John Mills
Institute for Prosperity

UK ECONOMY

Road to Recovery: What can the UK learn from **Germany?**

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'What can the UK learn from Germany?'

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He was for many years a senior Labour elected member of Camden Council, the London Borough's Association and the Association of Metropolitan Authorities, and in the late 1980s he was deputy chairman of the London Dockland Development Corporation. He was chairman and then deputy chairman of Vote Leave, joint chairman of Business for Britain and the founder of Labour Leave, all campaigning for Brexit during the run-up to the June 2016 EU referendum. He is vice-chairman of the Economic Research Council and founder of both The Pound Campaign, Labour Future and The John Mills Institute for Prosperity, all concerned in different ways with the UK's economic and political prospects. He is a frequent commentator on TV and radio and he has a large number of published books, articles, pamphlets and blogs to his credit.

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FOREWORD

BY PROFESSOR STEPHEN POLLOCK

In his writings, John Mills has persistently highlighted the deleterious effects that the over-valuation of sterling has had on the ability of Britain to sell its goods abroad. It has led to a withering of Britain's industrial sector. Britain has managed to pay for its imports by maintaining a positive balance of payments in its provision of services and by selling its capital assets to foreign owners.

In a recent publication, (The Elephant in the Room, published by Civitas in 2020) Mills has depicted the malaise of the U.K. economy within the perspective of an economic and social history that reaches back to the late Victorian era. In this pamphlet, he draws a comparison between the British experience and that of one of our European competitors, which is Germany. He does so within the same deep historical perspective.

Following the Second World War, Germany had an outstandingly successful economic performance; and it came to be regarded as an exemplar of good economic and financial management. Its economic success has been regarded as a mirror image of Britain's economic failure. However, as Mills shows, this is an oversimplified view of the relative performance of the two economies.

Germany's exceptional postwar economic performance has contained the seeds of a subsequent decline. Its export success, which has lead to a chronic balance of payments surplus, has been a factor in depressing the neighbouring European economies, which has, eventually, limited the growth of Germany's export markets.

Mills' writings contain a clear message regarding the steps that must be taken to unlock Britain's manufacturing potential and to improve the nation's economic performance. However, as this pamphlet serves to demonstrate, there are numerous interrelated factors that can combine to create a favourable or a deleterious economic outcome. Sometimes, success begets failure.

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INTRODUCTION

Germany certainly seems to be doing some things right. In particular, year after year, the country has a trade surplus and the Government has a positive fiscal outturn. According to the World Bank, living standards are a little higher than those in the UK – $46,259 in Germany against $42,300 in the UK in 2019 on a straight financial comparison and $56,278 versus $48,698 on a PPP basis.[1] Germany has a much stronger manufacturing base than the UK, with about 19% of GDP coming from this source,[2] powering the export surplus which Germany earns every year, compared with barely 10% of GDP coming from manufacturing in the UK,[3] leading to large balance of payments deficits year after year.[4]

But some things are – or have been – not so good. Germany has had relatively high levels of unemployment in the past compared to the UK, particularly in the 2000s[5] when the German average was 8.8% compared to 5.5% in the UK, but the unemployment percentage by 2019 was slightly lower in Germany at 3.0% than the UK's 3.8.[6] The growth rate of the German economy, despite its apparent strength, has been marginally lower than that of the UK – 1.4% cumulatively per annum between 2000 and 2017 compared to 1.7% in the UK[7] – and Germany looks like being slower than the UK to recover from the coronavirus pandemic. Although Germany is very strong on manufacturing, the UK has a much more impressive record on exporting services, with a surplus recently running at about 5% of GDP compared to a roughly 1% deficit in Germany, with the UK particularly strong on financial services.[8]

What might the UK be able to learn from German history and experience?

German Recent Economic History

Modern German history really begins in 1945 at the end of World War II. During the war years, of all the major European economies, Germany was by far the worst affected. Constant bombing by day and night for the last half of the war had reduced most German cities to ruins. Coal production, which had totalled 400m tons in 1939, fell to just under 60m tons in 1945.[9] Crude steel production, which had been nearly 24m tons in 1939, fell to almost nothing by the end of the war.[10] The German standard of living plummeted to a fraction of its pre-war level, as the German people eked out a living as best, they could amidst their shattered country.

