



John Mills  
**Institute for  
Prosperity**

UK ECONOMY

# Manufacturing a recovery from **Coronavirus**

“ John Mills maps steps that can underpin our recovery and provide a path to greater self-sufficiency.”

**Rt Hon Caroline Flint**

‘Manufacturing a Recovery From Coronavirus’

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John Mills is an entrepreneur and economist who has long been involved with political affairs. He is the founder and chairman of John Mills Limited (JML), which specialises in selling high volume consumer products, using audio-visual methods for promoting their sale both in the UK and in many other countries – about 85 at the last count. His main interests as an economist are the UK’s relationship with the EU and the relatively poor performance of western economies compared with those in the East.

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 now joint-chair and treasurer of the Foundation for Independence. 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

## RT HON CAROLINE FLINT

Politics struggles with long-term decisions. As leaders, ministers and their opposites look to the next election, or the next reshuffle, the long term seems a lifetime away.

This dreadful coronavirus crisis, with life and death decisions, widespread shutdowns, and a growing death toll, puts the here and now into sharp focus. Few politicians can predict beyond next week, let alone next year.

Just as in the 1930s when economic gloom and ominous signs of war were approaching, our country needed ideas from those who could see over the hill, beyond the crisis, to map a route out of despair. Crucial to restoring the UK economy to health is to rejuvenate manufacturing – too much of which has been sacrificed on the altar of an over-valued pound.

Today's contribution by John Mills may offer the seeds that, if sown, will guide tomorrow's journey; a path to the UK becoming more productive, more prosperous and a fairer country, as well as overcoming our over-reliance on the South East, while most other regions slowly decline. It is sad that the North, which a century ago enjoyed higher living standards than the South, has declined so much.

The John Mills Institute for Prosperity maps a few crucial steps that can underpin our recovery; that can make UK PLC a more substantial producer of goods to sell abroad; steps that offer not just a hand-out to our struggling regions, but a hand-up and a path to greater self-sufficiency.

This pamphlet does not shy away from the inevitable pressures the UK faces. As John Mills lays out, there is no way of avoiding the new challenges of climate change adaptation; healthcare spending; social care with an ageing population and the need to invest more in tertiary education and training. These pressures alone may cost an additional 8% of UK GDP every year for the foreseeable future.

Underpinning this analysis is a compassion for those who do not have the sustainable, secure work that the post-war generation took for granted. An analysis that does not shy away from the need to upskill, so every person contributes more, in return for fairer rewards and an end to excess at the top.

John Mills suggests Covid-19, the inevitable economic recession and, very possibly, a long slow recovery, will lead to government financial intervention on an unprecedented scale. He doesn't need to say it – but the rule book, economic orthodoxy, has been thrown out of the window. The UK needs a few, big, and radical decisions to address the failings of UK productivity, sluggish growth for generations, and the collapse of many UK manufacturing sectors.

As a champion of devolution, I welcome the observation that tackling regional inequality actually requires what I have termed a 'muscular economic nationalism' to enable businesses to thrive.

His proposal for a devaluation of the pound; for a step change in investment in training; and for a quantum leap in investment in our productive capacity - with lending to industry underwritten by government - is convincingly argued. These are the steps that could grow our manufacturing base by 50% and end the long slow decline of UK PLC and gradual sale of many of our economic assets to the highest (foreign) bidder.

In this pamphlet, the John Mills Institute puts hard economics behind a belief in the capacity of the UK to rebuild itself. As UK aerospace manufacturers are shedding jobs and the blast furnaces of South Wales risk being extinguished, John Mills' vision of saving and rebuilding our industrial base, is one that is timely and urgent.

We must do what is necessary to survive this dreadful pandemic. But, what kind of Britain we rebuild, and the new economic settlement, will not shape itself. It requires leadership to forge.

The challenge is laid out in every page. I hope it is heard and acted upon.

A handwritten signature in black ink, appearing to read 'Caroline Flint', written in a cursive style.

Rt Hon Caroline Flint  
Member of Parliament for Don Valley 1997-2019

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# INTRODUCTION

## The UK and Covid-19

How is the UK coping with coronavirus compared to other countries? “Not very well”, is the honest answer. Deaths per head of the population look like being one of the highest in Europe. We very probably should have locked down earlier than we did. We were way behind the curve on testing. Despite herculean efforts to keep up with demand, our hospitals and care homes are short of personal protection equipment (PPE).

And recovery? We are not in good shape for this either. Our economy was deeply lopsided even before the virus struck and is now clearly much more unbalanced. Productivity has been almost static for the past decade. Our growth rate has recently been one of the slowest in the world. We badly lack the ability to create the resources which we will urgently need if we are to bounce back quickly.

Is there a connection between both the extent to which we have succumbed to the virus and our recovery prospects? Is it a coincidence that countries with a strong industrial base – Germany, Switzerland, Singapore, South Korea and China – have all done much better than countries such as the UK which lack the capacity to produce their own tests and PPE? Are countries with substantial manufacturing capability in a much stronger position, therefore, than we are both to protect their populations while the virus is a threat and to recover as it recedes? This pamphlet argues that indeed they are and that we need to learn some important lessons from them. Will the coronavirus crisis be the trigger for the rethink we need about how to make our economy stronger, more resilient, and more sustainable?

## In Perspective

First, a brief recapitulation on how we have got to where we are now. The coronavirus outbreak, from which we are currently suffering, is far from being the first pandemic to afflict humanity. It is, nevertheless, the first outbreak to hit the developed world in a major way since Spanish Flu did so almost exactly one hundred years ago. Spanish Flu was caused by a particularly virulent version of the H1N1 influenza virus to which coronavirus is quite closely related. It infected some 500 million people – about a quarter of the world’s population at the time – and is thought to have killed up to 50 million individuals.<sup>1</sup> Although a terrible scourge, responsible for more deaths than World War I with many sufferers being relatively young, it is remarkable how small a mark on history this outbreak has left.

Further back in history, there have been much worse pandemics. The Plague of Justinian in the sixth century AD is thought to have been responsible for the deaths of up to 50 million people in the West, nearly half those alive at the time.<sup>2</sup> The Black Death, which hit the world in the fourteenth century was as bad, if not worse. Between 1347 and 1351 alone, another 200 million people are thought to have

died an agonising death.<sup>3</sup> By contrast, the current coronavirus outbreak had, by mid-April 2020, generated just under 2 million reported individual cases worldwide with a total of a little over 125,000 deaths.<sup>4</sup> These are evidently much lower figures than the totals experienced in previous pandemics, but in a number of key ways, our economies and our perceptions of disease are much more vulnerable, less resilient and more sensitive to loss and suffering now than they were in earlier times.

It is impossible to predict with any accuracy what the final toll from the current pandemic, but the huge advances in medical knowledge and in the overall resources available over the past century suggest that the eventual numbers, at least in the developed world, will be only a small fraction of what they were with, say, Spanish Flu, especially taking account of the much larger populations nowadays compared to those then. About 600,000 people die in the UK every year<sup>5</sup>, so the extra deaths from the current outbreak, if they are kept to the recent estimate of about 20,000 (which now looks too low), would add some 3.3% to the total, of whom many would have reached the ends of their lives anyway within a few months. If the pandemic had been allowed to run its course in the UK however, generating an estimated 250,000 extra deaths<sup>6</sup>, the ratio would have been much worse, although this now seems to be a very unlikely outcome.

The fact that the numbers may be smaller however, has not blunted the impact of coronavirus - or Covid-19 - proportionately for much else has changed since the end of World War I. Nowadays, we are much less used to seeing people snatched away from life before reaching old age than was the case then. We have been softened by three quarters of a century of peacetime existence. We are used to seeing problems, particularly medical problems, solved by technology as one disease after another has been banished from existence. The experience of those who suffer from serious cases of coronavirus is particularly unpleasant and therefore alarming. We are not prepared to see large numbers of people dying without our medical services being asked to do all that they can to save them. It is therefore not surprising that such a huge effort has gone into combatting the current outbreak, although doing so has had a devastating effect on both our way of life and particularly on our economy.

## **The Coronavirus Pandemic**

It seems almost certain that the coronavirus outbreak started in a wet market - although just possibly in a laboratory<sup>7</sup> - in Wuhan in central China, when the virus jumped from an animal species - possibly bats - to humans. The first cases became apparent during the autumn of 2019. By the end of the year, the appearance in China of a new viral threat was evident although the news that this was happening was initially suppressed. By January 2020, however, Wuhan and Hebei Province, where Wuhan is located, were in lock-down.

If not checked, generally by the development of immunity, viruses spread exponentially. Coronavirus is highly infectious but has symptoms which take days to materialise during which the infection can be passed on. This makes it difficult to contain the rate at which the infection spreads. The numbers of those affected, at least outside China, started small and took a little time – although not much – to start building. As late as 21st February 2020, the threat to western countries from Covid-19 was perceived by a consensus of medical experts to be “moderate”.<sup>8</sup> It was not until March 2020 that the full scale of the threat became apparent, initially in Italy where the north of the country has a large immigrant Chinese population with close commercial ties to Wuhan. It was, nevertheless, earlier, during week beginning 17th February 2020, that the markets suddenly began to wake up to the enormity of the threat which everyone faced. The FTSE 100, which had peaked at 7,674 on 17th January 2020, dropped by a third between 20th February and 23rd March, from 7,436 to 4,993, before recovering some lost ground.<sup>9</sup>

Governments everywhere were suddenly faced with extraordinarily difficult choices. Initially, many hoped that with reasonable efforts being made to protect the most vulnerable – those over 70 and people with underlying health conditions<sup>10</sup> – the restrictions necessary to protect the rest of the population from being seriously affected could be limited and managed effectively without unduly disrupting economic life. Unfortunately, it rapidly became clear from mounting hospital admissions, morbidity and deaths, and from the models into which such data was fed, that this policy was unsustainable. The death toll would be far too high, and the UK government ordered a full-scale lock-down on 23rd March 2020.<sup>11</sup>

These developments led directly to the dilemma all now face. By locking down, the number of people needing to be hospitalised can be kept down to a level with which the health services – at least in the West – can more or less cope. The cost, however, is that as much as about one third of all economic activity grinds to a near total halt. The dilemma then faced by governments everywhere – in the absence of a vaccine which doesn’t seem likely to be available for at least a year – is that relaxing the lock-down risks increasing the incidence of Covid-19, but keeping the lock-down in place will do cumulatively more and more damage to the economy.

