BREXIT ECONOMICS

How to make the UK economy the powerhouse of Europe whatever happens with the Brexit negotiations

John Mills

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72 Albert Street, London, NW1 7NR
E-mail: john.mills@jmlgroup.co.uk

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Author

John Mills is an entrepreneur and economist with a life-long political background in the Labour Party, leading him to being one of its largest donors. 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 a 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 EU 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 Chair 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 grossly unbalanced economy. He is the author or joint-author of ten books, these being: *Growth and Welfare: A New Policy for Britain* (1972); *Monetarism or Prosperity* (with Bryan Gould and Shaun Stewart, 1982); *Tackling Britain's False Economy* (1997); *Europe's Economic Dilemma* (1998); *America's Soluble Problems* (1999); *Managing the World Economy* (2000); *A Critical History of Economics* (2002); *Exchange Rate Alignments* (2012); *Call to Action* (with Bryan Gould, 2015) and *The Real Sterling Crisis* (with Roger Bootle, 2016).

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BREXIT ECONOMICS

How to make the UK economy the powerhouse of Europe whatever happens with the Brexit negotiations

Introduction

We have a major problem in our financial relationship with the other EU countries. It would exist whether or not the Brexit vote on 23rd June 2016 had gone the way it did. Furthermore, unless action is taken to deal with it, this challenge is likely to continue to be with us whatever the outcome of the Brexit negotiations currently in train. This is a matter which ought to concern all the political parties in the UK as everyone in the country shares a common interest in finding a solution. The table below sets out what the problem is:

	EU27	Rest of The World	Overall Balance
Goods Deficit	-£96bn	-£38bn	-£134bn
Services Surplus	+£24bn	+£73bn	-£97bn
Overall Trade Position	-£71bn	+£34bn	-£37bn
Net Investment Income	-£10bn	-£13bn	-£23bn
Transfers	-£11bn	-£13bn	-£24bn
Total	-£93bn	+£9bn	-£84bn

Source: Table C in Balance of Payments 2016 Q4. London: ONS, March 2017. All figures are for 2016.

We have a trade deficit with the EU which, in 2016 – a reasonably typical year – came to £71bn. We had an additional deficit of £10bn on "primary income", which is the difference between the return on EU investment in the UK and our investment in other EU countries, plus net remittances to the EU27 from EU immigrants. And then, on top of this, we had a further deficit of £11bn in the form of our net contribution to EU funds, which is unlikely to diminish for several years whatever the outcome of the Brexit negotiations. This all comes to a total of £93bn, which is just short of 5% of UK GDP. It is a huge sum – representing a little less than £1,500 per person per year in the UK, or almost £6,000 per annum for a typical four-person family[1].

This very large deficit stands in sharp contrast with our dealings with the rest of the world. Here, we have an overall surplus which, in 2016, came to £9bn. We had a £38bn deficit in goods but a £73bn surplus on services and this trade surplus easily covered our £13bn negative net income from abroad and £13bn in transfers abroad – mainly aid programmes and remittances[2].

Our overall foreign payments deficit – running at £84bn in 2016, for which our deficit with the EU27 is more than entirely responsible – is a huge problem for us. To fund this gap, every year we have to sell assets or to borrow money from abroad, as a result of which we are getting deeper and deeper into debt. Because we have had large balance of payments deficits for many years, with the gap being filled largely by sales of UK assets, we have lost control over large swathes of our economy. Two thirds of all manufacturing companies in the UK employing more than 500 people are now owned abroad. So are most of our rail franchises, our utilities, our energy companies, our ports and airports, many of our football clubs and large numbers of residential properties. With ownership goes both control and the returns and the dividends from profit distribution, which is one of the major reasons why we have gone from having net income from abroad running at about £20bn a year not so long ago, to the current negative figure nowadays of around £25bn.

Our balance of payments deficit is also largely responsible for the fact that the government cannot balance its books. All borrowing in the economy has to be

matched by all lending and the table below shows the position which the UK has been in for the past few years.