Assisted by the very generous US Marshall Plan,[11] however, before very long the economic situation began to improve. Currency reform in Germany in the summer of 1948 was followed by a substantial and, as it turned out, largely unnecessary 20% devaluation in 1949.[12] In the same year, an excellent harvest did much to solve the food shortage, suddenly leaving West Germany in an extraordinarily competitive position. Over the next fifteen months exports more than doubled from 19% to 43% of the pre-war figure.[13]

The scene was then set for dismantling wartime controls and letting the economy rip, supported by the extremely competitive exchange rate the German economy then enjoyed. History recounts that in July 1948 Ludwig Erhard, Director of West Germany's Economic Council, abolished food rationing and ended all price controls on his own initiative. General Lucius Clay, military governor of the US zone, called him and said: "My advisers tell me that what you have done is a terrible mistake. What do you say to that?"

Erhard replied: "Herr General, pay no attention to them! My advisers tell me the same thing." Erhard turned out to be right and the Deutsches Wirtschaftswunder – the economic miracle of German recovery – got under way.[14]

Between 1950 and 1973 the West German economy expanded at an average cumulative annual rate of about 6% per annum.[15] By 1973, the German economy was 3.6 times the size it had been in 1950. Taking population growth into account, GDP per head – a close approximation for living standards – was three time as high at the end of this period as it had been at the beginning.[16] Whereas in 1950, GDP per head in the UK was almost 80% higher than it was in Germany, by 1973 the gap had almost completely closed.[17] This very rapid progress was not, however, to last. For the next quarter of a century – over the period from 1973 to 1998, the growth rate of the German economy slowed to a cumulative 1.8% increase year on year compared to 2.0% in the UK.[18] Three major factors caused this slowdown to happen:

One was the turmoil which struck the world as a result of the breakup in 1971 of the Bretton Woods international financial regime, which had governed world trade since 1945. When the USA decided no longer to back the world's currency system by maintaining the price of gold at $35 per ounce, the constraints on monetary reflation worldwide were loosened. The result was an unsustainable boom, followed by a painful bust, as both inflation and unemployment soared, generating the sour mixture of stagflation. Germany was not as badly hit as many other countries with price increases peaking in 1973 and 1974 at 7%[19] and unemployment at 4% in 1975 and 1976 although it was much higher in the following decade, peaking at almost 10%.[20] The German economy depended on exports and world demand for its output grew much more slowly than it had done previously, dragging down the German growth rate with it.

Second, there was a marked change in intellectual fashion on economic policy, amplified in Germany by fears of inflation stemming from both the hyper-inflation of 1923 and the collapse of the Reichsmark at the end of the war in 1945. The Keynesian regime which had fostered the very fast growth of the past decades had no clear remedy for combatting stagflation and a much harder money policy took its place, buttressed both by monetarist ideas from Chicago University and Austrian scepticism about Keynesianism which came from the Viennese school of economic thought. The result was a much tougher monetary regime, overseen by the Bundesbank, which may have curbed inflation, but at the expense of growth.

The third major influence on the performance of the German economy was attempts by what was then the European Economic Community to link European currencies together, initially in the Snake and then subsequently in the Exchange Rate Mechanism – the precursors to the Eurozone. The problem was that German discipline and efficiency held down increases in German export prices at the same time as much higher levels of inflation in other European countries left them unable to cope with German competitiveness. The consequence was that the deficit countries had to deflate their economies to contain otherwise unmanageable balance of payments problems, which in turn depressed Germany's main export markets.

