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**Institute for  
Prosperity**

# How to make the **Economy grow**

**The key is competitiveness**

John Mills | July 2024



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## **Low growth in the UK – and across the West compared to the East is not inevitable. It has happened because we have strived to achieve the wrong policy goals.**

Chasing inflation down to 2% per annum requires deflationary policies which push up the exchange rate, making the economy uncompetitive. The result is a dearth of profitable investment opportunities combined with perennial balance of payment deficits, leading to slower and slower growth. Instead, we should pursue an activist exchange rate strategy oriented to keeping the economy competitive enough to generate export led growth and investment. We need an exchange rate which will stop us haemorrhaging our share of world trade, making the economy grow sustainably by at least 2.5% to 3.0% per annum. This will require a one-off devaluation of around 25% but will provide us with a growth rate strong and consistent enough to keep the performance of the UK economy up with the rest of the world for the foreseeable future.

**The key to economic growth is not stability. It is competitiveness.**

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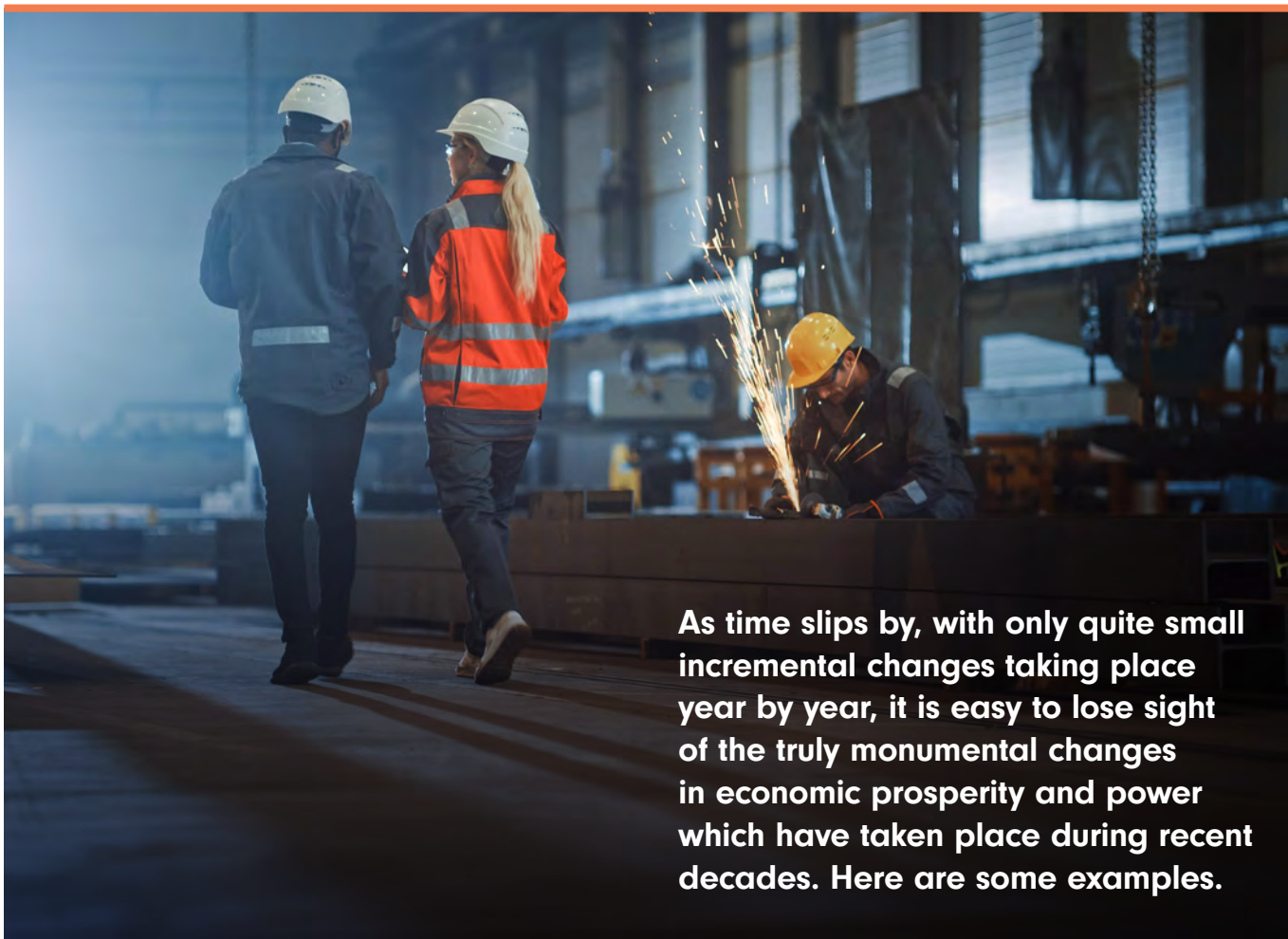
### **Author**

John Mills is an economist with many years of experience in business and politics. His main economic interests have been the UK's relationship with Europe and the poor performance of the UK economy against the background of slow growth in much of the West compared with the East. He does not believe that our increasingly dismal economic growth record is inevitable. On the contrary, it is the result of longstanding policy errors which we very urgently need to rectify.

### **Acknowledgments**

Special thanks are due to Vedran Planinic for his assistance in preparing this report.

# 1. The Status Quo



**As time slips by, with only quite small incremental changes taking place year by year, it is easy to lose sight of the truly monumental changes in economic prosperity and power which have taken place during recent decades. Here are some examples.**

During the nineteenth century, Britain was the most powerful country in the world. As late as the first quarter of the twentieth century, the UK was – at least in part – responsible for the governance of a quarter of the world’s land area<sup>1</sup> and of a similar proportion of its population,<sup>2</sup> which was about 10 times the number of people living in the UK at the time.<sup>3</sup> Now, nearly 30 countries enjoy higher living standards than we do. Norway’s GDP per head is about 40 per cent higher than ours, while Singapore’s is at around 130 per cent above our level.<sup>4</sup>

In 1950, Chinese GDP (Gross Domestic Product) per head is estimated to have been \$439 per annum, measured in 1999 dollar values,<sup>5</sup> only marginally higher than the \$400 per head prevailing in Europe during the dark ages

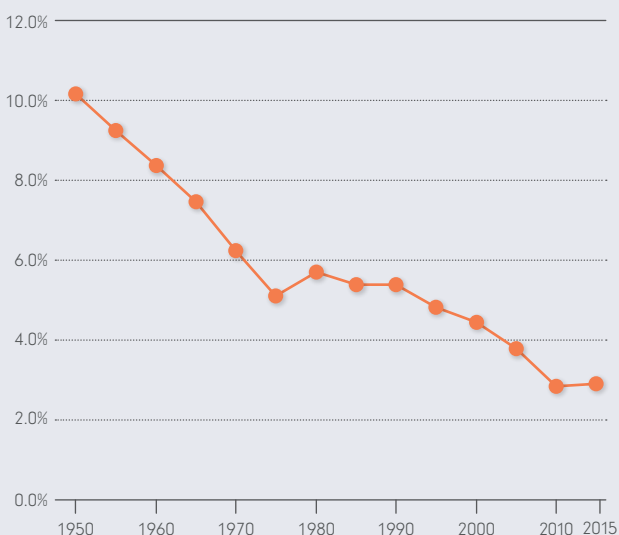
following the collapse of the Roman Empire.<sup>6</sup> In 2020, average Chinese living standards were over 30 times higher than they had been in 1950.<sup>7</sup> Total Chinese GDP is now expected to overtake the US total in nominal terms in the 2030s,<sup>8</sup> having already done so on a PPP (Purchasing Power Parity) basis in 2016.<sup>9</sup>

In 1950, GDP per head in South Korea was \$770,<sup>10</sup> compared to \$6,907 in the UK.<sup>11</sup> In 2023, the corresponding figures were \$56,552 and \$57,492.<sup>12</sup> By 2023, Korean living standards had risen from 11 per cent of the UK level to 98 per cent. In 1990, GDP per head in Poland was less than a tenth of ours,<sup>13</sup> but estimates based on World Bank data project Polish living standards overtaking ours by 2030.<sup>14</sup>

The UK economy, by contrast, having grown by 2.2 per cent per annum between 1980 and 2017, grew at a still slower rate – 1.4 per cent annually – between 2006 and 2017.<sup>15</sup> Much of the rest of western Europe did comparably badly over the same periods, at 1.82 per cent and 1.05 per cent, respectively.<sup>16</sup> The Italian economy – perhaps presaging what may happen in the UK – was actually 0.1 per cent smaller in 2017 than it had been in 2006.<sup>17</sup>

Trade tells a similar tale. In 1950, 25 per cent of all manufactured goods sold overseas worldwide were made in UK factories.<sup>18</sup> Now, only 2.3 per cent are made in the UK.<sup>19</sup> If services and commodities are included, over the same period, total UK exports fell from 10.2 per cent of the world total to 2.9 per cent – a ratio fall of over 70 per cent.<sup>20</sup> **Table 1.1** shows this data in graphical form.

**Table 1.1. Percentage of UK share of world exports**



Source: IMF. *Trade of Goods selected indicators*. Available at: <https://data.imf.org/regular.aspx?key=61545859> (Accessed: 15 May 2024).

These depressingly weak figures, reflected in the gloomy views about our current circumstances and future prospects, are now widely shared throughout the UK. The performance of the UK economy under successively led Conservative administrations over the period since 2010 has been dismally poor, with median living standards – especially recently – either staying static or falling.<sup>21</sup> Few people are optimistic enough to believe that Labour will do much better.

With our population increasing nearly as rapidly as our GDP, it is hard to see how average disposable incomes can rise. Indeed, they will almost certainly fall as a number of pressing cost commitments have to be accommodated, mostly falling on the public sector through the tax system. These include rising expenditure on climate change, the increasing costs of health and social care, higher interest charges, funding the reverse of recent training cuts and finding the money for increased military expenditure.