It may be that testing on a very large scale both for current coronavirus carriers and for antibodies which show whether people have previously had the disease and have thus accumulated immunity, will be a way out. This would allow much more accurate pinpointing of carriers to take place, with quarantine for those at risk of spreading the disease. There is evidence from China, South Korea and elsewhere that an approach along these lines might work in the West. The problem is that any such remedies, even if they are eventually successful, take time to implement and meanwhile the economic damage accumulates.



## A Disaster and an Opportunity

How much economic damage is likely to result from the current coronavirus outbreak? Almost all public sector activity, which makes up roughly one third of UK GDP, including central and local government, the military, the administration of the welfare state and of course the NHS, is at full stretch. So is roughly half the private sector, not least those sectors of it which produce and distribute food, fuel and power, utilities such as water and waste disposal, and companies selling and delivering direct to the final consumer. About half the private sector, making up roughly one third of the economy, however, has been either shut down completely or is operating at far below full capacity. Activities involved include transport by land, air and sea, the hospitality and catering industries, large sectors of retail trade and myriads of business delivering personal services, from hairdressers to dentists, from builders to taxi drivers.

Initial estimates as to how GDP will fare in 2020 compared to 2019 showed a drop of perhaps 5%, roughly the same as happened between 2007 and 2008. Estimates of this size were based on expecting a dip between the second quarter of 2020 compared to the same period in 2019 of around 15%, with a recovery towards the end of 2020. The estimated drop for the current year, however, now looks likely to be much higher than previously anticipated. This is both because the second quarter drop may well be greater – perhaps as high as 30% or even 35% – and whatever the drop is may last for longer. A year-on-year fall in GDP of the order of 15% or 20% between 2019 and 2020, may well be on the cards.<sup>12</sup>

All the depressions or recessions which we have experienced within our lifetimes have happened essentially because, for one reason or another, demand has fallen away. This time it is different. It is large volumes of supply which are no longer available and the big unknown is what proportion of the output from the sectors of the economy which have not been able to function for weeks or months will be able to get going again and, if so, to what extent will they be able within a reasonable time period to do so to anything like their previous levels of performance.

Governments throughout the developed world, including the UK, have understandably announced massive programmes both to relieve hardship among furloughed employees who might well otherwise have lost their jobs and to keep companies' workforces in being ready for the recovery. Much as one can appreciate how strong the pressure has been to create this support, however, unpinning and unpicking it once the recovery gets under way is going to be fraught with problems and recovery of lost GDP would very probably take years rather than months even in the most favourable circumstances. Unfortunately, however, because the UK economy suffers from a number of acute imbalances and its recent growth and productivity record have been so poor, it is not going to be in a favourable position to recover the ground which has been lost. We turn now to why that should be the case and what we might be able to do about it.

## LONGSTANDING UNDERLYING PROBLEMS

The UK's economic record over the last decade has had its successes. Unemployment – at least until very recently – has been very low and the proportion of the population in work has never been higher. Inflation has been maintained at close to the target rate of 2%. Government borrowing, which peaked at £156bn in 2009 had fallen by 2019 to £46bn.<sup>13</sup> Despite these good figures however, all has not been well, providing a much weaker base from which to launch recovery from Covid-19 than is optimal.

The UK economy has grown so relatively slowly recently because it is extraordinarily unbalanced. We invest far less of our GDP than most other countries do, and the investments we do make are largely not in the most productive areas. We have deindustrialised to a dangerous – arguably reckless – extent. Our very large balance of payments deficits year after year highlight our inability to pay our way in the world. These deficits also reflect the fact that we enjoy a standard of living which is considerably higher than we are actually earning. To finance it we have – every year – to sell national assets and to borrow more and more money, increasingly losing control over our economy in the process. Inequalities – both regional, inter-generational and socio-economic – are becoming so wide that they are in danger of tearing our social fabric apart.

### Investment

In the UK, in recent years we have devoted barely 17% of our national income every year to investment in our future. This figure includes intellectual property, such as computer software. Excluding intellectual property, physical investment has recently been running at around 12% of GDP<sup>14</sup> – more or less equal to the depreciation charge on existing assets, so that there is no net increase every year.<sup>15</sup> The world average for total investment as a percentage of GDP is over 50% higher than ours, at 26%. In China, the figure has recently hovered round 45%.<sup>16</sup>

Worse is to come. Homing in on where our investment goes, only 2.7% of GDP – down 25% from 3.6% in 2008 – goes towards the most productive forms of investment, reasonably accurately covered by the Office for National Statistics (ONS) heading for “Other machinery and equipment”.<sup>17</sup> In practice, this is investment clustered round mechanisation, technology and power and Table 1 shows just how critical this is. Most investment – in road, rail, schools, hospitals, public buildings and housing in the public sector, and in office blocks, shopping centres, new restaurants and IT support services in the private sector – produces total returns of little more than the interest charges needed to finance them, as the very low figure for the UK in the table shows. The reason why countries such as China and Singapore grow so much faster than we do is that they spend far more on these key sectors – machinery, technology and power – where the big overall returns to the economy lie.

Table 1

<b>Gross Investment, Social Rates of Return and Growth Rates for Selected Countries and Periods</b>				
<b>Country</b>	<b>Period</b>	<b>Gross Investment as a % of GDP</b>	<b>Average Social Rate of Return</b>	<b>Average Growth Rate</b>
UK	1934-1941	14%	37%	5.6%
USA	1939-1944	7%	144%	10.1%
Japan	1953-1970	29%	35%	10.1%
China	2002-2012	37%	25%	9.1%
Korea	2005-2016	30%	12%	3.5%
Singapore	2005-2016	26%	20%	5.3%
UK	2005-2016	17%	8%	1.4%
World	2005-2016	26%	14%	3.5%
<p>NB the Gross Investment figure for the USA for the period 1939 to 1944 covers private investment only, so the average Social Rate of Return for the US economy as a whole must have been lower than 164%.</p> <p>Source: The Social Rate of Return is calculated as the ratio between total investment and total increase in GDP over a long enough period – around ten years – to iron out fluctuations. Data from <i>International Monetary Statistics Yearbooks</i>, Washington D: IMF and <i>100 Years of Economic Statistics</i> by Thelma Liesner</p>				

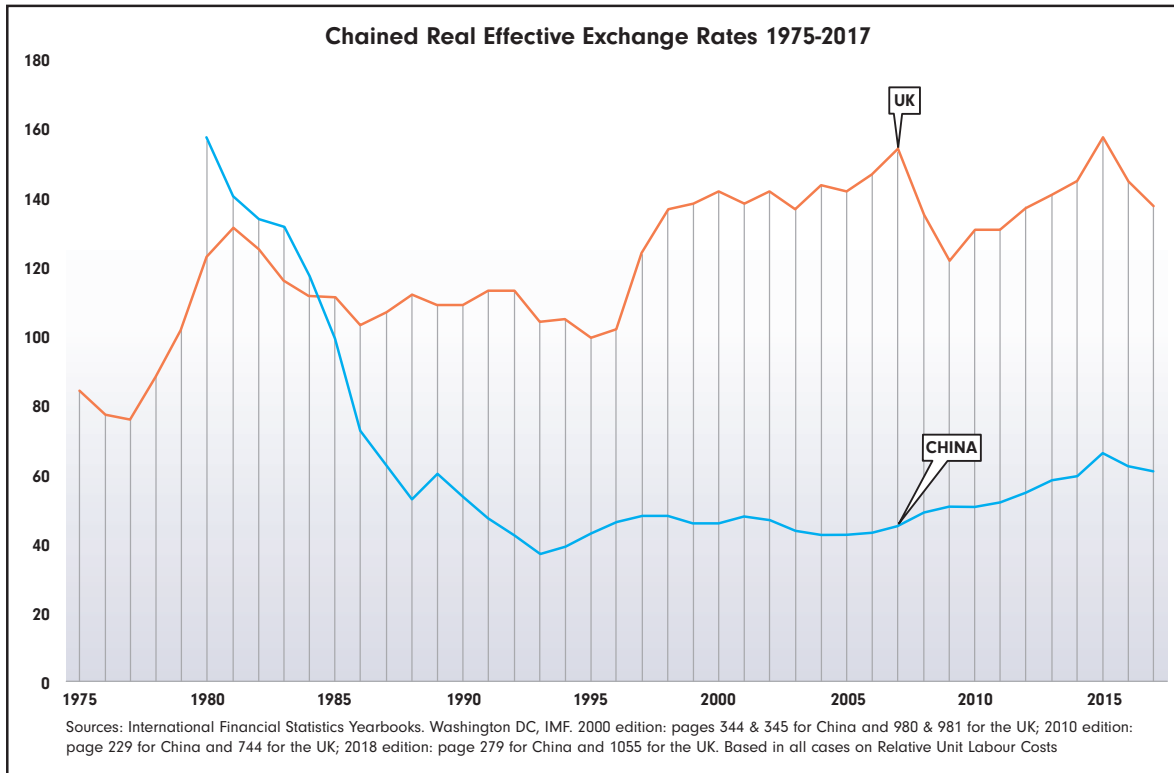
These types of investment are capable of producing much higher total returns – often referred to in aggregate as the social rate of return – than is the case with almost all others. Think of a combine harvester replacing a sickle, a large truck instead of a wheelbarrow, a computer replacing a multiplication table or a new machine producing twice as much as the one it replaces with the same inputs. Investment of this high-powered sort can and does achieve social rates of return which are far higher, as the figures in Table 1 show. The returns come back to the economy in a variety of different ways as higher wages and salaries, better and often cheaper products, higher profits and a bigger tax base.

