact of devaluations on the UK price level were the reduction in consumer price inflation from 5.9% in 1991 to 1.6% in 1993, when we left the Exchange Rate Mechanism in 1992, and the lack of impact on the price level there was when sterling went down from around £1.00 = $2.00 in 2007 to $1.50 in 2009.[27][28]

The reason why devaluations do not have much impact on inflation is that import price rises are always partly or wholly offset by other factors associated with a lower parity. The economy grows more rapidly, usually leading to interest and tax rates being lower than would otherwise have been the case. Production runs are longer, lowering costs, as demand switches to domestic suppliers rather than imports. The wage negotiation climate improves as the economy performs better. Devaluations do not, therefore, lead automatically to higher inflation, despite widespread belief to the contrary.

Retaliation

Would other countries retaliate against us if we moved to adopting a competitive exchange rate strategy? They have not done so in the past – for example in 1992, 2007/9 or when the pound fell after the 2016 EU referendum. We have given an undertaking to the G7 not to get involved in competitive devaluations and it should certainly not be our plan to run a large balance of payments surplus – as countries such as Germany, Holland, Switzerland, Singapore and China have done. Our intention should be to maintain a small balance of payments deficit but – while doing so – to keep our currency at a level which enables us to avoid our previous losses of share of world trade, thus encouraging sufficient investment to enable us to maintain a reasonable growth rate.

At the same time, we would be offering our goods to the rest of the world at lower prices than before and therefore with better value for money at the same time as we would become a bigger market for the rest of the world's exports. We would not be planning to destabilise world trade by under-pricing our goods to provide us with an unfair advantage; merely to avoid ourselves slipping further and further down the world growth league table.

Impoverishment

It has been argued that if we devalued by, say, 30%, this would genuinely make us 30% poorer than we were before. The fallacy in this argument is that we spend money on almost everything in the domestic currency – sterling of course in the UK – and this would not change, leaving living standards the same as they were before. What is true is that if we devalued and, as a result, we wanted the economy to grow faster, we would have to spend more of our GDP on investment rather than on consumption. Furthermore, if we wanted a smaller balance of payments deficit again, we would have to find room to do this by cutting back on consumption. These are not essentially issues specifically concerning the exchange rate, but real resource problems concerning growth and the balance of payments which would have to be confronted by any policy mix chosen to make the economy perform better and grow faster.

Markets

It is also argued that it would be impossible to bring the exchange rate down as long as the UK remained an open market. The exchange rate, it is argued, is fixed by market forces over which the authorities have little or no control.

A very brief inspection of the way in which exchange rates ae fixed throughout the world shows that this cannot be true. Of course, the exchange rate will be determined on a day-by-day basis by the balance between supply and demand for the currency. There is plenty that the authorities can do to affect where this balance lies, to bring it, as countries throughout the world know well, to where it needs to be for strategic competitive reasons and to keep it there.

Past Experience

A major problem with the international trading system, at least since the establishment of the Bretton Woods system at the end of World War II, is that countries with balance of payment surpluses have no incentive to revalue while those with deficits are forced to make a choice between devaluation and deflation. Since devaluation is all too frequently regarded as a failure, it is often put off in favour of ultimately unsuccessful deflationary policies. The economy then stagnates but eventually the damage done by over-valuation breaks through and the exchange rate drops. Unfortunately, however, this well-worn process has tended to lead to a lower exchange rate being perceived as a misfortune rather than a blessing. The fact is, however, that economies almost invariably do better with lower exchange rates despite the fact that - too often - devaluations, when they come, are too little and too late. They are then – but wrongly – perceived as an unpopular failure.

Talent

Finally, it is sometimes argued that the UK is no good at manufacturing and that we ought not try to compete. It is true that we have deindustrialised to a very substantial extent, but this has happened because our goods have been over-priced for world markets. Talent has then been sapped from industry by lack of profitability and the consequent lack of esteem which manufacturing enjoys compared to other ways of making a living. There is no reason to believe, however, that, if manufacturing was profitable, UK entrepreneurs would not take advantage of this situation as they have done all over the world, when the circumstances are right. The UK was the country in which the Industrial Revolution began to take place. It is completely implausible that our current population could not be as successful as people in other countries if the profitability environment in industry was as favourable as it is in many other parts of the world.

Do we really need Economic Growth?

