RAISING PRODUCTIVITY

How to get the UK economy to grow sustainably at 3% to 4% a year, and why it is so important to get this done not just for economic but also for social and political reasons.

John Mills

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

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Author

John Mills is an entrepreneur and economist with a life-long political background in the Labour Party, leading him to being one of the largest individual donors. He graduated in Philosophy, Politics and Economics from Merton College, Oxford, in 1961. He is currently Chairman of John Mills Limited (JML), a consumer goods company specialising in selling products requiring audio-visual promotion at the point of sale, based in the UK but with sales throughout the world. He was Member of Camden Council, specialising in Housing and Finance, almost continuously from 1971 to 2006, with a break during the late 1980s when he was Deputy Chairman of the London Docklands Development Corporation. He was a Parliamentary candidate twice in 1974 and for the European Parliament in 1979.

John has been Secretary of the Labour Euro-Safeguards Campaign since 1975 and the Labour Economic Policy Group since 1985. He has also been a committee member of the Economic Research Council since 1997 and is now its Vice-Chairman. During the period running up to the June 2016 referendum he was Chair of The People's Pledge, Co-Chairman of Business for Britain, Chair of Labour for a Referendum, Chair and then Vice Chair of Vote Leave and Chair of Labour Leave, which became independent of Vote Leave two months before the referendum.

John is the author of numerous pamphlets and articles and he is a frequent commentator on radio and television. He is Chair of the Pound Campaign which regularly produces Bulletins advocating that economic policy should be far more focused on the exchange rate than it has been for many decades, arguing that an over-valued pound has been largely responsible for UK deindustrialisation and our grossly unbalanced economy. He is the author or joint-author of eleven books, these being: *Growth and Welfare: A New Policy for Britain* (Martin Robertson and Barnes and Noble, 1972); *Monetarism or Prosperity* (with Bryan Gould and Shaun Stewart; Macmillan 1982); *Tackling Britain's False Economy* (Macmillan 1997); *Europe's Economic Dilemma* (Macmillan 1998); *America's Soluble Problems* (Macmillan 1999); *Managing the World Economy* (Palgrave Macmillan 2000); *A Critical History of Economics* (Palgrave Macmillan 2002 and Beijing Commercial Press 2006); *Exchange Rate Alignments* (Palgrave Macmillan, 2012), *Call to Action* (with Bryan Gould; Ebury Publishing 2015), *The Real Sterling Crisis* (with Roger Bootle, Civitas 2016) and *Britain's Achilles Heel – Our Uncompetitive Pound* (Civitas 2017).

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How to get the UK economy to grow sustainably at 3% to 4% a year, and why it is so important to get this done not just for economic but also for social and political reasons

Introduction

The UK has a chronic productivity problem. Output per person is virtually the same as it was ten years ago. This is why the economy is growing so slowly and why most people's incomes, net of inflation, have stagnated or declined. Furthermore, without significant policy changes, there is little prospect of this situation improving as far ahead as we can see.

This pamphlet argues that we are in this predicament not because it is unavoidable but because of policy mistakes which badly need to be corrected and which – if they were – could lead to the UK economy expanding sustainably at 3% or 4% per annum, with real incomes for almost everyone rising steadily. From every point of view – economically, socially and politically – if it is possible to do this, it is vital that it is done.

Recent Growth and Future Prospects

There has been some growth since 2007, the year before the crash. The Office for National Statistics (ONS) reports that in 2017 UK GDP in real terms was 11.4% larger than it had been ten years previously[1]. The meagre average growth rate thus achieved, averaging 1.1% per annum, has not, however, been sufficient to lift real wages for most people for four main reasons.

Population Growth Between 2006 and 2016 (the latest figure for which exact population figures are available) the population of the UK rose from 60.8m to 65.8m[2], an increase of 8.2%, thus diluting down GDP per head by a corresponding amount.

Net Income from Abroad During the same decade, the UK had a cumulative balance of payments deficit of £770bn[3], financed by a combination of borrowing and sale of assets with a rate of return averaging around 2% per annum[4]. This removed some £15bn from the total sum available to provide incomes to UK residents.

Share of Wages in GDP Because during this decade the rate of return on capital was considerably higher than the increase in real wages, the proportion of GDP arising from wages and salaries, as opposed to unearned income from rents, interest and dividends, has drifted downwards from 50.5% to 49.5%[5], reducing the wages pot by approximately a further £20bn. The combined effect of these two factors has been to dilute down average earned incomes by roughly a further 2%.

Income Distribution Finally, a variety of different factors have meant that such increases in real incomes as have taken place have tended to go to those already on relatively high wages or salaries. There has been an overall reduction in income inequality over the last decade, and the position post-tax and benefits differs from the pre-tax distribution, but most of this has been the result of reductions in incomes at the very top which have not been redistributed significantly to those lower down the income scales.