The average figures in the table are made up of a mixture of low returns on social investment and much higher returns from machinery, technology and power. To produce the average social rates of return achieved by Japan in the 1950s and 1960s – and China much more recently – they must be achieving total returns on these types of very highly productive investment of at least 50% per annum and often more.

The problem with the UK is that the 2.7% of GDP which we spend on these types of investment is far too low to increase the stock of high-powered investment needed to push up our average social rate of return anywhere near the 14% world average, let alone the levels reached in really fast-growing economies. This is why we have a chronic

productivity problem. But why, is investment in the UK as a percentage of GDP – and particularly the most high-powered – so low? It is because its natural home is in the internationally tradable light industrial sector, which unfortunately has been chronically unprofitable, clearly exemplified by the fact that we have deindustrialised to the extent we have.

**Table 2**



Typically for manufacturing operations, about one third of total costs are machinery, raw materials and components, for which there are world prices. The other two thirds are made up of direct labour and overhead costs, including interest and a provision for taxation.<sup>18</sup> All these costs are incurred in the domestic currency – sterling of course in our case – and are then charged out to the rest of the world, via the exchange rate.

Most manufacturing output – especially the medium- and low-tech variety – is very price sensitive internationally and the key problem for the UK is that the exchange rate is too high for most UK manufactured output to be competitive. The graph above in Table 2 shows what has happened to sterling’s competitiveness *vis à vis* China since the late 1970s when, even then, UK manufacturing was none too internationally competitive. It has been a combination of very high interest rates and tight money in the 1980s followed by the liberalisation and encouragement of capital imports in the 2000s, which between them pushed up the exchange rate to something like double its mid-1970s level by the late 2000s, and which has been directly responsible for the collapse of most UK industry.

The UK service sector and high-tech manufacturing are both relatively price insensitive. Furthermore, services benefit to a substantial degree from natural advantages we have in our language, our geography, our legal system, our universities and the characteristics of our labour force. Unfortunately, none of these advantages apply to any great extent to manufacturing. This is why services can live happily with an exchange rate of perhaps \$1.50 to the pound, while manufacturing needs a far lower rate, something like parity between sterling and the dollar. This is the crucial UK problem.

## Deindustrialisation

As recently as 1970, nearly a third of UK GDP came from manufacturing.<sup>19</sup> Now, it is less than 10%.<sup>20</sup> The conventional wisdom is that the decline of manufacturing is both inevitable and does not really matter. Neither proposition is correct. Manufacturing is critically important for at least four overlapping reasons.

Table 3

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

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

First, productivity increases are much easier to achieve in manufacturing than they are in services, as Table 3 very strongly indicates. This is the case because manufacturing is the most natural home for mechanisation, technology and power – the critically important types of investment for increasing productivity. Economies with a low percentage of GDP derived from manufacturing tend therefore to have relatively low growth rates, as the table shows.

Second, deindustrialisation has not affected all regions of the UK equally. Some were much more dependent on manufacturing than others before the decline in manufacturing as a percentage of GDP set in, and – hardly surprisingly – these have been far the most seriously hit by its decline. As a result, the most adversely affected regions have seen

their percentages of GDP steadily falling. Between 2010 and 2016, the London economy grew by 22% net of inflation, while the North East managed only 4%. By 2016, gross value added (GVA) per head in London was 76% above the UK average and more than double that of 7 of the 11 remaining regions and countries of the UK.<sup>21</sup>

Third, understandably, the increase in regional GDP inequality is reflected in what has happened to real wages. Since 2007, real incomes in London have, on average, held their own. This is far from being the case in Wales and the North East, where the average real wage has fallen over the last 10 years respectively by 10% and 9%.<sup>22</sup> The result of London pulling away from the rest of the country is a huge and still increasing disparity in annual GVA per head of the population.

Some of these large disparities pre-tax are blunted by redistribution through the tax and benefit system, so that disposable incomes are not as sharply different as GVA, but the consequence has been to make the regions more and more dependent on redistributive taxation and benefits, grants, loans and the sale of assets, at least partially to close the gap. London, reinforced by services, can hold its own in the world, but much of rest of the country is dependent on grants, and subsidies of various kinds for well over 10% of their living standards, which are still much lower than those in London.

Fourth, the collapse of so much of the country's manufacturing industry has left the UK with far too little to sell to the rest of the world to enable it to pay its way. Although services make up over 80% of the UK economy, in 2018 they provided no more than 45% of our export earnings. Manufacturing, comprising less than 10% of GDP, supplied another 44%, with the balance being made up from raw materials and commodities such as oil.<sup>23</sup> Because services are generally much more difficult to sell abroad in sufficient quantities than goods, if the UK's balance of payments gap is ever going to be closed – or at least reduced to manageable proportions – this will have to be done by the UK increasing its export of manufactures.

To rebalance our economy, we need to increase manufacturing as a percentage of GDP from its present barely 10% to around 15%. We do not need to emulate the 20% ratio achieved by countries such as Germany, Singapore and Switzerland because we have such a successful services export sector, which makes a balance of payments contribution on its own every year of some 5% of GDP, but only 10% coming from manufacturing is unsustainably low.

## **Balance of Payments**

Table 4 shows what has happened to the UK's balance of payments over the past dozen years, from which a number of key conclusions can be drawn.

First, while we have had a steadily deteriorating balance of trade on goods, this has been largely and successfully offset by our rising surplus on services, thus reducing the impact of our increasing lack of competitiveness on visible trade. Because the goods

deficit is much larger than the services surplus, however, this has still left us with an overall trade deficit, albeit one which has been reasonably stable and of manageable size. The problem is that our overall balance of payments deficit has been much bigger than our trade deficit because a relatively small trade gap only makes up about one third of our total foreign payments' deficit.

**Table 4**

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

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

The second component of our balance of payments is our net income from abroad. This is made up very largely by the balance between what we get paid from abroad on our investments overseas and what investors in the UK receive in returns on their investments in the UK. Here there are obvious signs of marked deterioration. The main underlying reason for this is the cumulative effect of having an overall balance of payments deficit year after year. This has to be financed by a combination of net sales of UK assets and borrowing from abroad, both of which involve cumulatively increasing negative net income streams. The inevitable result is that the net income balance tends to worsen.

Furthermore, the higher the exchange rate, the worse the income balance tends to be. This is because our foreign earnings are largely paid in world currencies while the returns on foreign investment within the UK are mostly paid in sterling. It is easy then to see that, the stronger the pound, the worse the net balance will tend to be. This effect is particularly pronounced because there are very large aggregate values – of the order of \$15trn<sup>24</sup> – in both the value of UK investments overseas and foreign investment in the UK. The net figure is then the difference between the returns on these two large totals,



meaning that a change in the value of the pound makes a disproportionately large difference to the net figure.

The third component of our overseas balance is the net position on transfers abroad. About half of these are currently our net contribution to the EU budget, with the remainder split roughly equally between our overseas aid programmes and net remittances abroad by migrants to the UK. As the table shows, these have been on a slowly rising trend.

Since 2000, the cumulative value of the UK's balance deficit has been close to £1trn.<sup>25</sup> To finance this very substantial sum, which is equal to about half our annual GDP, not only have we had to borrow large sums from abroad, we have also sold off huge swathes of our national assets. These include most of our ports and airports, our football clubs, our power and utility companies, billions of pounds worth of residential and commercial properties, and much else. An ONS report produced in 2014 showed that by then as much as 29% of UK annual gross value added was generated by foreign owned companies.<sup>26</sup>

To a degree, most people would agree that it does not matter that much who owns our companies or even our housing, as long as it is well managed and used productively. But pushed beyond a certain point, this line of argument has to become suspect. It does matter if more and more of our economy is owned abroad by people who inevitably are going to put their home countries' interests before ours; who are going to concentrate their research and development activities near their head offices; who are going to pay most of their taxes to their home countries; and who may well divide up world markets in ways which may not suit us. Ever since 1999, when the Monopolies and Mergers Commission was abolished and replaced by the Competition Commission and the 2002 Enterprise Act,<sup>27</sup> unlike almost any other country in the world, we have had no public interest test which has to be passed before major takeovers of UK companies are allowed to take place. The result has been that we have lost control of large sectors of our economy, while the City earned an estimated £50bn in fees and charges over the years between 2000 and now from the sale of UK assets.<sup>28</sup> The resulting inflow of capital pushed up the value of the pound to a point where our manufacturing industry has been decimated and we cannot pay our way in the world.

## **Borrowing and Lending**

It is an accounting identity that – in any economy and indeed across world – all borrowing has to be exactly matched by equal lending and all surpluses have to be matched by equal but opposite deficits. Unfortunately, our policymakers seem to have lost sight of both the inevitability of these relationships and their practical implications.