The Berlin Wall came down in 1989 and unification followed shortly afterwards. Chancellor Helmut Kohl, in a well-meaning but badly misguided attempt to placate the former East German Democratic Republic, agreed that there should be one for one

parity between the Ostmark and the Federal Republic's Deutsche Mark. Unfortunately, this took no account of the massive gulf that existed between the competitiveness of East and West German output, the result being that for years the West Germans had to support their eastern compatriots with huge subsides, overtaxing the West German economy in the process. Inflation rose to 5.1% in 1992[21] – one of the highest rates in Europe at the time. Gradually, however, the cost of unification dropped back and by 2000, inflation in Germany was lower again than in almost all other EEC countries and German competitiveness reasserted itself.[22]

And this has been the position for the whole of the period since then. The establishment of the Eurozone in 1998 cemented the very different levels of competitiveness within it in place. The result has been that Germany has had huge balance of payments surpluses year after year, mirrored by deflationary policies particularly in southern Europe, depressing Germany's export markets and contributing in turn to continuing low growth rates in both Germany and the Eurozone generally. In the late 2010s, Germany's balance of payments surplus was running annually at around $300bn a year,[23] while Italy has seen almost no growth in GDP at all since the introduction of the euro in 1998.[24] The impact of the 2008 financial crisis was to tip all European economies, apart from Poland,[25] into negative growth territory for a year or two, Germany included. Greece saw a precipitate 25% fall in real GDP.[26] The slow recovery from the 2008 financial crisis contributed to the whole of Europe being relatively ill-prepared to deal with the coronavirus when it struck in 2020.

The legacy from this experience is that, although Germany has a powerful economy with high average living standards, it is troubled – like the UK – by slow growth, imbalances between the different regions and rising inequality. Germany is saddled with too strong an export performance for its own or anyone else's good, while the UK suffers from chronic deficits. In both countries, potentially avoidable problems have become very hard to solve.

Different Paths taken by the UK and Germany

The big differences between the German and the UK economies revolve round their relative competitiveness in world markets, linked together in each case by their manufacturing, investment, and export performance, and all the supply side implications that flow from them. For different reasons, both Germany and the UK suffer from very slow growth but, as a result, in a number of other key ways, the major problems faced nowadays by Germany and the UK are broadly similar.

Because Germany has produced very competitively priced exports for the whole of the period since the end of World War II, it has always managed to maintain a strong manufacturing base, relatively high levels of investment and a large balance of payments surplus, based on exports of goods being much higher than imports. Germany has the largest balance of payments surplus in the world, averaging $250bn[27] a year during the decade running up to the coronavirus crisis, an average of 7% of German GDP, peaking at 8.9% in 2015.[28] Germany's total cumulative surplus – which has always had to be matched by deficits somewhere else – between 2007 and 2017 came to just over $3.3trn.[29] By contrast the UK has not had a balance of payments surplus any year since 1985, and in 2019 – a fairly typical year – the UK imported £131bn more goods than were exported, of which the deficit in manufactures made up £95bn.[31]

With price competitiveness for UK produced goods lacking in international markets, manufacturing as a proportion of GDP has fallen from 32% in 1970 to less than 10%[32] now, dragging down UK investment, productivity increases and economic growth in the process.

Why has Germany failed to translate its export competitiveness into relatively fast economic growth? There are two main reasons why this has happened. First, although export of goods represents a high percentage of German GDP, generating a big trade surplus, the growth rate of German exports has been relatively slow. In the ten years between 2007 and 2017, net of inflation, German exports of goods increased in real terms – i.e. net of inflation – by no more than 2.9%[33] per annum, compared to 7.0%[34] in China. The result was that China's share of world trade grew between 2007 and 2017 from 8.8% to 13.2%, whereas Germany's fell from 9.6% to 8.4% – better than the UK's, nevertheless, which went down from 3.2% to 2.6%[35] as the total volume of UK exports actually fell slightly.[36] The main reason for the relatively slow growth in German exports was that about half of them went to other Eurozone countries, many of which suffered from relatively deflationary policies as a result their being unable to stand up to German competitiveness.

The second reason for slow German growth has been the reluctance of German economic authorities to use the country's strong trading and fiscal position to reflate both their own economy and that of the Eurozone by pursuing expansionary fiscal policies. Although recently, there has been some move towards spending more money, particularly on infrastructure, the sums of money involved have been comparatively small.[37] Whereas in the UK, the main reason for the Government holding back on fiscal expansion has been balance of payments weakness and the risk of over-taxing the economy, in Germany it has been a widely shared proclivity for very conservative financial policies, with comfort being garnered from large surpluses. By contrast, the UK's faster rate of economic growth has been achieved at the cost of a chronic tendency for there to be high and increasing balance of payments deficits.