UK Net Lending (+) and Net Borrowing (-) by Sector in £bn

Year	Public Sector	Corpor-ations	House-holds	Rest of the World	Net Totals
2008	-76.8	35.0	-12.9	54.8	0
2009	-160.5	65.5	50.6	44.4	0
2010	-150.4	36.3	71.1	43.1	0
2011	-124.6	3.4	41.7	29.5	0
2012	-139.4	41.7	36.2	61.6	0
2013	-99.5	19.0	3.6	76.9	0
2014	-101.7	16.0	0.3	85.4	0
2015	-80.2	-6.5	-2.8	81.3	-8.2
2016	-63.9	17.1	-22.7	86.5	17.0
2016 Q1	-15.7	-3.8	-2.6	25.3	3.2
2016 Q2	-16.4	2.2	-3.1	21.3	4.0
2016 Q3	-19.4	3.5	-5.9	26.5	4.7
2016 Q4	-12.4	15.2	-11.1	13.4	5.1

Source: Figure 5 and subsequent tables in – Quarterly National Accounts 2016 Q4 and previous versions of Table I in the same publication. London: ONS, March 2017. Figures for 2015 and 2016 are still being reconciled by ONS and the net totals will also be at or very close to zero when this process is complete.

This table shows how all surpluses and deficits have to balance out and that – unless completely implausible assumptions are made about consumers and the corporate sector levels of borrowing – the government deficit has to be more or less the mirror

image of the negative foreign payment balance. We will therefore never eliminate government borrowing on the current scale unless we get the balance of deficit down to much more manageable proportions.

Concerns about the size of the government deficit are, in turn, responsible for government cut-backs in expenditure and the austerity from which the country has been suffering, especially since the 2008 crash. This in turn, is a major reason why the economy is growing relatively slowly and why, for most people, their incomes are no higher – and often lower – than they were ten years ago.

What can we do about this situation, and does the Brexit vote help or hinder us in finding a solution? Some of the signs are reasonably hopeful. So far, the performance of the UK economy since the EU referendum has been much better than predicted by many people, including the UK Treasury, the Bank of England, the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD), all of whom predicted a downturn – which never materialised – after the Brexit vote. In fact, according to the ONS's latest revised figures, the UK economy grew by 0.2% during the first quarter of 2016, and by 0.6% for each of the second and third quarters and at 0.7% for the last quarter. The result was a 2.2% growth rate for the whole of 2016, which left the UK economy expanding at a faster rate than any of the other G7 economies. Projections for 2017 have recently been raised by the Bank of England from 1.4% to 2.0% – up from 0.8% in August 2016 – suggesting that at least most of the post-Brexit momentum may be sustained. There are, however, evidently hazards which may need to be overcome over the next few years in addition to anything to do with the EU. This pamphlet suggests ways in which not only all these risks might be contained, but how the UK economy could be managed in a way which would produce a far better outcome in terms of growth and sustainability than we have seen recently, whatever the outcome of the current Brexit negotiations and taking fully into account the £93bn EU deficit problem.

Brexit Negotiations

The UK – and the EU – have two years after the UK triggers Article 50 in which to conclude negotiations on the UK leaving the EU, unless – which may not be easy to arrange – this period is extended by mutual agreement. It may be that this two-year goal will be achieved. To move matters forward as fast as possible, the UK government has set out the outline of its negotiating position which, by being relatively simple and straightforward, might make this possible. This entails the UK leaving the Single Market, exiting the European Economic Area (EEA) and the Customs Union and then negotiating a free trade deal with the EU27. In all the circumstances, arrangements along these lines look like being much the best outcome to the negotiations for both the UK and the EU27. Their achievement, however, depends on there being sufficient goodwill and sense of urgency to get an agreement in place within the two-year time limit. This may happen but there are a number of reasons for being concerned that it may not. In particular:

1. The negotiations for the UK leaving the EU fall essentially into two parts. One is agreeing the terms of separation and the other is determining the relationship to be in place after we have left. While the UK government would like these two processes to take place concurrently, the EU has indicated that they might prefer them to be dealt with consecutively. This would clearly be more time-consuming than dealing with them together.

2. Before negotiations start in earnest there are difficult issues to resolve round UK commitments to the EU covering, in particular, past overspends, pension entitlements and future commitments, potentially totalling as much as €60bn, although there are offsets which may bring this figure down to perhaps half this amount. There is a danger that this issue may delay getting negotiations under way on other matters.

3. Although, broadly speaking, the exit negotiations are to be conducted by the EU Commission, and are thus subject to Qualified Majority Voting, subsequent

trading arrangements may involve all of the remaining EU27 Member States separately, obviously increasing the risk of hold-outs and delays.

4. A large amount is going to depend on how pragmatic the EU27 are in agreeing terms for the UK's exit from the EU. There is a risk that "punishing" the UK – perhaps to discourage others from following us out of the EU as much as anything else – becomes a more important objective for EU negotiators than agreeing arrangements which are in everyone's best interests. Developments along these lines would clearly make it much more difficult for the UK to reach a satisfactory agreement with the EU.