Between 1990 and the start of the 2007/2009 financial crash, real disposable incomes rose in the UK by 2.3 per cent per annum.<sup>22</sup> This was fast enough to fund at least some of the rising aspirations and expectations for which our increasing national income could reasonably be expected to pay. With little or no additional resources now in prospect, people feel more and more disappointed, stressed, disillusioned and generally frustrated. Interminable cuts and shortages undermine the stability of our political system. What is the use of social democracy if it cannot deliver a decent lifestyle for most people? The stakes are getting very high.

**We very urgently need to get our economy to perform much better.**

## 2. Value Added



**How do we reverse this state of affairs, thus getting the economy to grow reasonably fast on a sustained basis? How do we increase the total value added we create, which is essentially what we need to do? The only way to achieve this goal is to increase productivity, that is, to raise the value of overall outputs in relation to total inputs. This is the process which generates more total value added than there was before, thus enhancing GDP.**

A striking example of increasing productivity, showing both the scale of what can be accomplished as well as the process by which it can be achieved, can be seen in our agricultural history. In the middle of the eighteenth century, just under 40 per cent of the UK's work force was employed on the land.<sup>23</sup> Now, as a result of huge increases in output per head, total UK agricultural employment is barely one per cent<sup>24</sup> of the UK labour force as a result of tractors, combine harvesters, artificial fertilisers and better seeds. Compare this huge increase in value added per worker with what has happened over the same period to the productivity of waiters serving meals or hairdressers providing hair cutting services where output per person is barely different from what it was 300 years ago.

Similar contrasting potential increases in productivity can be found across a wide range of economic activity. Think of a 44-tonne truck compared to a wheelbarrow, a computer in place of a slide rule, or a new machine which produces twice as much output from the same inputs as the one it replaces. It is the increased value added generated by inventions and investments such as these which drive up output per head, productivity and GDP.

Generally, the innovations which are particularly likely to produce productivity increases fall into three broad categories. One is mechanisation – using machines to produce output faster and more accurately than would otherwise be possible. The second is the use of technology in both tangible and intangible form to produce outcomes which are more valuable than those which would otherwise be obtainable. The third is to use power to produce more output by speeding up and enhancing the scale of operations which therefore produce more value added. The more any economy can take advantage of the potential increases in productivity thus made available, the faster it will grow.

**Achieving a reasonable growth rate then entails giving priority to policies which will maximise the chances of these innovations being successfully applied. What might these policies be?**

“ In this pamphlet, John Mills provides a brutally frank assessment of the UK's economic predicament and some radical ideas for how to improve matters. It is well worth a read.

**Larry Elliot**  
Economics Editor at The Guardian

### 3. Generating Economic growth

This section looks at the key factors which may correlate with economic growth. **Tables 3.1a** and **3.1b** show the raw data on which are based the outcomes shown in **Table 3.2**. These are correlations of growth against five other economic metrics which policy makers may pursue or prioritise. They are calculated over two periods: 1980 to 2017 (referred to as the long period) and 2006 to 2017 (the short period).<sup>25</sup>

**Table 3.1a. Correlation analysis raw data: factors affecting economic growth, 1980 to 2017**

Country	Growth Rate per annum % (1980-2017)	Neoliberal Institutions Index Value (1998 median value)	GDP per head USD 2024 values (1998 median value)	Manufacturing Value added, % of GDP (1998 median value)	Gross capital formation % of GDP (1998 median value)	Competitiveness % change in exports (1980-2017)
Argentina	2.0	70.9	9,283	17.8	21.0	-0.1
Australia	3.1	75.6	20,395	12.5	25.6	0.2
Austria	2.0	65.4	27,399	17.7	26.1	0.1
Bangladesh	5.0	52	488	14.9	22.1	0.1
Brazil	2.4	52.3	5,199	12.2	18.2	0.2
Canada	2.4	68.5	21,047	16.3	21.0	-1.0
China	9.6	53.1	821	32	34.8	12.3
Denmark	1.8	67.5	33,427	14.5	22.7	-0.3
Egypt, Arab Rep.	4.9	55.8	1,455	17.0	21.5	0.0
France	1.8	58.9	25,818	14.7	20.7	-2.9
Germany	1.7	64.3	27,528	20.4	24.0	-1.5
Hong Kong SAR, China	4.7	88	25,649	5	29.0	2.2
India	6.1	49.7	413	15.7	25.0	1.3
Indonesia	5.1	63.4	572	25.0	27.4	-0.1
Ireland	4.8	73.7	24,201	23.2	24.1	0.4
Italy	1.2	59.1	22,348	18.4	19.7	-1.1
Japan	1.9	70.2	32,437	22.8	29.6	-2.7



Country	Growth Rate per annum % (1980-2017)	Neoliberal Institutions Index Value (1998 median value)	GDP per head USD 2024 values (1998 median value)	Manufacturing Value added, % of GDP (1998 median value)	Gross capital formation % of GDP (1998 median value)	Competitiveness % change in exports (1980-2017)
Korea, Rep.	6.2	73.3	8,271	25.5	27.8	<b>2.4</b>
Malaysia	5.8	68.2	3,521	28.8	26.7	<b>0.6</b>
Mexico	2.4	57.9	5,759	22.2	22.8	<b>1.5</b>
Netherlands	2.1	69.2	28,019	14.2	22.9	<b>0.0</b>
New Zealand	2.6	79.2	14,890	15.8	20.8	<b>-0.1</b>
Nigeria	3.1	52.3	1,803	17.5	7	<b>-1.1</b>
Norway	2.5	68	34,732	10.5	28.3	<b>-0.4</b>
Philippines	3.8	62.8	988	27	20.0	<b>0.1</b>
Poland	2.6	59.2	4,459	17.3	25.1	<b>0.5</b>
Portugal	2.0	65	12,217	16.0	28.3	<b>0.1</b>
Saudi Arabia	2.0	69.3	8,512	10.2	22.9	<b>-4.4</b>
Singapore	6.5	87	21,829	22.7	31.5	<b>1.2</b>
South Africa	2.3	64.3	3,508	19.3	16.4	<b>-0.8</b>
Spain	2.3	62.6	15,457	16.6	23.9	<b>0.8</b>
Sweden	2.2	64	30,585	19.9	21.6	<b>-0.7</b>
Switzerland	1.8	79	42,724	18.4	27.4	<b>0.2</b>
Taiwan	5.8	70.4	12,767	28	30	<b>0.8</b>
Thailand	5.1	67.3	1,846	27.1	20.1	<b>1.0</b>
Turkey	4.5	60.9	4,384	22.3	23.9	<b>0.8</b>
United Arab Emirates	3.8	72.2	26,572	8.6	23.0	<b>0.7</b>
United Kingdom	2.2	76.5	28,283	14.4	18.3	<b>-3.1</b>
United States	2.6	75.4	32,834	15.8	23.0	<b>-2.6</b>

**Table 3.1b. Correlation analysis raw data: factors affecting economic growth, 2006 to 2017**

Country	Growth Rate per annum % (2006-2017)	Neoliberal Institutions Index Value (2011 median value)	GDP per head USD 2024 values (2011 median value)	Manufacturing Value added,% of GDP (2011 median value)	Gross capital formation % of GDP (2011 median value)	Competitiveness % change in exports (2006 - 2017)
Argentina	2.7	51.7	12,788	15.9	18.4	<b>0.0</b>
Australia	2.8	82.5	67,289	7.4	26.5	<b>0.3</b>
Austria	1.3	71.9	51,452	16.6	24.1	<b>-0.2</b>
Bangladesh	6.3	53	1,032	16.0	27.4	<b>0.1</b>
Brazil	2.1	56.3	13,631	11.8	21.8	<b>0.1</b>
Canada	1.7	80.8	52,286	10.0	24.2	<b>-0.8</b>
China	9.1	52	5,553	32.1	46.7	<b>5.1</b>
Denmark	1.1	78.6	61,864	11.0	19.1	<b>-0.2</b>
Egypt, Arab Rep.	4.4	59.1	3,077	15.8	17.1	<b>0.0</b>
France	1.1	64.6	45,420	10.4	23.2	<b>-1.0</b>
Germany	1.6	71.8	46,697	20.2	21.6	<b>-0.8</b>
Hong Kong SAR, China	3.4	89.7	34,955	1.6	24.1	<b>0.5</b>
India	6.9	54.6	1,450	16.1	39.6	<b>0.7</b>
Indonesia	5.5	56	3,690	21.8	33.0	<b>0.1</b>
Ireland	3.8	78.7	52,159	20.6	17.2	<b>-0.1</b>
Italy	-0.2	60.3	38,276	14.2	20.5	<b>-0.5</b>
Japan	0.6	72.8	48,761	19.5	23.5	<b>-1.3</b>
Korea, Rep.	3.6	69.8	25,100	28.2	33.3	<b>0.6</b>
Malaysia	4.9	66.3	10,398	23.3	23.2	<b>-0.1</b>
Mexico	1.9	67.8	10,554	17.7	24.3	<b>0.3</b>
Netherlands	1.3	74.7	54,342	10.8	20.0	<b>-0.1</b>
New Zealand	2.3	82.3	38,062	10.9	20.6	<b>0.0</b>
Nigeria	4.9	56.7	2,544	7.2	16.0	<b>-0.2</b>

Country	Growth Rate per annum % (2006-2017)	Neoliberal Institutions Index Value (2011 median value)	GDP per head USD 2024 values (2011 median value)	Manufacturing Value added,% of GDP (2011 median value)	Gross capital formation % of GDP (2011 median value)	Competitiveness % change in exports (2006 - 2017)
Norway	1.4	70.3	100,816	6.8	25.4	<b>-0.4</b>
Philippines	5.8	56.2	2,473	21.7	20.7	<b>0.0</b>
Poland	3.9	64.1	13,777	16.3	22.5	<b>0.4</b>
Portugal	0.3	64	23,213	11.3	18.6	<b>0.0</b>
Saudi Arabia	3.6	66.2	26,966	9.9	27.5	<b>-0.5</b>
Singapore	5.4	87.2	53,891	19.6	26.7	<b>-0.1</b>
South Africa	2.3	62.7	8,799	12.9	18.9	<b>0.0</b>
Spain	0.9	70.2	31,677	11.5	20.6	<b>0.1</b>
Sweden	2.0	71.9	60,540	14.6	23.8	<b>-0.3</b>
Switzerland	2.0	81.9	90,944	18.2	28.5	<b>0.5</b>
Taiwan	3.5	70.8	20,839	28.0	25.0	<b>0.0</b>
Thailand	3.4	64.7	5,492	29.0	26.8	<b>0.3</b>
Turkey	5.2	64.2	11,221	16.4	31.0	<b>0.2</b>
United Arab Emirates	3.5	67.8	42,987	8.1	22.5	<b>0.6</b>
United Kingdom	1.4	74.5	42,107	9.3	15.9	<b>-1.2</b>
United States	1.6	77.8	50,008	11.9	19.0	<b>0.5</b>

Source: For growth rate per annum, see: World Bank. *GDP growth* (annual %).