Looking ahead, most forecasts are for the UK economy to expand over the next few years no more rapidly than about 1.5% – or, at most, 2.0% – per annum[6]. If these predictions turn out to be correct, the factors outlined above strongly suggest that we are likely to see real incomes for most people stagnating or falling for as far ahead as we can see. This is an extremely depressing prospect not only from an economic perspective but also from a social and political standpoint.

Imbalances

Why is the UK economy performing so relatively poorly, achieving a growth rate in GDP per head which is a small fraction of the world average – 1.2%[7] in the UK over the past decade compared with 22%[8] for the world as a whole? It is because the UK economy is almost uniquely unbalanced among the world's developed economies, thus stunting growth. In particular:

Investment The proportion of UK GDP devoted to investment is lower than almost anywhere else in the world. In 2016, including intellectual property, it was 17.0%, compared to a world average of 26% and almost 50% in China[9]. Excluding intellectual property, and thus taking into account only physical investment, the UK figure was 12.8%[10]. Less than a quarter of this sum – just under 2.8% of GDP – however, was expended on the relatively narrow range of investment opportunities which really generate significant increases in output per hour[11]. These are clustered round mechanisation, technology and power – and very little else. Nearly all public sector investment – in infrastructure, schools, hospitals, roads, rail and housing – however desirable it may be in social terms, does little to contribute at least directly to economic growth. Nor does a large proportion of private sector investment – in office blocks, IT, opening new hotels, restaurants and shopping centres, or in infrastructure to support activities such as banking, insurance, accountancy and legal work. Ever since the dawn of the Industrial Revolution, it has been very largely machinery, new production techniques and better use of energy which have raised living standards – and not much else – which has pulled up Gross Value Added in all the rest of the economy in ways which had not been possible before. The problem in the UK is that we currently spend less than 3% of our GDP – a quarter less than a decade ago[12] – on these headings and, by the time the cost of depreciation is subtracted from this gross figure[13], nothing is left. This is by far the main reason why productivity in the UK has stalled.

Deindustrialisation As late as 1970, almost 30% of the UK's GDP came from manufacturing. Now the figure is less than 10% – 9.7% at the last count[14]. This matters hugely for three reasons. First, productivity is much easier to increase in manufacturing than in services, because the keys to increased output per hour – mechanisation, technology and power – most readily find a home in light industry. The smaller the proportion of GDP coming from manufacturing, therefore, the slower the overall growth rate is likely to be. Second, manufacturing produces a much better geographical and socio-economic distribution of employment opportunities, paying higher than average wages. Despite the adverse treatment meted out to manufacturing in the UK, earnings there are still about 17% higher than in the economy as a whole[15]. Third, the UK, like all economies, depends proportionately far more on exports of goods than services and we produce not nearly enough manufactures to enable us to avoid heavy trade deficits every year. Although we do relatively well on services, with a surplus in 2016 of £92.4bn, this was exceeded by a wide margin by our £134.1bn deficit on goods[16], of which £99bn came from manufactures alone[17], giving us an overall trade deficit of £40.7bn[18].

Balance of Payments A trade deficit of around £40bn a year on its own might be tolerable in relation to the overall size of UK GDP – now close to £2trn a year[19]. Unfortunately, however, our annual overall balance of payments deficit is much larger than £40bn as a result of two other major factors. One is that we have a large and growing foreign income deficit, which is very largely the consequence of the cumulative deficits which we have incurred over a long period. Even as recently as 2011 we had an income surplus of £6.6bn. In 2016 the deficit was £50.5bn and still on a rising trend[20]. The other reason for our chronic foreign payments deficit is the rise in transfer payments we make every year, covering net payments to the EU budgets, net remittances abroad by migrants and our foreign aid payments. These have gone up from £13.2bn in 2008 to £22.5bn in 2016[21]. The overall result that year is that we had a total balance of payment deficit of £113.6bn, which is nearly 6% of our GDP[22]. In the short term, we may be able to continue to finance this gap with more borrowing and asset sales but in the longer term we are not going to be able to continue enjoying a standard of living which is about 6% more than we are actually earning.