In other respects, however, German and UK problems are similar, even though they may have a different source. Both countries have wide disparity in prosperity between different regions. The reasons for these disparities lie largely in the differing exchange rate histories between the UK and Germany. The German economy had a competitive exchange rate when stagflation struck the West in the 1970s and managed hold on to it notwithstanding the arrival of Monetarism and Neoliberalism. IMF figures measuring relative unit labour costs – the best measure of international competitiveness – show the German index (with 100 in 1995) hovering round 70 and 80 throughout all the 1970s and 1980s[38] whereas in the UK the index (with the same 1995 base), rose from a low of 76 in 1977 to a peak of 132 in 1981, and then stayed at around 110 before temporarily dropping when the UK came out of the Exchange Rate Mechanism in 1992.[39] The result was that UK manufacturing haemorrhaged while German industry by and large continued to prosper.

This varying experience had to do with the different reasons for the uneven spread of prosperity in Germany compared with the disparities in the UK. There had for a long time been a gap in GDP per head in the UK between London and the rest of the country, but the difference had been a comparatively narrow one.

This changed radically when deindustrialisation materialised in the UK from the 1980s onwards and manufacturing as a proportion of GDP fell from 32% as late as 1970 to less than 10% today.[40] There was nothing equivalent in Germany to the wiping out of industrial employment in large areas of the UK, leaving many towns and cities with much too little to sell to the rest of the world to pay their way. Indications of the scale of this problem can be garnered from the fact that the UK has recently had annual balance of payments deficits of around £100bn a year, [41] while Greater London Authority figures show London having an annual surplus of at least £50bn.[42] This means that the whole the UK outside London must have an annual deficit of around £150bn. With total UK GDP excluding London being about £1.5trn, this means that rest of the country must be running with an average deficit of 10%. If some cities outside London, such as Manchester, Bristol, Oxford and Cambridge and other university cities, are doing well enough to hold their own, this means that less favoured areas are doing even worse – dependent on transfers, grants and benefits from London to avoid living standards plummeting.

Germany has a similar problem but stemming from a different source. In Germany, regional prosperity disparities are mainly a legacy of the much lower productivity and living standards in the former DDR before reunification compared to those in the Federal Republic. Whereas in 2019, gross regional product per capita was €67k in Hamburg, it was €29k in Saxony-Anhalt[43] – roughly the same disparity as the widest in the UK. Gross value added per head in London in 2017 was £49k compared to £20k each in Wales and the North East.[44]

How does Germany maintain its Manufacturing Sector?

It is certainly widely perceived in the UK that the German economy is in better shape than ours because it has a much stronger manufacturing base than the UK does. Germany's very competitive profile within the Eurozone clearly has a lot to do on the demand side with Germany's industrial strength, but this is not the whole story. Germany also provides considerably better supply side support to its manufacturing industry than the UK does. If we are to learn lessons from the German experience, we need to pay careful attention to these supply side contributions which make a big contribution to Germany's industrial success.

Education and Training: For well over a century now – indeed going back to the Great Exhibition in 1851[45] – there have been concerns in Britain about the quality of technical training compared to what has been available in Germany. Much of this has to do with the status of technical as opposed to academic education. It is much higher in Germany than it is in the UK, resulting in both the quantity and quality of those with technical qualifications being correspondingly much greater. About half of all school leavers in Germany undertake some kind of vocational training,[46] compared to about a quarter for the UK.[47]

Much of the problem is at secondary level in schools in the UK where there has for a long time been heavy pressure brought to bear on the more able pupils to opt for academic courses leading to university rather than acquiring a technical qualification as a way into working life. The result has been a surfeit of academic graduates, many of them employed in jobs which do not need a degree, at the same time as there has been a chronic shortage of engineers and people with other technical qualifications in the workforce, such as electricians, plumbers and bricklayers.