Available at: <https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG> (Accessed: 15 May 2024).

For Index of Economic Freedom, see: Heritage (2023) *All Country Scores*.

Available at: <https://www.heritage.org/index/pages/all-country-scores> (Accessed: 15 May 2024).

For GDP per capita, see: IMF (2024) *GDP per capita, current prices*.

Available at: [https://www.imf.org/external/datamapper/NGDPDPC@WEO/OEMDC/ADVEC/WEO\\_WORLD](https://www.imf.org/external/datamapper/NGDPDPC@WEO/OEMDC/ADVEC/WEO_WORLD) (Accessed: 15 May 2024).

For manufacturing, see: World Bank. *Manufacturing, value added (% of GDP)*.

Available at: <https://data.worldbank.org/indicator/NV.IND.MANF.ZS> (Accessed: 15 May 2024).

For gross capital formation, see: World Bank. *Gross capital formation (% of GDP)*.

Available at: <https://data.worldbank.org/indicator/NE.GDI.TOTL.ZS> (Accessed: 15 May 2024).

For competitiveness, see: IMF. *Trade of Goods selected indicators*.

Available at: <https://data.imf.org/regular.aspx?key=61545859> (Accessed: 15 May 2024).

For Saudi Arabia and Philippines competitiveness, see: IMF (2000) *International Financial Statistics Yearbook, 2000*.

For Nigeria gross capital formation, see: CEIC. *Nigeria NG: Gross Capital Formation: % of GDP*.

Available at: <https://www.ceicdata.com/en/nigeria/contribution-to-gdp/ng-gross-capital-formation--of-gdp> (Accessed: 15 May 2024).

For Taiwan growth rate per annum, see: IMF. *Real GDP growth*.

Available at: [https://www.imf.org/external/datamapper/NGDP\\_RPCH@WEO/TWN?zoom=TWN&highlight=TWN](https://www.imf.org/external/datamapper/NGDP_RPCH@WEO/TWN?zoom=TWN&highlight=TWN) (Accessed: 15 May 2024).

For Taiwan growth capital formation, see: CEIC. *Taiwan Investment: % of GDP*.

Available at: <https://www.ceicdata.com/en/indicator/taiwan/investment--nominal-gdp> (Accessed: 15 May 2024).

Note: for Hong Kong, SAR, China manufacturing and Taiwan manufacturing, the data are estimates based on data a few years later.

**Table 3.2. Correlations with growth rate, results from table 3.1a and 3.1b**

Period	Neoliberal Institutions Index Value (1998 median value)	GDP per head USD 2024 values (1998 median value)	Manufacturing Value added,% of GDP (1998 median value)	Gross capital formation % of GDP (1998 median value)	Competitiveness % change in exports (1980-2017)
<b>1980-2017</b>	-0.06	-0.50	0.53	0.46	<b>0.73</b>
<b>2006-2017</b>	-0.41	-0.56	0.46	0.61	<b>0.63</b>

The results are inevitably indicative rather than precise because so many variable and conflicting factors are involved. They do, however, provide a very clear broad quantitative indication of the factors that both positively and negatively correlate with growth. What do the figures show?

### Neoliberal Institutions

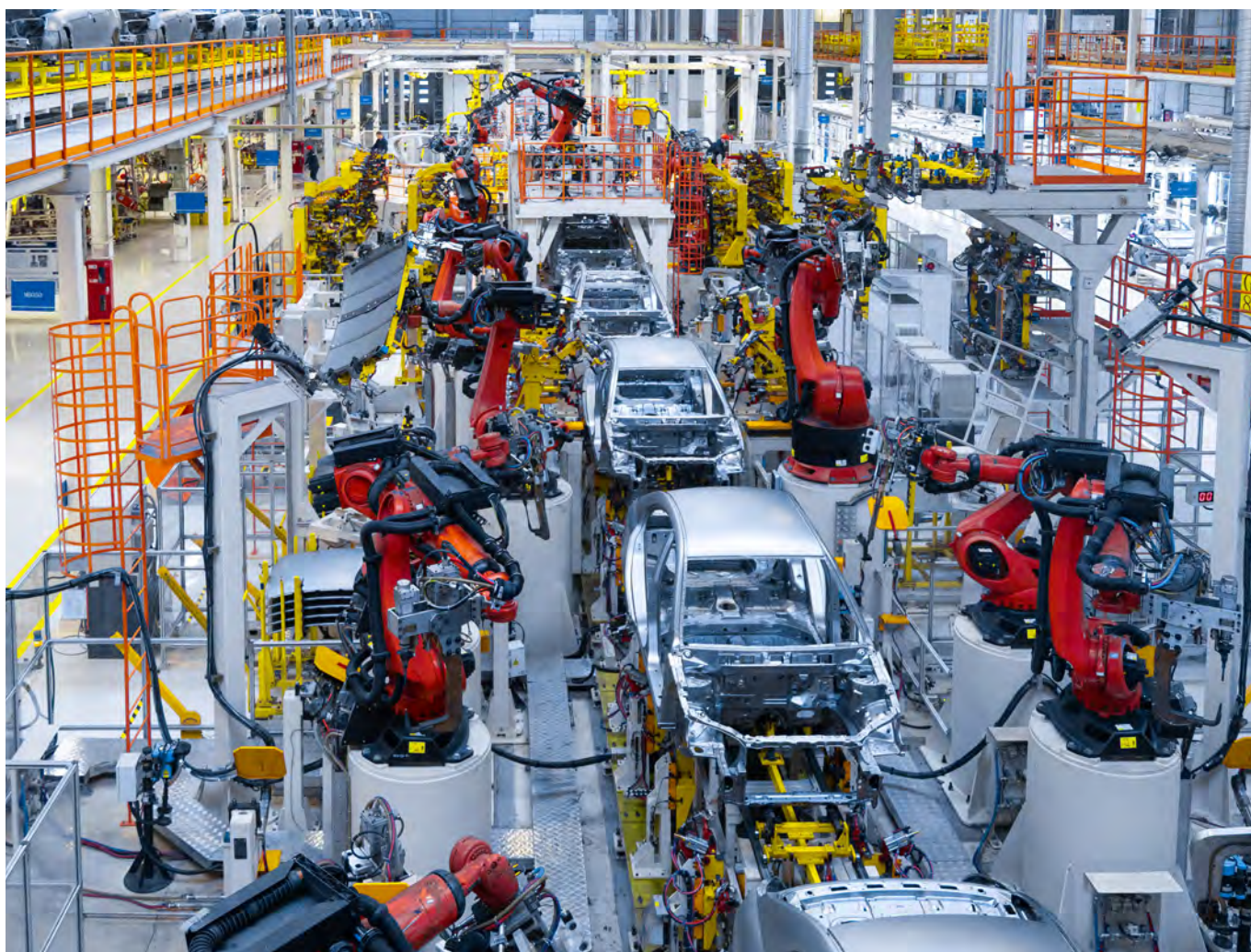
The table shows the correlation between growth rates and the neoliberal institutional architecture generally favoured in the West, as ranked numerically by the US Heritage Foundation. It is widely believed that the political and administrative institutions which are characteristic of the West, which prioritise stability and keeping inflation down to two per cent per annum, favour economic growth more than authoritarian environments. This is not, however, what the correlations in the table show. On the contrary, over the long period – 1980 to 2017 – with a correlation of -0.06, there is little sign that the quality and independence of institutions made much difference to growth rates over the long period. During the short period, moreover, the correlation was moderately negative at -0.41, reflecting deteriorating economic performance in the West post the 2007/2009 financial crash. Freedom of thought and stable governance may have been significant factors in getting the Industrial Revolution going, but autocratic countries are now growing faster on average than those with democratic regimes. Profitable opportunities evidently count for more than stable institutions.

### Existing GDP Per Head

Do countries with low GDP per head tend to grow more rapidly than those which are richer? There is a moderate negative correlation between low levels of GDP per head and growth rates, indicating that percentage growth rates tend to be higher in poorer rather than in richer countries. The relative weakness of this correlation, however, -0.50 for the long period and -0.56 for the shorter one, indicates that there is still plenty of scope for economic growth in already higher income countries. It is also the case that a one per cent increase in GDP in a relatively poor country is, of course, smaller in absolute size than the same percentage increase achieved in a richer country of the same size.

### Manufacturing

It is generally recognised that it is easier to secure increases in productivity in manufacturing than it is in services. This is consistent with the positive correlations in **Table 3.2**, which are 0.53 for the long period and 0.46 for the shorter one, between growth rates and manufacturing as a percentage of GDP. The fact that the correlations are only moderate, however, highlights that other factors are quite strongly at play.