5. There are elections taking place in a number of EU countries during the next two years, particularly those in France and Germany in 2017. It is not clear, therefore, that the UK will have a consistent team of people with whom to negotiate, opening up the possibility of negotiation stances being altered during the negotiation period, with the consequent lack of consistency inevitably producing more delays.

There are therefore risks that the negotiations will either reach deadlock or that they will not be completed within the two-year period, with the possibility of an extension not then being agreed. If this happens, unless the UK has a fall-back position prepared, there is a risk that the EU may confront the UK with a "take-it-or-leave-it" deal which falls well short of what the UK hopes to achieve but which we could have little alternative but to accept. This might well be for the UK to remain in the Single Market, probably through EEA membership, and thus still bound by the European Court of Justice, obliged to accept free movement of people and very probably committed to paying a substantial net sum to the EU every year. As is the case with Norway, in this scenario, the UK would be bound by all the Single Market constraints, albeit with access to Single Market customers, but with no more say than the Norwegians have on how the Single Market develops.

There are, no doubt, some people in the UK who are so against any severance of our existing ties with the EU that they might not be too dismayed by an outcome along these lines. This is not, however, what the electorate voted for in June 2016 and there would almost certainly be a majority who would be extremely disappointed by this result, not least because it might make any action to reduce our huge financial deficit with the EU much more difficult to achieve. To avoid an outcome along these lines, the UK needs to have a fall-back policy which does not depend on an agreement with the EU being reached within the two-year period. This is not to say that we should not try to achieve reaching an agreement with the EU27 within the two-year period. We just need to know where we are going if this cannot be accomplished.

There is a widely shared view that the fall-back strategy should be for the UK to be willing to trade with the EU27 on World Trade Organisation (WTO) terms. These are the same as those applying to many large trading partners with the EU, such as China, the USA, Australia, Japan and India, none of which have any preferential arrangements with the EU. The average tariff on industrial goods is now no more than about 2.5%. If all visibles, including food, are included, this percentage rises to about 4%, but if services, on which there are no tariffs, are also included, the figure drops back again to about 2.5%. Of course, there are also non-tariff barriers to be taken into account and the rates of duty on some items, such as cars and components, are much higher than the average – about 10% if the full rate is paid, although various rebates and concessions usually provide abatement. Free movement of goods within the EU involves rather less paperwork and checks than even a free trade regime but, all the same, tariff barriers averaging 2.5%, or even slightly more taking account of extra documentation and procedures, are unlikely to be insurmountable. Some co-operation would be required to increase customs staff and to make sure that mutually acceptable arrangements over product standards and safety requirements remained in place, but no radical changes from what already exists would be needed.

The big problem is that, whether or not we succeed in negotiating a free trade deal within the two-year period – or some extension to it – or whether we fall back on WTO terms, and especially if we were to remain in the EEA, we are still at risk of having a massive deficit on our trade with the EU and indeed with our dealings generally with our former EU partners. Whatever arrangements we finish up by coming to with the EU27, therefore, a really big question concerns what we can do to bring our overall financial dealings with them into some sort of reasonable balance.

Trading with the EU27

The reason why we have such a large trade deficit with the EU27 is that we have very substantial negative trade balances in goods with several of the EU27, the largest numbers, for 2016, totalling £76bn, being as follows[7]:

Germany	-£32.1bn
Netherlands	-£15.9bn
Belgium & Luxembourg	-£12.5bn
Italy	-£7.6bn
Spain	-£6.2bn
Sweden	-£1.8bn

Source: Table 11 in *UK Trade – December 2016*. London: ONS, February 2017

Some of the reasons for these deficits are that, as we always have been, we are net importers of food and raw materials from continental Europe. This is a situation which it will for the foreseeable future make sense for us to maintain. We will always want to buy wine from France and Italy, for example, and timber from Sweden. Most of the problem, however, is with the huge imbalance we have on manufactured goods, where continental countries have few natural advantages which we lack, but where they produce many manufactured goods at much more

competitive prices than we do. The reason why they are so much more successful than we are at manufacturing is partly because – at least in Northern Europe – they have much more accumulated capital per worker, far superior training schemes and better management attracted by the prestige associated with manufacturing, compared to those in the UK. It is partly, however, also because at prevailing exchange rates, their domestic costs are charged out to the rest of the world at a much more competitive level than ours. This means that they can pay similar wages to those received by manufacturing employees in the UK but, because their productivity is so much higher, their wage costs per unit of output, charged out on international markets, are on average, much lower than ours. This is why they have such huge trade balances in their favour with the UK.