The UK solution has been to go for one centrally administered apprenticeship scheme after another with very limited success. The German VEF system, on the contrary, is driven by companies regarding the recruitment of apprentices as a key part of their workforce development, with little public sector finance and control being involved.[48] A move in the UK towards the German approach thus requires a least two major changes, neither of them easy to achieve. One requires a major upward change to the status of technical training in schools and the other a much greater commitment among employers to training their workforces for the future. Both are crucial to the success of a manufacturing revival in the UK.

Investment: Investment as a percentage of GDP is much lower in the West than it is in the East – roughly 20% here and 40% there[49] – which obviously has a huge amount to do with the much higher growth rates achieved by China and many other countries in the East compared to performance in the West. Germany has been spending about 20% of its GDP on investment year on year whereas the UK has been achieving only 17% – a ratio which is still trending downwards.[50] Furthermore, a significant part of the fall in UK investment has been in manufacturing, reflecting lack of profitable opportunities caused by the strength of sterling.

It has been claimed that recent reductions to the rate of corporation tax would increase industrial investment but there has been little sign that this has happened. The Government is now trying to redress this situation with strong investment incentives, allowing 130% of qualifying expenditure to be deducted from net profit before tax. The problem here is that the sorts of investment which the UK most urgently needs to improve our growth rate – in mechanisation, technology and power – are likely to remain unprofitable with sterling anything like as strong as it is at present, in which case the tax incentives to invest may not work. Both in Germany and in the UK, if either economy is going to grow faster in the future than it has done recently, investment as a percentage of GDP will have to increase.

Finance for Manufacturing: The German banking system is significantly different from the UK's and more orientated to providing long term finance for industry than banks in the UK. The German finance and insurance services sector accounts for about half the GDP percentage in Germany than it does in the UK – 3.76% compared to 6.79% in 2019[51] – but it has a much better record in supporting manufacturing industry. Germany has a long tradition of local banks – Landesbanken – orientated to attracting local savings and lending to local businesses on a long-term basis rather than the shorter-term "repayable on demand" lending terms favoured by UK banks. These local banks are relatively frequently shareholders in the businesses to which they provide financial support. The result is a longer-term approach especially among the German Mittelstand – often family owned and controlled firms with high-quality competitive niche products for the markets which they serve. Whereas the exceptional financialisaton of the UK economy puts pressure especially on quoted companies to turn in good results in the short-term – sometimes achieved by cutting back on investment which may take time to pay off – the Landesbank support model is much more concerned with long-term strength and sustainability.

The UK has a chequered history in trying to set up banks to perform a similar role to those in Germany – and indeed increasing financial pressures in Germany have pushed some Landesbanken to diversify away from industrial lending and into what

they hoped would be higher yielding fields, such as derivatives, sometimes with disastrous results. This situation has not helped by the fact that a good deal of the German banking system is very highly leveraged – with large volumes of lending in relation to its capital base - and thus relatively vulnerable to downturns. Profitability has been comparatively low.[52]

The fundamental problem with manufacturing in the UK is that it has not been very profitable for a long time for macroeconomic reasons whereas German industry has a much better record. This means that lending to manufacturers has been intrinsically safer and more profitable business for banks in Germany than in the UK. They have adapted to these conditions in a way which would not be possible in the UK as long as manufacturing prospects here are so challenging. Setting up regional banks, or a national bank orientated to lending to industry, is not therefore likely to provide a solution to finance for British manufacturing as current poor long-term profitability prospects remain in place.

Infrastructure: International comparisons have recently been calculated by ONS to achieve an aggregate value of all infrastructure as a percentage of GDP in a number of countries in Europe. Unfortunately, no figure is available for Germany but in 2016 the UK came in at 47% compared to 52% in Italy and 54% in France,[53] with anecdotal evidence suggesting that Germany would be rather higher than Italy and France and thus well ahead of the UK. Germany has an excellent road and rail system although there have recently been rising complaints of deteriorating standards and arrears of maintenance and lack of investment.[54] In 2019, as in the UK, almost all – 96% – of German households had access to the internet but speeds were poor by international standards – and worse than the UK – as copper wiring has been slow to be replaced by glass fibre.[55] Housing in Germany is of a relatively high standard and is comparatively cheap compared to similar accommodation in the UK, although there are quite wide regional variations.[56] Generally, Germany has an edge on the UK on infrastructure, which is the result of higher levels of investment expenditure than in the UK over a long period.