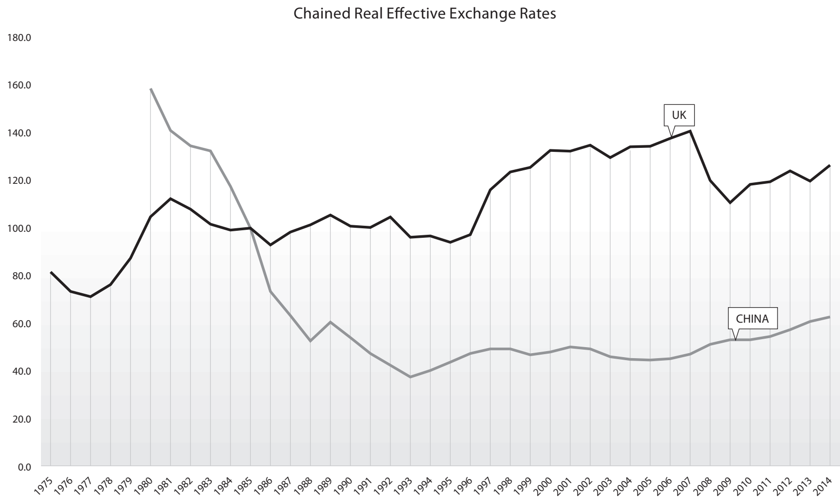
Debt The result of having balance of payment every year is not only that the country as a whole has got more and more into debt, but so has the government and the household sectors of the economy. Balance of payments deficits suck demand out of the economy, which has to be replaced by unfunded expenditure if the economy is not to plunge into recession. All borrowing within the major four sectors of the economy – government, corporations, consumers and the foreign payments balance – has to equal all lending and all surpluses have to equal all deficits. Thus, if there is a large balance of payments deficit, it is almost inevitable that this will have to be matched by government borrowing, which is not caused by unwarranted overspending but by the compelling need to provide enough demand to stop the economy spiralling down. Borrowing on the scale which is now materialising, however, is unsustainable and the cumulative amount of credit created over the period since 2000 is frighteningly large. The total monetary base in the UK is now 14.8[23] times what it was in 2000 while the UK economy has grown in money terms since then by no more than 31.6%[24].

Inequality The pressure to create more debt to add to demand led directly to very low interest rates to stimulate borrowing, and to Quantitative Easing to provide banks with more incentive to lend. The result has been an enormous boom in the value of assets and a huge increase in wealth and life-chance inequality as these conditions have benefitted those already well off far more than those not so lucky. The average value of housing in the UK as a whole rose between March 2009 and November 2017 by 46%, and in London by 96%[25]. Since the lowest point during the 2008 crash until January 2018, the FTSE 100 has risen by 119%[26]. As the economy stabilised, total wealth held by the top UK decile rose between 2010 and 2014 from 25 times what was held by the bottom decile to 34 times[27].

The Underlying Problem

Is there an underlying reason for all these imbalances? This pamphlet argues that there is, and that the chain of causation to expose what it is runs as follows:

During the 1950s and 1960s, the UK economy achieved a rate of economic growth, averaging 3.2%[28], albeit one considerably smaller than the average 5.3% being achieved at the time on the continent[29]. The Keynesian policies, which were largely responsible for this relatively good performance, however, had no effective response to the huge increase in inflation which materialised during the 1970s. The result was a decisive move away from policies following broadly the lines of which Keynes might have approved to those advocated by Milton Friedman and his followers. Keynesianism was abandoned and monetarism, which morphed into neo-liberalism, focused primarily on fighting inflation, took their place.



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

The policies used to bring down the rate at which prices were increasing – which peaked year on year at 25% in 1975[30] – were focused on reducing the money supply, primarily by raising interest rates and restricting borrowing. Bank base rate, which had averaged around 5% during the 1950s and 1960s fluctuated round twice this level in the 1970s before peaking at 17% in 1980 and staying well above 10% for most of the 1980s[31]. By this time, the fixed exchange rate which was a central component of the Keynes inspired Bretton Woods system had been abandoned. As a result, attention to the balance of payments, which had previously been almost obsessive, largely evaporated.

The result of the much higher interest rates now in place was a huge increase in the UK's exchange rate. As the graph above shows it rose between 1977 and 1982 by just over 60%[32]. In the new policy environment, it was assumed that market forces would take care of any imbalances thus created, so that the foreign payment implications of the big interest policy changes change would take care of themselves, as a different equilibrium was re-established. In some respects, this is what happened, and in some key respects the UK economy performed considerably better during the 1980s than many critics had expected, not least the 364 economists who wrote to The Times in 1981[33] fulsomely condemning the monetarism now being implemented. The huge increase in the exchange rate, however, was to have a massive long-term highly destabilising effect, reinforced by other policies pursued for the next 40 year, which pushed it up even further.

For the exchange rate increase between 1977 – when the UK economy was already showing signs of being none too competitive – and 1982 was not only largely maintained for the following decades, it was heavily reinforced, especially from the late 1990s onwards. Interest rates, although lower than they had been, were still higher in the UK than the international average[34], but this was not the main reason why the pound soared to a $2.00 valuation by the 2000s. This happened because of another major policy change This was to open up the sales of UK assets to all comers in a way not replicated anywhere else in the world. The abolition of the Monopolies and Mergers Commission in 1999 and its replacement by the Competition Commission, removed any public interest test on take-overs[35]. It did not matter who owned or controlled UK businesses as long as there was a competitive market. This approach was reinforced by the 2002 Enterprise Act, the overall result being a huge net sale to foreign interests of UK portfolio assets – shares in existing companies, bonds and property, excluding direct new investment in factories and machinery – which the ONS estimated to amount to £615bn between 2000 and 2010 as we sold our energy companies, our rail franchises, our football clubs, many other businesses, our ports, our airports and huge swathes of property[36]. The inevitable result of this very large inflow of capital was a further massive increase in the exchange rate.