Because they are much more competitive than the UK is, economies on the continent have a much higher proportion of their GDPs coming from manufacturing than we do. Recent figures are as follows[8]:

Country	%
Germany	22.8%
Sweden	17.0%
Italy	15.8%
Belgium	14.3%
Spain	13.3%
Netherlands	11.7%
France	11.2%
UK	9.8%

Source: World Bank Database. Figures are all for 2015.

The continental economies also have a much better spread of manufacturing than the UK does. The next table shows the make-up of export earnings as a percentage of GDP for several different EU countries. These figures provide a reasonable indication of the spread of different grades of manufacturing, in terms of technical sophistication, across their economies.

Country	High-Tech	Medium-Tech	Medium/Low	Low-Tech	Total
Holland	12.4%	16.7%	13.5%	11.4%	54.0%
Germany	6.8%	18.6%	6.2%	5.3%	36.9%
Sweden	5.8%	11.0%	7.0%	6.0%	29.8%
Italy	2.3%	8.6%	5.5%	5.7%	22.1%
France	4.8%	6.9%	3.2%	3.8%	18.7%
UK	4.3%	5.9%	3.1%	2.4%	15.7%

Source: https://stats.oecd.org/Index.aspx?DataSetCode=BTDIXE

The crucial insight that these figures provide is that success in manufacturing does not depend exclusively – or even mainly – on high-tech production. Only 7% of German exports are high-tech and only 2% of those from Italy. It is therefore a major mistake for the UK to rely too heavily on high-tech manufacturing to provide us with the volume of export earning we need. Economies with stable and adequate foreign earnings earn at least three quarters, if not more, of their sales of goods abroad from activities which are not high-tech.

It is true that the UK economy is relatively very good at producing services and that we have a substantial export surplus in this area with both the EU – £24bn in 2016 – and with the rest of the world – at £73bn in the same year[9]. The UK has a number of natural advantages in services which we have been extremely good at exploiting. These include our geographical location, our language, the integrity of our legal system, the attractiveness of London as a place to live and work, the depth of talent oriented to highly skilled service employment and our financial and political stability. There are, however, several severe problems about relying on services to pay our way in the world.

First, even though services make up about 80% of our total economy[10], they provide less than half of our foreign earnings. The fact that we have a huge export surplus

on services – £97bn in 2016[11], which was almost 5% of our GDP[12] – is a big help but because manufacturing tends to be much more orientated to exporting than is the case on average with services, it is much more difficult to avoid big deficits if the main reliance is on service rather than manufacturing output.

Second, productivity increases are much more difficult to secure in services than they are in manufacturing. This means that any economy which depends very heavily on services is likely to grow more slowly than one which is more manufacturing orientated.

Third, the provision of high quality services tends to be much more concentrated geographically than is the case with industry, which is one of the major reasons for the huge disparities in earnings between London and much of the rest of the country. ONS figures show that in 2015, average gross value added per employee in London was £44k compared to £19k in the North East[13].

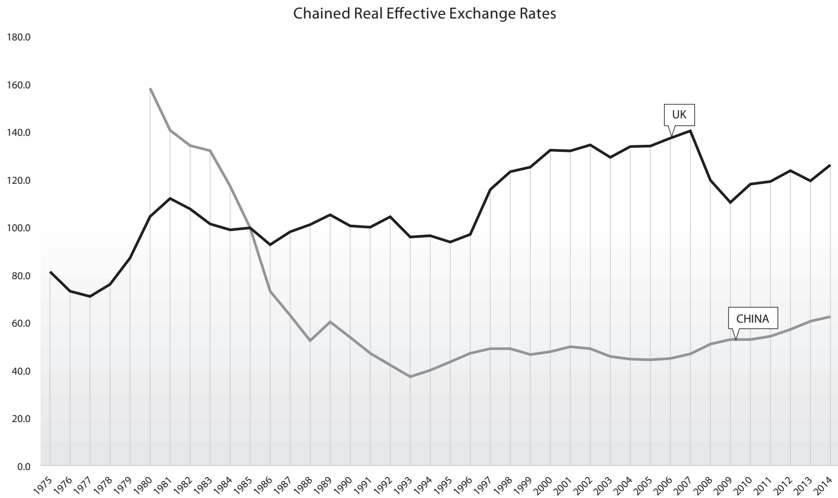
We are thus back to our huge deficit on goods with the EU27. What can be done to get this deficit down at least to more manageable proportions? There is only one solution which really has the capacity to solve the problem. We have to be able to produce more that the world, including the EU27, is prepared to buy off us. Because services will never fill the gap, the only alternative is to get the UK economy reindustrialised to a point where we can pay our way in the world again. Only if we have enough goods to sell to foreign buyers will we be able to avoid the foreign payments and government deficits which have been a millstone round our necks for past decades.