While both Germany and the UK have comparatively well-developed infrastructure by international standards, both countries – and to a greater extent the UK – suffer from the same problem on their overall levels of investment. All the international evidence shows that if the aim to achieve a higher rate of economic growth than 1% to 2% per annum, this cannot be done unless the percentage of GDP devoted to investment is considerably higher than Germany's 20% and the UK's 17%. The world average growth rate recently has been about 3.5% per annum but achieved with average levels of investment in relation to GDP of about 25%. If either Germany or the UK is going to aspire to growth rates approximating the world average, Germany is going to have to shift about 5% of its GDP out of consumption and into investment – while the corresponding figure for the UK would be about 8%.

If this were done, roughly half the increased investment would need to go into the sorts of investment with the highest total – or social – rates of return, mostly in industry, in the form of mechanisation, technology and the use of power. The other half would need to be used to enhance environment expenditure.

At the moment, there is little sign of increases of this type occurring in either Germany or the UK, but this is both a cause and a consequence of the fact that both Germany and the UK have for a long time been stuck in the slow economic growth lane.

Energy Costs: Another important respect in which both Germany and the UK have started with broadly similar policies is on raising energy prices by cross-subsidies to reduce carbon emissions. Electricity in Germany is very expensive, with average costs in 2020 of $0.38 per kilowatt hour compared with a still relatively high cost of $0.26 in the UK.[57] The figure for the USA is $0.15 and for China it is $0.08.[58] UK charges are thus nearly twice as high as in those in the USA and over three times those in China – but in Germany they are proportionately higher still. German prices for diesel and petrol are about the same as they are in most developed countries, including the UK, leaving the USA as an outlier with prices for these fuels about half those common elsewhere.[59]

Why are German energy costs, particularly for electricity, so exceptionally high? It is partly because the reaction in Germany to the Fukushima nuclear disaster in Japan was an extremely expensive decision to close down all German atomic reactors. It is also because Germany is heavily committed to those parts of the Green agenda which – as in the UK – have led to heavy subsidies for non-fossil fuel power sources. Germany has had a particularly expensive lead in tariff system. Notwithstanding Germany's Green commitments, the effect of decommissioning nuclear power stations has been to increase the proportion of German electricity generated from heavily subsidised coal and lignite as the only way to keep adequate power supplies available.[60]

Germany has generally taken a different attitude to where high energy costs should fall, compared to the UK. In Germany, most of the burden has fallen on final consumers as industry has benefitted from a variety of exemptions to supplementary tariffs to pay for the extra costs of renewables. In the UK, manufacturing has to bear a much higher proportion of the total costs. This is yet another example of the political clout which German industry can muster to protect its interests, in sharp contrast to the position in the UK.

Research and Development: The latest available figures show Germany with one of the highest expenditures in the world on research and development per head of the population, with total expenditure at $118.8bn being only exceeded by the USA at $511.1bn, China at $275.0bn and Japan at $165.7bn. At $44.8bn, the UK spent well under half the total German amount, and about half the German figure per head of the population.[61]

Germany also scores well on patent applications, with 67,898 in 2018 compared to 1,542,002 in China, 597,141 in the USA and 313,567 in Japan. The whole of the EU only achieved 174,397, just over twice the figure for Germany on its own. The UK total was 20,941.[62]

Increasing R & D expenditure is not a short-term solution to overcome slow growth as its fruits inevitably involve time delays – often quite long ones – between when expenditure is incurred and when the benefits come through in the longer-term. However, it must be the case that fundamental research and patent applications pay off in terms of securing a robust future.

Germany's strong manufacturing base also ensures that the benefits from expenditure on intellectual property tend to stay in Germany whereas in the UK, too often, production in the UK is too expensive and the industrial base is too weak for promising inventions and

discoveries to be commercialised in the UK by UK-owned companies. Instead they are exploited overseas or by UK registered companies that sell out to foreign buyers as soon as they have a favourable opportunity to do so.