In the meantime, many countries in the Far East, particularly after the 1997 Asian financial crisis, were moving in exactly the opposite direction. With China as the pre-eminent example, they were reducing their exchange rates, ensuring that their economies became more competitive and shoring up their financial reserves. The result was that a huge gap in the cost of running manufacturing operations opened up between the West and the East. And why was this so crucial in causing the West, including the UK, to deindustrialise, while light industry leapt ahead in the East? The reason is that trade in manufactured goods, whether domestic or international, is much more price sensitive than in services. This is partly because prices for manufactured goods are generally much easier than services to compare, not least because manufactured goods tend to be produced in large uniform quantities, and partly because falling production costs as volumes increase magnify any initial cost advantage. This means that the total cost of producing goods which are internationally traded is critically important if they are to be competitive.

Now the reason why the exchange rate is so important in this regard is that, for the average manufacturing operation, only about one third of costs – mainly for raw materials, machinery and components – are for inputs which are charged at world prices[37]. All the remaining costs – for direct labour, management salaries and for all other overhead costs, including interest and taxes plus a provision for profit – are incurred in the domestic currency, sterling of course in the UK's case.

It is then easy to see what impact an exchange rate increase of the size experienced by the UK between 1977 and 1982 would have on competitiveness. If UK export costs in US dollars were 100 in 1977, as a first approximation, with a 60% rise in the exchange rate, they would have been 33 + 67 x 1.6, which comes to 140, in 1982. With even more drastic disparities opening up in the 2000s as the pound further strengthened at the same time as countries such as China devalued, it is not hard to see why from the 1980s onwards the UK rapidly deindustrialised.

More specifically, the outcome for the UK from its loss of manufacturing competitiveness was that large swathes of manufacturing industry were rendered hopelessly uncompetitive internationally and the country rapidly lost about two-thirds of its manufacturing capacity. As late as 1980, nearly 30% of UK GDP came from manufacturing. Nowadays the ratio is less than 10% – 9.7% at the most recent estimate[38].

If manufacturing matters as much as it does – because productivity is much easier to achieve in manufacturing than services, because manufacturing provides a better quality and spread of jobs than services and because we need goods to sell broad to pay for our imports – why have we allowed this to happen? There are many reasons why politicians, the civil service, academia and public opinion seem to have a blind spot on this crucial subject, the most important ones being:

Dominant service providers and importers Public opinion in the UK is dominated by people and their acquaintances who have done well over the last few years in service industries and by importing, rather than by manufacturing. We have a string of natural advantages in services – our language, our geographical location, our legal system, our universities and our skilled services labour force – for which we have no comparable plusses in manufacturing. Clearly high exchange rates help importers and, for a variety of reasons, services generally are much less price sensitive than manufactures. The result is that views on the exchange rate are heavily influenced by people who can live happily with an exchange rate of perhaps $1.50 to the pound – a level which is lethal for manufacturing.

Low status of manufacturing In successful manufacturing countries, such as Germany, Switzerland, Japan, China, South Korea and Singapore, there are strong manufacturing confederations which are in a position to exercise a well-articulated and powerful amount of pressure on public opinion and the financial authorities to maintain the exchange at the competitive rate needed for manufacturing to prosper. No such body exists in the UK. Even the Engineering Employers' Federation is not interested in the capacity of a lower exchange rate to improve its member's prospects[39].

Low esteem The result is that in the UK manufacturing – with exceptions for the very best companies – suffers from low esteem bordering sometimes on contempt, all of which makes its need for an environment in which it can compete hard to get across to opinion formers who have little sympathy and interest in making and selling anything. Generally, the most able people do not go into industry in the UK, which is why its management has a relatively low reputation

Perception The situation is certainly not helped by the terminology used to discuss how the pound is doing. It sounds better if it is strong rather than weak, better if its value is going up rather than going down. For many people, their main interest in the exchange rate is that they get a good rate for exchanging pounds for foreign currencies when they go on holiday, combined with worries that their incomes will not go so far if the price of imported goods go up in the shops. There is little or no perception as to what the long-term damage to any economy of an over-valued exchange rate is.

Fear of inflation These concerns shade into a general fear that devaluation will always cause both more inflation and lower living standards – a view which is strongly supported by monetarist thinking. Those devoted to this view should, however examine the ample evidence showing that these fears are very largely misplaced. What the evidence shows is that devaluations sometimes produce a little more inflation than there would have been anyway, sometimes rather less, but generally very little change. Furthermore, all the evidence shows that economies tend to grow more quickly with lower exchange rates and it cannot be true that GDP per head goes down if the overall size of the economy increases. It is true that rebalancing the economy to achieve sustainable growth will mean shifting resources out of consumption into more investment and that sooner or later space from consumption will have to be found to reduce the balance of payments deficit, but these are requirements for any strategy to get the UK to perform better.