Reindustrialisation

At the beginning of 2017, about 9.7% of UK GDP came from manufacturing – down from just under one third as late as 1970 and 20% in 1990[14]. Because of our very strong service export performance, we do not need to get this percentage back up to

what it was – not far short of 30% – the last time we had a trade surplus, which was in 1982[15]. Nor do we have to mirror the percentages in countries with strong export performances such as Germany (22%), Japan (19%) and Switzerland (18%)[16], whose service exports make only a relatively small contribution to their foreign earnings. We will, however, need to get the UK manufacturing percentage back to something like 15%, and to do this we will need also very substantially to increase the percentage of our GDP which we spend on physical investment. This has now fallen to just under 13%[17], but badly needs to be at least 20% – or rather more – if our economy is to grow at a reasonable speed on a sustainable basis. How are we going to get this done? The answer is that we have to make heavy investment into low- and medium-tech to make the industry in the UK profitable – which it patently is not at the moment. The only way to do this is to change our exchange rate policy to one which supports the re-establishment of a sufficient amount of manufacturing industry to enable us to avoid unmanageably large foreign payment deficits every year.

This will involve a major change in policy priorities because the reality is that we have had no policy towards the exchange rate to speak of ever since the break-up of the Bretton Woods system in 1971 and the move that then took place away from fixed to floating rates. Instead, we allowed the advent of monetary policy to push the sterling parity up drastically – by about 60% between 1977 and 1981 and then by a further 50% or so as we moved from the late 1990s into the 2000s. As this was done, countries in the Far East moved strongly in the other direction. The graph below shows what happened between the UK and China over the period from 1980 to now. No wonder British manufacturing was decimated. Nearly all our low- and medium-tech manufacturing was forced out of business, leaving only high-tech, which is more difficult – and therefore takes much longer – to attack from a low cost base. This is because of complicated supply chains, the need for accumulation of experience, heavy branding and strong intellectual property rights, but does not mean that it will necessarily be invulnerable in the longer term as the Chinese get more fully into aerospace, the Indians into pharmaceuticals and the Koreans start making better cars.



Sources: International Financial Statistics Yearbooks 1989 (UK pg 717). 2000 (UK pg 981, China pg 344-5), 2004 (UK pg 651, China pg 236) and 2015 (UK pg 833, China pg 246): IMF, Washington DC. Based in all cases on Relative Unit Labour Costs

There is little doubt why there has been such widely prevalent lack of concern about these developments despite the damage done to UK manufacturing. It is because the exchange rate requirements in the UK are so different for services than they are for manufacturing. Because services are much less price sensitive and because we have strong natural advantages in the service sector of our economy, services can live with an exchange rate at the level we had before the EU referendum – about $1.45 to £1.00. Unfortunately, manufacturing, on which almost half our export earnings depend despite its ever-diminishing proportion of our GDP, cannot do so. This is why we so badly need to have an exchange rate policy which recognises the requirements of manufacturing in the UK, and which recognises that its weakened state can only be remedied by giving it the break it needs by helping it with an exchange rate which makes our output competitive despite the disadvantages in capital equipment, training and management from which it currently suffers.

Why is a competitive exchange rate the key to reindustrialisation?

There is a clear reason why getting the parity for sterling right is critical to getting the UK economy rebalanced, so that we can get investment as a percentage of GDP up, start paying our way in the world, stop running up debt which we will never be able to repay, get the economy growing again at reasonable speed and start raising living standards for ordinary people. It is because most manufactured goods have close substitutes that they are relatively price sensitive and most of the costs involved in manufacturing are locally based. ONS figures show that, on average, about a third of all the cost of manufactured goods are machinery, raw materials and components, for which there are world prices[18]. About two thirds of costs, on the other hand are incurred in the domestic currency – sterling, of course in the UK. Typically, about 15% of total costs are for direct labour, while around 50% of them are overheads of all kinds – management salaries, audit fees, transport costs, repairs and maintenance, rent, rates and interest charges – plus a provision for taxation and profit.