## Gross Capital Formation

Similar comments apply to investment, which can take the form of either physical expenditure on items such as machinery and roads, or on intangibles, such as films and computer programs. Correlations are 0.46 and 0.61. The more investment there is, the faster the growth rate tends to be, but, as with manufacturing, a moderate rather than a strong correlation indicates that increasing investment as a percentage of GDP does not by itself provide any guarantee that much increase in productivity and growth will be achieved.

## Competitiveness

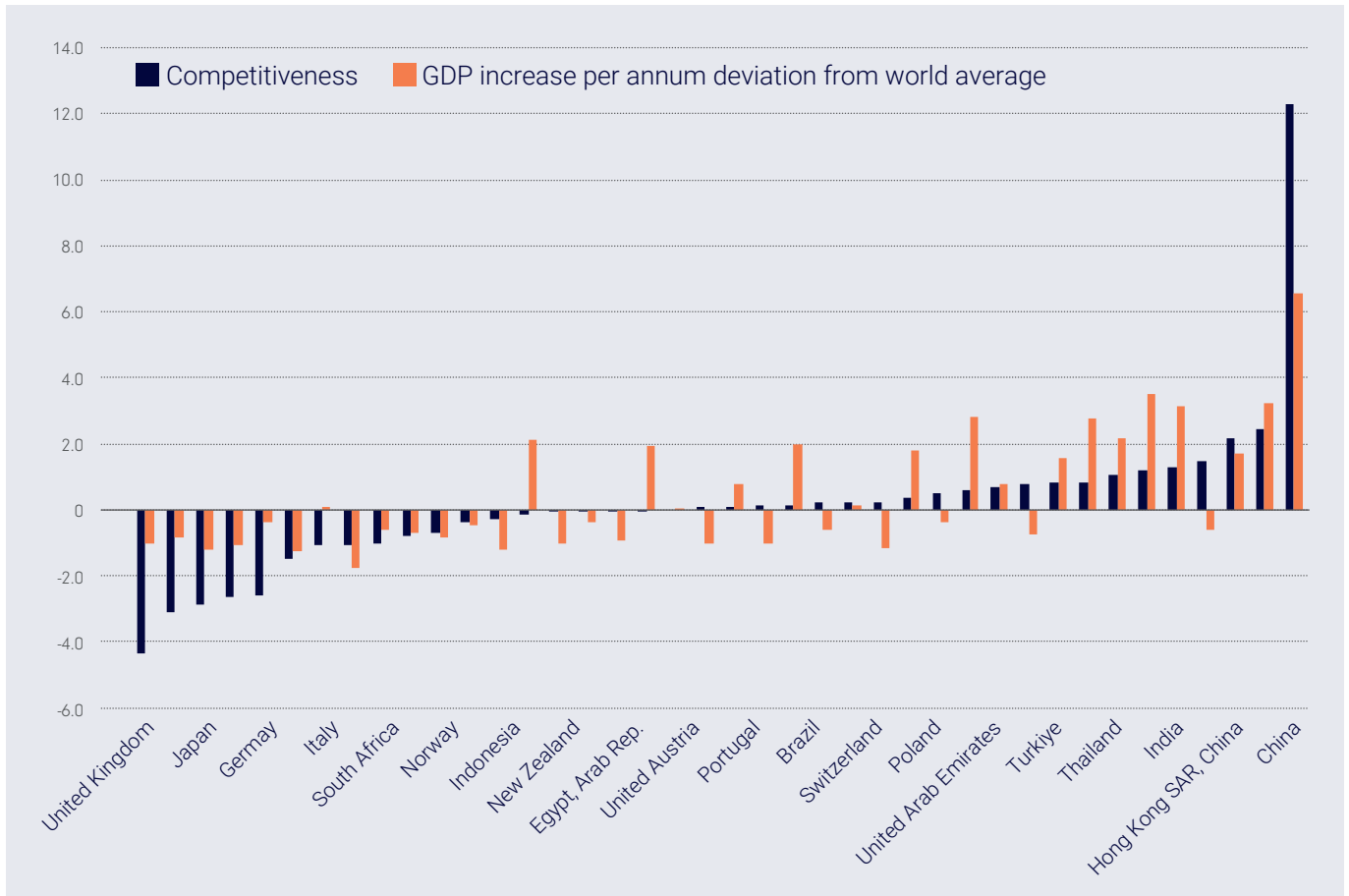
Using trade as a measure of competitiveness is extremely effective, since it measures the actual outcome of all those factors that contribute towards competitiveness. Crucially, the strongest correlations with growth, 0.73 and 0.63, are provided by competitiveness, measured by the extent to which any economy is gaining or losing share of world trade. These high correlations strongly indicate that policies orientated to making any economy more internationally competitive in its pricing for its export markets are more likely than any other strategy to increase productivity and growth. **Table 3.3** shows that countries which have increased their shares of world trade nearly always grow faster than the world average, and vice versa.

**Table 3.3. Competitiveness and growth (1980-2017), sorted by competitiveness**

Country	Competitiveness	Average GDP
Saudi Arabia	<b>-4.4</b>	2.0
United Kingdom	<b>-3.1</b>	2.2
France	<b>-2.9</b>	1.8
Japan	<b>-2.7</b>	1.9
United States	<b>-2.6</b>	2.6
Germany	<b>-1.5</b>	1.7
Nigeria	<b>-1.1</b>	3.1
Italy	<b>-1.1</b>	1.2
Canada	<b>-1.0</b>	2.4
South Africa	<b>-0.8</b>	2.3
Sweden	<b>-0.7</b>	2.2
Norway	<b>-0.4</b>	2.5
Denmark	<b>-0.3</b>	1.8
Indonesia	<b>-0.1</b>	5.1
Argentina	<b>-0.1</b>	2.0
New Zealand	<b>-0.1</b>	2.6
Netherlands	<b>0.0</b>	2.1
Egypt, Arab Rep.	<b>0.0</b>	4.9
World	<b>0.0</b>	3.0
Austria	<b>0.1</b>	2.0
Philippines	<b>0.1</b>	3.8
Portugal	<b>0.1</b>	2.0

Country	Competitiveness	Average GDP
Bangladesh	<b>0.1</b>	5.0
Brazil	<b>0.2</b>	2.4
Australia	<b>0.2</b>	3.1
Switzerland	<b>0.2</b>	1.8
Ireland	<b>0.4</b>	4.8
Poland	<b>0.5</b>	2.6
Malaysia	<b>0.6</b>	5.8
United Arab Emirates	<b>0.7</b>	3.8
Spain	<b>0.8</b>	2.3
Turkey	<b>0.8</b>	4.5
Taiwan	<b>0.8</b>	5.8
Thailand	<b>1.0</b>	5.1
Singapore	<b>1.2</b>	6.5
India	<b>1.3</b>	6.1
Mexico	<b>1.5</b>	2.4
Hong Kong SAR, China	<b>2.2</b>	4.7
Korea, Rep.	<b>2.4</b>	6.2
China	<b>12.3</b>	9.6

**Table 3.4. Competitiveness and growth (1980-2017)**



Source: World Bank. *GDP growth (annual %)*. Available at: <https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG> (Accessed: 15 May 2024). And IMF. *Trade of Goods selected indicators*. Available at: <https://data.imf.org/regular.aspx?key=61545859> (Accessed: 15 May 2024).

What all these figures show, however, is that, while there is no single or simple reason why some economies grow much more rapidly than others, there is a pattern to the factors at play. Competitiveness is the most important factor, and the only one showing a 'strong' correlation above 0.7. If this is the case, it certainly suggests that policies focusing on achieving export competitiveness are much more likely than others to push up the growth rate.



## 4. Investment

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**Table 3.2** (see page 12) shows that expenditure on investment correlates positively and fairly strongly with economic growth. **Table 3.2** also shows that there is a wide variation between countries in the percentage of GDP which they invest. The UK trails the rankings in this respect, at about 18 per cent compared to an international average of around 25 per cent, and 35 per cent - and sometimes more - in China. In 2010, the Chinese ratio had been as high as 47 per cent.<sup>26</sup> There is, however, another major factor to be taken into account. All investment is not equally productive in its capacity to increase total value added, and hence GDP. On the contrary, there is a very wide variation in the rate of return to different sorts of investment and any policy directed at increasing the growth rate needs to take this into account.

These wide variations come about mainly because the total rate of return on investment is often but not always more - and frequently much more - than the private rate of return, which is the reward which goes to whoever finances the investment in the first place. This wider and more comprehensive total return includes all the value added that flows from investment. It is known as the social rate of return. It includes not only private returns but also all the other ways in which increases in value added materialise from investment in the form of higher wages and salaries, greater profits, a stronger tax base, and better and often cheaper products.

This is how some types of investment produce much higher rates of return than others. Typical of those providing low social rates of return, averaging in the region of five per cent per annum, are most investment expenditures in the public sector - on road, rail, schools, hospitals, public buildings and housing. Similar low rates of return are to be found in much of the private sector's investment expenditure - on office blocks, shopping malls, hotels, for example, and again on housing.

The low social rate of return in these areas means that expenditure of this kind can only contribute a small amount to economic growth. Even if as much as 10 per cent of GDP is devoted to this type of investment, 10 per cent of GDP times five per cent return only produces a 0.5 per cent increase in GDP per annum. Many economies are clearly doing much better than this. How do they do it? The answer is that a significant amount of their investment expenditure goes on projects - such as mechanisation, technology and the use of power - with a much higher social rate of return than five per cent.

How much higher? The average social rate of return is easy to calculate. It is the growth rate over any particular period divided by the percentage of GDP devoted to investment. As an example close to world averages, if the growth rate is 3 per cent per annum and 25 per cent of GDP is invested, the social rate of return is 3 per cent divided by 25 per cent, which is 12 per cent. **Table 4.1** shows the resulting figures for a number of countries over varying time periods.