There are, however, arguments that need to be considered in a wider context if we are to give serious consideration to policies to achieve a step change in growth. The main ones are set out briefly. Can we afford such a change, in the light of global warming? Is it a democratic choice? What is the impact of slow growth on inequalities and fairness? What is the bearing of current economic policies on growth on the future carrying capacity of the world? These issues are covered in summary below but clearly merit wider consideration.

Climate Change and the Green Economy

There is no doubt that faster economic growth tends to lead to higher resource usage but generally rising GDP output involves fewer material inputs per unit of output as demand switches towards services, and technology improves. The key issue is whether the increased resources which faster growth produces can be used effectively enough to provide a net positive impact on global warming and to mitigate its effects. This is the battle against global warming to be won. Clearly, it depends much more on how well resources are deployed internationally than on the relatively marginal benefit from constraining growth in the UK.

Requirements for extra resources for climate change are going to have to compete with many other claims, particularly the demands on public expenditure made from rising health and social care costs, increasing pensions and more vocational training. The fact that the benefits from climate change expenditure are a long way in the future certainly does not help to win the case for them. It seems probable, however, that it would be much easier to marshal the resources needed from a national income which is growing than from one which is static or potentially even falling.

Democratic Choice

Do people want higher incomes? There is a lively debate about whether higher living standards make people happier but there can hardly be much doubt that the vast majority of people would prefer a higher rather than a lower standard of living. This is what wage negotiations are all about and “the economy, stupid” is the territory on which general elections are fought. There have always been growth sceptics, but there is little doubt where the democratic majority lies. Rightly or wrongly, people want higher living standards.

Inequalities and Fairness

The world has gotten much richer since globalisation really bean to get into its stride about 40 years ago and the past five decades have seen huge changes in relative living standards across the world. There have been increases almost everywhere in the East but very little growth in much of the West, especially for middle and low-income people, while the already rich have seen their incomes and wealth soar. Generally, inequality between nations has tended to fall as poorer nations have seen their economies growing more rapidly than those that are richer. But within nations income and wealth disparities have widened.

How much of these changes has been the result of economic growth rather than other factors? Since there has been a tendency for income and wealth disparities to widen throughout history, with or without industrialisation, it seems hard to blame growth itself for the resulting inequality. It therefore appears to be much fairer to blame globalisation for relative changes in income levels, especially between East and West, while recognising that it is much more difficult to attribute recent increases in inequality to growth itself. There is certainly little evidence, for example, that countries which have been growing very fast, such as China, are notably more equal or unequal than ones which have been growing relatively slowly, such as the USA and the UK. Inequality depends on many factors, but economic growth on its own does not appear - to any significant extent a least – to be one of them.

Population

Ultimately, the limiting factor on human existence is very likely to be the world's capacity to support and sustain its human population. The United Nations produces predictions every two or three years and the latest one, from 2019, has three main projections. The Low Variant shows world population peaking at 8.9trn in about 2050 - and then slowly declining. The Middle and High Variants both show world population still growing, albeit slowly, in 2100 by which time the world population is projected to be respectively much higher - 9.7trn and 15.6trn - and still slowly climbing.[29]

By far the biggest influence on these numbers stems from the birth rate over the coming decades and particularly the number of children on average which women decide to have. In all societies this has historically been as much as five births per woman. When average incomes reach round about $5,000 (measured in 1990 US dollars), however, the birth rate falls to around two, or even lower almost everywhere.[30]

By far the most effective way of getting the world population to peak at a manageable number, therefore, is to increase average living standards, especially in still poor countries such as those in Southeast Asia and Africa. What will raise incomes in these places is export led growth and investment – for which open markets in the developed world are key. It seems much more likely that these markets will remain relatively free of protectionism if the rich world is prosperous and confident than if it is plagued with stagnation and discontent.

Is Faster Growth Possible?

Even if the UK decided that it was prepared to change its macro-economic and exchange rate policies to achieve a higher growth rate, would it be possible to do so? Is the world going to run into real resource problems which will make much more growth everywhere impossible? Would a shift to a competitive exchange rate by the UK be a breach of our international obligations which would simply not be allowed? Would it ever be possible to bring public – and expert – opinion on side. Clearly, there would be substantial obstacles to be overcome, but are they insurmountable?