Now consider the position of a country which has an averagely competitive currency. Measured in international currency terms – say, US dollars – if its export prices are 100, they will be made up of 33 for world price inputs and 67 for those incurred domestically. Compare this then with a country like the UK which the graph above suggests might have a currency which has been over-valued by as much as 50%. Measured in dollars, our export prices will still be 33 for world-priced inputs but 67 x 1.5 for those incurred domestically – so we have to try to sell our exports for 30 + 67 x 1.5, which comes to close to 130. Of course, this is a simplified model but it contains a key core of truth which explains why our share of world trade has gone down and down. It was 10.7% in 1950, 5.7% in 1990 and it is now just under 3%[19]. If we want to get our country at least partly reindustrialised, we have to get our cost base down to a competitive level, so that it is worth siting new manufacturing plants in the UK and not elsewhere as well as expanding existing production both for export and import saving markets.

How low would the exchange rate have to be to achieve this objective? Careful calculations show that it would be with a parity of about £1.00 = $1.00, or maybe a little more[20]. This looked like an impossible target prior to the referendum when £1.00 = $1.45. At $1.25, which is about where we are now, the exchange rate we need looks a lot more attainable. How would we do it? The government would need to set a target. The Bank of England would need to sell sterling and buy foreign currencies to help to implement the government's goal. It might well be worth introducing a withholding tax to make holding UK assets less attractive. We could make it more difficult for foreign interests to take over UK companies and to buy British properties. Other countries have done all these things, and so could we. The Japanese, using exactly these sorts of tactics, got the yen down by about one third between 2012 and 2015[21]. If the will was there, we could certainly do it.

Brexit again

And this takes us back once more to the Brexit negotiations. To reiterate, the best result, as probably most people would see it, would be for the UK to reach agreement with the EU27 that we would leave the Single Market, the EEA and the EU Customs Union with, instead, our trading relations with the EU27 being governed by a free trade deal covering goods and services. These general arrangements might then be refined with some carve-backs into the Single Market to provide free movement of goods in sectors such as motor vehicles, aerospace, probably also with special arrangements for agriculture and some services. There are strong arguments for believing that this would be the most beneficial outcome for not only the UK but also for the EU27.

For all the reasons set out above, however, this may not be the way the negotiations pan out. Instead, it seems entirely possible that there will be no agreement reached within the two-year period, or any agreed extension to it. If this happens, it seems probable that the outcome will then be the choice referred to earlier. On the one hand, the EU27 will make an offer to the UK, which will probably be for us to leave

the EU but to stay in the EEA, thus giving us access to the Single Market but still paying substantial dues every year, still subject to free movement of people and still subordinate to the European Court of Justice. On the other hand, the UK could opt to have no trading deal with the EU at all on the basis that future relations would be governed by WTO Most Favoured Nation (MFN) terms.

Choosing between these options could present the UK with substantial difficulties, not least because – at least at the moment – both the House of Commons and the Lords are much more Europhile, and thus likely to go for the EEA option, than the population as a whole. But in deciding which way to go, dealing with the deficit with the EU needs to be a major factor and it is clear which way the pressures here are likely to materialise.

If the UK decides that fundamentally the only way of resolving its financial imbalance with the EU is to trade its way out of the EU deficit by operating with a much lower exchange rate to increase our exports and – at least relatively – to reduce our imports, then we will need to take account of what this stance will be on our overall negotiations. In fact, the EU27 would benefit from having a more prosperous UK on their doorstep, whatever the outcome of the negotiations. We would become a bigger market for EU exports while the UK supplied the EU with cheaper goods, probably improved over time as a result of higher levels of investment. The EU negotiators, however, will probably not see things this way. They will regard the UK adopting a more competitive exchange rate as a threat to the EU27 rather than an overall benefit to them. In this case, the more they are in a position to call the shots, the more likely it is that part of any deal the UK does with the EU27 will be one which constrains us using the exchange rate to improve our overall balance of payments position and, in particular, our financial balance with the EU27.

This, then, is the danger. If we do finish up by having a choice to make between terms offered by the EU in the form of the EEA route or some variant of it, or the WTO option, and we choose the EEA option, part of that deal may be that we lose the exchange rate flexibility which we so urgently need. If this happens, we may well be left with a £90bn a year financial deficit with the EU27 for the indefinite

future. With the WTO option in place, however, no such constraints would exist. The UK therefore needs to realise just how much is at stake in ensuring that the Brexit negotiations do not dictate our future exchange rate policy.