**Table 4.1. Social rate of return and investment rates of various countries**

Country or region (2008-19, unless otherwise stated)	Gross investment as % of GDP	Annual Growth Rate	Social rate of return
UK	17.2%	1.22%	7.6%
Italy	18.7%	-0.31%	-1.9%
Thailand	24.6%	3.09%	13.0%
Brazil	19.0%	1.57%	9.4%
Russian Federation	23.1%	1.42%	8.0%
India	34.2%	6.42%	18.9%
China (2005-19)	44.4%	7.98%	17.0%
World (2004-16)	26.0%	3.50%	14.0%
USA (2006-16)	19.6%	1.62%	8.1%
South Korea	30.1%	3.50%	11.4%

Source: For gross investment as a percentage of GDP, see: World Bank. *Gross capital formation (% of GDP)*. Available at: <https://data.worldbank.org/indicator/NE.GDI.TOTL.ZS> (Accessed: 15 May 2024). For Annual Growth Rate, see: World Bank. *GDP growth (annual %)*. Available at: <https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG> (Accessed: 15 May 2024).

Note: The presentation in the table above depends on key simplifying assumptions, which are:

1. All growth comes from investment rather than being achievable via other means such as education and training. It is assumed that all inputs of this sort are embodied and coupled to investment.
2. Gross investment is a reasonable proxy for investment net of depreciation.

The figures show that the average rate of return is well above five per cent in almost all cases. Given that the returns on much private sector investment and nearly all of that which takes place in the public sector is only around five per cent on average, the social rate of return on the remaining investment expenditure must be much higher. In favourable circumstances, it must be 50 per cent per annum or even greater.

It is remarkable how variable the average social rate of return is between different economies. During the period from 2008 to 2019, China achieved an average social rate of return of 17 per cent per annum, while Italy did so badly that their average was actually negative.

**Clearly, one of the key ways to achieve a high overall growth rate is to maximise the proportion of investment which falls in the highest return category. How do we do this?**

## 5. Competitiveness



**Table 3.3** shows that there is a strong correlation between the growth rate of economies which grow fast and those which are competitive in international markets. It is not difficult to see why this should be the case. It happens because competitive pricing produces strong export demand, which drives investment and growth. We have also seen that the way to determine whether any economy operating in a reasonably open trading environment is competitive or not is by observing whether it is gaining or losing share of world trade. Any country which is losing out in this regard will tend strongly to grow more slowly than the world average. And the greater the lack of competitiveness, the slower the resulting growth rate will be.

The reason why this is the case is that uncompetitively priced exports have two major negative impacts, both of which are very evident in the UK's case. One is that they inevitably make investment – especially in the internationally traded sector – less profitable and attractive, so that total expenditure on new production capacity is lower than it would otherwise be.

The other major problem stemming from weak export performance is chronic balance of payments deficits. These inhibit fiscal and monetary expansion, as constraints on borrowing and the threat of inflation bite. **Table 5.1** shows the UK's recent foreign payments experience.<sup>27</sup>

We have done relatively well on services but very poorly on manufactures. The result has been overall deficits year after year, with no trade surpluses (except in 2020) to offset deficits in primary and secondary income. The well-known tendency for productivity increases to be much more difficult to achieve in services than they are in manufacturing does nothing to make the situation any better as manufacturing as a percentage of GDP falls while services increase. **Table 1.1** (see page 5) shows the huge loss of share of world trade which the UK has sustained over successive recent decades.

**The key issue then is to determine what can be done to ensure that our exports are priced sufficiently competitively to avoid our losing further percentages of world trade which we can ill afford to forego.**

**Table 5.1. UK balance of payments (£ billions in current prices)**

Year	Manufactures balance	Goods balance	Services balance	Trade balance	Primary income	Secondary income	Total
<b>2008</b>	-59.9	-96.0	69.2	-26.9	-21.0	-13.6	<b>-61.5</b>
<b>2009</b>	-56.7	-89.3	70.0	-19.2	-13.0	-15.3	<b>-47.5</b>
<b>2010</b>	-68.1	-99.4	74.3	-25.1	0.7	-20.0	<b>-44.4</b>
<b>2011</b>	-62.5	-104.0	90.9	-13.1	6.9	-20.9	<b>-27.1</b>
<b>2012</b>	-65.4	-112.6	95.7	-16.9	-16.0	-21.0	<b>-53.9</b>
<b>2013</b>	-70.4	-125.0	99.7	-25.3	-31.6	-25.9	<b>-82.7</b>
<b>2014</b>	-80.7	-131.1	94.9	-36.2	-33.3	-24.1	<b>-93.5</b>
<b>2015</b>	-84.7	-125.3	96.3	-29.0	-41.8	-24.1	<b>-94.8</b>
<b>2016</b>	-101.4	-139.3	101.6	-37.8	-46.7	-24.0	<b>-108.5</b>
<b>2017</b>	-102.6	-139.8	111.9	-27.9	-22.4	-22.4	<b>-72.8</b>
<b>2018</b>	-97.3	-141.3	111.5	-29.8	-29.3	-25.5	<b>-84.5</b>
<b>2019</b>	-105.7	-145.0	113.8	-31.2	-2.3	-26.6	<b>-60.0</b>
<b>2020</b>	-94.1	-127.4	140.2	12.8	-44.8	-28.4	<b>-60.4</b>
<b>2021</b>	-105.5	-163.4	159.9	-3.5	12.5	-19.8	<b>-10.8</b>
<b>2022</b>	-145.6	-217.0	150.2	-66.8	12.4	-22.7	<b>-77.2</b>
<b>2023</b>	-120.8	-186.7	153.3	-33.4	-34.9	-20.3	<b>-88.5</b>

Source: ONS (2024) *UK Economic Accounts time series*. Available at: <https://www.ons.gov.uk/economy/grossdomesticproductgdp/datasets/unitedkingdomeconomicaccounts> (Accessed: 15 May 2024).

## 6. The Exchange Rate



Whether any economy has competitive or uncompetitive average export pricing depends on two separate but interlocking factors. One is the condition of the domestic economy: the quality and quantity of its accumulated capital stock combined with the level of education and training among its labour force. The more capital equipment there is per worker and the better trained the workforce, the higher the value of its output measured in the domestic currency and the more that can be charged for it at home and abroad.

Of at least equal importance, however, is the rate at which all the domestic costs of producing exports are charged out to the rest of the world. These charges are made up of a combination of the domestic costs of producing goods and services for export and the rate at which all these charges are offered to overseas markets, compared to competing world prices, after taking account of the exchange rate.

The impact of the exchange rate on competitiveness is often underestimated, leading to the view that the parity of the currency on foreign exchanges does not make much difference. International experience, as well as our own, however, shows that this cannot be correct.

Exchange rate changes have an immediate and direct impact on competitiveness. They affect all the costs of producing exports incurred in the domestic currency but charged out to export markets through the exchange rate. These include labour wages and management salaries, nearly all overhead costs, and interest and tax charges. Typically for manufactured exports, these add up to about 75 per cent of the total.<sup>28</sup> This leaves about 25 per cent to pay mainly for raw materials, components and machinery, for which there are world prices which stay the same in world terms whatever happens to the exchange rate. Services typically have an even higher domestic component ratio because they are less import intensive.<sup>29</sup>

It is now possible to appreciate how large the impact of exchange rate changes can be. Suppose there is a 25 per cent devaluation. Other things being equal, export costs for manufactures, measured in world currency, then become 75 per cent times 25 per cent, that is, a little less than 20 per cent lower and correspondingly more competitive, impacting in turn on export and import volumes. But by how much?

## 7. Price Elasticities



The extent to which lower or higher export prices make a difference to export and import performance depends on how sensitive to price changes export volumes are. These sensitivities are measured by price elasticities which quantify the impact of price changes on both export and import volumes. In other words, elasticity measures the degree to which overseas customers will purchase more of a good if the price drops. Taking exports first, if one per cent cheaper export prices lead, for example, to a 1.5 per cent increase in the volume of sales, this would denote a price elasticity of 1.5 divided by one, which is 1.5. If the sales volume went up by 0.5 per cent the elasticity would be 0.5. As regards imports, if a change of price of one per cent generates a 1.5 per cent fall in import volume, this produces an elasticity of 1.5, and a two per cent fall in volume an elasticity of two. The sum of the elasticities for exports and imports (ignoring signs) provides a value for total price elasticity.

A combined value greater than one is required for the trade balance to improve with a reduction in the exchange rate, thus fulfilling what is known as the Marshall-Lerner condition.<sup>30</sup>

An elasticity of one for imports implies that total import values remain the same as they were before as reduced volume is exactly offset by increased costs. On the export side, every one per cent reduction in the exchange rate generates a 0.8 per cent increase in sales volume and value, measured in the domestic currency.

**Tables 7.1** and **7.2** exhibit two sets of estimates country by country as to what these elasticity values might be in the real world.

“ Over the years, John Mills has championed the case for a lower pound to help correct our woeful trading position and low productivity - and many of us agree with him that this is the only way to rebalance our economy.