A key example relates to the deficits run up by the government year after year. As Table 5 shows, there is a strong relationship between government borrowing and the balance of payments. This arises because the impact of a foreign payments' deficit is to siphon demand out of the economy as net payments go to foreign suppliers. This deficit has to be matched by excess spending over income – i.e. by borrowing – somewhere else in the



economy. Some of the slack may be taken up by either the household or the corporate sectors – or both – but their net impact has never been anything like sufficiently large to offset the correlation between government borrowing and the foreign payments deficit.

This relationship, however, has profound policy implications. The thrust of government policy since the 2008 crash has been to reduce the government’s deficit by a combination of cutting expenditure and increasing taxation. Leaving the household and corporate sectors on one side, this policy can only work if the foreign payments’ deficit is reduced pro rata. There is, however, no reason – at least directly – why this should happen. The foreign payment deficit is driven overwhelmingly by the factors exemplified in Table 4 and not by what happens – at least normally – by government decisions on taxing and spending. This is clearly the way causation goes.

Could the government really not reduce its deficit by cutting expenditure and raising taxation? Yes, it could but only by doing what happened recently in Greece. There, the government deficit was eliminated, but only by depressing the whole economy by about 25% in real terms<sup>29</sup> to such an extent that imports were reduced enough for them to be covered by exports. It was not prudent government management of its finances which got the Greek budget back in balance, it was plunging the economy into such a large depression that the foreign payments position was forced back into balance.

**Table 5**

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

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

The crucial lesson to be learnt from this experience is that balancing the government's books without depressing the economy can only be done via policies that work directly on improving the balance of payments. This is why austerity policies – cutting expenditure and raising taxes – are an extremely inefficient and a socially destructive way of cutting government borrowing. They only work by depressing the whole economy to improve the foreign payment balance. Essentially, this has to be the way in which austerity policies reduce government borrowing.

**Table 6**

**Total Assets Minus Total Liabilities - Selected Countries  
Ranked in Order of Net Balances to GDP**

All Figures are in Billions of US dollars

	<b>Year</b>	<b>Total Assets</b>	<b>Total Liabilities</b>	<b>Net Balance</b>	<b>GDP</b>	<b>Ratio Net Assets to GDP</b>
Switzerland	2017	4,889	4,019	870	678	1.28
Singapore	2016	3,150	2,854	296	291	1.02
Germany	2017	10,009	7,696	2,313	3,678	0.63
Japan	2016	8,444	5,565	2,879	4,795	0.60
China	2016	6,507	4,557	1,950	11,040	0.18
Russia	2017	1,341	1,073	268	1,572	0.17
South Korea	2016	1,454	1,205	249	1,449	0.17
United Kingdom	2017	14,386	14,738	-352	2,622	-0.13
India	2016	608	1,043	-435	2,332	-0.19
Italy	2017	3,028	3,366	-338	1,793	-0.19
France	2017	7,930	8,483	-553	2,375	-0.23
Brazil	2017	862	1,550	-688	1,658	-0.41
U.S.A.	2016	23,849	32,107	8,258	17,348	-0.48
Spain	2017	2,248	3,376	-1,128	1,173	-0.96
Greece	2017	239	539	-300	197	-1.52
Ireland	2017	6,030	6,571	-541	210	-2.58

Source: Country Tables in *International Financial Statistics Yearbook* Washington DC: IMF, 2018

Excessive borrowing by either the government or consumers is not, however, the only debt problem. There is also a major international dimension to it, particularly for the UK and the USA. Both have run very large balance of payments deficits for a long time and have thus moved from being major creditors to being increasingly large-scale debtors. Meanwhile other countries have run up surpluses, as Table 6 shows.

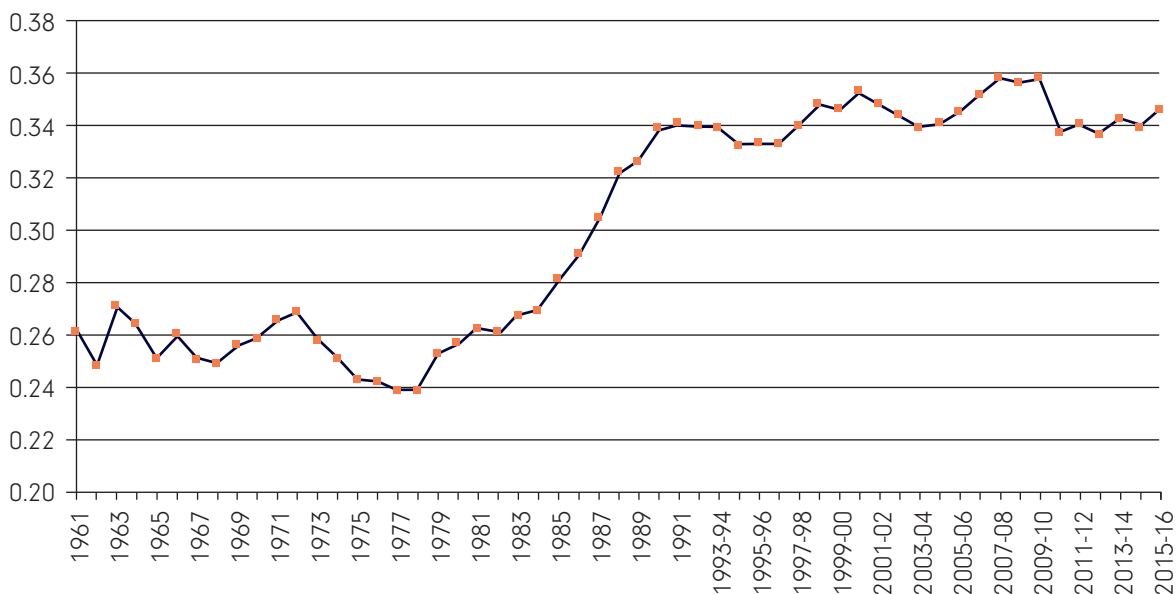
The danger here is that the trust on which the financing of these huge debtor and creditor position requires will break down as the sums of money involved reach levels which are clearly unrepayable and even the servicing costs may become unmanageable. It is not just the UK that needs to get its foreign payments position under much better control. The world has a major problem caused by some countries running unsustainably large deficits every year, matched by other countries with surpluses which could help to drag the whole world into a deeper recession.

## Inequality

Attaining complete equality between everyone is an impossible target and there are reasonable differences of opinion held by people as to how wide the gaps should be between those with the greatest advantages and those who are not so lucky. Different sections of the electorate have varying views as do the political parties that represent different interests, which is why democracies can live with reasonable disparities of income and wealth. It helps, however, to have a reasonably contented and stable society if two conditions are fulfilled. One is that income, wealth and life chances are not too widely dispersed and the other is if the economy is growing fast enough for nearly everyone to feel that their real incomes are increasing. The problem in the UK at present is that the first of these conditions is arguably no longer being fulfilled while the second is demonstrably not being achieved.

Table 7

### Gini Coefficient 1961–2015/16



Source: Office for National Statistics

The most commonly used measure of the overall degree in inequality is the Gini coefficient. This would be 0 if everyone had the same income and 1 if one person had everything and everyone else nothing. By this measure, as Table 7 shows, the UK became much more unequal during the Thatcher era and since then, except for a peak running up to the 2008 crash, has stayed roughly stable. Table 8 then shows what has happened to nominal and real wages over the period since just before the 2008 crash. Inequality in the UK has a multiplicity of different dimensions, especially between different regions of the country, between varying generations and between different socio-economic groups. Until the 1920s, average living standards were higher in the North of England than they were in the South.<sup>30</sup> Now this position has been comprehensively reversed. After the impact of taxation and expenditure has been taken into account, actual disparities in living standards within the regions – although still very considerable – are not so marked, but only because of huge net transfers from the South East to the rest of the country.

**Table 8**

**Average weekly earnings total pay: real and nominal, whole economy, seasonally adjusted, 2015=100**

**January 2005 to June 2018, Great Britain**



Source: Monthly Wages and Salaries Survey, Office for National Statistics

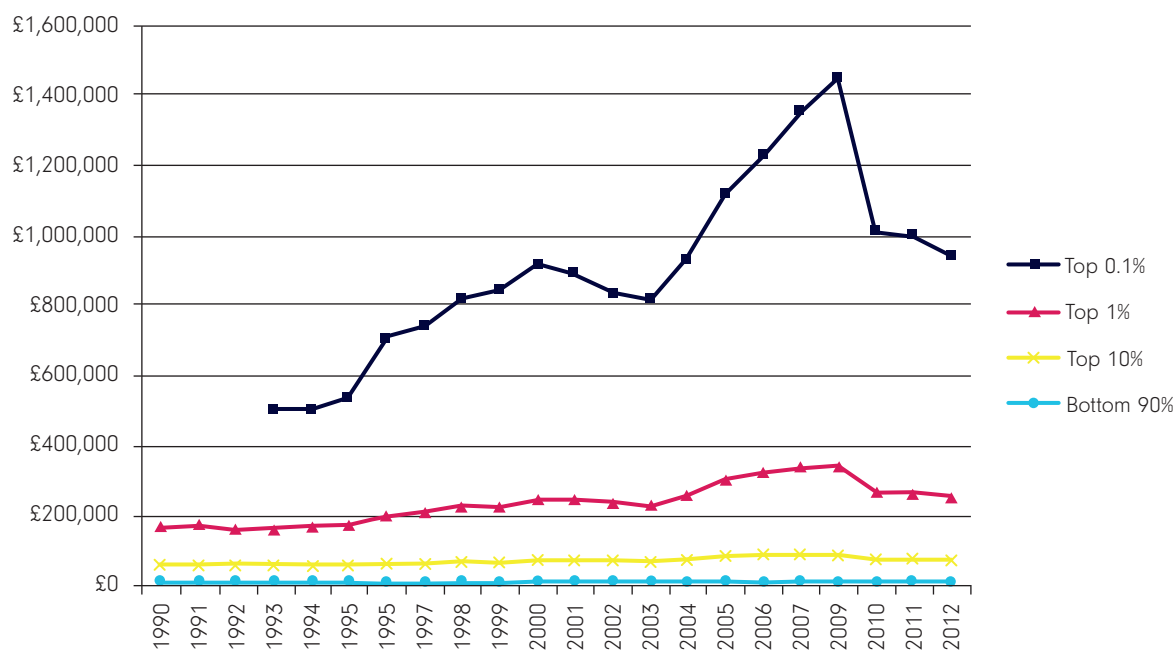
Between the generations born during the first 25 years after World War II and those whose life started since 1990, again there are huge contrasts between the opportunities which they have encountered in education, housing, incomes and job opportunities. Whereas the 1945-1970 cohort had free tertiary education, the 1990 onwards one has had to borrow £9,000 a year to help to pay for this privilege. Those who bought houses and flats before around 1980 have been the beneficiaries of very large real increases in the value of their properties, making it at the same time more and more difficult for