Nothing can be done There is a widespread but wholly misplaced view that nothing can be done about the exchange rate, and that for a variety of reasons covered in pages 16 to 25 of this publication, it is impossible to get it changed and that, even if we could, it would not make any material difference. This is not a view shared by public opinion in any of the world's successful advanced economies and there is no reason why it should prevail in the UK.

What needs to be done

The key conclusion to be drawn from this analysis is that, to get the UK economy back on track with sufficient growth – 3% to 4% per annum on a sustained basis – to raise living standards, we need to have an exchange rate which is low enough to make it profitable to invest on a substantial scale in the key areas of mechanisation, technology and power. To rebalance our economy, we need to get manufacturing back to being around 15% of GDP, instead of less than 10%. We do not need the 20% or so ratios typical of countries such as Germany, Switzerland, Singapore and South Korea – let alone China at about 30% – because we have a service export surplus of about 5% of GDP to plug the gap. At present, the total value of our manufactured exports is about £250bn a year[40]. If we could increase our manufacturing base from 10% to 15% of GDP, and our exports increased pro rata, as a first approximation our manufactured exports would increase by 50% – by about £125bn. Allowing for an import content of one third, this would, produce an improvement in our trade balance of two thirds of £125bn, which is approximately £80bn, reducing our annual balance of payments deficit to a manageable £20bn or so year.

Now, it is possible to see how to unwind at the same time the other major imbalances in the UK economy. With a much improved foreign payments position, the government deficit, matching borrowing and lending, would fall very substantially, once more to sustainable proportions. Crucially, the combination of a considerably larger proportion of GDP coming from manufacturing, where productivity improvements are so much easier to secure than in services, a steep increase in investment, especially in machines, technology and power, plus a much more accommodating financial situation for the government, would enable the economy to expand on a sustainable basis at 3% to 4% per annum. Some of this increase in resources thus created would be needed to provide the capacity for increasing investment and – at least eventually – to reduce the balance of payments deficit. All the available evidence, however, shows that the returns on investment in these circumstances would be sufficiently large for a determined and clear-sighted government to secure rises in real wages throughout the period when the transition to higher economic growth was taking place.

This is an infinitely better scenario to the one provided by the consensus on what is in prospect for the UK economy based on current policies being maintained. If a sufficiently large percentage of politicians, the civil service, the commentariat, academia and public opinion could be persuaded that a much more competitive exchange rate would achieve all these objectives, the crucial question then is whether a move in this direction would be feasible. 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.

Objections

There are six main arguments which are regularly advanced to support concerns about moving to a much more competitive exchange rate. They are first that devaluation always produces extra inflation which negates any gains in competitiveness; second that devaluation is impossible to combine with an open economy; third that, if we did devalue, we would be met by retaliation which would undermine its benefits; fourth that reducing sterling's parity would make us all poorer; fifth that we have tried devaluations in the past and they do 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 stands 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. On the contrary, 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%[41], but inflation fell from 5.9% in 1991 to 1.6% in 1993[42]. 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[43], and what increase there was in 2011 was very largely driven by an increase in commodity prices, which fell away as soon as they dropped back again[44].

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 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 it is a central tenet of monetarist thinking that it would do so. Perhaps this explains why so many people believe it to be the case even though it is not correct. On the contrary, the evidence very firmly indicates that economies which have strongly competitive international pricing tend to perform better and better, with only moderate overall rates of inflation, 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. The Japanese, to provide a recent example, brought the parity of the yen down against the dollar by a third between the beginning of 2013 and the start of 2015[45] as a result of deliberate policy. Further back, the Plaza Accord, negotiated in 1985, produced a massive change in parities among the major trading nations of the world at the time, causing the dollar, for example, to fall against the yen by just over 50% between 1985 and 1987[46].

It is of course true is 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 markets think that the Bank of England is going to raise interest rates, this will also push sterling higher. If the Bank evidently wants to help to keep the parity of the pound up as much as it can, by buying sterling and selling dollars for example, this will have a correspondingly strengthening impact on sterling. Instead, we need a widespread understanding among a combination of public opinion, the government and the Bank of the need for a competitive rate and a willingness to bring it down and to hold it there. This needs to be done primarily by a combination of using the tax system to discourage capital imports and Bank operations to sell sterling and buy foreign currencies and government announcements making it clear what its exchange rate strategy is and its determination to make sure that it is maintained – exactly as happens in countries such as Switzerland, Singapore, South Korea and China.