**Lord Vinson**

Co-Founder of the Centre for Policy Studies, and former Chairman of the Institute of Economic Affairs

**Table 7.1. The elasticity of demand for exports and imports of 16 industrial and eight developing countries. (Summary of numerous late 20th century academic studies)**

	Elasticity of demand for exports	Elasticity of demand for imports	Sum
<b>Industrial countries</b>			
Austria	1.02	1.23	<b>2.25</b>
Belgium	1.12	1.27	<b>2.39</b>
Canada	0.68	1.28	<b>1.96</b>
Denmark	1.04	0.91	<b>1.95</b>
France	1.28	0.93	<b>2.21</b>
Germany	1.02	0.79	<b>1.81</b>
Iceland	0.83	0.87	<b>1.70</b>
Italy	1.26	0.78	<b>2.04</b>
Japan	1.40	0.95	<b>2.35</b>
Korea	2.50	0.80	<b>3.30</b>
Netherlands	1.46	0.74	<b>2.20</b>
Norway	0.92	1.19	<b>2.11</b>
Sweden	1.58	0.88	<b>2.46</b>
Switzerland	1.03	1.13	<b>2.16</b>
United Kingdom	0.86	0.65	<b>1.51</b>
United States	1.19	1.24	<b>2.43</b>
<b>Average</b>	<b>1.11</b>	<b>0.99</b>	<b>2.10</b>
<b>Developing countries</b>			
Argentina	0.60	0.90	<b>1.50</b>
Brazil	0.40	1.70	<b>2.10</b>
India	0.50	2.20	<b>2.70</b>
Kenya	1.00	0.80	<b>1.80</b>
Morocco	0.70	1.00	<b>1.70</b>
Pakistan	1.80	0.80	<b>2.60</b>
Philippines	0.90	2.70	<b>3.60</b>
Turkey	1.40	2.70	<b>4.10</b>
<b>Average</b>	<b>1.10</b>	<b>1.50</b>	<b>2.60</b>

Notes: The estimates above refer to elasticities over a two-to-three-year period. The figures are based upon the result of a number of different studies. Individual studies give differing estimates depending on the time periods involved, the econometric methodology employed and the particular data sets used. Source: Gylfason, T. (1987) 'Does exchange rate policy matter?', *European Economic Review*, 31(1-2), pp.375-81. Available at: <https://www.sciencedirect.com/science/article/abs/pii/0014292187900547> (Accessed: 15 May 2024). Reproduced on p63 of Pilbeam, K. (1994) *International Finance*. Macmillan.

**Table 7.2. Elasticity of demand for exports and imports 2001-2004 (Estimates produced by the IMF and published in 2010)**

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

Sources: Export Supply Elasticities Table 2, page 21, and Import Demand Elasticities Table 1, page 15 in Tokarick, S. (2010) *A Method for Calculating Export Supply and Import Demand Elasticities*, IMF. Available at: <https://www.imf.org/external/pubs/ft/wp/2010/wp10180.pdf> (Accessed: 15 May 2024). NB Signs have been reversed for Imports in the table above for the sake of clarity.

**Table 7.1** summarises the results of a number of academic studies carried out towards the end of the twentieth century. **Table 7.2** shows the results of an extensive IMF study covering the early 2000s. In both cases, all the sums of export and import elasticities come to well over one. Taking this into account suggests that reasonable long-term UK elasticity values for exports might be around 0.8 and 1.0 for imports, generating a combined total of 1.8.

These figures then provide the basis for estimating the change in the exchange rate needed to make the economy sufficiently competitive to achieve a sustainable growth rate of 2.5 per cent to 3.0 per cent per annum.

In the UK's case, closing the balance of payments gap, thus holding our own in export markets, requires an increase in export sales value of about 20 per cent. A devaluation of around 20 per cent divided by 0.8 – that is, about 25 per cent - would therefore be needed. These figures, like some of those in Chapter 3, should not be regarded as being precise. They do, however, give a clear indication as to the direction and order of magnitude of the changes which need to be made.

“ John Mills has for a very long time argued for an economic policy that takes competitiveness as the key factor, so that the exchange rate and other determinants of competitiveness become of the utmost importance. A successful policy would therefore ensure that the exchange rate is held at a competitive level and - only then - can we then expect to regain our share of markets, both at home and abroad, that we have lost over recent years. John has been the most expert advocate of this straightforward policy and should be listened to before it is too late.

**Bryan Gould**

Former Shadow Chief Secretary to the Treasury, and Secretary of State for Trade and Industry

## 8. Historical Experience



The implication of the previous sections of this report is that export competitiveness has a very significant impact on economic growth. This is indeed what history shows by example after example, as changes in competitiveness and shares of world trade have taken place. Depreciations have stimulated growth, appreciations have stifled it.

The Industrial Revolution started in the UK, but our initial lead was steadily eroded away in the nineteenth century as the strength of sterling, reinforced by its role underpinning the Gold Standard, cut our share of world trade. Our export performance declined compared to what was being achieved by other rapidly industrialising countries such as Germany. In 1820, German GDP per head is estimated to have been 62 per cent of the UK's level. By 1870, it was 57 per cent and by 1913 it was 74 per cent – all reflected in export performance.<sup>31</sup> Between 1885 and 1913, UK exports grew by 230 per cent, and Germany's by 350 per cent.<sup>32</sup>



The 1920s were disastrous for the UK as deflationary policies were deliberately used to strengthen the pound to match its pre-1914 £1.00 = \$4.86 parity.<sup>33</sup> Contrast this with the 1930s. The 25 per cent sterling devaluation in 1931<sup>34</sup> produced the best peacetime growth rate – 4.1 per cent per annum between 1932 and 1937<sup>35</sup> – that the UK economy has ever achieved. After the end of the Second World War the UK made the same mistake as it had done after World War I. In the light of the huge cost to the UK of World War II, we ought to have devalued in 1945, or very shortly afterwards, by 25 per cent or 30 per cent. We should then have retained the competitive advantage this would have given us in all subsequent years, including 1949 when the devaluation that year proved to be not nearly enough. Instead, we ploughed ahead with an overvalued pound, losing ground to international competitors year after year (see **Table 1.1**). If a competitive currency had increased our average growth rate through the period from the end of World War II until now by one per cent per annum, our GDP would currently be over twice its present level.<sup>36</sup> Two per cent per annum extra growth would have made our economy – almost unimaginably – five times as large as it now is.<sup>37</sup>

Turning to the continent, the highly competitive currencies enjoyed by Germany, France and Italy for the first three decades after 1945 showed what high growth rates could be achieved. The drive to lock Europe's currencies together, however, which culminated in the euro, left almost the whole of Europe unable to compete with low inflation Germany, or with new competitors from the Far East. German competitiveness made the euro an overvalued currency for almost everyone else, and economic growth has stagnated as a result (see **Table 3.3**).

In the Far East, after World War II, the Japanese economy grew at an average of 7.7 per cent per annum between 1952 and 1980.<sup>38</sup> The world then choked on Japan's export surplus and the yen was revalued by about 65 per cent by the Plaza Accord in 1985.<sup>39</sup> The result was that Japan's share of world trade dropped from 9.4 per cent in 1985 to 3.8 per cent in 2018,<sup>40</sup> and the Japanese growth rate slipped to 1.7 per cent per annum.<sup>41</sup>

Perhaps the most telling example of all of the huge impact that different exchange rate policies can have is provided by the recent contrasting experience of Russia and China. In the 1980s, both countries moved away from traditional communism, with very different results. In 1980, the USSR's economy was 65 per cent larger than China's<sup>42</sup> but by 2017 the Chinese economy was nearly eight times the size of the Russian one.<sup>43</sup> In Russia, traditional exports of oil, gas, metals, timber and diamonds kept the ruble relatively strong.<sup>44</sup> Despite the Soviet era's in some ways impressive industrial legacy, Russia never produced competitively priced consumer products.<sup>45</sup> Its overall export performance and its growth rate flagged as a result. Russian GDP was only about 40 per cent higher in 2017 than it had been in 1980.<sup>46</sup>

China, by contrast, started in 1980 with almost no industrial base, and the Chinese share of world trade in 1980 was only 0.9 per cent.<sup>47</sup> China then devalued the yuan between 1980 and 1994 by about 75 per cent<sup>48</sup> net of inflation, thus making China capable of producing almost anything at a highly competitive price. The result was that by 2017, China's share of world trade was 13.2 per cent<sup>49</sup> and the Chinese economy had been growing by nearly 10 per cent per annum.<sup>50</sup>

**Across the world, economic growth depends very heavily on competitiveness and competitiveness depends very heavily in turn on the exchange rate. This is the lesson which we neglect to learn at our peril.**

## 9. Enhancing Outcomes

The UK's overvalued pound has not only curbed our growth rate. It has also unbalanced our economy in a number of important ways, weakening our current performance and worsening our future prospects. A competitive pound would therefore not only produce more growth. It would also get the UK economy into better shape for the years to come.

### Borrowing and Lending

**Table 9.1** provides a summary of the borrowing and lending among each major sector of the UK economy for the period from 2008 to 2023. The sector totals give a clear picture of what has been happening. The borrowing and lending net totals for the corporate and household sectors have been much smaller than those for the government and foreign sectors.

**Table 9.1. Net lending and borrowing by sector – 2008-2023 (£ billion)**

Year	Total Govt	Corporations	Households	Rest of the World	Net Totals
2008	-83.4	-7.6	29.6	61.5	0.0
2009	-157.7	34.6	75.6	47.5	0.0
2010	-149.6	18.3	86.1	45.3	0.0
2011	-123.5	39.4	56.0	28.1	0.0
2012	-137.7	31.5	51.4	54.7	0.0
2013	-95.3	-30.0	41.1	84.2	0.0
2014	-102.3	-20.1	26.7	95.6	0.0
2015	-87.5	-71.2	62.0	96.7	0.0
2016	-65.7	-56.2	11.8	110.1	0.0
2017	-51.3	-20.2	-11.0	82.5	0.0
2018	-48.1	-26.0	-13.1	87.2	0.0
2019	-54.9	-0.4	-6.1	61.4	0.0
2020	-274.3	34.9	175.9	63.4	0.0
2021	-179.8	53.9	112.8	13.0	0.0
2022	-115.3	61.2	26.5	80.3	52.8
2023	-158.0	22.5	77.4	94.1	36.1
	<b>-1,884.2</b>	<b>64.6</b>	<b>802.7</b>	<b>1,105.6</b>	<b>88.8</b>

Source: ONS (2024) *UK Economic Accounts time series*. Available at: <https://www.ons.gov.uk/economy/grossdomesticproductgdp/datasets/unitedkingdomeconomicaccounts> (Accessed: 15 May 2024). Note: March 2024 Figures for 2022 and 2023 are still being reconciled by ONS. The net totals will also be effectively zero when this process is completed.