younger people to get started on the housing ladder. The UK has a flexible labour force, which is one of the main reasons why unemployment is so low, but these favourable figures belie the fact that over a quarter of jobs in the UK are not full time and often not sufficiently secure to be properly protected by employment legislation.<sup>31</sup>

As regards to income, wealth and all the life chances which are associated with it, Table 9 shows what has happened over the last few years. The top 0.1% saw their incomes far more than doubling up to the time of the 2008 crash, but still settling down to about twice what they were in the early 1990s. At the other end of the scale, the whole of the bottom 90% of income earners have experienced no real increases at all for nearly two decades. At a time when FTSE 100 CEOs have been receiving on average annual incomes of £5.3mn a year - 386 times the income of someone earning the national minimum wage, 165 times more than the average nurse, 140 times more than teachers and 132 times more than police officers<sup>32</sup> - a higher and higher proportion of the population depends on food banks.

The issue here is not how can we achieve equality of incomes for everyone. It is how can we avoid the disparities becoming so wide that the country's social fabric starts to break down. Everyone has an interest in making sure that this does not happen, and it is our sluggish growth rate and our lopsided and unbalanced economy which is largely responsible for these excessive and unsustainable inequality trends which we urgently need to constrain and hopefully redress.

**Table 9**  
**Income growth at the top**



Notes: Income is gross income and measured at the individual level.

Source: Office for National Statistics

## NEWER CHALLENGES

Most people in the UK may not have had much, if any, income increases during the past ten years, net of inflation, but only a relatively small – although important – minority have suffered from significant falls in their living standards.

This may be about to change not only because of coronavirus but also because we may now be moving into a period when almost everyone in the UK is going to suffer from falling living standards for other reasons. This is because a number of very expensive problems are going to hit us over the coming years. With estimates as to what they might reasonably be expected to cost every year, in each case as percentage of GDP, these can be summarised as follows:

**Climate Change – 3% of GDP.** There are no very reliable estimates as to how expensive it is going to be both to combat and to mitigate the costs of climate change, but some suggestions have been made. In 2019, the Treasury produced a preliminary ball-park figure for the UK of £1trn spread over the period between now and 2050.<sup>33</sup>

The Committee on Climate Change, which advises the government, recently put the cost at £50bn a year while the Department for Business, Energy and Industrial Strategy believes it will cost more, with an estimate of £70bn a year. These costs include those which will be incurred directly by the public sector and those impacting businesses and private individuals.<sup>34</sup>

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

**Healthcare – 2% of GDP.** Public spending on healthcare in the UK was 2% of GDP in 1947 and no more than 4% by 1970. It fluctuated round 5% in the 1980s and 1990s, and then rose to a peak of 7.65% in 2010, before falling back to 7.1% in 2020. Between 1997 and 2010, spending in real terms doubled, since when it has risen much more slowly.<sup>35</sup>

The strain on the NHS from the resulting tight budget constraints at a time when the population is growing, aging, and suffering from new threats such as the current pandemic, while the costs of many treatments are rapidly rising, is all too apparent from media reports.

Total healthcare costs, including those in the private sector, were running in 2019 in the UK at 9.8% of GDP which is close to but slightly below the 10.1% average for comparable countries elsewhere.<sup>36</sup> It is notoriously difficult to increase overall productivity significantly in very heavily service sector organisations like the health service where about 45% of total costs are on wages and salaries<sup>37</sup> and where there is little scope for employing investment with high rates of return to increase output per hour. As a result of all these factors, it is difficult to see how total healthcare costs in the UK are going to avoid rising as a percentage of GDP over the next decade by perhaps 2% – from 10% to 12%.

**Education and Training – 1% of GDP.** Expenditure on education and training fell from 4.9% of GDP in 2012/13 to 4.1% by 2017/18<sup>38</sup>, a trend that very clearly needs to be reversed if we are going to be able to compete in the world. Despite these cuts, the UK still spends about the international average percentage of GDP on primary and secondary education and UK. PISA test results have recently improved as we moved up in 2018 compared to 2015 from 22nd to 14th on reading, from 15th to 14th on science, and to 18th from 27th on maths.<sup>39</sup>

Our really big failing is on tertiary education and training on which we spend no more than 0.5% of our GDP<sup>40</sup>, which is much less than most other developed countries and well below the OECD average.<sup>41</sup> We, therefore, badly need to spend at least another 1% of GDP over and above where we are now, on education generally but particularly on training.

**Social Care and our Ageing Population – up to 2% of GDP.** Despite our rising population, the total amount spent in the UK by local authorities on social care peaked at just under £20bn in 2009 and by 2017 it had fallen to £17.5bn, a fall of more than 10%.<sup>42</sup> Over the same period, the number of people receiving domiciliary care funded by local authorities fell by 20%.<sup>43</sup> Just to get back to the level per head achieved in 2009, we need to spend at least an additional £5bn on social care – but probably twice this amount just to satisfy even the most pressing demand.

But over the next decade these requirements are going to increase as our older population continues to rise, and the number of people entitled to pensions goes up in relation to the working population from 280 per 1,000 in 2016 to an estimated 375 by 2040, a ratio increase of just under 35%.<sup>44</sup>

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

## Implications

If these figures are correct, they imply that anything up to about 8% of UK GDP is going to be absorbed over the coming years by increased costs which will have to come out of the population's otherwise disposable income. As about 80% of UK GDP is accounted for by consumption,<sup>45</sup> there is a threat of a 10% reduction in living standards unless the growth rate in the economy can be increased to offset the additional costs which will have to be borne.

It has been argued by some people<sup>46</sup> that this paints too gloomy a picture and that increased expenditure on climate change, health care, education, training, social care and pensions will add to GDP rather than reduce it. This may be much too optimistic. More probably, any additional expenditure on these headings will have to be offset by exactly corresponding increases in taxes or prices to pay for them. Total GDP will therefore not increase but stay the same while within the total resources are shifted out of consumption and into meeting the new cost pressures.

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



## LEGACIES FROM THE VIRUS CRISIS

Sooner or later coronavirus will abate, and the current crisis will be over. What will the world look like then? Predicting the future is notoriously tricky and prone to error, but it is impossible to avoid the need to make some informed guesses, which may in turn impact on the way we tackle the present, thus providing some guidance to current policy.

Although there will be a recovery, some parts of the economy will have been much harder hit during the pandemic than others. In the public sector, central and local government, the police, the armed forces, and of course the NHS will all have been under great strain but with ample demand to stop them contracting. The same will be the case for large sections of the private sector, such as food, energy and pharmaceutical production and distribution, let alone distance shopping with all their deliveries. They will therefore have grown relatively to hospitality, much bricks-and-mortar retailing, air, sea and land transport, entertainment and all the other areas of the economy, that have for the time being lost nearly all their customers. Once something like normality returns the hardest-hit sectors will bounce back, but probably not very quickly to anything close to 100% of where they were before. People will have got used to new lifestyles such as more cooking for themselves and wider use of home entertainment, all of which will be hard and slow to fully reverse. The economy will therefore emerge with a very different shape compared to where it was before the coronavirus crisis started.

The commercial landscape will inevitably alter massively as a result. The government rescue schemes may have staved off bankruptcy for many companies which might otherwise have gone under but very probably at the price of substantial liabilities being accumulated by businesses in the sectors needing government support. This will take the form of either loans which will eventually have to be repaid or – perhaps – by the state acquiring equity stakes in some businesses once their credit worthiness for loans has been exhausted. After years of effort by successive governments to reduce the size of the public sector, to privatise and deregulate, the impact of coronavirus will substantially increase the proportion of economic activity owned or obligated to the state and thus at least to some extent controlled and run by it. Corporate solvency will take years to recover fully as repaying debt and regaining control over equity is bound to have priority. It is likely to be many years before the stock exchange recovers the ground it lost from its peak in January 2020.<sup>47</sup> The consequence will be potentially quite a significant reverse of the increase in wealth inequality which has marked the last decade.

Some reduction in wealth inequality may well also be accompanied by a widespread reassessment of the value and thus the remuneration and respect attached to different jobs compared to those awarded to them in the past. In the middle of the current crisis, who thinks that bankers and City solicitors deserve to be paid huge multiples of those keeping food on the shelves in supermarkets or keeping our streets clean or delivering our post, let alone those working on the frontline in the NHS? The varying amount of pay received by people with differing occupations is partly driven by economic factors but a lot of it is the product of convention, history and the leveraging of connections.