Why has the UK's manufacturing sector declined?

Manufacturing as a percentage of GDP has declined in Germany from 34% in 1975[63] to 19%[64] now but in the UK, it has fallen much further – from 32% in 1970 to just under 10% today.[65] Some of the declines in both of these ratios have been caused by goods falling in price in relation to services and by some activities previously classified as being manufacturing – such as in house cleaning and catering – now tending to be outsourced and classified as services. Even taking both of these factors into account, however, there is little doubt that manufacturing has sustained a fall in significance in both the UK and Germany, but much more here than there. Why has this happened? Why has the fall in the UK been so acute? It is hard to believe that relative pricing and international competitiveness has not had a lot to do with what has happened.

German history, especially since the end of World War II has been replete with steps taken to keep German manufactured exports competitive. The prestige and political clout of manufacturing interests kept the Deutsche Mark competitive during the decades following 1945, building on the very low exchange rates allocated to Germany in the immediate post-war period. German discipline has nearly always kept export cost increases at bay while other countries with which Germany had extensive trade relations suffered from considerably greater cost inflation. Efforts to lock the exchange rates of European currencies in place in the form of the Snake, the Exchange Rate Mechanism and eventually the establishment of the Eurozone, ensured that German competitiveness continued to be maintained, causing the share of manufacturing in GDP to remain relatively high.

The UK experience has been the reverse of this. When World War II ended the UK emerged from the hostilities with a rate of exchange which was manifestly too high against the US dollar, a situation vis-à-vis the USA which was largely resolved by the devaluation of sterling in 1949 from $4.03 to $2.80. This left the UK, however, with a severe lack of competitiveness against the rapidly recovering continental economies. The UK lost market share in the 1950s and 1960s and was plagued with balance of payments problems, inadequate investment, and relatively slow growth. When, from the 1970s onwards, the world's economic policy making switched away from Keynesianism to Monetarism and Neoliberalism, the exchange rate took another large leap upwards. The UK relative unit labour cost index – the best way of measuring changes in any country's competitiveness or lack of it – rose from 76.4 in 1977 to 131.8 in 1981, a 73% increase,[66] whereas over this same period, the German index actually dropped to a more competitive level, falling 22% from 85.3 to 66.6.[67] It is hardly surprising that – in contrast to what happened in Germany – the UK very largely deindustrialised as average UK export prices rose and then stayed well above the norm in the world's highly-competitive market for manufactured goods, while import prices tended to be cheaper than those charged for domestic production – a double blow to UK manufacturing.

Will the UK service sector orientation work?

The UK's economy is now very highly service sector orientated, with 80% of GDP accounted for in this way by the late 2010s – the highest ratio, equalled only by that of the USA, among all the world's major developed countries.[68] Unlike manufacturing, the UK service industry has done relatively well on exports, with a surplus running up to 5% of GDP,[69] although as a percentage of world trade the UK share has dropped – from 4.4% in 2000 to 2.5% in 2017.[70] The UK has substantial natural advantages in services in our language and geography, in our legal system and our universities and in our skilled financial services labour force. These are all advantages which do not apply to the same extent – if at all – to UK manufacturing. In addition, services are less price sensitive than manufactured goods so an exchange rate of, say, $1.50 to £1.00 works reasonably well for them, as our services export surplus shows. The hope in the UK among policymakers is that services rather than manufacturing will thus provide a platform for the future prosperity of the UK over the coming decades.

There are, however, two major reasons for thinking that this may be an over-optimistic perception. The first is that all international experience shows that it is much more difficult to achieve productivity increases in services than it is in manufacturing. Increases in GDP per head from services alone – from education and training, "learning through doing", etc. – seldom achieve more than 0.5% to 1% increases in output per head per annum.[71] Much social investment – in road, rail, schools, hospitals, public buildings, and housing, however desirable, adds little economic growth. The same is true of much private sector investment in shopping malls, office blocks, IT installations and projects such as new restaurants.[72] The really big gains in output per hour are to be found in a comparatively small cluster of investment projects – in mechanisation, technology, and power.[73] These tend to be concentrated in light industry and particularly in the internationally traded and highly-competitive international market where pricing is crucial. This is why a high exchange rate such as the UK has experienced in recent decades may not be helpful but not particularly damaging for services, but it has been lethal for UK manufacturing industry which is heavily exposed to international competition.