The big picture is of large-scale government borrowing financed largely by heavy lending to the UK from overseas. A key implication from these figures is that we are never going to be able to stop the national debt cumulating up unless we can get our balance of payments deficits under control.

## Deindustrialisation

Even as late as 1970, about 30 per cent of UK GDP came from manufacturing.<sup>51</sup> Now, less than 10 per cent does so.<sup>52</sup> The strength of sterling has put about two thirds of our manufacturing capacity out of business.

This matters greatly not only to our growth rate. It has left swathes of our erstwhile industrial heartlands without enough to sell to the rest of the world to support themselves. It has produced a gulf in average living standards between London and the Southeast compared to the rest of the country. Gross Value Added per head in 2022 was £58,557 in London, £23,521 in the Northeast and £23,804 in Wales.<sup>53</sup> London has been generating a financial surplus annually of rather more than £50 billion,<sup>54</sup> while the country as a whole has an annual deficit not far short of a £100 billion,<sup>55</sup> so the whole of the country outside London must be running a deficit close to £150 billion per annum. The result has been high taxes to finance some measure of redistribution, while depriving a large section of our labour force of the higher quality jobs which manufacturing provides compared to services.<sup>56</sup> It is difficult to see how these features of the UK economy can be remedied unless manufacturing is restored to perhaps 15 per cent of GDP. This will never happen without there being an export-led revival.

## Paying for Investment

Because our strong currency makes investment in the UK economy relatively unprofitable and therefore unattractive, the proportion of our GDP which we devote each year to investment is, as we have seen, very low by international standards - about 18 per cent compared to a world average of around 25 per cent.<sup>57</sup> No policy to increase the UK's growth rate is going to be sustainable unless this ratio is substantially increased, but getting it up will inevitably involve a further squeeze on disposable incomes. Unless we can get the economy to grow, increased investment is bound to lead to reduced consumption. The best way round this problem is to ensure, as far as possible, that the increased investment which a lower exchange rate will bring is concentrated where the returns on investment are highest and fastest.

## Globalisation

International trade certainly has its advantages. It has helped to lift millions of people out of poverty, especially in the East.<sup>58</sup> By concentrating production where it can be done most efficiently it has reduced costs. It is, however, far from being an unmixed blessing, especially for countries like ours which have allowed themselves to become uncompetitive, reinforcing all the disadvantages of globalization, particularly deindustrialisation. Furthermore, claims about the true overall net benefits from international trade may be exaggerated. The total increased value from all international trade has been calculated to be equivalent to no more than 2.5 per cent of world GDP - not that impressive if world output is growing at 3% per annum.<sup>59</sup> Generally, the winners from globalisation have been the countries which have maintained a competitive edge. This is where we need to be.

# 10. The Exchange Rate

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What would have to be done to engineer a major change in the exchange rate – and specifically a substantial devaluation – in a mature open democracy such as the UK? Is there a practical and acceptable suite of deliberate policies which would be capable of achieving a devaluation of, say, 25 per cent to 30 per cent? Persuading enough people that this would be a good idea is clearly difficult. Experience across the world, however, suggests that in principle there are no insurmountable difficulties to be overcome. The problems lie in persuading enough people that this needs to be done. There are four main ways of getting the pound down and keeping it there.

The first is to establish a large wealth fund, owned by the state, with powers to borrow extensively in sterling and to use the proceeds to buy foreign assets. This strategy has been used very successfully by countries as varied as China<sup>60</sup> and Norway, with sovereign wealth funds valued in 2023 at \$2.4 trillion and \$1.6 trillion,<sup>61</sup> respectively, to put heavy downward pressure on their currencies' rate of exchange.

Second, there is much that can be done through the tax system to achieve the same objective by discouraging capital imports and encouraging capital exports. A major reason why the pound has been so strong for so long is that year after year we have sold off vast swathes of our industries, our utilities, our residential and commercial properties, and our debt to foreign interests, with all of this activity pushing up the exchange rate. We need to change the tax system to make all these activities much less attractive, including measures such as introducing a withholding tax which would make it even less advantageous for foreign interests to own UK assets.<sup>62</sup> We do not need to cut ourselves off from the rest of the world, but we do need to nudge the capital markets to behave in ways which are consistent with a faster growth strategy.

Third, we should change the principal remit of the Bank of England away from keeping inflation close to two per cent. Instead, it should be to keep the pound trading on the international markets at a level which generates growth at an agreed rate – probably 2.5 per cent to 3.0 per cent per annum. As has been found across the whole of the western world, the problem with giving top priority to keeping inflation at two per cent is that the policies required to do this keep the currency much too strong. There are then calamitous consequences for growth.

Fourth, both the financial authorities and public opinion need to be sufficiently agreed on exchange rate reform, and to be on board with getting the economy to become more competitive, to give the policy changes required credibility. The world would need to know what we were aiming to achieve, and why, while continuing to act as good world citizens, we wanted to change direction.

**No policy deliberately to get the pound down will work unless there is widespread support for it. At the moment, this condition is far from being met. On the contrary, discussion about activist exchange rate policies is simply not on most people's agenda. This is the big obstacle which has to be overcome.**

“ Insightful, knowledgeable and practical – a valuable contribution into the UK policy debate.

**Gerard Lyons**, former advisor to Boris Johnson when Mayor of London and senior advisor to Gordon Brown's Business Council for Britain

# 11. Would a Deep Devaluation Really Work?



Even if all the policies advocated in this report were implemented, would they actually do the trick? Would a considerably lower exchange rate for sterling be achievable in the real world? Even if it was desirable, would it really be possible to engineer a major devaluation as a matter of deliberate policy rather than letting it happen when market pressures meant that it could no longer be avoided?

It is sometimes alleged that it is impossible to influence the exchange rate by government action because the rate is fixed by market forces that cannot be bucked. This cannot, however, be correct. Experience in China and elsewhere – such as the Plaza Accord – shows that governments can certainly move exchange rates if they are determined to do so, and willing to muster sufficient force.

Would a deep devaluation lead to increased inflation, perhaps on a sufficient scale to wipe out any initially gained competitive advantage? Contrary to widely held opinion, experience across the world shows that currency depreciations do not normally have much impact on inflation. Sometimes they generate relatively small extra price rises, sometimes inflation goes down and usually there is little change from what would have happened anyway. Import prices must rise but they are usually substantially offset by lower interest and taxation rates, longer and more economical production runs and cost reductions from increased investment. They always, however, achieve greater competitiveness than there was before. **Table 11.1** provides a number of examples.

**Table 11.1. Exchange rate changes, consumer prices, the real wage, GDP, industrial output and employment**

	Year	Consumer prices	Wage rates	Real wage change	GDP change	Industrial output change	Unemployment per cent
<b>Britain – 31% devaluation against the dollar and 24% against all currencies in 1931</b>	1930	-6.0	-0.7	5.3	-0.7	-1.4	11.2
	1931	-5.7	-2.1	3.6	-5.1	-3.6	15.1
	1932	-3.3	-1.7	1.6	0.8	0.3	15.6
	1933	0.0	-0.1	-0.1	2.9	4.0	14.1
	1934	0.0	1.5	1.5	6.6	5.5	11.9
<b>France – 27% devaluation against all currencies in 1957/58</b>	1956	2.0	9.7	7.7	5.1	9.4	1.1
	1957	3.5	8.2	4.7	6.0	8.3	0.8
	1958	15.1	12.3	-2.8	2.5	4.5	0.9
	1959	6.2	6.8	0.6	2.9	3.3	1.3
	1960	3.5	6.3	2.8	7.0	10.1	1.2
	1961	3.3	9.6	6.3	5.5	4.8	1.1
<b>USA – 28% devaluation against all currencies in 1985/87</b>	1984	4.3	4.0	-0.3	6.2	11.3	7.4
	1985	3.6	3.9	0.3	3.2	2.0	7.1
	1986	1.9	2.0	0.1	2.9	1.0	6.9
	1987	3.7	1.8	-1.9	3.1	3.7	6.1
	1988	4.0	2.8	-1.2	3.9	5.3	5.4
	1989	5.0	2.9	-2.1	2.5	2.6	5.2
<b>Japan – 47% revaluation against all currencies in 1990/94</b>	1989	2.3	3.1	0.8	4.8	5.8	2.3
	1990	3.1	3.8	0.7	4.8	4.1	2.1
	1991	3.3	3.4	0.1	4.3	1.8	2.1
	1992	1.7	2.1	0.4	1.4	-6.1	2.2
	1993	1.3	2.1	0.8	0.1	-4.6	2.5
	1994	0.7	2.3	1.6	0.6	0.7	2.9
<b>Italy – 20% devaluation against all currencies in 1990/93</b>	1990	6.4	7.3	0.9	2.1	-0.6	9.1
	1991	6.3	9.8	3.5	1.3	-2.2	8.6
	1992	5.2	5.4	0.2	0.9	-0.6	9.0
	1993	4.5	3.8	-0.7	-1.2	-2.9	10.3
	1994	4.0	3.5	-0.5	2.2	5.6	11.4
	1995	5.4	3.1	-2.3	2.9	5.4	11.9

Note: All figures are year on year percentage changes except for unemployment. Source: Liesner, T. (1985) *Economic statistics, 1900-1983: United Kingdom, United States of America, France, Germany, Italy, Japan*. Facts on File. And IMF *International Financial Statistics Yearbooks*, Eurostatistics and British, Argentine and Icelandic official statistics and International Labour Organisation tables.