This may be fertile grounds for a move back to something much closer to the top rates of income tax which prevailed during the first few decades after World War II when not only was there much less income inequality than there is now, especially post-tax, but our economy was growing faster than it has done recently.

Our current prospects are not, however, for a larger economy once coronavirus recedes but for a considerably smaller one. How much smaller? It is very hard to tell, but history within living memory tells us just how large reductions have been in the past. GDP fell in real terms by 30% in the USA between 1929 and 1993, and the fall in Germany over roughly the same period was 24%. We probably won't do as badly as this, but a reduction of, say, 15%, would mean that living standards would on average have to fall – other things being equal – by this amount across the board. We can't, certainly beyond a certain point, pay ourselves more than we are producing. This may cause very substantial problems over differentials. Is it fair that those on employment contracts in the less adversely affected parts of the economy should go on being paid the same amount as they were before while other people, through no fault of their own, see their incomes decimated? Because wages and salaries are very "sticky" and thus difficult to reduce, this may add to the pressure for higher levels of income tax, especially on high earners but also on everyone else, to level up the playing field and to stop the economy becoming overheated and inflation taking off again.

And where will this leave us with globalisation? Would the impact of coronavirus have been as bad as it is if here had been less foreign travel? Is it really the growth of international trade which has made the world so much richer than it was 50 years ago? Or is it investment in the most productive ways of building future increases in output – particularly those mentioned earlier – mechanisation, technology and power – which could have taken place much more evenly over the world, with a lot less depending on international trade? Is it sensible for the UK to have deindustrialised to a point where we are struggling domestically to produce anything like all the gowns and ventilators the NHS needs while China can produce them in vast quantities? Globalisation has undoubtedly had benefits in fostering the distribution of efficiency and best practice, spurring competition and taking advantage of specialisation, but it has also led to huge trade imbalances, the hollowing out of labour forces in the West and vulnerability as complex international supply chains get disrupted.

The result of pressure to reshape the way world commerce and industry is organised may be an important ideological battle between the East, led by China, with a potentially still isolationist USA providing a faltering lead in the West. China appears to be recovering from coronavirus with less damage done to it than seems to be likely to the case in Europe. The Chinese economy may therefore go on growing, as the government switches demand towards its huge population and away from depending nearly as much as it has done in the past on export markets. Meanwhile the West may struggle to get back on its feet with anything like comparable speed. If this happens, as seems likely, hard and soft power as well as economic muscle will continue to migrate eastwards, leaving the West and its liberal democratic way of life increasingly under threat of competition from a much more authoritarian East.

Where would all these changes leave our politics? Impossible to say. The initial impact of coronavirus everywhere seems to have been to restore a measure of faith in experts and to put a good deal of trust into our existing leaders. Will this last? It may do if their leadership and judgement justifies trust in them being maintained, but otherwise not. Which of these outcomes will materialise? Only time will tell.

What is clearly the case, however, is that all these potential changes to our economic, social and political circumstances are going to leave us with an economy which is very badly going to need to recover so that in terms of both publicly provided services and private living standards, it is capable of taking us ahead on a reasonably secure and prosperous basis.

## THE WAY AHEAD

Looking ahead, although exact projections are worthless, the general shape of recovery from coronavirus and the orders of magnitude involved seem likely to be along broadly predictable lines. The ultimate aim has to be the development of a vaccine which will provide immunity, but this seems unlikely to materialise in mass quantities before late 2020 at the earliest and quite possibly not until 2021.<sup>48</sup> In the meantime there will be overwhelming pressure to keep the death toll down to as low a level as is possible consistent with trying to control the damage to the economy, which has both material and health implications of its own.

If, as seems to be the case, it is correct that only a single figure percentage of the population in the UK – and in most other countries – have caught the virus, without a vaccine we will be a long way from having naturally achieved herd immunity. This requires some 60% of the population to be immune either naturally or because they have had the disease – provided that this does give immunity which appears not to be certain. The risk of too many deaths is generally perceived to be too high to allow herd immunity to be developed by allowing the disease to spread unchecked. The only realistic alternative then to keeping lock-downs in place until a vaccine is widely available is to increase the amount of testing sufficiently for carriers to be identified and quarantined quickly and accurately enough for the risks of raising lock-downs to be worth taking.

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

The key immediate problem, especially if the economy is slow to respond, may be the diminished capacity of the economy to meet the pent-up demand which is likely to be placed upon it as current restrictions which make spending difficult are lifted. Some projections have suggested a 'V-shaped' depression with a rapid recovery, while others have been much more cautious.<sup>49</sup> To provide some idea of possible orders of magnitude, taking an optimistic view, if GDP in 2020 Q2 is the same as in 2019 Q4 for the public sector and half of the private sector, but down by something close to 60% in the remaining half of the private sector, overall GDP will have fallen between 2019 Q4 and 2020 Q2 by about 20%. If it recovers to minus 10% in 2020 Q3 and to minus 5% in 2020 Q4, this would give us a year-on-year reduction between 2019 and 2020 of around 10%. In the absence of any further radical changes in economic policy to accelerate the

process of restoring lost economic growth, it may then take another two or three years for GDP to get back to the level seen in 2019. This, however, looks like being a “best case” scenario. There have been estimates that the 2020 Q2 drop in GDP may be as high as 35%.<sup>50</sup> If these pessimistic projections turn out to be right, it will inevitably take much longer for UK GDP to get back to its 2019 level.

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

## AN ALTERNATIVE STRATEGY

The key to an alternative policy aimed at getting the economy to perform much better is to get the sustainable underlying growth rate of the economy up by a significant amount. The target proposed is an increase of about 2% per annum above current expectations once the main recovery from Covid-19 has taken place. This would bring our growth rate up to an average of around 3.5% per annum instead of the 1.4% average we have seen recently.<sup>51</sup> This would then enable us to pay for the impact of Covid-19 and the other cost pressures which we know are going to hit us over the next few years by creating new wealth rather than by squeezing down incomes. We need to do this by a combination of rebalancing the economy and increasing its productive capacity.

How would this be done? The key to grasping the potential way of achieving this objective is to appreciate the crucial role of investment and, in particular, its most productive categories, in generating economic growth. As we have seen, the proportion of our GDP which the UK invests in its future is far lower than the world average. Even more important, however, is the fact that investment in mechanisation, technology and power – the key drivers which have made possible the vast majority of the increase in living standards which the Industrial Revolution unleashed – now appears to be no greater in the UK than the depreciation charged on existing assets.<sup>52</sup> It is because the UK has such low net expenditure on these crucial categories of investment that we have such a poor record on productivity, while we tolerate stagnant real wages and low economic growth.

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

Evidence that this is the case is all too clear from the statistics. In 1950, 25% of all manufactured goods exported to world markets came from the UK. Now the figure is less than 2% - a more than 90% ratio drop.<sup>53</sup> Over the same period, the UK share of total trade fell from 10.7% to 2.5%.<sup>54</sup> As late as 1970, almost a third of UK GDP came from manufacturing. Now it is less than 10%, compared with about 20% in Germany, Switzerland and Singapore, and an even higher ratio – almost 30% – in China.<sup>55</sup> It is in medium- and low-tech manufacturing, where the scope for productivity increases is as high as it is anywhere else, that the UK has seen the largest reductions. What UK export success stories there are have been achieved by companies such as Rolls Royce and BAE, where price competition is limited in a way which seldom applies to medium and low-tech exports. Tellingly, a study in 2011 showed that 27% of UK manufactured exports were high-tech, whereas in Germany only 17% of a much higher total were in this category. 38% of UK manufactured exports were medium-tech compared to 51% in Germany.<sup>56</sup>

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

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

Readily available statistics quantify the problem. The UK as a whole has a balance of payments deficit which averages approximately £100bn per year. A report produced by the Greater London Authority (GLA) shows that London on its own has a surplus of at least £50bn.<sup>57</sup> This means that everywhere in the UK outside London is running at a deficit of about £150bn a year – around 10% of its total GDP of approximately £1.5trn.

We know that some cities outside London, such as Oxford, Cambridge, Manchester and Bristol, are doing reasonably well and therefore holding their own, but this must mean that other towns and cities outside London are running at even greater deficits than 10%. These deficits are the mirror image of the support they get in the form of grants and transfers they receive from central government to stop the disparities in living standards between London and the regions becoming unbearably large. The solution to the problem is not trying to reverse austerity with larger and larger transfers to the poorest regions of our economy, which central government is bound to have problems affording. It is to provide the regions with an environment in which they can generate enough income for themselves to pay their way in the world. Services will never fill this gap. Reindustrialisation, with all the prospect it brings with it of stable high productivity jobs, is a much better solution.

A much lower exchange rate and a larger manufacturing sector is also the solution to our balance of payments problem. The UK has recently exported an average of about £270bn<sup>58</sup> worth of manufactured goods a year – around 45% of our total exports – even though manufacturing accounts for only 10% of GDP. If raising the proportion of GDP coming from manufacturing by 50% to 15% generated a corresponding increase in exports, allowing for an import content of, say, 30%, the annual first order improvement to the UK's balance of payments position would be about £270bn times a 50% increase in exports times 70% to allow for import content, which comes to just under £100bn. We

would then no longer need to sell assets or to borrow from abroad year after year to sustain a standard of living which we were not earning. Furthermore, if we largely or completely got rid of our balance of payments deficit, for the reasons set out on pages 16 and 17, we would no longer have to fight a constant battle to get government borrowing down.