Objections

This pamphlet argues, as our Brexit negotiations move to their outcome, that the only way to rebalance the UK economy and to get it into a position where it is capable of sustained growth, combined with as close to full employment as we can get and with an acceptably low level of inflation, is to get the parity of sterling down to a level which makes a number of objectives possible to achieve. We need to get the proportion of our GDP which we invest rather than consume up to at least 20% from its present 13%. We have to get manufacturing as a percentage of our GDP up from its current 10% to around 15%, without which we will never be able to pay our way in the world. It is also essential that the benefits of globalisation, in terms of secure prospects and good jobs, especially those provided by manufacturing, are widely enough dispersed throughout the economy to make most people, if not everyone, feel that they are beneficiaries rather than losers from the liberalisation and growth of world trade.

We need to get our overall balance of payments under control with the annual deficit as a percentage of GDP no greater than our growth rate, so that at least we are not sliding further and further into debt in relation to our capacity to service and ultimately repay it. This is also the only way in which we will be able to get the government annual borrowing requirement – which is largely the mirror image of the balance of payments deficit – down to the same sort of manageable proportion. In addition, we need to ensure that future growth does not depend on unsustainable increases in consumer spending but is driven much more by investment and net trade.

Many people, however, even if they were persuaded by the logic of this case, would 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. There are six main arguments which are regularly advanced to support these contentions. They are first that devaluation always produces extra inflation which negates any gains in competitiveness; second, that devaluation is impossible to combine with an open economy; third that, if we did devalue, we would be bound to be met by retaliation which would undermine its 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 international 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 what the statistics show. Looking at recent examples, when the UK left the Exchange Rate Mechanism in 1992, sterling fell by a nominal trade weighted 12%[22], but inflation fell from 5.9% in 1991 to 1.6% in 1993[23]. 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[24], and what increase there was in 2011 was very largely driven by an increase in commodity prices, which fell away as soon as these prices fell back again[25]. 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,

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 sharply, 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 domestic 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 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 monetarism, which perhaps explains why so many people believe it to be the case even though it isn't true. On the contrary, the longer term evidence very firmly indicates that economies which have strongly competitive international pricing tend to do better and better as 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. The Japanese, to reiterate a recent example, brought the parity of the yen down against the dollar by a third between the beginning of 2013 and the start of 2015 as a result of deliberate policy. 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[27].

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 makes 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 markets think that the Bank of England is going to raise 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 the UK may soon have sold so many assets that it will be increasingly difficult to find enough to sell in future, especially 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%, adds another £3bn to the underlying deficit every year. 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.[28]" 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.

Retaliation If the UK were to devalue by a sufficient amount – probably about 25% from its current level – 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? The answer to this question needs to come in several parts.

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 economies such as Germany, Switzerland and the Netherlands with huge surpluses – currently almost 8% of GDP in Germany's and the Netherlands' cases, and 15% for Switzerland[29]. 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 its exchange rate. We still have our own central bank and control over our own interest rate and monetary policy. Sterling is not a world reserve currency like the dollar, making it much easier for us to alter our exchange rate without there being major international consequences. The fact that our share of world trade is now so low – at 2.9% in 2015[30] – 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 12%[31] – and the fall in the rate for sterling against the dollar between 2007 and 2009 – about 25%[32] – both engendered no retaliation. Both 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 and this argument tends to take two forms, neither of which are correct.

The first is that if we reduced the value of the pound by, say, 25%, in world currency terms, we would make ourselves 25% 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 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, 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[33].

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 and the link between sterling and gold, combined with the dominance of financial interests over those of industry, all stretching back to the beginning of the nineteenth century when industrialisation in the UK really got under way, have always hobbled British industry. Although we initially showed the way, other countries have overtaken us as their industrial bases have got stronger and their more competitive currencies have allowed them to secure better net trade advantages.

As these other countries have invested more heavily in the future than we have, their output per head has grown more rapidly than ours, their wage climates have often 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%[34]. 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. The fall, by about 30% in 1931 – after near stagnation during the 1920s – enabled the UK economy to have its fastest spurt of growth ever during the middle of the 1930s – 4.4% per annum cumulatively for the four years between 1933 and 1937[35].