The second fundamental problem is that services are much more difficult to sell abroad than manufactured goods, even given competitive pricing. The UK's exports have recently been split almost evenly – at around 45% of the total each – between goods and services but services make up 80% of UK GDP compared to less than 10% for manufactures. If we are going to avoid a chronic balance of payments weakness going forward, we will have to sell more goods abroad. Services will never fill the gap.

For both these reasons, therefore, if the UK relies heavily on services at the expense of manufacturing for its future growth, it is likely to be very disappointed. Growth in GDP per head is likely to continue to be barely 1% per annum, which is insufficient to raise mean incomes per head of the population. For faster growth, manufacturing, capable of standing up to international competition, has to be a much bigger part of the mix.

What is the future likely to hold and what can we conclude?

Without radical change, the UK and Germany are both likely to continue to face much slower growth than the world average over the coming years, but for different reasons. In the UK's case it will be because sterling is too strong for manufacturing to flourish. In Germany it is because the economy is too competitive, driving its export markets into recession and slow growth which rebounds back on the sluggish increase in German exports. Productivity increases in both countries will remain very much in the slow lane. Both economies will remain deeply unbalanced particularly between areas in the UK which used to depend on industry and towns and cities now flourishing on services and in Germany because of the weak industrial heritage of the German Democratic Republic. Too many jobs will be low paid and insecure, even if registered unemployment remains relatively low.

In Germany's case, it is not that the euro is too strong for the German economy. A much more plausible case can be made out for it being too weak, aggravated by the fact that the German government over a long period has been reluctant to use the headroom provided by its fiscal and foreign payments surpluses to reflate its economy. Instead, the German government and its people have taken pride in the surpluses and savings which their policies have provided – but at a heavy cost.

First, the German trade surplus has been responsible for strong deflationary pressures in German export markets, brought on by their inability to cope with German competitiveness. As a result, these markets have grown mostly very slowly – and some like Greece, have severely contracted – so that German exports, though high, have been slow to grow, dragging down the German growth rate in consequence.

Second, mainly as a result of the relatively slow growth of the German economy, Germany suffers from many of the same problems as the UK. Disposable incomes have increased very slowly, if at all. There are wide variations in living standard between the more favoured areas of Germany and those who are more disadvantaged, especially those Länder formally in the DDR. Compared to other comparable countries, Germany has had a relatively even distribution of income and wealth – more so than the UK – but recent trends, as in many other countries, have seen uncomfortably large disparities developing.[74] In the UK, there was a big increase in inequality during the 1980s but since then income distribution has stayed roughly constant while wealth inequality has increased.[75]

Measured internationally, both Germany and the UK have lost share of world trade and GDP and consequently have become less influential and less of a model for other countries to want to admire and copy in world affairs. Both the UK and Germany, with their relatively high standards of living and comparatively stable politics, have much for which to be thankful but both are steadily losing ground to rising powers in the East, particularly China.

What can be done about this situation? The main message in this pamphlet – as with much of the work the Institute for Prosperity has done – is that exchange rates exercise a much more powerful influence on economic, social, political and international outturns than is commonly acknowledged. Both UK and Germany have not made good choices, judged by this criterion.

Sterling has for many decades now been much too strong for the overall good of the UK economy while the euro, at least in its role as Germany's currency, has been too weak – a situation which can only be rectified by the Eurozone breaking up or Germany becoming part of a fully united, federal European Union, both of which seem unlikely to materialise in the foreseeable future.

Looking ahead, therefore, the UK may be in a better position than Germany to break out of its current stagnation. Germany is stuck with its membership of the Eurozone whereas the UK still has its own currency and control over its exchange rate, if it chooses to use it. This may turn out to be the pivot on which the respective futures of Germany and the UK will turn.

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