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 borrowing and selling assets has kept the markets confident that the rate at which sterling is trading on the foreign exchanges is sustainable. It is far from clear that this confidence will continue indefinitely for two main reasons. One is that the UK may soon have sold so many assets that it may become increasingly difficult to find enough to sell in future, especially if more safeguards relating to the sale of UK assets are put in place, thus making it more difficult to keep the exchange rate as high as it is at the moment. The second is that every £100bn annual deficit, financed by selling assets with an average gross return of the order of 2%, adds another £2bn to the underlying deficit every year. The laws of economic gravity can be ignored for a long time but as Herbert Stein had it – incidentally with balance of payments deficits as a prime example – "Trends that can't continue, won't."[47] 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 has already shown this happening, although the pound's recovery back to around $1.40 by early 2018[48] will unfortunately ensure that any industrial revival precipitated by the referendum will be short-lived.

Retaliation If the UK were to devalue by a sufficient amount – probably about 30% from its current $1.40 level producing approximate parity between the pound and the dollar – 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 from the increased competitiveness which the devaluation had secured? The answer to this question needs to come in several parts.

In the first place, it depends on the position from which the devaluing country starts. The curse of foreign payment imbalances begins not with countries like the UK, with massive deficits, but with countries such as Germany, Switzerland and the Netherlands with huge surpluses – in 2016 almost 9% of GDP in Germany's and the Netherlands' cases, and over 10% for Switzerland[49]. 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 world reserve currency like the dollar, making it much easier for us to alter our exchange rate without there being major international consequences. The fact that our share of world trade is now so low – at 2.6% in 2016[50] – 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%[51] – and the fall in the rate for sterling against the dollar between 2007 and 2009 – about 25%[52] – as well as the post-EU referendum drop in sterling's parity, 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 and 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, 30%, in world currency terms, we would make ourselves 30% worse off and we would therefore genuinely be poorer by this amount. The fallacy with this argument is that, while it might be well founded if we did all our shopping in international currencies, such as dollars, this is not what UK residents do except perhaps when they go on holiday. UK citizens pay for almost everything they buy in sterling and it is therefore GDP measured in sterling, not in dollars, which counts. This is the way in which international accounting is done and this explains why IMF figures do not generally show falls in GDP when countries devalue. On the contrary, they almost invariably show the growth rate rising and GDP increasing. Since living standards closely approximate to GDP per head, especially over time, if the economy is increasing in size and the population does not change from what it would have been anyway, GDP per head and thus living standards must, as a matter of logic, go up rather than down.

The second potentially more substantial argument is that, if we are going to increase our net trade balance to a point where we are not enjoying a standard of living far beyond what we are earning – as we are at the moment – living standards will have to suffer. Relatively speaking, this has to be correct. If we produce more for export, there will be less for the home market. Furthermore, if, to get the economy to grow faster, we have to spend a considerably higher proportion of our GDP than we do at the moment on investment, there will again have to be a corresponding reduction in consumption as a percentage of GDP. The crucial question then is whether the economy can be made to grow fast enough to enable both the shift towards exports and investment to be accommodated without living standards falling – and indeed preferably rising. Careful calculations show that this would be possible – provided that a high enough proportion of increased investment goes to the most productive parts of the economy, mostly manufacturing. It can be done[53].

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 stretching back to the beginning of the nineteenth century when industrialisation in the UK really got under way, have always hobbled British industry. Although we initially showed the way, other countries have overtaken us as their industrial bases have got stronger and their more competitive currencies have allowed them to secure better net trade advantages.

As these other countries have invested more heavily in the future than we have, their output per head has grown more rapidly than ours, their wage climates have 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%[54]. It was against this kind of background that from time to time the over-valuation of sterling became so obvious that either the markets or the authorities or both tolerated, engineered or encouraged the parity for sterling to fall. The most conspicuous example of this happening was the fall in sterling by about 30% in 1931 – after near stagnation during the 1920s, which enabled the UK economy to have its fastest spurt of growth ever during the middle of the 1930s – 4.4% per annum cumulatively for the four years between 1933 and 1937[55]. More recently, when sterling left the Exchange Rate Mechanism in September 1992, the fall in sterling's parity, by a trade-weighted 12%[56], precipitated a period of reasonable growth which lasted for all of the following 16 years[57].

Going back to the period post 1945, 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[58]. Higher than average inflation in the UK than elsewhere and underinvestment in export industries resulted in steady trade deterioration in the 1950s and 1960s, culminating in the pound being devalued in 1967 from $2.80 to $2.40[59]. Once currencies started to fluctuate against each other in the 1970s, following the break-up of the Bretton Woods fixed parity system in 1971[60], monetarist policies, especially very high interest rates, kept sterling much too strong, especially 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 12% against all currencies[61], to escape from a sharp economic downturn.

After showing some signs of recovery, the UK economy then became more and more unbalanced as asset sales, starting in the late 1990s on a scale unparalleled anywhere else, pushed sterling up to very damagingly high levels in the 2000s. Its value fell between 2007 and 2009 – still by not nearly enough – since when it has climbed back, fallen immediately after the 2016 EU referendum, but with nearly all this increased competitiveness now having been lost as sterling has strengthened again. Meanwhile, in the East, over past decades, exactly the opposite policies have been followed as most of the economies there massively devalued, particularly after the 1997 Asian crisis, and then ensured that their export competitiveness was not eroded away as a result of their currencies appreciating[62].