Real Resources

On the issue of real resources, there clearly are constraints that are going to make further growth increasingly difficult and maybe eventually impossible sooner or later, but it does not seem very likely that we are going to reach this point in the reasonably foreseeable future – say by 2050. There is little sign of the world economy running out of the main raw materials on which the industrialised world depends although one commonly used material – zinc – may run short.[31] There are also already pinch points around some minerals, particularly those with high-tech uses such as cobalt, lithium, graphite and manganese, for batteries.[32] Nor does the world seem likely to run out of food, water, or facilities for waste and pollution management during the next three decades. There are clear risks of another financial melt-down or anther pandemic, which will need to be managed. There are also potential threats from natural causes, such as a major volcanic explosion, but these events take place rarely on a really major scale and therefore probably won't materialise during the next thirty years. Fears about real resources do not therefore appear to present a valid case for the UK not trying to improve its economic performance.

International Obligations

Would a move by the UK to making sterling a much more competitive currency destabilise the world economy and put us seriously in breach of the rule-based order which underpins the way the world's international economy works? It is important that we respect our international obligations, but it is also very important that we do not crucify our future by persisting with policies that do not work. Much depends on the UK putting forward clear and convincing reasons for what the country intends to achieve. We would also need to explain what steps – particularly avoiding damaging payments surpluses – were being taken to offset the fear of unwarranted and unnecessary competitive devaluations, such as those that took place between World War I and World War II.

There are many examples of countries pursuing policies on exchange rates to make sure – or otherwise – that their currencies are competitive. We do not need to do anything different from what is widely practised throughout the world. We need to make sure that we do it in a way which minimises any negative impacts, while providing reasonable opportunities to our citizens.

Public Opinion

Probably the biggest obstacle of all would be to persuade both public and expert opinion that a radical change of policy is required. For decades, people have been told that a strong pound is a good thing and a weak one is bad, although the opposite is true. They are wedded to cheap holidays abroad and low prices for goods in our stores with which domestic producers are unable to compete. The terminology about a "strong" and "weak" pound is ingrained into the national vocabulary. It is true that some of the policies needed to keep the pound high suit large sections of the population, at least in the short term. These include pensioners, for example, who tend to receive higher returns on their investments if real interest rates are kept relatively high to keep the pound up. In the end, however, everyone suffers if there is no - or very little - growth and both consumer incomes and public services stagnate.

Conclusion

The conclusion to be drawn from this brief report is that by far the biggest constraint on the UK's growth rate has been - and still is – that the UK's exchange rate has long been much too high in relation to the actual average cost effectiveness of UK manufacturing. As long as this condition persists, there will be no export-led growth and levels of investment, particularly in key areas around mechanisation, technology and power will remain low, productivity and living standards will stagnate and economic growth will be very slow.

So long as investment in export facing industries remains as unprofitable as it is at the moment, efforts to implement all the supply side agenda – however vital to achieving a balanced economy this would be in the right circumstances - will achieve very little.

On balance, there is a powerful case for increasing the UK's growth rate and plenty of international evidence to show that this would be possible, given sufficient government commitment. There are no insuperable technical reasons why a much lower exchange rate than the one enjoyed by the UK economy at the moment could not be achieved, if the will was there.

The issue is whether it ever will be. The UK establishment - and public opinion which supports it – are heavily entrenched. Discussion about whether we should have an exchange rate policy at all – let alone what it should be if we actually had one – is barely within the pale of polite conversation. We have had an over-valued currency for so long that it has become part of the intellectual furniture. Querying whether this really makes sense is off the agenda because - for many people - it is a topic which it is not respectable even to raise.

There is a high risk, then, that nothing will change. Manufacturing in the UK will continue to languish as we depend more and more heavily on services. The problems this will bring in train, however, are immense. Productivity will remain almost static and anything greater than snail-paced growth will remain elusive. There will be little in the way of new resources to deal with all the expensive new claims on the public and private realms which we can see in prospect - from climate change, health and social care, pensions and training. Our public services will face decades of austerity. Internationally, we will continue to lose our share of world trade, our growth rate will remain well below the international average and our hard and soft power in the world will continue to be whittled away. A century ago, the UK had higher average living standards than almost anywhere else in the world. Now nearly 30 countries are ahead of us. [33]

What will this do to our politics – and the levelling up agenda which is reflected all too accurately in the huge divisions there are in the UK between London and the regions, between rich and poor, between industry and services and between hope and despair? It does not need to be as bad as this. The future is ours to change, if we can muster the will and determination to make this happen.

Endnotes

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CSJ DISCUSSIONS

The Road to Prosperity

Why enhancing Britain's manufacturing base is essential for levelling up Britain

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