Would a strategy along these lines help to mitigate inequality? Perhaps, although whether it would actually do so depends largely on political rather than economic choices. Reindustrialisation would certainly help reduce regional inequalities below what they would otherwise be. The recovery from Covid-19 may well generate tax and asset valuation changes which will do something to reduce income and wealth inequalities. Millennials may get a better deal if the economy grows faster and investment, particularly in housing, goes up on the back of improved overall performance by the economy. Faster economic growth would certainly provide opportunities for generating greater equality whether or not they are taken.



## HOW TO DO IT

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

It is relatively easy to calculate from what we know of the price sensitivity – or more precisely the price elasticities of demand for imports and exports – the parity for sterling which would be needed to make a wide spread of medium- and low-tech manufacturing viable again in the UK. With an elasticity of 0.8 for exports and 1.0 for imports, it is about  $\text{£}1.00 = \$1.00$  or  $\text{€}0.85$ , or about 20% lower than the roughly  $\$1.25$  and  $\text{€}1.10$  prevailing in the middle of April 2020.<sup>59</sup>

What would need to be done to get the exchange rate down to this level? The most important requirement would be for the government to announce that this was its objective and that, once achieved it would be its settled intention to keep the parity at its new competitive level. The Bank of England would need to be marshalled to supporting this policy by selling sterling, if necessary, to keep the rate where it needed to be. Since all current account deficits have to be exactly matched by capital imports, downward pressure on sterling could be achieved by using public interest tests on takeovers of UK companies from abroad and tax penalties on the acquisition of property assets by foreign interests. Bearing in mind the scale of the UK's current account deficit, getting the UK economy into a more competitive condition is hardly likely to be perceived by the markets as pushing the economy in fundamentally the wrong direction.

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

is subsequent meteoric rise, when exactly this sort of targeted lending was a major component of the policies then pursued, shows what can be done.

These policies are not new ones in world terms. They are very much those employed by successful economies everywhere to sustain their manufacturing sectors and their export performances. A recent example, showing that they are achievable, was provided – again by Japan – whose authorities deliberately brought down the value of the yen by about a third between June 2015 and August 2016<sup>60</sup> by employing almost exactly the suite of policies recommended here for the UK – and for the same reasons. The problem entailed in getting sterling down to a competitive level is not technical. It is the very widespread and almost unthinking view in the UK among politicians, the civil service, the commentariat, the academic world, think tanks and public opinion, that a strong currency is an advantage. So, it may be in the short term for the City, for importers, for those who enjoy cheap holidays abroad and low prices for imported goods in our stores. Unfortunately, however, too strong a currency and restricted lending to industry have also entailed the UK having much too weak a manufacturing sector, unable to pay its way in the world, with low productivity increases, stagnant or falling real incomes, little or no growth, relative international decline and a deeply unsettled social and political future. And this is before we start dealing with the impact of Covid-19 on the economy and how to get it to recover from it.

## OBJECTIONS

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

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

**Devaluation and Inflation.** The contention that devaluation always produces a rise in inflation is true in so far as it applies to goods and services which are imported. Price rises here are inevitable and a necessary part of switching demand from foreign to domestic suppliers. It does not, however, follow that the price level generally will rise more quickly than it would have done without a devaluation, and a wealth of evidence from the dozens of devaluations which have occurred among relatively rich and diversified economies such as ours in recent decades shows that in fact lower parities sometimes produce a little more inflation, sometimes a bit less, but most of the time little if any change. This may seem a very surprising result to many people, but this is unequivocally what the statistics show. Looking at recent examples, when the UK left the Exchange Rate Mechanism in 1992, sterling fell by trade-weighted 12%<sup>61</sup>, but inflation fell from 5.9% in 1991 to 1.6% in 1993.<sup>62</sup> When sterling dropped from about \$2.00 to the pound in 2007 to \$1.50 in 2009, a drop of 25%, the rate of inflation barely flickered<sup>63</sup>, and what increase there was in 2011 was very largely driven by an increase in commodity prices, which fell away as soon as supply caught up with demand again.<sup>64</sup>

The reason why these are common outcomes is that, while higher import prices push up the price level, many factors to do with a lower parity tend to bring it down. Market interest rates tend to be lower after a devaluation, and so do tax rates. Production runs become longer, bringing down average costs. Investment, especially in the most productive parts of the economy, tends to rise significantly, increasing output per head, reducing costs and producing a wage climate more conducive to keeping income increases in line with productivity growth. Furthermore, as domestic supplies of goods and services become more competitive with those from abroad, demand switches to local sources, negating the need to pay higher import prices even if foreign suppliers reduce their prices to try to retain market share.

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

**Changing the Exchange Rate in an Open Economy.** Next, it is frequently contended that the parity of sterling is determined by market forces over which the authorities have little control, so that any policy to change the exchange rate in any direction is bound to fail. Again, historical experience indicates that this proposition cannot be correct, as Japan has recently shown. Further back, the Plaza Accord, negotiated in 1985, produced a massive change in parities among the major trading nations of the world at the time, causing the dollar, for example, to fall against the yen by just over 50% between 1985 and 1987.<sup>65</sup>

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

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

The second is that every £100bn annual deficit, financed by selling assets with an average gross return of the order of 3%<sup>66</sup>, adds another £3bn to the underlying deficit every year, as we forfeit the returns we would have had from the assets had we not sold them. The laws of economic gravity can be ignored for a long time but as Herbert Stein had it – incidentally with balance of payments deficits as a prime example – “Trends that can't continue, won't.”<sup>67</sup> It may, therefore, very well be the case that in

the foreseeable future there will be a change in market sentiment which will bring sterling down to a lower parity with or without the assistance of the authorities. The fall in the value of sterling following the EU referendum in June 2016 and its further fall during the coronavirus crisis has already shown this happening, although the fall from \$1.45 to \$1.20 or \$1.25 is unfortunately still not enough to precipitate a large-scale industrial revival.

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

In the first place, it depends on the position from which the devaluing country starts. The curse of foreign payment imbalances begins not with countries like the UK, with massive deficits, but with countries such as Germany, Switzerland and the Netherlands with huge surpluses – in the mid-2010s almost 8% of GDP in Germany and the Netherlands and 15% for Switzerland.<sup>68</sup> These surpluses have to be matched by deficits somewhere else in the world economy. Unfortunately, surplus countries are never under any immediate pressure to reduce the beggar-thy-neighbour impact of their surpluses by revaluing their currencies and this leaves economies such as ours, carrying big deficits, with no alternative but devaluation to get the situation under control. There is thus a very strong principled case for countries such as the UK to make for getting sterling to a more competitive level.

In terms of practicalities, the UK has a number of advantages which other countries do not share. We are not in the EU's Single Currency, membership of which would clearly preclude the UK from doing anything about our exchange rate. We still have our own central bank and control over our own interest rate and monetary policy. Sterling is not a major world reserve currency like the dollar, making it much easier for us to alter our exchange rate without there being very significant international consequences. The fact that our share of world trade is now so low – at 2.5% in 2017<sup>69</sup> – means that what happens to sterling has relatively little impact on the rest of the world.

As to recent evidence, the quite major changes in the parity of sterling when the UK left the ERM in 1992 – a trade weighted drop of 12%<sup>70</sup> – and the fall in the rate for sterling against the dollar between 2007 and 2009 – about 25%<sup>71</sup> – as well as the post-EU referendum drop in sterling's parity and the most recent one triggered by the coronavirus crisis, all engendered no retaliation. All were evidently seen by other countries – the markets and the authorities – as being exchange rate adjustments which were clearly warranted by the state of the UK economy. Against the background of our currently ballooning foreign exchange deficit, there is no reason why the same could not be made to happen again. If the manifest imbalances in the UK economy are clearly associated with an unsustainably high exchange rate this should also enable us to overcome any objections from our G7 partners, with whom we have jointly agreed not to indulge in unwarranted competitive devaluations.

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

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

The second potentially more substantial argument is that, if we are going to increase our net trade balance to a point where we are not enjoying a standard of living far beyond what we are earning – as we are at the moment – living standards will have to suffer. Relatively speaking, this has to be correct. If we produce more for export, too, there will be less for the home market. Furthermore, if, to get the economy to grow faster, we have to spend a considerably higher proportion of our GDP than we do at the moment on investment, there will again have to be a corresponding reduction in consumption as a percentage of GDP. The crucial question then is whether the economy can be made to grow fast enough to enable both the shift towards exports and investment to be accommodated without living standards falling – and indeed preferably rising. Careful calculations show that this would be possible – provided that a high enough proportion of increased investment goes to the most productive parts of the economy, mostly manufacturing. It can be done.<sup>72</sup>

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

As these other countries, by looking after their manufacturing industries, have invested more heavily in the future than we have, their output per head has grown more rapidly than ours, their wage climates have been better, and their inflation rates have been

lower. As an extreme example, in Switzerland, between 1970 and 2010, the price level rose by 88%. In the UK it increased by 780%. The average annual Swiss inflation rate over these 40 years was 1.6% while in the UK it was 5.6%.<sup>73</sup> It was against this kind of background that from time to time the over-valuation of sterling became so obvious that either the markets or the authorities or both tolerated, engineered or encouraged the parity for sterling to fall. Perhaps it is worth reiterating the often forgotten fact that sterling's fall by about 25% in 1931 – after near stagnation during the 1920s – enabled the UK economy to have its fastest peacetime spurt of growth ever during the middle of the 1930s – over 4% per annum cumulatively for the four years between 1933 and 1937, and faster still as we moved into full-scale war mobilisation.<sup>74</sup>

When World War II ended and the continent began to recover from wartime devastation, it soon became apparent that the UK had no chance of maintaining the pre-war dollar parity of \$4.03 to the pound, and sterling was devalued in 1949 to \$2.80.<sup>75</sup> Higher than average inflation in the UK than elsewhere and underinvestment in export industries resulted in a steady trade deterioration in the 1950s and 1960s, culminating in the pound being devalued in 1967 from \$2.80 to \$2.40.<sup>76</sup> Once currencies started to fluctuate against each other in the 1970s, following the break-up of the Bretton Woods fixed parity system in 1971<sup>77</sup>, rapidly rising prices combined with high interest rates kept sterling much too strong. This was especially so early in the 1980s and later in that decade as the UK entered the Exchange Rate Mechanism, which we left in 1992 with a devaluation of about 15% against all currencies<sup>78</sup>, to escape from a sharp economic downturn. After showing some signs of recovery, the UK economy then became more and more unbalanced as assets sales, starting in the late 1990s on a scale unparalleled anywhere else, pushed sterling up to completely unsustainably high levels in the 2000s, reaching a fraction under \$2.11 at its peak in November 2007.<sup>79</sup> Its value fell between 2007 and 2009 – still by not nearly enough – since when it has climbed back a bit and then fallen to roughly where we were in 2009 post the EU referendum and the start of the coronavirus crisis. Meanwhile, in the East, over past decades, exactly the opposite policies were followed as they massively devalued.