The reality is that the UK's exchange rate has been much too strong to allow our industrial base to flourish, compared with conditions in other countries for nearly 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 they have almost always 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, because the exchange rate and the cost base for it is much too high, there is no evidence whatever that, if more favourable conditions prevailed, UK entrepreneurs would not be just as good as those anywhere else in the world at taking advantage of the new opportunities which would then open up.

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

For those who need more systematic and intellectually robust reasons for believing that the UK would respond positively to a lower exchange rate, the place to look is in the numerous studies which have been carried out into the responsiveness of UK exports and imports to changes in the exchange rate. Two large-scale meta studies, one by academics covering the late decades of the twentieth century and another by the IMF[63] relating to the early 2000s, show elasticities easily in the right territory, especially after allowing a relatively short period of time – two to three years at most – for the effects to work their way through, given devaluations of a sufficient size.

It is true, nevertheless, that some recent studies[64] have shown that the responsiveness of the UK economy to a lower exchange rate is relatively low. If the exchange rate is much too high, however, and it has been over-valued for a long time, this is bound to be the case. We know that – for different reasons – services and high-tech manufacturing are not very price sensitive. Light manufacturing output is much more price sensitive, but the UK has too little of it at present to have a major impact on overall elasticities. As we have seen after the EU referendum, however, a lower exchange rate does help exports, but mainly by increasing foreign sales from existing production capacity. The crucial point to grasp is that really big increases in price sensitivity only materialise when it becomes worthwhile for companies not just to increase existing production in the UK for export, using already available capacity, but to change to siting production facilities here rather than elsewhere in the world. Price elasticities depend much more on decisions on where manufacturing is to be located than they do on volume response from existing production facilities. The really large responsiveness to exchange rate changes – on the elasticities of both imports and exports – comes at the tipping point when a lower exchange rate makes it worth investing on a large scale in manufacturing plants in the UK rather than elsewhere. Achieving this environment is the key objective towards which economic policy needs to be directed.

Conclusion

2016 was the year when the UK voted for Brexit and when Donald Trump was elected president of the USA. Both were events which the political elites either side of the Atlantic neither expected nor wanted to see happening. They both occurred because of heavily discontented electorates. Across the whole of the western world there is an increasing divide between those who are doing well and who are confident and contented and those who feel left behind, undervalued and alienated, with these discontents manifesting themselves in increasingly strident populist nationalism. Deindustrialisation in much of the West – not just in the UK – and the massive deterioration in job prospects which goes with it, is the core reason for so much discontent.

There is a clear reason why this is happening. It is because of unmanageable competition, especially in manufacturing as a result of the UK – and much of the rest of the West – pursuing trade liberalisation with the wrong exchange rate. The big divide in western societies nowadays is between those who have done well out of globalisation and those who have not benefited from the changes which increasingly liberalised trade and financial flows have brought in train – or at least by nothing like as much as those who have. This divide is now showing serious signs of destabilising the reasonably secure political environment which the West has enjoyed for many years. Indeed, at worst, it may pose a potentially existential threat to liberal democracy itself, if nothing is done to stop our politics sliding further and further towards irrationalism, protectionism and xenophobia as a result of electorates losing more and more faith in the capacity of those governing them to do so reasonably competently and fairly. All societies are unequal and history shows that free electorates are willing to tolerate this state of affairs, recognising its inevitability, but only provided that it is not to excess. Current developments, however, suggest that we are pushing against the limits of what an increasingly large percentage of voters are prepared to accept as part of what they think is a reasonable social compact. At the risk of over-gilding the lily, perhaps it is worth reiterating once more what the major imbalances and deficiencies in our economy are and what we need to do to put them right.

We have allowed the proportion of our GDP which we invest to drop to a point where productivity growth has almost completely stalled and where, as a result, median wages, allowing for inflation, are no higher than they were before the 2008 crash. We have deindustrialised to such an extent that literally millions of people have lost their good blue-collar jobs, leaving them in far too many cases with low productivity, unfulfilling, low paid and insecure service sector employment. Because we have lost most of our light industry, we have foregone the increases in output per hour which this sector of our economy is uniquely good at generating. We have also allowed disparities in income, wealth and life chances generally in different parts of our country to proliferate to a completely unacceptable extent. In addition – crucially – we have lost our capacity to pay our way in the world, leaving us with a vast balance of payments gap every year, which we have only been able to fill by selling off national assets on a scale unmatched anywhere else in the world and by getting deeper and deeper in debt to foreign countries.