	Year	Consumer prices	Wage rates	Real wage change	GDP change	Industrial output change	Unemployment per cent
<b>Finland – 24% devaluation against all currencies in 1991/93</b>	1990	6.1	9.4	3.3	0.0	-0.1	3.5
	1991	4.1	6.4	2.3	-7.1	-9.7	7.6
	1992	2.6	3.8	1.2	-3.6	2.2	13.0
	1993	2.1	3.7	1.6	-1.6	5.5	17.5
	1994	1.1	7.4	6.3	4.5	10.5	17.4
	1995	1.0	4.7	3.7	5.1	7.8	16.2
<b>Spain – 18% devaluation against all currencies in 1992/94</b>	1991	5.9	8.2	2.3	2.3	-0.7	16.3
	1992	5.9	7.7	1.8	0.7	-3.2	18.5
	1993	4.6	6.8	2.2	-1.2	-4.4	22.8
	1994	4.7	4.5	-0.2	2.1	7.5	24.1
	1995	4.7	4.8	0.1	2.8	4.7	22.9
	1996	3.6	4.8	1.2	2.2	-0.7	22.2
<b>Britain – 19% devaluation against all currencies in 1992</b>	1990	9.5	9.7	0.2	0.6	-0.4	6.8
	1991	5.9	7.8	1.9	-1.5	-3.3	8.4
	1992	3.7	11.3	7.6	0.1	0.3	9.7
	1993	1.6	3.2	1.6	2.3	2.2	10.3
	1994	2.4	3.6	1.2	4.4	5.4	9.6
	1995	3.5	3.1	-0.4	2.8	1.7	8.6
<b>Argentina – 72% devaluation against all currencies in early 2002</b>	2000	-0.9	1.2	3.3	-0.8	-0.3	14.7
	2001	-1.1	-2.6	-23.3	-4.4	-7.6	18.1
	2002	25.9	1.9	-11.5	-10.9	-10.5	17.5
	2003	13.4	17.6	8.8	16.2	16.8	
	2004	4.4	13.7	9.0	10.7	13.6	
	2005	9.6	22.8	11.9	9.2	8.5	8.7
<b>Iceland – 50% devaluation against all currencies in 2007/09</b>	2005	4.0	6.3	2.3	7.2	12.4	2.6
	2006	6.7	8.8	2.1	4.7	16.8	2.9
	2007	5.1	9.8	4.7	6.0	0.7	2.3
	2008	12.7	8.5	-4.2	1.2	35.5	3.0
	2009	12.0	3.0	-9.0	-6.6	3.8	7.2
	2010	5.4	6.1	0.7	-4.0	10.6	7.6
	2011	4.0	7.1	3.1	2.6	13.5	7.0

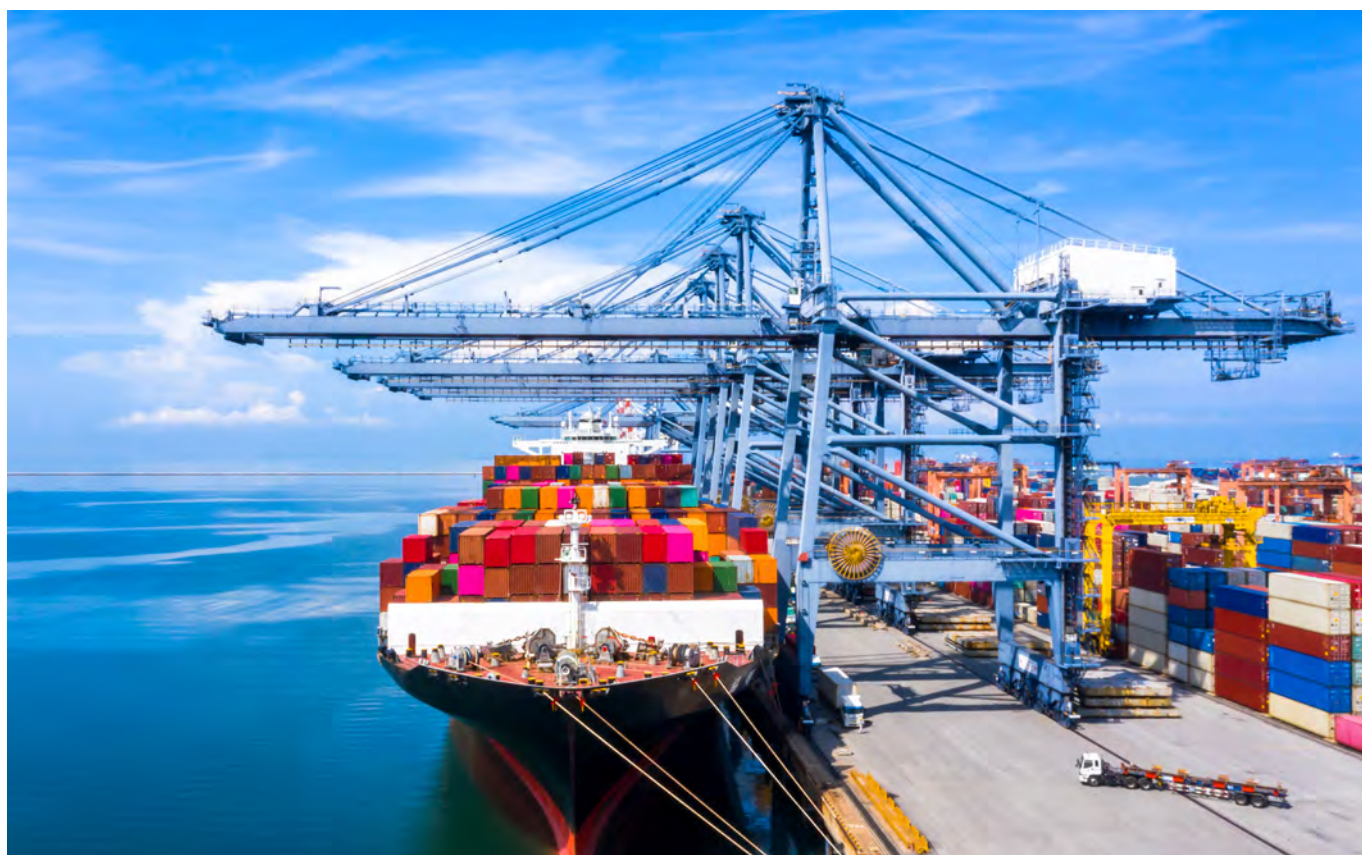
Would there be retaliation? It is very unlikely. The sterling is responsible nowadays for only 2.5 per cent of world trade.<sup>63</sup> We should have no intention of disrupting international commerce by running a predatory balance of payments surplus. The US dollar and the euro are much too powerful to be seriously bothered by a more competitive pound.

Would a much lower value for sterling make us all poorer? Measured in a foreign currency such as the US dollar, of course it would, but UK residents do not normally shop in dollars. As long as they pay for goods and services in sterling, their purchasing power will stay substantially the same as it was before, whatever happens to the exchange rate.

Would a devaluation in the future have a more positive impact on our growth performance than those in the past, which have all taken place as a result of market pressure rather than deliberate choice? All the evidence suggests that a major devaluation would do so, but only if it was deep enough and sustained sufficiently to make the

necessary difference to our competitiveness. In the past, UK devaluations have typically been too little and too late, only making up for other periods when sterling had strengthened. To solve our growth problem, we need to be competitive enough to hold our share of world trade continuously. We have fallen a long way short of doing this.

There are clearly significant international relations issues which would have to be tackled. We have important obligations not to disrupt world trade by adopting predatory policies which disadvantage other countries. We do not need to do this. In particular, we should not try to run a balance of payments surplus which would inevitably become somebody else's deficit. Instead, by lowering our export costs, we would be able to supply the world with better value exports while at the same time, as our economy grew, we would become a bigger market for the rest of the world's exports. We should honour our international obligations as far as we can, but not at the cost of committing our economy to permanent underperformance.





## 12. Conclusion

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We are back where we started. We have an economy which is not delivering. Occasional flashes of better news, such as the 0.6 per cent quarter on quarter increase in GDP during the first three months of 2024,<sup>64</sup> do not fundamentally change the picture. There is no consensus as to why we are doing so badly, and there is no agreement on what we should do to remedy the dire state of affairs which confronts us.

This report argues that there is a viable way ahead, but that for this to be adopted there has to be a radical change in strategy. Instead of having inflation at two per cent as our principal economic goal, competitiveness should be our primary objective. Having recognised just how deeply uncompetitive we currently are, the only remedy is much greater export competitiveness. We have to use export and investment-led growth to prevent us from continuing to hemorrhage share of world trade. The only way to do this is by having a much more competitive pound. In its absence, nothing else will work.

Adopting this strategy is crucially important but it is, of course, not the only thing which needs to be done. Its implementation is a necessary but not a sufficient condition for achieving a reasonable standard of governance. We need to complement greater competitiveness with all the other more familiar components of successful economic management. This includes better education and training, infrastructure modernisation, more patient capital, appropriate tax incentives – especially those designed to encourage investment – and a planning system that strikes a reasonable balance between industry and other priorities. Restoring manufacturing to perhaps 15 per cent of GDP will need to be an important part of the mix. This is a policy whose popularity with the public may help to make more acceptable the devaluation needed to make it occur.

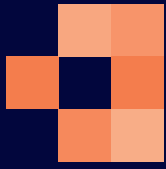
Is any of this going to happen? Maybe not. It is, however, surely possible that these dismal prospects in front of us may trigger a willingness to look beyond the conventional wisdom to new solutions to old problems.

If this does not happen, however, and there is no change in strategy thus leaving the UK uncompetitive and continuing to lose share of world trade, we can be sure that investment, especially of the kind which contributes most to economic growth, will languish. We will continue to have large current account deficits. And, of course, our economy will continue to stagnate. Is this really what we want?

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