The reality is that the UK's exchange rate has been much too strong to allow our industrial base to flourish as it could have done for almost all of the last two centuries. The devaluations that have taken place have made the situation rather better than it otherwise would have been, but, except very telling in the 1930s, they have invariably been too little and too late.

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



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



## CONCLUSION – A RISK WORTH TAKING

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

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

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

**Table 10**

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

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

The first concerns whether there is any unusual risk to be expected from inflation if the cost pressures from recovery from Covid-19 are combined with the inflationary impact on import prices from a lower pound. The answer is that the risk of significant price rises as a result of a depreciated pound on its own are limited, as Table 10 shows. There certainly is a risk of inflation going up if demand exceeds the capacity of the economy to supply as a result of the damage done to it by the lock-down period, but this threat will be there whether or not there is a lower pound. Is there a risk that a combination of both a lower pound and recovery from the coronavirus together would be cumulatively greater? Realistically, there has to be some risk here, but it does not look very great in relation to the benefits which ought to be secured. If – probably at worst – there is an increase in inflation of 1% or 2% as a price for increasing the growth rate by around 2%, it seems likely that most people would certainly a price worth paying.

The second issue is whether we can rely on the sensitivity of exports and imports to a much lower exchange rate being sufficiently large to generate enough new demand for exports, constraints on import volumes, and sufficient incentive to increase investment to make the policy work. This is potentially a matter of legitimate concern because some recent evidence suggests that the UK economy is a good deal less responsive to increased price competitiveness than it may have been in the past.<sup>80</sup>

Certainly, figures from the past indicate that the UK economy's elasticities of demand for imports and exports were easily high enough to make the policy work. Table 11 shows the result of major study carried out by the IMF covering the early 2000s and there is a ready explanation for why the elasticities may now be lower. This is that the high value for the pound especially over recent decades has run all the most price sensitive parts of our economy – medium- and low-tech manufacturing – out of business, leaving high-tech and services which are well known to be much less price sensitive as an ever increasing proportion of our foreign trade.

If the export and import elasticities are measuring the responsiveness of the UK economy to more competitive price only in terms of how much additional output can be squeezed out of existing production capacity, it is not surprising that they should be fairly low. The objective of the competitive exchange rate policy set out in this pamphlet, however, is much broader and less short-term than this. It is to make it worthwhile siting new manufacturing capacity in the UK rather than elsewhere, thus producing a quantum leap in the UK's exporting potential and its import saving capability. This is what is needed to bring the elasticities back to where they ought to be.

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

Table 11

**Elasticity of Demand for Exports and Imports and Imports 2001-2004  
Estimates produced by the IMF and published in 2010**

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

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

competitive exchange rate to make a substantial measure of reindustrialisation profitable in the UK, the risk of an inadequate elasticity response therefore looks low.

The third issue is whether it is realistic to assume that the overall or social rate of return on a substantial proportion of the new investment in mechanisation, technology and power, with most of it going into manufacturing industry, would be high enough. Would it be sufficient to make a shift towards both more investment and a better trade balance possible at the same time as paying for rising social and environmental costs, avoiding

a severe squeeze on disposable incomes and finding the resource for increased investment? The evidence from the table on page 11 indicates that this condition is also one which could be met. Both Japan and China have had long periods in their histories – matched by the USA and even to some extent the UK for shorter periods during the build-up to World War II – when returns on the required scale were achieved. We need to replicate them again – using the same determination and foresight to break ranks with the past as the government did in the UK when coronavirus struck – only this time to build the economy up rather than drastically to reduce its output.

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

## References

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- <sup>4</sup> *Times* Coronavirus Update 15th April 2020
- <sup>5</sup> Office for National Statistics mortality reports
- <sup>6</sup> Estimates by Imperial College, London, and others
- <sup>7</sup> There are persistent reports that the Wuhan Institute of Virology might have been involved
- <sup>8</sup> Newspaper reports on 20th February 2020
- <sup>9</sup> Google report on FTSE 100
- <sup>10</sup> UK government advice
- <sup>11</sup> Media reports at the time.
- <sup>12</sup> Announcements made by The Office for Budget Responsibility and the Chancellor of the Exchequer during week commencing 13th April 2020
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- <sup>14</sup> ONS code NPQT minus EQDO divided by YBHA. London: ONS 2018
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- <sup>19</sup> [www.economicshelp.org/blog/7617/economics](http://www.economicshelp.org/blog/7617/economics)
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- <sup>23</sup> ONS codes BOKI, IKBB, BOPO and BOPP
- <sup>24</sup> PE 1057 IN *International Financial Statistics Yearbook*. Washington DC: IMF 2018
- <sup>25</sup> Times Series Data Set for ONS code HBOP
- <sup>26</sup> Report in *The Guardian* 11th September 2014
- <sup>27</sup> Wikipedia entry on the 2002 Enterprise Act
- <sup>28</sup> Calculate s 3% of the gross value of the transactions involved.
- <sup>29</sup> Page 88 in *International Statistics Yearbook 2017*. Washington DC: IMF 2017
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- <sup>32</sup> Data from The Equality, Trust website
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- <sup>35</sup> [www.kingsfund.org.uk](http://www.kingsfund.org.uk) website
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- <sup>46</sup> This was an argument especially advanced by Rebecca Long-Bailey
- <sup>47</sup> 7,674 on 17th January 2020
- <sup>48</sup> Media reports in early April 2020
- <sup>49</sup> Office for Budget Responsibility report early April 2020
- <sup>50</sup> Statement by the Chancellor of the Exchequer in early April 2020
- <sup>51</sup> ABMI Time Series data. London: ONS
- <sup>52</sup> While ONS code DLWO, covering investment in Other Machinery and Equipment has fallen from 4% of GDP in 2008 to 2.9% in 2018, overall depreciation as a percentage of GDP has risen over the same period from 11.8% to 12.7%
- <sup>53</sup> OECD National Accounts Statistics
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- <sup>55</sup> World Bank Statistics
- <sup>56</sup> Data provided by the Centre for Progressive Capitalism

- <sup>57</sup> Table 4.1 in GLA London Input-Output tables, Working Paper 97
- <sup>58</sup> ONS codes BOPO and BOPP
- <sup>59</sup> Detailed calculations showing how these figures are reached can be found in *Call To Action* by John Mills and Bryan Gould. London: Penguin Random House, 2015
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- <sup>72</sup> *CALL TO ACTION: Britain's economic problems and how they can be solved* by John Mills and Bryan Gould: London: Ebury Publishing, 2015 contains the necessary calculations
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- <sup>74</sup> Table UK1 in *Economic Statistics 1900-1983* by Thelma Liesner. London: The Economist, 1985
- <sup>75</sup> Ibid, Table UK.15
- <sup>76</sup> Ibid
- <sup>77</sup> Wikipedia entry on Bretton Woods
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- <sup>79</sup> www.poundssterling.com
- <sup>80</sup> For example, a recent paper by Francesco Aiello, Graziella Bonanno and Alessia Via of the European Trade Study Group finds that "the long run level of exports appears to be unrelated to the real exchange rate for the UK". Quoted in an article by Lord Skidelsky in *The Guardian* on 21st October 2016



## **Recovery from the coronavirus crisis won't be easy anywhere in the world.**

It may, however, be considerably more difficult in the UK than elsewhere.

**This is because the UK's underlying economy was in much worse shape before the current crisis hit us than is generally realised.**

Inflation and unemployment have recently been low and government borrowing much reduced, but our rate of investment has not been nearly high enough and our economic growth rate has been way below the world average. Productivity and real wages have been stagnant. To finance huge balance of payments deficits every year, we have sold far too many assets and borrowed much too much. We have massive disparities between London and the regions and much too much inequality between the generations and between the rich and the poor.

**This pamphlet has a simple message.**

The main reason why our economy is so unbalanced and fragile is that we have allowed our country to become hopelessly uncompetitive as a location for manufacturing.

This is why we have deindustrialised to a greater extent than any other comparable country. As a result, we have lost the productivity gains and good, steady jobs that are so much easier to secure in manufacturing than in services.

Almost every town and city outside London has too little to sell to the rest of the world to pay its way which is why, as a nation, we are falling deeper and deeper in debt. With both the damage from coronavirus and other very expensive problems coming down the track, unless we get our economy to perform much better, living standards in the UK may well be significantly lower in 2030 than in either 2007 or 2019.