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[36]. Much higher than average inflation in the UK than elsewhere and under-investment in export industries resulted in a steady trade deterioration in the 1950s and 1960s, culminating in the pound being devalued in 1967 from $2.80 to $2.40[37]. Once currencies started to fluctuate against each other in the 1970s, following the break-up of the Bretton Woods fixed parity system in 1971[38], rapidly rising prices combined with high interest rates kept sterling much too strong, especially as the UK entered the Exchange Rate Mechanism at the end of the 1980s, followed by

leaving it in 1992, with a devaluation of about 12% against all currencies[39]. After showing some signs of recovery, the UK economy then became more and more unbalanced, as asset sales on a scale unparalleled anywhere else pushed sterling up to absurdly high levels in the 2000s. Its value fell between 2007 and 2009 – still by not nearly enough – since then it has climbed back a bit, and then fallen at least temporarily post the EU referendum. 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 for most 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 almost always been too little and too late.

Devaluation and the UK's 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, because the exchange rate and the cost base for it is much too high, there is no evidence whatsoever that, if more favourable conditions prevailed, UK entrepreneurs would not be just as good as those anywhere 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.

For those who need more systematic and intellectually robust reasons for believing that the UK would respond positively to a lower exchange rate, the place to look is in the numerous studies which have been carried out into the responsiveness of UK exports and imports to changes in the exchange rate. Two large-scale meta studies carried out recently, one by academics and another by the IMF[40], show that the so-called elasticities are easily in the right territory, especially after allowing a relatively short period of time – two to three years at most – for the effects to work their way through.

The reason why the UK has allowed manufacturing as a percentage of its GDP to fall from about one third in 1970 to barely 10% now is obvious. Nearly all our internationally traded low- and medium-tech manufacturing has been driven out of business and there is insufficient high-tech activity – also subject to long term threat – to fill the gap. We cannot allow this condition to continue.

Changing Course

The biggest problem is not delineating what needs to be done to get the UK economy rebalanced, to get the manufacturing industry re-established on the scale needed both to allow us to earn enough abroad to pay for our imports and to cover all the other components which make up our very large balance of payments deficit; to get the economy growing more strongly again; and to provide much better job prospects for the large swathes of our population who have recently lost out. The challenge is to persuade enough people that policy shifts of the kind described in this pamphlet both need urgently to be achieved and that they could be accomplished. The changes we need comprise a combination of what has to be done on the demand side – reformed monetary and exchange rate policies – and all the complementary changes on the supply side which need to be attained at the same time.

The Brexit negotiations on which the UK is currently embarking will hopefully provide the impetus for crystalizing the changes to policy which are required.

This may well be even more pressingly urgent if the negotiations do not proceed smoothly. If the choice with which the UK is eventually confronted is between continuing membership of the EEA or the WTO option, in both cases the impetus from a lower exchange rate is going to be urgently required, but it is likely to be much more difficult to achieve as part of the negotiation process in the EEA case. The fact that, in EEA conditions, we are likely to have to go on paying into the indefinite future heavy dues to be a member of the EEA, probably at the same time without being allowed to use an export led strategy to reduce our financial imbalances with the EU27, needs to weigh heavily in the decisions to be taken about what relationship we should have with the EU27 in future. In the case of the WTO option – as has already happened since the EU referendum – we would inevitably be in a much better position to benefit from a much more competitive exchange rate to tide us through the break away from the trading pattern we have had with our European neighbours since the 1970s.

Without the decision made by the UK electorate on 23rd June 2016, the need for radical changes to our approach to the UK economy's competitiveness would probably have taken much longer to come to the surface. Now they are much more pressing. Do we have the courage and wisdom to make the choices which now need to be made?

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Overlaying the Brexit negotiations with the EU27 with which the UK is currently involved is a huge problem. It is the enormous financial annual deficit we run with the EU27, taking into account both our trade deficit, our negative net investment income with the continent and our transfers each year to the EU, all amounting to a total of about £90bn. This massive sum, about 5% of our GDP, equates to almost £1,500 for every single person in the UK. It is in sharp contrast with the £10bn annual payment surplus we have with the rest of the world.

We very badly need to get our deficit with the EU27 down, and the only practical way for us to do so is for us to improve our trade balance. To do this, we will have to reindustrialise to the extent necessary to enable us to pay our way in the world. To achieve this objective, we will need a much lower exchange. A crucial component, therefore, of our Brexit negotiations is to ensure that their outcome does not compromise our ability to establish the exchange rate competitiveness we need to get our foreign payments deficit back under control.

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