Because we are not earning the standard of living which, as a nation, we enjoy, we have had to sell assets and to borrow vast sums of money to fill the gap both as a nation, as consumers and through our government. To try to stimulate the economy, interest rates are lower than they have ever been but the result has been to make it much easier for the rich than the poor to benefit from the asset inflation which ultra-low interest rates have generated, exacerbating the tendency for inequality to become both greater and increasingly obvious to everyone. Our society has become more and more divided on both an inter-generational, socio-economic and a regional basis. Those who have done well out of liberalisation and globalisation enjoy wonderfully secure, well paid and interesting lifestyles, while those who have lost out struggle with tight budgets, static or declining life chances and dwindling hope.

The fundamental reason why we suffer from all these problems is that we have allowed our country to become so deeply uncompetitive with those along the Pacific Rim, and with others, such as Germany and Holland, which have wage rates just as high as ours but who enjoy much higher productivity as a result of greater capital equipment per worker and much better trained workforces than we have. The reason why we have allowed ourselves to drift into this condition is that for many decades our exchange rate has been far too high for manufacturing to thrive. It is true that we have a vibrant and very successful service sector with a large export surplus, but this does not make up for the much larger deficit we have on goods, about 80%[65] of which are manufactures.

Because most services are not very price sensitive, the exchange rate does not make a huge difference to those who sell services abroad, buttressed by the fact that we have strong competitive advantages in our language, geography, legal system, our universities, etc. which make our services attractive to foreign buyers. For manufacturing, however, where we lack comparable natural advantages, and especially for light manufacturing which is very price sensitive, the exchange rate – essentially what we charge the rest of the world for our labour costs – is absolutely crucial. If we charge too much – as manifestly, for a long time, we have done in relation to the level of productivity we have actually achieved – all the usual adverse consequences described in this pamphlet are bound to follow. Our share of world trade has gone down because we have not had enough to sell to the rest of world at prices foreign buyers are prepared to pay; investment has faltered because most manufacturing has been unprofitable and large amounts of it have been closed down; because of poor prospects competent people have been put off a career making and selling, so our industrial management in too many cases has got worse and worse; balance of payments problems have become increasingly acute; and deflation, low growth, static incomes and increasing inequality have all followed.

If we are going to break out of this vicious downward spiral, we need to recognise what the fundamental cause of it is and to take action to counteract it. We need to get our economy rebalanced. We do not need to have as large an industrial base as countries such as Germany and Singapore because we have such a strongly exporting service sector, but we do need a bigger manufacturing base than 10% of GDP. Something like 15% of GDP looks like being a reasonable target, if we are going to be able to pay our way in the world at least to a point where we are not accumulating debt on an exponential basis in relation to our capacity to service and eventually to repay it.

To retrieve the degree of industrial strength we need, we will have to have a much larger percentage of our GDP than at present spent on physical investment – perhaps 20% or more rather than the current barely 13%. This will only happen if light industry is profitable. No industrial strategy is going to work without this condition being fulfilled and nor are free-market remedies such as deregulation and increased competition likely to be any more successful. Public sector investment – in roads, schools, hospitals, rail and housing – requires resources but not profitability to make it happen. In the private sector, without positive returns on investment being clearly achievable, there is no prospect of expenditure on the required scale materialising.

If we ran policies to get sufficient industry back to get our economy rebalanced, it would obviously make sense for most of the new manufacturing to be located in our erstwhile industrial areas rather than in London and the South East, and this will go a long way towards evening up prospects between different regions of the country. It will also produce a fund of new well paid jobs where they are most needed. The already well-favoured areas of the country – London in particular – obviously need to continue to be encouraged to flourish, but other parts of the country, which have not done so well, need to be given maximum opportunity to catch up.

The key to getting all this done is for the authorities – and politicians, the commentariat, the academic world and public opinion – to realise just how crucial competitiveness is in regulating our relationships with everywhere else in the world. We need an exchange rate policy just as badly as we need to make sure that we have fiscal and monetary policies which make sense. We cannot afford any longer the neo-liberal insouciance as to the value of the pound on the foreign exchanges – leaving it to market forces on their own to fix the going rate, with no official guidance or involvement. Very few other countries in the world with the capacity for controlling their own destinies do so, and nor should we. This does not mean that we would need to operate on a beggar-thy-neighbour basis, running a surplus which has to be someone else's deficit. Instead the most sensible policy would be to run a manageably small deficit while making sure that we maintain a fair and sustainable share of world trade and the manufacturing capacity to underpin it, so that we are not falling behind everyone else all the time.

The UK electorate does not look likely to tolerate in future the static wages and lost opportunities from which far too many of its members have suffered. Those who have done well need to pay more attention to the lot of those who have not been so lucky. Using an activist but benign exchange rate policy as the lever for doing so has a much better chance of success than any other policy option on the horizon.

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Ever since the crash in 2008, the UK economy has not grown fast enough to produce real wages increases for most of the population. As productivity continues to stagnate, this state of affairs looks set to stay with us, with potentially dire social and political consequences, as well as creating a huge missed economic opportunity.

This pamphlet explains why growth in the UK has been so slow and sets out the entirely achievable changes in economic policy we need to put in place to get our growth rate back up to 3% to 4% per annum.

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